Fiera Real Estate

UK Real Estate - Value Creation in a Transitional Market

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The Appeal of UK Real Estate Investing – A Transitional Buying Opportunity.

Foreword by Chris Button, Head of UK Value Add REIM, Fiera Real Estate

Leo Tolstoy wrote in War and Peace that "the two most powerful warriors are patience and time". As we watch COVID-19 impact the health and wellbeing of the world we live in, it is hard to predict the long-term effects of this crisis on society and the environment. However, this could but should not act as an advocate to waste the time we have now.

This paper sets out how thoughtful and patient investors should be preparing to enter a real estate market which Fiera Real Estate believes can create a generational buying opportunity. It also sets out why, as well as relying on the market opportunity created by dislocation, those investors brave enough to know when and how to add value in asset opportunities can receive attractive additional returns in the years ahead.

1. What is Opportunistic Investing?

Opportunistic investment in the UK real estate market is generally characterised by the generation of 'alpha', namely returns above the market return or 'beta'. To deliver this does not simply require market timing but instead relies on:

(i) a strategic approach to asset allocation across property sectors;

(ii) stock selection within these sectors; and

(iii) superior management capability to execute complex business plans.

2. The UK Opportunity Today

In the short term, certain key themes are driving Fiera Real Estate's UK investment strategy, namely the impending disruption from Brexit and the current economic distress caused by the effects of COVID-19. These shape our views of both UK real estate and the wider economy today, but as real estate is a long-term asset class, investors need to look beyond this. They need to acknowledge the UK's significant demand from a growing population, the shifting consumer demand for better technology enabled assets and investor demand for real estate income yields that are usually higher than fixed income alternatives. Real estate may lack the daily liquidity of equity and bond markets, but with over £2.1trillion of investible UK commercial real estate available and £6.8trillion of residential assets[1], this is a market that is deep and liquid enough for every cycle.

[1]IPF, December 2019

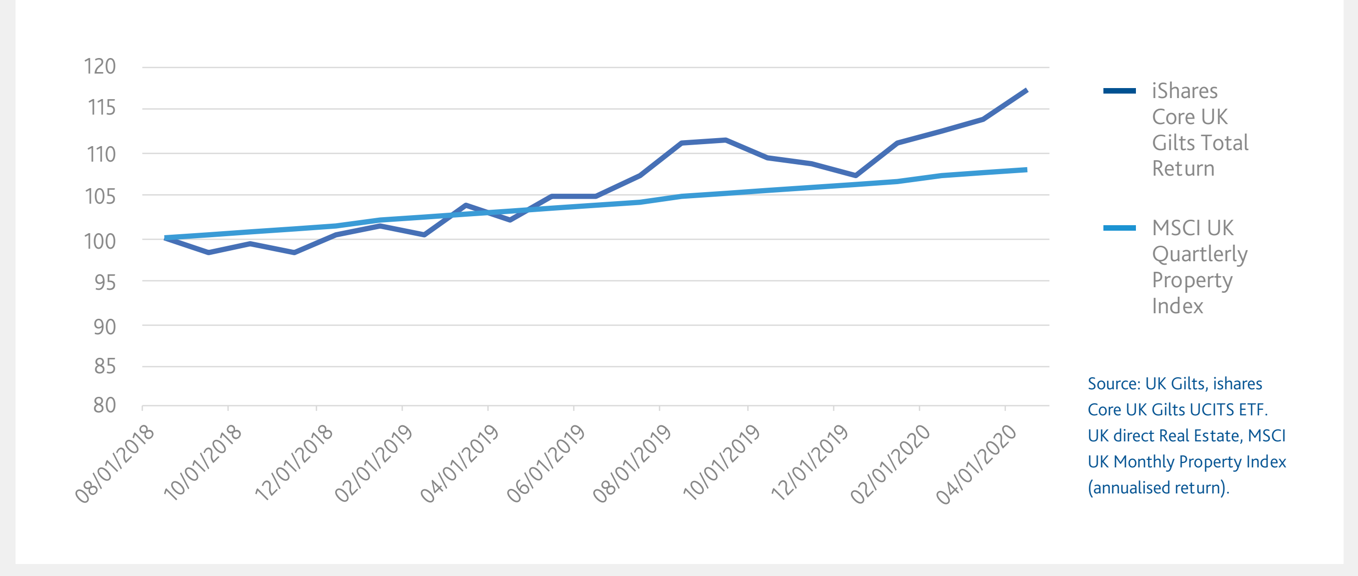
3. Immediate Impacts

COVID-19

The pandemic has been crippling for many parts of society, both at a personal and economic level, and will cause a deep recession in most major economies. However, in decades to come it is equally likely to be seen as a threshold in the transition from old business practices to new. The short term focus is on the likely distressed asset sales and reduced market liquidity. The growth in property values over recent years, mirroring the rise in the value of UK government bonds, has ceased in 2020, leaving the two asset classes decoupled, below in Figure 1.

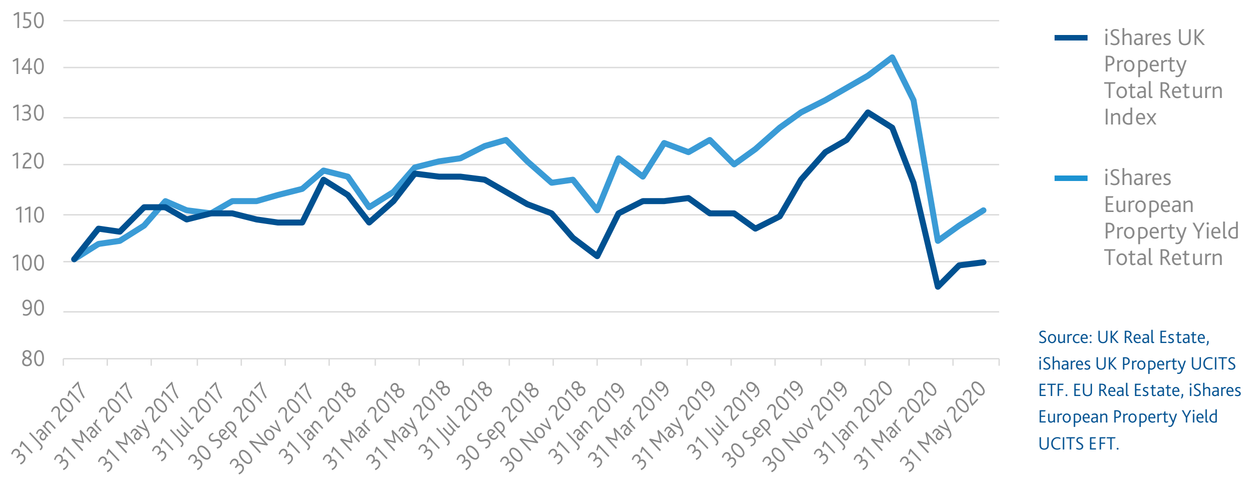
The crisis has also emphasised the need for changes around complex supply chains, with onshoring made possible as labour costs becomes a lower component of the manufacturing cost base. It has boosted online retail of almost all consumer goods, helping drive logistics demand. It has also demonstrated remote working practices for office workers can be successful, meaning office buildings will now need to provide a superior environment for collaboration and innovation if they want to compete with the convenience of working from home. This change creates the need for new industrial, logistics and office assets to be built and old assets to be repurposed.

Figure 1: UK Direct Real Estate v UK Gilts*



* Historical market performance is not necessarily indicative of future events.

Figure 2: UK v EU Real Estate*



Source: UK Real Estate, iShares UK Property UCITS ETF. EU Real Estate, iShares European Property Yield UCITS EFT.

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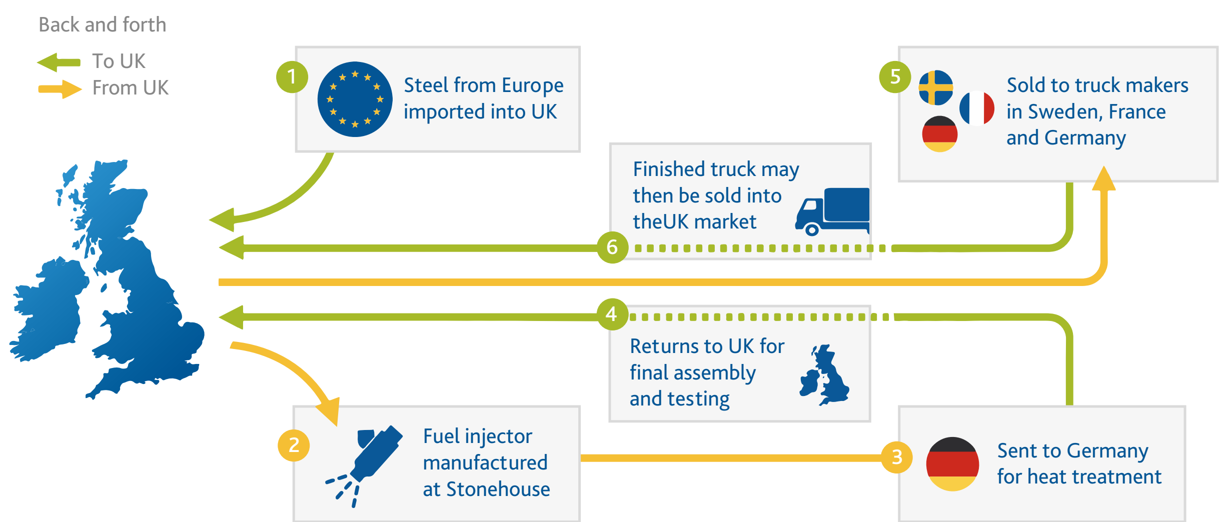
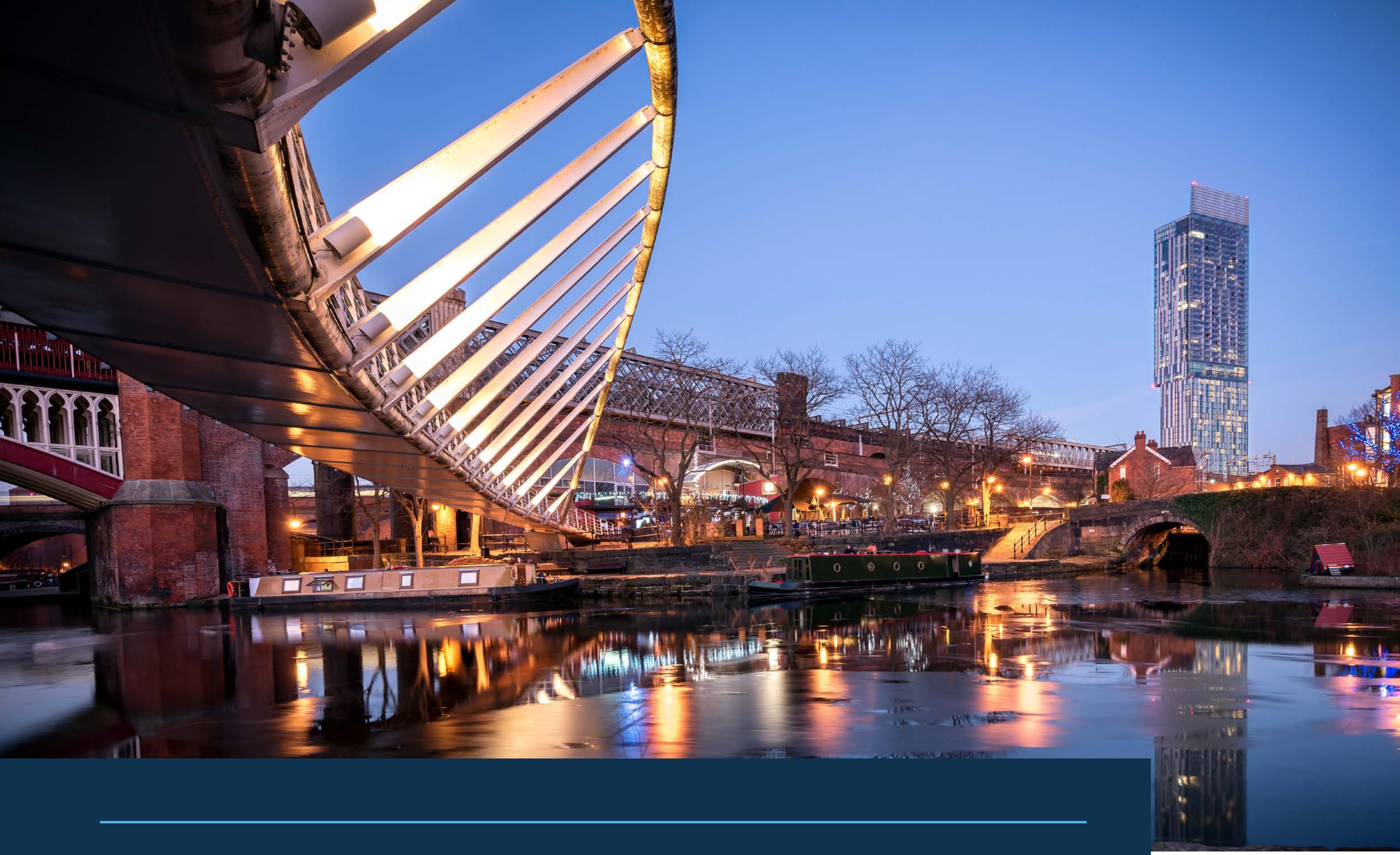
Brexit

Post the UK referendum to leave the EU in 2016, UK property values have lagged behind the performance of property values in the Euro-zone, as shown above in Figure 2. Despite Boris Johnson's emphatic General Election victory in 2019, and the passing into law of the EU/UK Withdrawal Agreement Bill, there remain significant challenges for corporations and their use of real estate post the 2020 UK/EU withdrawal transition period. In particular, the focus is on the impact on supply chains from the UK's departure from the single market and customs union. Figure 3 shows the current supply chain for a UK automotive parts manufacturer, highlighting the constant flow of materials and parts in and out of the EU.

In the longer term, many investors believe that post the UK and EU transition period, UK property values should close the relative performance gaps as the UK builds a successful trading relationship with its European neighbours and beyond.

Figure 3: Example of Impact on Supply Chains – Delphi (UK Automotive Parts)





4. Longer Term Fundamentals

Residential Assets – Relentless Demand and Undersupply

The UK population is forecast to grow by over 18% over the next 30 years, as shown in Figure 4, a significantly faster rate than most comparable EU countries. This will create increasing demand for assets, especially for residential accommodation.

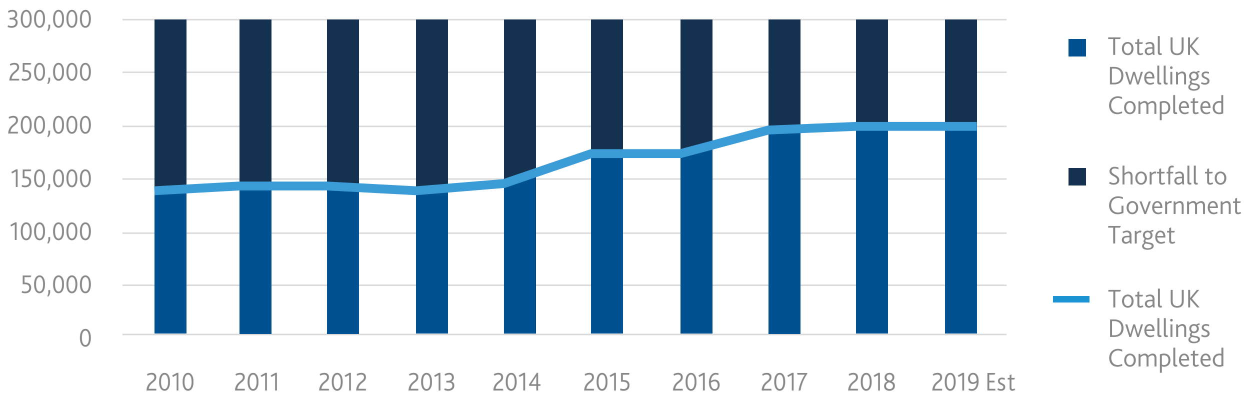
Figure 4: Forecast Population Growth: UK Growing Fast

	2020	2030	2050	% Growth
Germany	83.8m	83.1m	80.1m	-4.4%
UK	**67.9m**	**70.5m**	**74.1m**	**9.1%**
France	65.3m	66.7m	67.6m	3.5%
Italy	60.5m	59.0m	54.4m	-10.1%

Source: EuroStat Population Projections Jan 2020

Against this growth in demand is a structural undersupply. For example, the UK residential market has failed to create sufficient supply to match this demand or meet the UK government target for the delivery of 300,000 dwellings set in 2016 by the UK Parliament (see Figure 5).

Figure 5: Total UK Dwelling Completions vs Government Target



Source: GOV.UK, Live Tables on Housebuilding. StatsWales, New dwellings completed by area, dwelling type and number of bedrooms. Scottish Government, New housebuilding in Scotland. Northern Ireland, Department of Finance, new dwelling statistics. As at March 2020.

The shortfall provides an opportunity for investors to help the delivery of new property assets in the UK. Given that the residential market for building and selling housing is mature and competitive, there is an opportunity to provide ‘oven-ready’ consented residential sites that house building companies can develop out. This strategy relies on capturing the gain in land value between existing, usually obsolete, commercial use and higher land value of a site where residential units can be built – often a multiple of 2x to 3x to increase in land value.

Alongside this, increasing asset price inflation has made housing less affordable in many areas of the UK, increasing demand for rental property. Alongside this there has been a growth of an institutional investor base wishing to own build to rent (BTR) residential developments. These investors require new bespoke assets to be created for them across the UK, with lower depreciation risk and a higher correlation to inflation than commercial assets may provide. We believe this creates an opportunity to not only access gains from increasing land value but also from taking the risk of developing projects that have been pre-sold to the long-term owners.

Commercial Real Estate – A Changing Landscape

In the UK commercial real estate market, the last decade has seen investment into the construction of new office assets halve[1], even as the workforce grew by 4 million.[2] This undersupply is demonstrated by the fact that 2019 vacancy rates in the London office market stood at 4.4%, down from over 10% a decade before[1]. Looking forward, the impact of technology will continue to change UK commercial real estate, especially the office and retail submarkets.

Office occupiers are continuing to look at how best to retain and attract talent and how to help meet global environmental challenges, meaning a need for highly energy efficient and sustainable buildings. Corporate customers want buildings designed to maximise collaboration, whilst providing flexibility around use and high-quality amenity to attract remote enabled workers. These newly built or refurbished assets will be sought after by investors as they will depreciate less than lower quality and potentially obsolete assets.

Retail is also rapidly changing, as consumer spending online continues to grow, with the UK already a leader in online sales at over £700bn in 2019 alone[2]. Post the onset of COVID-19, these sales now account for over 30% of all sales in May 2020[2]. Households have become increasingly comfortable with online retail in the absence of access to high street stores.

This channel shift impacts retailers' decisions in terms of their desire for physical presence and how best to invest in the infrastructure and service levels needed to support purchases, especially in the fast-growing online space. The increase in development of logistic assets is a result of this trend, with excess demand meaning that this type of asset has seen, and will continue to see, increases in rents and reduction of investment yields as investors predict further growth. The opportunity is partly to own these assets but also to acquire the older physical retail units to create new commercial and residential assets that meet the UK demand for new supply chains and accommodation.

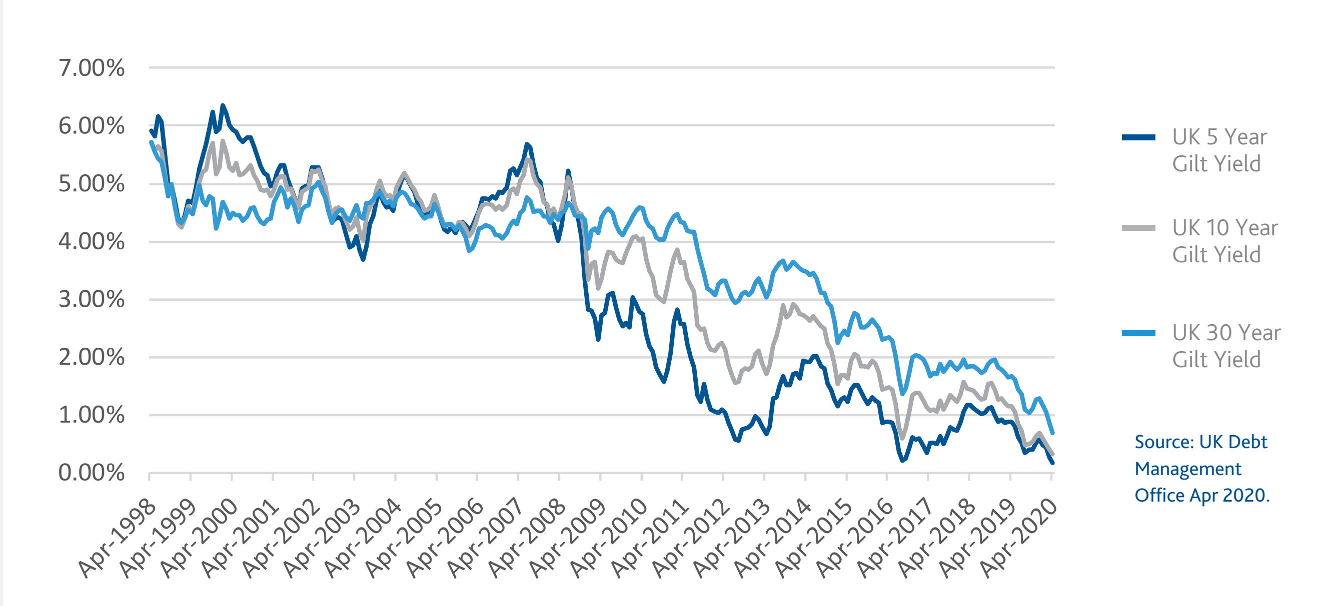
[1] Source: JLL, December 2019
[2] Source: ONS, June 2020

The Chase for Yield

Alongside an increasing demand from investors for higher quality income-backed commercial real estate and a consumer need to rent residential property, investors demand for income is also growing. Over the last decade fixed income yields have been steadily falling, as seen in Figure 6 below.

Whilst yields have been falling, UK defined pension funds also have greater liabilities that they need to meet, with the funding deficit standing at £136billion in May 2020.[3] An increasing need for GBP linked income combined with a reduced return from fixed income is leading many investors to look at real estate as a source of income backed returns. This is creating demand for stabilised high quality investment assets to be created to meet the tenant and end investor dual demand.

Figure 6: Falling Fixed Income Yields*



* Historical market performance is not necessarily indicative of future events.

[3] Source: Pension Protection Fund, May 2020

5. Accessing the UK Real Estate Opportunity Market

Sources of individual opportunistic real estate transactions vary considerably across the UK, but broadly they can be split down to:

- Institutional and private owners of potentially obsolete built real estate, who are unable or unwilling to take on the risk associated with redevelopment.
- Owners of land who want the simplicity and liquidity of selling unconditionally to realise value (rather than agree promotion agreements and defer value realisation).
- Corporate owner occupiers, whose existing real estate footprint is a by-product of a broader business mission.
- Distressed asset opportunities as a result of sales that are forced on the vendor (i.e. fund redemptions, bank re-possession).

In order to access the UK real estate opportunity market, investors can create dedicated real estate acquisition and asset management teams to invest directly into the strategies outlined in this paper, or to invest indirectly alongside experienced partners. However, given the many and differing sources of transactions in the opportunistic category, a strong network of relationships is required.

Here in the UK, Fiera Real Estate own a minority stake in ten operating partners, which cover every geography and sector in the UK market (see map below), providing the primary source of deal flow. This creates an operating framework providing access to a diversified portfolio of assets based on local presence, knowledge and underwriting. This model allows for post-acquisition asset management from a team based in the local market in conjunction with the Fiera Real Estate team

Regional Operating Partners

6. Risk Adjusted Strategies

At Fiera Real Estate, given our market views and competitive platform we have access to, we look at three main ways to generate alpha for clients:

(i) Development of new assets

The development of office, logistics and private residential for rent potentially with no formal lease commitment for some or all of the space at the outset of construction, but with the intention to lease up the space and subsequently sell to an incoming investor.

Case Study: Aurora, Bristol*

- Site acquired for £4m in March 2016.
- Speculative Grade A, BREEAM[1] Outstanding 95,000 sq ft office development undertaken.
- 85% pre-let by practical completion (PC) in September 2018 to tenants.
- Sold to Royal London Asset Management on completion for £62.1m.

[1]BREEAM: There are 5 score ratings from Pass (>30%) to Outstanding (>85%). BREEAM focuses on: Energy, Land use and ecology, Water, Health and wellbeing, Pollution, Transport, Materials, Waste, Management. A fee is paid for the certification.

*** This property is not held by the fund. Past performance is not a guarantee or indicator of future results. Inherent in any investment is the potential for loss. No discussion with respect to specific assets should be considered a recommendation to purchase or sell any particular investment. The companies discussed do not represent all past investments. It should not be assumed that any of the assets discussed were or will be profitable, or that recommendations or decisions made in the future will be profitable.**

(ii) Land entitlement/planning gain

The purchase of land, usually with a commercial or early stage residential consent in place, with the intention of obtaining an improved planning consent for a higher value use than currently exists. Example of this strategy would involve buying industrial buildings in urban areas, obtaining a residential planning consent, and selling land to a housebuilder to undertake the build and sale process.

Case Study: Steers Lane, Crawley*

- Site acquired for £7.5m in May 2018.
- Planning obtained for 185 residential units in February 2020, inc 40% affordable housing.
- Sold to Bellway Homes in May 2020 for £16.1m post receipt of planning.

(iii) Asset management, ideally in partnership with corporate occupiers

The optimisation of under-managed and under-invested real estate, ideally with a corporate partner that has an operational need we can support. Examples would include refurbishment and reletting of vacant commercial buildings and working with corporates to consolidate their real estate footprint, enabling surplus accommodation and land to be re-configured or re-zoned.

Case Study: Colworth Park, Bedfordshire*

- Property acquired in June 2014 for £47.5m.
- 352,000 business park, 90% leased to Unilever.
- Re-geared 20 year lease with Unilever on part and undertook asset management program on remaining vacant accommodation.
- Sold to Angelo Gordon for £62.75m in November 2019.

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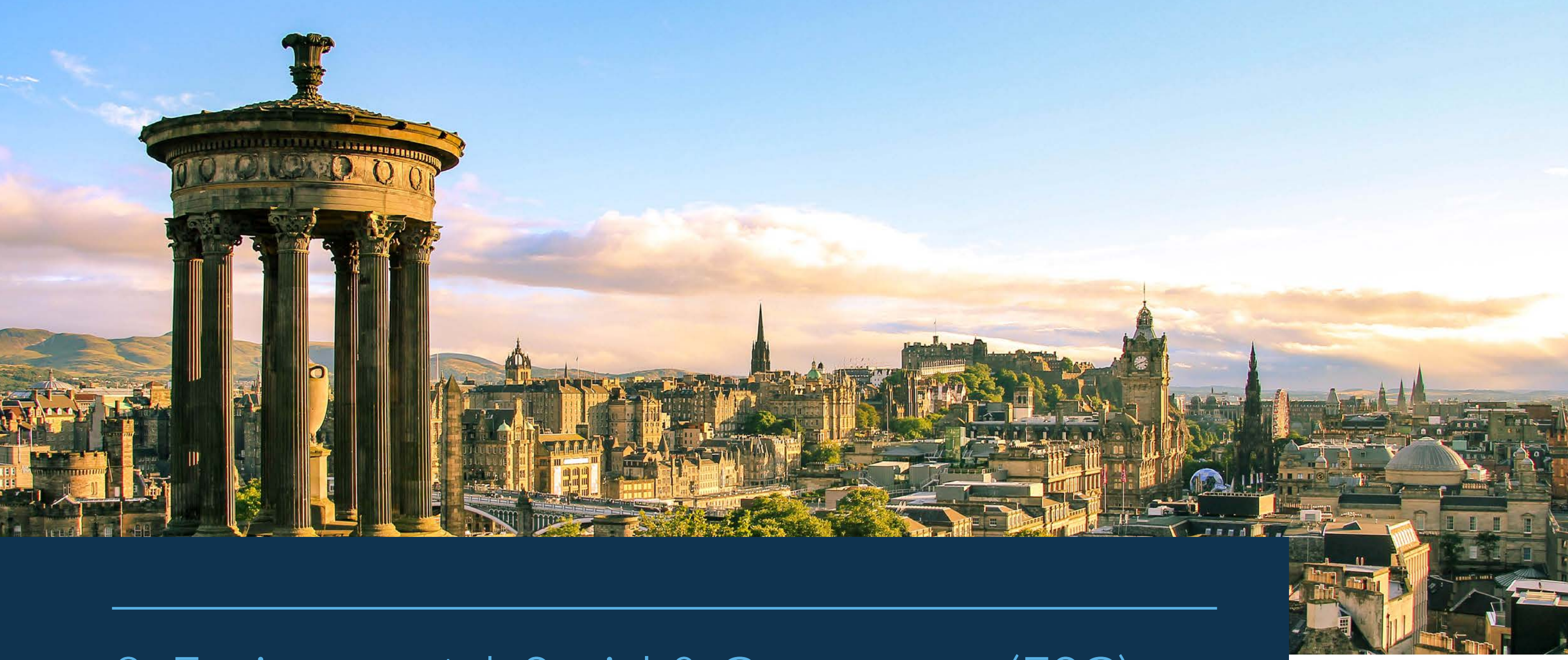
7. Managing Risk in an Opportunity Fund Strategy

Risk management is a key component of any investment, most significantly in higher return strategies. At Fiera Real Estate we are focused on creating superior risk adjusted returns through mitigating project specific risk. This is manifested in our rigorous due diligence pre acquisition, in conjunction with our local property companies and in the institutional framework we apply to managing the business plans once acquired.

Management of ongoing projects is undertaken by weekly verbal and monthly formal updates from our operating partners on every project. Business plans are re-validated every three months with a quarterly peer group review by the senior management team for all assets under management. This is communicated to our investors via quarterly reports and meetings, alongside ad-hoc requests for fund updates.

We have identified some of the key property risks for this style of strategy and have commented on how Fiera Real Estate seeks to mitigate these risks:

Risk Category	Principle Risks	Mitigation
Sector Allocation	Exposure to sectors which may under-perform in the future.	Focus on sectors with strong supply/demand fundamentals and liquidity on exit. Primary focus is sectors like residential and warehousing where oversupply doesn't exist and there is strong occupational demand.
Asset Selection	Poor risk adjusted choice of asset and business plan.	Focus on assets where our due diligence, working alongside our regional property company network, shows the business plan returns within the risk envelope is achievable. Ensure that multiple alternative exits also exist if the plan cannot be achieved. Diligence from both the macro (investment and occupational markets) and the micro/local issues (legal issues, local supply forecasts, asset location and history)
Planning	Underestimating the risks to achieving a new planning consent for a higher value use, increased density or improved layout.	All planning led business plans are underwritten through a pre-application meeting with the local planning authority to understand the issues in obtaining a change to the planning status. Use of regional partners (with dedicated planning and political consultants) to ensure local issues are understood. The long-term planning frameworks, local needs and competing sites are also considered. Fiera Real Estate has a strong track record navigating the planning system, with consents achieved for over 3,500 residential units in the last decade and an additional 1,200+ currently in the planning process.
Construction	Delays and/or increased costs.	Construction risk mitigated through the breadth of comparable data we have across the business to underwrite forecast build costs. The selection of top tier construction companies that undertake fixed price build contracts de-risks the projects, with monitoring undertaken by highly experienced operating partners who have co-invested into the projects. Fiera Real Estate has a deep knowledge of construction risk, having developed 2.8m sq. ft of mixed use and industrial space in the last 10 years and with 340,000 sq ft of projects currently on site.
Leverage	Excess leverage that reduces returns of ability to control business plan.	Creating 'alpha' means that leverage should avoided on most business plans, as it is a tool used mainly to magnify 'beta'. Leverage should only be used selectively to enhance returns on a de-risked basis rather than to replace shortfalls of capital on higher risk projects. Where leverage is used it should have sufficient head room against the financial covenants to allow for a fall in value from the asset against which it is secured. It should be underpinned by income or future capital receipt to allow a refinancing at its expiry date, which should be sufficient to complete the business plan.
Operating Partner Risk	Mis-aligned partner and/or poor execution of agreed plans.	Selection of a manager with a long track record of delivering alpha through opportunistic strategies is critical. This manager may use a specialist operating partner for specialist strategies, such as development. These partners also need to have similar long-term track records. Alignment through co-investment, profit sharing and long-term relationships further reinforce the delivery of plans.



8. Environmental, Social & Governance (ESG)

ESG is at the heart of any opportunistic investment strategy, with the ability to create new sustainable and energy efficient assets, to engage with local communities during the development process, and to deliver assets that meet the needs of society. Opportunistic investment, given the complexity required to create value, needs strong governance principles to succeed.

ESG is also an integral part in decision making at asset, fund and corporate levels, with dedicated environmental policies flowing through to each part of the asset lifecycle. During the acquisition process, a dedicated section should be devoted to ESG considerations, such as flood risk, contamination risks and the economic and social impact on the local community stakeholders. This includes the levels of affordable or key worker housing that can be provided by residential planning led business plans, as well as improvements to amenity and public realm.

Fiera Real Estate participates in GRESB to track our ongoing performance and our in-house dedicated ESG team work to improve performance year on year. In the UK we have achieved a minimum of 'BREEAM Very Good' on all new developments in the last five years, along with being awarded the only 'BREEAM Outstanding' rating achieved outside of London (Aurora, Bristol, 2018). Residential planning strategies are underwritten to deliver new affordable housing, usually between 30-40% of the new homes, to meet the UK's need. Wider local stakeholder engagement strategies include the pro-bono creation of the East Street Mews scheme in Bristol to combat youth homelessness, our corporate foundation partnership with the charity LandAid and the recent rent free leasing of Headley Court, owned by our funds, to the NHS to provide a 300-bed temporary hospital to assist efforts to manage the COVID-19 pandemic.

9. Conclusion

It is easy in the current market malaise to focus entirely on the recent past and the present, as these tend to be more pressing day to day than thinking about the future. This would be a mistake, as now is the time to build the platform to create wealth that can meet investor requirements for generations to come. It is the time to consider what assets are needed in the world that will emerge post COVID-19 and to ensure assets and strategies are aligned to meet this.

Fiera Real Estate have the team, track record, structure and sustainable culture to support investors who want to take advantage of the opportunity in the months and years ahead.

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