Frontier International

Europe or the US? Finding the best needs-based real estate opportunities

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Introduction

With international travel still off limits, Frontier's Real Estate team recently embarked on a virtual research trip of the US and Europe to assess and compare the relative opportunity set for needs-based real estate.

Many Australian investors remain underweight to these sub-sectors such as housing, healthcare, and life sciences, which are benefiting from demographic shifts. Equally, some Australian investors have also been hesitant to pivot portfolios towards the burgeoning logistics sector, fearful that they have 'missed the boat'.

Over recent years, Frontier has been investigating these opportunities, encouraging investors to harness the strong demand tailwinds and robust cashflows offered by non-traditional real estate.

However, the investment characteristics of each sub-sector are highly specific to the geography in which they are domiciled. Our meetings with a range of fund managers and industry players highlighted key differences between the US and European markets.

While there are unique considerations and risks for each opportunity, our findings demonstrate the compelling case for investors to continue diversifying their portfolios into needs-based real estate.

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Demographic trends drive needs-based real estate

Real estate sectors such as healthcare, life sciences and housing are growing to meet the needs of ageing populations and the lifestyle changes of younger generations.

But to take advantage of this 'needs-based' real estate opportunity, asset owners need to understand the nuances between sectors and markets.

Australian institutional investors typically remain heavily overweight to traditional sub-sectors such as office and retail.

Although growing, the opportunity set for non-traditional real estate remains slim in Australia. To build exposure, investors must venture offshore. However, the US and European needs-based real estate markets are at vastly different stages of maturity.

The US is more advanced and transparent. There are opportunities to invest through real estate trusts (REITs), pooled funds or co-investments alongside experienced partners with long track records. However, while market maturity provides greater certainty and potentially less risk, it is also coupled with greater competition for assets and therefore often sharper pricing.

The European market is more fragmented due to the region's wide-ranging regulations and cultural differences. However, investment opportunities still exist, and pricing tends to be more attractive.

Key points

- The needs-based real estate opportunity is largely driven by demographic trends, which are creating new demand.
- The US is a large, advanced and transparent market with multiple implementation options available to investors.
- The maturity of the US market also means there is greater competition and tighter pricing for quality assets or portfolios.
- Investing in Europe is more difficult, with disparate regulations and cultural differences running deep and making it hard to access data.
- Opportunities still exist across Europe with select partners, and pricing tends to be more attractive than in the US.

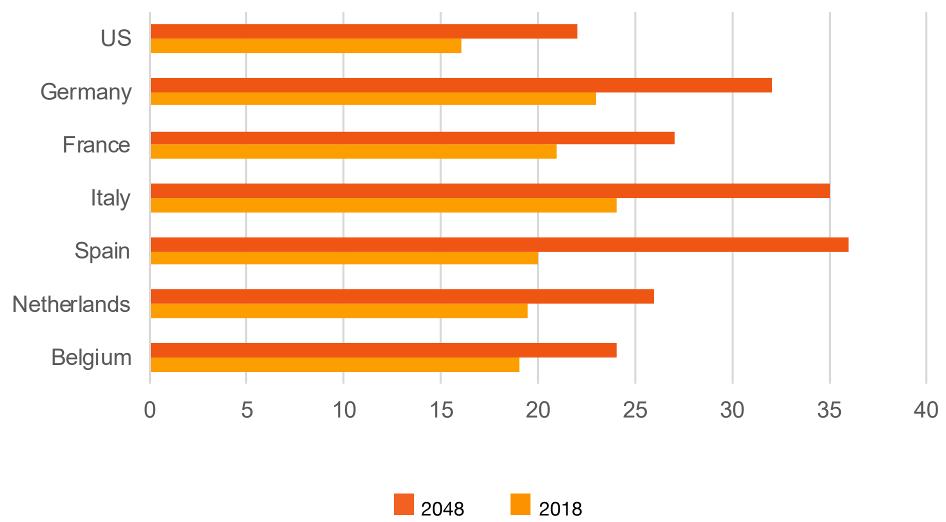
A compelling demographic case

The average age of the population is rising as people live longer and have fewer children, often becoming parents at older ages than previous generations.

There were 727 million people aged 65 years or above in 2020, according to the United Nations, which predicts that number to exceed 1.5 billion by 2050[1]. Globally, the proportion of this older population is expected to increase from 9.3 per cent to around 16 per cent by 2050[1].

This huge demographic shift is radically changing demand for services and products around the world, with major implications for investors.

Chart 1: Percentage of population aged 65+



Source: United Nations

An ageing population creates greater need for senior housing communities and healthcare. This is accompanied by a rise in obesity and other chronic diseases[2], amplifying the need for better medical services, most recently highlighted in our [December 2020 Real Assets Quarterly](https://).

It is resulting in new drugs and diagnostic services, along with increased investment in emerging life sciences research and development for areas such as cancer cures, genomic mapping and gene therapy.

General population growth and urbanisation is another driver for the real estate sector. Young families are increasingly priced out of the housing market, generating demand for affordable and workforce housing, as well as single family rental homes, previously highlighted in Frontier International Issue 36.

These changing societal trends are being met by needs-based real estate focused on healthcare, life sciences, and housing, previously highlighted in our Frontier International Issue 47.

The younger generation is also driving the strong take-up of e-commerce, which accelerated during the pandemic lockdown. This creates a greater need for logistics real estate, where goods are stored before delivery, previously highlighted in our Frontier International Issue 40 and a number of Real Assets Quarterly newsletters over recent years.

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[1] World Population Ageing 2020 Highlights | Population Division. (2021, May 20).
Retrieved from https://www.un.org/development/desa/pd/news/world-population-ageing-2020-highlights

[2] OECD

Housing

A structural shift in demographics and lifestyles is underpinning robust long-term demand for niche residential property. Urban populations are growing and demanding higher-quality housing, yet supply remains inadequate.

Niche housing sectors include institutional-grade sub-sectors outside the traditional multi-family sector in the US. This also includes the European private rented sector (PRS) and extends to senior housing, student housing, affordable and workforce housing, single-family rental, and manufactured housing.

All of these sectors are operationally intensive and require skilled partners.

However, performance is less correlated to the broader economy than traditional property due to different cyclical drivers, while valuations often hold up better during downturns as individuals are likely to prioritise basic need such as housing over other expenditure.

Institutional interest in deploying capital in these areas has been growing since 2015, although it is still small compared to total annual transaction volumes.

Across all housing sectors, growth will need to be driven by income. Last year, occupancy levels dropped, with senior housing occupancy delayed due to COVID-19, but as occupancy has rebounded in 2021, projected rental growth is looking relatively strong.

Subsector	Definition
Senior housing	Housing communities ranging from relatively low-touch private-pay communities to highly intensive skilled nursing facilities and government-funded hospitals. Managers commonly focus on class A and low service intensity assets.
Student housing	Rental accommodation to meet the needs of university students.
Affordable and workforce housing	Affordable housing can be subsidised or unsubsidised. It is often market-led (e.g. class B/C) multi-family or PRS residential apartments, while workforce housing targets key workers, e.g. emergency services, teachers, nurses and healthcare workers.
Single-family rental	Family houses either as portfolios of individual homes or single house community estates (US strategies only).
Manufactured housing	Communities of prefabricated houses fixed to temporary foundation sites provided by property owners (US strategies only).

Source: Data as of 30 June 2020. BAML, PineBridge Investments

Europe versus the US

Niche housing markets in the US, where specialist funds and established relationships underpin a premium stock pipeline, are more mature and liquid than in Europe.

Market maturity and a strong growth outlook has pushed niche housing cap rates below the average of traditional real estate. Investors should be prudent and selective. Build-to-core strategies offer a meaningful way to achieve scale, and the potential development premium can provide a key driver of outperformance, although selecting the right manager is crucial.

Europe may provide shorter-term opportunities, not only through a development pipeline, but attractive relative pricing, particularly for student housing.

However, data transparency, liquidity and cross-border operator efficiency issues increase the barriers to entry, especially for senior housing outside the UK where markets are not yet backed by institutional investors and are often highly regulated. Regulation varies across Europe, with tenant rights or rent-controlled legislation impacting housing.

Senior housing and student housing lease terms are typically short in duration, which provides an opportunity to capture rising rents, although also exposes investors to vacancy risk. Performance hinges on the ability of managers to attract tenants and fill vacancies. Operational and reputational risks are also more elevated in the senior housing sector.

Affordable housing - Paris, Ile-de-France region

Source: AXA Investment Managers

Manufactured housing - Harvest Gate, Puyallup, Washington

Source: PGIM

Medical offices and hospitals: opportunity varies by region

The world's ageing population creates in-built and rising demand for a range of healthcare services. Delivery of these services creates rising demand for real estate premises from which to consult, diagnose and treat patients. Increasingly, locations are community-based facilities rather than in hospitals.

Non-acute healthcare (i.e. ambulatory or primary) across Europe is typically provided by general practitioners. Specialist services are usually provided through hospitals (although not in Germany).

In the UK, there are about 9,000 medical offices – smaller primary care GP offices. About 45% are GP owned, 15% by REITs, 30% by other privates, and 10% by the National Health Service (NHS).

These assets are typically valued at a 3 to 5 per cent annual net income yield. Those not already owned by medical practitioners are often leased by GPs on 20-25 year terms, with rent reimbursed by the NHS.

Consolidation is happening through new medical care clinics and outpatient health centres, although the market remains highly fragmented and data is limited.

European countries often feature a mix of public and not-for-profit hospitals, while almost one-third (27%) of the US hospital market is privately owned.

In the UK, private operators are awarded licenses (at the discretion of the NHS) and 25-year leases are typical. However, the strong influence of the NHS across the healthcare ecosystem and the depth of the market limit the opportunity set in the UK.

Private hospital operators in France, Spain and Italy are re-imbursed by the government for providing services. While there are established frameworks, service prices change annually, and there is complexity in the way charges are determined. Payment can also be delayed in Italy.

There is a reasonable level of operator sophistication, although the depth of market and transparency is very limited. There is also a requirement for Spanish operators to own the real estate or maintain a controlling stake in any joint-venture to avoid additional tax, creating a hurdle for real estate investors.

Europe versus the US

The same attractive investment characteristics are found in both European and US healthcare real estate, namely the strong demographic demand tailwind and stability of cashflows. However, the two geographies also vary materially. Some of these key differences include:

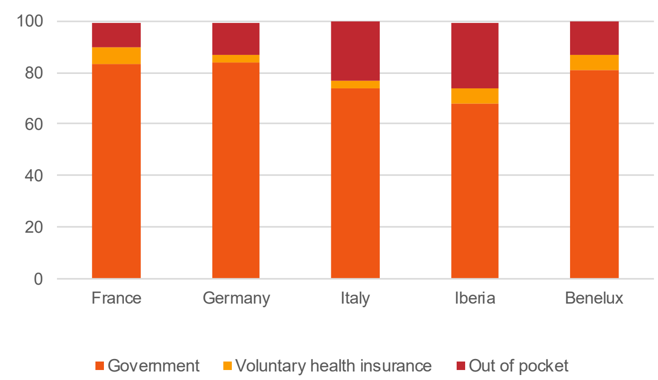
- competitive landscape
- healthcare funding (private vs public)
- depth of private healthcare operators and balance sheet strength
- regulation and taxation
- lease structures (e.g. rent reviews, lease length, and tenant obligations)
- types of investible real estate
- size and liquidity of investment market
- market transparency

This makes a comparison between the relative value of healthcare-related real estate in the US and Europe challenging.

For example, private health insurance plays a significant role in the US (and Australia), whereas European and UK healthcare is dominated by government funding. A greater proportion of private-pay funding may reduce regulatory risk but increases credit risk. Equally, regardless of the funding source, each geography has a distinct competitive environment and the role of the government/regulator/national healthcare provider can differ materially.

The European market is constrained by limited data, although this creates an opportunity for highly skilled, local specialists that can accurately underwrite investments.

Chart 2: How healthcare is paid for in European countries



Source: OECD, 2018

Life sciences: an emerging opportunity

The life sciences sector includes bio-engineering and bio-tech research and development such as:

- genomic mapping, gene therapy and editing, disease pathway research, and drug viability
- artificial intelligence linked to the delivery of medical treatments
- synthetic plant and food exploration and sustainable energy sources

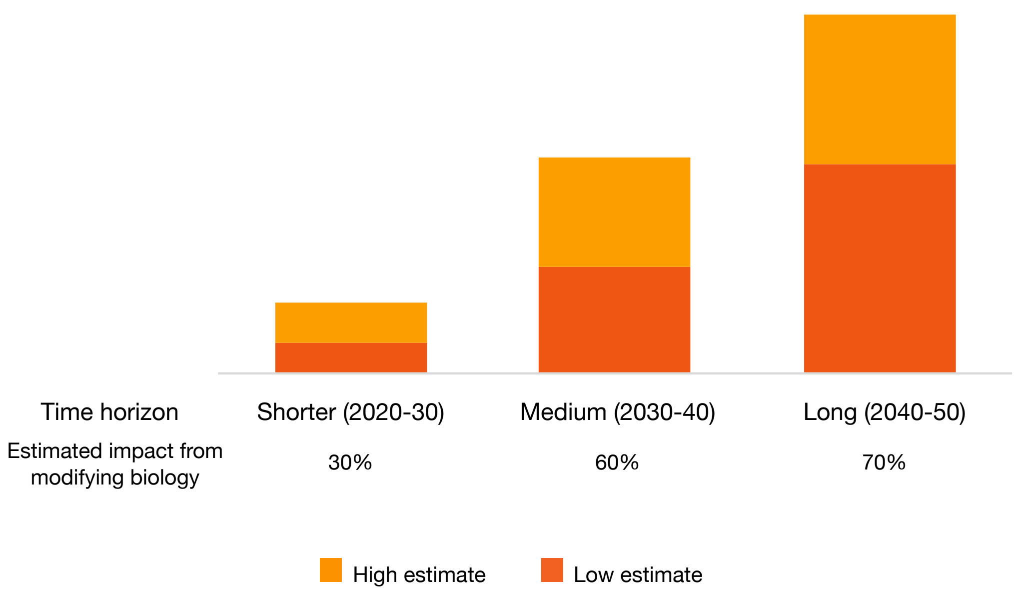
Healthcare spend for a globally aging population is a key driver of the life sciences sector and is forecast to outpace the rate of GDP growth[3].

The sector will generate approximately $2 trillion to $4 trillion of direct annual economic impact over the next ten to 20 years, according to the McKinsey Global Institute (Chart 3). There will be a corresponding demand to house specialised facilities for the delivery of these research and development activities.

The life sciences sector represents a different real estate investment opportunity compared to traditional medical, which requires office-like space, consulting rooms and surgery centres near hospitals and patients.

Instead, life sciences cluster around top research universities globally and includes highly specialised buildings to house wet and dry labs. Tenants are often major pharmaceutical companies such as Pfizer, Moderna, and Bristol, although can also feature smaller venture capital-backed biotech firms. High build costs are partially offset by triple net long duration leases (15 to 22 years).

Chart 3: The potential economic benefit of life sciences



Source: McKinsey, 2020

Europe versus the US

While the US life sciences market has a limited pool of skilled local operating managers with a strong track record, it is still more efficient and established than Europe and the UK, where investment is limited to a few single assets or small portfolios. According to CBRE, total commercial laboratory space in the US has grown by 12% in 2020 to 5 million sq. ft. Another 11 million sq. ft. is currently under construction. Despite the increased supply, lab rents are rising as tenant demand remains very strong and cap rates are circa 25 to 50 bps lower than traditional office sector (Real Capital Analytics Q3 2020).

US healthcare/life science venture fundraising surpassed $20 billion in 2018 and 2019. The US National Institutes of Health (NIH) is also a major funder of biomedical and public health research.

European funding differs between countries, with Germany, the UK and Switzerland attracting corporate funding, academic research relying on grants and related major funding bodies. R&D is primarily funded by big pharmaceutical companies and venture capital.

While industry practitioners consider the US market to be about ten years more advanced than European life sciences, European assets are well bid, with pricing currently factoring in a zero premium to traditional office buildings for assets adjacent to and around universities.

Nonetheless, the UK – home to five of the world's top 20 universities – is the leading centre for life sciences in Europe and is set to attract institutional investors making their first foray into Europe.

The outlook for the sector is strong but not without its risks (primarily supply). Frontier identified and is monitoring opportunities for fund investing with opportunity for co-investments.

[3] UN.

Logistics: Lockdown? Let's shop online …

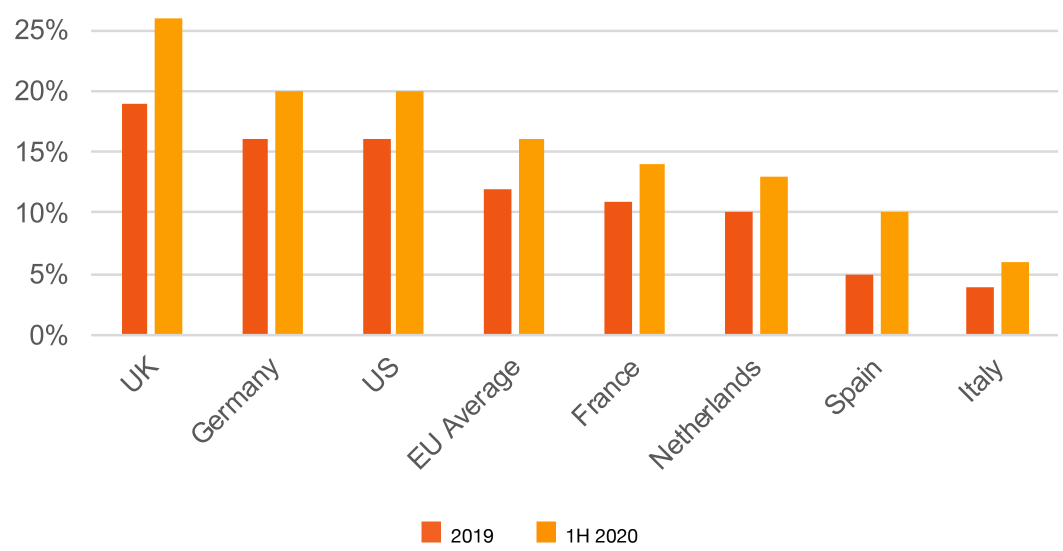
While the COVID-19 lockdown hurt some traditional real estate sectors such as offices and retail malls, it has been a net positive for logistics real estate globally.

The rise of e-commerce was already well underway, as shown in the graph below, and lifted again as populations in lockdown placed more online orders for goods they previously bought in-store.

US e-commerce sales grew by 32.1% year-on-year in the final quarter of 2020, and sales are expected to grow between 12-15% a year post-pandemic as consumers return to outdoor activities, supported by vaccine programs.

E-commerce tenants typically require three times as much warehouse space as traditional retail tenants, although over-supply in some countries remains a significant risk. Logistics cap rates are at historic lows across Europe, though material spreads to 10-year government bonds remain. European vacancy has risen moderately over the past two years; however, it is coming off historic lows in 2018. Development challenges – increasing construction costs, authority approval processes, local opposition, and land constraints – are expected to push new supply further away from customers and drive rent growth for well-located assets. The US market is also disparate, with many cities and regions exhibiting unique risk and return profiles. Densely populated coastal metro areas with limited land supply and port access, metro markets, such as those in California, Washington state, New York and New Jersey, have posted some of the strongest recent rent growth and total returns. Long before COVID-19, Frontier highlighted the case for allocation to this sector (refer our Frontier International issue 40). These tailwinds are expected to push annual fund level gross total returns in the US and Europe into high single-digit territory over the next three years, driven by rent growth and continued capital interest..

Chart 4: E-commerce as % of core retail sales



Source: Savills, Center for Retail Research, Clarion Partners

Europe versus the US

While Europe has a higher total population and population density than the US, its e-commerce market is generally less mature. Countries such as Spain and Italy have increased online retail shares off a low base. US giant Amazon is still in the initial stages of expansion in most European countries.

Fund-level gross total returns in both regions are expected to be high single-digit p.a. over the next three years.

With yields already so low, further cap rate compression is required to reach those projections, contributing around 40-50% of expected total returns. Spreads to current 10-year government bonds supports further yield compression for the sector, particularly in Europe (where nominal yields in several countries are negative or very close to zero), as is the weight of capital chasing what is a hot sector.

The tailwinds for logistics real estate is such that the outlook for the sector in both regions remains strong, though not without risk (notably supply). Europe's denser population and land-constraints, less-mature logistics real estate market, slower take-up of e-commerce and higher spreads to bonds are clear positives. With many newcomers investing in the sector, Frontier continues to prefer managers with deep local knowledge and experience, scale across markets and tenant relationships, and proven development capability.

The final word

The investment opportunity for needs-based real estate is driven by clear demographic change: an ageing population's higher healthcare needs, demand for more affordable housing, and life science/ bio-med facilities to house an insatiable search for solutions to live better, longer and more sustainably. Meanwhile, logistics continues to benefit from greater online sales penetration.

Our virtual research trip to the US and Europe confirmed these drivers remain in place but highlighted that some sectors and regions are set to benefit more than others.

The US is far more advanced and transparent. Investment opportunities are available via funds and co-investments with strong partners.

Europe is stymied by disparate regulatory and legal regimes and cultural differences which run deep. Data is challenging to access however opportunities exist with select partners. For example, in the case of the life sciences sectors, Amsterdam, Basel, Berlin, London, Milan, Leiden, Zurich are leaders within the region.

The intricacies of individual countries' healthcare, housing and life sciences markets complicate any comparison of relative value between the US and Europe. Even state and regional differences can be significant.

Varying stages of market maturity leads to tighter pricing, whereas an emerging market provides more attractive entry pricing. There are risks attached to both aspects.

Frontier continues to recommend increased diversification to needs-based sectors such as housing, healthcare, life sciences, and logistics for all institutional investors. We are actively monitoring opportunities across this spectrum for investors. Please contact our team to discuss any aspects of this paper.

Want to learn more?

We hope this paper has generated many ideas for your own portfolios. If this is the case, please reach out to Frontier to discuss how we can work with you in this space.

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