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**PREQIN GLOBAL
REAL ESTATE
REPORT**

Future-Proofing Core Real Estate

The pandemic has highlighted the rising importance of anticipating socioeconomic megatrends for fund managers to stay ahead

The abundance of risks to the world economy has underpinned the importance of future-proofing real estate portfolios. Even for relatively stable core assets, investment philosophies must look to the future rather than simply relying on what has worked in the past. Moreover, the COVID-19 pandemic has re-emphasized this need for an outlook that anticipates long-term socioeconomic trends.

Megatrends Are Here to Stay

While the pandemic has had short-term implications for most asset classes, it is unlikely to derail long-term strategies and may even accelerate some of the megatrends impacting society. For real estate in particular, demographic evolution, urbanization, and technology disruption will continue to have the most pronounced effects on the asset class.

The demographic evolution has reached a tipping point: by 2025, millennials will comprise 75% of all European employees. This cohort has a very different concept of living and workspaces, and a strong consciousness about sustainability issues such as the sharing economy, scarcity of resources, and climate change.

Although urban areas have been disproportionately impacted by the pandemic, the longer-term case for urbanization remains robust. By 2050, the urban share of population in Europe is expected to reach 82% – the same as in the US. Europe's cities have been incredible engines of economic growth, expanding considerably faster than non-urban areas in terms of GDP, employment, population, and the adoption of new technology. However, city authorities are generally unable to satisfy the needs of millennials and, increasingly, Generations Y and Z, who want most aspects of their lives to be contained within a single urban setting – that is sleeping, working, socializing, and shopping within a defined area.



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Part of this desire for convenience will be delivered through disruptive technology. Demand is rising for more flexible and adaptable buildings with smart technology such as air-quality sensors, energy tracking, and voice technology.

The Office Is Dead, Long Live the Office

These megatrends are likely to benefit certain real estate sectors – office, residential, and logistics – more than others.

Despite a retrenchment by workers from offices in 2020 and much speculation about working from home becoming the norm, the core office sector should not suffer long-term damage. The office environment will stay relevant and our base case is that many people will eventually go back to the office more often than not. Working from home can be efficient, but proximity to colleagues has its own efficiencies and important elements of teamwork, innovation, collaboration, and learning by example are lost.

However, office spaces will have to adapt. If employees are working from home for part of the week, larger commuting distances will be tolerated. More spacious common areas will be required for collaborative activities and hygiene-friendly, green environments will be at a premium.

Workspaces will remain an important part of the war for talent, increasingly aligning with workers' self-image and enhancing their sense of belonging – with design, layout, and location all reflecting their identity, as well as the brand and values of their employers. Proven micro-locations popular with workers and close to transport hubs will remain in high demand. As will up-and-coming locations, such as those close to the Crossrail project in London and those that have been developed to create new 'live, work, play' communities.

Demand Will Rise for Commercial Residential and Logistics

We have seen increasing demand for residential properties that offer outside space and room to accommodate home office working as a result of COVID-19. However, we believe the demand for small residential spaces will rebound, perhaps even stronger, as it is already being shaped by new lifestyles, including weekly or part-time commuters living far from cities and urban regeneration.

Micro and serviced living, adapted to the needs of targeted groups – such as students, young professionals, business travelers, and seniors – should provide stable income and support valuation growth. The increasing number of professionally managed micro apartments has already created a liquid and robust asset class.

Meanwhile, growing cities with high population densities are driving e-commerce growth, and the pandemic has only enhanced this trend. This dynamic in the logistics sector has created a need for more central urban logistics locations to reduce the costs of last-mile delivery. Similarly, there is rising demand for localized manufacturing to reduce dependence on long-distance imports, which requires greater diversification of manufacturing locations. Innovative logistics buildings such as multi-level warehouses are likely to proliferate as demand for urban industrial space grows.

ESG Is Key for Real Estate Investing

Overlaying these three real estate megatrends is a shift to ESG-aware investing. This applies to all asset classes and most institutional investors demand that asset managers both understand and can execute ESG integration.

For many occupiers, a building that does not meet certain standards will not even make it to the shortlist, thereby limiting its ability to generate revenues. Buildings with high ESG (and technological) credentials are more efficient, and therefore cheaper to run, which enhances returns. A building needs to meet all of the above criteria to make it an attractive investment for many institutions.

Stability and Liquidity

Taken all together, what can investors expect in terms of performance from a core real estate strategy based on the philosophy and processes described above? We think a target IRR, based on an allocation to offices, commercial residential, and logistics with a modest LTV, is around 5-7% a year. A stable income stream should be accompanied by targeting assets that also offer sufficient liquidity.

We believe this strong level of return is available to fund managers who are willing to hold an asset for the longer term and take a hands-on approach to managing both the asset and its tenant. Through open-ended funds with quarterly subscriptions, the strategy can be made available to a wider pool of institutions, providing them with both diversification and quality.

By investing in intrinsically high-quality investments in multifunctional locations it is possible to combine liquidity with attractive returns.

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