Real Estate in 2021

Global AM Perspectives – Podcast transcript

Podcast with Andrew Weir, Global Head of Asset Management and Real Estate, KPMG International, and Regional Senior Partner, KPMG in China

Musical intro

Announcer:

Hello and welcome to ‘Global AM Perspectives’, a new KPMG podcast series for asset managers, fund managers and investors around the world.

Through discussions with leaders from KPMG and major market players, this series will include short episodes that look at some of the most pressing issues, emerging trends and market opportunities within the asset management, real estate and private equity industries.

In our first episode, Andrew Weir, KPMG’s Global Head of Asset Management and Real Estate practices, who’s also the Vice Chairman of KPMG China and a Regional Senior Partner of KPMG in Hong Kong (SAR), China, will center our attention to real estate, an industry that is facing multiple challenges in an undeniably unusual year. And yet, we know that with challenges come opportunities for those who are prepared.

With that, let’s turn to Andrew – Andrew, thanks for joining me on the phone today.

Andrew:

I’m delighted to be here.

Announcer:

2020 has turned out to be quite an unexpected year. What has been the top of mind in your conversations with clients?

Andrew:

2020 has really been an incredible year, it has been a year of great challenge.

I think there's a few things we've learned. I think the first thing we've learned is that sense of purpose, what we as an organization are trying to do, what we stand for is very important. And one of the phrases I used is how we behave as an organization in the real estate sector now, will be looked at through an unforgiving lens in three years’ time when people will not remember this sheer uncertainty we faced. And this recognizing that one has many, many stakeholders is very, very important.

I think another thing which has come out of COVID has been that a lot of the questions about what was the legacy of COVID, and I think you've got three big things.

One is the purpose of an organization, stakeholders, et cetera. The second is recognition that technology and digital transformation, and it's gone from being a nice to have into a fundamental question about what is our business model and how can technology empower it.

And the third trend we've seen is a step change in the concept of sustainability in ESG. The environment part is now quite a well-worn path, but the social aspect is also something which is being looked at much more closely than before. And then governance is the wrapper around which ESG, climate change and other things are pursued, has got a different level of consideration.

Those are the main conversations KPMG professionals’ been having with clients.

Announcer:

So Andrew, from your perspective, how has the behavior of capital changed, especially with the uncertainty of valuations?

Andrew:

I think on capital the first think I have to say is there's no shortage of capital. And always in real estate the challenge has been where is there investible supply.

But capital, also a very fair question, is what is the required return, and what is the yield, what is actually the cap rate one would impute when looking at a transaction? And I think it’s fair to say there’s a lot of uncertainty out there.

At the moment cap rates haven't moved that much, which initially to an outsider looking in is quite surprising, but when you look in terms of probably the risk relating to individual assets has probably gone up, therefore risk premium is required, but the risk free cost of capital reflected by negative interest rates in Europe and elsewhere pulling at them, you can understand why cap rates maybe haven't moved too much.

But, I think a very fair question is on the deployment of capital, what will be the financial consequences of all the major government programs and all the economic story.

So in terms of valuations I think this is very difficult. At the half-year, 30th of June, it was noticeable the Royal Institution of Chartered Surveyors (RICS) has a caveat in relation to material uncertainty warning people to be very careful on valuations. We've started to see that lessen now. I think the 31 December valuations the situation is a bit clearer. But, the point I'd make on valuations is, if you're an organization, the board needs to understand them. It's not just the job for the valuer, the finance team, the auditor, the board needs to understand them and what it may mean for the future.

And when you look at the key components, the first one is projections of income, either through rent or rental reversion or normal income cash flow forecast, a good rule of thumb, at least three scenarios: base case, downside, upside.

Linked with that is how one handles concessions, rental concessions. You're starting to see now situations where even on a 12 month lease, excuse me, you're getting a five month rent free period. So, this projection of headline rent while giving concessions is a real challenge when you come to value, how far to go.

The other thing on the income projection side is how secure is the income and to what extent is underpinned by either direct or indirect government stimulus.

So, I would just say on valuation we go with our eyes open, we make sure the full range of possibilities is disclosed and we make sure that boards fully understand them, and then we fully disclose in accounts and financial reporting what it means, and accept that this is just a snapshot of time at 31 December.

One final point just on valuations, it is worth remembering it's meant to be a willing buyer, willing seller. Many times in transactions that's not actually the case. So, particularly in times of uncertainty that's also not the case, so one's got to be very mindful of what truly an open market value is in that period of uncertainty.

Announcer:

Andrew, earlier you mentioned digital transformation. How important is it really and why?

Andrew:

Digital transformation I think is an absolute game changer. You can look at it from many ways, every single aspect of real estate, be you're an owner or an operator or a tenant or a corporate, it brings a different level of data, a different level of analysis to business decision making. I think that's the first point I'd make.

Secondly, one can look at it rather like fintech. Does one really have proptech? And rather like fintech, has gone from being a bunch of very, very innovative small enterprises into now the whole scale application of technology with major organizations in that space, basically transforming technologically their business. With also certain expertise in niche from entrepreneurs, we're going to see the same in technology and property.

The third one is the sheer demand of consumers and expectation of consumers. I'm based in Hong Kong and I go to China a lot, the demand in China of consumers for access to their own data to inform their own shopping for example or their own data in their own place of work. The demand of the consumers is totally different and that changes the relationship between the consumer and the retailer or the office owner and the owner. A big, big difference on that.

Announcer:

So, Andrew, in your opinion, what can we expect to see in the real estate industry in 2021?

Andrew:

I think hospitality as an asset class will remain under great challenge, but already one thing very innovative is solutions and ideas being put forward, but the key for this is really a vaccine and ability to travel.

I think industrial and logistics seem as very strong sectors. They're benefitting hugely from the e-commerce fulfillment story. They're benefitting hugely from the new types of supply chains, the mitigation of supply chains, which are coming through the changing trading patterns and restrictions. And I think this combination of e-commerce and change in supply chains and risk mitigation supply chains, will give rise to significant demand for logistics hubs and warehousing hubs.

Then I think thirdly, you've got what used to be called alternative real estate, which is everything from student accommodation to aged housing to data centers. I would say this is no longer alternative, this is mainstream. And the advantage of this is the yield you can get is greater than in others. So I think that content-led real estate has got great opportunities.

One then gets to retail. I think on retail it's all a question of how organizations harness the e-commerce story and narrative, and change quickly to what is the purpose of their premises, what is the purpose of the location they're in. And I think you're going to see a bifurcation between those organizations have the agility and ability to respond to this and those who just can't change.

And then finally you've got office and residential. Just a couple of things.

On offices, I'd say I think they'll hold up better than people expect. But in offices I think if they're in the right locations as a source of collaboration, you're going to see, yes, a change in use of office, but it's worth bearing in mind that still there's a relatively shortage of supply of offices in key locations.

And finally on residential, at the end of the day the residential market is underpinned by demand. There is still pent up demand. There's still a relative shortage of accommodation housing in the world. A lot would depend on economic variables such as interest rates and affordability, but the need for residential and the need for residential developments is still there.

So I think when you go through asset classes by asset classes, you can actually see that 2021 can actually be quite an optimistic here but requires great agility of thought and ability to think three, five years ahead and basically see where the market trends are going.

Announcer:

And finally, for you Andrew, what are the key areas of opportunity, and what companies can do to prepare?

Andrew:

I think a very interesting challenge is just about every force at the moment has a positive and a negative. And I think it's far too simple to say the demand for real estate space by corporates will reduce, but the nature of it and the type of it will change. So, I think that gives rise to a lot of opportunity.

The other opportunity, but again it's going to be seen as a threat as well. If one is not mining one's own data well and working out what it means, or if one is not managing one's data or seeking data, somebody else will be.

So the final point I'd raise is what different is. How does one ensure at a board level or an executive committee level, one's got enough challenge to prevailing thinking? Is there enough understanding of the zeitgeist and how best to position what we're doing as an organization?

Just one final point I'd raise on what's different. Going back to ESG, at the moment 25 percent of assets under management are viewed through some lens of sustainability. Now the central banks, the global regulators are all aligned on the importance of this, so that's one force. Another force is the major passive investors, the major pension fund investors are driving this, and a third force is the millennials and beyond as individuals who expect it.

These three forces are creating a pincer movement, but if you're an organization you have to have a compelling ESG narrative. What you're going to see I think is within three years, 50 percent of assets under management worldwide will be seen through an ESG lens, and in our lifetime, or probably even less than that, I think all assets will have to be viewed through an ESG lens.

And those organizations who don't realize this, this quantum change in ESG, I think will find themselves left behind, because it's already coming home to roost in ESG ratings, in indices, cost of capital, and return on capital. It's already coming through. So I think that's something to keep a real close eye out for.

Announcer:

Thanks Andrew, that’s great.

Andrew:

Well thank you for listening to me today, and we're very keen to carry this on as a series. And in future episodes, I'm very keen for my senior colleagues on our global steering groups to share their perspective in what they're seeing and in their own markets. And I wish everybody well in 2021.

Announcer:

Andrew, on behalf of our listeners, thanks again for joining me today and we are looking forward to exploring other top of mind issues within the asset management, real estate and private equity industries, so stay tuned.

Andrew:

Thank you very much

Announcer:

In the meantime, let us know what you think about this episode, or if you have any ideas for future episodes, please email us at assetmanagement@kpmg.com.

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Musical exit