



## MARKET INSIGHT

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# 50 SHADES OF REAL ESTATE

Among all private and illiquid assets, real estate stands on top as the asset class that investors are the most willing to consider for an allocation. There are multiple reasons to this but the fact that real estate is tangible probably explains a lot. Investors can actually see what they are buying, dynamics behind cash flows generated by an office space for example are fairly straightforward to understand. Oddly enough, real estate is often underrepresented in client's portfolios despite its appealing attributes and the fact that it is investable in many forms and shapes. How to invest in real estate today as rates are set to rise and why Southern Europe is top of the menu as the place to be for investors?

Financial crisis have a history of hitting real estate hard, but also acts as an indicator of how an economy is recovering. The global credit crunch and the European crisis were no exception and real assets in Europe suffered a great deal, especially the infamous PIIGS as they have been dubbed. Institutional investors retrenched from those markets, prices fell across all segments while GDP contracted and unemployment soared. Fast forward a few years, the recession has passed: Spain and Portugal real estate is booming on all segments, with robust demand sustained by a diversity of investors, from western retirees lured by tax incentives, to US hedge funds taking advantage of dislocated prices and forced sellers. The market is now more mature as overseas institutional money came with some standards but the outlook continues to be very strong across all segments as upbeat economic outlook is boosting investor's confidence.

Although investors should be aware that each country and city is driven by its own particular dynamics and these should be taken into account before investing. Offices in Spain have had tremendous growth recently, as illustrated by Madrid which saw more than 600,000 sqm of office space transacting in 2017 while Barcelona generated 345,000 sqm of activity in the same year. Considering that an office building is usually a transaction involving a large amount of bank financing, with interest rates increasing, the market needs to see a continuation in rental rates growth, but the current lack of available supply in Madrid and Barcelona should act as a good support for yields. The hospitality sector is also well supported by tourist growth evidenced by the 82 million tourists who visited Spain in 2017. However, it is worth noting the hospitality market is considered to be more complex to navigate as an investment. This is thanks to the intricacies of operating a hotel, being independent or operating under a banner and matching the constantly evolving international standards which might require significant Capex. Residential remains a very appealing value proposition as the market is currently consolidating its recovery and the main indicators are showing a bullish trend, with housing demand growing constantly and valuations revised upwards. On top of that, the Socimis (publicly listed real estate companies, similar to US REITS) are pushing prices higher by continuing to add residential assets in their portfolios. As sourcing of existing assets can be difficult due to the solid demand, development is currently among the most attractive segment today.

Local developers are hungry to kick off new sizeable projects but need financial partners. Demand for residential development and office space is strong as existing assets are difficult to source so local developers have seen a huge opportunity. Following the 2011 European crash many developers went bankrupt meaning there is significantly less competitors operating in the market. However, developers need partners with the financial means to kick-off their projects as they are not cash rich. A number of investment funds have grasped the opportunity to partner with local experts who will manage the day to day of the operation while retaining a majority stake in the deal. The internal rate of return (IRR) for residential development is in the high double digit range, unlevered, as there is construction and development risk. Prices for buildable land is also below historical levels as usually those assets do originate from balance sheets of banks that are de-risking, hence willing to sell at a discount. Funds can be invested throughout the full life of the development and even retain ownership of the asset after it is finished or they can participate to the early stage of the financing, a strategy that is currently gaining traction in Spain.

Bridge financing in the context of development, being residential or office, belongs to the general disintermediation trade family. Banks are highly constrained to use their balance sheet and they carefully select the projects they finance. Typically, banks are willing to lend to real estate developers when all permits have been granted and when the land is fully entitled. Before these prerequisites are on the table,

traditional lenders are reluctant to step in as collateral is either hard to value, or too cumbersome to create solid security packages. At this point, real estate developers have no other solution than to looking at alternative lenders, which are usually specialist credit shops or hedge funds who have the tools and resources to offer loans at attractive conditions. Alternative lenders as a whole are providing flexible solutions at a fast execution, hence gaining more attention from developers who continue to find the doors to be closed for their businesses. In this particular area, bridge financing is becoming very appealing, especially in Spain where bank balance sheets continue to be clogged with non-performing assets, and alternative lenders are able to deploy capital at interesting risk returns parameters. In a context of rising interest rates, being able to invest 12 to 18 months and be paid double digit in interest rate is an attractive value proposition for investors. The flipside is that the exposure to real estate is indirect as this type of opportunity is mostly a financing-type of transaction using real estate as collateral. Bridge financing has to be understood in the context of bank disintermediation.

Investors with sufficient assets under management should consider making room for private assets and especially real estate in their portfolios. Obviously there is a give up on liquidity, but the benefits of holding real assets are greater. Not only are real assets and real estate immune from market gyrations, hence providing stability during rough times but they often generate cash flows. Real estate funds

are probably the best gateway to the asset class for investors, providing diversified exposure in terms of asset typology, geography and size. Investors wishing to go one step further can allocate to bespoke structures and funds aimed at investing in one particular sub-segment such as Spanish bridge financing or residential development in a particular region. It takes usually the first cycle of investment for investors to feel comfortable, but once their investment in the first fund is returned with solid IRR, it is not uncommon for investors to roll their investment into a new fund, and so on and so forth.



**NICOLAS ROTH**  
HEAD OF ALTERNATIVE ASSETS

*«Investors with sufficient assets under management should consider making room for private assets.»*

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