Real estate, the value-add way

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Investors are living through a period of heightened market volatility. No one quite knows where asset prices are going – be that for listed or private assets. In such an environment, it's particularly important to be able to generate returns that are independent of broader market moves through active asset management. Real estate offers that possibility.

Its historically low correlation with other asset classes is a real benefit. Our analysis shows that in the past direct real estate returns have had only a fairly weak link with government bonds and credit, and a weaker one still with global equities (see Fig. 1).

In our experience, the correlation of returns is even lower for what are known as "value-add" real estate investments – assets which require management and/or structural improvements. Here, investors are not just relying on rental income and passively rising property prices to generate returns but are actively creating them by improving the purchased buildings.

Such improvements can include renovations or refurbishment, change of use (to reflect shifts in occupier dynamics, such as the rise of online shopping or a fashion for health), as well as restructuring lease agreements. Value-add portfolios can also include some construction projects.

Sustainable demand

One particularly effective way to add value, we believe, is through making buildings more climate resilient. Today, with environmental regulations tightening and society becoming increasingly climate-aware, this is more important than ever.

The surge in energy prices, fuelled by the war in Ukraine, has meant that improving energy efficiency and reducing its use to a minimum have now become priorities for the real estate industry.

All this tallies with the broader drive towards sustainability, reduced emissions and combatting climate change. The financial benefits of, meanwhile, are felt both by the building owners and their tenants – potentially improving the operational margins for the former and increasing desirability for the latter.

There is a growing body of evidence that climate resilient buildings command premium rents. Over the past five years, rents for European offices with green certification, for example, have on average been 21 per cent higher than for non-certified ones, according to research from CBRE.[1] For investors, that presents an opportunity to enhance yields.

Creating climate resilient buildings is good for the planet, but it also makes real business sense.

For us, sustainability is a primary consideration in any refurbishments or repositioning. That could mean installing heat pumps – which can both heat and cool. It could also be about using sustainable building materials (such as laminated timber), installing photovoltaic panels to generate renewable energy or committing to send zero waste to landfills.

With just 1 per cent of buildings worldwide rated carbon neutral,[2] there is a lot of work to be done. Particularly given that real estate accounts for 36 per cent of global energy consumption and 37 per cent of energy-related carbon dioxide emissions.[3]

European advantage

Within value-add real estate, we believe opportunities in Europe are particularly compelling.

Firstly, Europe is at a different stage in the interest rate cycle. The European Central Bank has been much less aggressive than the US Federal Reserve in hiking rates, and concerns about the level of indebtedness in certain euro zone member states – notably Italy – are likely to prevent it from tightening too rapidly. That, in turn, limits the increases in financing costs.

Secondly, supply and demand dynamics are very supportive. Supply in Europe has been limited by stringent urban planning legislation as well as by banks' reluctance to lend money for development projects since the global financial crisis. Demand, meanwhile, has been strong – the consultancy Deloitte estimates that demand for residential reached record highs over the past year.[4] With the economy slowing, we would expect construction activity to moderate further, in aggregate, resulting in an even greater gap between supply and demand in most sectors and most regions across Europe.

The occupier mix also favours Europe over other regions. In the US, a significant proportion of the economy – and thus of office occupiers – is represented by tech and tech-related industries. In the current climate, such companies are finding it harder to attract new financing. Many of these firms have begun making redundancies, which could reduce demand for office space. In Europe, occupiers come primarily from more traditional industries – such as financial services or public tenants – which tend to be less volatile.

In it for the long term

It helps that real estate is a long-term investment, particularly where active management is involved. Asset transformation takes time, and our investment horizon is three to seven years. So, when we are looking to exit, we will be in a very different world to the one we are in today.

Indeed, for experienced, long-term investors the current climate can provide very attractive entry opportunities, as other players pause some of their activity. We are seeing price discounts of around 5 to 15 per cent in some areas. And, while cap rates – the return investors are willing to accept from property investments – will rise alongside central bank interest rates, we should also see higher rental growth, not least due to rents often being indexed to inflation measures. The art, for investors, will be to find sweet spots where rental growth potential can exceed cap rate increases.

For all these reasons, we therefore believe that, despite the economic slowdown and rising interest rates, European value-add real estate can offer some attractive opportunities to generate returns, and to protect a diversified portfolio from volatility in other markets.

Figure1: Diversification benefits

5-year correlation of real estate to traditional asset classes

	REAL ESTATE	GLOBAL EQUITIES	EM EQUITIES	GOVERNMENT BONDS	CORPORATE BONDS	REITS
REAL ESTATE	1.00					
GLOBAL EQUITIES	-0.18	1.00				
EM EQUITIES	-0.35	0.89	1.00			
GOVERNMENT BONDS	-0.49	0.35	0.42	1.00		
CORPORATE BONDS	-0.47	0.80	0.79	0.78	1.00	
REITS	0.06	0.86	0.65	0.18	0.62	1.00

Source: Pictet Asset Management. USD Return covering period 30.06.2017-30.06.2022. Real estate performance based on NCREIF Property Index, global and EM equities on MSCI indices, government bonds on FTSE WGBI, corporate bonds on Barclays GLB Agg Corp and REITS on FTSE NAREIT ALL Equity REITS.

For more information, scan the QR code or visit am.pictet

FOOTNOTES:

1 CBRE, "Is sustainability certification in Real Estate worth it?", 2021
2 World Green Building Council, 2022
3 UN Environment Programme, "Global status report for buildings and construction", 2021
4 Deloitte, "Property index: overview of European residential markets", August 2022

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