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MARKET ADAPTATIONS:

# Maximizing New Growth Opportunities in the US Real Estate Sector

Investors are keen to make up for lost time, with significant interest in broadening investments, both geographically and by sector.





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# INTRODUCTION

Before the Covid-19 pandemic the real estate investment industry experienced a long bull run and held some well-established views on what made for sound and risky investments. However, the past year has thrown all of that into doubt and investors are now having to take time to re-evaluate their positions.

The picture that emerges is mixed and unpredictable, largely because of profound and long-lasting changes in consumer and business behaviour. Over the coming years asset classes will need to be re-evaluated: bricks and mortar retail and commercial real estate firms face an uncertain future after a challenging 2020, with much depending on what the "new normal" will look like once the dust has settled. In contrast, the warehousing and logistics industries are already experiencing a surge in investment which is likely to continue for the foreseeable future.

In North America in particular, the real estate market outlook is buoyed by a recent $1.9 trillion stimulus plan, as well as a major infrastructure plan initiated by the Biden administration that will see a total of $2.3 trillion distributed over an eight-year period. However, the sector is still very much in recovery, with transaction activity slowing in Q1 2021 after a surge at the end of 2020, with quarterly sales volumes of $79 billion down 40% compared to Q1 2020[1].

Perhaps the biggest impact will be felt by those investing in office space, particularly in once-prime central city locations such as New York, San Francisco and Seattle. Many companies are now re-evaluating their square-footage requirements as they adopt a more hybrid approach to their office space.

Retail, another previously safe real estate sector, experienced a precipitous fall in Q2 2020 as governments enforced 'stay at home' measures, leading to larger retail businesses scaling back their physical operations and many smaller businesses suffering insolvency as a result of their inability to maintain a steady cash flow. Similarly, hospitality suffered as tourism and travel ground largely to a halt.

This report, conducted with a global panel of 100 senior real estate fund managers - of which almost a third were based in North America - was commissioned by Auxadi to identify the industry's response to these challenges and give an indication as to which industries and sectors are most likely to be on the receiving end of investment as the pandemic eases.

As is highlighted in the report, investors are keen to make up for lost time, with significant interest in broadening investments, both geographically and by sector, tempered by caution around elements such as the demand for transparency and analysis and the growing importance of technology. However, with this rapid expansion will come greater administrative and compliance burdens that will need to be properly addressed in order to ensure the hard work about to be undertaken isn't wasted.

In spite of short-term uncertainty, the long-term appeal of real estate has held for investors, and the number of funds targeting it has continued to rise. As of Q4 2020 there were more than 1,000 funds active in the market - more than double the number in Q1 2016. Funds are now targeting almost $300 billion of investments, suggesting investor momentum moving into 2021[2].

With many real estate sectors experiencing unprecedented troubles over the past year, this has opened up huge opportunities for investment as the world slowly emerges from the pandemic. 2021 is set to see US GDP grow by 6.4% year-over-year and 3.7% in 2022[3]. The global real estate market is expected to grow by an estimated $87.1 billion (3.2% CAGR) to almost $2.8 trillion[4] in 2021.

[1] "North American Real Estate Market Outlook Q2 2021", published 3 May 2021 by Aberdeen Standard Investments.
[2] "2021 Preqin Global Real Estate Report", published on 4 February 2021 by Preqin.
[3] "Economic Forecast for the US Economy", published on 7 May 2021 by The Conference Board.
[4] "Real Estate Global Market Report 2021: COVID-19 Impact and Recovery to 2030", published in January 2021 by Research and Markets.

# Emerging from Covid-19





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## EMERGING FROM THE PANDEMIC

With dry powder standing at a record $324bn[5], there's likely to be considerable competition for deals across all aspects of real estate. Sector-specific valuations will depend on factors such as the success of vaccine roll-outs (hospitality and retail) and returning to traditional working patterns (office and industrial). Despite persistent challenges faced by some sectors, real estate remains an asset class that's currently underpinned by solid income and low interest rates, which means assets will remain attractive despite some recalibration in their use.

Unsurprisingly, real estate deal volumes suffered in 2020, with global investment volumes down by 28% in the 12 months to November 2020 compared to the same period the year before[6]. While the share of total real estate investment to office (35% to 33%) and hotel (8% to 5%) fell over this period, residential (26% to 28%) and industrial (17% to 21%) rose, showing resilience in the face of structural changes which are likely to continue into 2021.

As lockdowns gradually ease, we'll begin to see a rapid resurgence in appetite by people for retail experiences. Our panel of North American real estate investment professionals expect industrial (logistics) to see the biggest recovery in valuations over the next two years, with 67% backing the sector to outperform other areas between now and 2023. Sentiment for alternatives (such as hotels, student accommodation, social housing and senior living) remains negative, with only 20% of respondents backing the sector to recover over the same timeframe.

### WHICH REAL ESTATE SECTORS ARE LIKELY TO SEE THE BIGGEST RECOVERY IN VALUATIONS OVER THE NEXT TWO YEARS FOLLOWING THE PANDEMIC?

| | |
|---|---|
| **Industrial** (logistics) | 67% |
| **Retail** (high street) | 63% |
| **Offices** (central business districts) | 60% |
| **Retail** (food anchored retail parks) | 47% |
| **Supermarkets** | 27% |
| **Alternatives** (hotels, student accommodation, social housing, senior living) | 20% |
| **Residential** | 17% |

This is a short-term view, however, and more than four fifths (83%) of investors expect the fundraising climate for alternative strategies to improve over the coming two years, with 43% expecting a "significant" improvement. This is ahead of retail, logistics (both 73%) and supermarkets (70%).

### HOW DO YOU EXPECT THE FUNDRAISING CLIMATE TO CHANGE OVER THE NEXT TWO YEARS FOR THE FOLLOWING TYES OF REAL ESTATE STRATEGY?

| | |
|---|---|
| **Alternatives** (hotels, student accommodation, social housing, senior living) | 83% |
| **Retail** (food anchored retail parks) | 73% |
| **Industrial** (logistics) | 73% |
| **Supermarkets** | 70% |
| **Residential** | 67% |
| **Offices** (central business districts) | 60% |
| **Debt** | 60% |
| **Retail** (high street) | 57% |

As a result of the turmoil over the past year, 77% of investors expect to see an increase in fundraising and valuations over the coming 12 months, with the same proportion also anticipating an increase in digitization and technology enablement of assets held in portfolios. 73% of investors expect to see an increase in the reallocation of capital to commercial sectors with safer cash-flows, while the same proportion expect to see debt become more widely available.

[5] "2021 Preqin Global Real Estate Report", published on 4 February 2021 by Preqin.
[6] "Real estate investment in 2021: global outlook", published in January 2021 by Savills World Research.

## European commercial real estate's recovery from Covid-19

Covid-19 measures have caused shops and offices to close across the majority of Europe, leading to a drop in demand for traditional brick-and-mortar retail and office space. European commercial real estate transaction volumes fell dramatically in Q4 2020, falling by nearly 40% year-on-year, driven primarily by an 80% fall in hotel deals. Price growth was also down year-on-year in Q4, driven by a 20% fall in retail[7].

Just over a third (37%) of North American respondents believe that the market will recover fully by the end of 2021, which is more confident than the UK (23%) but not as confident as continental Europe (46%).

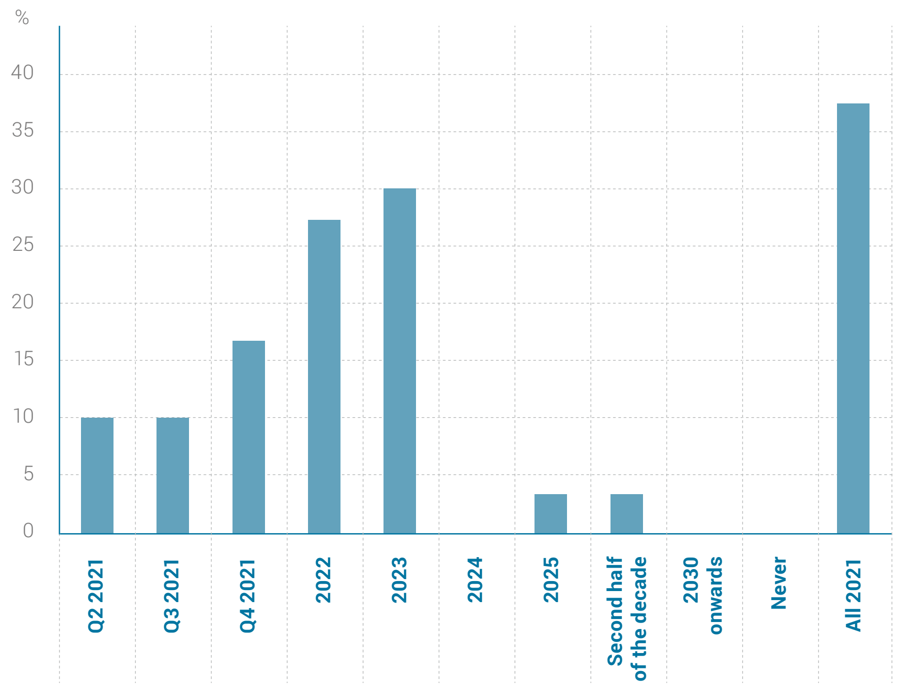
[7] "Global Financial Stability Report: Pre-empting a Legacy of Vulnerability", published in April 2021 by the International Monetary Fund.

### HOW DO YOU EXPECT EACH OF THE FOLLOWING TO CHANGE OVER THE COMING 12 MONTHS COMPARED TO THE PREVIOUS YEAR?

| | Increase | Stay the same | Decrease |
|---|---|---|---|
| **Valuations** | 77% | 17% | 7% |
| **Fundraising** | 77% | 17% | 7% |
| **Upgrading digitization and tech enablement of assets held in portfolio** | 77% | 17% | 7% |
| **Reallocation of capital to commercial sectors with safer cashflows*** | 73% | 20% | 7% |
| **Availability of debt** | 73% | 13% | 13% |
| **Property maintenance** | 70% | 17% | 13% |
| **Inclusion of climate** | 70% | 23% | 7% |
| **Distressed asset sales** | 67% | 27% | 7% |
| **ESG investment** | 67% | 20% | 13% |
| **Cost of debt** | 63% | 33% | 3% |
| **Deal flow** | 60% | 27% | 13% |
| **Reconfiguring office space** | 53% | 23% | 23% |

* e.g. medical, self-storage, industrial

### WHEN DO YOU EXPECT EUROPEAN COMMERCIAL REAL ESTATE MARKETS TO RECOVER FULLY FROM THE IMPACT OF COVID-19?





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# Demand for Outsourcing





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## THE GROWTH IN DEMAND FOR OUTSOURCING

The vast majority of real estate investors will look to re-evaluate their operating models and reduce costs over the next two years, with 93% overall holding this view, of which 60% state that this outcome is "extremely likely". In comparison, none said that they were "not at all likely", suggesting a sea change in how real estate investment companies operate over the coming years. This is also supported by the fact that 47% of respondents stated that the ability to identify and generate cost savings is likely to shape sentiment among institutional real estate investors over the same timeframe. On average, respondents expect costs to fall by 23% over this time-frame more than the global average (18%) and their UK (17%) and European (15%) counterparts.

Due to the dramatic impact Covid-19 has had on real estate investment and global mobility, it's predicted[8] that cross-border flows to safe-haven locations and flows between 'near-neighbours' will set the tone for cross-border deals in 2021, with the United States, Germany, United Kingdom and Singapore most likely to be major players in cross-border activity.

While appetite for cross-border investments is holding up, lockdown and travel bans have made the process more complex, in that it has been impossible to view assets or meet owners in person. While a deal enacted in another country may look and feel the same as one in a domestic market, cultural nuances and different regulations and legal frameworks can lead to unexpected challenges.

The greatest complexities identified by investors when engaging in cross-border investment activity were revealed as increased competition for assets (80%), regulatory frameworks (63%), political stability (50%) and tax regimes (47%). While the former is likely spurred on by the appetite among real estate investors in the wake of the pandemic, the subsequent factors - bar political stability - are all a result of administrative complexities which can be alleviated by specialist outsourced fund administration.

One major administrative hurdle over the past few years has been the introduction of economic substance regulations. A large number of real estate investors have already started outsourcing specifically to combat the added administrative burden of economic substance in their jurisdiction. With a high uptake in outsourced functions such as accounting, cash monitoring and reconciliations and legal entity administration already, investors are also likely to start outsourcing elements such as company secretarial support and loan administration in the future to lighten the administrative load.

WHICH OF THE FOLLOWING ELEMENTS HAVE YOU STARTED, OR PLAN TO START, OUTSOURCING AS A RESULT OF THE IMPLEMENTATION OF ECONOMIC SUBSTANCE REGULATIONS IN YOUR JURISDICTION?

| | Have started outsourcing | Plan to start | No plans to start |
|---|---|---|---|
| **Accounting** | 77% | 23% | 0% |
| **Cash monitoring & reconciliations** | 50% | 40% | 10% |
| **Legal entity administration** | 60% | 23% | 17% |
| **Loan administration** | 50% | 43% | 7% |
| **Company secretarial support** | 63% | 33% | 3% |

When looking at the specific elements of economic substance regulations, those that have posed the biggest challenges to real estate investment operating models include ensuring the business is directed and managed in the jurisdiction and ensuring all appropriate staff are adequately trained to understand the regulations (both 60%).

[8] "Where will capital flow in 2021?", published on 1 January 2021 by Knight Frank.

## WHAT ELEMENTS INVOLVED IN THE ECONOMIC SUBSTANCE REGULATIONS HAVE POSED THE BIGGEST CHALLENGES TO YOUR OPERATING MODEL?

**60%**
Ensuring the business has adequate people, premises and expenditure in the jurisdiction

**60%**
Ensuring all appropriate staff are adequately trained to understand the regulations

**43%**
Ensuring the business is directed and managed in the jurisdiction

**43%**
Ensuring the business undertakes core income-generating activities in the jurisdiction

**17%**
Administration associated with the reporting of compliance with the regulations





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# Real Estate Outlook





## THE OUTLOOK FOR REAL ESTATE

While investors may have identified certain complexities associated with cross-border deal completion, it hasn't dampened their enthusiasm. When asked about the most attractive overseas markets for investment over the coming five years, the UK came out on top, with 97% of investors either moderately or extremely likely to invest between now and 2026.

When looking at the sectors they intend to invest in over the coming five years, interest was similarly high and broad; real estate (97%), telecommunications services (93%), and financials (90%) top the list, ahead of materials (87%), energy and industrials (both 83%), though even utilities - the least frequently-selected sector - was still rated as attractive by more than half (53%) of respondents..

However, several factors are likely to play a significant role in investors' ability to complete deals across these jurisdictions and sectors. Paramount among these, according to investors, is the increased demand for reporting transparency analysis (63%). Despite the appetite for investment, 53% of respondents believe that there will be greater caution towards transaction activity, possibly resulting from persistent uncertainty about pricing (33%).

WHICH OF THE FOLLOWING ARE MOST LIKELY TO SHAPE SENTIMENT AMONG INSTITUTIONAL REAL ESTATE INVESTORS OVER THE NEXT TWO YEARS?

| | |
|---|---|
| **Increased demand for reporting transparency and analysis** | 63% |
| **Greater caution towards transaction activity** | 53% |
| **Identifying and generating costs savings** | 47% |
| **Wait and see attitude will prevail during this period** | 43% |
| **Persistent uncertainty about pricing** | 33% |
| **More due diligence on financial strength of prospective tenants** | 27% |
| **More due diligence on ESG credentials of prospective tenants** | 27% |
| **Lower valuations in sectors hit by the pandemic present a buying opportunity** | 20% |
| **Increased use of technology** | 20% |

Investors are divided over the impact investor demand for ESG factors will have on overall private equity real estate AUM volumes in the next five years.

Also likely to shape sentiment in the coming years are environmental issues, with investors divided over the impact investor demand for ESG factors will have on overall private equity real estate AUM volumes over the coming five years. While the majority (63%) believe that it'll increase as funds successfully incorporate ESG factors into their investment process, a significant proportion - 37% - are of the opinion that it will fall as a result of firms struggling to effectively implement ESG factors.

WHICH ENVIRONMENTAL ISSUES ARE MOST MATERIAL TO YOUR FIRM?

| | |
|---|---|
| **Sustainable property management** | 50% |
| **Energy efficiency** | 47% |
| **Green building certification** | 47% |
| **Sustainable development / fit-out** | 43% |
| **Climate change resilience** | 30% |
| **Innovation / green technology** | 27% |
| **Waste management** | 20% |
| **Indoor air quality** | 17% |
| **Water efficiency** | 10% |
| **Biodiversity** | 7% |
| **Mandatory green lease clauses** | 3% |





## The rise of technology

Technology has already proven invaluable as the industry adapts to Covid-19 and is likely to play a significant role in the future of real estate investment. Not only will funds be able to invest in technology that creates smarter, more valuable properties, but they'll use technology such as artificial intelligence and data analytics to understand more about what makes a successful investment and which factors should be taken into account when assessing opportunities.

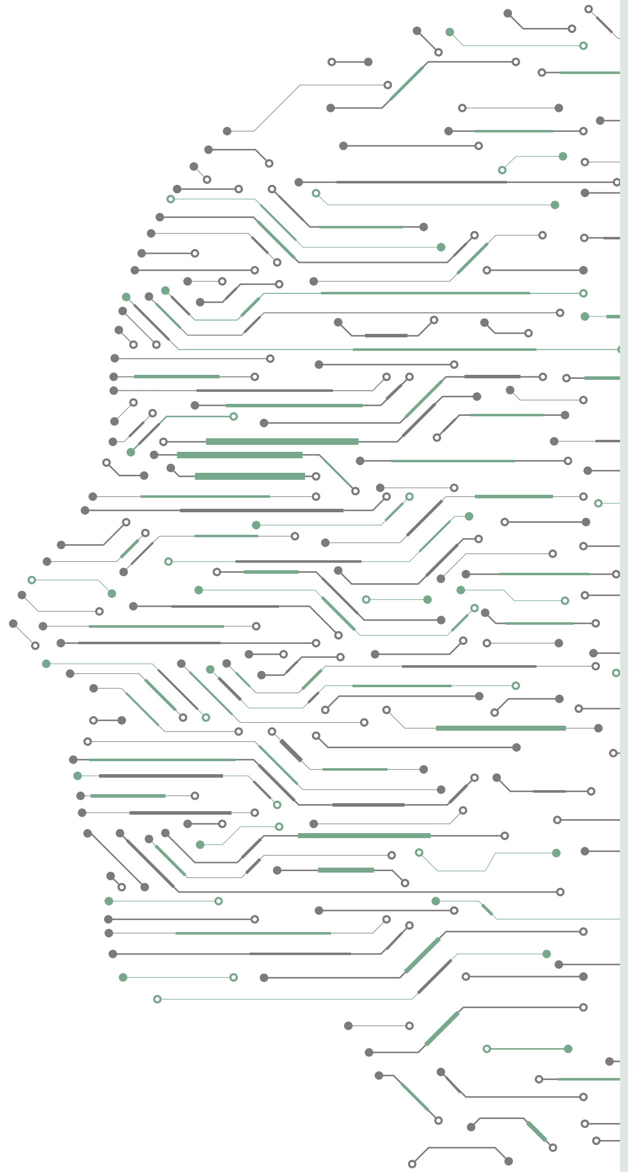
The real estate investment industry is firmly behind the integration of technology in the investment process, with more than three quarters (77%) stating that it'll have a transformational effect on investment performance and 50% believing that it'll offer greater operation efficiencies.

However, coupled with this enthusiasm is a fear of failing to truly implement this technology successfully, with 47% stating that keeping pace with technology is a challenge and a further 40% stating that they're already falling behind their competitors.

Over the next five years, investors believe that the technology most likely to have the biggest impact on the real estate fund management industry is artificial intelligence (83%), ahead of virtual reality (67%) and the Internet of Things (57%).

WHICH OF THE FOLLOWING TECHNOLOGIES IS LIKELY TO HAVE THE BIGGEST IMPACT ON THE REAL ESTATE FUND MANAGEMENT INDUSTRY OVER THE NEXT FIVE YEARS?

| | | | |
|---|---|---|---|
| 83% | 67% | 57% | 33% |
| Artificial intelligence | Virtual reality | Internet of things | Robotics |
| 33% | 17% | 13% | |
| Machine learning | Big data | Blockchain | |



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**Despite the numerous challenges faced by the real estate investment sector last year, investors are confident in their ability to emerge from the pandemic, with widespread optimism for recovery across all sectors over the coming years.**

However, while investors have been successful in navigating Covid-related shocks over the past year or so, there are still question marks that remain about how strong the recovery will be should pandemic-induced factors such as remote working or online shopping remain beyond the end of local lockdown restrictions.

The two key themes likely to impact the sector in coming years - the influence of technology and the ESG agenda - currently split the panel and will present their own opportunities and pitfalls, while a third - the demand for outsourcing - is only likely to intensify as investors look to new markets and sectors in the hunt to capitalize on every opportunity presented in the post-Covid landscape.





## ABOUT AUXADI

With more than 40 years' experience, we're experts when it comes to working with multinational companies, private equity and real estate funds.

### How we help real estate firms

Auxadi is a specialist provider of tailored international accounting, tax compliance and payroll services. Operating in 50 jurisdictions across the USA, Europe and Latin America, we provide an end-to-end solution through cloud-based technology to make your lives as easy as possible. Our IT platform, employees and methodology are all designed to act as a seamless extension of your accounting departments to ensure that your administrative requirements are met across your real estate investment portfolio, no matter the volume of deal flow.

Our culture is based on ethics, excellence and exceeding the expectations of our clients and we achieve this through flexible and efficient solutions developed by a motivated, committed and solid team. With more than 40 years' experience, we're experts when it comes to working with multinational companies, private equity and real estate funds.

### Research methodology

Research was conducted via an online survey amongst a panel of 100 senior-level Research was conducted via an online survey amongst a panel of 100 senior-level real estate fund managers in April 2021, of which 30 were based in North America. The average stated AUM of respondents in North America stood at €19.2bn.

*Note, some percentages may not add up to 100% due to rounding.

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