



AUXADI

MARKET ADAPTATIONS:

Maximising New Growth Opportunities in the Real Estate Sector

 40 years
making life easier
for our clients

Investors are keen to make up for lost time, with significant interest in broadening investments, both geographically and by sector.



INTRODUCTION

Before the Covid-19 pandemic the real estate investment industry experienced a long bull run and held some well-established views on what made for sound and risky investments. However, the past year has thrown all of that into doubt and investors are now having to take time to re-evaluate their positions.

The picture that emerges is mixed and unpredictable, largely because of profound and long-lasting changes in consumer and business behaviour. Over the coming years asset classes will need to be re-evaluated: bricks and mortar retail and commercial real estate firms face an uncertain future after a challenging 2020, with much depending on what the “new normal” will look like once the dust has settled. In contrast, the warehousing and logistics industries are already experiencing a surge in investment which is likely to continue for the foreseeable future.

Perhaps the biggest impact will be felt by those investing in office space, particularly in once prime central city locations, as the true long-term implications of the remote working culture fostered over the course of 2020 becomes clearer.

Retail, another previously safe real estate sector, experienced a precipitous fall in Q2 2020 as governments enforced ‘stay at home’ measures, leading to larger retail businesses scaling back their physical operations and many smaller businesses suffering insolvency as a result of their inability to maintain a steady cash flow. Similarly, hospitality suffered as tourism and travel ground largely to a halt.

This report, conducted with a global panel of 100 senior real estate fund managers, was commissioned by Auxadi to identify the industry’s response to these challenges and give an indication as to which industries and sectors are most likely to be on the receiving end of investment as the pandemic eases.

As is highlighted in the report, investors are keen to make up for lost time, with significant interest in broadening investments, both geographically and by sector, tempered by caution around elements such as the demand for transparency and analysis and the growing importance of technology. However, with this rapid expansion will come greater administrative and compliance burdens that will need to be properly addressed in order to ensure the hard work about to be undertaken isn’t wasted.

In spite of short-term uncertainty, the long-term appeal of real estate has held for investors, and the number of funds targeting it have continued to rise. As of Q4 2020 there were more than 1,000 funds active in the market - more than double the number in Q1 2016. Funds are now targeting almost \$300 billion of investments, suggesting investor momentum moving into 2021¹.

With many real estate sectors experiencing unprecedented troubles over the past year, this has opened up huge opportunities for investment as the world slowly emerges from the pandemic. 2021 is set to see global GDP grow by 6.3% this year and 4.6% in 2022², and the real estate market expected to grow by an estimated \$87.1 billion (3.2% CAGR) to almost \$2.8 trillion³ in 2021.

¹ “2021 Preqin Global Real Estate Report”, published on 4 February 2021 by Preqin.

² “Oxford Economics global economic outlook for May/June 2021”.

³ “Real Estate Global Market Report 2021: COVID-19 Impact and Recovery to 2030”, published in January 2021 by Research and Markets.

Emerging from Covid-19

EMERGING FROM THE PANDEMIC

With dry powder standing at a record \$324bn⁴, there's likely to be considerable competition for deals across all aspects of real estate. Sector-specific valuations will depend on factors such as the success of vaccine roll-outs (hospitality and retail) and returning to traditional working patterns (office and industrial). Despite persistent challenges faced by some sectors, real estate remains an asset class that's currently underpinned by solid income and low interest rates, which means assets will remain attractive despite some recalibration in their use.

Unsurprisingly, real estate deal volumes suffered in 2020, with global investment volumes down by 28% in the 12 months to November 2020 compared to the same period the year before⁵. While the share of total real estate investment to office (35% to 33%) and hotel (8% to 5%) fell over this period, residential (26% to 28%) and industrial (17% to 21%) rose, showing resilience in the face of structural changes which are likely to continue into 2021.

As lockdowns gradually ease, we'll begin to see a rapid resurgence in appetite by people for retail experiences. Our panel of real estate investment professionals expect retail (food-anchored retail parks) to see the biggest recovery in valuations over the next two years, with 57% backing the sector to outperform other areas between now and 2023. Sentiment for alternatives (such as hotels, student

↓ WHICH REAL ESTATE SECTORS ARE LIKELY TO SEE THE BIGGEST RECOVERY IN VALUATIONS OVER THE NEXT TWO YEARS FOLLOWING THE PANDEMIC?

Retail (food anchored retail parks)	57%
Industrial (logistics)	54%
Retail (high street)	50%
Offices (central business districts)	49%
Supermarkets	40%
Residential	30%
Alternatives (hotels, student accommodation, social housing, senior living)	20%

accommodation, social housing and senior living) remains negative, with only 20% of respondents backing the sector to recover over the same timeframe.

This is a short-term view, however, and nearly two thirds (73%) of investors expect the fundraising climate for alternative strategies to improve over the coming two years, with 30% expecting a "significant" improvement. This is ahead of retail (71%), industrials and supermarkets (both 66%).

↓ HOW DO YOU EXPECT THE FUNDRAISING CLIMATE TO CHANGE OVER THE NEXT TWO YEARS FOR THE FOLLOWING TYES OF REAL ESTATE STRATEGY?

Alternatives (hotels, student accommodation, social housing, senior living)	73%
Retail (food anchored retail parks)	71%
Industrial (logistics)	66%
Supermarkets	66%
Offices (central business districts)	60%
Retail (high street)	59%
Residential	59%
Debt	53%

As a result of the turmoil over the past year, 71% of investors expect the reallocation of capital to commercial sectors with safer cashflows, such as medical, self-storage and industrial, over the coming 12 months. This will be paired with the offloading of distressed assets (67%), while 61% of respondents expect an increase in fundraising. Investors are less optimistic about the availability and cost of debt, with 19% and 15% of investors respectively expecting it to worsen in comparison to the previous year.

⁴ "2021 Preqin Global Real Estate Report", published on 4 February 2021 by Preqin.
⁵ "Real estate investment in 2021: global outlook", published in January 2021 by Savills World Research.

European commercial real estate's recovery from Covid-19

Covid-19 measures have caused shops and offices to close across the majority of Europe, leading to a drop in demand for traditional brick-and-mortar retail and office space. European commercial real estate transaction volumes fell dramatically in Q4 2020, falling by nearly 40% year-on-year, driven primarily by an 80% fall in hotel deals. Price growth was also down year-on-year in Q4, driven by a 20% fall in retail⁶.

Just over a third (35%) of respondents believe that the market will recover fully by the end of 2021, with confidence strongest in continental Europe (46%), ahead of North America (37%) and the UK (23%).

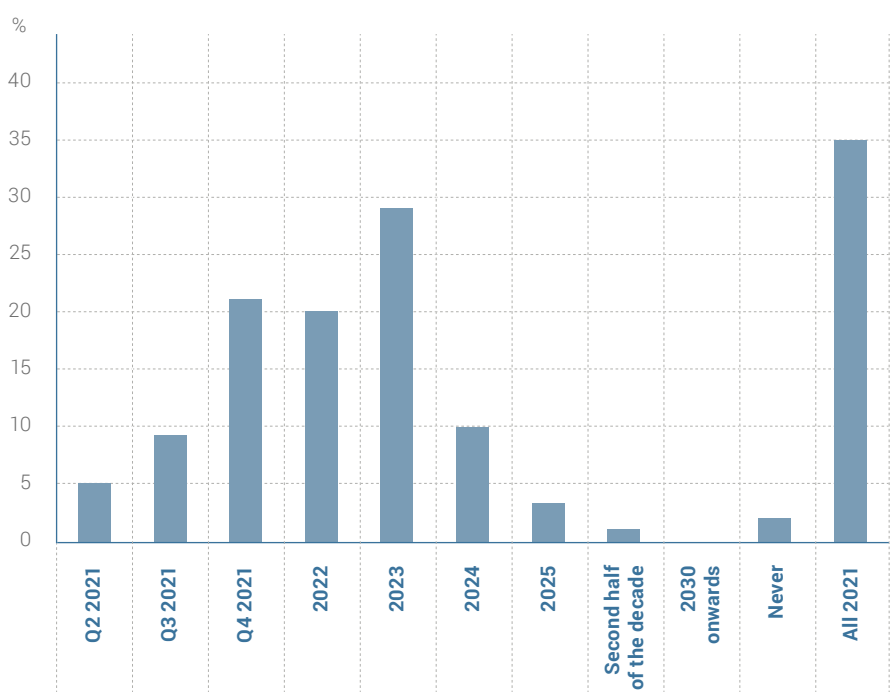
⁶ *Global Financial Stability Report: Pre-empting a Legacy of Vulnerability*, published in April 2021 by the International Monetary Fund.

↓ HOW DO YOU EXPECT EACH OF THE FOLLOWING TO CHANGE OVER THE COMING 12 MONTHS COMPARED TO THE PREVIOUS YEAR?

	Increase	Stay the same	Decrease
Reallocation of capital to commercial sectors with safer cashflows*	71%	20%	9%
Upgrading digitization and tech enablement of assets held in portfolio	67%	19%	14%
Distressed asset sales	67%	24%	9%
Valuations	64%	20%	16%
Property maintenance	62%	26%	12%
Fundraising	61%	23%	16%
Inclusion of climate	61%	27%	12%
ESG investment	60%	30%	10%
Availability of debt	59%	22%	19%
Cost of debt	57%	28%	15%
Reconfiguring office space	56%	25%	19%
Deal flow	54%	30%	16%

* e.g. medical, self-storage, industrial

↓ WHEN DO YOU EXPECT EUROPEAN COMMERCIAL REAL ESTATE MARKETS TO RECOVER FULLY FROM THE IMPACT OF COVID-19?



Demand for Outsourcing



THE GROWTH IN DEMAND FOR OUTSOURCING

The vast majority of real estate investors will look to re-evaluate their operating models and reduce costs over the next two years, with 87% overall holding this view, of which 32% state that this outcome is “extremely likely”. In comparison, only 2% said that they were “not at all likely”, suggesting a sea change in how real estate investment companies operate over the coming years. This is also supported by the fact that 47% of respondents stated that the ability to identify and generate cost savings is likely to shape sentiment among institutional real estate investors over the same timeframe.

This attitude is felt most strongly in North America, where 93% of respondents will be re-evaluating their operating models - with 60% saying that it is “extremely likely”. This is followed by the UK (89%), with Europe seemingly most resistant to re-evaluating their business models, with 20% saying that it is unlikely.

On average, respondents expect costs to fall by 18% over this timeframe, with North American respondents expecting the greatest cuts (23%) ahead of the UK (17%) and Europe (15%).

Due to the dramatic impact Covid-19 has had on real estate investment and global mobility, it’s predicted⁷ that cross-border flows to safe-haven locations and flows between ‘near-neighbours’ will set the tone for cross-border deals in 2021, with the United States, Germany, United Kingdom and Singapore most likely to be major players in cross-border activity.

While appetite for cross-border investments is holding up, lockdown and travel bans have made the process more complex, in that it has been impossible to view assets or meet owners in person. While a deal enacted in another country may look and feel the same as one in a domestic market, cultural nuances and different regulations and legal frameworks can lead to unexpected challenges.

The greatest complexities identified by investors when engaging in cross-border investment activity were revealed as increased competition for assets (64%), regulatory frameworks (61%), due diligence and tax regimes (both 58%). While the former is likely spurred on by the appetite among real estate investors in the wake of the pandemic, the subsequent factors are all a result of administrative complexities which can be alleviated by specialist outsourced fund administration.

One major administrative hurdle over the past few years has been the introduction of economic substance regulations. A large number of real estate investors have already started outsourcing specifically to combat the added administrative burden of economic substance in their jurisdiction. With a high uptake in outsourced functions such as accounting, cash monitoring and reconciliations and legal entity administration already, investors are also likely to start outsourcing elements such as company secretarial support and loan administration in the future to lighten the administrative load.

↓ WHICH OF THE FOLLOWING ELEMENTS HAVE YOU STARTED, OR PLAN TO START, OUTSOURCING AS A RESULT OF THE IMPLEMENTATION OF ECONOMIC SUBSTANCE REGULATIONS IN YOUR JURISDICTION?

	Have started outsourcing	Plan to start	No plans to start
Accounting	61%	36%	3%
Cash monitoring & reconciliations	48%	40%	12%
Legal entity administration	46%	32%	22%
Loan administration	44%	41%	15%
Company secretarial support	41%	43%	16%

When looking at the specific elements of economic substance regulations that have posed the biggest challenges to real estate investment operating models, no one rule stands out, with regional pockets of difficulty being highlighted, such as ensuring the business has adequate people, premises and expenditure in the jurisdiction in the UK (66%), ensuring all appropriate staff are adequately trained to understand the regulations in North America (60%) and ensuring the business undertakes core income-generating activities in the jurisdiction in Europe (57%).

⁷ “Where will capital flow in 2021?”, published on 1st January 2021 by Knight Frank.

↓ WHAT ELEMENTS INVOLVED IN THE ECONOMIC
SUBSTANCE REGULATIONS HAVE POSED THE BIGGEST
CHALLENGES TO YOUR OPERATING MODEL?

-  **51%**
Ensuring the business has adequate people, premises and expenditure in the jurisdiction
-  **51%**
Ensuring all appropriate staff are adequately trained to understand the regulations
-  **50%**
Ensuring the business is directed and managed in the jurisdiction
-  **48%**
Ensuring the business undertakes core income-generating activities in the jurisdiction
-  **25%**
Administration associated with the reporting of compliance with the regulations



Real Estate Outlook



THE OUTLOOK FOR REAL ESTATE

While investors may have identified certain complexities associated with cross-border deal completion, it hasn't dampened their enthusiasm. When asked about the most attractive overseas markets for investment over the coming five years, the UK came out on top, with more than four fifths (82%) of investors intending to invest between now and 2026. Established markets Europe and North America were popular (both 71%) but interest in emerging markets was also high, with 70% of respondents looking to complete deals in the Middle East, 60% in Asia Pacific and 58% in Latin America.

When looking at the sectors they intend to invest in over the coming five years interest was similarly high and broad; materials (81%), real estate and energy (both 80%), financials and telecoms (both 78%) were popular, though even utilities - the least frequently-selected sector - was still rated as attractive by nearly three fifths (59%) of respondents.

However, several factors are likely to play a significant role in investors' ability to complete deals across these jurisdictions and sectors. Paramount among these, according to investors, is the increased demand for reporting transparency analysis

↓ WHICH OF THE FOLLOWING ARE MOST LIKELY TO SHAPE SENTIMENT AMONG INSTITUTIONAL REAL ESTATE INVESTORS OVER THE NEXT TWO YEARS?

Increased demand for reporting transparency and analysis	47%
Identifying and generating costs savings	47%
Wait and see attitude will prevail during this period	42%
Greater caution towards transaction activity	41%
Persistent uncertainty about pricing	37%
More due diligence on financial strength of prospective tenants	29%
Lower valuations in sectors hit by the pandemic present a buying opportunity	25%
More due diligence on ESG credentials of prospective tenants	17%
Increased use of technology	15%

(47%), along with the identification of potential cost savings. Despite the appetite for investment, 41% of respondents believe that there will be greater caution towards transaction activity, possibly resulting from persistent uncertainty about pricing (37%).

Investors are divided over the impact investor demand for ESG factors will have on overall private equity real estate AUM volumes in the next five years.

Also likely to shape sentiment in the coming years are environmental issues, with investors divided over the impact investor demand for ESG factors will have on overall private equity real estate AUM volumes over the coming five years. While the majority (56%) believe that it'll increase as funds successfully incorporate ESG factors into their investment process, a significant proportion - 40% - are of the opinion that it'll fall as a result of firms struggling to effectively implement ESG factors.

↓ WHICH ENVIRONMENTAL ISSUES ARE MOST MATERIAL TO YOUR FIRM?

Energy efficiency	42%
Sustainable development / fit-out	42%
Sustainable property management	39%
Green building certification	35%
Climate change resilience	32%
Biodiversity	28%
Waste management	28%
Indoor air quality	20%
Innovation / green technology	16%
Water efficiency	14%
Mandatory green lease clauses	4%



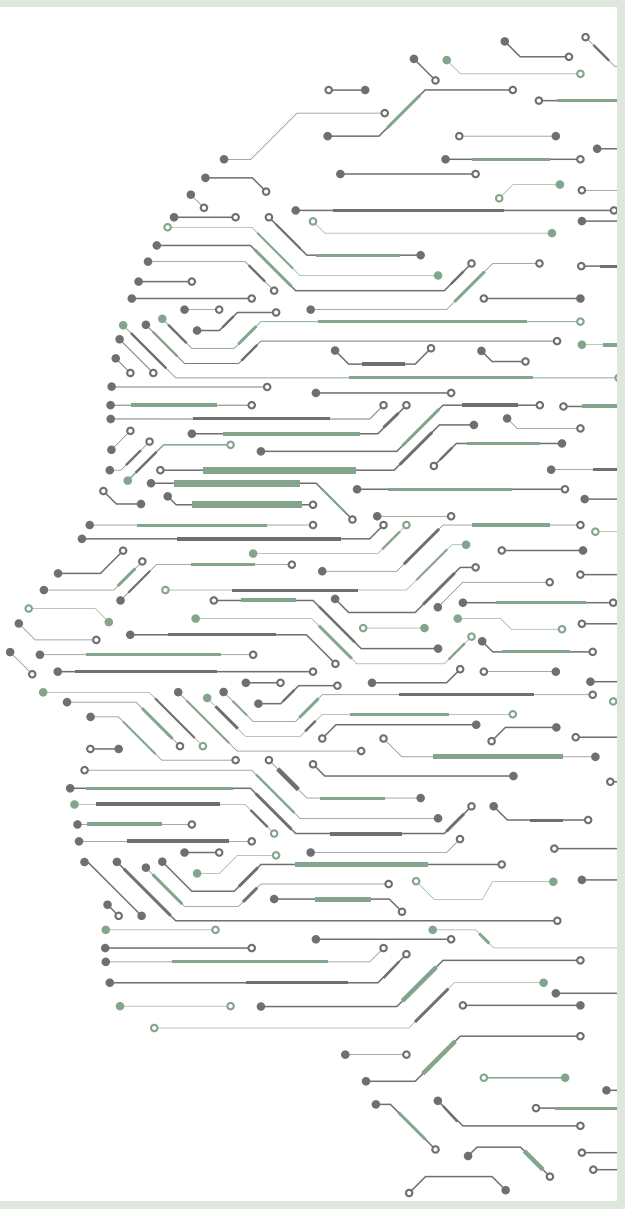
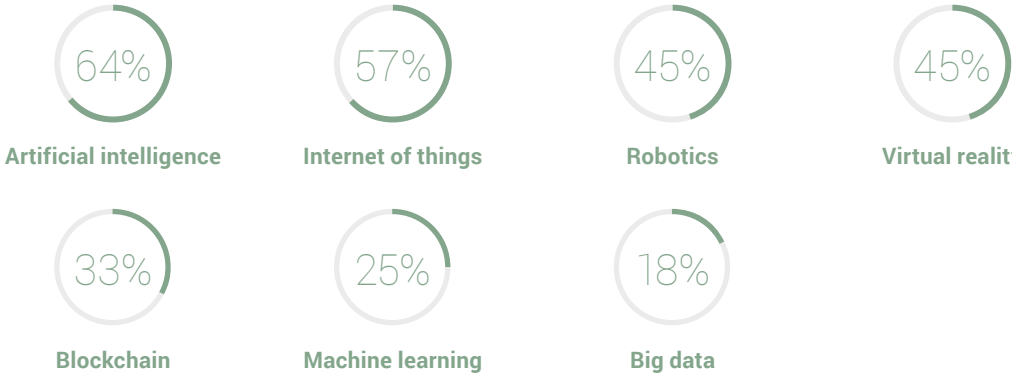
The rise of technology

Technology has already proven invaluable as the industry adapts to Covid-19 and is likely to play a significant role in the future of real estate investment. Not only will funds be able to invest in technology that creates smarter, more valuable properties, but they'll use technology such as artificial intelligence and data analytics to understand more about what makes a successful investment and which factors should be taken into account when assessing opportunities.

The real estate investment industry is firmly behind the integration of technology in the investment process, with 66% stating that it'll have a transformational effect on investment performance and 47% believing that it'll offer greater operation efficiencies. However, coupled with this enthusiasm is a fear of failing to truly implement this technology successfully, with 39% stating that they're already falling behind their competitors and a further 34% stating that keeping pace with technology is a challenge.

Over the next five years, investors believe that the technology most likely to have the biggest impact on the real estate fund management industry is artificial intelligence (64%), ahead of the Internet of Things (57%).

↓ WHICH OF THE FOLLOWING TECHNOLOGIES IS LIKELY TO HAVE THE BIGGEST IMPACT ON THE REAL ESTATE FUND MANAGEMENT INDUSTRY OVER THE NEXT FIVE YEARS?



Conclusion

Despite the numerous challenges faced by the real estate investment sector last year, investors are confident in their ability to emerge from the pandemic, with widespread optimism for recovery across all sectors over the coming years.

However, while investors have been successful in navigating Covid-related shocks over the past year or so, there are still question marks that remain about how strong the recovery will be should pandemic-induced factors such as remote working or online shopping remain beyond the end of local lockdown restrictions.

The two key themes likely to impact the sector in coming years - the influence of technology and the ESG agenda - currently split the panel and will present their own opportunities and pitfalls, while a third - the demand for outsourcing - is only likely to intensify as investors look to new markets and sectors in the hunt to capitalise on every opportunity presented in the post-Covid landscape.

ABOUT AUXADI

With more than 40 years' experience, we're experts when it comes to working with multinational companies, private equity and real estate funds.

How we help real estate firms

Auxadi is a specialist provider of tailored international accounting, tax compliance and payroll services. Operating in 50 jurisdictions across Europe, the USA and Latin America, we provide an end-to-end solution through cloud-based technology to make your lives as easy as possible. Our IT platform, employees and methodology are all designed to act as a seamless extension of your accounting departments to ensure that your administrative requirements are met across your real estate investment portfolio, no matter the volume of deal flow.

Our culture is based on ethics, excellence and exceeding the expectations of our clients and we achieve this through flexible and efficient solutions developed by a motivated, committed, and solid team. With more than 40 years' experience, we're experts when it comes to working with multinational companies, private equity and real estate funds.

Research methodology

Research was conducted via an online survey amongst a panel of 100 senior-level real estate fund managers in April 2021. The sample was split evenly between decisionmakers at firms based in the UK, Continental Europe and North America. The average stated AUM of respondents stood at €13.5 billion, with North American (€15.9bn) and UK (€15.0bn) respondents coming from slightly larger firms than European respondents (€9.9bn).



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