# No time but the present for value-add investing

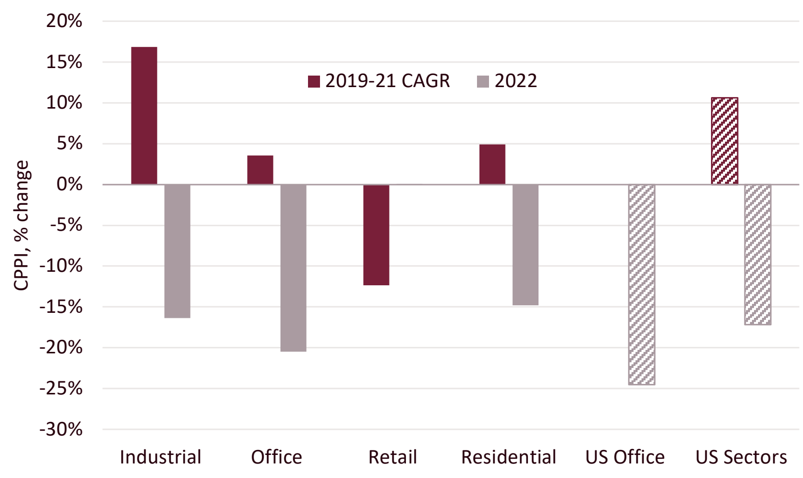
These are, it has to be said, dramatic times. No sooner than most of the world was starting to emerge from the long shadow of the Covid-19 pandemic, it was confronted with another crisis. As a result of Russia's illegal invasion of Ukraine, energy costs started spiralling last year, causing havoc in economies worldwide. Inflation was already going to be an issue, but the war - by far the largest in Europe since World War II - made the situation far worse.

In response, central banks, notably the Federal Reserve in the US, the European Central Bank and the Bank of England, started increasing the interest rates far more quickly than would otherwise have been the case. This led to a repricing of the fixed income and public equity markets and a great deal of immediate pain for those with tracker mortgages and continues to do so as fixed-rate mortgage periods come to an end. In such circumstances, it would be easy to be pessimistic for the wider real estate market.

However, this environment will also create interesting opportunities, as rising interest rates have triggered an ongoing market correction in the European real estate market. The number of buyers and sellers actively involved in dealmaking was at a decade low in Q4. Values have started adjusting, but with bearish signals from the listed market and more interest rate hikes expected, further adverse valuation movements are likely to occur in H1 2023.

However, it should also create more higher octane opportunities than were previously available in Europe, although the dynamic will naturally play out differently in different geographies. Specifically, it is already apparent that there will be an over-correction in some markets, which creates a window of opportunity for investors - especially value-add investors. Moreover, faced with the challenge of refinancing in a much higher rate environment, highly leveraged owners may have to choose between selling or injecting more equity. This will exacerbate the market correction in certain segments.

**Significant ongoing repricing: more price discovery expected in 2023**




Green Street, PATRIZIA

Three areas in particular - grade A, CBD offices, industrial and alternatives - stand out, particularly in major urban areas with strong demand fundamentals and a relative lack of quality supply. When it comes to the office sector, most European stock is somewhat dated at this point in time, especially compared to the North American market. Concurrently, what most corporates want from their offices has been changing for some time, a trend only accelerated by the Covid-19 pandemic.

## Less space, but better

Majority of big companies may want less space these days due to most white-collar professionals no longer work full time in the office. Still, they want higher quality space in the best locations in order to lure workers back to the office, in order to foster collaboration and creativity. The ESG (environmental, social and governance) and wellbeing credentials of buildings is a significant factor here. In part to motivate staff, but increasingly important for all stakeholders: investors, occupiers and planners.

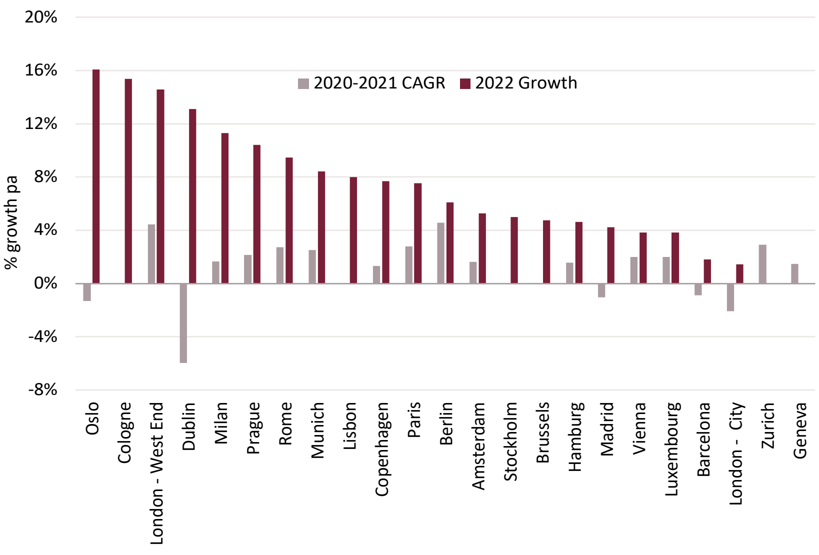
Increasingly, regulatory concerns will also be an issue and thus the need to upgrade European properties is becoming critical. Data from Savills indicate that more than 80 per cent of office stock in London is below EPC B, the level anticipated to be required by 2030, for instance.

Inevitably, it is increasingly evident that greener properties increasingly command higher values. MSCI data suggests that office buildings with sustainability ratings are achieving substantial (and growing) sales premiums in cities such as London and Paris. Yet this trend is increasingly widespread across Europe. A similar dynamic is playing out in other sectors, not least when it comes to industrial and residential rental performance.

As a result, there is an opportunity to acquire undermanaged office assets that are underpriced and invest in bringing them up to modern standards, especially from an environmental perspective. There are some important caveats here, however. Retrofitting existing structures to a high environmental standard is an expensive business, especially when everything from materials to labour is getting more expensive. Inflation might be forecast to fall this year, but the price hikes seen during 2022 are now baked into the equation for the foreseeable future.

It is, therefore, incumbent on investors to leverage top-down research and data analytics together with the experience of the teams on the ground to ensure that a value-add approach is viable. In short, decision-makers must be confident - and have a good reason to be convinced - that acquisition and retrofit costs will be more than compensated for the anticipated increase in rents and capital value. On the positive side,

**Prime rental growth improved in 2022 – driven by "flight to quality"**




Source: CBRE, PATRIZIA

we expect the flight to quality to continue. Tenants will increasingly move from the obsolete stock into grade A sustainable assets and market fundamentals are supportive. Core CBD locations have vacancy rates of 5% across Europe, supporting the rental growth for grade A space. Quality of amenities, location and ESG credentials will be increasingly important.

With persistently low vacancy rates for major logistics hubs, the outlook for occupancy and rents remains strongest amongst mainstream sectors. The more cautious approach from developers amidst several headwinds (financing costs and construction costs) should further restrict supply and support the medium-term rental outlook. From a pricing standpoint, the sector is in a period of price discovery. Still, the prospects for rental outlook and capturing the embedded reversion will continue to drive investment performance for the sector. Scarce availability of land in growing cities and increased demand bolstered by e-commerce and alternative uses (self-storage, data centres, film studios etc.) should continue to support the long-term rental outperformance of urban industrial.

## Playing catch-up

In the US, industrial rental growth has been consistently high during the past 5 to 10 years and exceptionally high in the past two years. Europe is now seeing similar growth. The reason for that is simple enough. E-commerce may have grown enormously in Europe - indeed around the world - as a result of the pandemic on top of natural market evolution. However, the e-commerce penetration rate still lags behind the US in many countries, and there is an expectation that the gap will narrow.

Increased demand cannot be explained by e-commerce alone, however. As a result of supply chain disruption - primarily caused by the pandemic, but also Brexit and the war in Ukraine, amongst other factors, required inventory levels in European industrial assets have increased and are likely to remain high. Companies are looking to diversify suppliers and source parts and materials closer to home, further increasing demand. Crucially, availability remains very limited, particularly in supply-constrained urban areas. All of this adds to upwards pressure on rents, which will ultimately support capital values, even if the market is currently experiencing a price correction owing to interest rate rises.

Finally, alternatives, including healthcare, life sciences, self-storage and data centres, also offer a source of opportunities for savvy investors, not least due to the fact that there is a relative pricing advantage in Europe, where they are less established compared to the US. Here, the life sciences sector is particularly interesting from an investor's perspective. The sector is already well-established in the US, where it has seen relative outperformance over the previous cycle, and it is already evident that momentum is building in Europe. Yes, there has been a recent hiatus in venture capital funding, but leasing activity should remain on a sustained upward trend given the structural trends underpinning demand. Quite simply, the region is playing catch-up.

## From opportunity to delivery

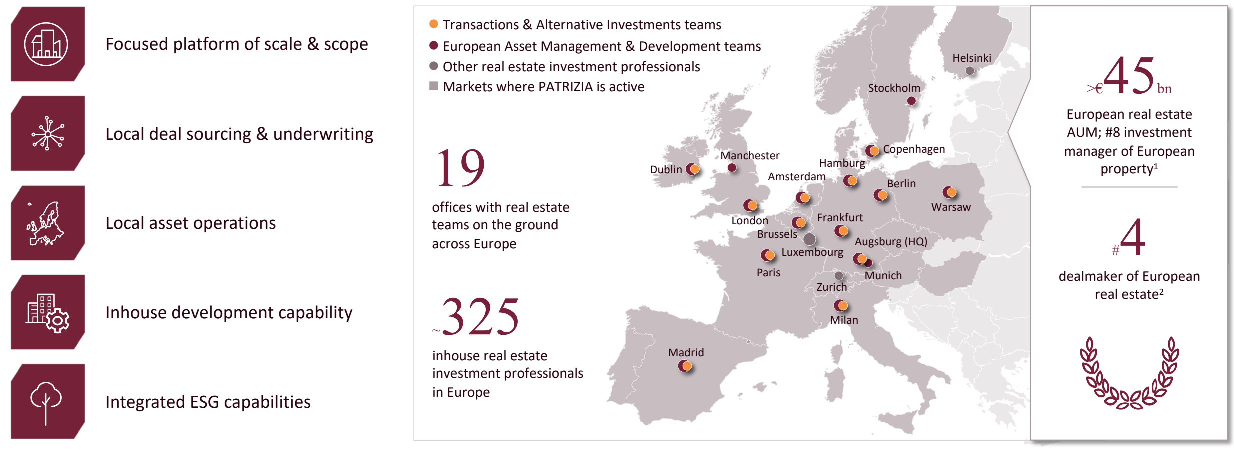
All in all, we are at the beginning of a new real estate cycle. Amidst expectations of structurally higher interest rates and significant ongoing repricing, European real estate is starting to offer good relative value. Having the ability to translate observable opportunities into successful investments is a different thing entirely. For years, many investors and fund managers have been content to acquire commercial assets and watch as both rents and capital values grow. However, that is no longer the world we live in. With the leveraged beta window now closed, the ability to reposition assets and grow income through active asset management will be critical for generating enhanced returns. We have now entered an asset management cycle.

When it comes to a value-add strategy, PATRIZIA benefits enormously from having what we believe to be an unrivalled pan-European real estate platform and a team that has proven itself over multiple cycles. We have in-house operating and development teams across 19 offices in the continent. Our team is made up of seasoned professionals with a combined total of over 48 years of experience in the industry. We are proud to have team members like Paul Hampton, Head of International Funds at PATRIZIA, and Charles-Nicolas Tarrière, Managing Director, Fund Management, who bring a wealth of knowledge and expertise to the table. With 24 years and 15 years, respectively, at PATRIZIA, they are a testament to the longevity and commitment of our team. Additionally, our team is diverse and represents multiple nationalities, ensuring a broad range of perspectives and approaches to our results.

As a result of their consistent hard work and meticulous approach, PATRIZIA can be proud of a strong track record. Since 2007, our value-add funds have delivered an average of 20% IRR (initial rate of return) each year from investments in 14 European countries, something that has only been possible due to an active approach to asset management and sound, conviction-led market calls.

So, while the world is undoubtedly facing a great deal of uncertainty, we firmly believe that the situation also presents opportunities for those able to recognise and execute them. At PATRIZIA, we can point to a history of solid performance and have the in-house capabilities for both identifying attractive investment opportunities and creating value post-acquisition in this new cycle. The time for value-add investment really is now.

**Unrivalled presence & capabilities in European real estate**
Inhouse operating & development teams across 19 offices in Europe




Information as at 30 September 2022. Sources: PATRIZIA, 1 IREI Global Investment Manager Survey (July 2022). 2 Property EU Top100 Dealmaker Ranking; PATRIZIA analysis based on 5 year aggregate results or 2017-2022 rankings.

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