Thinking outside the box

The long-term influence of four megatrends is likely to increase the appeal of alternative assets

by Britta Roden

Ever since Carmen M. Reinhart and Kenneth S. Rogoff outlined the "this time is different" syndrome in their 2011 book *This time is different: A panoramic view of eight centuries of financial crises,* economists and investment market researchers have been wary of using this analogy when analysing market performance across asset classes.

Their research is a good starting point for what we are currently seeing in real assets. Once again, we are going through a period of uncertainty leaving many institutional investors with exposure to real estate wondering whether "this time is different". I was recently invited to speak on a panel at a conference, entitled *Clash of asset classes,* which illustrated this general unease among investors. It struck me how deeply some of the participants at the conference were concerned about the outlook for real estate as an asset class. One of the takeaways from the discussions at the event was the view — shared by some investors — that real estate and real assets such as infrastructure or renewable energy are seen as distinct asset classes with little in common. From this point of view, it is not difficult to imagine that a clash is imminent.

The four "Ds"

By making this clear-cut distinction, investors tend to create a contrasting juxtaposition in their investment strategy. But we are not seeing a clash of asset classes. Instead, what can be seen is a continuum along four major trends that are shaping all asset classes. The four "Ds": deglobalisation, decarbonisation, digitalisation and demographic change, are the drivers of this long-term dynamic. The investors best positioned for future appreciation will be those whose real asset strategies are best aligned with these trends.

Digitalisation is transforming and permeating value creation processes across all asset classes simultaneously. The resulting efficiency gains and resource savings are closely linked to ESG objectives. As a result, digitalisation has become an indispensable priority for investors as a long-term value driver.

In its immediate impact on real assets, digitalisation has helped to boost data centres. They have become an investment sector in their own right. According to CBRE, many players consider new regulation such as the German Energy Efficiency Act (EnEfG) as a medium- to long-term pull factor. New regulations require more energy-efficient data centres and a sustainable energy supply.

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This leads directly to decarbonisation as a megatrend. The EU's climate change objective of limiting global warming to 2 degrees Celsius by 2050 will require a massive energy transition away from fossil fuels and towards renewable energy. This will require a joint effort to decarbonise all economic sectors and industries, including real estate. On the one hand, the existing building stock will have to become more energy efficient, and on the other hand, we need to anticipate the investment requirements to roll out a low-carbon energy supply. Classification service provider DNV estimates that the expansion of the renewable-energy generation infrastructure will require investments amounting to some €2 trillion by 2050.

Demographic change is adding further momentum. In Europe, we are witnessing a decline in the total population while the major conurbations continue to see population growth and a growing number of households. In the aviation sector, rising incomes translate into more travel and demand for passenger flights.

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Deglobalisation, which goes hand in hand with derisking, creates new opportunities in diversified logistic markets. Subject to political risks, we see a costly diversion of shipping routes on a global scale. Air freight tends to benefit from its flexibility in keeping supply chains intact with mission-critical components where reshoring is not an economically viable option.

Taking into consideration the impact of these four megatrends, against the backdrop of the interest rate turnaround, leads us to bold conclusions as investors grapple for alternatives to rebalance risk and return. Yield compression as we have known it for many years, driving valuations, is not coming back. Investors will increasingly be on the lookout for pockets of value. The old "core" as we have known it — delivering consistent total returns with a stable income component, at a relatively low risk point — is being replaced by other future-proof asset classes.

Yesterday's core, such as single-tenant office properties, will not reemerge — even if interest rate cuts loosen the monetary policy brakes going forward.

KGAL estimates that only 20 percent of today's core office assets will be considered core in the future. The remainder will be subject to severe haircuts. As the four "Ds" take their toll, many investors may still be underestimating the downside risk of today's non-core European property assets.

Previous core investments to be replaced by future-proof asset classes

Risk	Past	Future
Core	Office Retail Residential	Office (prime) Mixed-use Social infrastructure (schools, childcare, administration) Local amenities Wind energy (operational) Solar energy (operational)
Core-plus	Business hotels Senior living Student housing Wind/solar energy	Office refurbishment Business and leisure hotels Alternative living sectors Data centres Life sciences Wind/solar energy (development)
Value-added	Development Data centres Life sciences Green hydrogen Battery storage	Office conversion Repowering (wind parks) Distressed loans Green hydrogen Battery storage
Opportunistic	Distressed loans	Office (stranded assets) Department stores Development

Source: KGAL

Looking for sweet spots

Tomorrow's core will include mixed-use properties. These assets will combine living, working and services — offering grocery stores, entertainment, drug stores and urgent care, all in one place.

Proximity to services will play an important role in future living quarters, such as medical services, wellness offerings or childcare services. Social infrastructure will move into the core segment. Mixed-use properties, offering public services such as schooling, kindergartens, nursing, libraries, neighbourhood and community centres with multifamily rental apartments, will offer security of rental income through public sector tenants, as well as apartment residents as renters.

Beyond real estate, the future core segments will encompass renewable-energy infrastructure, such as power generation from wind and photovoltaic (PV) installations. PV and wind energy asset portfolios will be considered core, offering stable income via power purchase agreements (PPAs) as demand for energy from renewable sources is set to exceed that for energy from fossil fuels. One interesting approach to decarbonise existing property stock will be to utilise renewable energy to reach net-zero carbon goals in older properties. From a risk perspective, non-core real estate assets harbour higher risks than "real" alternatives such as renewable energy.

Risks outside the core segment are underappreciated. Investors pursuing "manage-to-green" or "manage-to-core" strategies run the risk of underestimating the expertise and resources required to turn around assets. Retrofitting and decarbonising existing building stock requires strong asset management skills.

So, what are the real asset alternatives for investors in search of yield?

In search of yield

Those investors who look out for highest yields, of about 10 percent to 15 percent IRR annually, will be best served in the aviation segment. Again, the four "Ds" are propelling this momentum, from a global perspective.

In some developed markets, our perception of the massive demand and growth opportunities in the aviation sector may be blurred. But Asia, notably, has a lot to offer from an investor's perspective. In the world's economic powerhouse, the need for derisking creates strong demand for both air transport and air travel by replacing single hubs with multi-hub networks. As global manufacturers with operations in Asia experienced frictions in their supply chains during the COVID-19 crisis and ongoing political tensions, they have extended their supply chains to multiple locations to spread their risks. This, in turn, is leading to unprecedented growth multiples in future demand for air freight capacity.

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From a consumer market's perspective, the mass affluent account for up to 40 percent of household wealth in major Southeast Asian markets, and more than half of the total spending in premium and luxury categories. By 2030, the ranks of the mass affluent are expected to reach 136 million and represent 21 percent of the population, according to Boston Consulting Group. Due to Southeast Asia's geography, most of this intra-regional travel and shopping tourism is done by aircraft, as road links — between the Philippines and Taiwan, or between Vietnam and Thailand and South Korea, for example — do not exist. Asia's consumers no longer want to spend hours in transit between hubs. Bain & Co thus anticipates significant intraregional demand growth in Asia — a 59 percent increase from 2019 to 2030. Low-cost airlines, which fared somewhat better through the COVID-19 pandemic than larger carriers, continue to grow market share.

It is worth noting that real assets evolve gradually, and their valuations are tied to interest rates and macroeconomic developments. Still, their valuations have consistently been less correlated to economic cycles than liquid assets.

Looking ahead, the fundamental drivers propelling real assets' future development will likely serve as a textbook case study for scholars and students as economies adjust to the four "Ds". Following the money will once again show that this time, things aren't really that much different than before. ❖

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