

ALVARIUM

Real Estate: Painful Cross-Roads, Long-Term Opportunity

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Overview

Over the last 10 years, Alvarium has invested more than \$5bn of capital across a range of real estate debt and equity investments, achieving a realised IRR north of 25%. Shareholders, partners, and employees provided 18% of that capital. We have always used our powerful 'themes and teams' execution approach: finding and backing the right proprietary opportunities, using our keen understanding of shifting real estate trends, and partnering with the best execution talent. We look for mispriced quality and have a strong track record navigating through past periods of stress in real estate, including in the wake of the 2008-2009 financial crisis to find recovery opportunities. We then commit capital side by side with our family clients.

As the Covid-19 pandemic has moved across different countries, our global footprint with local presence and expertise gives us a distinctive lens. Real estate as an asset class consists of many sub-sectors and it is the nuanced understanding of these segments which is so important to understanding how and when to commit future capital. There is no doubt that parts of the industry are in stress; this creates opportunity. From our experience, buying well can represent a significant part of real estate's long-term return.

In this paper, we aim to share with you some of our current thinking in three ways, by:

- Providing what we are seeing across real estate sectors, globally;
- Shedding light on how policy makers are addressing the problem; and
- Finally, highlighting some areas of opportunity that may emerge.

Setting the Scene

Pockets of real estate are experiencing significant stress. The problem, as we know, is the combination of a cessation in economic activity due to the exogenous shock of the virus, combined with financial leverage and then exacerbated by mark to market pricing practices in some parts of the market. Economic stress combined with rising unemployment is forcing an increasing percentage of individual, retail, and commercial tenants to forego all or part of rental payments. Then there is leverage. Most owners of real estate have borrowed money to finance a property. Thus, with requests for abatement in rental payments, at least temporarily, some of the most highly leveraged property owners may need to seek technical default waivers as interest rate cover covenants are triggered. Banks are seeing a rising number of requests for 'payment runway relief', requests to suspend interest payments for 60-90 days. Marked to market rules such as FASB 157 in the US and rising margin calls have only served to exacerbate the problem.

However, real estate is a crucial sector for most economies, with estimates of US real estate, commercial and residential at somewhere north of 35% of US GDP; globally, this percentage is not dissimilar. Policy makers understand the magnitude and potential ripple effects of the crisis across the economy and employment, with measures already announced and some actively being considered. More help may be needed, but the message is beginning to sink in.

Before the crisis, an increasing number of real estate sectors were showing signs of late-stage cyclicality. Prices had risen in individual segments to loftier valuations compressing yields. Rental growth had begun to slow in certain markets and there were signs of oversupply in some areas. In some respects, the crisis has reset the clock on valuations. Properties in areas with strong fundamentals may now be more attractively priced after tighter credit conditions have forced banks to retreat from the market. As other market participants deleverage, we expect there to be opportunities for quality assets at senior positions with low loan to value ratios (LTVs).

Moreover, we believe the demand for real estate as an asset class will rise in importance. Near-term, we will likely continue to live in a zero-interest rate world; quality real estate with sound fundamentals will only increase in demand as sovereign wealth funds, pension plans and high net worth families and investors seek stable yield and an income alternative to bonds. Long-term, ongoing deficit financing needs could well spark a pick-up in inflation. Real estate remains one of the few asset classes with tangible value in an inflationary environment that can help protect long term capital and wealth in real terms.

I. Real Estate Sectors

As we look across real estate sectors, we see the crisis impacting different sectors in different ways.

Residential real estate: The largest part of the global real estate market, is probably the least painfully affected as people still need to live in their homes and liquidations take time. Governments are most likely to protect their constituents first (after all people having homes equates to votes for incumbents). Landlords will likely emphasise retention over eviction, given the humanitarian and exogenous nature of the crisis. Indeed, some countries have established moratoria on evictions and foreclosures, in addition to the de facto pause caused by the closure of most courts.

Prior experience has shown that operational downturns in the residential market lag office and retail by some time. However, some areas of distress have already emerged. Taking the US by way of example, the National Multifamily Housing Council, believes that nearly a third of US apartment renters did not pay all or part of their April rent, compared with 82% who did a year ago in April of 2019. Unpaid rent sets-off a negative chain reaction impacting property owners and investors in pools of mortgage backed debt. The month of May could be worse, given the rapid increase in jobless claims in recent weeks.

Those residential property owners with too much debt may be forced into some form of negotiated forbearance, even for properties with strong underlying fundamentals. Highly leveraged government entities may seek further outright liquidity injections; Fannie Mae and Freddie Mac may need a second government bailout before the \$10trillion US mortgage market can stabilise further.

Commercial Real Estate (CRE): We are seeing three scenarios playing out in the CRE market. First is a select group of properties that are experiencing increased demand as a result of the crisis. Second is the properties with strong cash rich tenants that will likely be less affected, assuming some form of normalcy is restored in the next few quarters. Third is properties that are distressed, characterised by weak tenant profiles, too much leverage, or exposure to hard-hit markets.

Similar to residential markets, approximately 30-40% of the CRE market may not be paying their rent as of April. As a result, there are now two distinct categories of distressed CRE. The first consists of loans on properties that are themselves distressed (hotels and retail being the most common). In other cases, such as mortgage REITs, the underlying assets may still be solid, but the holder has levered these assets and is now unable to meet margin calls. Capital markets in securities used to finance commercial real estate, particularly at the lowest credit tier, have seen a significant widening in spreads. This makes it hard for new loans to be originated and maturing loans to be refinanced. The problem is exacerbated by so-called repurchase financing agreements with mark to market and margin clauses, through which many of the largest global banks have purchased portfolios of commercial loans from REITs or debt funds.

The least and more affected CRE sectors are examined below:

Least Affected, Opportunities:

Industrial: the crisis has further heightened the need for supply chain efficiency and resilience. As social distancing becomes the new norm and perhaps a lasting behavioural habit, we expect online procurement, shopping, industrial shipments and everything that needs to be delivered via a pipe to gain massive and irreversible market share. Digital real estate infrastructure with trophy technology clients and long-term leases will increase in demand. The sector does not have an inherent degree of physical proximity among its tenants and is thus benefitting from e-commerce increases during the crisis.

Office: distress is not as widespread or immediate, but it will certainly follow if the health crisis leads to a prolonged recession. Parts of the office market may not be as affected at all. For example, a government department occupying an office property on a 10-year lease is as close an investor will see to nil risk of default. Strategic national industries will also be largely unaffected. Many single or multi-tenanted properties with cash rich businesses have the means to see the crisis through. However, office assets outside the major cities will take a longer time to recover. Operators with excessive leverage or facing margins calls may be forced sellers.

Skilled nursing and assisted living are currently under strain and will likely suffer for a while post-crisis, but hospitals and urgent care facilities are still solid. Medical office buildings have good long-term fundamentals, but for now, non-urgent care is being reduced, so parts of this area (such as dentists) may be suffering. But this is a sector with favourable long-term demand and demographics and should recover as economic activity is restored.

Hardest Hit, Caution:

Hospitality: The virus has hit the hospitality industry the hardest; no one has ever envisioned a world of near zero hotel occupancies globally. The revenue loss is unlikely to be recouped. For the weakest and most leveraged in the hotel segment, many will fold, and for others, it may be years before the industry recovers, and the equity has any value at all. However, not all hotel assets will suffer to the same degree, as some operators have strong cash resources and brand equity, and people will likely travel again once the virus wanes.

Retail and Leisure: Retail and leisure sectors have been similarly hurt as malls and shopping centres already suffering from the rise of online shopping were forced to close for business. Footfall will take time to be restored. Many landlords are bracing themselves for a flood of requests for rent relief, particularly from smaller business tenants. It is also conceivable that after the virus runs its course, the retail sector will not snap back immediately as social distancing may remain in force (until a vaccine is found) and consumer discretionary spend is likely to take a hit for some time to come.

Longer-term, suburban shopping centres with anchor tenants in the food, grocery and pharmacy sector may grow in importance, while mega destination malls may struggle to recover.

Other Areas of Real Estate:

Real Estate Eco-system: The buying and selling of properties have ground to a halt impacting a huge sub-sector of the industry: brokers, surveyors, lawyers, agents, servicers and online listing platforms. Home sales could fall by 35% annually this spring, compared with the last quarter of 2019, according to Capital Economics. Moreover, if history is any guide, house prices are still needing to adjust. After the September 11 terrorist attacks in 2001 and the fall of Lehman Brothers in 2008, sale prices fell 25% to 35% on a global basis. It is unclear where prices will end up, but most expect a downward adjustment. With wealth wiped from stock market values globally and concerns around employment security, the real estate market is likely to see an abundance of caution among buyers and sellers.

Construction: Home and property builders are feeling not only the demand pullback, but social distancing means delays in building and permitting with costly implications for developers. This part of the industry is also experiencing supply shock with delays in materials from around the globe. Whether this is considered force majeure, 'business interruption' will vary depending on contract, insurer, terms, and country by country. Insurance protection is a point of huge contention and is not likely to be resolved any time soon, with repercussions still unmeasured.

II. Rescue Coming and More is Needed

Policy makers understand the need to stem the rising tide of negative feedback loops. Workers need security and income support to make rental payments; companies need access to

borrowing lines to replenish depleted cash, and hard-hit borrowers need some form of interest delay or forbearance to survive the crisis.

Unorthodox and unprecedented policy tools are being thrown at the problem. Central Banks around the world are now in full pursuit of unlimited quantitative easing, through various bond buying programmes, driving interest rates to zero (and beyond). The most important panacea in a liquidity crisis is to get liquidity into the system, targeting those individuals and sectors that are experiencing the greatest shortfalls. This is happening.

Fiscal stimulus globally is also being ramped up to meet the challenge, with a range of income and business support programmes around the world. The size of the packages could well reach 10-12% of GDP, versus 6.5% at the time of the financial crisis, with more being announced each day. Tax reform will be the inevitable outcome as a result of unprecedented stimulus packages; but for now, this is tomorrow's problem. Auditors and regulators may need to review going concern accounting and mark to market policies, at least temporarily, given the forced nature of the crisis and the realisation that these rules may be exacerbating the problem.

Federal authorities across the globe have been urging banks to be lenient with struggling borrowers, lenders, and investors during the crisis, stressing that regulators will not hold it against them if they take on additional risk. Central Banks have started to relax capital adequacy requirements as banks are fast becoming the transmission vehicle for business support.

A **phased reopening of economies** combined with these massive stimulus programmes should over time bring economic recovery and thus real estate relief.

III. Where to look for value

There may be permanent changes, both positive and negative, that real estate investors need to consider. Longer-term, CRE office space needs may be affected, given the increased acceptance of flexible working conditions and desire to reduce fixed costs. Public officials may amend building codes to reduce allowable human usage per square meter. In certain countries, the UK and Australia, by way of example, there remains a significant imbalance between long term demand and supply. Government-backed programmes and well-funded housing and student accommodation opportunities are still likely to be long-term attractive areas of investment.

Domestic onshoring of supply chains could change demand and supply dynamics. Business travel and thus hospitality may be affected by the new-found acceptance of video conferencing. Consumers may accelerate the trend of online shopping, increasing demand for all things related to e-commerce fulfilment. New hybrid university models may emerge combining in-situ and remote learning. Overnight the crisis has increased the importance of digitalisation and the resilience and demand for digital infrastructure.

Near term, we believe that investors should focus on top tier assets in top tier markets. There is no need to stretch on location quality, this is (or will be in a few months) the time to buy A

assets in A markets at prices that rarely occur. Conversely, assets that are already operationally challenged in markets with shallow tenant pools may not be a bargain at any price. Today's 60% occupied lease-up play may become June's 20% occupied foreclosure.

As we look across the globe, we highlight some of the areas of potential opportunity:

- **Senior Debt:** Potential to acquire senior debt from banks or corporates, with first loss provisions and 60-70% LTV, where the underlying property is fine, but the lender is needs balance sheet relief.
- **Pockets of Strength:** Investments **where the crisis has actually *improved* demand** and where strong fundamentals may now be **more attractively priced**, such as in:
 - digital infrastructure where 'shelter in place' rules have created an insatiable demand for connectivity, and with 5G, this trend is likely to accelerate;
 - industrial, particularly last mile distribution, with good long-term fundamentals as online shopping demand continues to rise, or where the crisis has increased the need for resiliency in the supply chain of critical goods;
 - life science lab/medical office space, an area likely to grow in importance and demand, directly as a result of the crisis;
 - mixed-use real estate; residential units affording better work and living space combined;
- **Strategic Residential Planning Plays:** Buying land, seeking planning permissions (development margin), and then on-selling development to Governmental authorities to deliver housing. This has worked well in the past, particularly in the UK and Germany, and our experience shows that only reliable players with access to finance and expertise will continue to be favoured.
- **Opportunistic Land Purchases:** Long-dated leases to hospital, or life science tenants are likely to continue to offer an attractive yield relative to other assets perceived as low risk.
- **Capital light:** Capital light planning on prime development sites. Planning opportunities with local partners who have secured call options on pre-existing largely obsolete buildings; these opportunities do not have any reliance on cashflows over the near term.
- **Hospitality Assets:** Over the next few months, it may be possible to buy the debt on high profile hospitality assets at pricing that provides an acceptable return if they perform and a very attractive basis if the debt position takes over the equity.
- **Partially Completed Developments:** If the lockdown and resulting recession are steep and or prolonged enough, previously attractive developments in growth segments with good tenant profiles could become attractive.

The pandemic has been first and foremost a humanitarian crisis and we offer our thoughts to keep safe to our clients.

As stewards of capital, however, we are focused on how the crisis may bring opportunity for attractive long-term returns. This asset class is experiencing both stress and change, an

advantage to the discerning investor who can underwrite the right opportunities with credible access to finance and in structures offering good downside protection.

Real estate will remain, in our view, a highly sought-after asset class. Whether we continue with zero interest rates or see rates rise if inflation takes hold, real estate will continue to provide a stable, income advantage relative to bonds and long-term inflation protection. These characteristics are well-understood and will be in demand by a whole host of investors from sovereign wealth funds to pension funds to high net worth families and investors.

For Alvarium, we believe in backing great teams, with great projects at great prices. More to the point, you need to have ‘feet on the ground’ locally to identify and underwrite risk quickly. Our global footprint with local teams gives us that advantage.

That is what we do: investing side by side with our families.

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