Summary

- Real estate investment has long been a mainstay in pensions investment, but in this highly cyclical sector, the landscape is constantly changing.
- Pre-pandemic changes to consumer behaviour, with increased online shopping and reduced footfall in retail properties, intensified during and after the height of the health crisis.
- Changes in working practice and increases in remote working mean office blocks – once a popular and secure asset – sit empty, while data centres, storage and logistics and distribution have looked stronger.
- Moves by large pension names such as PIC and Legal & General and others into social housing and other sustainable sectors could signal a shift into a different subsector of property.

Property investment – new decisions

Sandra Haurant explores changing trends within DB schemes' real estate investments

The Pensions Insurance Corporation (PIC) made headlines in November when it announced a partnership with London Square and Square Roots, leading to its first-ever investment in social housing. PIC's investment director Allen Twyning said of the project: "Not only does this create secure, low-risk cashflows with which we can pay the pensions of our policyholders pensions, but it creates huge social value in Kingston-upon-Thames."

Co-investment of this kind is one way into the real estate sector for pensions, but many schemes also invest in bricks and mortar through pooled investments such as unit trusts and Real Estate Investment Trusts (REITs), allowing access to diversification in different parts of the property sector through collective investments.

But what specifically is it that pensions seek when investing in property? "It depends on a pension scheme's funding level," Cardano senior investment manager, Julita Perelgritz, says. "Real estate as an asset class has a lot of granularity and can play a role in both portfolios targeting growth or income."

For DB schemes in the process of de-risking, for example, Perelgritz says: "The focus has been, and is likely to continue to be, on income generating features of real estate investment strategies. This is particularly relevant in the context of cashflow-driven investing undertaken by many DB schemes, where real estate offers cashflows and security."

A good balance

According to JTC Jersey-based director, fund services, Will Turner, in a balanced fund, one would expect to see: "Stable assets with a strong and lower risk income stream, such as an office building in a city centre location, let to a single tenant on a long lease with a low risk of financial failure. This would provide a steady income stream but would be expected to return a lower level of capital growth."

At the other end of the scale, Turner says, he would expect: "Opportunistic assets with limited income but significant value add possibilities – such as a development project with little to no existing income but in a high value location for a change of use." Turner offers the example of "a dilapidated office building on a business park close to major infrastructure in which there is high demand for distribution or logistics property". If it were pre-let to an operator who was at "low-risk of financial failure" and who designed the whole development to its own specifications, a project of this kind could, says Turner, hold the potential for "significant increase in capital value".

Current state of play

While high-profile projects such as PIC's partnership in the social housing development show there is appetite for certain kinds of real estate, high interest rates, seismic shifts in consumer

behaviours, as well as a fundamental change in the way people work, have all had a significant impact on the sector.

"We are definitely seeing a subdued level of investment into real estate across the board, and this is having a knock-on effect on transaction volumes at the moment, as a result of high interest rates and inflation," says Turner. "High inflation is eroding the level of returns that investors may receive, which is further eroded by high interest rates significantly increasing the cost of any debt. On the flip side, high interest rates have significantly increased returns for lower risk investments such as government bonds and bank deposits, which further reduces the attractiveness of real estate."

What's more, the highly cyclical nature of real estate makes it inherently sensitive to certain pressures, according to Perelgritz. "Broadly, the weaker economic backdrop has made investors more cautious about taking substantial cyclical risks," she says.

Add to this aftershocks from the 2022's gilts crisis, and it's clear that real estate – an essentially illiquid asset class – can look off-putting from certain angles, and particularly, perhaps, from the point of view of DB schemes.

Shifting sub-sectors

Broader societal changes have a real impact on these very concrete assets, says Perelgritz. "There have been structural shifts in the real estate sectors that are still playing out, further weighing on investor appetite for the asset class," she says.

This, in turn, plays out in the investment activities of pension schemes. "In my experience, there has been a trend for a number of years away from investing in traditional retail assets, particularly large shopping centres with a high number of tenants in non-core locations," Turner says. "This is on the back of changing consumer shopping habits, in which online shopping is increasing and shopping in bricks and mortar stores is reducing."

And while there are assets that buck the trend, such as "high-profile destination retail outlets or those that incorporate an element of leisure as well as retail", there's no doubt the retail property landscape, already undergoing changes pre-pandemic, has been further altered recently.

On the flipside, Turner says: "Logistics and distribution property has seen a trend of significantly increasing investment in recent years – which was again hugely accelerated during the pandemic." Even with a post-pandemic price correction, he adds, the longer-term trajectory for the sector has been upwards. Other areas that saw post-pandemic growth, including storage and data centres, have since corrected, according to Perelgritz. "However," she adds, "there are still solid fundamentals."

"There have been structural shifts in the real estate sectors that are still playing out, further weighing on investor appetite for the asset class"

With obligatory home working during the pandemic, and the realisation that work can be done differently, the role of the traditional office has also been thrown into question. "The office sector is undergoing existential crisis, similar to retail a few years back," says Perelgritz. "It's particularly relevant in the US where the 'return to the office' has not happened in any breadth."

Turner agrees: "With many employers now operating a hybrid or flexible working model, this means that many do not require the same amount of office space that they did pre-pandemic." On the other hand, companies are facing pressure to create attractive spaces where people actually want to come to work, and many have been making serious adjustments to their workspaces. As a result, Turner says: "Highly desirable locations with Grade A office space (such as newly constructed high quality office space in the City of London) is continuing to attract investment."

The future for property

Changes of use and economic pressures, then, have shaken certain parts of the real estate sector. And on a regulatory note, there have been other stresses; Reuters reported in October 2023 that DB schemes were selling office blocks and private equity stakes at "hefty discounts to the value marked on their books" due to regulatory concerns over valuations.

Nonetheless, the nature of cyclical asset class means that after a storm such as this, the future could be brighter. Perelgritz says she has seen the emergence of alternative sustainable sectors within traditional real estate portfolios, including social housing, build-to-rent, assisted living and education.

PIC's London Square project is just one example of the wider pensions sector building foundations in affordable housing. The firm says it aims to invest £500 million over the coming years to "help alleviate the housing shortage in Greater London, whilst providing cashflows to back the pensions of PIC's policyholders". And last year, Legal & General Retirement Institutional announced plans to invest "a further £2 billion of retirement funds into affordable housing over the next five years" in a move it said would help to create more than 10,000 new homes across the country, as part of "Legal & General's purpose of inclusive capitalism".

Perhaps these areas of the market – particularly those which can meet the demands of the country's housing crisis – could open doors to new, solid, bricks and mortar opportunities.

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