The smart value-add investor – 2024 edition

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When the market turned decidedly negative in early 2022, the strong value-add investment opportunity in the wake of the global financial crisis (GFC) came back to mind for many and inspired a number of real estate players to pursue the strategy. Significant capital has since been raised, but very little of it has been invested to date.

The value-add playbook of the post-financial crisis era was to acquire properties below fundamental values from financially overstretched owners and leverage them with cheap debt. The recovering economy took care of vacancies while rental growth resumed. Exiting to cash-rich core investors, at historically low yields delivered very attractive returns. Arguably, the results were a reward for bold market entry rather than any particularly strong effort by the new owners in the holding period.

The root cause of the current market reset is different, hence the treatment will have to be different. The last two down markets (dot.com bust and GFC) were characterised by financial and occupier market stress, relieved by central banks lowering interest rates. This time round, conditions are the polar opposite, with substantially higher interest rates and occupier markets remaining resilient.

Value-add investors will need a different set of tools for this new environment:

1. Financing: Debt is not the answer, but exploiting other investors' entanglement in debt they can no longer afford. Five- and 10-year swap rates have hovered just above 3% for euros and just over 4% for sterling since autumn 2022, with the forward curve signalling little change to come for long-dated financing costs. Borrowers may wait in vain for central banks to bail them out in due course. Banks are under pressure to avoid the extend-and-pretend approach, which risks clogging up the financial system for years. Existing lenders, including debt funds, seeking to avoid disruption, will welcome new capital coming in and taking problems off their books. Taking advantage of that needs patience, strong relationships with lenders and creative solutions.

2. Out-of-favour sectors: With occupier markets remaining resilient across sectors, stressed assets to pick off will be concentrated in the office and retail sectors – but even there it will be limited to specific asset types. For both sectors, large lot sizes will be a key predictor of restricted liquidity and as a result high transaction yields. That means primarily shopping centres in the retail space and secondary offices with significant environmental, social and governance (ESG) capital expenditure challenges in offices.

3. Alternatives: In all other sectors – logistics, residential and the key alternative markets (student housing, hotels, data centres and self-storage) are more likely to deliver continued rental growth even in a recession, rendering a stress-inducing rental market fallout very unlikely. That does not mean they are out of scope for value-add return expectations. High growth means cap rates have to rise less to offer attractive returns. Turbulence will take different forms, for example in shape of struggling sub-scale operators or poorly planned and timed development projects.

4. Development issues: Development is primed to play a key part in the market clean up to come. At current financing rates and development costs, and with sticky land prices, many developers have been caught on the wrong foot and are unable to deliver their planned projects profitably. That will open opportunities for fresh capital to come to the rescue.

5. PE toolkit: Pressure on the financial and legal structure of real estate investments and opportunities to aggregate assets, as well as consolidate operations hint to a blurring line between real estate value-add and private equity strategies. Bolstering returns through restructuring rather than plain real estate acquisitions may create a niche of private equity-type deals with a real estate flavour.

6. ESG: Net zero carbon is the standout risk as well as the top opportunity of this decade. Asset owners holding buildings that are complex and expensive to turn to a greener path will fall prey to market leaders. Investors with the technical capability and the foresight to target the right measures at the right time in the most promising property type and jurisdiction will have the opportunity to reap outperformance.

7. Obsolete assets: Market resets expose underlying weaknesses propped up by buoyant cycles. These market segments and individual assets should have been flushed out, but market optimism and cheap capital kept them afloat. A whole generation of offices in Frankfurt, Stockholm and Amsterdam were swept away by the dot.com bust. Swathes of secondary stock in Southern and Eastern Europe never recovered from the eurozone crisis and a host of weak retail and leisure assets were ended by covid-19. Dead-end assets ready for redevelopment and under new ownership will be plentiful in areas such as: low-building quality logistics, outdated office, low foot traffic retail, residential in compromised locations, outdated leisure assets and unattractive senior-living estates. Would-be investors must think carefully whether these assets are cheap and full of potential or beyond rescue at any price.

The financial market's reliance on cheap debt has been exposed and will create winners, losers and plenty of opportunity for conviction investors, as long as they are not shying away from complex workouts.

The question remains as to why this process has not started yet? By summer 2023, distressed sales remain near historical lows. Market yields look like they are getting closer to plateauing, while rental growth slowed somewhat in many sectors, but has not reversed; even offices report continued rental increases.

There is reason to believe this is a false dawn. The key is held by the lending sector: Real estate has not got an issue with fundamentals, but finance. Regulation brought following the GFC made it much less attractive for lenders to try sitting out breaches. Low-cost loans from the years prior to 2021 will only slowly reappear for refinancing, where borrowers will be exposed to the hard reality of higher financing costs and lower leverage. It will also start to dawn on distressed borrowers that hanging on a little longer will not save them as the forward curve points to falling short-term interest rates, but also indicates that longer-dated debt will not become any more affordable in the foreseeable future.

The approaching refinancing reckoning is unlikely to cause an all-encompassing real estate market slump, as occupier markets and the economy are structurally too resilient for that, but for many market participants the deck is about to be reshuffled. Value-add investors will have the opportunity to play a key part in building new market foundations.

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