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Drilling deeper
Seeking out the untapped wells of prime real estate

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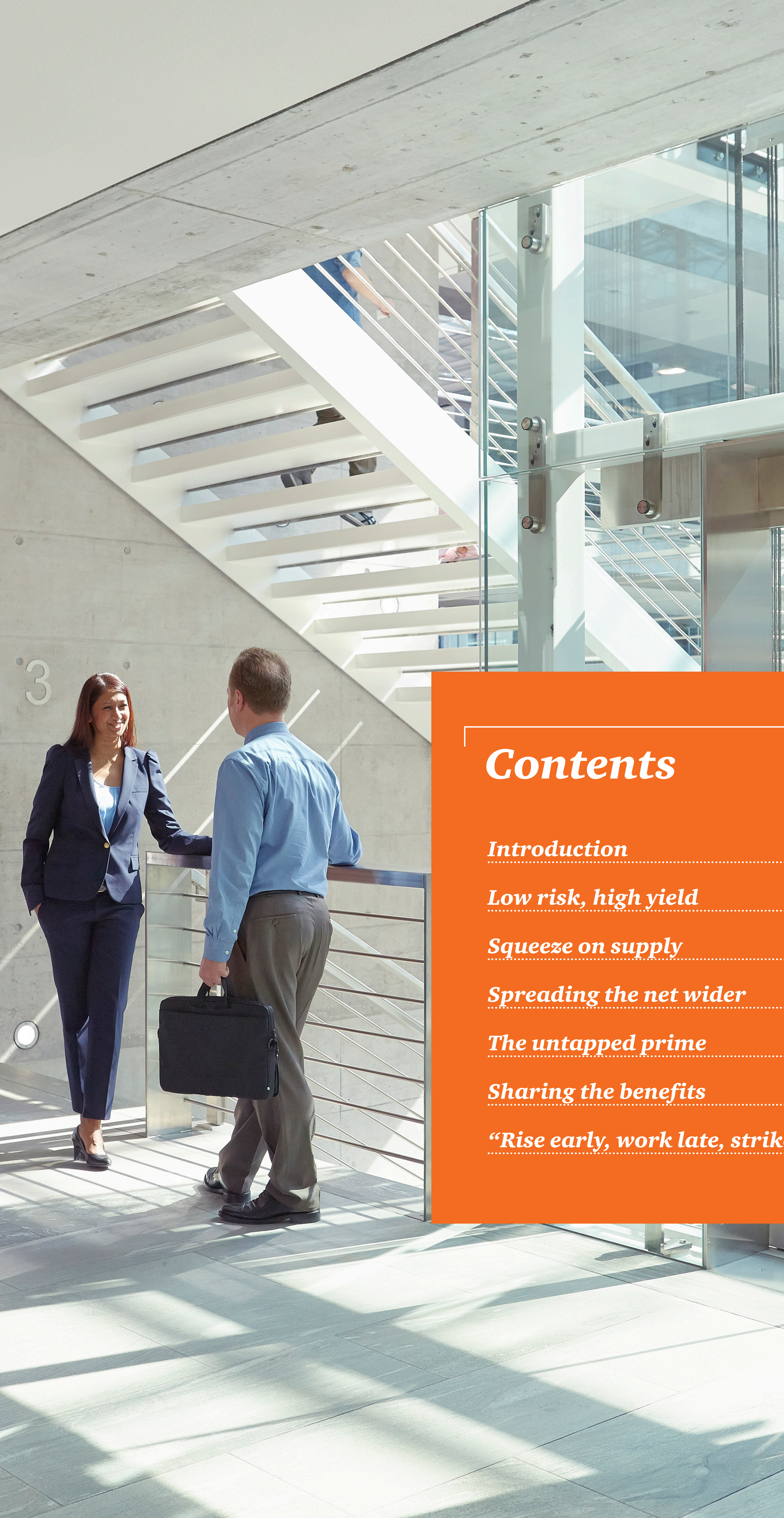

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Introduction

The search for yield has spurred a surge in sovereign wealth funds' real estate allocations. Yet as a wall of capital comes up against limited supply, many funds are finding it increasingly difficult to access investment grade stock. So is the well of prime assets really running dry or, like the oil from which so much sovereign wealth stems, might there still be untapped reserves? Craig Hughes, PwC's Global Sovereign Wealth Fund and UK Real Estate Leader, explores the opportunities for sovereign wealth funds who are prepared to drill deeper and further afield and how investors can put themselves in the strongest position to capitalise.

Sizeable gas deposits had been detected off the shores of the Netherlands from the 1940s onwards. Yet after some initial interest, the possibility that the field might stretch northwards up to Scandinavia had been widely dismissed by the 1960s. Then in 1969, prospecting in the Norwegian zone revealed the first signs of what would prove to be the giant Ekofisk oil and gas field. It was not until the Oil Crisis of 1973 that prices were high enough to make large scale North Sea oil extraction commercially viable. And even then, developing the technology needed to prize the oil from these inhospitable depths required more investment than it took to put a man on the moon. But it was all clearly worth it. At its peak in 1999, the North Sea was producing six million barrels of high grade crude per day.

Nearly 50 years on, a huge slice of the rewards from the Ekofisk find are administered on behalf of the Norwegian people by Norges Bank Investment Management (NBIM). With some $775 billion of assets under management (AUM), NBIM is the largest sovereign wealth fund in the world[1]. A huge amount of NBIM's own prospecting efforts are now focused on prime real estate. Up until the global financial crisis, its property holdings had been negligible. Then in 2010, NBIM took the strategic decision to build up what by September 2014 had become a $10 billion real estate portfolio (1.3% of total AUM)[2]. By 2020, it wants 5% of its AUM to be held in property. While this would still only be a fraction of its equity and fixed income holdings, it would make NBIM one of the world's largest real estate investors.

Low risk, high yield

And NBIM is not alone, nine out the ten biggest sovereign wealth funds (ranked by AUM) have allocations to commercial real estate[3] and many have been creating or expanding specialist teams. From Canary Wharf to the Champs-Élysées, some of the biggest property deals of recent years have involved a sovereign wealth fund as either the direct buyer or major investor in a consortium or real estate fund. If a top tier property comes up for sale, sovereign wealth funds are now certain to be in the agent's first round of calls.

With the yield from the highest government bonds running at near record lows, it's easy to see the attractions of real estate for sovereign wealth funds. Despite the primary focus on relatively low risk opportunities (the usual criteria are high quality assets in superior locations of prime cities such as Paris, London and New York, which are occupied by financially sound organisations), the investor can achieve returns of 3%-6%. Real estate also has the attraction of inflation hedging and portfolio diversification, with increased property allocations often running alongside investment in infrastructure.

Estimates of new sovereign wealth fund equity allocated for deployment in global real estate markets range from $350 billion to $500 billion. Some funds may scale back real estate allocations if and when fixed income yields move back towards historical norms. But most funds would appear to be building up real estate capabilities for the long-term.

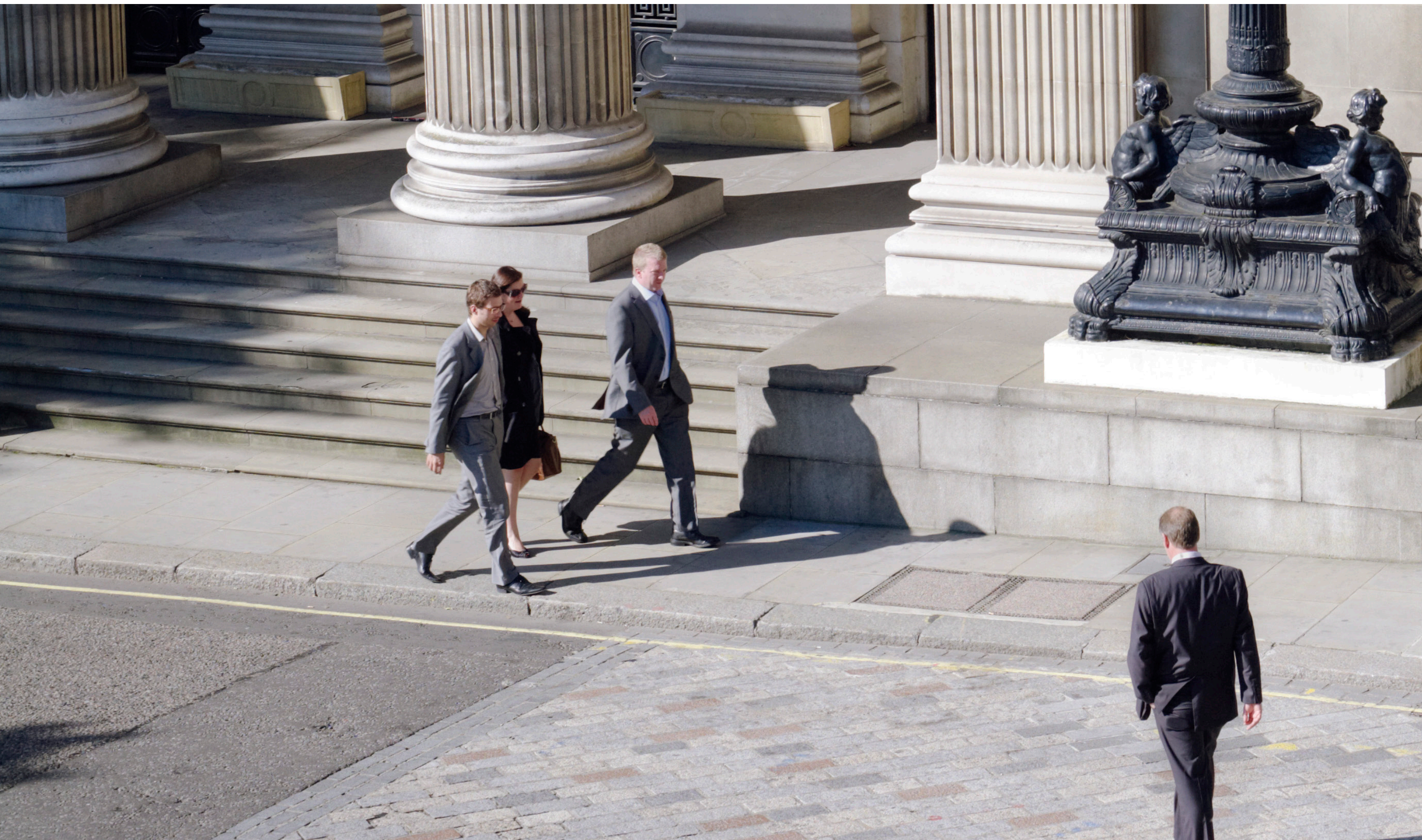
1 Sovereign Wealth Fund League Table – Preqin
2 NBIM Investments website (http://www.nbim.no/en/investments/) and Experience with real estate investments, 10 March 2014 (http://www.nbim.no/globalassets/documents/submissions/2014/experiencewith-real-estate-investments-final-10-march-2014.pdf)
3 Top ten sovereign wealth fund real estate deals of 2014, Sovereign Wealth Fund Institute

Squeeze on supply

The challenge is how to put all these funds to work. Sovereign wealth funds' low cost of capital gives them a clear advantage over leveraged competitors in any price auction. But even with this bidding edge, meeting ambitious allocation targets is going to be difficult at a time when there is far more demand than supply. Even if the focus is moved beyond the core prime cities the sheer weight of capital flooding into the premium real estate market means that there are still not enough suitable properties to go around.

So why is there such a squeeze on available supplies? Prime real estate assets have always tended to be long-term investments, which restricts the amount that come up for sale. At a time when occupancy demands are changing fast, these buildings can also quickly fall below today's expected standards. The risks involved in refurbishment and re-letting mean that some less well maintained properties may no longer be considered as prime assets. The dip in investment during the height of the financial crisis has exacerbated constraints on available supply and the risk that properties will be left long enough to slip into obsolescence. While the pace of development has since picked up, the long lead times in planning and construction mean that the impact of the dip will continue to be felt for some years to come.

At the same time, it's important to avoid making too many generalisations about this market. While the capital is global, real estate is a primarily local business, in which the price and availability of assets can vary by post/zip code or even street. Supply might dip in one neighbourhood, but pick up in another. This underlines the importance of local knowledge and an eye for an opportunity that others might miss.



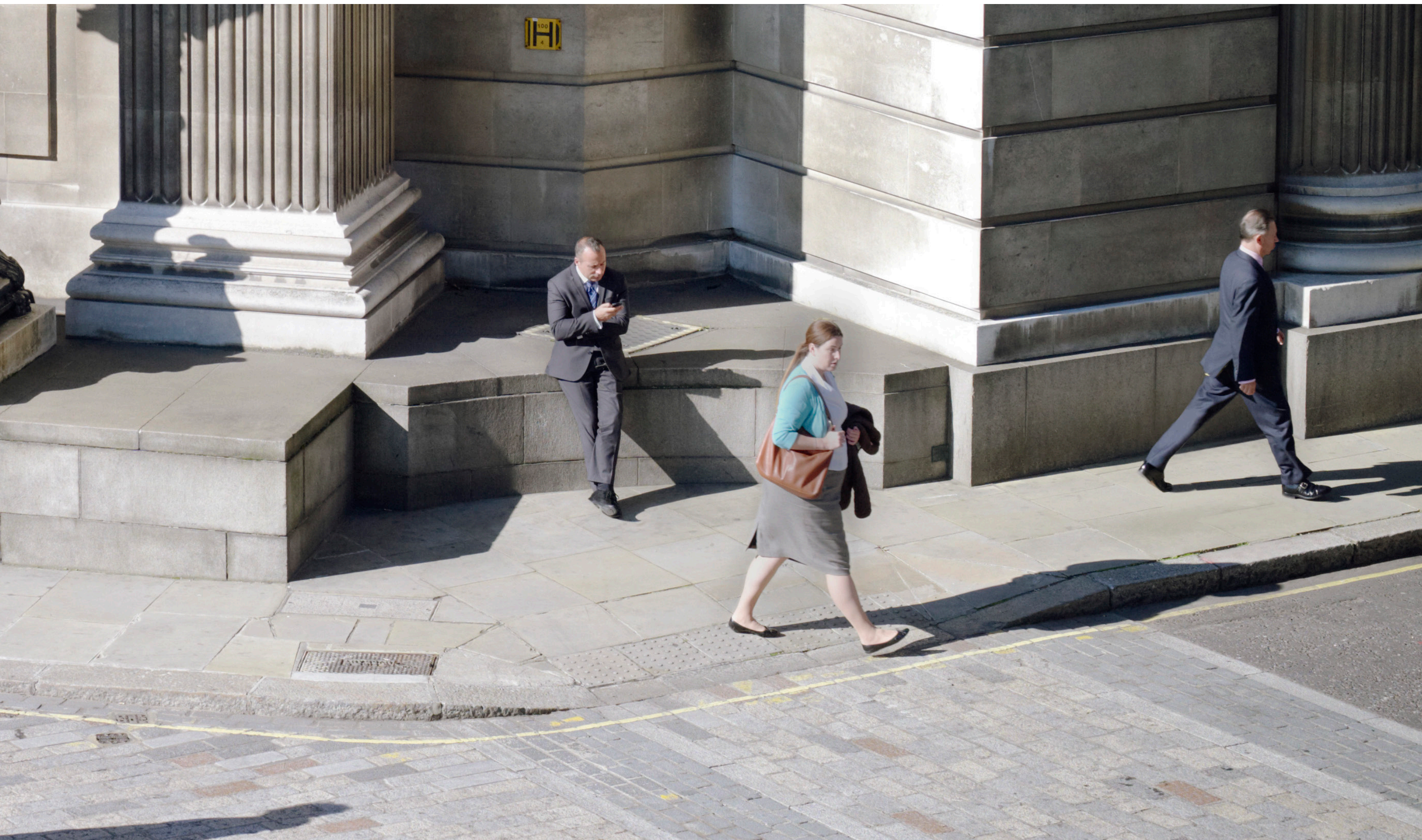
Spreading the net wider

So if we assume that there aren't enough prime assets to meet rising demand, what are the alternative options?

Relaxing the risk appetite would open up a broader range of available assets. While sovereign wealth funds are generally seen as risk averse, some have a mandate to seek out relatively high risk investments in the pursuit of higher yields. These are also exceptionally sophisticated investors, who would be prepared to move into value-add assets, development schemes or second tier cities if the right opportunity comes along. "Sovereign wealth funds are no longer interested in trophy assets at top of the market prices and are being more considered," said a fund manager that regularly invests on behalf of this type of investor in an interview for the latest Emerging Trends in Real Estate in Europe report[4]. Of the 500 participants from across the real estate market who were canvassed for the study, two-thirds believe there is a need to consider secondary markets or assets. The willingness to take on more risks is reflected in the rankings for city investment prospects, a clear example of which is Birmingham's rise from 17th to sixth on the list of markets to watch. The broadening of sovereign wealth investment horizons has also taken them into areas ranging from retail in Southern Europe to student housing in London.

Nonetheless, these higher risk assets are only likely to form a small part of the real estate portfolio within most sovereign wealth funds. Given the risk and reward profile, they may even fall into a separate asset allocation. While local knowledge is vital, the natural constraints on staff resources mean that few will be able to cover so many different markets and therefore partners are needed to provide the necessary expertise. At the same time, it's important to consider the structure objectives of potential partners, many of whom may depend on high levels of leverage or see corporate real estate investment as a macro-economic play rather than source of portfolio diversification and long-term return.

[4] Emerging trends in real estate Europe 2015, produced by PwC in partnership with the Urban Land Institute (http://www.pwc.com/gx/en/deals/sovereign-wealth-investment-funds/index.jhtml)



The untapped prime

What if the assumptions about limited supply are actually wrong and plentiful opportunities do still exist for investors who are prepared to search a little bit further?

The analogy with oil exploration would be apt here. If the easy to extract reserves are drying up, could we look further out to sea? While it may take new techniques to realise the potential, the rewards would justify this, especially if prices are buoyant. When oil was above $100 a barrel, all sorts of possibilities had come onto the drawing board – there was even talk of fracking under the North Sea. The economics of oil extraction may have changed as prices have fallen, but for real estate the rewards for drilling deeper would be akin to a $100 a barrel market.

A rich seam for prospectors could be headquarters buildings and other prime real estate assets held by corporates. There are several reasons why sale would be a good option for the owner, even if they've yet to explore the possibilities.

Corporations sometimes own prime assets that could be better utilised, may no longer match the organisations needs, or may require significant capital expenditure to upgrade them. They may not be best use of their own capital but could represent an opportunity for a sovereign wealth fund to provide that capital together with applying the skills of its real estate team.

Moreover, ownership of the current headquarters building or other prime office asset may not be strategically core for the corporation. For instance, while a car manufacturer needs state-of-the-art production facilities as a commercial priority, it is questionable whether owning non-strategic prime real estate is as critical. Some investors have looked at such instances from an arbitrage perspective – comparing what may be a favourable cost of leasing compared to owning to encourage the corporation to sell. But few seem to have determined whether the cost of ownership is diverting funds that could yield a better return through deployment in the core business. Some of the information about property assets is set out in the report and accounts. To capitalise on such opportunities, sovereign wealth funds could leverage those with deep expertise in the occupiers specific sector to determine what assets are strategically core and what others might make more sense to divest.

Prime real estate assets may also be sitting as collateral on the books of banks. These are just one element of what PwC believes is more than €2.4 trillion in non-core assets held by European banks. With so many other non-core assets to wind down or divest, the real estate assets may be sitting at the back of a long queue for attention and sale. But the pace of obsolescence in today's market means that without refurbishment, the property could soon slip out of the premium bracket. Examination of financial returns would allow the sovereign wealth fund to identify such assets and prepare an approach to the bank.

Sharing the benefits

Further possibilities include local and central government property assets (in the UK, health trusts are also big owners of prime-sited real estate). Many of these assets are sited in prime city centre locations or up-and-coming urban areas, which could generate much needed funds through a sale. Some of these assets are poorly utilised or in significant need of renovation and refurbishment. A list of UK government property assets and their usage is available in the UK National Asset Register and similar databases in other markets.

In December 2014, the UK government sold the Old War Office building in London's Whitehall on a long-lease arrangement[5], though few such prime publicly-owned assets come on to the market every year. It's more likely that opportunities will emerge in the secondary market, including the development of surplus land or acquisition and management of housing, student accommodation and other long-term income streams.

If a sovereign wealth fund was interested in pursuing such opportunities, the deal would be subject to government procurement and value for money assessments. They are also likely to attract significant public scrutiny, so it's vital to ensure that the potential benefits are shared between the seller and buyer. If a prime asset is bought, refurbished and re-let, for example, it would make sense to offer the seller a proportion of the profits on top of the proceeds from the sale. Moreover, money isn't everything in creating the right conditions for an agreement and public support. Further incentives might include support for regeneration or plans to develop trade, investment and cultural links between the city and the sovereign wealth fund's home state. Examples of such investor/government partnership arrangements include the investment in the regeneration of the deprived neighbourhood around Manchester City FC's stadium by the club's' owner in Abu Dhabi[6].

[5] BBC News Online, December 13, 2014
[6] Financial Times, December 8, 2014

"Rise early, work late, strike oil"[7]

The surge in sovereign wealth fund real estate allocations shows no signs of abating, though some investors may be held back by the limited supply of assets coming on to the market.

It isn't clear that Sovereign wealth funds are looking at corporate and government assets in any great depth, so there will be early mover advantages for sovereign wealth funds that can identify and capitalise on these openings. This isn't wildcat prospecting, however. Making the most of these openings will require systematic analysis, deep local knowledge and a clear understanding of the strategies and priorities of potential sellers.

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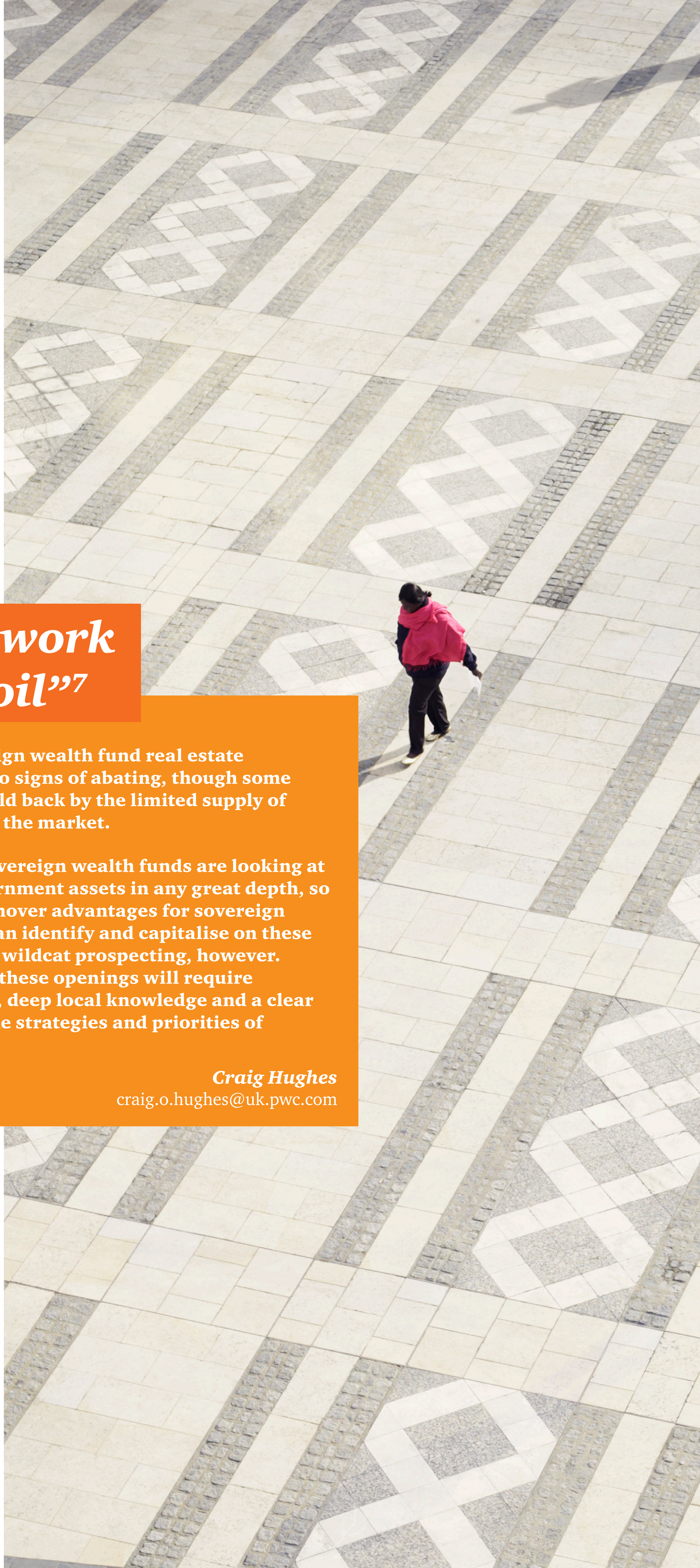
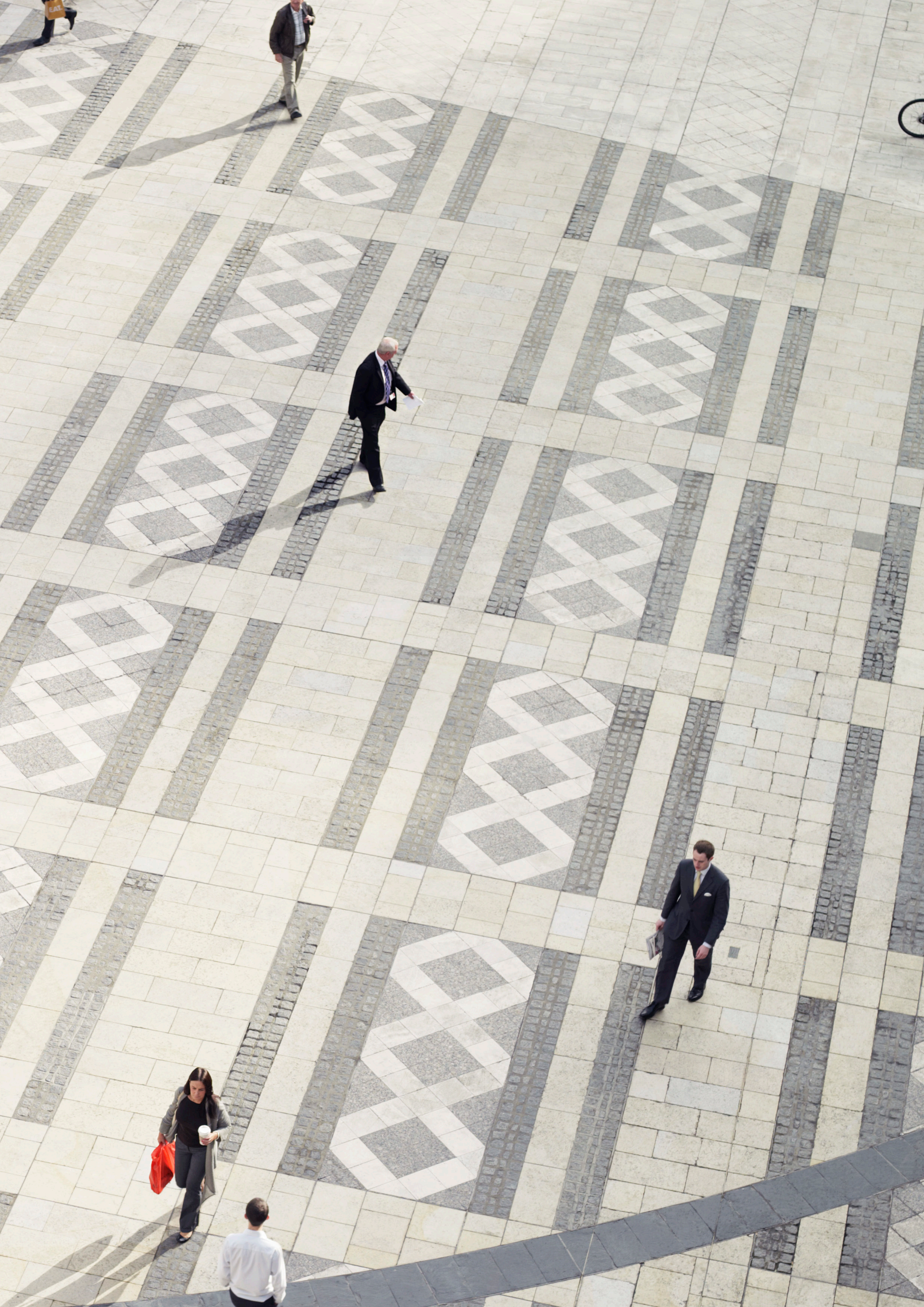


[7] Legendary oil man, John Paul Getty I, describing his formula for success



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