INVESTMENT

Rooms to spare

Norwegian Government Pension Fund Global has acquired a number of stakes in property over the past few months. ***European Pensions*** **looks at the reason for this and what property can offer European pension funds in today's market**

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Investment in real estate by funds, particularly Norwegian funds, has gathered pace. In May, it was reported that Norges Bank Real Estate Management, acting on behalf of the Norwegian Government Pension Fund Global, had bought three properties in London in a deal in partnership with The Crown Estate. This was followed by similar deals in July where the same fund purchased a stake in property in Washington DC, and the purchase of an office building in Berlin. Hot on the heels of those was a property purchase in central Paris.

Building interest

These developments are not storms in a teacup, but reflect a larger shift in how funds operate. Data from Preqin shows that in 2012, the number of active European pension fund investors in real estate stood at 203, with an average allocation of 10.4 per cent. By 2017, that had grown by 22 per cent to 248 investors, and average allocations of 12.2 per cent. The same trend is replicated across the globe: in 2012, the number of active pension fund investors around the world stood at 650, with an average allocation of 8.2 per cent; five years later, that first figure had increased 27.5 per cent to 829, with average allocations of 10 per cent. The data also shows that 87 per cent of all public and 73 per cent of all private sector pension funds currently invest in real estate.

The writing may have been on the wall for some time – in 2013, Jones Lang LaSalle predicted that direct investment in real estate by pension funds and sovereign wealth funds would double over the following decade.

There are specific reasons for this. One argument posited by J.P. Morgan in 2013 as a reason for funds to invest in real estate was that assets such as property provided 'all-weather' protection for pension funds, delivering better returns in high-growth environments than bonds, while being more defensive than equities in periods of lower-growth.

Another reason is that real estate provides a stable income stream over the longer term, allowing funds to closely match their liabilities. Diversification is also key, as is lowering risk and providing a hedge against inflation. As interest rates remain low, investors have looked towards asset classes like these because they currently outperform equities and fixed income products.

However, investment has not been uniform: allocations by public pension funds in this sector are more than double those of the private sector – $681 billion to $340 billion.

The reason for this, says Jones Lang LaSalle's head of capital markets Matthews Richards, is that the former tend to be larger than their counterparts and require more diversification.

"For some of the smaller company pension funds with a smaller volume of capital available to deploy," he adds, "it makes more sense for them to invest indirectly via private real

estate funds or the equity market, rather than purchasing real estate directly, which requires active asset management."

Investment approaches

The size of a fund's AUM also by-and-large influences real estate investment. Only 13 per cent of public funds with less than $1 billion AUM invest directly in real estate; among those with AUMs over $50 billion, that figure increases to 66 per cent. "This happens," says Preqin head of real estate product Oliver Senchal "because public sector pension funds have been in this space for a longer time. Indeed, 87 per cent of them have investments here and they've been doing it for much longer than private sector funds so they're more."

A lack of direct investment, however, does not correlate to a lack of overall investment; smaller pension funds, says Richards, may not have the 'critical mass' available to deploy in direct real estate investment. They might, he says, explore other avenues such as investing in REITS or private real estate funds. "For example, a small pension fund with $1 billion AUM with a typical 4 per cent allocation to real estate can only deploy $40 million to real estate, which would not even buy you one prime office building in London. Hence, economies of scale apply: as the size of the pension fund increases, the more capital and expertise there is at hand to invest in direct real estate to achieve the required diversification."

Such wide investment in property has knock-on effects, though. The city of Berlin has seen rent prices skyrocket in recent years as a result of intense property investment – often by pension funds – in the city. The so-called 'Berlin lifestyle' of cafes, cheap rents, and cultural cache has drawn investors and residents from around the world. At one point, the city was, according to Schroders, '[…] rated the number one investment market by ULI and PwC'. The result was an increase in rents of 70 per cent between 2004 and 2016. From this has come tensions in areas such as Prenzlauer Berg, Kreuzberg, and Neukölln, that have been transformed by gentrification.

"The pension funds that we speak to," says Richards, "are frontrunners in ESG investing, and this also applies to their investments into real estate. Both private and institutional investment can offer a number of important benefits and advantages to cities pursuing long-term goals, including supplying critical capital in areas which are traditionally under-funded by the public sector, such as infrastructure, and adding diverse perspectives, ideas and solutions to city development."

However, Willis Towers Watson's senior investment consultant, Douglas Crawshaw, maintains that there are limits that funds can go to in this respect. "At the end of the day," he says, "they have a fiduciary duty to their members. They are there to provide pensions when those members retire. That's their purpose."

Recent research indicates that 64 per cent of funds believe it harder to find attractive opportunities in real estate than it was a year ago, and a little over two-thirds think asset prices to be a key industry concern. A tightening of supply is driving prices higher, too, and reducing the cost-benefit of investing in real estate. "Nonetheless," say Preqin, "real estate remains a crucial part of many pension fund portfolios, with investments in the asset class able to mitigate against fluctuations in traditional bond and stock markets."

Moving out

Senchal acknowledges that current trends have shown it to be harder to find attractive, viable real estate within Europe. "Fund managers are looking at different markets and regions. Where once they may have gone for core properties, they may now go for core-plus properties. A core property is an asset that has strong tenants in a prime location, making a consistent income stream. A core-plus property means it might need some renovations and improvements in order to bring it up."

Richards says that long-term investors may seek to target secondary cities or emerging markets in order to achieve higher yields. "The key success factor for these markets to attract pension fund investment is transparency and liquidity.

"For example, improving transparency in Central Eastern Europe had led to Asian investors such as Korea's NPS investing in a Prague office building together with LaSalle Investment Management."

He adds: "There is, however, still plenty of potential supply in real estate which doesn't trade often yet, such as buildings owned by corporates and governments."

The risk when talking about European property is in treating each country as if they are all the same. They are not. Recent, heavy investment in infrastructure in Poland and Czechia has made those countries attractive options with competitive pricing. Other countries, such as the UK, may be heading for more-turbulent waters.

Crawshaw says: "I think continental Europe is a few years behind the UK in terms of cycle and you could argue that there's still some upswing to go on the continent. It's not gone in the UK but we could be at a later point. And if the UK is perceived as riskier because of Brexit, they may encourage investors to switch and become more focused on the EU." ■