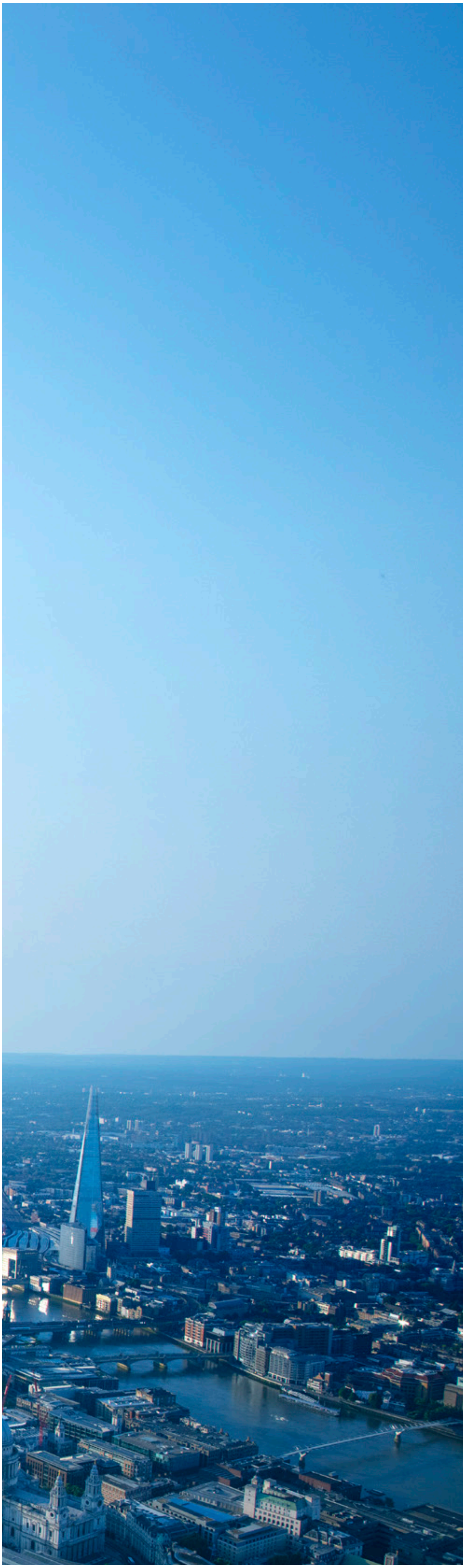
Tomorrow

Real estate takes the long view

2023



Contents

Taking the long view

Even in challenging times, real estate investors continue to have a strong degree of confidence in the future of the sector.

Welcome to our eleventh annual piece of real estate thought leadership.

A lot has happened since we began gathering data for our last report in March 2022 – when Russia's invasion of Ukraine was just two weeks old and the Bank of England base rate was 0.5%.

Inflation and interest rates have rocketed around the world. Global tensions have increased. Energy prices have soared and fallen. The Eurozone has slipped into recession. The UK has had three prime ministers. 'Normal' news – and good news – has often been drowned out by unprecedented headlines.

It's not surprising that many in the real estate market have been taking some time to reflect, to process these extraordinary events and to consider how the future is likely to unfold.

Against this background, we felt that our report this year should not only consider key short-term market issues but also look beyond them – to long-term yields, net zero targets, new technologies and fresh opportunities.

We knew that senior industry players would have plenty to say about their immediate concerns. But we also wanted their thoughts on the long-term prospects for real estate, and the changes the sector will see as we move into the second quarter of the twenty-first century.

Around the world, the opinions and choices of investors are crucial in shaping the wider market – indeed, it is hardly an exaggeration to say they shape the world we work and live in.

Gathering the views of 270 UK industry professionals and over 1,000 global institutional investors, we've found worldwide confidence in the fundamentals of real estate as an asset class.

There is a healthy degree of optimism about the mid to long term. There is enthusiasm about participating in the evolution of the industry. But there is also a pragmatic appreciation of the current state of the market, and issues around asset values and finance that are likely to prevail through 2023 and into 2024.

Investors are both upbeat and cautious, hopeful and reserved. As I write this, many are in a waiting game. But once there's an assessment that conditions are changing, a lot of energy – and money – stands ready to re-enter the market.

Until then, there are still some deals to be done, investment strategies to be shaped and assets to be managed. As Chiang Ling Ng of Hines reminds us (on page 22), even challenges such as the resetting of commercial loans and steps on the journey to net zero can be "flipped to opportunity".

The investors with the most considered long view are often also those with the smartest short-term perspectives.

Clare Thomas
Real Estate, Partner, CMS UK

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The big picture

Despite a difficult year and an uncertain outlook, we found strong underlying positives among investors globally.

88% said that real assets are a **good investment** in the current global economic climate.

87% believe that the **current correction** in real estate value offers a **good buy opportunity**.

61% expect the **annual returns** on their assets to **increase** over the next five years, with another 21% anticipating broadly similar returns.

Every real estate **asset class** appeals to a **significant majority** of global investors.

Long-term convictions, short-term tactics

But our respondents also cited a number of anxieties and headwinds. In the words of M&G's Jing Dong Lai (see page 6): "uncertainties over inflation, interest rates and recessionary risks have affected real estate values globally."

Although a large majority of investors say that the correction in real estate value offers a good buy opportunity, it is clear that most believe the correction is still in progress.

So while they are optimistic about the long term, they are cautious in the short term – a stance that accounts for many of the deal levels and valuations seen in recent market data.

Many would echo Jay Kwan of QuadReal, on page 11: "Our … long-term convictions in real estate haven't changed, but our short-term tactics have … evolved to meet our view of the market today."

Finance is a key concern for nearly all the investors we polled, with 95% concerned about **interest rates**.

Most investors (87%) also expressed concern that the instability of global banks might make **access to capital** more difficult.

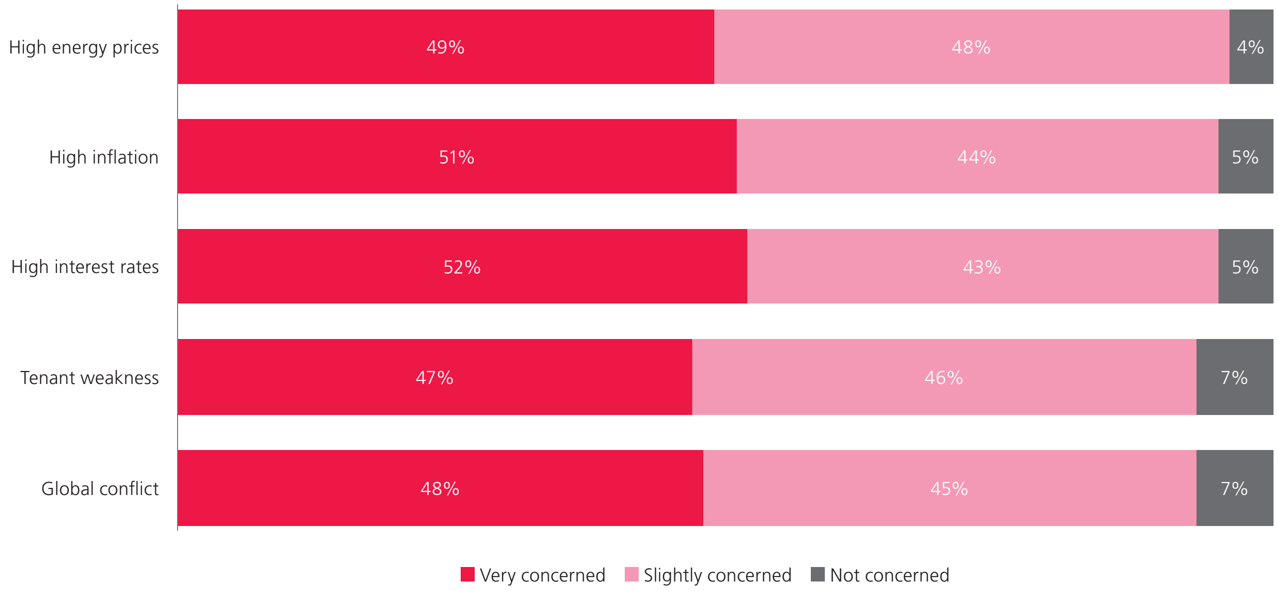
Unless such instability becomes systemic, its impact will probably be limited to a small number of institutions. A bigger issue may be the reaction of other banks to such instability, as they attempt to strengthen their loan books.

But there are other threats to real estate finance (as we explain more fully on page 21). Issues around refinancing and access to affordable debt are likely to become increasingly pressing for the rest of 2023 and across 2024. Probable consequences include an increase in the forced sales of property, more businesses searching for additional equity, and a growth in the number of owners in distress.

Says CMS partner Jules Needleman: "With interest rates at a 15-year high, and probably heading higher, over the next couple of years I expect to see some forced sales as investors struggle to afford refinancing options.

"There are already signs of this in the US, with increasing reports of defaults and of assets being sold at significant discounts. And while there are undoubtedly specific US factors at play, it is also clearly a warning of what could become a major problem in other markets, causing valuations to fall still further."

How concerned are you about the following, in relation to your real asset portfolio?*



Other headline concerns

Unsurprisingly, current rates of **inflation** are another major concern, with 95% of investors worried that they will have a long-term impact on their portfolios. Over half (51%) of investors describe themselves as "very concerned".

High **energy prices** worry 97% of investors, with half (49%) saying they are very concerned. Wholesale energy prices have fallen drastically since their highs in 2022. But with typical prices still significantly up on their levels two years ago, occupiers and others may still be affected – especially as contracts expire and new deals have to be negotiated.

The substantial fall in energy prices is also of no immediate benefit to businesses that signed contracts on the basis of the high prices prevailing in 2022.

One knock-on effect of the recent high energy prices – and of financial stresses generally – has been heightened **tenant weakness**. Most investors (93%) are concerned about this, with 55% having seen an increase in tenant failures in the last year. Numbers are particularly high in Asia Pacific, where 73% report a rise. We look at this in more detail on page 20.

Global conflict is also a concern for 93% of investors, with 48% "very concerned" about it. Many will be at least as anxious about how such conflict could affect supply chains, energy prices and the wider economy as they are about its direct impacts. But investors are also aware that if conflicts or potential conflicts reshape the market for real estate assets – e.g. if reshoring, driven by security and supply chain concerns, increases the demand for industrial or logistics properties – they will bring opportunities as well as challenges.

*As a consequence of rounding, data totals do not always equal 100%.

Interview

Jing Dong (JD) Lai
CEO and CIO, M&G Real Estate Asia

How has M&G's appetite for the real estate sector in Asia evolved in the last 12 months?

In the last 12 months, uncertainties over inflation, interest rates and recessionary risks have affected real estate values globally. But as yields stabilise, M&G believes assets will reflect an attractive long-term value opportunity.

Investors' appetite for real estate in Asia has increased, as the region's performance clearly contrasts with that of Europe and the US. The prospects of creating the next best vintage of investments will improve after repricing.

Which sectors does M&G favour in Asia and why?

Many parts of the market benefit from structural drivers supporting prospects for income and growth, giving investors inflation protection in the coming years.

We like the private residential rental sector in markets backed by positive demographic and immigration trends, continued affordability constraints and encouraging regulatory changes.

Modern logistics will do well as demand remains healthy, underpinned by new online shopping habits formed during the pandemic. Global manufacturing and supply chains are shifting as countries seek to improve resilience and diversification, and this would also provide a boost to certain logistics markets.

Which Asia cities does M&G favour and why?

Each Asia Pacific market has different economic structures and unique market fundamentals. This gives us opportunities to diversify our exposure and tap into the value proposition offered by individual markets.

For example, Singapore is a gateway hub for Asia Pacific and Southeast Asia. Meanwhile, Australia is characterised by high population inflow and high levels of transparency. Japan is emerging from three decades of deflation and we expect the change in wage growth, inflation expectations and mindsets to drive sustained economic growth over the coming decade.

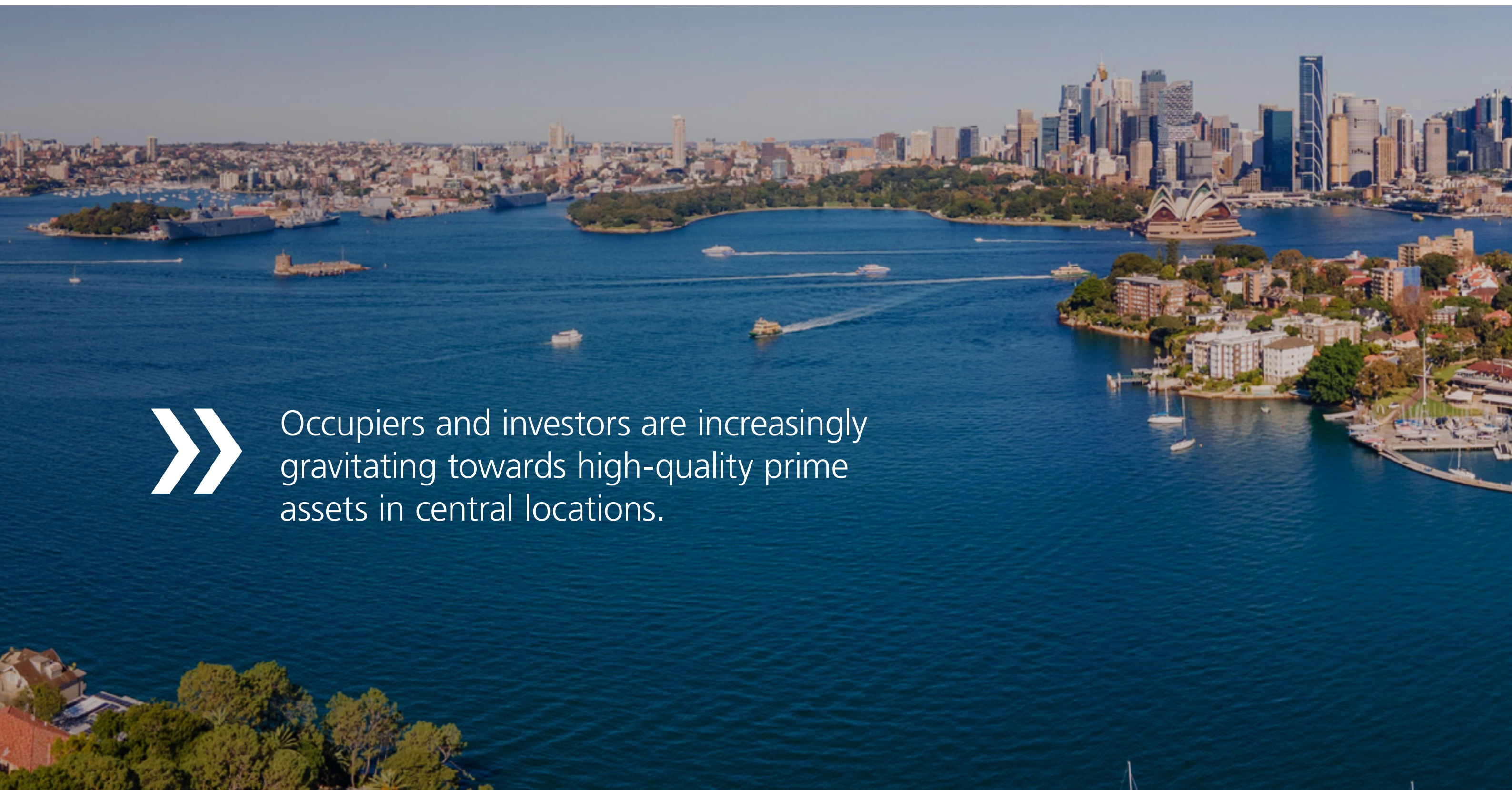
What do you see as the biggest opportunities and concerns in Asia over the next year?

Opportunities

Private residential rental

Japan's multi-family sector has remained resilient through the pandemic, with stable demand for inner-city living in cities such as Tokyo and Osaka driving the potential for further rental growth.

Australia's build-to-rent market is positioned to mature over the medium term, backed by positive demographic fundamentals, high home prices in major cities and favourable regulatory changes.



Besides Japan and Australia, South Korea also looks interesting. Home prices in Seoul doubled between 2017 and 2021 but transactions and prices are correcting sharply due to rising interest rates. This could open up opportunities for investors to seed the growth of an institutional multi-family sector, potentially in partnerships with local developers.

Modern logistics

Markets with limited supply of modern industrial stock, such as Osaka and Fukuoka, could offer a resilient long-term investment opportunity. The reshoring of strategic production chains for resilience and diversification could benefit the logistics market in Japan, in addition to increased demand from the growing e-commerce sector.

Concerns

We are cautious on older offices in secondary locations. While working patterns is not a huge risk in most APAC markets, occupiers and investors are increasingly gravitating towards high-quality prime assets in central locations. That could increase the risks of obsolescence and underperformance for secondary assets that typically lack green credentials and are in weaker locations.

Another area of concern would be South Korea's logistics. The volume of incoming logistics facilities completed in 2023-24 could double the existing stock. As credit conditions have tightened sharply in South Korea, some developers may face refinancing issues. Asset valuations are now significantly lower than their underwriting as borrowing costs are much higher. Assets in sub-markets with severe oversupply or poorer quality assets are likely to trade at higher yields. Investors will be able to demand increased risk premia and enter the market at an attractive price point.

What returns does M&G anticipate making from real estate over the next year and the next five years?

This varies depending on the strategy and risk profile.

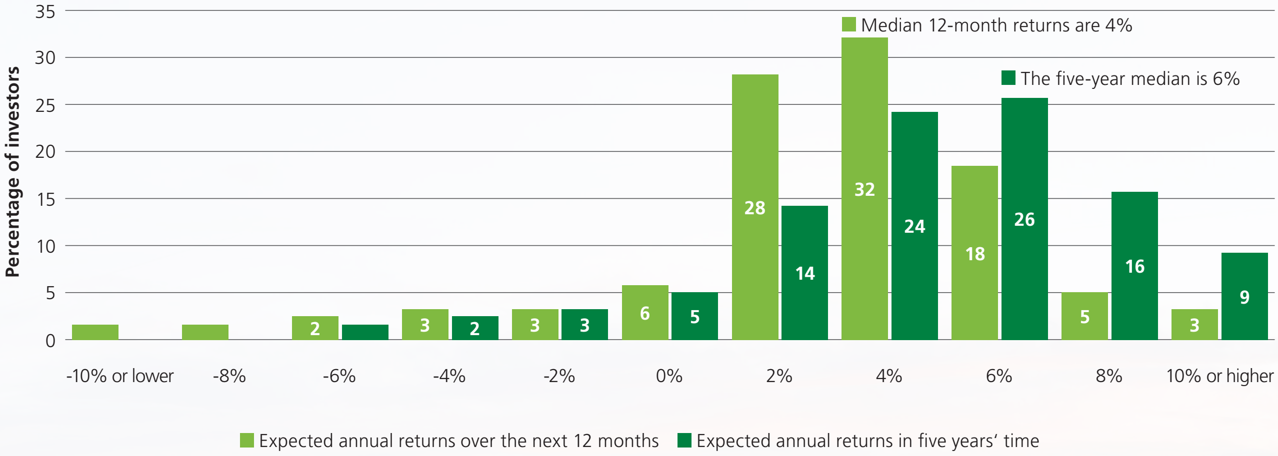
What is M&G's approach to ESG?

Responsible investing forms a huge part of M&G's investment process. As a business, we have committed to carbon net zero by 2030 and as an asset owner and manager we are committed to managing carbon net zero investment portfolios by 2050.

We have had a dedicated Responsible Property Investment team in place for the last 15 years. In 2021, we achieved Green Star status for 10 funds in the Global Real Estate Sustainability Benchmark (GRESB) survey and retained our A rating in the Principles for Responsible Investment Real Estate.

Returns

On average, for the real assets in your portfolio, what do you expect the annual returns to be over the next 12 months and in five years' time?



Global investors are generally positive about the outlook for returns in the medium to long term.

The median expectation for returns in five years' time is 6% – a significant improvement on the average of 4% that investors anticipate over the next 12 months.

Actual results will of course vary between asset classes, and many investors will hope for annualised returns a little higher than 6%. But this is a broadly encouraging figure. It highlights investors' long-term confidence in real estate as an investment proposition and their rejection of some of the gloomier recent predictions of the sector's future.

Interview

Paul Clark
Head of European Property, AustralianSuper

How has AustralianSuper's appetite for the real estate sector evolved in the last 12 months?

We're more cautious and conscious of the mismatch between valuations and prices.

We continue to focus on achieving stable long-term income by finding attractively priced investments benefiting from the structural changes driving demographics, digitisation and placemaking, underpinned by limited land supply, restrictive planning and deep pools of talent.

Which sectors does AustralianSuper favour and why?

We believe in the future of cities and look for pockets of genuine underlying value growth, particularly: major mixed-use, city-centre development and investment; pan-European logistics and industrial; and the living sector. In all cases we're focused on opportunities with the right location, scale, commitment to quality and sustainability.

We believe that investing in large-scale, high-quality assets benefiting from underlying structural drivers will deliver superior returns for members over the long term.

Which world cities does AustralianSuper favour and why?

Not every city in the world can offer the kind of large-scale investment opportunities we're seeking. We have invested in London and are examining cities like Berlin, but the exacting nature of our criteria focuses the locations where we believe the best opportunities lie.

What returns does AustralianSuper anticipate making from real estate over the next year and the next five years?

Our investment horizons go beyond five years. Essentially, over the life of an investment we're aiming to deliver income and capital appreciation to the fund's members.

What is AustralianSuper's approach to ESG?

We have a strong focus on asset decarbonisation, underpinning long-term scale investments as regulations tighten, encouraging industry change. ESG sits at the heart of the fund's investment assessment processes, and it is an engaged owner.

What do you see as the biggest opportunities and concerns over the next year?

Repayments, refinancing and repricing are presenting significant challenges across the market – not least to lenders – and will continue to do so.

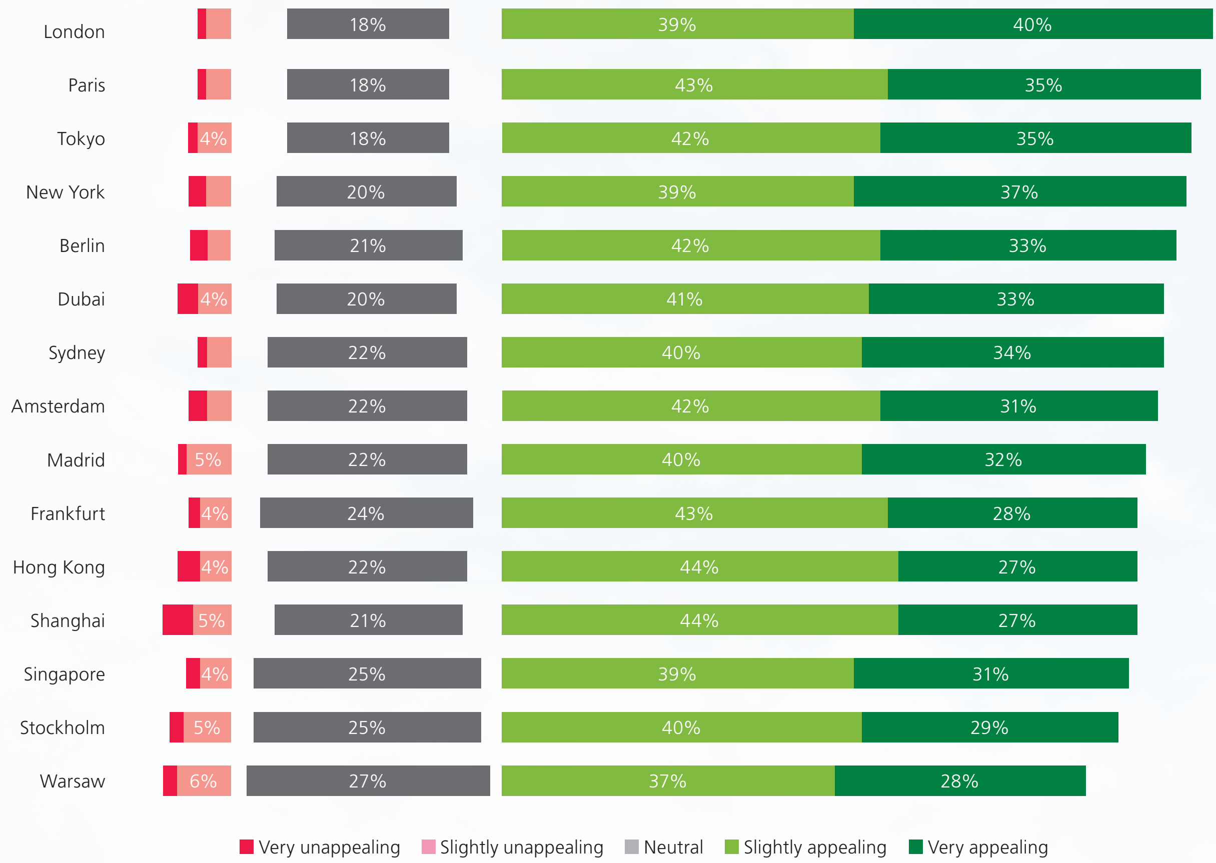
In this environment there will undoubtedly be attractive opportunities for well-capitalised investors, like AustralianSuper.

The one issue that will impact us all is climate change and in particular the net zero carbon agenda – it's a central tenet of our investment and portfolio management processes.

In this environment there will undoubtedly be attractive opportunities for well-capitalised investors.

Global cities

How appealing are these global cities for real estate investment?



As our chart shows, the genuinely 'global' cities remain the most appealing (albeit by slim margins), with the top four slots going to London, Paris, Tokyo and New York.

One piece of long-established real estate wisdom is that investors tend to default to major cities in times of uncertainty. Flight to quality is a natural reaction to economic stress, as is the inclination to fall back on tried and trusted locations and asset types. In the current climate, stability is a highly prized quality, and global cities offer robust long-term prospects that may be hard to find elsewhere.

London's position at the top of our table is also a natural curtain-raiser for our UK-focused material, which begins on page 12.

Interview

Jay Kwan

Managing Director, Head of Europe, International Real Estate, QuadReal

How has QuadReal's appetite for the real estate sector evolved in the last 12 months?

Our specific long-term convictions in real estate haven't changed, but our short-term tactics have appropriately evolved to meet our view of the market today. We have sharpened our focus even more in three ways – to focus on the threads of demand that drive cash flows and whether they will outperform inflation, to closely assess current and future supply risks, and to assess the relative attractiveness of an entry point in any investment.

Which sectors does QuadReal favour and why?

In general we don't find entry points to be particularly compelling. In fact, many return indicators point to UK industrial having outperformed all other European sectors in the first quarter 2023. It's still very early days, but it does beg the question whether now is an attractive point to re-enter that sector.

We further have a strong conviction in the living sectors in the long term, but we're going to observe cap value movements in the short term before we decide to re-enter the market in earnest.

Which world cities does QuadReal favour and why?

That's a very broad-based question, as it depends what sector we're considering.

We remain constructive on London as a global city in the long term and will continue to be active in its residential and logistics sectors. Both enjoy a favourable supply and demand imbalance, as well as high barriers to entry for more stock to be built.

We also continue to focus on the world's most economically powerful centres and their environs – New York, Los Angeles, Paris, Toronto, Vancouver, Tokyo, to name a few. They provide the best opportunity to invest in industrial, residential, office and the alternative sectors and provide strong, stable long-term returns. We are committed to helping build communities, where people live, play and work.

What returns does QuadReal anticipate making from real estate over the next year and the next five years?

While short movements in price are an important measure to track, we base our investment decisions on an asset's long-term intrinsic value.

When we buy real estate, I want to know how that property will have performed in 10 years' time and beyond, not what its short-term market to market movements will be.

What is QuadReal's approach to ESG?

As part of QuadReal's commitment to being a responsible company, we are involved members of the communities where we invest and we believe in advancing ESG through our actions. QuadReal's entire team is dedicated to integrating environmental, social and governance practices into the company's core activities, including corporate, global real estate debt and equity due diligence, investing activities, and management. We take a systematic approach to understanding our ESG responsibilities – identifying and prioritising our biggest levers for positive change.

In 2022, QuadReal committed to an accelerated target to reach net zero carbon by 2050 across its global portfolio. And we hold ourselves accountable by benchmarking our success through the Global Real Estate Sustainability Benchmark (GRESB). We were ranked first in the Americas for real estate in 2022, and fourth globally.

What do you see as the biggest opportunities and concerns over the next year?

There are always challenges and opportunities in the market, and today is no different. There are material debt maturities coming due in the next five years – more than the five years after the Global Financial Crisis. We established credit investment capabilities in 2022 to capitalise on those opportunities, as such maturities become a catalyst to reset overall market pricing.

We also see opportunity where there is indiscriminate sell-off, where entire sectors fall below long-term intrinsic values.

Fundamentally we need to incorporate being a value investor in addition to being a growth investor; being a situational investor alongside being thematic; and to advance the capability to be a credit investor while awaiting the right moment to continue our equity-based strategies.

The view from the UK

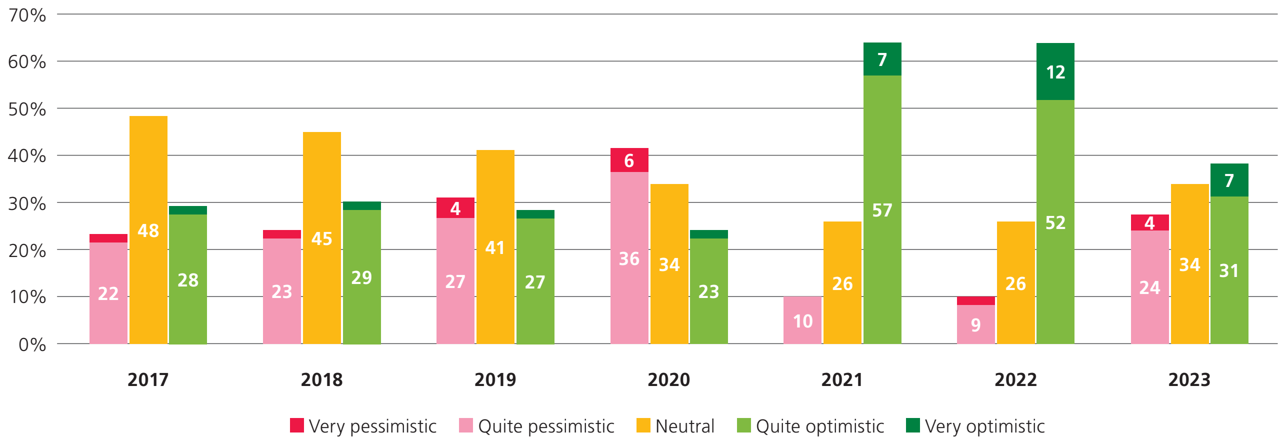
Every year we ask a cross-section of leading UK real estate professionals for their views on the market.

This year we polled 270 experts, including 62 investors and 54 developers. In many ways they share the outlook of the global investors we surveyed, with long-term confidence tempered by short-term concerns.

Overall, 38% reported feeling optimistic about the market, while 34% describe themselves as neutral and 28% are pessimistic.

Although positive, this take on the market is unsurprisingly more cautious than the one we found 12 months ago, with sentiment falling back to levels last seen at the beginning of the pandemic as the more bullish outlook of the past two years recedes.

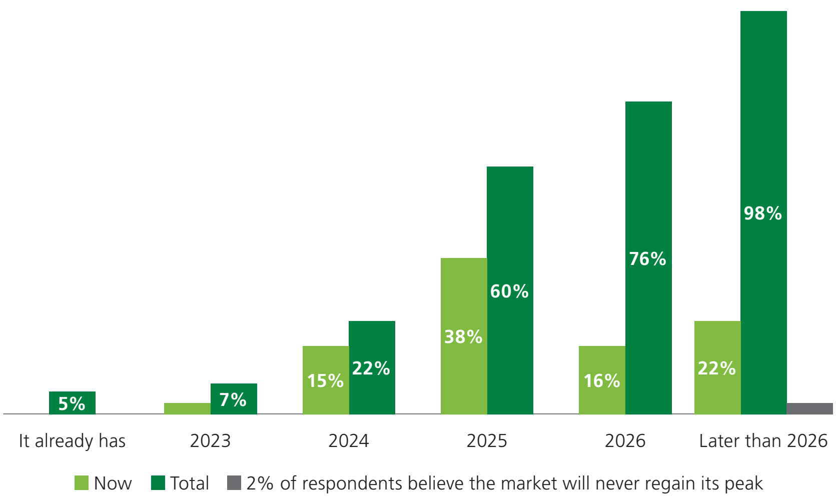
How optimistic or pessimistic do you feel about the UK real estate market in the short term?



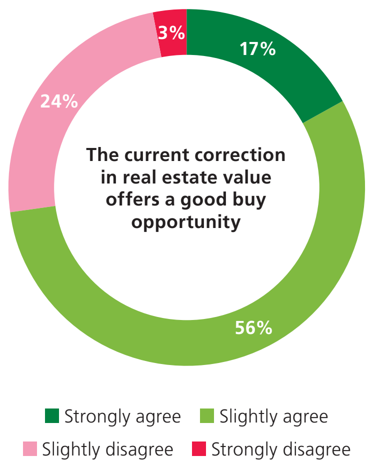
Just over three-quarters (76%) of those we polled expect the UK investment market to recover to its last peak by the end of 2026. A similar number (73%) believe the current correction in values is a good buy opportunity.

But as the chart on the next page shows, most also continue to have concerns about inflation, higher interest rates, the cost of living and the instability of global banks.

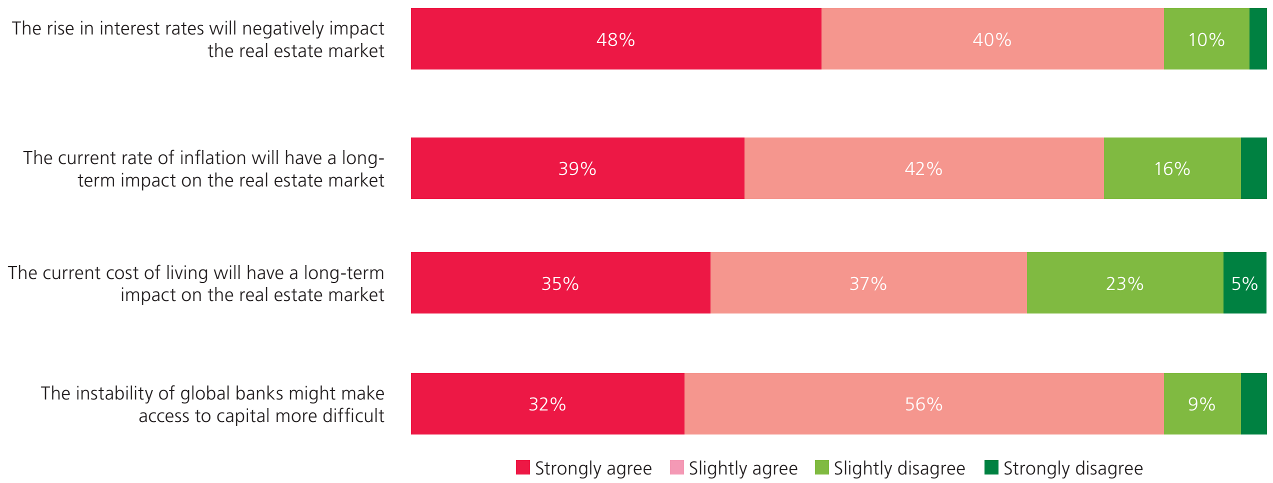
When will the UK real estate market recover to its 2019 peak?



The current correction:
What do UK investors think?



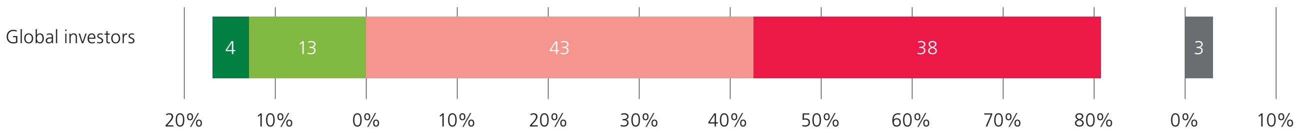
Headwinds: What do UK professionals think?



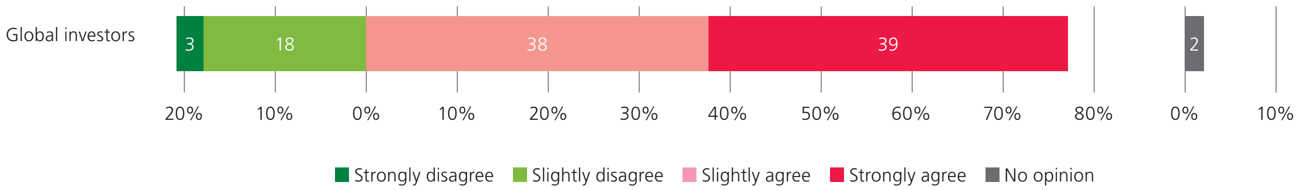
Our finding that 87% of UK professionals think the last few years of fluctuating, politically-driven reform proposals have had a negative effect on the industry is a reminder of the impact that turbulence in Westminster can have on the UK's real estate market.

In a similar vein, most global investors (80%) say that the UK's recent political dramas have made them reconsider investment in UK property. Over three-quarters (77%) believe Brexit has disincentivised international investment into UK property (as do 73% of UK professionals).

Global investors: Do you agree or disagree that the UK political changes of the past year have made you reconsider investment in UK property?



Global investors: Do you agree or disagree that Brexit has disincentivised international investment into UK property?



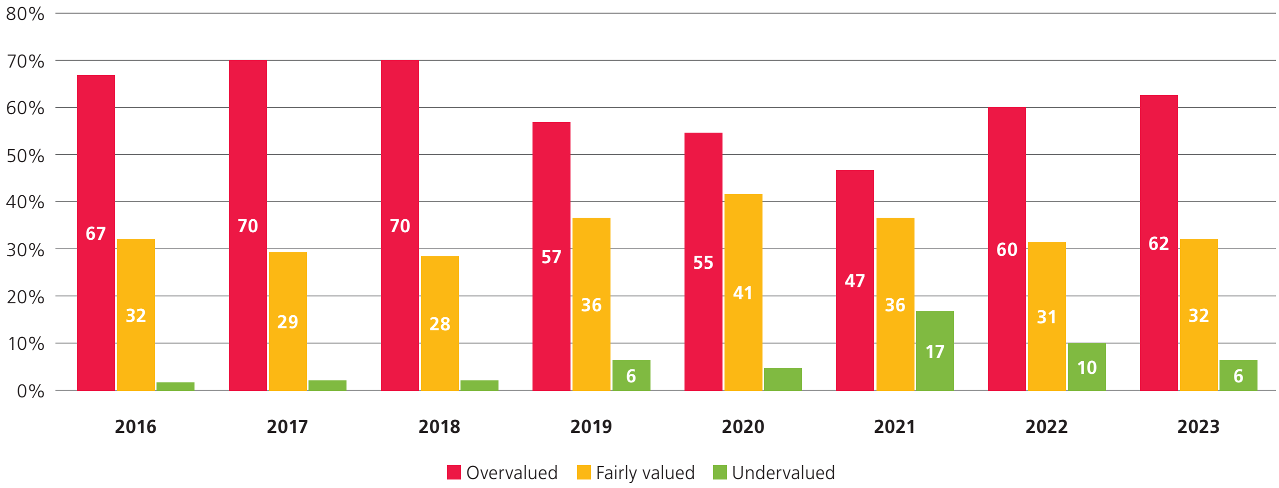
London

The majority of UK real estate professionals continue to believe that London is overvalued. As our chart shows, this is very much business as usual.

Over the past eight years, only 2021 – when investors began to wonder what a post-covid market might look like – has challenged the status quo. Even then, what we saw was only a significant narrowing of the gap, not a reversal.

In this year's polling, 62% of our respondents feel London is overvalued, as opposed to 6% who believe it is undervalued. These are the most bearish numbers we have seen since pre-Brexit days.

What is your current view of the London real estate market?



Yet, as we highlighted on page 10, London remains – albeit by a whisker – the top global city for international investors, with 78% classing it as appealing (and 40% finding it very appealing). Many who believe it is overvalued still want to have prime London property in their portfolio. And the price correction already seen in London markets is clearly enough for some investors, even though analysts tend to argue that deal volumes overall won't start to tick up until we near the end of of 2023.

As CMS real estate partner John Cumpson says: "Although transaction volumes in London are down, there is still life in the market. In addition to some opportunistic trades, there's a continuing interest in high-quality assets, particularly as tenants are increasingly demanding buildings with the latest facilities and strong green credentials. Deals such as Munich RE's co-investment into 120 Fenchurch Street and Tik Tok's pre-letting of 140,000 square feet in Farringdon, both of which we advised on, clearly demonstrate the resilience of the capital."

Though nearly three-quarters (73%) of UK professionals believe Brexit has disincentivised international investment into UK property – a view which most global investors, especially those from Europe, share – it's clear that there's still plenty of life in London.

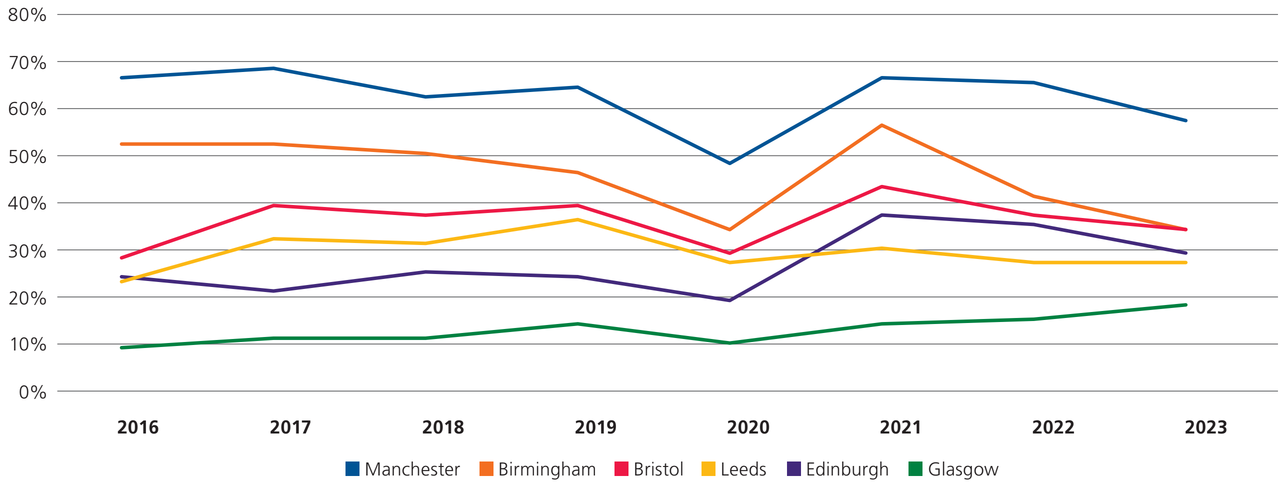
> There's a continuing interest in high-quality assets, particularly as tenants are increasingly demanding buildings with the latest facilities and strong green credentials.

Other UK cities

Looking at the rest of the UK, Manchester still remains on top of our ranking of regional cities, popular with 58% of UK professionals.

Our chart shows how the gap between Manchester and the 'chasing pack' of regional cities has increased, with the pack converging at a lower level of appeal – remaining significant options, but perhaps also reflecting a tendency to look to core locations and assets at times of greater instability.

Which of these 'big six' regional cities are particularly appealing as investment prospects?



The unsung hero here, though, may be Glasgow. While still the last among our six cities, it is the only one to have followed a steady upward trend since 2016. The gap between Glasgow and Manchester, 57 percentage points in 2016, has shrunk to 39 points.

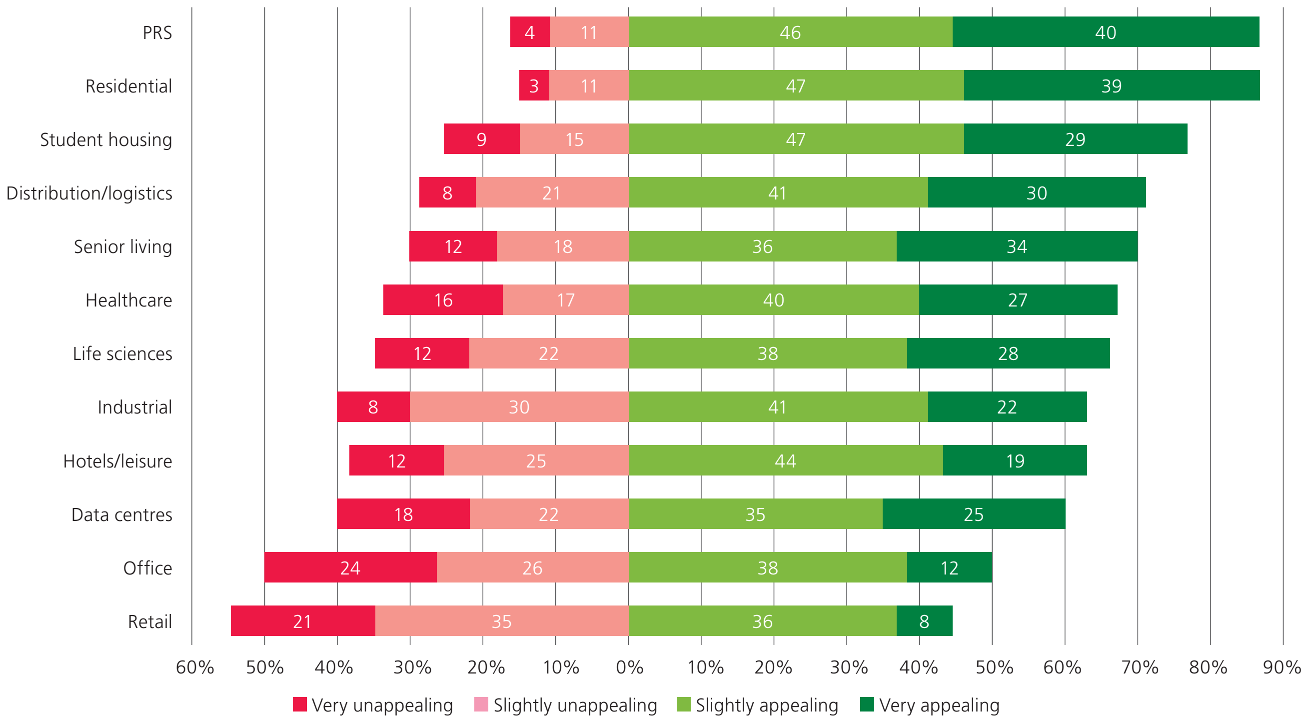
Says CMS Glasgow partner Chris Rae: "Glasgow has significantly narrowed the gap with table-topper Manchester. Indeed it's often compared with Manchester, not least because of their strong transport links and top-tier talent pool. It does suggest that there are great opportunities yet to be explored in this dynamic city."

» Glasgow is often compared with Manchester, not least because of their strong transport links and top-tier talent pool.

Asset classes

Given the strong demand/supply imbalance, it is no surprise to see 'living' asset classes take the top spots when professionals are asked which sectors they favour.

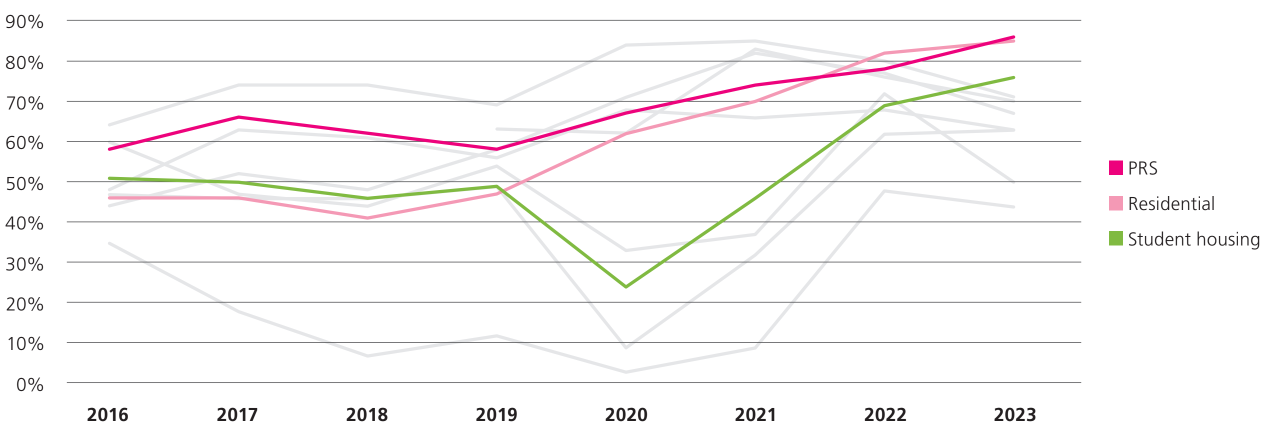
UK professionals: How appealing are following asset classes?



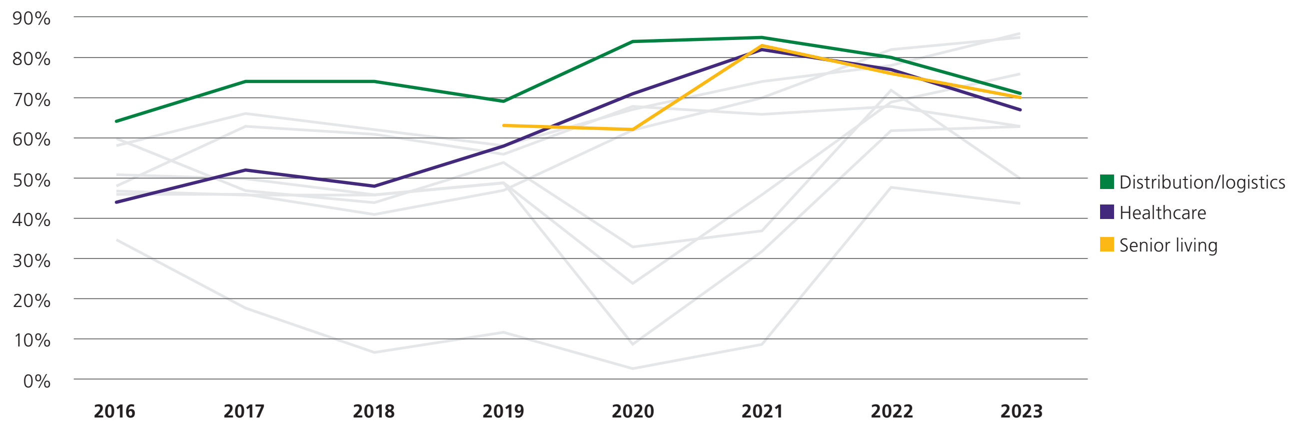
The **private rented sector (PRS)** has come out on top this year, inching ahead of **residential**, which topped last year's table. **Student housing** has recovered from its dive in the early days of the pandemic to secure its highest ever score this year.

For CMS partner Tanya Francis, these results highlight the strength of living asset classes generally. "The demand across the sector continues to outstrip supply, which naturally feeds into the appeal of the living asset classes to developers and investors. Seemingly, even in an

Appeal over time: PRS, residential and student housing



Appeal over time: distribution/logistics, healthcare and senior living



economy struggling with a 'cost of living crisis', many occupiers still prioritise high-quality accommodation in the right location and with the right amenities.

"This is coming through across the whole of the living sector, from student accommodation to senior living, with standards increasing across the board and our clients report strong sales, lettings and high occupancy levels."

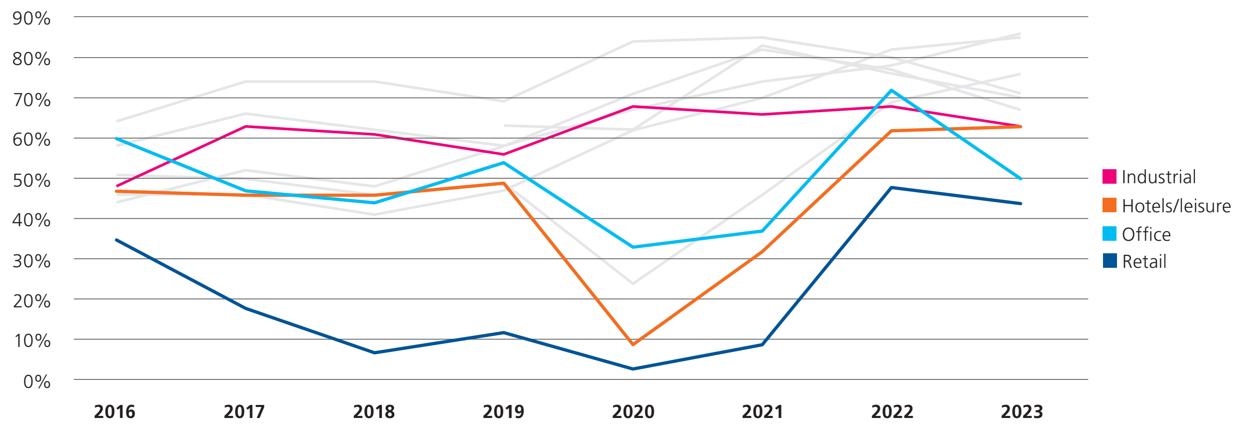
Distribution and logistics, healthcare and **senior living** all show a slight downward trend while remaining strong. So does **life sciences**, a recent addition to our poll. Their underlying strength is not surprising, as all are positioned to benefit from secular demographic trends; their current mild slide may partly reflect the fading of various pandemic-related boosts.

Hotels and leisure properties have been on a rollercoaster ride. Badly hit by covid, which saw them plunge to a point near the bottom of our table, they now look to have recovered and stabilised, this year achieving their best ever score in our survey – ahead of **data centres**, another new addition, and only narrowly behind the much more historically successful **industrial**.

By contrast, last year's **office** popularity seems to have been a blip – possibly reflecting a rush of enthusiasm at the first signs of a post-pandemic return to the workplace. Office appeal is now back in its pre-covid ballpark.

Retail has been propping up the bottom of our survey since 2016. But while it still ranks last, it has recorded its second strongest appeal in eight years, after 2022's record high. Factors include a partial return to the high street and the mall, with online shopping levels rebalancing as covid eased.

Appeal over time: industrial, hotels/leisure, office and retail



Global investors: how appealing are the following asset classes?

Global asset classes

The global ranking of asset classes looks significantly different from our UK ranking – a reminder of how diverse the world's real estate markets can be.

Seen from a global perspective, every real estate asset class appeals to a significant majority of investors. Differences in levels of sentiment appear less substantial across a broad international canvas than they do locally.

One thing both our global and UK data show is a relative lack of enthusiasm for offices. They topped our global ranking in 2020, when fully 50% of investors found them "very attractive". But now only 30% see them that way.

This is clearly connected with the rise of hybrid working: 90% of global investors believe the lives of office workers are now a blend of centralised offices and remote working, with 85% agreeing that office workers spend more time working at home than they did five years ago.

The implications of this change will take time fully to unfold. There are already indications that we are seeing the evolution of the 'destination office': a high-end property that is as much a social hub and learning and ideas centre as it is a traditional workplace. And at the other extreme, as discussed below, we are seeing a marked growth in the number of old office buildings being repurposed.

Changing places

In 2022 we found that almost a third of industry respondents planned to repurpose retail to housing, while a quarter were aiming to convert offices to housing. This year, there are signs that the trend is growing.

While out-of-town retail is doing relatively well in traditional terms, some of the demand for retail in towns and cities – especially for secondary properties – appears to reflect its potential to be repurposed for residential and other uses.

Earlier this year, research from trade body Revo and Lambert Smith Hampton suggested that up to 40% of high street shops would need to be repurposed over the next five years, as demand for that type of retail slows.

Another recent report, from CBRE, also suggests that a significant number of central London secondary office deals are now being undertaken by buyers who see an opportunity to convert the properties for new uses.

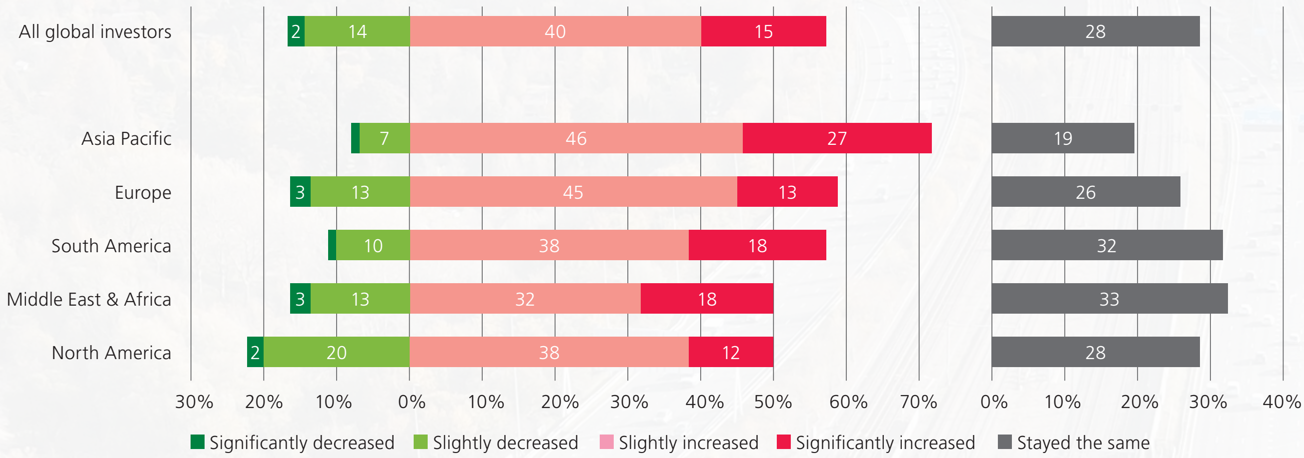
Offices whose prospects may have been increasingly uncertain in the new era of hybrid working are being reborn as hotels, student housing and apartments.

Such projects are not without risk – including planning issues, and the need to comply with tougher environmental regulations – but offer hope for buildings that might otherwise be in danger of becoming stranded assets.

In the bigger picture, they also offer hope for urban regeneration, and creative solutions to some of the problems that afflict many town and city centres.

Tenant failure

How has the frequency of tenant failure in your portfolio changed in the past 12 months?



The vast majority (93%) of global investors are concerned by tenant weakness, with 47% very concerned.

This corelates with the fact that, as our chart shows, over half (55%) have seen an increase in tenant failure in the last year. Numbers are particularly high in Asia Pacific, where nearly three-quarters of investors (73%) have seen an increase.

According to CMS partner Danielle Drummond-Brassington: "In times of economic uncertainty it is inevitable that we see tenant failures or tenants seeking to restructure deals to alleviate some of the financial pressure they are under. The increase in tenant failures that were expected post pandemic has been delayed, and is only now really ramping up as the withdrawal of government financial support bites."

Finance

There is general agreement that, in the short term, financing is getting harder – with 70% of UK real estate professionals believing it will become more difficult to access debt over the next 12 months.

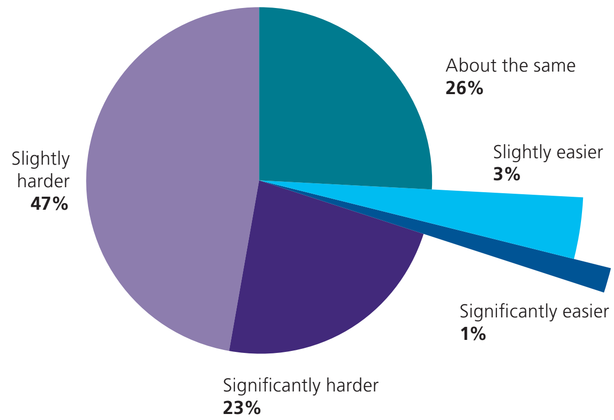
As the bar chart on the right shows, the most widely anticipated impacts of a restriction in the flow of debt are forced sales of property (60%), injections of additional equity, (53%) and a growth in the number of owners in distress (48%).

Even where debt is available, businesses may struggle to find it on acceptable terms. In the current environment, the cost of borrowing will be a problem for a growing number of real estate players. Investors who enjoy access to capital at favourable rates are likely to have a significant advantage, just as they have in similar markets in the past.

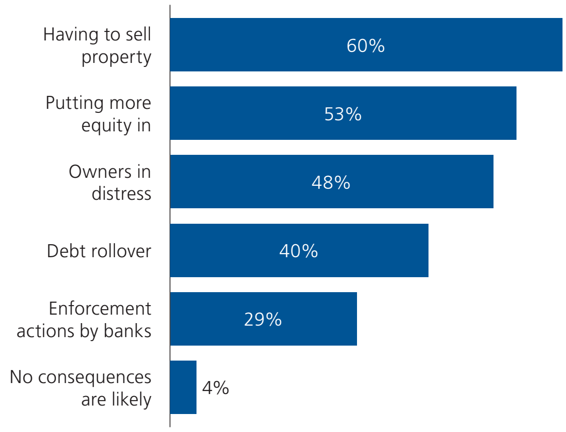
The current climate may also prove to be a fertile one for non-traditional lenders. As CMS real estate finance partner Rob Whiddett says: "The continuing uncertainty in the sector could lead to a higher cost of capital for the traditional bank lenders, which would increase margins and – when added to a lower risk appetite – may provide an opportunity for alternative lenders. We have also noticed that alternative lenders' speed of execution gives them an advantage over banks in certain circumstances."

A decade ago our research highlighted the growth and diversification of non-bank lending in the aftermath of the Global Financial Crisis. Some sources suggest that it now accounts for over a quarter of the UK's commercial real estate debt market. There is every indication that it will grow still further over the next few years.

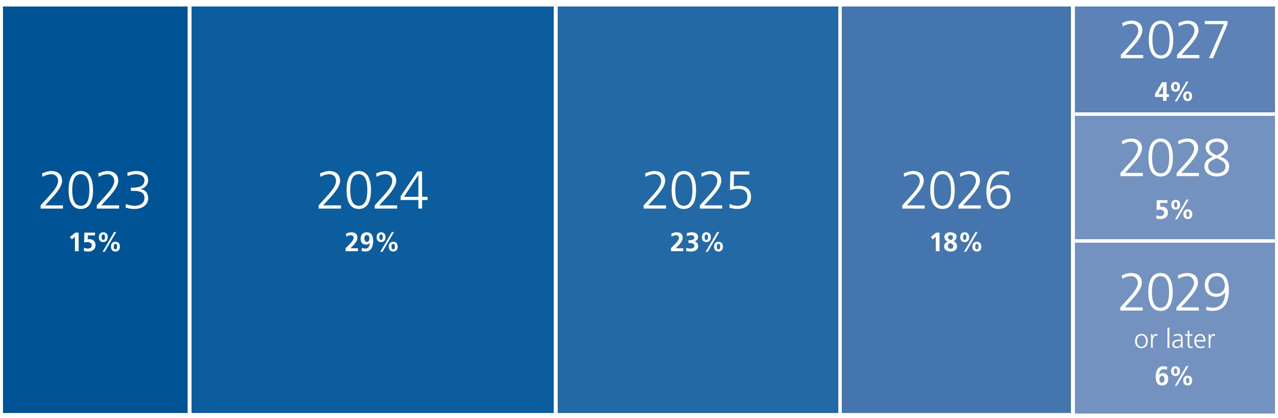
How hard will it be to access debt this year?



What are the likely consequences of current refinancing in real estate, as a result of debt issues?



When is your next significant refinancing? (UK investors and developers)



Interview

Chiang Ling Ng
Chief Investment Officer, Hines Asia

How has Hines' appetite for the real estate sector evolved in the last 12 months?

As a real estate investment specialist, we clearly have a long-term conviction for the sector which has a proven track record as one of the most resilient asset classes. In the current climate, we are finding our integrated operating platform is proving invaluable in providing hands-on management at asset level. This enables us to not only protect our investments, leverage income generation and drive value, but also gives us flexibility and agility in responding to a fluid and rapidly evolving market.

Which sectors does Hines favour and why?

We are active across all the main sectors and focus on sustainability, which enables us to piece together different components for all investments. Regarding mixed-use, we take a holistic approach in integrating work, living, retail and leisure spaces to best meet the needs of the communities in which we are operating. The common thread running through all our projects is putting people and their needs first.

Which world cities does Hines favour and why?

In Asia, our focus is on the key gateway cities which offer good and growing investment in infrastructure, a large and expanding population bringing demand for real estate. We follow a data-driven approach to particular demographic trends in the region, where urbanisation continues an upward trajectory.

What returns does Hines anticipate making from real estate over the next year and the next five years?

Due to the illiquid and localised nature of the asset class, we can expect to make an additional return of a hundred basis points or more above long-term bond yields at the unlevered level. However, this is also a function of expectations on rental growth and conditions of the capital markets. At the levered level, return expectations are generally higher in the short term due to uncertainty in the economic outlook. Returns expectations may taper off as recovery cycle sets in over a five-year period.

What is Hines' approach to ESG?

We launched our ESG Framework in 2021 which includes a science-based operational carbon target of net zero by 2040. As we cover the whole value chain from investment to development and operations, our approach is holistic yet systematic in action and getting the necessary systems, programmes, partnerships, and resources in place. With a diversified portfolio in 30 countries, 395 cities and across property types we benefit from cutting edge best practices and access to emerging know-how that enables a network effect across the global Hines business. We are also committed to leveraging our real estate expertise and partnerships to address the social inequities existing in our cities and promote human health and well-being in the built environment and beyond.

What do you see as the biggest opportunities and concerns over the next year?

The resetting of commercial loans maturing in the current dislocation in the credit market is clearly a concern, alongside the monumental challenge and high expectations of transferring to a greener future and achieving net zero. However, both challenges can be flipped to opportunity, both in terms of the ability to source equity to facilitate the transition on the credit front, and to work together towards a greener and more environmentally and socially conscious society.

» The resetting of commercial loans maturing in the current dislocation in the credit market is clearly a concern.

Sustainability

If any doubts remained about the importance of sustainability in global real estate, our survey results should dispel them.

An overwhelming majority (98%) of global investors now view environmental performance as important, with 56% describing it as “very important”.

Virtually all investors (99%) also believe environmentally sustainable buildings are important – again, with over half (57%) describing them as “very important”. UK professionals are even more convinced, with 69% saying they are “very important”.

As Paul Clark of AustralianSuper says on page 9: “The one issue that will impact us all is climate change and in particular the net zero carbon agenda.”

For APG’s Robert-Jan Foortse too (on page 27), “climate change is the single biggest issue. We are all well-versed in adapting to market cycles, but this is clearly a much bigger, existential challenge.”

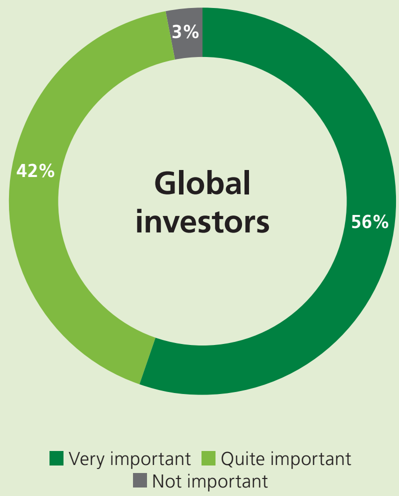
But there are still practical problems to overcome on the road to net zero.

In this section we will look at some of the most topical sustainability issues for real estate:

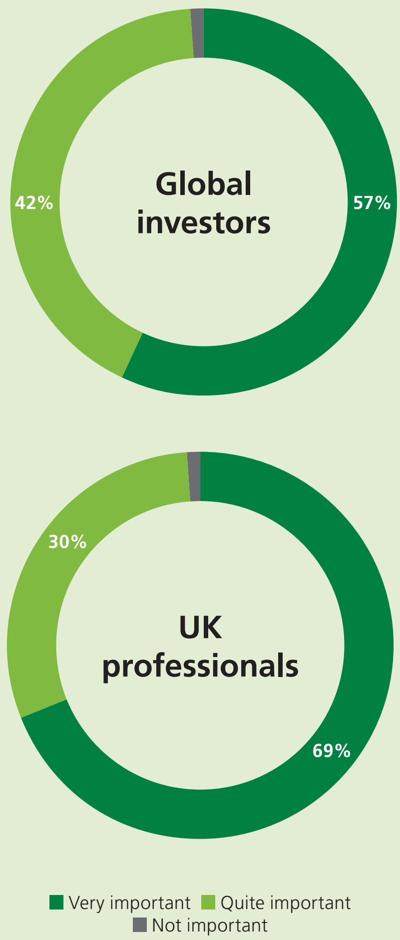
- When will we reach net zero?
- How big is the challenge?
- The economy and net zero.
- Sustainable offices and EPC requirements.
- Technologies to achieve net zero.

89% of global investors believe that future purchasing decisions will be strongly influenced by sustainability considerations, as do 96% of UK professionals.

How important for you is the environmental performance of a company, property or development you invest in?

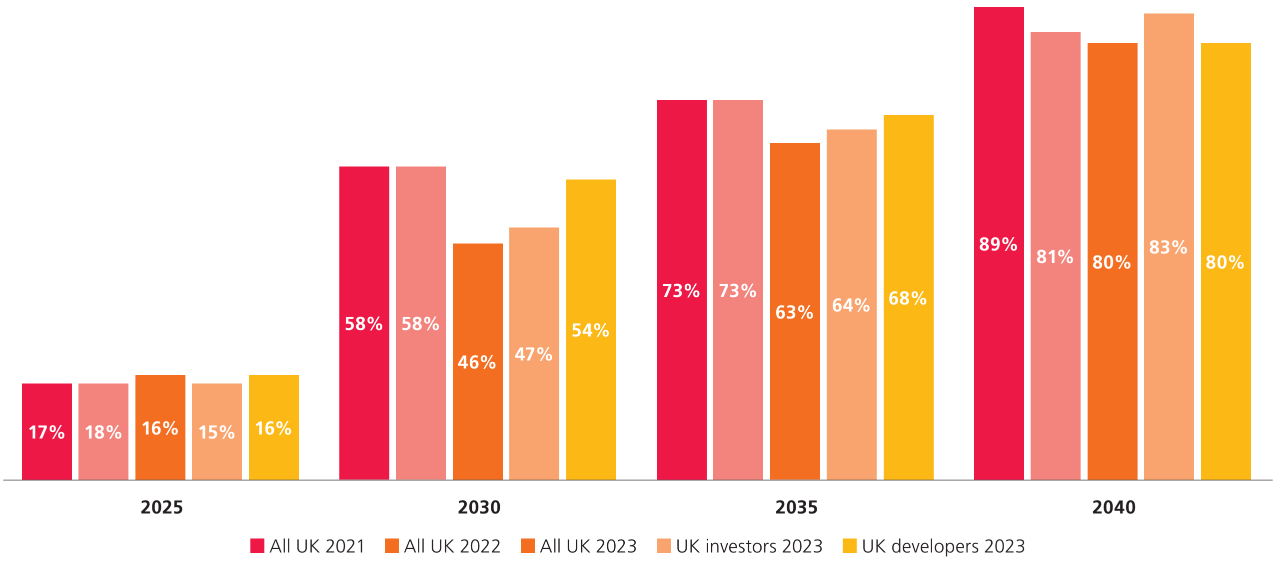


How important do you consider environmentally sustainable buildings to be?



When will we reach net zero?

By what year do you expect your company to achieve net zero emissions?



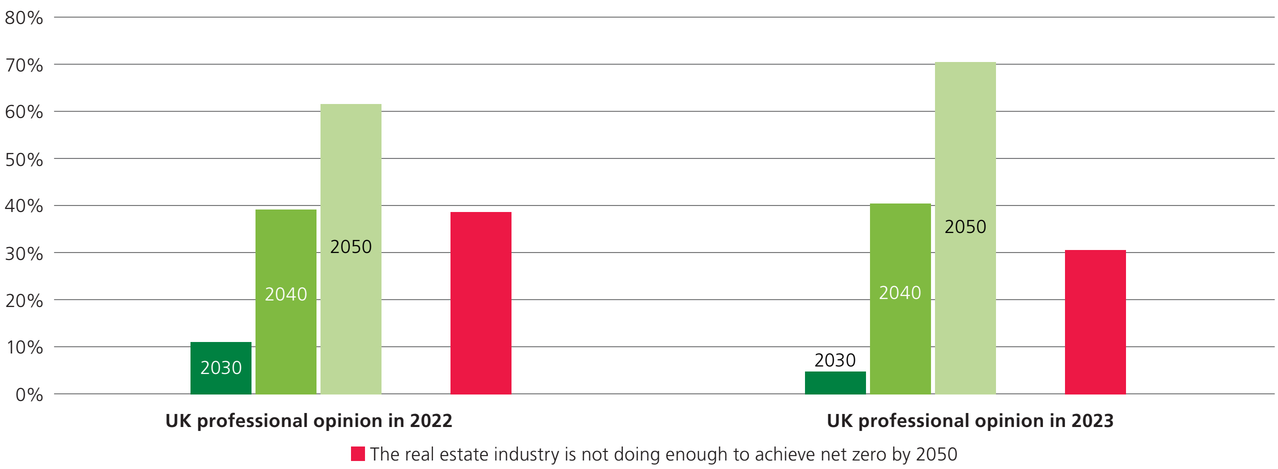
As chart above shows, on average UK professionals believe it will take slightly longer for their company to reach net zero than they thought a year ago or two years ago – though the average delay is not as great as some commentators predicted. A majority (63%) now expect to achieve net zero by 2035.

Clearly there have been some setbacks. One in five (20%) now don't believe they will reach net zero by 2040 – a level double that which we found in 2021. Most expect to do so later (although 9% say they won't get there at all).

Nevertheless, the data shows only a limited shift in expectations over time and suggests the general trend of the path towards net zero is unlikely to change.

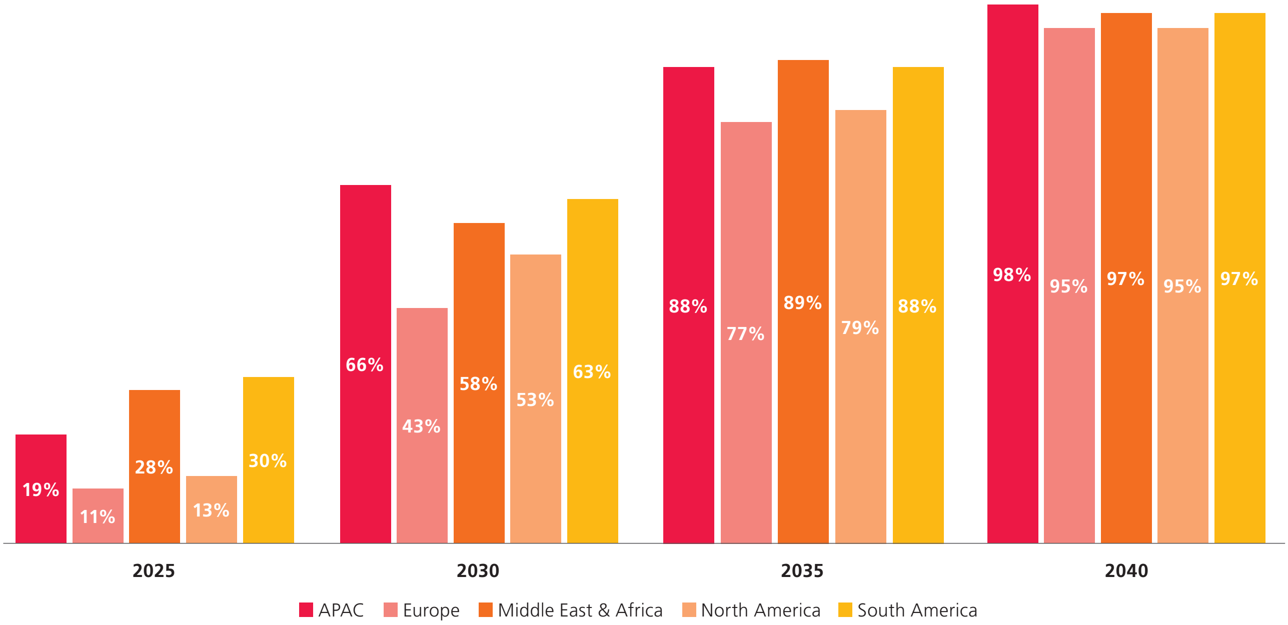
However, our respondents mostly think they are doing better than the industry average, as the chart below shows. Only 60% of them believe the industry as a whole is doing enough to achieve net zero by 2040. Nearly one-third (30%) say it is not even doing enough to hit net zero by 2050 – although this is an improvement on last year, when 38% said that 2050 was unrealistic.

When will the real estate industry reach net zero, given what it is currently doing?



Global portfolios

By what year do you expect the real estate assets in your portfolio to achieve net zero emissions?

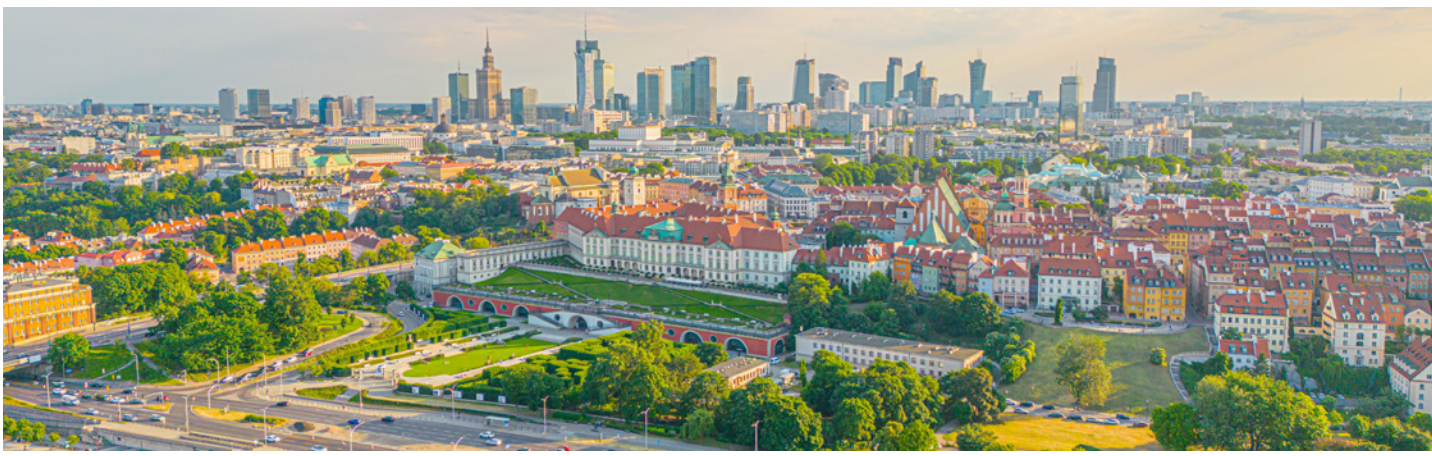


Global investors expect their portfolios to achieve net zero in a wide range of time frames, with those based in North America and Europe lagging somewhat behind the rest of the world.

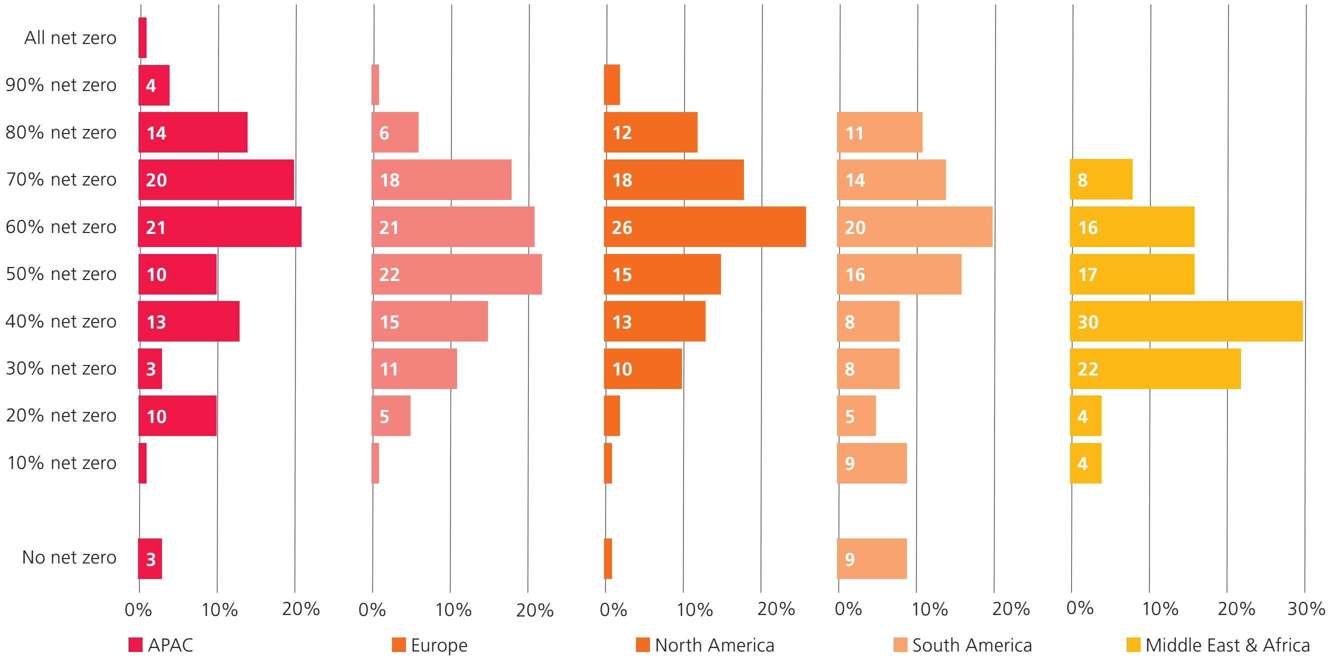
We also asked global investors what percentage of their portfolio was already net zero. The answers we received present a more positive picture than some commentators might expect.

In North America and APAC, the median percentage of net zero assets was 60%. Europe lags a little, at 50%, with the Middle East and Africa further behind at 40%. Our data from South American respondents shows a 'thick tail' of non-green portfolios, where 10% or less is net zero. This pulls down the regional median to 50%.

Overall, this data suggests that the dates mooted by investors for achieving net zero in their portfolios are realistic. It also suggests that most investors will likely be close to reaching net zero by the end of the decade – although many may find the final steps to be the hardest ones, as they seek to deal with their most recalcitrant and carbon-intensive assets.



What percentage of your real estate assets are currently net zero?

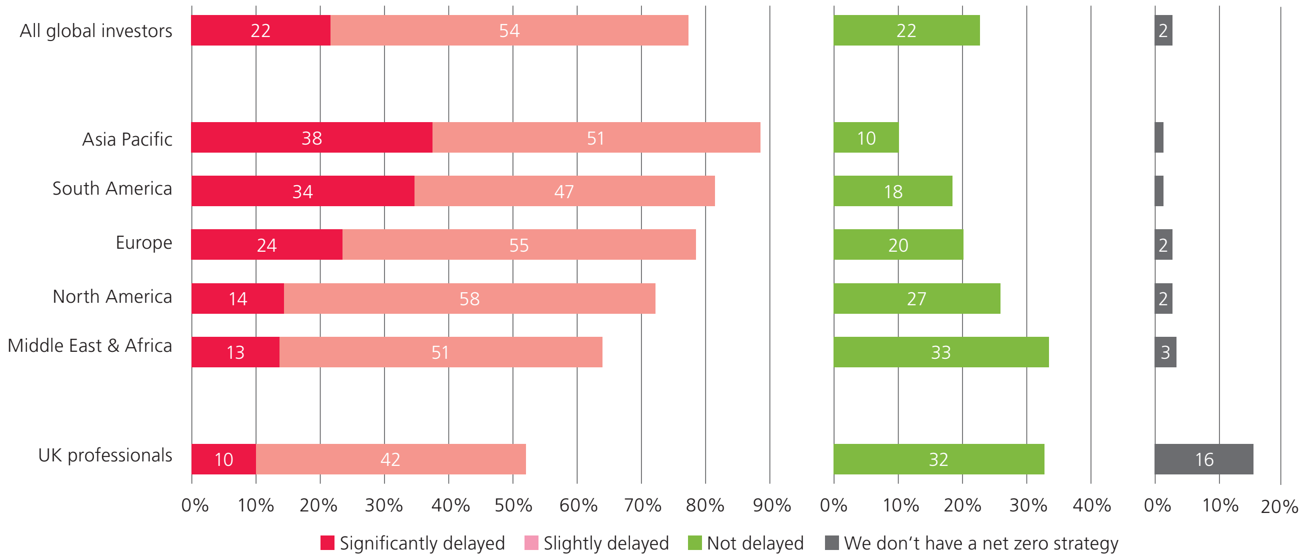


Net zero and the economy

How far have economic headwinds hit the progress of real estate towards net zero? Our findings show that they have delayed the delivery of the net zero strategies of about three-quarters (76%) of global investors. But for most of the investors affected (78%), the delay was slight.

The net zero strategies of UK professionals have been significantly less affected by the economy. However, any delay is obviously bad news for the climate. It may also be bad news for any investors whose green credentials are important for their business.

How much has the current economic climate delayed the delivery of your net zero strategy?



Interview

Robert-Jan Foortse

Head of European Property Investments, APG

How has APG's appetite for the real estate sector evolved in the last 12 months?

As a long-term investor, our appetite for real estate has always been consistent, accounting for around 10% of our overall portfolio. It is a proven resilient asset class, and our strategy is shaped by the global macro trends rather than market cycles.

Which sectors does APG favour and why?

In recent years we have pivoted towards residential and logistics, while retaining a selective interest in offices and reducing our exposure to retail.

We have an increasing focus on operational real estate which, while requiring a more proactive and hands-on approach to management, enables us to build deeper relationships with occupiers and provides more scope for income generation and additional returns.

Which world cities does APG favour and why?

We have a global portfolio, predominantly in the more developed markets, in the key cities and large gateway destinations. Urbanisation is a clear global trend which influences our strategy.

What returns does APG anticipate making from real estate over the next year and the next five years?

We are long-term investors and as such our outlook extends beyond five years. Our fully integrated strategy combines REITs and non-listed real estate so we build and manage a portfolio of investments that offers consistent dividends and grows in value over the long term.

What is APG's approach to ESG?

We place a strong emphasis on sustainability and plot all our assets adopting the strict certification measurements of GRESB, BREEAM and CRREM.

This is a high priority for all our stakeholders and our success has been a key factor in the ongoing execution of our strategy.

Also, we have also undertaken a comprehensive independent climate risk audit of all our 110,000 assets worldwide to identify our higher risk assets so we can subsequently take action where possible to address and mitigate risks. Social impact will become an increasing priority for us in the next few years, while strong and robust governance has always been part of our DNA.

What do you see as the biggest opportunities and concerns over the next year?

Climate change is the single biggest issue. We are all well versed in adapting to market cycles, but this is clearly a much bigger, existential challenge. The opportunity for the industry is to come together in collaboration to work harder and smarter to find and deliver solutions. This will require a different mindset and approach to the inherent instinct to find a competitive edge and differentiation to our peers.

> The opportunity for the industry is to come together in collaboration.

Sustainable offices and EPC requirements

Investors may be moving towards the view that making offices sustainable does not necessarily equate to higher costs for occupiers.

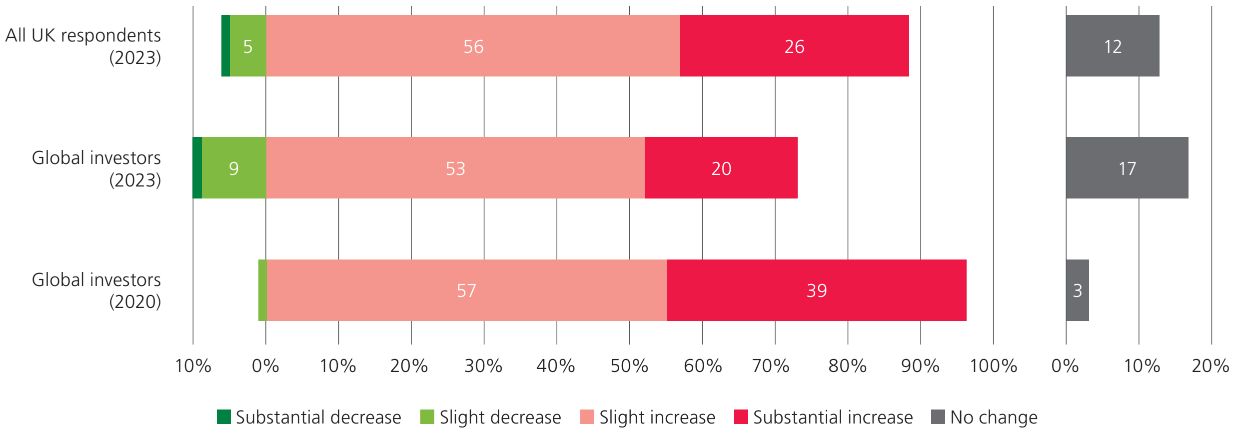
In 2020 the perception of global investors was overwhelmingly that making offices sustainable would cause an increase in costs, with 96% taking that view.

But that number has dropped to 73% this year, with 17% believing there is no change in overall costs and 10% that there is actually a decrease.

Views of increased costs will reflect the 'green premium' tenants pay for net zero assets. JLL and Knight Frank both estimate rental premiums of 10% or more for the most sustainable buildings.

But they will also reflect the advantages tenants derive from sustainable offices, such as reduced energy consumption, and the workforce-related benefits that are increasingly obvious to occupiers.

What is your impression of overall costs for occupiers of environmentally sustainable office buildings?



Energy performance certificates

The UK government has consulted on proposals for stricter minimum energy efficiency standards for business premises in 2027.

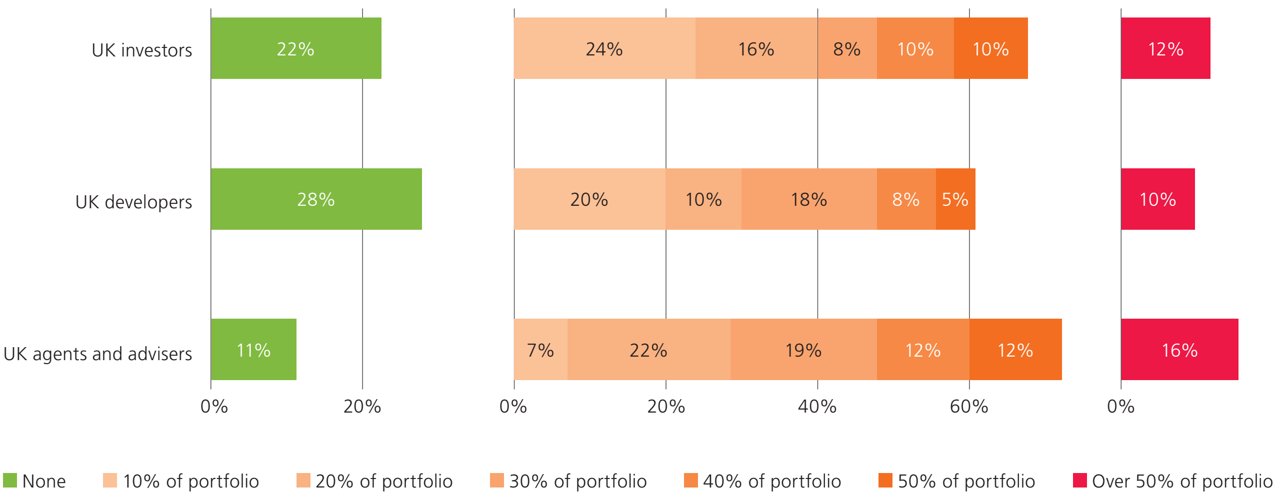
There has been no substantial government response on this since the consultation was published in 2021, and some commentators hope that – in view of this delay – there will be an equivalent deferral of the date on which stricter standards might take effect.

But in the absence of any news on this, the real estate industry is still contemplating a 2027 deadline.

We asked UK real estate professionals how much of their portfolio would need upgrading to meet the proposed minimum acceptable EPC requirement of a 'C' rating by 2027 and a 'B' rating by 2030.

Of the respondents who said the issue was applicable to them, nearly a quarter (23%) will need to upgrade 50% or more of their portfolio.

What percentage of your portfolio will need upgrading to meet the anticipated EPC requirements?



CMS real estate partner Cheryl Gurnham anticipates a number of consequences for the market. "Stricter ratings will have a significant impact on the cost of ensuring that a landlord's portfolio is compliant. There may also be a greater focus on the limited statutory exemptions and the exemptions register.

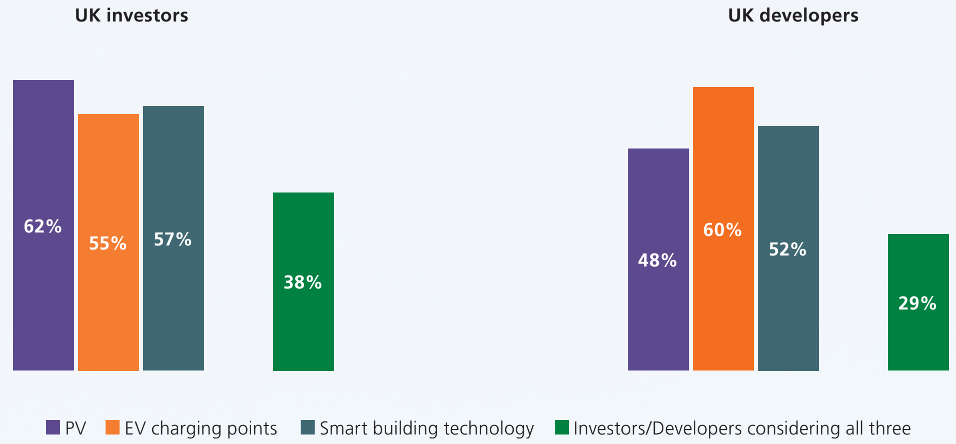
"Occupiers should, in theory, see the cost benefits of occupying premises with a better EPC rating, as their energy consumption should be lower. However, as new builds and recently refurbished buildings are more likely to have better EPC ratings, it is often difficult to establish whether better EPCs result in higher rental values, or whether the values are a broader reflection of the state of the premises.

"It's quite possible that as we near the prospective 2027 deadline there will be shortages of the skills and resources needed for upgrading. And if the owners of non-compliant buildings decide to sell rather than upgrade, we may see a surge of older, unlettable properties hitting the market, which would tend to drag down values.

"If you're an owner, I think the key thing is to start planning now. Look at the EPC standards your portfolio already meets, and then evaluate your options."

Technologies to achieve net zero

What technologies are you considering installing in the next three years to help achieve your net zero strategy?



Of the UK investors who answered this question, nearly two-thirds (62%) are considering rooftop solar/ photovoltaic installations, compared with fewer than half of the developers who answered (48%).

The differences are less substantial for electric vehicle charging points – which are more popular with developers – and smart building energy management systems. Well over a third (38%) of UK investors are considering all three technologies.

Technology

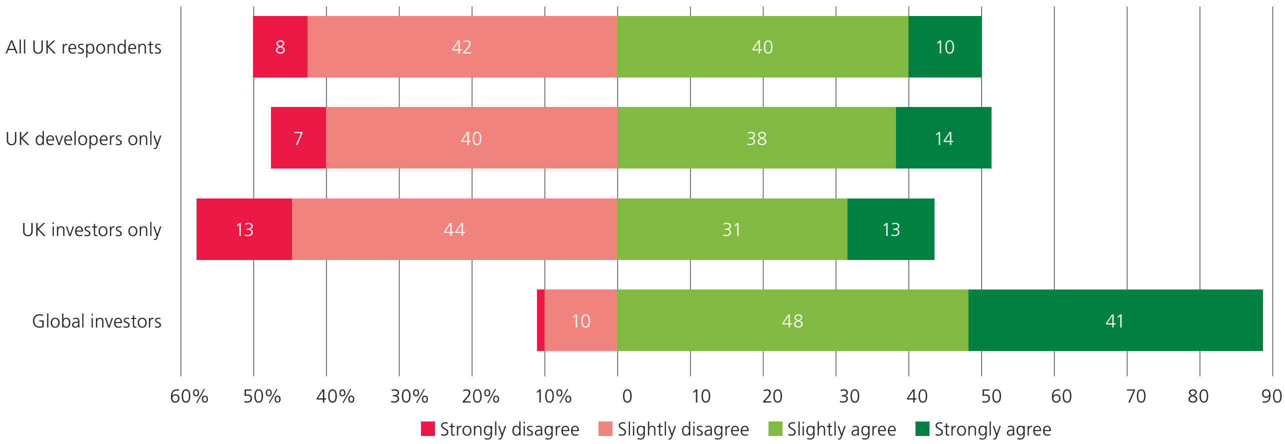
Many in the real estate industry are keen to embrace technological innovations, including – as highlighted on the previous page – green technologies.

But technology in real estate goes far beyond tools to help us reach net zero. It encompasses everything from intelligent security systems, the Internet of Things and AI-powered predictive maintenance solutions, through virtual tours of the 'digital twins' of buildings, to complex issues around the use of cryptocurrencies, smart contracts and tokenisation in real estate deals.

And while our survey shows that most global investors (88%) believe that the real estate industry is keeping up with technological changes, the picture in the UK is more ambiguous.

Only 50% of those we questioned in the UK feel that the industry is keeping up – a noticeable dip from the 57% we recorded in 2022.

Do you agree that the real estate industry is keeping up with technological changes?



Technology has always been a driver and an empowerer for real estate. Nobody could have built skyscrapers if the elevator hadn't been invented first, or developed out-of-town retail in an era before affordable mass-produced cars. But digital transformation will affect every type of property, in ways that are still unfolding, and with an impact that will take decades to play out.

New properties may be state-of-the-art, at least for a time, but for most of the built environment the question will always be how to reconfigure and adapt real estate, ensuring synergies between old and new. Technology that transforms real estate often does so by enhancing or interacting with the previous generation of developments.

Says Dominic Dryden a partner in the CMS technology team: "Data-driven and AI-powered technology is delivering significant new value to the real estate sector. But real estate investors and managers are also focusing on how it can help them to remain competitive and adapt existing assets to the major challenges of today – not just climate change but demographic, economic and social change.

"On a macro level, technology is changing the way our clients plan, develop and buy and sell real estate. It is also having a substantial impact building by building. We have seen this in the rise of 'smart' offices that collect data from sensors to manage energy consumption, working patterns and maintenance needs.

"But the use of innovations such as big data and AI in real estate can also raise novel legal challenges, for real estate investors, managers and tenants alike. We're advising a rapidly growing number of forward-thinking clients on how to unlock the transformative power of technology, whilst managing any risks appropriately and commercially."

Investment may be challenging at a time of reduced access to capital, but some investors may need to do more to keep up with technology. The rate of transformation is increasing, accelerated across different asset classes by everything from hybrid working to remote healthcare.

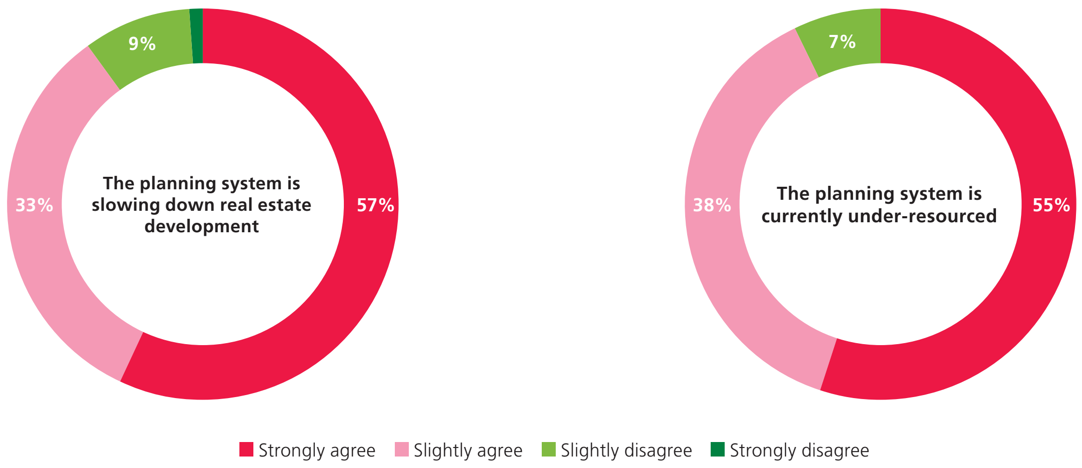
Ultimately, the smartphone will change real estate as much as the car or the elevator ever did.

» Ultimately, the smartphone will change real estate as much as the car or the elevator ever did.

Future planning?

One thing nearly all our UK respondents agree on is that the planning system is not working and needs investment. A massive 90% say the system is slowing down real estate development, while 93% reckon it is under-resourced.

How strongly do you agree with the following statements?



To some extent, these views dovetail with the belief of 87% of UK professionals that the last few years of fluctuating, politically-driven reform proposals have had a negative effect on the industry. A failing planning system is seen as one part of a wider systemic failure to deliver the real estate the UK needs. Says CMS Head of Planning Ashley Damiral: "It's not that the architecture of the system is broken. It suffers from a chronic lack of investment in it and uncertainty caused by constant attempts to overhaul it."

Our 2022 report focused on levelling up, noting that "there is an industry-wide opinion that levelling up is necessary if we are to build a sustainable future for towns and cities. However, whether the government is getting it right is up for debate." And that debate continues: this year, nearly three-quarters of UK professionals (73%) told us that the government has not committed enough towards the levelling up agenda.

Would political change make anything better? Opinions are sharply divided. A slim majority of our respondents (51%) believe that "planning would be better under a Labour government" – but that leaves 49% who disagree. It is not clear how many of that 49% think that a Conservative government is better for planning and how many simply believe that neither of the main political parties is likely to fix it.

Adds Ashley Damiral: "Some areas might work better under a Labour government – for example, if they allow onshore wind in England again and adopt a more robust approach to housing targets. There also needs to be an honest conversation about green belt, which could host significant development without undermining its purpose. Any new administration should concentrate on these targeted policy changes rather than wholesale reform."

According to Martin Evans, a partner in the CMS planning team: "In all sectors we have seen more complexity and delay, particularly on major proposals. This creates a perfect storm of uncertainty and additional cost and time, and is pushing back the delivery of much-needed new homes, business and other infrastructure. In a growing number of cases developers have to appeal as a last resort and the secretary of state is 'calling in' proposals which have been found acceptable at a local level.

"Planning is also something we are seeing increasingly raised as an issue when inward investors are looking at the UK as a potential location. Resourcing is clearly an issue and needs to be improved. This is coupled with a continually shifting political dynamic. The recent dropping of national housing delivery targets and the introduction of the 'beauty' test for new development significantly adds to this uncertainty."

Survey methodology

1.	**Investors** (online polling between 28 April and 3 May 2023)	n=1,002 global institutional investors. Results were weighted by region to ensure comparability with previous results.
2.	**Industry** (online polling between 21 April and 10 May 2023)	n=270 professionals in the UK real estate industry. Results were weighted by role to ensure comparability with previous results.

As a consequence of rounding, data totals do not always equal 100%.

For more information: Dan.Healy@fticonsulting.com

About us

With a presence in 44 countries across 79 offices and over 5,000 lawyers worldwide, CMS offers deep local market understanding with a global perspective. Our lawyers provide future facing, business-focused advice tailored to our clients' needs, whether in local markets or across multiple jurisdictions.

Across our eight core sectors – Consumer & Retail; Energy; Financial Institutions; Hotels & Leisure; Infrastructure; Life Sciences & Healthcare; Real Estate; and Technology, Media & Telecommunications – we have some of the brightest and most creative legal minds ready to advise you.

In addition to this report, we have a range of thought leadership papers covering major sector issues.

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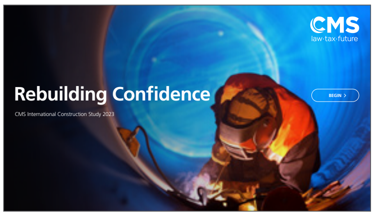

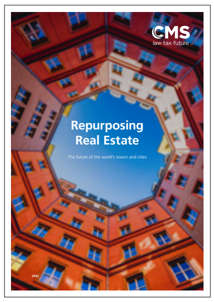

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When it comes to real estate, with over 800 lawyers we have the largest dedicated team in Europe, which is band one/tier one ranked in the latest legal directories.

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