October 2021

Insights

Real Estate

SwissLife
Asset Managers

Operational real estate –
structural change draws attention to the niche segment

Health and well-being –
when the workplace should contribute to health

Hospitality –
the pandemic has not affected all hotel categories equally

Contents

Editorial

Dear readers,

Following a brief respite in the summer and short-lived hopes that the pandemic was soon to end, the old uncertainty is creeping back. This has not gone unnoticed in the real estate sector: although real estate investments promise positive returns due to low interest rates, investors are reverting to risk aversity. As a result, they are reaching for their black-and-white spectacles when looking for returns on the real estate market.

In other words – to stay with the black-and-white analogy –, it is important, as with chess, to analyse every situation precisely and not to dull the longer-term view. Even supposedly unattractive sectors such as retail can offer interesting investment opportunities on closer inspection.

The overall picture shows that the real estate sectors that are quickest to adapt to the new conditions offer robust investment alternatives. One example of this is commercial and residential real estate, which is increasingly focusing on health aspects in the wake of the pandemic. As in chess, those players who prepare well, adapt when necessary and don't see everything in black-and-white terms, are most likely to succeed. Otherwise they run the risk of a premature check mate.

We hope you enjoy this issue of Insights

Stefan Mächler
Group Chief Investment Officer Swiss Life

In the black-and-white world of real estate

In an environment of prevailing uncertainty, resilient real estate sectors are in demand. In more controversial real estate sectors, differentiating helps to separate the wheat from the chaff.

Gudrun Rolle, Research Swiss Life Asset Managers, Germany

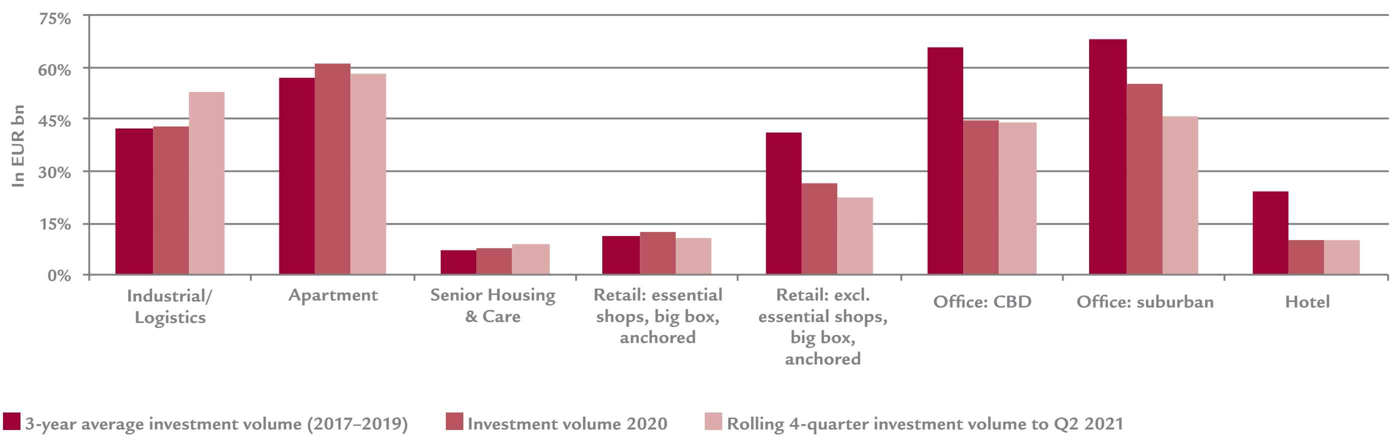
Clouds pervade the economic outlook: As the vaccination progress turned sluggish, countervailing measures to fight the spreading of corona variants emerge. As uncertainty levels up, economic sentiment slides again. Overall, risk aversion is pronounced, while investors' quest for yields continues.

Given that the ECB signals to keep interest rates low, despite a relative increase in inflation, real estate investments remain attractive as they keep their positive yield expectations. However, risk aversion leads to a black-and-white valuation of sectors, affecting investment activity.

On the one hand, sectors with intact occupier markets, i.e. residential, industrial/logistics and healthcare, are in demand. Their investment volumes during the pandemic and into H1 2021 either remained stable or increased in comparison to pre-pandemic volumes. On the other hand, shaken sectors such as retail are avoided at first sight. At second sight, a differentiation offers a more appropriate picture: Retail properties whose tenants promise to generate stable sales volumes, such as essential shops or assets with an anchor tenant that ensures consumer traffic, prove resilient. Their less sales-stable peers, e.g. shopping centres lacking anchor tenants, face continued declining capital inflows. In the office sector, investments in (supply-restrained) CBD (central business district) properties started to stabilise, under the assumption that post-pandemic, (high-quality) CBD offices benefit from the structural changes undergoing the occupier market triggered by remote working options. On the contrary, demand in suburban properties with less positive prospects continues to fall.

As long as uncertainty prevails, the pattern in investment activity will continue to colour real estate markets in black-and-white. ■

Contrasting investment volumes before and during the pandemic in the European real estate market



Essential shops: grocery, drug store, convenience store

Source: RCA

The rise of operational real estate – seizing the opportunity

Structural economic and consumer changes are altering occupational demand, causing real estate to become more dynamic and operationally intensive. This is driving interest in operational real estate, presenting new challenges and advantages for investors seeking to build future-proofed portfolios.

Frances Spence, Director, Research, Strategy and Risk, Mayfair Capital Investment Management

The UK Investment Property Forum defines operational real estate as: "real estate investment where the return is directly and deliberately linked to the revenues and profits of the business conducted on or from the premises."

Once a niche segment, operational real estate is becoming mainstream for several reasons:

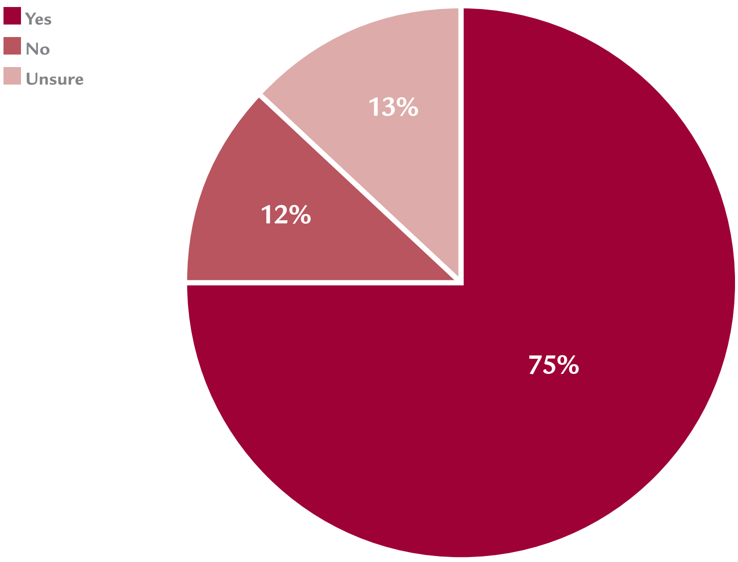
First, the attractive income profile and strong structural fundamentals within sectors that typically offer an operational model, such as hotels, care homes, residential or self storage, has attracted interest.

Second, shorter lease terms show rising demand for a more flexible, service led offer. As a result, landlords must become more attentive and increase operational intensity to preserve income streams. This has narrowed the gap between traditional leasing models and operational real estate.

Finally, innovative disruptors, such as flex office providers offering amenities and "on-demand" space, have led to the emergence of operational models across all sectors.

Landlords expect office tenants to demand more flexible lease terms

Do you expect your tenants to require more flexible leases?



Source: Savills "Landlord Flex Survery", March 2021

Why invest in this sector?

An allocation to operational real estate will create resilient portfolios, capture outperformance and provide a diversifier for traditional real estate exposure.

Investors with operational control can deliver tailored products well aligned to end user needs. They should have greater success attracting occupiers and reducing voids. As half of new UK leases in 2020 were for five years or less, this is increasingly relevant.

Rapid rental value polarisation is evident between high-quality, service-oriented space and secondary pure service products. By establishing an operational model, landlords can increase returns by capturing upside through rental premiums from well-run assets, rather than passing these to an external provider.

There are also environmental advantages. Investors wanting to move towards net-zero positions will need greater operational control.

What are the risks?

Notwithstanding the opportunities, it is important to understand the challenges.

Mayfair Capital's refurbishment of Forge, Woking, offers flexible, service-led office space.

Operational real estate carries higher income risk and greater volatility, given income is no longer tied to a fixed rent. Other challenges reflect the higher costs of more intense asset management and in-house operating platforms. Alternatively, partnership risk with an established operator requires mitigation through diligent credit risk analysis and understanding of broader sectoral trends. For this, investors need to broaden their skill set.

Investor appetite will increase further

Structural changes are driving occupational demand in "alternative" sectors that function within an operational model. This will attract increasing capital and Swiss Life Asset Managers is well positioned to offer respective investment opportunities. Furthermore, across the market, building management and services will increasingly determine asset returns as real estate shifts from a passive investment to a more operationally intensive model. Investors must understand the challenges and opportunities this poses to capture the performance prospects and the diversification benefits to their real estate portfolios. ■

Sectors that offer operational real estate models, such as self-storage, are attracting investors.

Life science real estate relies on the health megatrend

The health sector is important in affluent societies with an ageing population. Investments in European healthcare assets are well established. Commercial property investment in spaces occupied by life science companies provides an opportunity to benefit from the strength and growth of this sector.

Andri Eglitis, Head Research, Swiss Life Asset Managers, Germany

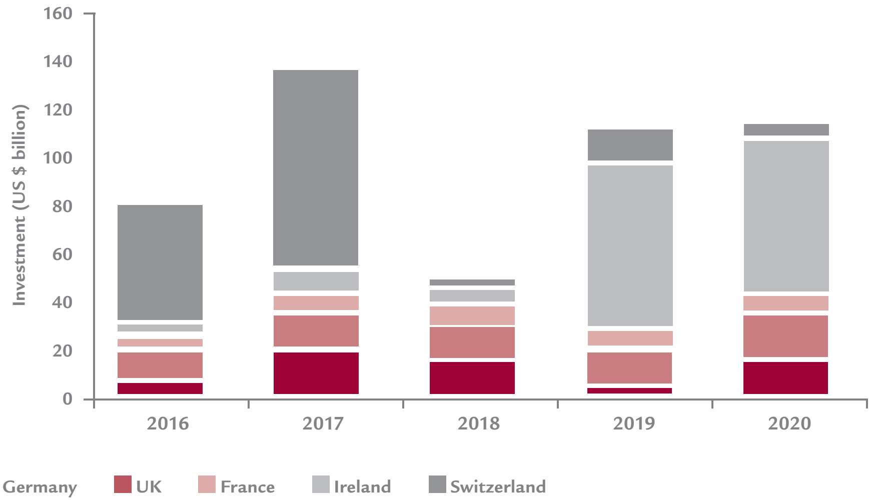
Life sciences cover a wide range of activities and can be described as the application of biology and technology to health improvement. Life sciences include pharmaceutical research and manufacturing through to medical diagnostics, genome-mapping, and the development and production of medical devices.

Due to the importance of research and development, life science companies often prefer to locate near public and private research institutions. At the same time, new companies are being created out of these organisations which drives localised occupier demand.

From a real estate perspective, life science companies require a mix of office, lab space and production facilities. They often need real estate that provides specialised functions such as clean rooms or R&D facilities. Established, domestic companies often possess their own stock, whereas start-ups are likely to rent most of the space they need. Start-ups are increasingly active as technology is integrated into healthcare services through biotech and medtech.

Capital investment in European life sciences

High, growing capital investments in life sciences in Europe, driven by corporate acquisitions, underline the attractiveness of the sector among investors.



Source: Savills, "Life Sciences – Trends & Outlook 2021"

The sector appeals to attractive tenants

Regional differences should also be considered, as companies in continental Europe are more reluctant to rent than they are in the UK. For investors, high owner-occupation implies a lack of product, which can be addressed, for example, by sale-and-lease-back agreements. The life science sector offers landlords attractive tenants: many companies have strong credit ratings and negotiate long-term leases in order to secure specialised real estate from a strategic point of view, driven by occupants' investments in individual fittings.

In contrast to the US, the European life science real estate investment market is less mature and difficult to measure. According to the Urban Land Institute, transaction volumes into life sciences in 2020 were less than 1% of the overall EUR 275 billion invested. Stock traded was characterised by a high share of cross-border investors. Initial yields are about 100 basis points above the level of prime office or residential assets.

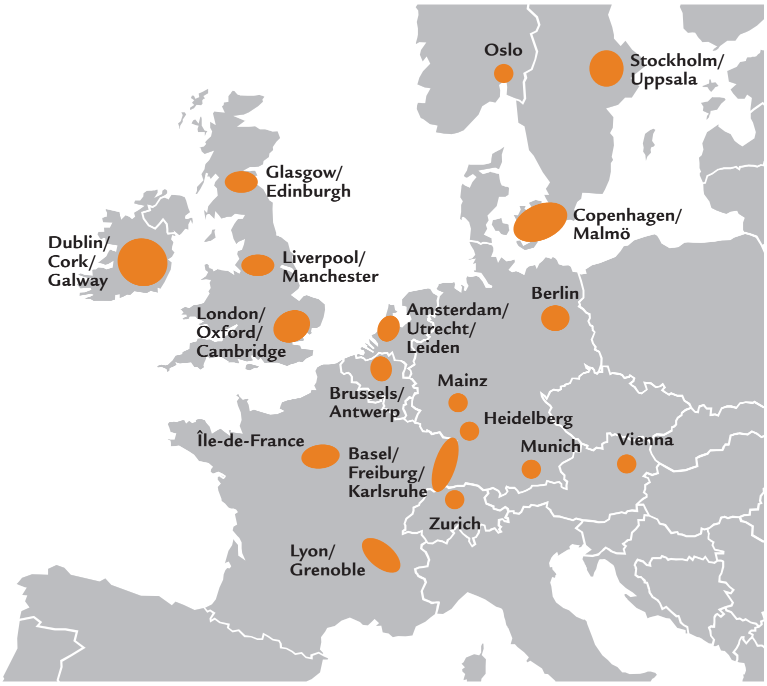
Several factors fuel the industry

Given its attractive risk-adjusted return prospects, allocations into life sciences can be an interesting way to diversify real estate portfolios. Swiss Life Asset Managers, via its German operational property specialist BEOS AG, manages investment programmes that hold a number of flex properties occupied by suitable tenants, but classified as part of the industrial and logistics sector. In 2020, BEOS AG acquired an office and laboratory building in Essener Bogen Business and Technology Park in Hamburg. The property, with approx. 11,000 m² of rental space, serves as headquarters for a biotech company, and a further building with another 11,000 m² of office and lab space is to be constructed for the company on an adjacent site.

Whilst the life science sector is still a fledgling category in Europe, the benefits of properties designed and occupied by such tenants are apparent to investors. Demographic change, rising healthcare spending and new technologies fuel the industry, while the properties themselves feature an attractive risk-return profile through diversification across product type and tenants. ■

Major life science cluster in Europe

Led by universities such as Oxford and Cambridge and as measured by the inflow of venture capital, the UK is the European leader in life sciences. Other emerging clusters are located around top research institutions in the German-speaking countries as well as in France and the Nordics.



Source: Swiss Life Economic Research

Evotec headquarters, Hamburg

Source: BEOS AG

The pandemic is shaking up the real estate health and well-being expectations

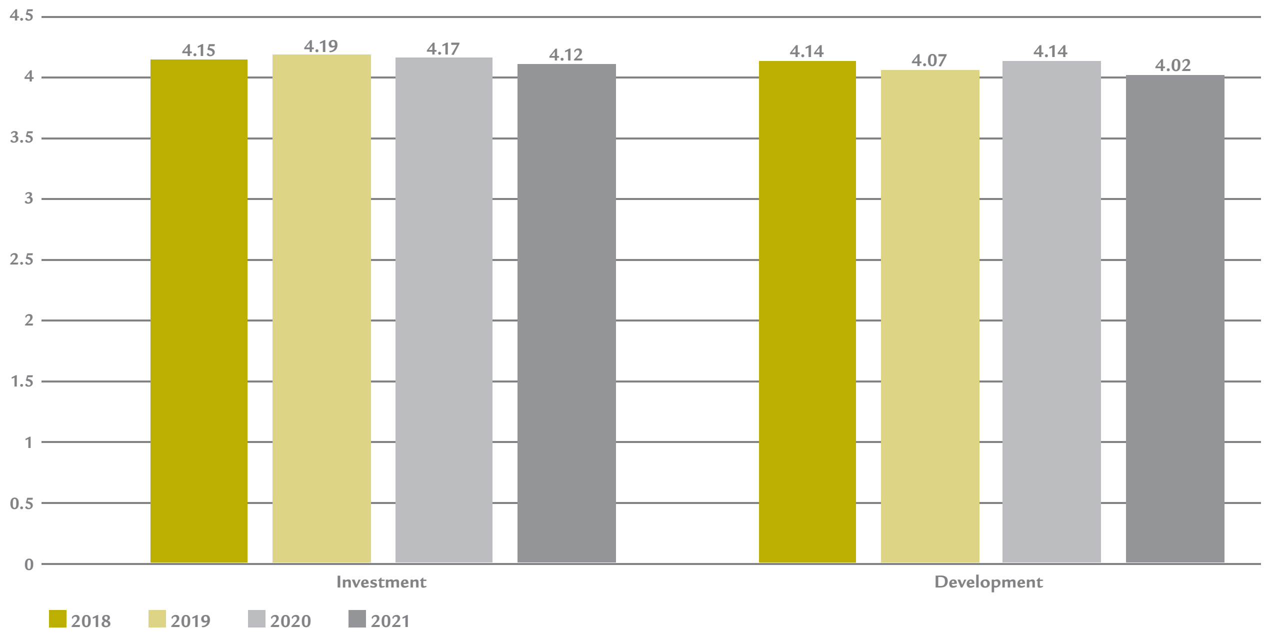
For both commercial and residential asset classes, the pandemic shed light on the role of real estate in the health and well-being of societies, and this is expected to be a game changer.

Valérie de Robillard, Head ESG Real Assets, Swiss Life Asset Managers

Commercial real estate is undergoing one of its most severe and probably long-lasting periods of change, while the residential market has been one of the most resilient markets during the Covid era. According to Statista, between 2019 and 2020 commercial real estate investment volumes in Europe fell by 23 percent. However, the below European residential market survey among 995 respondents shows the stability of the market throughout the crisis.

Another survey carried out by PwC in Europe states that "some respondents expect working from home to reduce demand for office space, others expect it to even increase in certain areas in the long term, as companies increase the space per employee to allow for permanent social distancing" [1]. In the office market, we observe a polarisation towards prime objects in easily accessible, amenity-rich city centres that offer high-quality/specified space and that possess ESG conformity. In the residential sector, the occupier market is characterised by a housing shortage in urban areas. Due to preferences pushed by working from home, and also afforda-

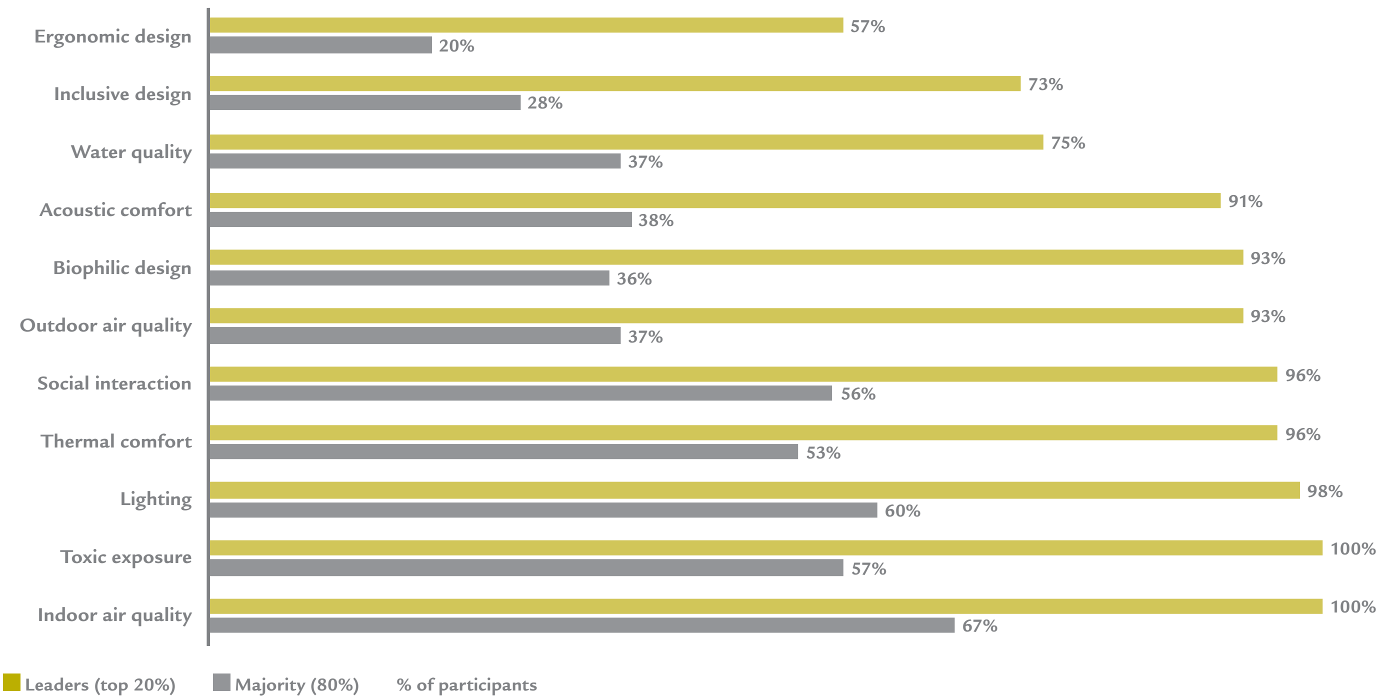
European real estate investment and development prospects in privately rented residential properties between 2018 and 2021 – average index score



Source: Statista 2021

Strategies to promote tenant and customer health and well-being implemented by market leaders (top 20% of GRESB health and well-being score) in 2018

Design and operation strategies, 2018



Source: "Health & Well-being in Real Estate, Green Health Partnership & GRESB – 2016–2018"

bility, occupiers are starting to move into suburban areas.

Simultaneously, some companies now identify the need for creating physical social interaction for employees, and the office will be one of the means to achieve it. Here the challenge might be how to convince employees – and especially the younger generation – to come back to the office. Health and well-being components will be one of the drivers which will possibly lead the office market out of the post-Covid crisis. In addition to well-being services at work, some tangible metrics relevant to real estate might increasingly be taken into consideration by tenants: acoustic comfort, indoor air quality or access to green space, as well as well-being certificates like Well, Fitwell or Osmoz.

Jones Lang Lasalle real estate consultants surveyed French office employees regarding their post-pandemic expectations: 71 percent wish to have access to wellness services at the office (e.g. massage, yoga room) while 66 percent would appreciate sports facilities (shower, gym).

What used to be a pre-pandemic trend, or a nice-to-have feature, might well become a post-pandemic differentiating factor for commercial real estate. It is quite possible that there will be a major split between two categories of office buildings in the post-pandemic era: Health and well-being ready commercial assets which will bring value to both customers and investors as well as other assets which have not been able to set themselves apart through health and well-being characteristics. Overall, in this shifting post pandemic world the most recent trends and evidence show that health and well-being will be a distinguishing factor for the success of the office sector. However, its importance for society goes well beyond the office, as it may well become a determining factor that shapes the demand and characteristics of all facets and nuances of the real estate market. ■

[1] PwC, "Emerging Trends in Real Estate®: Europe 2021 – An uncertain impact"

Hospitality: the worst is over, better days lie ahead

Before Covid-19, the hospitality sector had a strong risk-return profile on top of its long-term lease characteristics. The pandemic underscored the sector's pro-cyclical nature: risk aversion still lingers in the air while some early movers start to anticipate a strong, but mixed recovery.

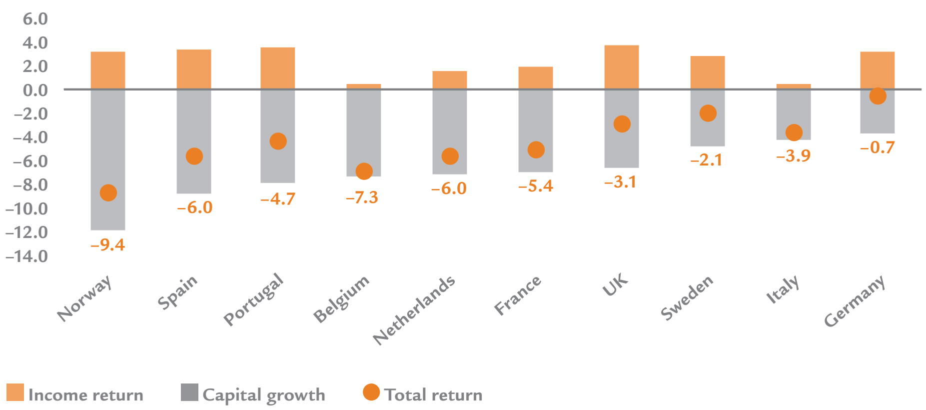
Béatrice Guedj, Head of Research & Innovation, Swiss Life Asset Managers, France

Historically, Europe has been the world's number one tourist destination, with Spain, Italy, France, and Germany ("the Big Four") being the top four largest markets in terms of both the number of visitors and nights spent. On the European hotel property market, the impact of the pandemic in 2020 was clear: according to MSCI, which covers almost EUR 24 bn of assets in the hospitality sector, total returns by country were highly negative across the board. Unsurprisingly, countries highly reliant of inbound tourism such as Spain, Portugal, Belgium, the Netherlands, the UK, and France observed the largest downward adjustment in terms of capital values. On the other hand, in Germany or Sweden, where inbound tourism represents a share lower than 25% of total tourism, the fall of capital values remained more moderate. A notable highlight remains on the income side, which was positive across all markets in 2020, although far lower compared to past trends. Large differences in income returns remained across countries and categories of hotels: in 2020, the luxury and upper upscale assets were highly penalised by the lack of international travellers while economy and midscale chains showed strong resilience in terms of income returns (see chart 2). This trend is likely to continue until the whole sector recovered.

Listed real estate equity markets, a good proxy to appraise key changes on direct markets, experienced a turning point alongside the news of the vaccine in October 2020: the European hospitality index bounced back. In 2021, the index reached its pre-crisis level, just like its peers in the US or Asia. This new sense of optimism for economic recovery echoed the rising vaccine rollouts. In Europe, and regardless of the hospitality sector itself, the digital green pass or the vaccine passport is key to gradually restoring confidence across countries and boosting the pace of the overall euro zone output growth. However, despite this consecutive recovery, hospitality is set to face some collateral effects from the home office disruption. Such a scenario is already priced in by the equity markets: flagship hospitality companies in Europe with large business brands within their portfolio continue to suffer the most. On the other hand, in a bullish scenario, home office could increase leisure demand translating into larger length of stay in specific locations.

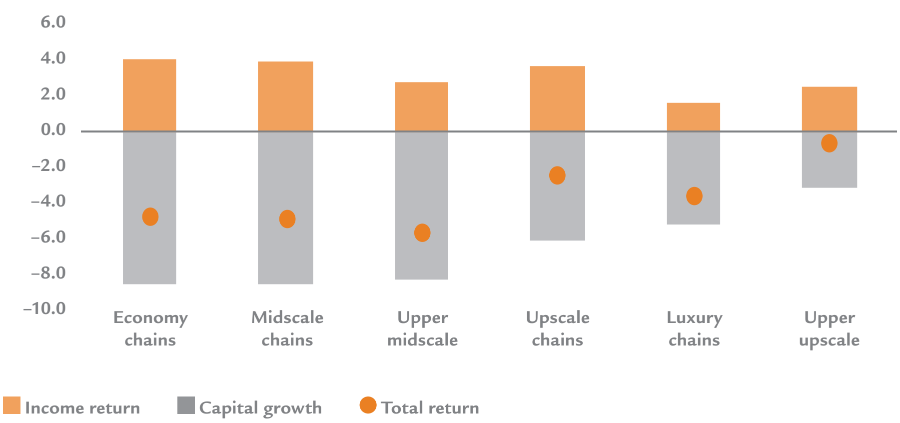
Also, the ever-increasing digitalisation across the hospitality value chain and growing data analytics are likely to allow for improved risk management while also

European hotel performance by country 2020 (%)



Source: MSCI and Swiss Life Asset Managers

European hotel performance by category 2020 (%)

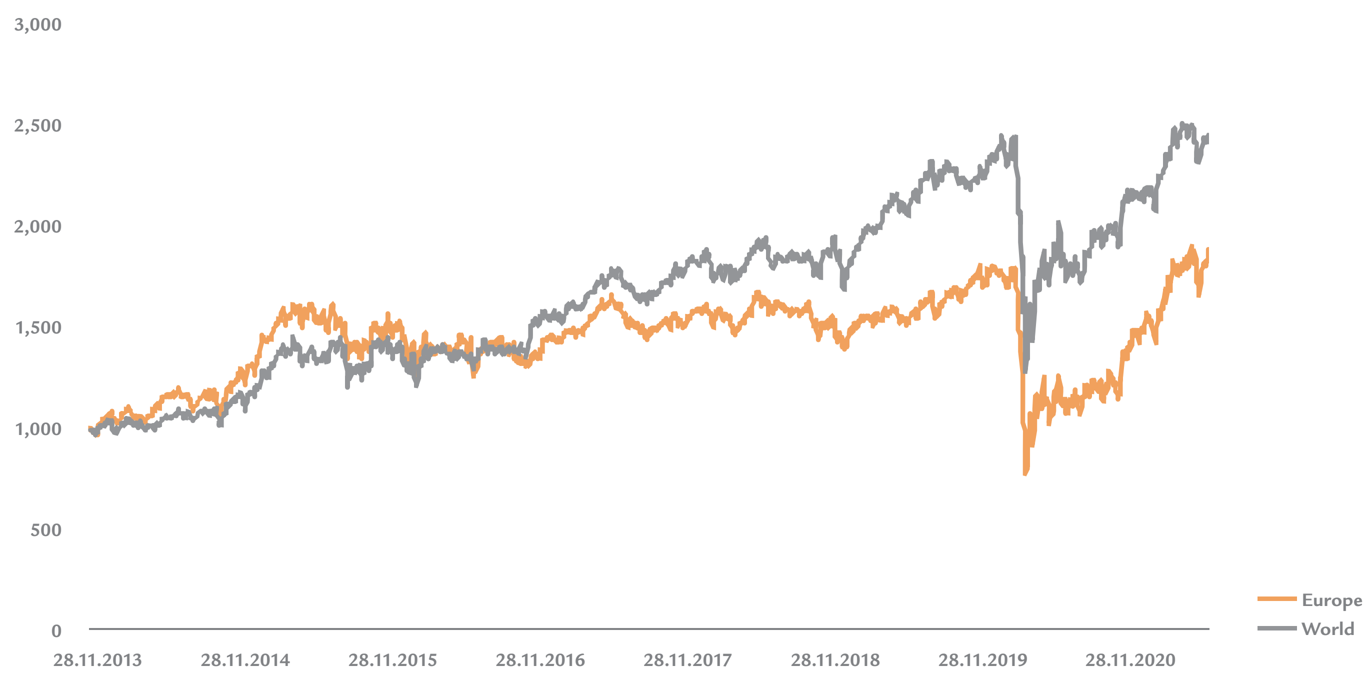


Source: MSCI and Swiss Life Asset Managers

optimising income potential in the future. Therefore, capital values are anticipated to bounce back although the overall sector might not see pre-crisis levels before 2023. Given balanced divers of demands, a portfolio allocation made of the Big Four plus satellites countries is set to provide a well-diversified effect in the long term.

However, and considering the ongoing structural changes of the sector, combining the right market timing on top of stock-picking of assets and locations with the selected operators by geography and segment are key factors to secure stable cash-flows and capital value gains over time. ■

European and World Hospitality performances: bars, restaurants and hotels – Base 1000 end of 2013



Source: Bloomberg

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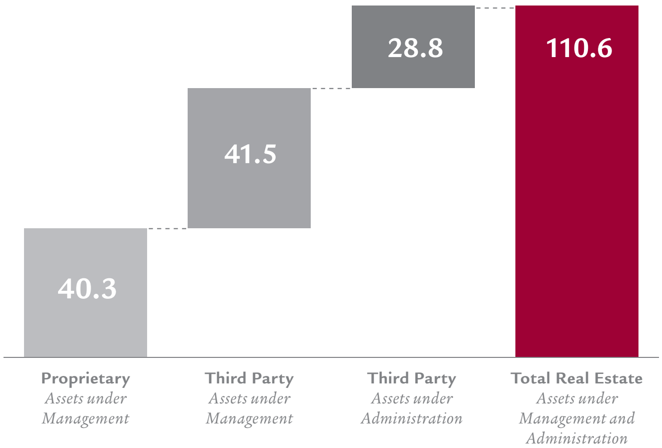
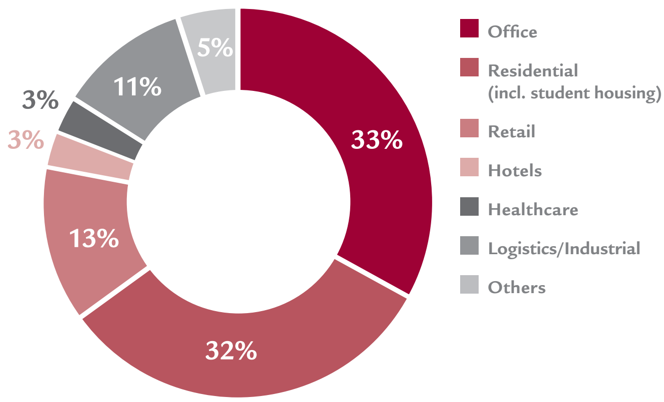
Real estate – facts and figures

Assets under Management and Administration

(in CHF bn)



Breakdown by real estate sector



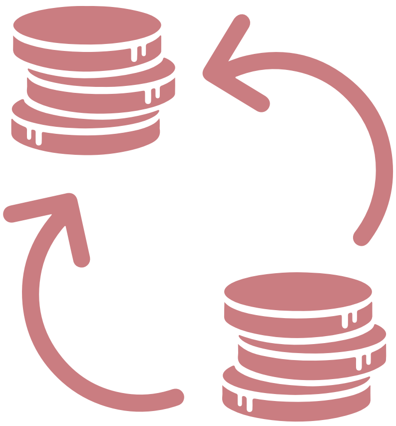
REuM CHF 81.8 bn

Transaction volume real estate

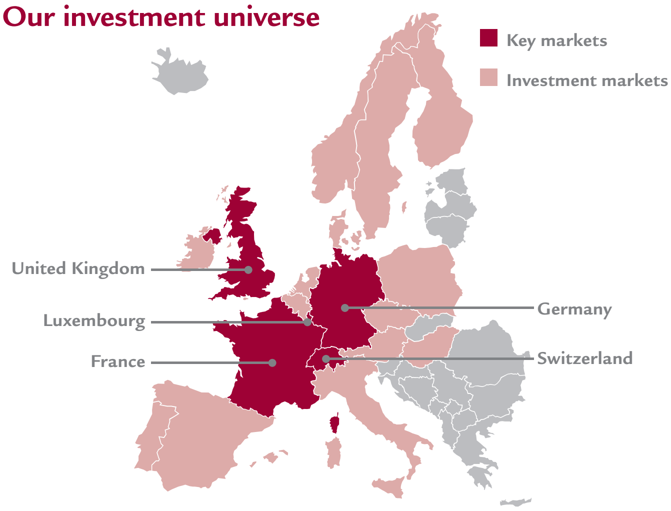
(in CHF bn)

10.6

(average 2018, 2019, 2020)



Our investment universe



All figures as of 30 June 2021 unless stated otherwise.

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