Time for Core European Alternatives

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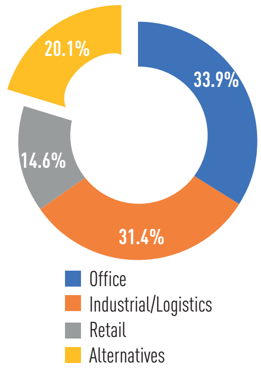
2024 is an attractive entry point for European alternative real estate sectors. The current market dislocation that has arisen from changing capital market conditions has led to significant repricing in the past year, providing an opportunity to acquire core, well-performing alternative assets at an attractive basis discount. Due to the growing maturity of alternative real estate assets, alternative portfolio composition that once relied on ground-up development of assets can now be formed by acquiring stabilised assets across selective markets. This provides a significant opportunity for investors in alternatives to drive outsized returns – particularly while there is lower competition from other investors.

Alternative sectors such as student accommodation and Build-to-Rent (BTR), have continued to outperform commercial sectors due to recurring non-cyclical demand that has driven strong real estate fundamentals. Alternatives have maintained high occupancy and strong rental growth compared to the commercial sectors, such as offices and retail. The weaker capital markets environment has also impacted new deliveries, further strengthening the supply/demand imbalance that has underpinned this performance. Consistent performance through black-swan events over the past few years has proven alternative sectors' ability to provide durable income for investors.

Despite the strong fundamentals and performance that underpin alternative sectors, core vehicles in Europe remain significantly underweight to the alternative sectors. The make-up of existing European core fund portfolios is still heavily weighted towards traditional commercial sectors. According to INREV's ODCE Index, which tracks 16 pan-European open end diversified core equity funds, alternative sectors represent just 20% of total allocations, versus 34% offices, 31% industrial and 15% retail.[1] Similar to generalist European core funds, global core vehicles with the ability to invest in European alternatives only offer investors minimal exposure to these sectors as part of a wider commercial-focused real estate strategy. Even when looking specifically at open-ended alternatives strategies, existing vehicles are either focused entirely on specific sub-sectors of alternatives on a pan-European basis or have focused on alternatives in a much narrower geography within Europe. This creates an opportunity for specialist alternative investment managers to create a diversified portfolio of high-quality, stabilised alternative real estate assets across major European markets. This is why Harrison Street believe that now is the time for core alternatives and why Harrison Street is developing a pure-play core alternative real estate strategy in Europe.

European Core Funds Are Underweight to Alternative Sectors



Source: INREV ODCE Index Q4 2023.
Alternatives defined as residential and 'other'.

Why European core alternatives?

Harrison Street believes that this strategy will result in an attractive combination of strong current income with inflation linked characteristics and long-term growth, access to alternative real estate sectors at an attractive basis and at scale, providing diversification within wider real estate portfolios with low correlation to current business cycles and commercial sectors.

1. Strong Income Growth

Sector selection is now more important than ever. We believe that real estate returns in the near-term will be driven by strong income growth. Alternative sectors, such as BTR and student accommodation, have seen rental growth of upwards of 6% in the past year and we believe that this is likely to be sustained into the medium-term due to the strong supply/demand imbalance that characterises many alternative sectors in Europe. Our view is that the income outperformance recorded by the alternative sectors in the past few years will be maintained as a result of strong demographic tailwinds and the consistent demand for these asset classes.

2. Access to alternative real estate sectors at scale and on an attractive basis

Gaining exposure to these nascent sectors has often been achieved primarily through ground up development. A marked increase in forward transactions has boosted liquidity in these sectors as alternatives' share of total European investment increased from 11.8% in 2009 to 26.3% in 2023.[2]

Due to this increased activity, select alternative sectors in Europe have now have a deeper investable universe. It's estimated that there are now 5 million institutional owned private multifamily homes and an additional 1 million private PBSA beds across Europe.[3] The market growth now provides an opportunity to acquire core alternative assets often at an attractive basis compared to 12-18 months ago. Yields in these sectors have moved out by between 50 basis points to 100 basis points since the start of 2022 despite strong asset level performance. The capital markets disruption has also led to a much smaller buyer pool for alternative assets as investments in core alternatives due to higher financing costs. We anticipate that sellers may be forced to sell well-performing assets as their need for liquidity exacerbates, principally as a result of near term refinancings or closed-end fund timing restrictions. This provides a significant opportunity to undertake an all-equity investment strategy in most of these sectors in the short-term, with the ability to refinance these assets later in the hold period.

3. Additive Diversification

Core alternative real estate strategies would also provide diversification benefits within wider real estate portfolios with low correlation to commercial sectors. Alternative real estate sectors tend to be driven by non-cyclical demand and demographic-led fundamentals, while many commercial real estate sectors are vulnerable to macro trends such as a slowing economy and secular changes. Commercial sectors, such as the office, industrial and retail sectors, have long comprised the majority of European core strategies but now face new challenges and significant disruption. Historic performance data in the US further highlights the strength of alternative sectors, as core alternative real estate assets have been operating there for over a decade. This data points to both low correlation and risk-adjusted outperformance to commercial sectors.[4]

European core strategies remain underweight to alternative real estate sectors, driven by limited scale for investment, inadequate performance data to support investment decisions and a lack of knowledge of these assets perform during difficult economic times. Over time, these issues have been overcome. We believe that current market timing supports a dedicated core alternative strategy in Europe. The fundamentals for alternative sectors in Europe have demonstrated resilience during multiple black swan events and have been strengthened further during recent periods of macroeconomic disruption. These macro events are continuing to deepen many of the supply/demand imbalances that underpin the strong performance of these demographically driven, needs-based sectors. These sectors have also demonstrated their ability to be effective inflation hedges due to shorter lease durations and as such provide defensive, low-risk investments that are the foundation of a core investment rationale. 2024 is a particularly attractive entry point as a result of the current market dislocation that has also led to significant repricing in the past year, providing an opportunity to acquire core, well-performing assets at discounted levels. In our opinion, a unique opportunity currently exists to acquire alternatives assets at an attractive basis in an environment with significantly less competition, and we believe that Harrison Street will be the first manager to pursue a pure-play core alternative real estate strategy in Europe to capitalise on this opportunity.

FOOTNOTES
1 INREV European ODCE Index. Data as of Q4 2023.
2 JLL. Alternatives defined as BTR, Student Housing, Life Sciences and Healthcare.
3 JLL
4 Harrison Street Research

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