The Investment Podcast

Episode 10: A focus on European real estate
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Jose [00:00:33] Welcome to another episode of The Investment Podcast from M&G. Today we have David Jackson, one of the most experienced fund managers in the business with over 30 years track record of investing internationally. His focus, over the last 15 years or so, has been continental Europe and as such, he has a deep knowledge of European markets and the open-ended fund landscape, a landscape that has substantially changed since the global financial crisis. David, welcome to the podcast.

David [00:01:09] Thank you, Jose.

Jose [00:01:10] So, you're clearly an experienced fund manager with many years of experience. What would you say are the key elements of your investment philosophy that you've developed at this time?

David [00:01:21] Yeah, I suppose I would probably regard it more as an investment style rather than a philosophy, but I think it's probably a style which is, in my opinion, appropriate for a core, low risk, diversified real estate strategy. So, it's really focusing very much on investing for the longer term, which you would expect for a core strategy, investing over multiple market cycles with a very key focus, I would say, on income return. Typically for a core real estate strategy, you'd probably expect around two thirds of the total return to come from income. I would also say there is a pretty clear focus on disciplined risk management, a very strong focus on broad diversification, both at a sector level and a regional level. Now I would say increasingly now, and this is certainly the case in the last few years, a very strong focus on environmental and strong ESG credentials.

Jose [00:02:19] OK, I now want to focus a little bit on your past, and the length of your career. You've clearly been investing internationally for quite a few years. What prompted M&G to start investing internationally?

David [00:02:37] Yeah, you're right Jose. I guess the first investments by M&G Prudential in non-domestic real estate were probably made over 30 years ago. You're right, I was there at the time, so I do recall those early days. Clearly the main driver at that time, and I think it's still the case, was diversification. So, the diversification benefits of investing in good quality international real estate, not doing so with significantly enhanced risk, though. I think it's very important to say that when we first put forward recommendations to invest internationally, it was to do so in a very low risk way. In core markets, not taking too much risk. We started with North America, and we then proceeded with the more transparent markets in Europe, France, and Germany, and then followed with the core markets in Asia. So, it's very much driven by diversification, but doing so while still having a keen eye on the risk profile.

Jose [00:03:36] OK, so the strategy that you're working on at the moment, which you've been working on for the last 15 years or so. You started and then shortly after came the global financial crisis, which was very challenging for many property investors, how was it for you?

David [00:03:55] Yes. We launched the strategy for our European core portfolio, as you say, 15 years ago, back in 2006. Of course, with the benefit of hindsight, given the global financial crisis followed pretty quickly after that, it wasn't the best time to be launching a new strategy. However, we learnt a number of lessons going through the GFC. I think a few of those are something that we now apply in our core strategies. So going into the crisis, in our European strategy, we had low leverage, no development and pretty low vacancy across the European portfolio. We also had zero exposure to some of the riskier emerging markets in central and Eastern Europe. I think a lot of those resilient foundations we had in place meant that we actually emerged relatively unscathed from the GFC. Like everybody, we took write downs and I recall in particular the negative sentiment at the time for office markets in the Netherlands. There were some pretty big challenges there, but actually we emerged pretty strongly. We had no breaches of loan covenants, and we had no interruption to income distributions. So, a number of those key risk measures we put in place, I think put us in good stead.

Jose [00:05:18] And did you get the question, is the euro going to collapse?

David [00:05:23] Yes. So, we had the euro crisis, absolutely. It was almost the first question in many client presentations at that time, such as, what is the percentage chance that you are giving a collapse of the euro? How will you value assets? How will you denominate your strategy? (Given it was the fund was EU at the time) I seem to recall we were saying the worst case would be a maybe a 15% chance of an EU collapse. I think the thing that stood out for me in all of that debate was actually, again, the defensive qualities in that particular turbulent market environment of real assets and of real estate in particular, and of course, especially higher quality prime real estate, which again, is more defensive and more resilient in those markets of significant turbulence.

Jose [00:06:16] Yeah, and I'd like to move a little bit to the present right now. So obviously the open-ended fund universe has changed substantially from the time you started. How would you describe it now and how would you see its future developing?

David [00:06:37] You are right Jose. It has changed a lot over that 15-year period, as you would expect. I suppose the first thing to say would be the scale of the universe. Clearly, it is much bigger. There are a lot more strategies, a lot more funds in the European space than there were back then. I do think scale is important because going back to what I was saying earlier on about diversification, if you are investing in a pan-regional strategy and we are investing here in about 12 different European jurisdictions, it is important to have scale. It is important to be able to incorporate diversification. I think that size and scale is partly a reflection of the increasing appetite over that time for institutionals for non-domestic international real estate. To your point about looking to the future, we see that appetite increasing. We see the allocations to non-domestic real estate continuing to increase as we go forward. The other key change, José, is around the asset mix we now see. So, the allocation of assets within European strategies is different. Probably the most significant difference is the addition of residential to the investment pallet, if you like, of the two it was principally commercial. It was principally retail office and logistics. However, in the last few years, we have seen this strong, if you like, evolution of residential as an appropriate asset type for a core fund. I am very strongly in favour of that. I think there are very strong long term growth fundamentals in core markets in Europe. I don't think that is simply restricted to the conventional private rented sector, the apartments and the direct let's. I think it's also extending to student accommodation, residential opportunities and also extending to senior housing and residential opportunities. So, I think that will continue going forward and if you look at our own objectives, we are probably looking to allocate maybe up to around 30% over time of the asset mix to the residential sector.

Jose [00:09:02] Indeed, of course. The number of sectors is increasing, and the countries are very, very diverse. So clearly, local presence must be very important to be a very successful fund manager in this space?

David [00:09:18] Well, I think so. To use a bit of a cliche, real estate is a local business. You need good, strong local asset managers, good deal sourcing locally, good relationships such as pipeline relationships with local landowners and local developers to enable deployment of capital. So, I think it's very important in this space to have the depth of resource locally, but also some of the more central functions in terms of the key areas of expertise. You also need tax and deal structuring, for example. These are all areas that require significant platform scale to be able to invest most efficiently.

Jose [00:10:03] The other point I think about when investing internationally and you have been very involved in, is that sometimes you've got to work with operating partners, particularly in very specialised sectors. So, what has been your experience in that? What is your view on utilising operating partners or combining operating partners with local offices?

David [00:10:26] Yes, I think you have to be flexible. So, again, I think we can learn lessons from the evolution of the big open-ended core funds in North America, the so-called Odyssey funds that have grown very significantly over time. They have been quite early movers in broadening that asset mix to include residential or multifamily as they would term it. They've also been early movers in adding to the portfolio mix, other so-called alternatives within the real estate space, be that life sciences, self-storage, or other more smaller niche sectors. I think once you begin to go into those smaller alternative sectors, if they are appropriate for core strategy, I think very often you need to do so with a good, strong operating partner in place. I think you can work in partnership with an operating partner, not only to have the expertise in those types of assets, but also to have an off market, if you like, future pipeline of opportunities for deployment and investment of capital.

Jose [00:11:37] OK, as I said earlier, the market is very diverse, countries are very different, there are different ways of doing business and there are different planning regimes. So which countries have you found it difficult to do business in?

David [00:11:54] It's always difficult to generalise, but it's probably fair to say that some of the smaller, less transparent markets and some of the markets which are dominated more by local players and local capital, are more challenging to break into. I think some of the markets in central and Eastern Europe are less transparent and present quite a few challenges. If I use an example of one of the smaller jurisdictions that we invest in, going further west, so Portugal, this was a few years ago now, quite a small jurisdiction. What we did in that particular case to mitigate some of those some of those challenges was to focus on high quality defensive assets very much. Now, we bought a portfolio in Portugal, which was food stores, grocery anchored retail so supermarkets. This was with 20-year income streams with 20-year fixed leases let to the country's biggest food operator, so there was reasonably good quality credit with annual indexation in the lease's and this was with annual RPI increases in the rents. For us, that was quite a good way to enter a slightly smaller, less transparent market to do so in a defensive way. Those assets have performed very well for us.

Jose [00:13:24] Yeah, it sounds like a very good philosophy. If you go to a country where it's harder to do business, go as defensive as possible, sounds perfectly reasonable to me. So just to conclude and being conscious of time. In the last 15 years of the strategy that you have been working on at the moment, what would be your three key takeaways from that period of your career?

David [00:13:52] If I were to try and summarise some of the key takeaways and we've talked about a couple already, we've talked about the importance of size and scale with pan regional funds. We talked about the evolution of the asset mix and in particular the evolution of allocations to residential and alternatives. We have just touched upon ESG, and I think it would be worth reinforcing that point because, the landscape has changed, as everybody knows dramatically in recent years in relation to environmental considerations. For me it's not just looking at existing assets, it's integrating that analysis and approach to ESG at the buy, hold and sell stages in the evolution of assets. So, screening at the outset, enhancing the certification of assets during asset management and actually considering as a key consideration when you come to sell the environmental credentials of individual assets. Also, considering how expensive it might be to upgrade properties to attain an appropriate environmental standard. In fact, we just sold a couple of buildings in Germany where we think the market is not properly factoring in the real cost of upgrading to achieve long term sustainable ESG credentials. If I may add a couple of other themes that are also important...

Jose [00:15:23] You may.

David [00:15:25] These are more around the depth of resource, the depth of team and platform that are needed for a diversified pan regional strategy, and this is probably more so in real estate perhaps than some other asset classes or asset types. You do need the good local asset managers, property managers, transaction professionals, tax professionals and a whole range of support alongside the fund manager to be able to execute a strategy successfully on a broad pan-European basis. For me, that's a very important take away. It's not something you can do with a very small team. You need that strength, depth, and that multi-asset team.

Jose [00:16:13] So in a way, ESG, people and scale are the three key takeaways from your career and that sounds very reasonable to me. With that David, thank you very much for your time and for everyone listening, have a very good day.

David [00:16:31] Thank you Jose.

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