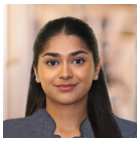
# UBS Asset Management: Exploring value creation across real estate markets and strategies

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**Exploring new avenues for value creation**

In this article, we look at ways investors might generate higher returns from real estate and at the current opportunities for doing so. We also review the factors we think investors must consider when managing the risk of these investments. We look at the potential opportunities, along with the types of investment vehicles and structures that might be used to access them. These are also important considerations and key factors that influence performance for investors.

Real estate investors are increasingly seeking strategies that might deliver higher returns in an evolving investment landscape where debt is less accretive than it has been in the past. In particular, fixed income returns have increased following the post-GFC decade, during which government bond yields languished at and below zero. In the standard financial economics risk-return framework, higher returns can only be achieved by taking on additional risk. For real estate, this could mean buying buildings that are not fully leased or that have vacancies, improving assets via refurbishment projects, or taking on leverage to enhance returns.

Investors can also generate higher returns by participating in development activity. Construction is normally undertaken by specialist developers, with whom investors can either undertake a joint venture (JV) or commit to purchasing the completed asset. Under the JV approach, investors provide equity and participate in development profits (and risks). Alternatively, investors can commit to buying the asset once construction is completed, often on a fixed or capped-price basis, and either fully leased or accept some form of lease-up risk in return for a lower price and higher potential returns. As with the traditional asset classes, investors in real estate can also look to generate alpha by investing opportunistically. Alpha investments are those with expected returns in excess of those warranted by their expected risk. Generating alpha is the ultimate goal for investors across asset classes and relies on skill, expertise, specialist knowledge, and insight.

**Generating alpha from asymmetric information**

How can investors generate that elusive alpha in real estate? Asymmetric information and good market intelligence can potentially lead to excess returns for well-informed investors with strong insight. Real estate markets can be opaque and subject to differing opinions on valuations and prospects. In general, creating alpha stems from opportunistic investing, strong networks, deal-sourcing capabilities, and taking advantage of idiosyncratic opportunities that arise. One possibility is benefiting from market dislocation and distress.

Market dislocation and distress can arise from falling asset prices or shifts in debt availability, prompting owners to sell assets due to loan covenant breaches or lenders to foreclose and then sell assets quickly to meet capital requirements. This often leads to sales below market value, as sellers seek rapid liquidity. The upcoming maturity of real estate loans in 2026 and beyond may result in refinancing shortfalls and defaults, creating both risks and opportunities for investors.

**Unlocking value in overlooked assets**

The disruption of COVID-19, as well as the high inflation and interest rate hikes that followed, has led to many assets being capital-starved and undermanaged for several years. As a consequence, opportunities may still arise to purchase these assets at prices below their fundamental values and replacement costs, with the potential to drive strong net operating income and capital growth and to generate excess returns and alpha. Buyers who have suitable risk allowance and dry powder can look to exploit these opportunities.

Another potential opportunity for investors to generate alpha is to correctly identify significant trends in the market in advance and to execute transactions before market pricing moves (both buying and selling). Arguably, this is the hardest way to generate alpha, since it can often rely on investors taking contrarian views against the market overall and holding their nerve. For example, investors who correctly identified the shift to online retail early, which was further boosted during the pandemic, could have generated outsized returns by rotating their portfolios away from traditional brick-and-mortar retail and towards logistics assets, which proved to be a core component of the online retail ecosystem.

Another example is investors who exited the office sector prior to the structural disruption it underwent following the pandemic amid the widespread shift to hybrid working. Class B quality offices are now experiencing high vacancy rates and little if any investor interest, and have seen significant repricing. On a very selective basis, however, refurbishing and repositioning Class B offices in strong locations or repurposing Class C offices for residential use can create an opportunity for skilled managers. Best-in-class office buildings in sought-after locations, with attractive amenities, proximity to public transport, and sustainability features, have been exhibiting robust rental growth and are seeing investor demand.

Specialist investments and niche sectors can also potentially generate excess returns: here, investors can focus on niche property types or specific strategies, and target growth drivers like demographics or technology. These strategies require deep sector expertise. Data centers are an example of a specialist investment opportunity that has now become mainstream. The widespread adoption of AI, and companies' incorporation of AI into their businesses, are resulting in greater requirements for computing, cloud-based data and data center capacity. We expect this trend to continue. As such, data centers and towers present potentially high-returning development opportunities, as well as longer-term opportunities to acquire stabilized assets.

**Accessing opportunities beyond traditional funds**

As well as the investments themselves, the way investors access opportunities is of critical importance. In private real estate, co-investments are ownership interests in real estate equity or debt, held as a limited partner (LP) in a single investment or portfolio managed by a general partner (GP). Co-investments are typically made alongside a fund of a GP, and are mostly only made available to a smaller group of investors who are either invested in the fund or have a separate relationship and/or agreement with the GP. Co-investments typically involve comprehensive due diligence at the asset level, including underwriting and business plans. Importantly, they can offer lower fees compared with traditional fund investments.

Co-investments, while complex, can offer sophisticated, well-resourced investors the ability to handpick high-conviction opportunities, build a carefully curated portfolio of individual investments, and exert control over asset selection. Often, co-investments better align with the interests of investors than traditional fund structures and can be customized to meet specific requirements. Additional advantages include GP diversification, strategic relationship-building, enhanced transparency in investment deployment, and access to extensive deal pipelines (including off-market deals) and new markets via multiple GP platforms. A portfolio of co-investments can help provide sectoral, geographical, and GP-level diversification, thereby minimizing single-GP selection risk and potentially leading to alpha generation.

Effective co-investment relies on the careful selection and thorough due diligence of general partners, especially when considering smaller, specialist partners. While smaller GPs may lack the extensive resources of larger global and regional GPs, they often provide agility, specialist skills, and a hands-on approach that can enhance risk-adjusted returns and may more closely align their interests with investors.

The current market landscape lends itself to smaller managers, though successful allocation depends on identifying those with the discipline and resources to deliver consistent results. Smaller local partners require sophisticated due diligence to assess their investment strengths, underwriting standards and asset management execution capabilities. They may also be able to adapt more quickly to changing conditions and shift strategy based on evolving events. This can give smaller, sophisticated managers a level of flexibility not typically seen among the larger managers. In contrast, larger managers can offer more developed track records, consistent returns, and broader expertise and experience – though they may lack flexibility compared with their smaller peers.

**Understanding dispersion in real estate returns**

For a portfolio with global exposure and multiple investments across different GPs, the skill of the portfolio manager in selecting the countries and strategies for investment is crucial in positioning the portfolio appropriately. Real estate markets typically exhibit variations in performance across countries and sectors, and portfolios should be positioned to take advantage of these trends, tilting towards those markets and sectors with the best expected risk-adjusted returns.

Looking at income-producing, stabilized properties, the range of total returns at the country and sector levels can be significant. Moreover, within some markets, the range of performance achieved within a single sector can vary tremendously, emphasizing the importance of asset selection. As such, a concentrated allocation – such as one made via co-investments – to the right assets and operating partners could potentially deliver significant outperformance and alpha for investors.

Recapitalizing funds and other investment vehicles that reach the end of their life can present an opportunity to potentially generate higher returns. This may provide a good opportunity for targeted investments and co-investments. Success will depend on understanding which funds will be maturing when and which offer the most attractive opportunities; ensuring that appropriate vehicle structures are put in place and used for recapitalizations; and that the right investment managers are selected as partners. Participating in large portfolio deals where the final equity is offered to investors at a discount to secure the capital needed can also be an opportunity to generate alpha.

Market timing, or 'vintage', plays an important role in the returns that investors can expect to receive from real estate. From mid-2022, rising interest rates began to impact the real estate sector and pushed real estate capital values down by around 16%, globally according to MSCI data. Following the commencement of the rate-cutting cycle in 2024, we believe values appear to have reached an inflection point, and we think that the market is now in the early stages of a recovery phase. Hence, an appealing window of entry appears to exist for investors, with potential strategic opportunities to take advantage of attractive entry pricing.

**Seize the opportunities now available**

We think that the current real estate investment landscape presents a good opportunity for investors seeking higher returns and alpha from real estate. As capital values recover from the impact of rising interest rates and global uncertainties, we think that investors who adopt a high-conviction, flexible approach may be better positioned to pursue potentially outsized returns. We think that market dislocation continues to generate mispricing and attractive entry points for those with the risk appetite and agility to act swiftly, while specialist and niche investments may offer avenues for alpha generation beyond traditional value-add opportunities.

Co-investments can also potentially further improve the ability of sophisticated investors to access unique deal flows and benefit from lower fees and GP diversification. Investment manager selection is critical, and smaller local managers can sometimes deliver superior risk-adjusted returns. As the market transitions into a recovery phase, we think that the interaction between bottom-up asset selection and top-down thematic positioning will be essential for success. A focus on fundamental value and investing at below-replacement cost may provide a basis for investment conviction and the potential for positive returns.

Ultimately, investors who think laterally, develop strategic insight, and partner with skilled investment managers and operators may be the best equipped to navigate the current cycle and achieve higher returns over the long term.

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