

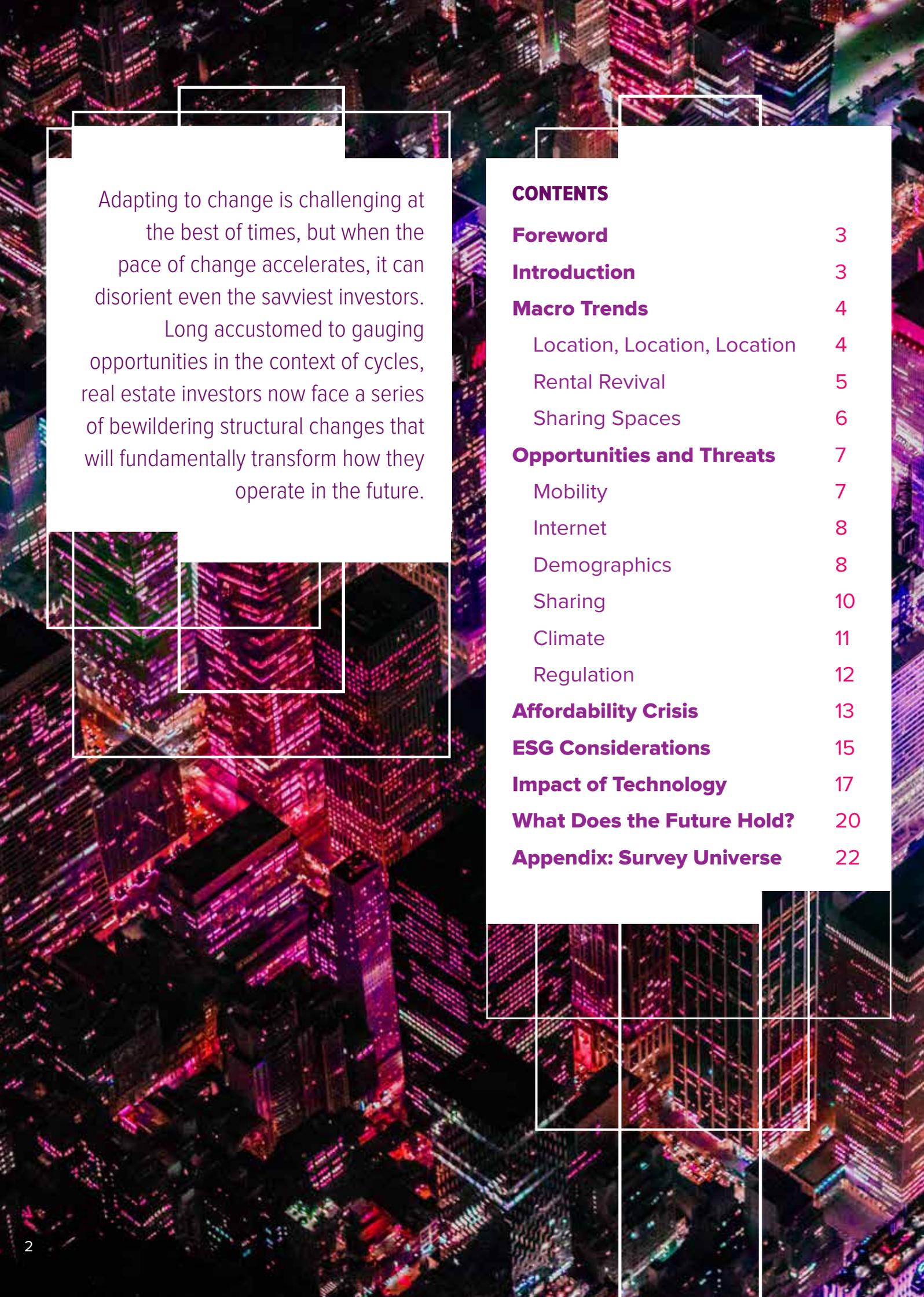


THE FUTURE OF REAL ESTATE INVESTING

2020 SEI/Preqin Survey of Real Estate Managers and Investors

“The future depends on what you do today.”

– Mahatma Gandhi



Adapting to change is challenging at the best of times, but when the pace of change accelerates, it can disorient even the savviest investors.

Long accustomed to gauging opportunities in the context of cycles, real estate investors now face a series of bewildering structural changes that will fundamentally transform how they operate in the future.

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Foreword

Around the time we first contacted real estate investment professionals to participate in the writing of this paper, reports were beginning to emerge about the outbreak of a novel coronavirus in Wuhan, the capital city of Hubei province in the People's Republic of China. In the intervening months, the virus that became known as COVID-19 morphed into a pandemic, rampaging around the globe, taking lives and bringing economic activity to a grinding halt. How the pandemic ultimately plays out is anyone's guess, but it is clear that we are unlikely to see a return to "normal" anytime soon.

With the possible exception of the two world wars, nothing in recent history has proven so disruptive to so many lives and livelihoods. Setting aside the tragic consequences of this virulent disease, its impact should be of great interest to real estate investors. Self-isolation and social distancing are having a profound effect on people's relationships with their build environment. Work is largely happening from home as offices sit idle. Food and other supplies are being delivered while restaurants and shops quietly go out of business. Hotels are empty. Church is a virtual affair attended in pyjamas. Homes for sale are being shown online.

The unprecedented upheaval caused by the coronavirus will inevitably shift priorities and perspectives. Perhaps most profoundly, it could change how we all think about physical space and how it is shared with others. Whatever short-term contortions the property market goes through in response to the economic devastation wrought by this virus, real estate investors should not lose sight of long-term changes in behaviour. These will inform how people live and work in the future, ultimately shaping the types of developments that are most desirable in a world that will never be quite the same.

Introduction

The investments business does not have a reputation for innovation. New regulations or technologies occasionally spur change, but fiduciary concerns and a need for predictability largely preclude sudden shifts in *modus operandi*. Several converging factors now threaten to upend the status quo, bringing an unprecedented revolution that is forcing both investors and asset managers to reexamine their beliefs, processes, and infrastructure.

Nowhere is this truer than in real estate investing, where technology, demographics, climate, and affordability are just some of the factors quickly reshaping how and where people live, work and play. Investors and managers need to make increasingly complex calculations, weighing sometimes conflicting concepts such as density versus distance, affordability versus desirability and economics versus sustainability. Will secondary cities that have historically been overlooked but are attractive to dynamic young populations become popular? How will commercial real estate be affected by telecommuting and declining automobile ownership? Will climate change render waterfront property worthless or spur innovations that enable a different relationship to aquatic environments? These and many other questions are being pondered by investment committees worldwide.

Predicting the future is especially problematic when the rapid pace of change makes it even more difficult to tease future trends out of current events. In response, we cast as wide a net as possible, surveying the landscape for clues and triangulating our research by combining primary research, in the form of surveys and interviews of fund managers and investors, with secondary research sources.

When the inimitable Mahatma Gandhi wisely observed that the future hinges on our actions in the present day, he was highlighting the difficulty of enacting future change without igniting a spark of some kind in the present. Investors are now confronted with a slightly different conundrum. They are facing rapid-fire change whether they like it or not. The larger point, however, still rings true: Inaction is not a viable option. We hope this research will assist in making informed choices that lead to improved investment outcomes.



Macro Trends

Many changes are remoulding the real estate world, but certain developments are particularly significant. Asset managers and investors participating in the survey agree that one of the biggest shifts in the industry is the growing emphasis on secondary and tertiary cities (Figure 1). Both groups also concur that a growing consumer preference for rental properties is a trend that is likely to inform their investment decisions. Beyond this, there was less agreement. Investors are more prone to cite a variety of developments influencing their thinking, including some that are viewed by fund managers as distinctly niche issues, such as co-working projects and facilities for digital nomads.

LOCATION, LOCATION, LOCATION

The attention being lavished on second- and third-tier cities is especially prevalent among investors based in North America. Memories of the last financial crisis and speculation about the likelihood of a coming retrenchment are causing worries around the durability of many of the high-end developments built to capitalise on the skyrocketing valuations in some major cities. Jenna Gerstenlauer, CEO of Sound Mark Partners, notes that her firm finances Class A projects in secondary markets, explaining that they have found “investors favour these sorts of projects over luxury condos priced at the top of the market that might not be able to command the same rents in a downturn.”

FIGURE 1 Developments expected to play a larger role in real estate investment decisions
(% of respondents)



Source: 2020 SEI/Prequin Future of Real Estate Survey

The growing concern is understandable. Real estate prices in the most expensive markets are enough to produce vertigo: A 60-square-metre apartment in London costs the equivalent of 14 years' salary.¹ The lack of affordability in some urban areas is changing behaviour, sometimes radically. In San Francisco, where one square foot of living space now trades for approximately US\$1,000,² one-bedroom apartments are being converted into barracks for six or more young tech workers whose only realistic option would be to join the legions of "super commuters" spending three or more hours getting to and from their jobs each day.

For many buyers and renters, quality of life is an important enough consideration that they are flocking, in growing numbers, to second- or third-tier cities. These are not all created equal from the standpoint of residents or investors. The most attractive growth prospects are often found in markets anchored by prominent universities, large medical facilities or major research and development centres.

Strong employment and low prices are an irresistible combination to young families and young companies, whose presence contributes to a solid and more resilient foundation for growth. A vice president at one of the world's top 10 largest sovereign wealth funds said that their ideal residential property development strategy would "focus on university towns where there are space constraints, an educated workforce and potential for innovative micro-hubs."

RENTAL REVIVAL

Both GPs and LPs also point to a growing emphasis on rental properties. This cannot be entirely due to the well-publicised preference among millennials for flexibility and mobility, because their successors in Generation Z appear to be moving in the opposite direction, placing greater emphasis on stability.³ Nevertheless, rising home prices put ownership out of reach for a growing number of potential buyers. As Maurice Malfatti, Managing Partner at Blue Heron Asset Management points out, "The move away from home ownership to renters, and a focus on experience over ownership, is permeating all age groups, not just millennials."⁴ Census data supports his assertion, revealing that the number of renters in the US aged 60 or older grew by 32% over the past decade, compared to single-digit increases among younger cohorts.⁵



SHARING SPACES

While European and North American respondents often bring a shared perspective, their Asian counterparts revealed a different set of priorities. Asian investors, for example, are much more likely to attach importance to the growth of co-work spaces as well as lodging and infrastructure for so-called digital nomads, who are not tied by their work to any specific physical location. This flexibility is made possible in part by the kind of technological infrastructure that one can find in many Asian cities, making it easy to survive for days at a time with only a smartphone to pay for goods or services.

Another contributing factor is the growing culture of entrepreneurship in markets that were previously dominated by state-owned enterprises and large conglomerates. More women are joining the white-collar workforce in Asian countries, a trend that is often accompanied by an emphasis on more flexible work arrangements. Commuting and pollution concerns are also more acute in many Asian cities, further reinforcing the trend toward remote work. The emergence of COVID-19 as a global pandemic has now suddenly accelerated this trend by triggering a work-from-home experiment of unprecedented proportions.⁶

Asian investors are also much more excited than their American and European counterparts by growth in nontraditional residential developments centred on the notion of shared spaces. In a new spin on the tried-and-true concept of flatmates, co-living properties are now marketed as intentional communities of like-minded residents in North American and European property markets. They are attracting significant attention and being associated with millennials' penchant for sharing as well as an interesting and cost-effective choice for retiring baby boomers. Still, they remain niche developments in most developed economies.

There are some interesting indicators that the shared-housing business model is particularly well-suited to dense urban areas featuring very fluid workforces. This makes it a natural fit for Asia's cities. The sheer volume of new construction, coupled with the number of workers who arrive in order to earn and send money to homes in smaller villages, has developers constructing more purpose-built buildings with private bedrooms and shared living areas.⁷ All of these preferences point back to Asia's position on the leading edge of digitisation, mobility and connectivity. Different dynamics in the North American market might prevent widespread adoption there, but it would not be surprising to see co-living developments take root in cities across other regions in the coming years.

“The move away from home ownership to renters, and a focus on experience over ownership, is permeating all age groups, not just millennials.”⁴



Opportunities and Threats



Even respondents who agree on the significance of certain secular trends can find themselves disputing their impact. Any given development can have both positive and negative influences on real estate portfolios. Sources of disruption can intersect, overlap, and amplify each other depending on context. In order to make some sense of the myriad forces at work on their investments, we asked survey participants to comment on how they view the net effect (i.e., “pros” less the “cons”) of the trends on their activities.

MOBILITY

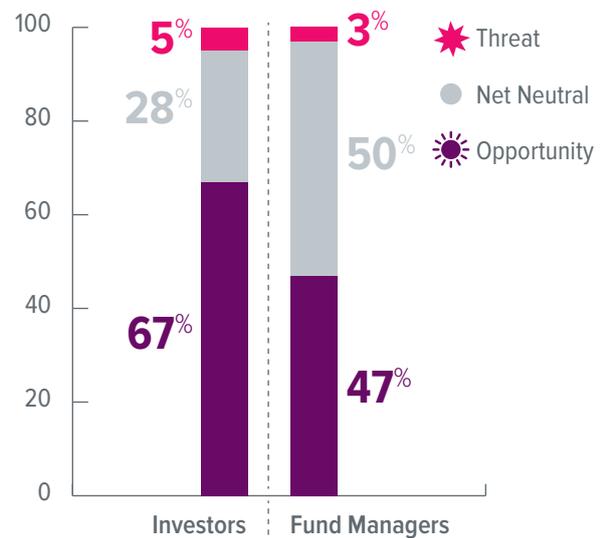
Changing modes of mobility are collectively expected to present an opportunity for real estate investors. Electric cars are increasingly practical, popular and cost effective. Autonomous vehicles are on the cusp of becoming widespread. Broadband internet and a multitude of delivery options mean people are less tied to specific locations in order to work, shop, eat or be entertained. When they leave the house, they are increasingly likely to use a ride-sharing service. Deliveries via automated drones are seen by many as not far off.

These changes will affect demand for a variety of commercial properties, including dining and retail. Similar to the way we have seen the market for shopping centre properties sour while warehouses soar, demand may shift away from restaurant spaces built for on-site consumption to staging areas optimised for food preparation. Real estate investors may want to look to Uber founder Travis Kalanick’s newest venture as a bellwether: Having exited the shared-ride space, Kalanick is now investing in “dark kitchens,” which function as staging areas for

restaurants’ delivery businesses. Like ride-sharing, it is a model in which underutilised assets can be split or shared among multiple renters based on ebbs and flows in demand.

Changes to mobility may profoundly reshape the outlook for real estate investments that are premised on the status quo, but they have not yet overcome the vital importance of location. The owners of a parking garage in the middle of Manhattan can repurpose that space into condominiums, fulfilment centres, or shared office spaces. But the owner of a parking garage located next to a suburban strip mall currently has far fewer options.

FIGURE 2 Impact of changing modes of mobility (% of respondents)



Source: 2020 SEI/Prequin Future of Real Estate Survey

This dynamic may change over time, as new forms of transportation raise as many questions as they answer. Shaunak Tanna, Head of Structured Investments at Basis Investment Group, views

mobility solutions as a major wildcard: “Uber and Lyft have made arrangements with some suburban office park campuses to provide discounted rides to nearest transit centres, which reduces the need to be located next to transit hubs. Once you get to fully autonomous cars, maybe we’ll see more suburban sprawl as people are able to use their commute times effectively and be productive at that time, as opposed to now when they’re driving.”

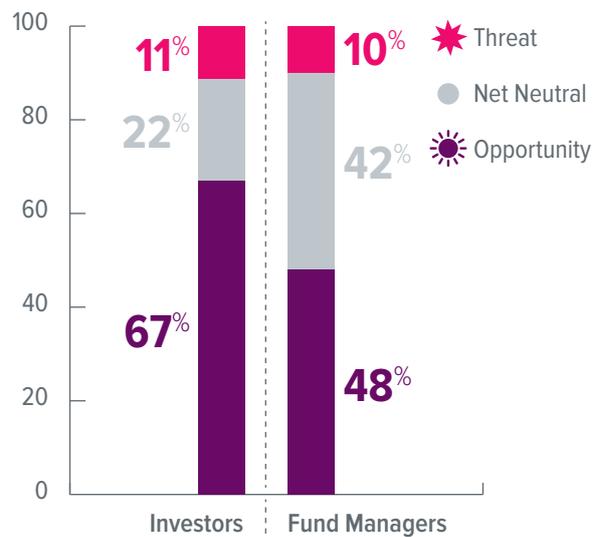
INTERNET

Society’s shift toward internet-based interactions is another trend that is widely viewed as a net opportunity. Commerce and social interactions increasingly take place online, leading to declining interest in traditional commercial developments and the replacement of these facilities in growing numbers by logistics infrastructure. The future, however, is not all warehouses and dark kitchens.

As fewer businesses are patronised out of necessity, there is a growing emphasis on providing pleasurable and memorable experiences. As counterintuitive as it may seem, people spending more of their time online means urban cores are being repurposed with residential mixed-use developments centred on open-air markets, specialty stores, cafes and restaurants. Rather than fixating on transactions, commercial developments are increasingly focused on being integrated into the daily lives of residents, satisfying their craving for experiences and community.

It is unclear how this trend will ultimately play out. It is possible that the trend toward greater urban density will continue as people seek proximity to a cultural core and are able to push less exciting necessities to the periphery, but it is also possible that the newfound freedom from fixed workplaces will render distance irrelevant, spawning even more sprawl.

FIGURE 3 Impact of shift to internet-based interactions
(% of respondents)

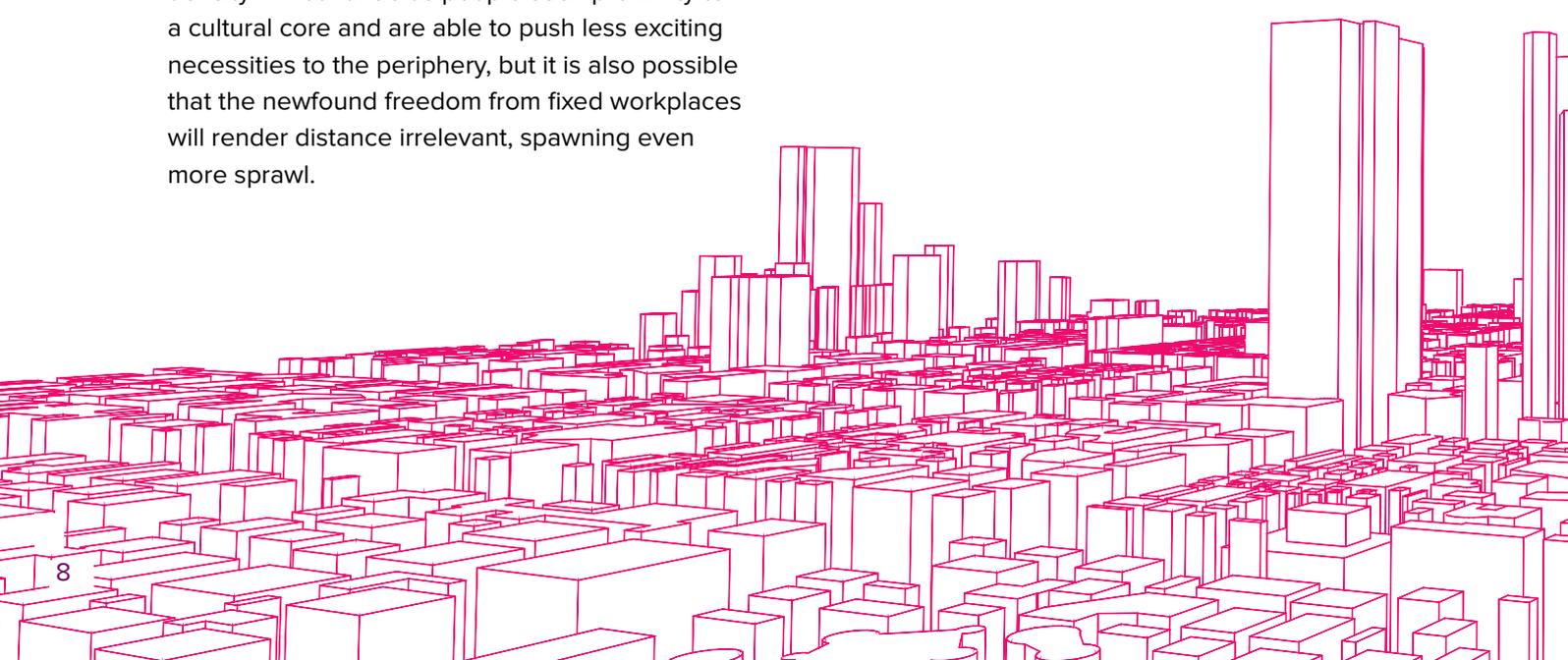


Source: 2020 SEI/Preqin Future of Real Estate Survey

DEMOGRAPHICS

Aging populations are also widely perceived to be a positive development, particularly in Asia, where 8 of 10 fund managers view this demographic trend as an opportunity. A growing elderly population will fundamentally alter how residential and commercial properties are designed and developed. For example, newly designed urban spaces are more likely to incorporate green spaces with additional seating and activities for elderly residents.

These types of developments may become more commonplace as more seniors balk at leaving their homes. Gerstenlauer points out that “a lot of (assisted-living) investments are in trouble because



seniors don't want to leave their home and live in isolation with people their age, and because this generation can't afford it. The majority of baby boomers don't have the US\$4,000-\$10,000 per month to spend on rent in one of those facilities."

Even with this reluctance, the sheer size of the baby boomer generation means that a flood of single-family homes owned by boomers will be hitting the market over the next few years. Strong demand from younger buyers may not materialise, distorting the market and making this an important consideration for any investor in residential real estate.

Millennials, on the other hand, are more likely to prize mobility and want the option of picking up and moving to wherever their work happens to take them. Joe Lubeck, CEO of American Landmark, notes that his firm has responded to this trend by devising rental programmes that allow tenants to move geographies without penalty as long as they stay in one of their properties.

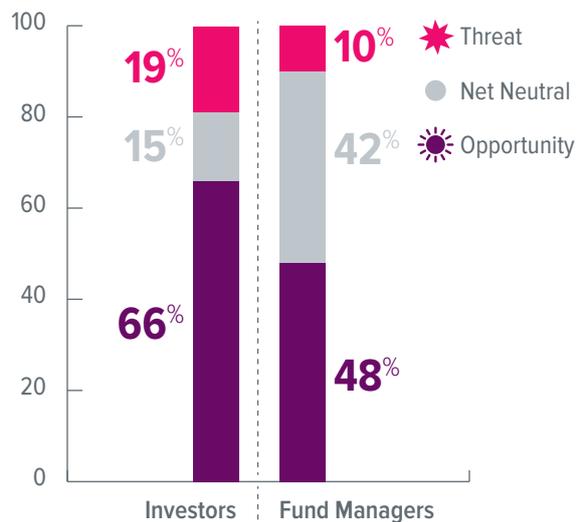
Oscar Vasquez, COO of Encore Capital Management, cautions against generalising too much when it comes to generational preferences, pointing out that 83 million millennials are not likely to be in lockstep when it comes to their preferences for urban or exurban life. He goes on to note, however, that it is broadly true that "major life milestones like marriage, family formation, and the purchase of their first home are delayed by five to eight years. They're carrying a tremendous

amount of student debt, and wages have not been trending upward. It's not that millennials won't do these things, they've just postponed them."

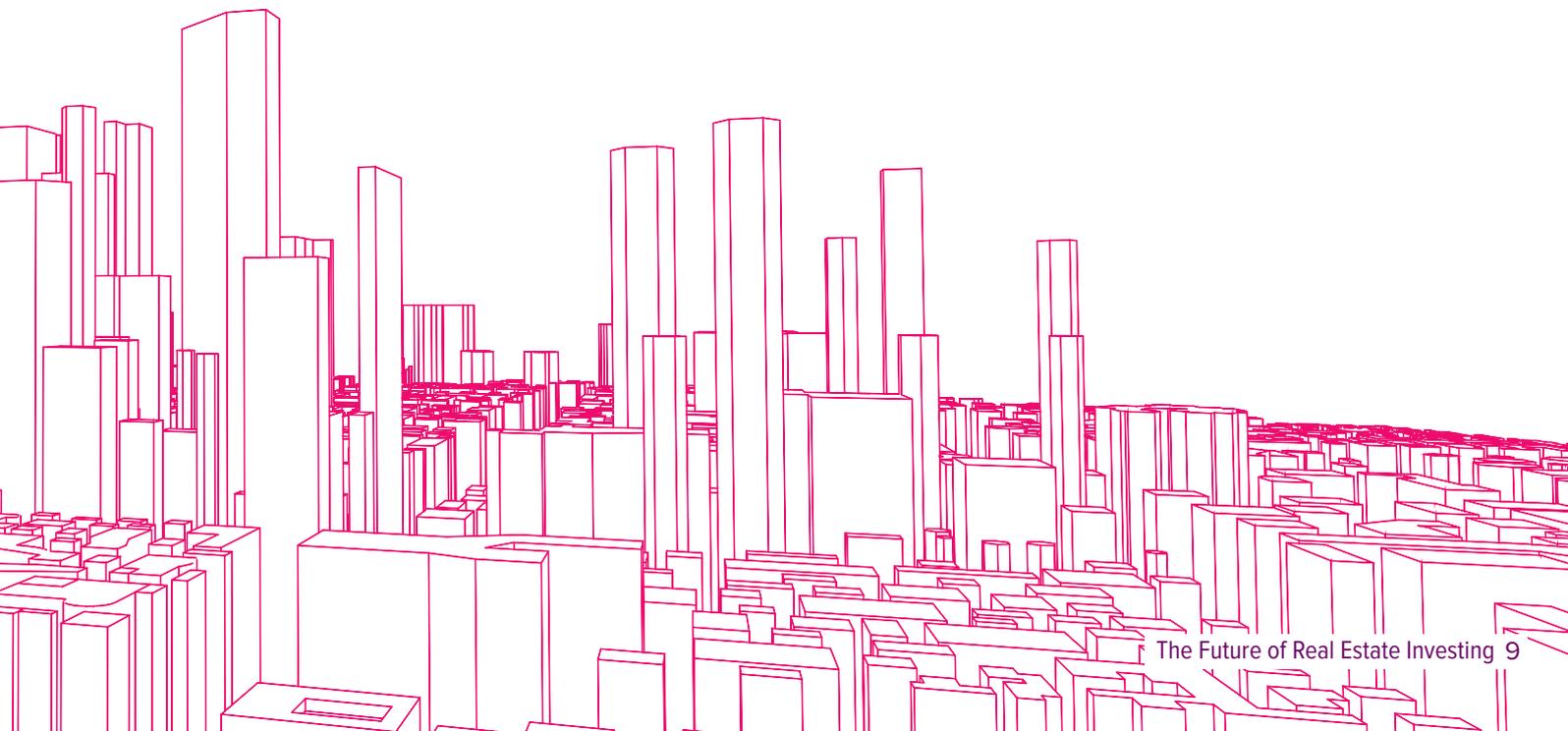
Pat Jackson, President and CEO of Sabal Capital Partners, agrees while pointing out that delays reflect shifting priorities among millennials: "Thirty years ago there was a flight to the suburbs, but now people are moving back to cities. Younger people want to rent—they don't care as much about some of the things earlier generations cared about. Younger people view flexibility as valuable. They saw their parents lose their nest eggs in the previous cycle, so many of them view the cost to own as being higher than the cost to rent."

FIGURE 4 Impact of an aging population

(% of respondents)



Source: 2020 SEI/Preqin Future of Real Estate Survey



SHARING

Many fund managers are neutral on the rise of the sharing economy, and even those viewing it positively are more likely to see an opportunity for cost-effective modifications rather than a source of industry disruption. The elephant in the room—WeWork—was ultimately not as innovative as once thought, and low barriers to entry meant similar models could easily be adopted seamlessly into the offerings of competitors. Any market with a steady supply of entrepreneurs and small businesses is likely to support some level of co-working properties going forward.

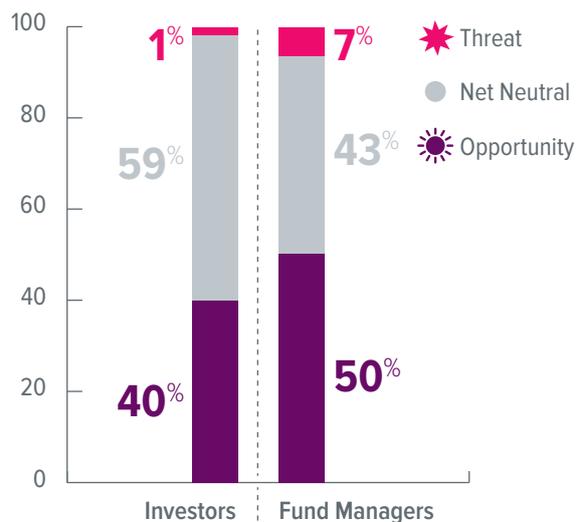
On the residential side, some existing developments are being updated to accommodate residents with a high tolerance for shared spaces and a willingness to embrace shared services. A longtime developer in the multifamily sector, Lubeck thinks “sharing” is unlikely to revolutionise the status quo, ranking its impact at three on a scale of one to 10. Nevertheless, he points out that his firm’s properties will offer “bigger and more robust business centres for people who work from home.” They also provide conference rooms and co-working spaces that can be leased on an hourly, daily, weekly or monthly basis.

Airbnb’s impact on the hotel market is perhaps the most outright “disruptive” example of the sharing economy’s impact on a segment of the industry. According to Gerstenlauer, her firm has long avoided hotel projects for this very reason. She goes on to point out that not all locations are equally vulnerable. Hotels next to airports or business parks are much less likely to face pressure from Airbnb, VRBO and other home-sharing alternatives.

Others point out that sharing has its limits. A youthful preference for collaborative cohabitation may prove to be temporary, and a reversion to previous patterns may ultimately prove co-living to be a fad rather than a trend.

Vasquez notes that “Uber and Lyft and Spotify and Netflix and all the sharing economy darlings are great, but once people have kids, a detached home with a little breathing room is still going to be a natural thing to want, which is why we are betting on the future of residential land.” An interviewee at a large sovereign wealth fund warns that “as millennials begin to have partners and settle down, I think there will be less demand for things like communal areas and shared spaces that meet the demand for social interaction. Certain spins on the sharing model might work as people ‘graduate’ from student accommodations to adulthood, but long term I do not think you’re going to see married couples wanting to use this model.”

FIGURE 5 Impact of a sharing economy
(% of respondents)



Source: 2020 SEI/Prequin Future of Real Estate Survey

CLIMATE

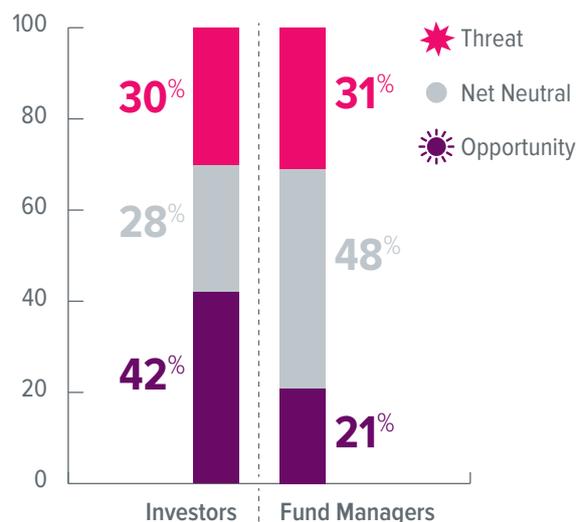
Climate change tops the list of potential threats. Fund managers are especially likely to consider it a net threat, and much of their attention is focused on coastal areas that are vulnerable to rising sea levels. Lubeck stated that his firm is “very cautious about coastal investments and we don’t do waterfront investments at all, mostly due to insurance.” Pat Jackson of Sabal Capital underscores the potential threat to real estate investments when he says, “You better start thinking about that ‘thousand-year flood’ happening twice in 10 years. Natural disasters that might have been historically rare are becoming regular due to climate conditions. We think about that every time we evaluate a portfolio or single investment.” The recent discovery of faster-than-expected glacial melting in Antarctica⁸ underscores the fact that this is no longer a hypothetical problem, but a very real challenge for millions of vulnerable property owners from New York to Shanghai.

Investors are more convinced that climate change will ultimately present a net opportunity, but much of their optimism hinges on enhancing properties rather than countering global challenges. Equipping new or renovated properties with environmentally friendly materials and technologies, for example, is one way developers can enhance the value proposition for owners or renters concerned about climate change. Lubeck points out that they “try to be as sustainable and innovative as possible when it comes to water saving, energy saving and the like.” Sound Mark Partners financed the first “passive house” residential project in the US Northeast. Located in Hoboken, NJ, it is an ultraefficient building with very low requirements for heating or cooling, not only lowering costs for its residents but also contributing to a reduced carbon footprint.

There may even be an opportunity to address two challenges in one fell swoop. Vasquez observes that “climate change and housing affordability are not disconnected. You can mitigate both issues through greater density of housing in less vulnerable areas.”

The full effect of climate change is impossible to predict, but it will inevitably extend far beyond obvious effects such as coastal flooding. In light of this uncertainty, some investors are looking to their managers to help them formulate thoughtful long-term strategies. Vignesh Vijayakumar, of Miras Investments, a large Oman-based family office which has been building a programme to invest in real estate managers over the past several years, illustrates this approach by highlighting the recent trend in Europe toward ‘flight shaming.’ This, he says, has produced more “emphasis on overnight train travel. If that continues, there’s going to be projects developed to serve that, but also potential ramifications for the aviation industry should it come under pressure. That would very likely impact hotels and other buildings around airports. These are difficult things to consider because people’s attitudes about these things are constantly changing. But everywhere there is more awareness about climate change and the impact of carbon footprint. As investors, the only thing you can really do is select the best fund managers who are able to take long-term views on these decisions and sit with them through a range of investment cycles.”

FIGURE 6 Impact of climate change
(% of respondents)



Source: 2020 SEI/Prequin Future of Real Estate Survey

REGULATION

Incentives and tax breaks can sweeten certain deals, but regulation is widely seen as a threat to the industry. Lubeck neatly summarises the attitude of many others in the industry when he says, “I think generally the regulatory environment tends to have rules of unintended consequences. The fewer government regulations there are the better.” Gerstenlauer expands on this by saying, “We’ve seen regulations that are promoted as favourable to renters reduce landlord’s willingness to make the investment necessary to upgrade the existing housing stock. This impacts everything from residents’ comfort to the energy efficiency of buildings.” Rent control, in some cases, can lead to properties not being properly maintained or updated in areas like cities in California such as Berkeley or Santa Monica.

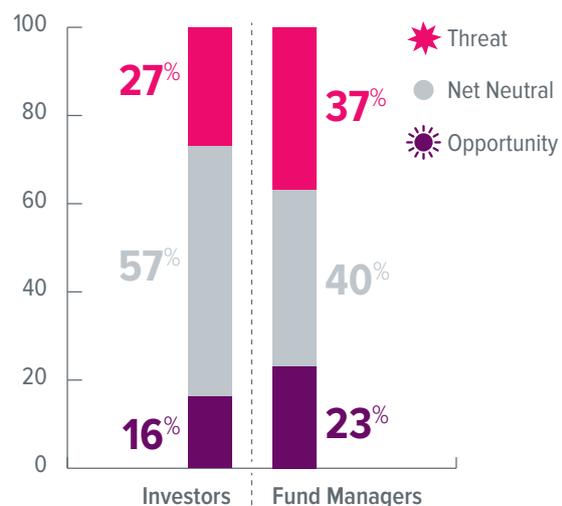
Others echo this sentiment, pointing out that unintended consequences can be undesirable not only for real estate investors but also society as a whole. Rent controls are prime examples of good intentions sometimes causing harm, with artificially low rents choking the supply of housing and ultimately exacerbating the affordability crisis.

The emotional appeal of rent controls is understandable, especially in areas hardest hit by the lack of affordable housing. Nevertheless, initiatives like California’s recent foray into statewide rent control can have immediate and severe repercussions. Acutely aware of future constraints, many landlords chose to impose significant rent hikes before the law was implemented.

Vasquez thinks other types of government regulations also reduce affordable housing indirectly. “Restrictions on housing density have to go,” he says. “Politics are actually a place where the so-called ‘greedy’ developers complaining about excessive restrictions and the progressives protesting the lack of affordable housing might join forces. Current ‘below market rate’ quotas on new developments make many urban projects unprofitable. Removing height and density restrictions, thereby allowing more housing units to come on the market, would do much more to alleviate the affordable housing crisis.”

The relationship need not be adversarial. Vasquez goes on to say: “We work with the government. We’ll tell the local authorities that instead of 500 luxury homes, we’ll put in 1,000 attainable homes, including homes for active adults and first-time homeowners. We’ll put in a parking lot and a playground. Now the city is generating fees from the developer and getting property taxes from the new residents.”

FIGURE 7 Impact of government incentives and regulations (% of respondents)



Source: 2020 SEI/Prequin Future of Real Estate Survey

Affordability Crisis



A booming economy combined with wage stagnation and wealth inequality has led to an acute housing affordability crisis in and around certain cities around the world. Real wages have simply not kept pace with housing prices or rental costs, causing longer commutes and skyrocketing rates of homelessness. The size of the growing crisis means it is virtually impossible to avoid. Basis Investment Group's Tanna says of his firm: "Any new deal we are seeing right now from a development perspective in a major market has some affordability component attached to it, often through mandates by the local government."

Demand is clearly outstripping supply, an imbalance highlighted by Vasquez: "We see a huge affordability crisis in America, which really can only be solved by creating more housing. In the US, we're at approximately a 64% homeownership rate. We can talk about policies, tax credits, opportunity zones, etc., but at the end of the day, more housing needs to be built. We produce pretty much the same level of housing that we did back when the US had about 80 million fewer people." He further notes that insufficient supply is being exacerbated by the fact that "boomers are retiring 'in place' rather than selling their homes and moving into assisted living. They're also retiring later in their lives than previous generations did."

There is a silver lining: Real estate investors are keen to fill the void, despite the challenges. Approximately half of all investors in North America and Europe see significant potential in real estate projects that address this particular need (Figure 8). Lubeck says, "Our concern continues to be with being able to make a reasonable profit at every turn of our investment while at the same time

delivering affordable and high-quality products to our residents. There's a lot of new construction in the apartment world, but it's almost all high end. We really try to focus on serving the midmarket where working-class singles or couples can afford to rent and rent comfortably, while at the same time, delivering a first-class experience and great amenities."

FIGURE 8 Views on the affordable housing shortage
(% of participants)



Source: 2020 SEI/Preqin Future of Real Estate Survey



This is easier said than done. Jackson outlines the obstacles facing developers: “The costs of construction and development are going up. Labour cost is the biggest increase, materials and other expenses are also rising. Investors need to charge higher rents to get returns in that environment, and given wage stagnation among the average worker, they can’t expect those rents. The result is investors end up sinking money into Class A projects like luxury condos because there’s more slack in that demographic’s budget and an investor can charge enough to make their money back.”

Suggested remedies for the affordability crisis run from the mundane to the revolutionary, but every builder knows it is not unusual for costs to creep up when using novel or unproven approaches. Modular construction methods continue to evolve, and Lubeck recalls seeing pitches for projects utilising shipping containers as the building blocks for affordable housing. He questions the viability of such approaches, however, noting that the costs of transport and refurbishment may ultimately make shipping containers no more cost effective than traditional types of construction. An even more radical approach is 3D printed buildings, which are being ventured as a possible solution in some parts of the world. Testing is still in the early stages.

North American fund managers are more likely than their European and Asian counterparts to expect commutes will get longer, leading them to focus more on residential and commercial projects farther from city cores. According to Vasquez,

his company invests “in places near job centres but not too near to be unaffordable. We invest in the suburbs and exurbs. The people living there are working in the hospitals, the schools, the businesses and governments in the surrounding suburbs. The wealth gap and affordability crisis has forced us farther outside central business districts, but not driven us to entirely new markets or geographies.”

The long-term solution, as Jackson points out, “is simply more supply” and avoiding public policies with negative repercussions for developers “like rent caps, which counteract incentives to build, only exacerbating the problem over the long term.” However, this position is not universally held. A vice president at a top 10 sovereign wealth fund told us that while government interventions are generally undesirable, “there needs to be political pressure ultimately to increase the supply of affordable housing, because the incentives that exist in the market are insufficient to stimulate supply at the moment. In the current market, development projects are getting better value by putting a dollar or a pound to work by targeting the upscale market segment, which is willing to pay a premium to live in highly desirable areas. Whether the government comes in with subsidies or legislates mandates for all new developments to have a certain allocation to affordable housing, those are the types of measures that need to happen to address the current shortage ... there needs to be closer cooperation and partnerships between the public and private sector.”

“Real wages have simply not kept pace with housing prices or rental costs, causing longer commutes and skyrocketing rates of homelessness.”

ESG Considerations



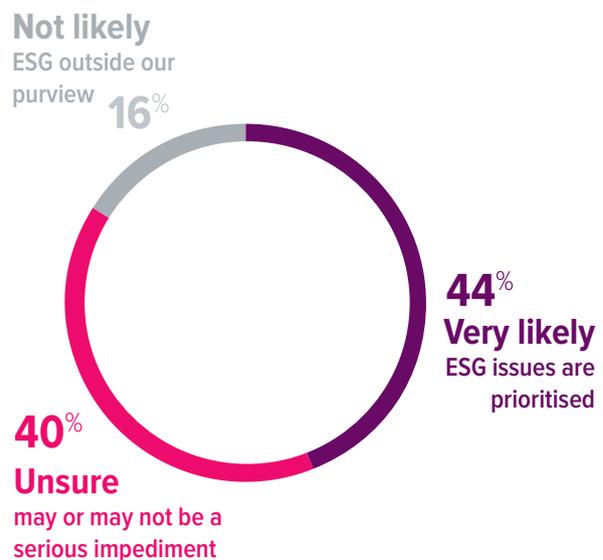
With societal impact and sustainability weighing on the minds of many these days, environmental, social, and governance (ESG) factors are having an appreciable impact on the real estate business, much like the rest of the asset management industry. Our survey attempted to get a sense of the seriousness with which these issues are being addressed. The results indicated that the concern is more than talk: Among investors, 46% have passed on specific opportunities due to ESG concerns over the project or partners involved. As seen in other parts of the industry, European investors are more likely to draw a line in the sand: 57% of European investors have turned down investment opportunities, compared to 33% of their North American counterparts.

Some are quick to add a caveat. An interviewee at a several hundred billion dollar sovereign wealth fund stated, “In terms of ESG, I wouldn’t say there’s been a massive shift in investors going out of their way to make a positive impact, despite the optics some companies cultivate. Hopefully, we’ll see a cultural shift, but the changes are incremental though generally in the right direction. I just don’t see it as a massive factor in the decision-making of most companies on the investment level at the moment.”

The growing emphasis on ESG is more pronounced among fund managers, where 56% say they have turned away otherwise attractive investments on ESG grounds. That figure rises to 69% of managers based in Europe, compared to only 51% of North American firms. Even firms that haven’t yet found themselves in this situation are not likely to be cavalier about such a decision, with only 16% saying it is unlikely they would turn down an opportunity if the economics of a deal were otherwise favourable (Figure 9).

FIGURE 9 If you have not yet turned down an opportunity due to ESG factors, how likely is it in the future should the occasion arise?

(% of fund managers)



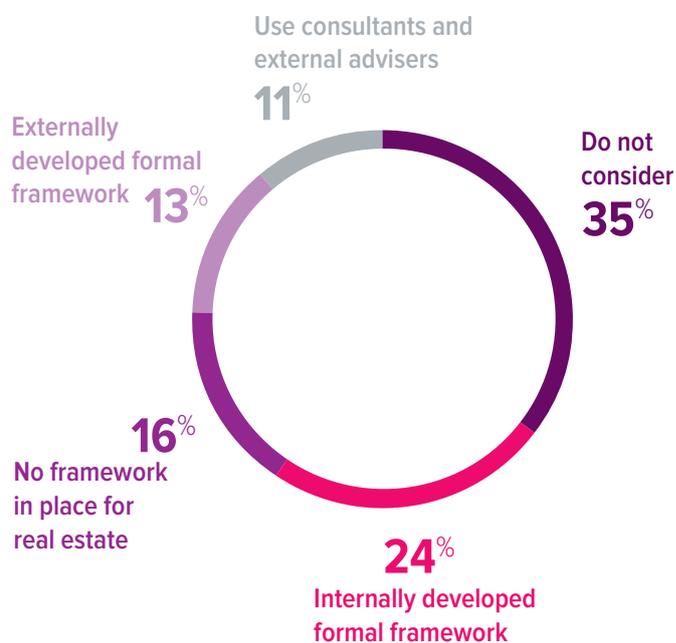
Source: 2020 SEI/Prequin Future of Real Estate Survey

More than a third of all investors claim that past performance on ESG is not factored into their decision to hire managers (Figure 10). Another 16% say they have no framework in place to formally assess the ESG performance of real estate managers, despite using them in other asset classes. One out of 4 has developed a formal internal framework for assessing prospective managers' performance on ESG-related issues. A similar proportion either applies externally developed frameworks or relies on consultants and external advisers to assess prospective managers' performance on ESG-related issues.

ESG can be perplexing, even for firms that are confident in their own principles and processes. Gerstenlauer suggests that a “lack of uniform measurements and standards makes some of the discourse around this topic more confusing and less impactful than the movement could be.” The development of clear standards and accountability may have the added benefit of reducing some of the inevitable lip service that is paid to ESG concepts. Fund managers are in a good position to amplify the effects of their own ESG policies by encouraging their borrowers to also focus on sustainability and other practices that benefit society. An Asian-based investor points out, “If ESG mandates become more widely adopted among institutional investors and that affordable housing investments are recognised as fulfilling the ‘socially responsible’ element, expertise in making such investments may become a sought-after criteria in managers.”

ESG investing in the real estate sector could evolve quickly. Many managers may currently limit their ESG activities to screening assets, but that is likely to change in coming years if broader industry trends are any indication. Private equity and mutual fund managers are responding to strong market demand with more intentionally constructed portfolios and, in some cases, greater engagement with company management. In what may be the purest variant of ESG investing, a growing number of managers are launching impact funds dedicated to addressing various social or environmental ills.⁹ Given the vast potential to make a difference by thoughtfully designing and developing public and private spaces, it is easy to envision a growing number of real estate impact funds being brought to market.

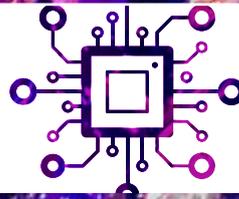
FIGURE 10 ESG considerations with assessing prospective real estate managers
(% of investors)



Source: 2020 SEI/Preqin Future of Real Estate Survey

“ ESG can be perplexing, even for firms that are confident in their own principles and processes. ”

Impact of Technology



Technology is transforming every aspect of the asset management industry, and real estate investing is no exception. In some ways, real estate is particularly vulnerable to disruption. Innovation has typically lagged in the property sector, not least of all because each project is unique. High barriers to entry also protect existing players and, as pointed out in a report by ING: “Many regulations and complex ownership structures make real estate transactions bureaucratic, complex and (opaque).”¹⁰ But data analytics are already chipping away at the lack of transparency, and those high barriers to entry may be indirectly lowered by the use of technology to develop and market more liquid investment vehicles. Real estate investment and trading platforms are proliferating, democratising access to the asset class and changing the value chain.¹¹

PropTech, a word coined to collectively describe various types of real estate technology, is a close cousin of the more familiar fintech. Represented by more than 7,200 companies globally,¹² PropTech is poised to change the workflows of real estate fund managers and investors. A dazzling array of technologies already exist to help with property management, portfolio management, analytics, lending, listing services and a range of other applications. This is a fast-moving environment, however, and a seemingly endless stream of startups offer new ways to simplify tasks, reduce costs or improve outcomes for investors, fund managers, developers, owners and tenants. Recent innovations include everything from roOomy's virtual staging business to PHYSEE's SmartSkin product, which can “autonomously power, sense, and regulate your building’s climate.”^{13, 14}

Fund managers and investors are particularly excited about the ability to quickly screen a high volume of projects in more detail, allowing them to more precisely focus their investments on specific sectors or situations (Figure 11). Leigh Roumila, Managing Director at Basis Investment Group and COO of Basis Multifamily Finance, says, “The commercial real estate industry in particular is one of the last industries to really embrace technology, but at this point, if you don’t embrace it, you’ll be at a competitive disadvantage. The speed of collecting and analysing data has led to a huge transformation. We’re at a point now where one can make decisions using real-time data.”

FIGURE 11 Impact of PropTech on investing over next 5 to 10 years
(% of participants)



Source: 2020 SEI/Preqin Future of Real Estate Survey

Next-level targeting of this sort is a good fit with the increasingly customised and dynamic portfolios demanded by investors, but not everyone is convinced. Lubeck says that his firm has assessed “systems to help select target properties and do evaluations of acquisitions, but frankly feel (their) existing methods of fundamentals-based analysis are still superior to technology-based ones.” This advance may also come with a less desirable side effect. Almost half of all fund managers and investors agreed that better matching of buyers and sellers will mean more competitors for targeted assets.

There is no consensus on who is likely to benefit the most from advancing technology. Large firms were more likely to think that they would accrue the most benefits as they leveraged technology to amplify the informational and operational benefits of scale. Interestingly, fund managers at the other end of the AUM spectrum take a similarly optimistic view, positing that smaller firms will become more successful as technology removes the informational and operational advantages of scale. Perhaps technology will act as a rising tide that lifts all boats. Applied thoughtfully, it can enhance the competitive standing of large and small investors alike.

Will PropTech improve economics? Fund managers are cautiously optimistic at best. One out of 3 say PropTech will meaningfully improve the operating margins of their projects. Investors are even more circumspect, with just 1 out of 5 forecasting higher margins as a result of technology.

There are a number of ways in which technology could contribute to higher margins. Gerstenlauer points out that her firm sees most benefits in the form of “enhancements to residents’ comfort and convenience as well as the increasing efficiency of buildings, particularly when it comes to energy usage.” She also strikes a note of caution, stating that, “In many ways real estate is still a high-touch vs. high-tech space—someone needs to visit the buildings, understand transit accessibility and make certain the fixtures work.”

Some of this will change with the growing use of sensors, the internet of things (IoT) and artificial intelligence, but it will take time for high levels of integration and automation to have a meaningful impact, particularly outside of new developments. Ironically, technology may first be integrated most visibly into the housing market for seniors, who might otherwise be less interested in such things. Carpets that can take pulses and monitor the movements of residents are only one example of the innovations starting to be seen in this market. Lubeck points out, “Technology facilitates communication between maintenance personnel, office personnel and residents. It’s not only software, it’s also hardware. We are actively utilising smart IoT, smart thermostats, package locking systems and the like.” Users and owners are not the only ones that stand to benefit. Data streams from smart buildings also mean “more knowledge of the use of the building, which results in lower risk for financing.”¹⁵

“Real estate investment and trading platforms are proliferating, democratising access to the asset class and changing the value chain.”

The transformative potential of technology extends far beyond the sourcing of assets and managing of portfolios. It is regularly demonstrated in innovative building projects around the world. Some cities are experimenting with pavement that generates power by harnessing the power of the sun or the pressure of people walking on it. This power can be used for creative illumination, reducing the dependence on the grid and improving the aesthetics of the neighbourhood.¹⁶ Some cities are setting their sights notably higher. A sextet of European cities recently announced that they were looking to tap artificial intelligence as part of their strategy to achieve carbon neutrality.¹⁷

In addition to enabling the reinvention of infrastructure, technology also has the potential to transform processes, allowing previously untenable business models to thrive. According to Jackson, his business “built a national presence (and is) processing thousands of loans nationally, thanks to a rigorous process and enabled by technology customised to our platform. We’re always looking for new niches and especially seek opportunities where we can apply that technology.” In addition to unprecedented scalability, their technology platform offers flexibility and a substantially improved client experience: “Our investors know how we manage the underlying loans so typically they aren’t interested in reviewing the status of the loans on an individual basis, but they are comfortable investing with us because they know that we can. As long as we have the input data, we can accommodate any reporting needs our investors have.”

A vice president at a large state-owned investment fund sums up the state of play: “Real estate is undergoing a transformation. The industry has woken up and realised there’s a lot of value to be had by integrating technology across the value chain. People are looking into disruptive plays for legacy systems across industries, and real estate is no exception.” He goes on to remind us that radical transformations are rarely easy, and the other parts of the industry may need to be reinvented to accommodate new technology. “The critical factor in an institution’s ability to leverage technology is its access to a skilled staff that are trained in both investing and data science. That skillset is still a rare commodity to some degree and having to pair investment professionals with data science professionals does slow down processes. You’ll probably see investment analysts having to come through with some form of formal data science training in the next five to 10 years.”

While many firms will follow this path, others will choose the focus and agility that comes with expert partners and service providers. The real estate market is already starting to outsource their fund accounting functions, much like mutual funds, hedge funds and private equity funds before them. Various other technical functions in the back, middle and front offices are sure to follow.

“Real estate is undergoing a transformation. The industry has woken up and realised there’s a lot of value to be had by integrating technology across the value chain. People are looking into disruptive plays for legacy systems across industries, and real estate is no exception.”



What Does the Future Hold?

The real estate business is likely to look very different by the end of the decade we just entered. The details may be debated, but fund managers and investors have a more pressing concern: How to prepare their organisations and portfolios to absorb the inevitable shocks while simultaneously positioning themselves to profit over the long term.

The decisions facing real estate investors are already more complex, even before factoring in the reality that changing modes of work, life and entertainment mean properties are being conceived and developed in novel ways. Now, they find themselves asking questions like:

- ① Will shared mobility fundamentally reformat how communities are (or should be) designed?
- ② Will co-living take root beyond its current niches?
- ③ Are intergenerational living arrangements among strangers realistic?
- ④ What binds communities when all products and services can be delivered?
- ⑤ When will going to work become a quaint notion, and what happens to office space?
- ⑥ Given the considerable carbon footprint of new construction, will renovations get a boost?
- ⑦ Will climate concerns shift the focus from operating efficiency to lifecycle carbon footprints?
- ⑧ Do green roofs go from experimental to de rigueur?
- ⑨ How does the rapidly declining cost of renewable energy sources change real estate economics?
- ⑩ When will we move from isolated examples of smart buildings to integrated smart cities?



It is not unreasonable to think that the real estate market might change in ways that we cannot even imagine right now. Innovative technology has a way of disrupting industries in unexpected ways and, according to the Deloitte Center for Financial Services most investors expect technology to have the greatest impact on their legacy properties within the next three years.¹⁸ There are also likely to be unintended consequences stemming from new regulations.

Changes will not be limited to how things are planned or built. The entire asset class is likely to be transformed as investment vehicles morph. Imperfect as they are, REITs have long provided retail investors with broad liquid exposure to real estate as an asset class. Now crowdfunding, direct lending, and secondary trading platforms will further open the doors for retail investors to add or remove targeted exposure to real estate as conveniently as they can with other types of assets.

This is more than idle speculation, as real estate would be following in the footsteps of other alternative investments that pioneered this particular migration. A representative at one of the world's top 10 sovereign wealth funds commented, "I think you'll see one of the biggest order of magnitude changes in the real estate sector if certain players in the markets are successful in moving real estate closer towards the 'liquid' end of the investment spectrum. This would require a fundamental shift and institutional buy-in, as well as comfort in the tech stacks providing this form of service. Fundamentally, institutional investors would need to decide that the change would be beneficial for their interests. As things work now, institutional investors are able to take advantage of inefficiencies in illiquid markets. Whether or not there's enough positive upside for institutions in more liquid markets to compensate for the benefits they currently receive from their monopolies of scale and longer time horizons, it's not quite clear yet. If it does though, it will be extremely transformative to the real estate sector."

Customisation is another profound trend that can be observed among institutional investors and their fund managers. A 2019 report by EisnerAmper and supported by Preqin data describes the shift: "As investors have become more sophisticated, so too have their portfolios, as they seek custom solutions to complement their fund holdings. As the demand for custom vehicles grows, many fund managers are seeking to expand their offerings. Nearly half of all managers surveyed by Preqin planned to offer more co-investment and separate account solutions in a bid to attract investor capital and build relationships in a fiercely competitive market."¹⁹

Change is certain. The COVID-19 pandemic will almost certainly influence these trends, but it is unlikely to reverse them. Prices may fall in some markets, but basic supply and demand imbalances remain. People may become more reluctant to share space with others, but our collective—and so far apparently successful—experiment with working from home may result in the need to accommodate more flexible work arrangements. Firsthand experience with a silent killer may spawn more thoughtful responses to other existential threats such as climate change.

With even more uncertainty introduced into an already evolving real estate market, planning and positioning are paramount. It is critical to focus on the emerging trends, formulate well-informed responses and nurture deep working relationships with partners who possess expertise in business strategy, investments, technology and operations.

Appendix: Survey Universe

177 organisations participated in the survey. Of these, 117 are fund managers and 60 are institutional investors. The survey and interviews were conducted in the fourth quarter of 2019 and the first quarter of 2020.

FIGURE 12 Location of headquarters

(% of participants)



FIGURE 13 Assets under management

(% of participants)

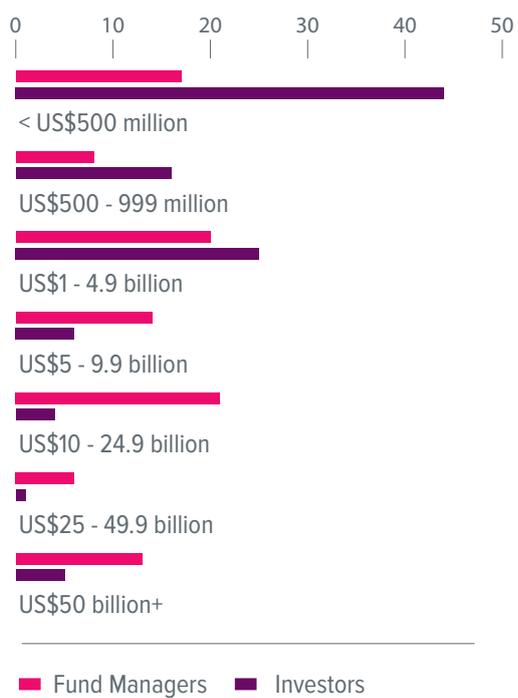


FIGURE 14 Type of investor

(% of investors)



Source: 2020 SEI/Preqin Future of Real Estate Survey

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