The Investment Podcast

M&G Investments

Episode 15: The Investment Podcast: Adding value to high-quality assets in complex situations
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Romil Patel: Hello, and welcome to this instalment of the investment podcast brought to you by M&G investments. Across Europe, value add investing has evolved over a time span of almost a decade-and-a-half, and to quite a large extent, this has been driven by a number of crises: economic, political, and health. With markets at various stages of recovery, what's the current value add landscape in Europe, and what are some of the best avenues to maximise the opportunity set? I'm your host, Romil Patel, and joining me to discuss all of this and much more are fund managers, Paul Crosby and Andrew Amos, and Jose Pellicer, head of investment strategy for real estate. Welcome to you all. Jose, I'll come to you first for a view of the landscape.

Jose Pellicer: Thank you. The landscape actually is fairly favourable for value add at the moment, and it's fairly favourable for three key reasons. Number one, the pandemic, as we all know, has been particularly dire for sectors that rely a lot on people's concentration and travel. Retail, hospitality, restaurants, aviation, trains, transport, etc. A number of players in that sector have been distressed and a number of properties have underperformed big time. There is value to be found in those sectors.

The second point is that 2021 was a recovery year, but the recovery is not finished. Whilst, I totally admit that this cycle is different to a normal cycle, businesses are beginning to make decisions – and this means that the right assets will probably experience growth, rental growth, which is the typical thing that happens after a recession even though, as I said, this recession has been a little bit different because it was prompted by the pandemic.

Then, finally, it is the emphasis on ESG. There is a lot of work to be done in the European real estate landscape to improve the assets and to reduce energy consumption, water consumption, use recycled materials, reduce embodied carbon, develop sustainably, etc. I think there is an opportunity right now before sustainable refurbishment becomes standard to add some value in that aspect as well. I think those three characteristics provide a very good landscape for value add investment in the 2020s. That doesn't mean that there are no risks, but we can talk about risks later on in the podcast.

Romil: Steady ground for unlocking value. Paul, which markets and sectors across real estate can these trends be tapped into and indeed maximised?

Paul Crosby: Thanks, Romil, and thanks Jose for providing the introduction, setting the scene. I think we've got to begin with the basic premises that we are relating these trends across the countries and the real estate markets, which are experiencing the most compelling demand and supply imbalance. It's worth highlighting that the supply of good quality real estate across core Europe, especially the gateway cities that we are targeting is severely limited. A lot of the property inventory is quite tired or indeed obsolete.

This plays quite nicely into the recovery theme because as lockdown restrictions lift and economies reopen, we will experience a bounce-back in consumer spending, business expansion, and growth. Now, for occupies and investors, they're much more discerning than they were pre-pandemic.

They're much more focused on quality, for example. Office occupiers, especially, they want quality grade -A accommodation with enhanced levels of amenities, the ESG credentials that Jose has highlighted. The opportunity here is for us to upgrade fundamentally well-located office assets, which are simply tired or dated and I believe that prime urban , vibrant locations will attract employees back. The role for us really is to identify those undersupplied markets, apply our capex and asset management skillset to enhance that accommodation.

Secondly, just picking up on the relative value point, the dislocation in pricing because of this heightened level of uncertainty is creating a disparity in pricing between what is considered core and non-core. The sectors that are obviously mostly affected by the pandemic were retail, leisure, and hospitality. Retail is an obvious example. Physical stores clearly face challenges from the structural trends that have accelerated over the past two years.

In most parts, they are good businesses that were just forced to close their doors to customers. I think, for example, convenience retail in town or edge of conversion, especially with a home-centric tenant line-up, such as DIY, food or furniture should perform strongly over the near-term. Demand has been resilient. The supply levels are constrained and a lot of that older, poorer quality stock will be converted to logistics.

Romil: Thanks, Paul. Andrew, could you tell us more about the distressed environment and some of the sectors where opportunities are being found?

Andrew Amos: The distressed environment is very, very interesting at present. Really deep distress has been prevented by the various government support programmes and central bank intervention keeping rates low, but assets have still ended up in the wrong hands. High-quality assets are now being managed by the workout teams in banks. They're held for sale by receivers or administrators, and there are many developers who have high-quality assets, but simply don't have the capital to develop them. This leads to high-quality assets being in very complex situations. These complex situations often take many, many years to resolve. We see a flow of interesting opportunities in consequence.

Following the European crisis, we saw these types of opportunities. We saw banks working through assets for a number of years, taking a long time to work through assets in countries like Germany and Spain, but also seeing, really compelling, opportunities in Ireland and in the UK. A really good example of high-quality assets being in a complex situation following the European crisis were some investments that we made in Spanish residential plots.

As an example, we found a situation where there were eight high-quality plots, well located, zoned for residential development, but the eight plots had eight different borrowers and the loans were owned by the bad bank in Spain, by Sareb. The eight plots were cross-collateralised because of various joint ventures. [It was a] very, very complex situation, but underlying it, very high-quality residential plots.

We had the opportunity to secure those residential plots. If we could do eight separate deals with the eight separate owners, we did that. We then secured a development partner, a local partner, and we've developed out those residential plots and driven really compelling returns from that situation. Again, following the pandemic, we're seeing similar opportunities where high-quality assets are stuck in complex situations.

Romil: Skilfully navigating high-quality assets out of difficult situations is no mean feat. What's the recipe for succeeding in a distressed world?

Andrew: To succeed, you really need to be willing and able to take on this complexity that we've been talking about. That requires you to have a specialist resource. You must have deep real estate expertise right across Europe. You have to have people on the ground in all the local jurisdictions with expertise of doing real estate deals in that jurisdiction.

You will also need to have specialist restructuring skills to navigate the complexity of the particular situation. If you have this combined specialist resource of real estate skills and restructuring skills, this leads to the ability to source opportunities from specialist relationships. From relationships with workout teams in banks, from receivers and administrators, and relationships with developers who are starved of capital.

We then use those specialist skills to solve the complexity of the situation and unlock value. Now, a really good example of this that we've seen post-pandemic is an opportunity that is a reason for us to work with a Scandinavian hotel group. This hotel group has assets in prime locations but the group needs to be reorganised. Post-pandemic, some of these sites will continue to function very well as hotels, but others of them need to be converted to alternative uses.

In this case, conversion to student accommodation is going to drive a lot of value out of those sites. The situation needs capital and it needs very specialist skills to unlock the value. We've been working with a local partner to secure the situation and drive compelling returns out of the opportunity.

Paul: Precisely, Andrew. The choice of trusted operating partners is a critical element of success. Value-add investing is about choosing the right partners and combining local on-the-ground expertise with deep in-house sector knowledge. That will ensure both the unlocking of investment opportunities and importantly, the execution of business plans.

Romil: Thanks, Paul. Before we sign off, Jose, what are some of the key risks at present, and how can they be effectively managed?

Jose: Well, Romil, this is a very topical question. Today's the 2nd of March 2022, and at the time of recording, there is a quite serious conflict between Russia and Ukraine. Who knows how long is it going to be and what the economic and financial implications are going to be? That is an obvious risk. At this point, we don't know how this is going to pan out.

Other risks that are better-known are inflation. Is inflation going to be really high and is it going to be persistent? Does that mean that interest rates are under upwards pressure? I believe that most of the drivers of inflation are temporary, and when I say temporary, I mean 18 to 24 months temporary, but I might be wrong.

Finally, the other risk is that we've talked about recovery, but might the recovery be slow? Is the recovery going to be slow? There is a lot of that in the system. Business expansion is happening, but it might happen more slowly than we are expecting at the moment. There are a number of risks, but hey, this is value add investment. Value add is about managing those risks. It is important that from a bottom-up perspective, we choose the right assets and the right situations to manage those risks appropriately.

Romil: That's all we have time for in this episode of *The Investment Podcast*. Thank you to Paul Crosby, Andrew Amos, and Jose Pellicer for sharing their expert insights, and to you, our audience, for tuning in. We'll see you next time. Goodbye for now.

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