02

Operational excellence

10 TRENDS FOR 2023

Real estate investing used to be mainly about buying buildings and collecting rent, but today we couldn't be further from the "let and forget" approach of the past. The range of assets included in the broad church that makes up the mainstream commercial property market has expanded exponentially, with many investors now as much business operators as they are landlord owners. Indeed, even in the most traditional sectors, a focus on what goes on inside the building is more important than ever before.

A number of factors have come together to drive increased operational intensity in the real estate sector. Structural changes are clearly evident across the office, retail and industrial sectors – the traditional core components of a real estate portfolio. Increasingly sophisticated and complex occupier demands, enhanced ESG requirements, technological advances coupled with economic and demographic trends are requiring a more active asset management role for real estate owners.

The increasing operational intensity of real estate can also be seen in rapidly expanding investor demand for "alternative" or operational investments that typically require detailed understanding of – or even direct involvement in – the underlying business that creates the income stream.

Real estate as a service

The last decade has seen an acceleration in the operational demands of successfully driving performance in even the traditional real estate investment sectors.

Retail

For retail owners, the rise of e-commerce was a challenge even before the onset of the pandemic. Coupled with a straightforward oversupply of retail floorspace in some countries, the growth in online purchasing has made a material proportion of space obsolete, especially in secondary locations. The remainder is increasingly oriented towards service and "experience" in order to entice shoppers back into stores and increase dwell time. Many malls are now home to health services, spas and beauty salons, leisure, educational, recreation or co-working spaces. Enhanced promotional campaigns and wider marketing efforts all require a huge focus from asset owners on helping retail tenants drive footfall and spend through their assets.

The growth of online retail has also had significant, although far more positive, implications for the industrial sector. The term "logistics" used to be thought of in the context of network planning and the science of moving goods around. It is now synonymous with the warehouse sector, as industrial owners spend as much time supporting multi-modal global supply chains and digital inventory tracking as they do on conventional real estate issues.

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Office

The office sector is in the midst of its own transformational transition, albeit the jury is still very much out on the extent to which fundamental demand for space will be altered by increased flexible working. Nevertheless, occupiers are becoming more demanding of their facilities in order to attract and retain talent. Under pressure from flex operators, whose serviced offices more closely resemble a hotel than a traditional workplace, the office landlord-tenant relationship is changing to a supplier-customer one. Integration of technology, amenities such as gyms, restaurants and function spaces, and the implications of ESG legislation all require owners to be regularly and actively engaged in managing their assets. Good owners have been doing this for years to distinguish themselves from their competitors. Now, it's table stakes.

Real estate is increasingly service and experience-oriented.

It's real estate, but not as we know it

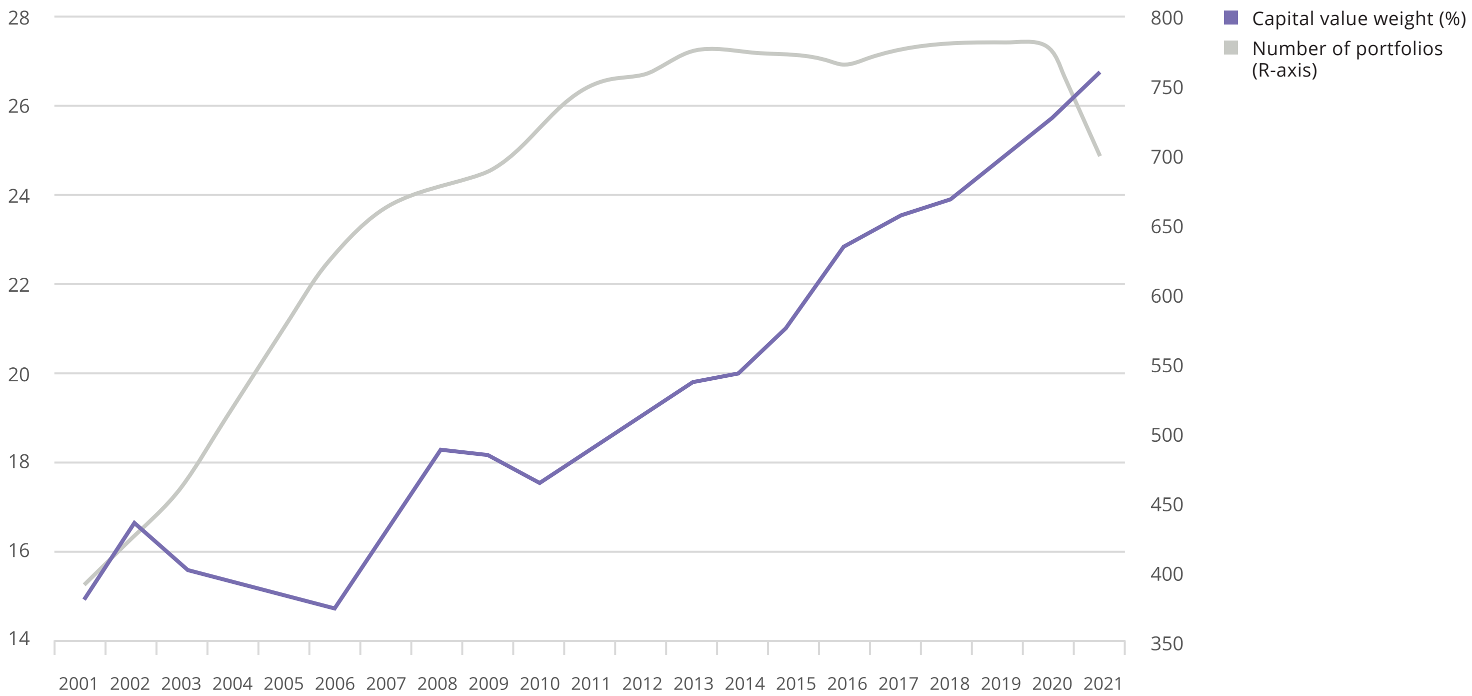
The clearest illustration of how active ownership has become the norm is the expansion of investment into "operational real estate". This can best be defined as a real estate anchored investment, where the return is directly and deliberately linked to the revenues and profits of the business conducted on the premises.[1] This encompasses a diverse range of alternative sectors with different demand drivers and risk-return profiles, including but not limited to:

- **Specialist residential** (student housing, micro-living, senior and affordable housing)
- **Self-storage**
- **Healthcare** (hospitals, medical practices, assisted living, life sciences)
- **Education** (nurseries, schools, colleges)
- **Leisure** (cinemas, pubs, restaurants and hotels)
- **Serviced and co-working offices**
- **Technology infrastructure** (data centres, cell towers and phone masts)
- **Vehicle refuelling and charging stations**
- **Other infrastructure** (energy generation and transmission, roads, airports)

These types of investments have accounted for an increasing proportion of investment turnover and asset portfolios in recent years, particularly if the expansion of multi-family residential – a longstanding staple of north American portfolios – into markets with little history of institutional resi ownership is taken into account.

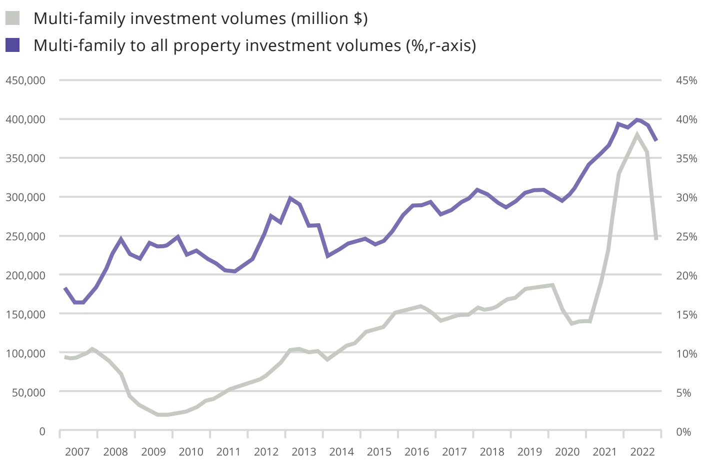
Operational real estate gaining traction

OPERATIONAL REAL ESTATE, MSCI GLOBAL PROPERTY



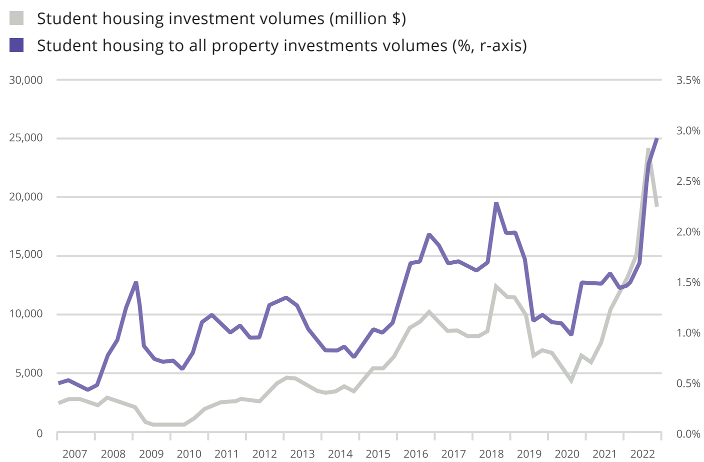
Source: MSCI

U.S. MULTI-FAMILY, ROLLING FOUR QUARTERS



Source: MSCI

U.S. STUDENT HOUSING, ROLLING FOUR QUARTERS

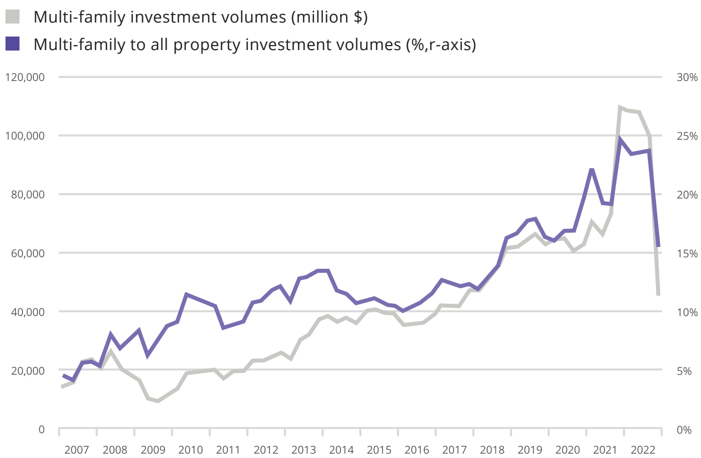


Source: MSCI

Operational excellence

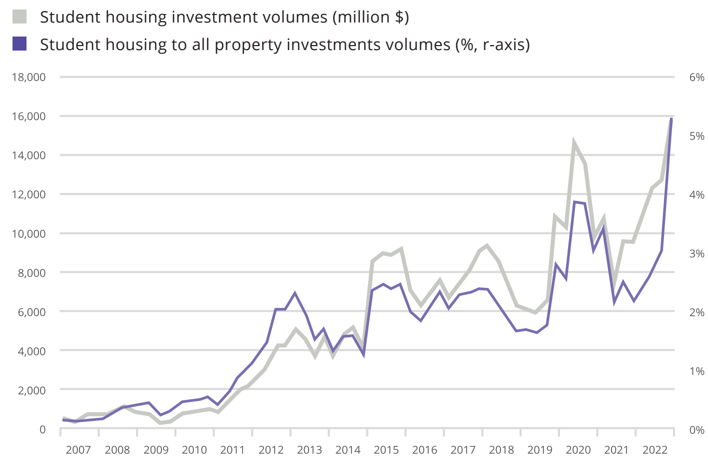
10 TRENDS FOR 2023

EUROPE MULTI-FAMILY, ROLLING FOUR QUARTERS



Source: MSCI

EUROPE STUDENT HOUSING, ROLLING FOUR QUARTERS



Source: MSCI

Survey evidence shows growing investor interest in alternative assets, which have been the top-ranking sectors over the past five years, suggesting that there is further rebalancing ahead.[2]

RANKING OF SECTORS’ INVESTMENT PROSPECTS OVER SELECTED YEARS

2004

1. Shopping centres
2. Residential
3. High street shops
4. Industrial / warehouse
5. Retail parks
6. Manufacturing
7. Suburban offices

2008

1. City centre shopping centres
2. Central city offices
3. Hotels
4. Shopping centre
5. High street shops
6. Industrial / warehouse
7. Retail parks
8. Housebuilding for sale
9. Suburban offices
10. Manufacturing

2010

1. City centre offices
2. Apartment residential (rented)
3. High street shops
4. City centre shopping centres
5. Shopping centres
6. Retail
7. Mixed used property
8. Retail parks
9. Residential
10. Office
11. Industrial / warehouse
12. Hotels
13. Manufacturing

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2016

1. Retirement / assisted living
2. Flexible / serviced offices and co-working
3. Healthcare
4. High street shops
5. Logistics facilities
6. Private rented residential
7. Student housing
8. Hotels
9. City centre shopping centres
10. Housebuilding for sale
11. Serviced apartments
12. Data centres
13. Central city offices
14. Self-storage facilities
15. Industrial / warehouse
16. Parking
17. Social housing
18. Suburban office
19. Business parks

2020

1. Retirement / assisted living
2. Logistics facilities
3. Co-living
4. Student housing
5. Healthcare
6. Self-storage facilities
7. Private rented residential
8. Data centres
9. Affordable housing
10. Flexible / serviced offices and co-working
11. Serviced apartments
12. Hotels
13. Industrial / warehouse
14. Science parks
15. Housebuilding for sale
16. Central city offices
17. Social housing
18. Leisure
19. Parking
20. Business parks
21. Suburban offices
22. High street shops
23. Retail parks
24. City centre shopping centres
25. Out of town shopping centres / retail destinations

2023

1. New energy infrastructure
2. Life sciences
3. Data centres
4. Self-storage facilities
5. Retirement / assisted living
6. Healthcare
7. Logistics facilities
8. Affordable housing
9. Social housing
10. Private rented residential
11. Leisure hotels
12. Co-living
13. Industrial / warehouse
14. Serviced apartments
15. Flexible / serviced offices and co-working
16. Leisure
17. Housebuilding for sale
18. Central city offices
19. Retail parks
20. Parking
21. Business hotels
22. Business parks
23. High street shops
24. City centre shopping centres
25. Out of town shopping centres / detail destinations
26. Suburban offices

Source: Emerging Trends Europe survey 2023

Emerging Trends Europe has analysed a burgeoning number of sectors over the past two decades, from just eight in 2004 to 27 in 2023. This is driven by increased diversity in housing and growing investor interest in alternative assets, which have been top-ranking sectors over the past five years.

Data centres rank third in terms of operational investment prospects for 2023, according to Emerging Trends Europe.

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This is happening for two main reasons: the strength of the underlying supply-demand drivers for these sectors, and their return characteristics.

Supply and demand

Most of the “alternative” sectors have their own unique supply and demand characteristics, albeit that many of them are driven in some way or another by the global megatrends of demographics, technology and ESG. Secular macro-economic and demographic trends underpin demand for operational real estate sectors:

Most of the ”alternative” sectors have their own unique supply and demand characteristics.

An aging society

With people living longer, driving demand for more and different residential options, often outside existing urban centres with varying levels of care and support. This is also related to the rising demand for medical and healthcare services which is increasingly being met by the private sector even in markets where there is strong history of public provision **(see Doctor’s orders).**

Technology and automation

Technology and automation are placing a greater premium on education – particularly further education. Many countries have a significant undersupply of purpose-built student accommodation coupled with rising domestic or international student numbers. Expansion of technology usage also drives demand for associated infrastructure such as data centres.

A flexible and mobiles society

The rise in flexibility and mobility is creating demand for self-storage as divorce rates and single person households rise (creating demand for more, smaller accommodation units) and our collective ability to buy ever increasing amounts of “stuff” outstrips the space to accommodate it in our homes.

ESG and decarbonisation

ESG and decarbonisation initiatives are driving development of renewable energy infrastructure **(see Deglobalisaton 3.0)** and encouraging capital flow into investments that generate a social as well as financial return **(see Impact Investing)**.

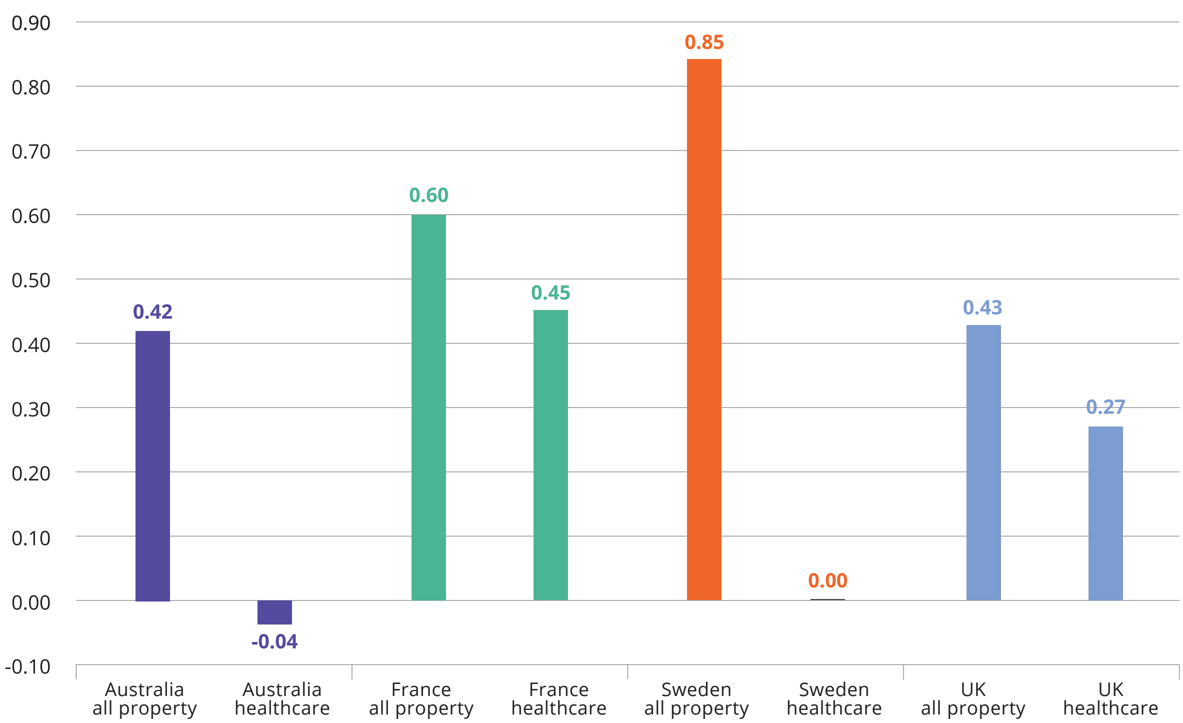
Risk and return

Not only do they have attractive structural demand stories, but their returns are in many cases either uncorrelated with the business and economic cycle – or are positively countercyclical. They thus serve as a good diversifier in a traditional real estate portfolio.

This isn't necessarily true for all operational sectors - hotels, for example, tend to be more volatile and closely linked to general economic activity. However, sectors as healthcare and senior housing are less affected by business cycle fluctuations, whilst student numbers tend to increase in a downturn. With fewer jobs available, people turn to higher education as a way to gain new skills and improve their future job prospects.[3] Self-storage could also be a countercyclical industry to the economy, as many renters are likely to downsize due to higher uncertainty of income/ fear of unemployment.

HEALTHCARE PERFORMANCE IS LESS CORRELATED TO THE ECONOMIC CYCLE

RETURNS CORRELATED WITH GDP GROWTH



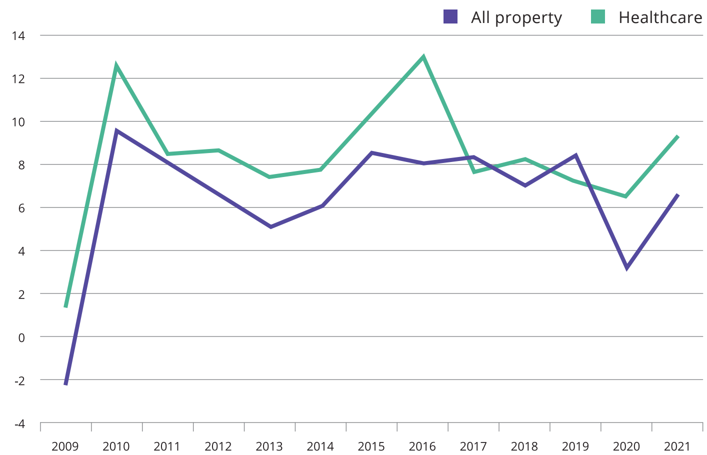
Source: MSCI, NCREIF

Despite limited data availability on operational real estate sectors, there is some evidence of out-performance vs traditional sectors. For example, in many countries the healthcare sector exhibits higher absolute and risk-adjusted performance relative to the market as a whole, with similar or higher performance and lower volatility in the majority of countries in the sample.[4]

AUSTRALIA
HEALTHCARE VS ALL PROPERTY PERFORMANCE
(TOTAL RETURNS)

Source: MSCI, NCREIF

FRANCE
HEALTHCARE VS ALL PROPERTY PERFORMANCE
(TOTAL RETURNS)

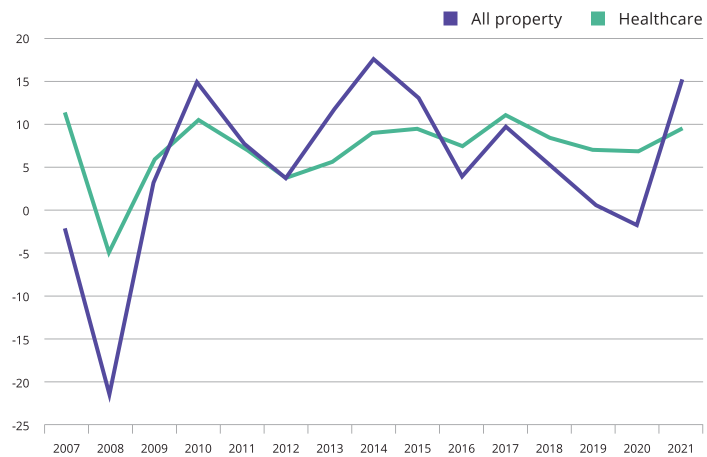


Source: MSCI, NCREIF

SWEDEN
HEALTHCARE VS ALL PROPERTY PERFORMANCE
(TOTAL RETURNS)

Source: MSCI, NCREIF

UNITED KINGDOM
HEALTHCARE VS ALL PROPERTY PERFORMANCE
(TOTAL RETURNS)



Source: MSCI, NCREIF

Return data for residential also suggests better risk-adjusted performance to all property, with similar or higher performance and lower volatility in the majority of countries in the sample.[4]

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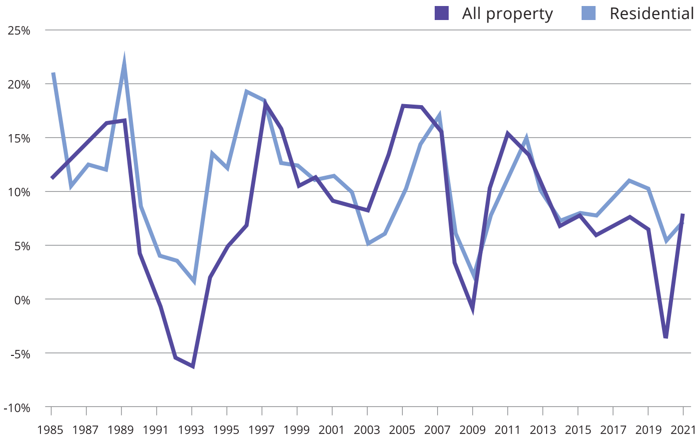
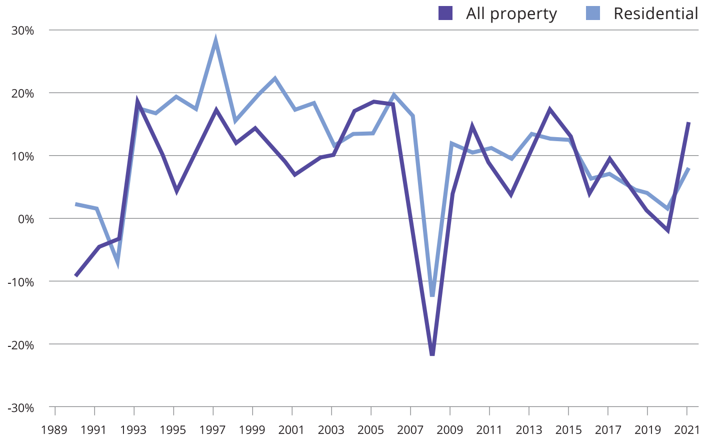
CANADA
RESIDENTIAL VS ALL PROPERTY PERFORMANCE
(TOTAL RETURNS)



Source: MSCI, NCREIF

U.K.
RESIDENTIAL VS ALL PROPERTY PERFORMANCE
(TOTAL RETURNS)



Source: MSCI, NCREIF

Structure matters

Overall, the performance characteristics of operational real estate investments depends heavily on the investment structure and operating model adopted, which in turn reflects the risk appetite and the operational expertise of the investor. Different models and structures require differing levels of investor involvement; the closer the investor is to the underlying business, the greater the return resembles an operational rather than conventional rental income stream:

Lease agreement

Model with separate real estate and operational entities, which can be very close to a "conventional" real estate investment.

Hybrid lease

Model where the investor participates to some extent in the operational income or profit of the operator (for example a retail turnover rent).

Management (or franchise) contract

Model where the operator manages the property on the investor's behalf. The investor is responsible for all operating costs and repairing liabilities, and receives a return heavily influenced by the operational performance.

Owner/operator

Model where the investor directly runs the underlying business.

Investing in operational real estate is inherently more complex than conventional sectors.

Investing in operational real estate is inherently more complex than conventional sectors, with the investment performance differing not only between sectors but also between countries depending on regulatory requirements as well as market depth and maturity in addition to conventional supply-demand issues. These sectors tend to be smaller and less liquid, and more fragmented which may be an attraction for smaller operators as opposed to larger institutions. On the other hand, higher levels of direct operational involvement requires specialist knowledge and often a larger in-house team, although even less direct approaches need internal expertise to evaluate opportunities and asset manage investments.

Horses for courses... but a growing field

Different aspects of the market therefore appeal to different segments of the real estate investment community. More fragmented, immature sectors requiring high levels of operational commitment and expertise are likely to appeal to smaller, niche operators – at least in the early stages. More institutional players may come in initially to provide development funding or equity capital, but then seek to build larger direct stakes when the market is ripe for consolidation and investment at scale can justify building – or acquiring – larger specialist in-house teams.

Whatever the approach, and even if they remain focussed on more traditional sectors of the market, real estate investors are increasingly being pulled closer to the underlying operational businesses that occupy the buildings that they own. That places greater emphasis on truly understanding the spatial and demographic dynamics of those businesses, with major implications for the use of data and analytics in strategic and tactical decision making – a topic we explore in more detail in relation to the healthcare sector in Doctor's orders.

[1] IPF Research Report, Operational Real Estate: Risk and Reward, February 2021
[2] Emerging Trends Europe Survey 2023, ULI and PwC
[3] Dellas, H. and P. Sakellaris (2003): "On the cyclicality of schooling: theory and evidence," Oxford Economic Papers, 55(1), pp. 148-172; Clark, D. (2011): "Do recessions keep students in school? The impact of youth unemployment on enrolment in post-compulsory education in England," Economica, 78(311), pp. 523–545; Barr, A., and S. Turner (2015): "Out of work and into school: Labor market policies and college enrolment during the Great Recession," Journal of Public Economics, 124, pp. 63-73
[4] Sample: Canada and US (1985-2021); UK (1990-2021); France, Germany, Netherlands and Sweden (2001-2021); Japan (2002-2021). Residential outperformed All Property in risk-adjusted terms in all countries in the sample, with the exception of the Netherlands, which has a high proportion of social housing. Source: MSCI, NCREIF