Beyond the core: how value-add strategies are taking center stage in real estate

Q&A with Mike Bryant, Head of Private Real Estate

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Mike Bryant, Head of Private Real Estate

A decade of low interest rates, stable growth and double-digit returns made for a golden era of investing in core real estate assets. But this period of benign economic conditions is now in the past. Double-digit IRR returns will increasingly depend on a hands-on approach to thematic sourcing and transforming assets.

Mike Bryant, Head of Private Real Estate at Partners Group, explains how value-add investing is capturing investors' attention by creating opportunities aligned with evolving ESG requirements and the changing dynamics of corporate and consumer occupier behavior.

How is investor appetite for core real estate changing?

In the last decade or so, core real estate investment lived a golden era. With low interest rates and cheap debt available, managers could buy assets in the core segment – for example, a well-leased office with high occupancy rates and low maintenance requirements in a big city – and secure an attractive return from rent collection. But clearly many of the macro tailwinds that supported strategies focused on core assets have become headwinds.

In today's volatile environment, debt costs have soared, and GDP growth and stability are not guaranteed. The pressure over core real estate is clear when you look at the narrowing spread between US cap rates – a measure of real estate returns – and 10-year Treasuries, which function as a proxy of debt costs. The high-single-digit and even double-digit returns investors had grown used to from core real estate are a thing of the past. So, investors are instead turning their attention to 'value-add' strategies that prioritize a hands-on approach to transforming assets.

Partners Group's value-add real estate approach

STRATEGY	TEAM	PLATFORM INSIGHTS	SUSTAINABILITY
Global thematic perspectives USD 250bn real estate portfolio	**>100** professionals globally	**Private Equity and Infrastructure** Leveraging insights from portfolio companies to understand occupier needs	**19%** sales premium captured for sustainable buildings[2]
	>100 local operators		
Local asset transformation through on the ground presence	**>20 years** average experience[1]	**Private Debt** Assess tenants' financial health and incorporate views into underwriting	**12** ESG & sustainability focused professionals

Source: Partners Group (2023). Past performance is not indicative of future results. There is no assurance that similar results will be achieved. For illustrative purposes only. 1 Average across senior members of management. 2 Sustainability linked sales premiums seen for sustainable office assets, in line with Partners Group Sustainability strategy https://www.partnersgroup.com/en/sustainability/. The performance presented reflects model performance an investor may have obtained had it invested in the manner shown and does not represent performance that any investor actually attained. Although ESG factors may be considered throughout the investment decision process, it should be noted that ESG is not the predominant strategy of this fund.

At the same time, we recognize that there are challenges in the real estate sector, especially in many office markets where the reduction in occupier demand coupled with higher interest rates is creating challenges for owners and lenders. Our thematic sourcing approach means our current focus lies within the living and logistics sectors, where limited supply and strong demand underpin market tailwinds. We are able to match this with value-add strategies and conservative leverage to deliver attractive returns.

Core real estate is typically considered a lower risk asset class. What makes a value-add approach more compelling to investors today?

First, it goes back to the fact that investors are recognizing that the returns they obtained from core assets in the past aren't available anymore. Second, there's a realization that real estate investors should focus on assets that address occupier needs arising from the disruptions in how we work, live and shop. Frequently these assets don't exist in scale and need to be created and aggregated through asset transformation. At Partners Group, we believe in value creation as the bedrock of how we generate returns across all our asset classes, so, for us, this is nothing new. But I do think there has been a marked shift in sentiment among other real estate investors.

What role is ESG playing in this change?

Globally, buildings are responsible for approximately 40% of carbon emissions, which are generated from both their construction and how they operate. It is clear today that both tenants and investors are demanding assets with lower carbon footprints. In addition, we have existing and pending regulations around energy performance in Europe that will make it very difficult for landlords to lease assets that fail to reach the required energy standards. Getting assets to that level of efficiency will most certainly involve significant transformation work.

And this is where you have a positive convergence between value-add investors looking to create value by improving assets and increased tenant and investor demand for better performing assets. For us, ESG is an integral part of our value creation strategy, as we seek to own assets that appeal to the broadest possible tenant base and to the broadest possible investor base when we eventually look to exit in the future.

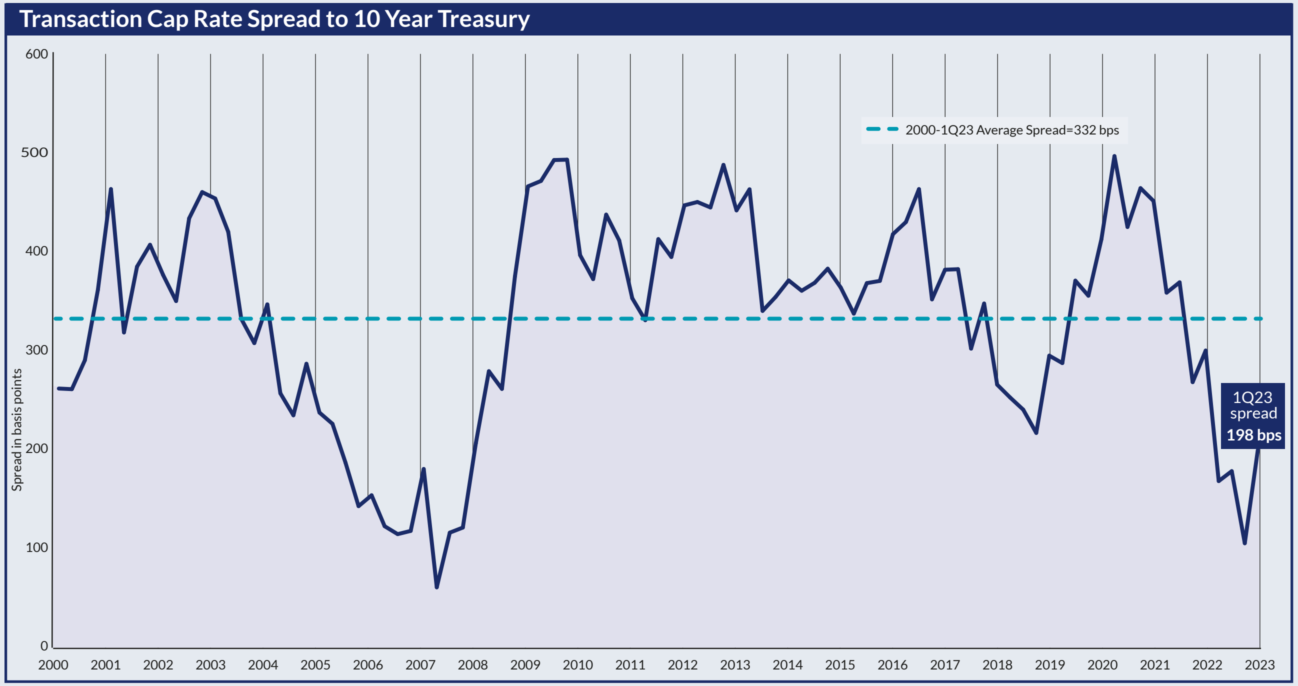
What is your process for identifying value-add opportunities?

It begins with having thematic conviction. As value-add investors, the most fundamental thing we do is introduce a tenant to a vacant building. To do that effectively, we need to identify themes that we believe underpin strong and long-term occupancy demand. Our starting point at Partners Group is a set of giga themes – Digitization & Automation, New Living, and Decarbonization & Sustainability – from which we then derive many attractive real estate themes. We track over 40 individual themes which provides us with a large opportunity set. Within these themes we identify those in which we have conviction to be future winners. For example, we currently focus on single family rental, the active adult segment (purpose-built residential aimed at the 55+ demographic), and third generation automated self-storage.

After that comes the bottom-up work of selecting assets and operating partners within those targeted themes. As experienced investors, we also know that when you underwrite a business plan with a view to a five-to-seven-year hold, that rarely plays out exactly as you would have expected. So it is important to have a governance framework that allows you to revisit your business plan and make the necessary adjustments on an ongoing basis. The aim is to do everything necessary to ensure the assets have the best possible appeal to the tenant universe.

Core investing headwinds

Transaction spread for US real estate is now below the long-term average, limiting returns from rent collection



Sources: Partners Group (June 2023), NCREIF, Federal Reserve. For illustrative purposes only.

And how do you transform these assets to maximize their appeal and value?

We have a three-fold approach to asset transformation. First is the drive to make operational improvements. This can involve light-touch capex or more substantial improvements, but ultimately the aim is the same: to increase occupancy and capture rental growth by marking rents to market rates post capex upgrades.

In parallel, we work on futureproofing our assets through repositioning and improving ESG standards. We're already seeing a real differentiation between the best performing assets from an environmental standpoint earning green premiums, compared to those that are not fit-for-purpose. Ensuring our investments are fully futureproofed, to satisfy end-users and evolving ESG requirements, is therefore critical.

Finally, our transformational approach also seeks to build scalable platforms, which not only gives us the natural efficiencies of scale but is also fundamental to make our assets appeal to a broader investor base at exit point. Like us, long-term institutional owners want to be thematic owners and are increasingly looking at topics such as residential and logistics. But managing these more granular assets is an issue for them as it typically involves a lot of resources. So, part of our value creation plan involves aggregating these assets into larger platforms through add-on acquisitions and putting strong management teams in place to make these assets ready for core ownership.

Warsaw Green Logistics Portfolio, part of Partners Group's Private Real Estate platform

"Real estate investors should focus on assets that address occupier needs arising from disruptions in how we work, live and shop."

This seems to require a wide range of skills and expertise. How can a manager act on all these fronts at the same time?

As a firm, you need to work as an integrated platform and leverage the expertise of different teams and their geographic footprint. We have 100 people globally in our real estate team, spread across our offices in the US, Europe and Asia. On a direct and indirect basis, we have a look-through exposure of around USD 250 billion in real estate assets, which means there is a lot of intelligence we can gather from across our real estate business.

For example, we are seeing in Europe a trend of growing rental demand for residential property, as opposed to ownership. That is partly a function of affordability, but it is also driven by choice. The new generation of renters is looking for more professionally managed stock, with better amenities and higher environmental credentials. We've been able to take best practices from our real estate platform in North America, where we have a lot of experience in this type of residential offering, and apply it to the European market.

There are also the benefits of sitting within a broader private markets platform. In our private equity and infrastructure portfolios, there is a lot of businesses that are occupiers in their own right, which can offer us really valuable insights for our sourcing and value creation efforts.

How does that work in practice?

I can give an example. We're currently building a last-mile logistics business in Warsaw, Poland. Partners Group has in its portfolio a big retailer in

Poland called Zabka. The team at Zabka has been able to give us great insights based on their first-hand experience as users of last-mile logistic services in terms of location, service specification, and environmental credentials, just to name a few criteria.

Energy is another topic that we have tapped our portfolio companies for insights. Poland is still very dependent on energy from coal, so many corporates are looking into ways of reducing their carbon footprint. Part of our value creation plan for this class-A logistics park was to give it high ESG credentials. With the help of VSB, our portfolio company specialized in renewables, we implemented a rooftop solar project at the park. Techem, our smart metering specialist, contributed with its expertise to create an all-encompassing assessment of the site's energy requirements and solutions, looking at the potential for solar, heat-pumps and EV charging, among others. Those are just some of the ways in which we seek to collaborate with our portfolio companies to make us a more effective investor and landlord.

Examples of companies in the Partners Group platform that contributed to Warsaw Green Logistics Portfolio*

techem

Germany-based global energy services provider for the real estate sector.

VSB

Germany-based developer, owner and operator in the renewable energy sector in Europe.

żabka

Poland-based convenience retailer.

*There is no assurance that similar investments will be made. Selected investments represent a sample of a private equity secondary and private infrastructure investments that Partners Group made on behalf of its investors. The examples shown represent transactions made between 2017 and 2020 and may be part of several private markets and open-ended products, managed by Partners Group.

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