Identifying opportunity and creating value in a turbulent European real estate market


Frederick Neske
Partner

Boris Olujic
Partner

The European real estate market continues to recalibrate in the face of elevated interest rates, declining valuations, and economic uncertainty. Apollo is navigating this with a thematic focus, grounded in data-driven analysis and a flexible approach to tactical deployment. Here, we discuss how we're currently engaging with the opportunities and challenges posed by the current market environment.

How is Apollo approaching the market today?

Apollo believes in the versatility of investments across market cycles. Real estate has benefitted from a supportive rate environment and positive macro tailwinds that were, historically, highly unusual. Now, with normalised debt costs and increased volatility, the relative value of European CRE as a fixed income replacement has changed. We continue to seek to identify and execute strategies with potential for attractive risk adjusted returns.

As an active manager, we seek substantially stabilised assets with embedded value creation levers. Owing to the nature of our Core+ capital – we have a longer duration bias with tactical flexibility supported by regular (re)appraisal of our investment thesis against the changing macro environment. We approach deployment with a detailed sectoral thesis that we believe is underpinned by deep macro- and market-level analyses.

We avoid "reversion to the mean" thinking, recognising enduring shifts in space utilisation. Leveraging our expertise can position us to capitalise on opportunities created by today's market dislocation.

What real estate sectors do we have conviction in and why?

High conviction sectors and the rationale behind them include:

1. Purpose Built Student Accommodation (PBSA):

a. The student housing sector benefits from attractive long-term secular tailwinds. As education globalises, demand for quality student accommodation rises. This provides countercyclical risk mitigation, especially in the current inflationary environment where, historically, PBSA has achieved above inflation rates[1] rental growth.

b. Despite the UK having 20%[2] of the world's top 100 universities with English-taught programs and its global leadership in higher education with 2.1 million[3] full-time students, two-thirds are unable to access purpose-built stock.

c. This supply-demand mismatch, at a time of growing pressures on the broader residential market, creates a compelling investment case that is supported by the breadth of domestic and international student demand.

d. Operational performance has historically shown low correlation to macroeconomic trends while university enrolments have risen during times of economic uncertainty.

e. Against these fundamentals, PBSA yields continue to represent a positive spread to single and multi-family residential properties, with greater stability and predictability of income making the sector an attractive risk adjusted investment proposition.[4]

2. Logistics:

a. The European logistics sector continues to benefit from long term positive secular tailwinds from e-commerce growth, supply chain evolution, and greater onshoring. These drive leasing demand in a structurally undersupplied market, particularly for purpose-built, modern facilities with ESG credentials and adequate power.

b. These trends are compounded in key logistics nodes, where long term fundamental demand drivers continue to be supportive of rental growth.

c. As the sector evolves, investors can no longer rely on a "rising tide" to generate returns, instead requiring a deeper understanding of fundamentals for which active management and tenant relationships rooted in partnership are essential.

d. We believe we benefit from a breadth of cross sector corporate relationships, deep industry know-how, and a solution driven approach to occupier requirements seeking to avoid a one size fits all approach.

3. Other Sectors:

a. *Residential:* The sector remains stable with attractive long-term fundamentals due to supply and demand dynamics and the need to deliver new, affordable stock.

b. *Life Sciences*: Advances in healthcare and scientific innovation create opportunities and innovation that can be drivers of the European economy for decades ahead.

How do we unlock value in these sectors?

Our operating model is rooted in purchase price discipline and hands-on management throughout the investment cycle, actively seeking multiple pathways to growth, in a scalable fashion. Through deep sectoral knowledge and occupier relationships we partner with our counterparties by providing creative solutions to specific challenges. Through this we gain valuable insight that allows us to refine and iterate our execution. By deploying significant affiliated capital alongside our investors, we believe strategically align with for success.

What do we see as the main challenges for 2024?

1. **Economic Uncertainty:** Geopolitical tensions (e.g, regional conflicts and upcoming national elections), inflationary pressures and interest rate fluctuations all impact demand. Despite signalled monetary policy normalisation by central banks, we expect interest rates to remain higher for longer, impacting borrowing costs, access to capital, and investment allocation strategies.
2. **Occupier Demand:** The impact of working from home will continue to weigh on office demand, while we expect much greater pressure on occupier balance sheet as higher costs of capital start to bite through 2024.
3. **Sustainability impact:** Achieving sustainability within the real estate sector requires a fundamental rethink of practices and investment philosophy, requiring time and working capital investment.
4. **Technological Disruption:** Disruptive technologies, such as AI, are reshaping the way we view spatial dynamics – and operating models must adapt to technological innovation and digital transformation.
5. **Investor Alignment:** Quantum and manner of capital allocation will require significantly greater manager alignment for which we are well positioned.

Where do we see the main opportunity?

Currently, we stand at a crossroads of macro dislocation, technological disruption, and profound shifts in asset fundamentals. This environment can present opportunities for solution-driven investors. We believe our expertise, multi-disciplinary approach, and hands-on execution empower us to optimise performance across all investment stages. Co-investing alongside our partners reinforces our confidence in the next 24 months as we embrace a new cycle.

FOOTNOTES:

1 Student Source 2022
2 2023 Q5 World Rankings
3 HESA as of Academic Year 2020/2021
4 ONS

APOLLO