INTERVIEW

Diversification makes a difference

Theo Andrew catches up with European Public Real Estate Association (EPRA) policy officer, Jana Bour**, on why pension funds should be targeting real estate and the best solutions for Europe's pension issues**

What can listed real estate offer European pension funds?

We believe listed real estate should be identified as a 'must-have' asset class in a diversified investment strategy. Listed real estate provides investors with significant diversification benefits due to its low correlation with other asset classes and diverse geographical location of their asset portfolio, such as in the case of Unibail-Rodamco-Westfield. The more diversified the portfolio, the more you achieve either higher returns with the same risk or the same returns with a lower risk. This makes it very interesting for investors such as pension funds, as they are looking to diversify portfolios with long-term savings goals.

Although publicly-traded property companies are perpetual businesses operating and managing long-term assets, the listed market in which they function provides the opportunity for investors to invest over their own time horizon and 'vote with their feet' by buying or selling their shares at any time. As a consequence, and despite that the listed property sector represents only 5.86 per cent of the total commercial real estate in the EU (as at Q1 2018), it delivers a much more dynamic trading market than the direct property market thanks to its liquidity, low transaction costs and accessibility.

Real estate can offer a stable source of income and capital appreciation to pension funds, outperforming inflation over the long term, which is the case of listed property companies thanks to the transparency of the public markets. When compared to other asset classes, real estate appears to be able to provide higher income returns as well as capital returns. When compared to other real estate investment vehicles, listed real estate companies have demonstrated better performance as well. Companies in the FTSE EPRA/NAREIT Developed Europe Index have yielded an average dividend of 3.5 per cent over the past five years. The index has consistently demonstrated a strong long-term performance – the annualised 20-year total return for the Developed Europe Index stands at 8.5 per cent (as at May 2018).

Listed real estate in a particular way can satisfy the characteristics of the long-term investment, which is well sought after by pension funds.

What are the main challenges and opportunities for pension funds?

The key challenges often translate to the biggest opportunities. If we assume that the pension funds industry is not an exception then both main challenges and opportunities could relate to the aging population, low interest rates and the impact of new technologies, such as e-commerce, which has driven listed property companies to changes in their strategies. Besides all that, implementation of environmentally-friendly investment decision may pose a significant challenge for the industry. On that note, we have observed over the past few years that listed property companies have increasingly adopted sustainability practices to improve the performance of their underlying properties. Enhanced performance has been greatly appreciated and sought after by institutional investors, including pension funds.

EPRA also actively promotes sustainability reporting within its membership, mainly by issuing Sustainability Best Practices Recommendations (i.e. EPRA sBPR) and awarding the best performers in ESG disclosure (i.e. EPRA sBPR Awards). The EPRA Sustainability Best Practices Recommendations establish common metrics on environmental, social and governance issues among listed properties companies and respond to the growing expectation for reporting on non-financial performance, not just by the EU legislative framework but also in response to the needs of our investors. Our mission is to increase transparency of sustainability practices of listed property companies for those pension funds, who are looking for green investment opportunities to contribute to joint efforts in meeting the UN SDGs.

Do you see Pan-European Pension Products (PEPP) as the solution to Europe's pension problems?

EPRA welcomes the PEPP proposal, its objectives and content, especially the proposed 'prudent person principle'. We view it as a significant opportunity for Europe to help decrease the pensions gap, not in isolation of course, but together with other initiatives, either at national or at the EU or even global level. There are currently many EU countries where the second pillar pension schemes are underdeveloped and hugely insufficient. Especially for the CEE countries a well-designed PEPP product has a potential to improve pension provisions.

What does PEPP mean for real estate investment management?

We would like to see PEPP providers being able to invest in shares of publicly-traded property companies because it is real estate. Investments in listed property companies, including REITs, are well-suited to offer a safe and profitable (risk-adjusted) investment opportunity because of their daily market pricing, low cost, enhanced liquidity, as well as opportunities for portfolio diversification. They operate within a framework that is transparent, accountable and well regulated.

Therefore, it is important to design a PEPP that would offer such opportunities while promoting long-term investments. What is crucial for us at EPRA is to demonstrate to policy makers that listed real estate investments are certainly instruments with a long-term economic profile, as they are strongly influenced by the underlying properties. In fact, their performance correlates to the underlying property after just 18 months as evidenced by a recent MSCI report.

In addition, EPRA is working to educate all stakeholders on the similarities and synergies between real estate and infrastructure (i.e. real assets). PEPP providers should be equally encouraged to invest in real estate as they are in infrastructure projects and corporates.

How does changing demographics and workforce effect real estate, and how are listed property companies approaching it?

That is a very interesting question. Indeed, changing the composition of a population, such as gender, age, income, and so on, is having a significant effect on the industry. This is because when acquiring assets listed property companies need to step into the shoes of their prospective tenants, to understand what they value in space, neighbourhood and so on. The demographic shift, such as the growth of the urban population in several countries, or the aging of the population, will provide a variety of opportunities for listed property companies in the coming years. We already observe a diversification of the companies portfolios with a focus on niche sectors, such as student housing and retirement homes. For example, in 2017 the leading German residential property company, Vonovia, began converting 13,000 of their vacant apartments for senior-friendly living.

A changing workforce is another significant driver for listed property companies to adjust their investment strategies. Demand for collaborative and co-working spaces has grown significantly in the past years, while occupiers demand greater connectivity and personalisation. Tenants also expect greater flexibility in their lease terms. Technology makes it easier to forecast occupancy and space usage so that they can be optimised.

How are listed real estate companies approaching the EU sustainable finance initiative?

Listed real estate companies understand how crucial the role of investment in real estate is in ensuring a low-carbon, resource-efficient and increasingly circular European economy, considering that buildings are responsible for around 40 per cent of energy consumption in Europe.

Currently, the EU is not on track to deliver the €11.2 trillion required to meet its 2030 energy policy targets. The latest estimates put the annual investment gap at around €177 billion between 2021 and 2030, totalling €1.77 trillion out of which the biggest gap relates to investment in energy efficiency in buildings (74 per cent), as is well highlighted by the European Commission.

It is therefore essential to make energy efficient buildings in Europe the top priority, including its financing through financial markets. This is why EPRA welcomes the EU initiative on sustainable finance. In fact, we would like to see investments in green, environmental and also social real estate being recognised as a sustainable investment in the EU's upcoming taxonomy legislation.

We would also welcome any potential future changes in the EU Solvency II rules so that it would not prejudice but rather incentivise long-term investments, in particular green long-term property investments, by for example requiring a minimum percentage of buildings in the insurer's real estate asset allocation to be certified by voluntary rating schemes, such as Leadership in Energy and Environmental Design or BREEAM.

Endorsement of the sectoral market led ESG reporting guidelines, such as EPRA sBPR, would help increase availability and also comparability of public data and thus not only strengthen the credibility of the existing benchmarks, but also allow to build new indexes and benchmarks, so that the investors would have a tool to assess their 'green' investments. ■