31 March 2023

EUROPE DIDN'T FREEZE

Don't believe everything you read

If you glanced at the news sometime last summer, you might recall that Europe was supposed to freeze this winter. At the time, the prevailing narrative was that Europe would run out of energy within a few months, as winter gas demand peaked while Russian pipelines remained largely shut. Europeans were warned that they faced imminent blackouts, fuel shortages, and energy rationing. The headlines ranged from cautionary to apocalyptic: "Europe's Energy Crisis May Get a Lot Worse"[1]; "Europe's Energy Crisis Is Going to Get Worse"[2]; "You Really Don't Understand How Bad It Could Get in Europe this Year"[3]; "Europe's Worst Energy Nightmare Is Becoming Reality".[4] Six months later, what happened?

With winter now over, it's clear that "Europe's Coming Big Freeze"[5] never actually came. By mid-January, the price of European natural gas—which generates about a quarter of Europe's electricity and 40% of its households' heating—had plummeted to a 17-month low of about €55 per MWh. (European natural gas prices peaked at about €350 per MWh in August.) The price of electricity had also declined. Wholesale electricity prices in Germany fell from €469 per MWh in August to €257 per MWh in December, after having declined to €158 per MWh in October. In the UK, wholesale electricity cost £133 per MWh in November, down from £364 per MWh in August. Meanwhile, Europe's stored gas reserves were still 83% full at the end of January. (Typically, they would be about 65% full around that time of year.) This should provide European countries with a head-start on gas procurement for next winter, reducing the odds of a repeat of last year's scramble for energy.

European industry held up reasonably well, too. Although energy-intensive sectors have struggled to absorb higher energy costs, last year's fears of widespread plant closures ("a complete meltdown of German and European industry") never materialised. Instead, Europe's industrials-heavy equity markets outperformed US markets. At the end of January, the FTSE 100 was up about 4% year-on-year, French stocks were up 1%, and German stocks were down 2%. Across the Atlantic, the S&P 500 lost about 10% over that period. Closer to real estate, European travel and leisure stocks, which reflect companies that often have high energy elements in their cost structures, had largely recovered by the start of this year, after falling about 30% between January 2022 and last summer. (See Figure 1.) Meanwhile, the eurozone economy grew by 3.5% in 2022, outpacing America's economy, which expanded by just 2.1%. Thus, not only did Europe avert an energy disaster, but instead it had a relatively strong year overall—in spite of a war in Ukraine and a volatile euro.

[1] https://www.nytimes.com/2022/08/10/opinion/europe-energy-crisis-ukraine.html
[2] https://time.com/6209272/europes-energy-crisis-getting-worse/
[3] https://fortune.com/2022/09/24/europe-energy-crisis-winter-natural-gas-putin/
[4] https://foreignpolicy.com/2022/07/11/europe-energy-crisis-natural-gas-russia-nord-stream-1/
[5] https://www.theamericanconservative.com/europes-coming-big-freeze/

FIGURE 1. EUROPEAN TRAVEL & LEISURE STOCKS HAVE ALREADY RECOVERED[6]

How to avoid an energy crisis

There are three reasons the grim predictions of last summer did not pan out: (1) cooperative weather; (2) an efficient demand response, especially on the part of European companies; and (3) Europe's surprisingly effective push to quickly obtain new sources of energy.

First, luck played some role: the weather was unusually warm across the continent this year, with temperatures in Germany almost 1.6 degrees Celsius above average between the end of September and January. As a result, households burned less fuel to heat their homes, leaving more fuel available for other uses, including industrial ones.

Second, European companies managed to reduce their energy consumption, and this was achieved without the need for drastic policy measures like rationing. Firms responded to higher energy prices on their own, generally by optimising their operations to use energy more efficiently. As a result, Germany cut commercial gas consumption by 21% last year relative to the average level of consumption in the three years prior, while French companies consumed 13% less gas. Notably, even adjusting for the effect of higher temperatures, overall gas consumption in Germany was 15% lower than usual in December and January.

Finally, Europe diversified its energy supply chain faster than anticipated, largely by finding new sources of natural gas to replace imports that had historically flowed through Russian pipelines. As recently as two years ago, Europe received almost half of its total gas imports from Russia; by the end of last year, Russia accounted for less than 13% of European gas imports. In large part, Europe replaced Russian pipeline gas with liquified natural gas (LNG), importing about 95 million tonnes of LNG in 2022, up from 57 million tonnes in 2021. Most of that incremental supply came from the US, which exported about 39 million tonnes of LNG to Europe last year, almost 24 million tonnes (160%) more than it sent the year prior. Altogether, between new supplies of LNG from America, pipeline gas from Norway, and coal from places like Australia and Colombia, Europe secured enough energy to power its economy through the winter.

[6] Yahoo! Finance

Better late than never

Looking to the future, a silver lining runs through the chaos of the past year: the threat of an energy crisis spurred Europe into taking meaningful steps towards long-term energy security. This was a long time coming. As we describe below, the strategy that Europe adopted over the past nine months provides a model for what long-term energy security will look like on the continent. In short, it will involve more and more supply chain diversification.

As Europe further disentangles itself from Russian energy suppliers, LNG will probably continue to plug much of the gap. The EU intends to expand its LNG import capacity by at least 34% (about 13% of Europe's overall gas demand) before the end of next year, with Germany, Poland, France, Finland, Italy and Greece all set to build new re-gasification facilities. (These facilities convert LNG back into a useable, gaseous state.) There are yet more LNG projects slated to come online beyond 2024. Meanwhile, America's LNG export capacity is set to grow by at least 40% within the next two years, based only on projects currently under construction; a lot of that capacity will service Europe. In addition, Europe is increasingly looking eastward to find new sources of gas. In June, the EU signed a trilateral agreement to import more offshore Israeli gas via Egypt's LNG terminals, and as Qatar looks to grow its LNG production by 60% over the next four years, Europe is expected to be a significant buyer. Closer to home, Norway now expects its gas exports to Europe to remain elevated until at least 2030.

Even further ahead, clean energy will play an increasingly prominent role. Although hydro and nuclear sources generated a lower share of Europe's electricity last year than in 2021—primarily due to droughts that curtailed hydro generation and technical malfunctions that put some of France's nuclear plants out of service—wind and solar sources still generated 22% of Europe's electricity. This represents their highest share on record, surpassing the percentage of electricity generated by gas for the first time. As Europe continues to invest aggressively in renewable infrastructure, it is positioning itself to become a world-leader in clean energy generation. All told, a new European energy strategy is already well underway.

A RENAISSANCE FOR MANUFACTURING?

Over the past half-century, Western economies largely deindustrialised. In the US, manufacturing employment as a percentage of total employment fell from 23% in 1970 to less than 1% by 2010, and has remained mostly flat since then. Meanwhile, manufacturing output as a percentage of GDP nearly halved between 1970 and 2010, declining from about 23% to about 12%. As manufacturing receded, places that had previously thrived as hubs of industrial activity (e.g., the Rust Belt in the US or parts of the North East of England) were gutted, often leaving behind depopulated cities with depressed local economies.

While political leaders have for years spoken about reinvigorating domestic manufacturing, usually to little effect, there are now some signs that reindustrialisation is starting to take place. This is being driven both by government policies aimed at bringing critical industries onshore and by private sector efforts aimed at improving supply chain resiliency.

Over the last few years, disruptions to global trade flows, caused by the pandemic, persuaded many firms to re-evaluate the wisdom of largely offshore, "just-in-time" supply chains. Mentions of "onshoring", "reshoring", or "nearshoring" in US public-company earnings calls and conference presentations increased by factor of eight between the first quarter of 2020 and the first quarter of 2022. Importantly, these comments are paired with actual investment

programmes. Since 2021, manufacturers have announced plans to invest, onshore in the US, in the construction of some $144 billion of semiconductor fabrication plants, $47 billion of battery factories, $26 billion of auto plants, $10 billion of steel and aluminium factories, and $5 billion of biomanufacturing facilities. As Figure 2 shows, construction spending for manufacturing facilities in the US has already risen sharply: in the fourth quarter of 2022, manufacturing-sector construction spending stood 94% above its 2010-2020 average.

FIGURE 2. FACTORY CONSTRUCTION IS ON THE RISE IN THE US[7]

Europe is seeing a similar push to build up manufacturing capacity. In particular, the European Commission wants to double Europe's share of the global chipmaking market (to reach 20%) by the end of the decade. It is off to a good start. In what is expected to be the largest foreign investment programme in Europe's history, Intel now plans to spend at least €68 billion over the next 15 years on new semiconductor factories on the continent, including a €17 billion facility in Magdeburg, Germany. In July, GlobalFoundries and STMicro announced plans to build a €6 billion plant in the French Alps. Earlier this year, yet another chipmaker, Wolfspeed, said that it would invest €2 billion to develop a facility in Saarland, Germany. Many of these initiatives will be subsidised by the European Commission's new Chips Act, which will provide €45 billion to support the development of the continent's semiconductor sector. Although it has not yet been announced, the UK government is also expected to introduce a multi-billion pound programme to help build domestic chipmaking infrastructure.

If it continues to accelerate, reindustrialisation will have a significant impact on real estate markets. Most obviously, it will create demand for new industrial real estate. This will likely be undersupplied, after decades of underinvestment in industrial capacity and, in more recent years, the conversion of some portion of the industrial stock into logistics space for e-commerce. Reindustrialisation should also drive growth in secondary cities, where many of these new plants will be located. This could create compelling opportunities, across real estate asset classes, in local markets that have not been attractive for decades.

[7] Federal Reserve

WILL HEADWINDS FOR TECH CREATE TAILWINDS FOR THE OFFICE?

To the moon... and back to earth

The technology sector had a rough go last year. First, valuations collapsed: the S&P 500 Information Technology Index lost 29% in 2022. Then, fundraising dried up: VCs invested $238 billion globally in 2022, about 31% less than the $345 billion they invested in 2021. At the other end of the funnel, VC-backed exits totalled $71 billion in the US in 2022, about a 90% decline on the $753 billion of VC-backed exits in 2021. Most recently, Silicon Valley Bank imploded, partly because last year's fundraising drought forced the bank's tech-dominated depositors to withdraw cash to fund their operations over the past nine months.

This "tech recession" was sparked by the realisation, in early 2022, that money might not remain abundant and cheap forever. As central banks hiked interest rates, investors' patience for long-duration assets wore thin. In particular, markets started to demand something that just a year earlier had seemed virtually unthinkable: (1) that businesses actually generate positive cash flows, and (2) that they do so now, not sometime next decade. This posed a problem for a large part of the technology sector. After a decade of patient, low-cost capital, even well-established tech companies had grown comfortable remaining indefinitely unprofitable (e.g., Uber), or had gotten accustomed to pouring their profits into expensive moon-shot projects rather than returning cash to shareholders (e.g., Meta). As a result, marginal capital flowed out of long-duration growth investments, including technology companies, and into assets capable of generating income in the near term.

"Time to get fit"

The technology industry is adapting in response. The growth-at-all-costs" ethos that characterised the sector over the last decade seems to be giving way to a culture that instead emphasises fiscal discipline, efficiency, and productivity. Last summer, Sequoia told its founders that "the era of being rewarded for hypergrowth is quickly coming to an end". Y Combinator advised its portfolio companies to "cut costs and extend your runways", warning that "your fundraising experience was most likely not normal, and future fundraises will be much more difficult". The good old days—when, for example, VCs would write checks at 100x-ARR valuations—seem long gone.[8] Even large, profitable tech firms are changing to cope with the new environment. As Microsoft's Satya Nadella said earlier this year, "we in the tech industry will have to get more efficient", and "we will have to show our own productivity gains." In short, as the investor Brad Gerstner titled a recent activist letter to Meta, it is "time to get fit".

The shift now underway in the tech sector will probably outlive the specific circumstances that gave rise to it. Even if interest rates come down over the next couple of years as inflation moderates, financial conditions should nonetheless get structurally tighter over the next decade. As we have written in previous letters, the ultra-low interest rate environment of the last decade was unsustainable in the long term, given slow working-age population growth, large energy-infrastructure investment requirements, and diminishing (or even reversing) gains from globalisation. The dismal environment that tech companies saw in 2022 will pass,

[8] https://www.theinformation.com/articles/the-100x-club-software-startup-valuations-skyrocket-despite-small-revenue

but we probably will not soon see a return to the ZIRP-driven euphoria of the last half-decade either. The times are changing.

Time to get back to work

Real estate will change as a result of this shift. Efforts by tech companies to trim costs have raised questions about the durability of demand for office space, especially in gateway cities, like San Francisco, New York, and London, where tech firms have accounted for a substantial percentage of new absorption in the last few years. Although some of these office markets do face challenges (particularly in their lower-quality sub-segments), this specific worry is misplaced: initial indications suggest that the tech sector's renewed focus on efficiency is driving a return to the office, not a retreat from it. In particular, as tech companies look to "get more efficient" and show investors "productivity gains", management teams are increasingly instructing their employees to come back to the workplace—and as the tech labour market has cooled, employees are complying.

As a preliminary point, it is worth noting that office rents now represent a small fraction of most tenants' total expenses. In the early 1970s, occupational costs per employee in the City of London were about 150% of the median London wage. In the last two decades, the ratio of office rents to labour costs fell to less than 20%. (This figure assumes a constant desk area per employee ratio; after adjusting for reduced space usage per person, the ratio of office rents to labour costs falls below 10%.) Office space is especially cheap, relative to labour, for blue-chip technology firms, which employ legions of highly skilled and expensive workers. Thus, even ignoring any costs of lost productivity, most tech-sector occupiers would simply not save much by reducing the size of their (leased) office footprints.

More importantly, however, technology companies are fixated on the creative productivity of their workers. This is particularly true in the current environment, where investors are demanding to see results. While outsiders will continue to argue ad nauseum about whether remote work is conducive to innovation, the actual behaviour of managers increasingly suggests that a large portion of the technology sector believes in the value of in-person work. In fact, the list of organisations that have summoned their employees back to the office seems to get longer each week. Earlier this year, Bob Iger told Disney's workers that he expects them to be in the office four days a week starting in March. Reed Hastings, Netflix's outgoing CEO, described work from home as "a pure negative". Keith Rabois of the VC firm Founders Fund said that he is "only investing in start-ups that are primarily IRL [in real life, i.e., not remote]" because "the ambitious people want to work IRL". The online grocery delivery company Getir announced that it will "fully return to office working globally, which means five days in the office". And, on Twitter, Elon Musk invited Tesla employees who wish to work remotely to "pretend to work somewhere else".

Ultimately, as technology companies look to get more productive, we may see office occupancy continue to rebound at a faster pace, and to a higher equilibrium level, than the office bears had expected.

CHINA'S REOPENING

Over the last decade, Chinese tourists helped drive a global surge in international travel. Annual international tourism departures from China nearly tripled between 2010 and 2019, increasing from about 57 million to about 155 million. In 2019, residents of China spent nearly $255 billion on international travel, roughly double the amount spent by Americans in the

same year, and a sixfold increase on China's 2011 international travel expenditures. As the country's outbound tourism market expanded, China came to represent a meaningful source of new demand for hotels and luxury retailers across Europe. While Chinese tourists made 883,000 visits to the UK in 2019, up 570% from 130,000 visits a decade earlier, spending by Chinese travellers in the UK grew at an even faster pace over that period, by 870%, or from £176 million to £1.7 billion.

After a decade of sustained growth, Chinese tourism ground to a halt at onset of the pandemic. Visits abroad by residents of China fell by about 87% in 2020, to about 20 million, and have remained at similar levels ever since, even as outbound travel elsewhere largely recovered. (For example, in the third quarter of last year, visits abroad by UK residents had returned to about 85% of 2019 levels.) The persistence of China's tourism slowdown was mainly a product of government policy. Even after most countries in the West had opened their economies and borders, China continued to pursue a strict "zero-Covid" strategy, involving quarantines, lockdowns, and mandatory testing. These policies made international tourism effectively impossible.

That has now changed. In January, after relaxing its zero-Covid policy, China's government eliminated mandatory quarantines for new arrivals, effectively opening the door to outbound travel.

It will take some time for Chinese tourism to recover. The number of scheduled international flights out of China remained depressed in the first quarter of this year, at just 19% of 2019 levels. In addition, some 20% of Chinese travellers had their passports expire over the last three years, and the government has only recently started to process renewals. Foreign governments will also need to work through visa backlogs. But these are relatively minor obstacles, and they should mostly get resolved over the course of this year. Lufthansa already has plans to double its weekly flights to China from March, and British Airways and Virgin Atlantic have announced that they will resume daily flights to China late this spring. As supply comes back online, demand should follow.

There is almost certainly pent-up demand for overseas travel. In a survey of Chinese travellers conducted by a travel analytics group late last year, more than half of the respondents said they would plan to travel outside mainland Chinese within 12 months of the lifting of restrictions, and another third said they would travel abroad within two years. Within 30 minutes of the government's December announcement that restrictions would be lifted, Chinese searches for international flights and hotels on Trip.com shot up 1,000% to reach a three-year high. More concretely, domestic trips within China recovered to 90% of 2019 levels during the Chinese New Year period earlier this year. (The holiday period, normally a popular time for international travel, took place too soon after China's reopening to book trips abroad, especially given the limited flight schedules.) This suggests that people in China are eager to travel again.

As we discussed in our last letter, China faces economic and demographic challenges that pose some risk to the continued expansion of the country's middle class. At the same time, the Chinese middle class already represents a meaningful source of global demand for international travel; in many markets, that demand was sorely missed over the last three years. Now, its long-awaited recovery—which looks likely to happen at a faster pace than most people had expected—should provide a welcome boost to the global hospitality sector.

A CHANGING OF THE GUARDS

Mike's body is not quite sure what time it is, spending a grand total of 12 calendar days in London from mid-February and mid-April (fortunately, our team has now grown to the point where there are 43 other people who got to enjoy the full brunt of London's late winter cold snap). The trip took him from GMT+9 in February all the way to GMT-8 in April, and spanned Asia, the Middle East, Europe and the US. It was a great opportunity for Castleforge to hear about what investors all around the world were doing, and what was on the top of their minds as 2023 kicked off.

The Annus Horribilis Might Not Be So Horribilis

One of the most consensus views by the middle to end of 2022 was that there would—for sure—be a recession all across most major markets in 2023. Various measures of CEO confidence were registering either the lowest reading for the past 40 years or levels only meaningfully eclipsed by 2008. A survey of professional forecasters reported by Bloomberg and the Philly Fed noted that the highest percentage of respondents in 50 years was forecasting a quarter over quarter decline in real GDP one year after the survey (that 40-45% of respondents saying so compares to about 20% in the lead up to the Lehman collapse).

That started to change by the time Mike boarded his first flight to Singapore in mid-February. As the clock struck midnight to ring in the new year, Goldman Sachs issued a significantly more bullish outlook for 2023 than the consensus, and many others followed suit. Although recent banking runs at Silicon Valley Bank and Credit Suisse have thrown new sources of economic uncertainty into the mix, renewing fears of a potential slowdown, by March, many investors were nonetheless waking up to the fact that they might be looking to meaningfully deploy capital into the market this year.

However, the rules of the game had fundamentally changed. On the back of a nearly 500 basis point rate hike by the Fed and similar hikes around the world, investors knew that how they had been making their returns prior to 2022 was going to have a change materially as long as five-year or ten-year money actually cost something. It remains to be seen whether those bank failures will indeed result in systemic contagion, but in the event that they do not, investors need to make hard decisions around allocations this year. What does everyone plan to do?

Pendulums Swing

As one of our astute investors remarked in a recent conversation, markets go through cycles. Looking across global financial markets today, we seem to be witnessing the start of a new cycle. Within real estate specifically, we feel that the structural changes now facing certain asset classes—like retail and offices—combined with the cyclical challenge of higher interest rates—faced by all asset classes—will produce a new set of market dynamics in the years ahead. Real estate will look very different over the next decade compared with the previous one, and investors will have to adapt accordingly.

The End of the Carry Trade and the Rebirth of Situational Real Estate

For one thing, it's going to be a lot more difficult for investors everywhere around the world to achieve the kind of cash-on-cash returns that they were used to over the previous ten year period of easy money. It's no longer possible to pay in 3-4%-land for an Amazon distribution centre, or a gateway office HQ or a city centre multifamily block, and then use leverage to get

to a 6-8% cash return: either the now-shorter lease length reprices (basis erodes), a refinancing prevents positive leverage (lease vs. debt duration mismatch) or a general movement out in rates causes cap rates to move out (not 1:1 but there has been movement outward in most all asset classes). Carry trades are no longer viable.

What's more, investors can no longer count on broad, macro-driven bets on entire sectors either. Over the past five years, logistics investors of all stripes benefitted from the secular tailwind of e-commerce, no matter whether they owned a last-mile warehouse with a long-term lease to Amazon or a shed used by a precarious 3PL in the middle of nowhere. Logistics sounded (and was in fact) attractive, given the compelling e-commerce story, and so investors looking for cash-on-cash yield (made possible by the availability of positive leverage) crowded into any logistics asset they could find. The rising tide lifted all the boats in turn. This dynamic will likely fade: with higher interest rates, investors now confront tougher choices about how to allocate scarcer and more expensive capital. Even within favoured sectors, some assets will perform well, and many others won't. In short, beta alone will not suffice.

Thus, real estate investors will need to be increasingly selective, not only choosing the right sectors in the first place, but identifying genuine value within those sectors. This is particularly true in the office market, as we have discussed in the past. While large segments of the office market have run into secular headwinds, a small number of office buildings are seeing stronger occupier demand than ever—indeed, stronger than demand for buildings in sectors that, in aggregate, are outperforming offices, in aggregate. The point is that investing is becoming situational again: real estate investors will increasingly need to comb through markets to find specific winning assets, and these will be found across sectors and geographies.

As situational real estate returns, investors will have two options: (1) add value or (2) operate.

First, investors might accept that some of their return is going to have to move into the capital value growth column away from the current cash yield. That means taking on value-added risk through specialist repositioning of a building or rent roll.

Second, investors could move some deployment away from lower-yielding, bond-like investments in core assets into more operationally intensive sectors that offer higher yields but have a higher degree of NOI volatility. Hotels, for example. That may sound riskier, in that NOI isn't secured by long term leases and it could bounce around a mean expectation. But the appearance of certainty in the alternative approach which worked so well since the GFC is as dangerous to an investor as the apparent certainty in Silicon Valley Bank investing over 90% of its held to maturity book in 10+ year agency-issued mortgage securities. Nickel-picker-upper, meet steamroller.

Both strategies will require a movement up the real estate operational risk curve (although conversely, likely down the financial risk curve), and require specialist developers, partners or operators in order to execute the strategy. Which leads us to our second take-away from the trip.

Seek Professional Help

It's way too early to tell for sure, but there certainly was a sense that investors might just be slowing the growing preference for "going direct" with asset managers or operators, and opt to make indirect fund allocations instead. Of course, this is not meant to suggest that we are

ever going back to the pre-GFC days and investors will be ruling out co-investments and direct strategies. Far from it, in fact. Often many global investors have a larger team in certain far-flung markets than teams of country-specific, small-cap managers. Nevertheless, Mike, Iris and Laura heard the words "fund of funds" more in the past two months than they had heard over the entirety of 2022.

And from an LP perspective, investing indirect or even through a fund of funds could make a lot of sense in this world. First, geopolitical risk now appears to be emerging from anywhere, and that puts more of a premium on getting the diversification unavailable to a country-specific, sector-specific or an asset-specific direct deal. Second, as noted above, investors will likely need to pursue more value-add strategies or operational strategies if they want to maintain a similar leveraged spread to the risk-free rate that they have got used to over the previous decade. These strategies will require a lot of specialist know-how that vertically integrated private equity funds like Castleforge are set up execute. And finally, the need to invest situationally into real estate and not just invest into broad macro-driven themes with strong tailwinds also argues for investing into the funds of private equity managers set up to turn over all the stones and stock-pick in their home markets.

As the pendulum starts to swing, we are increasingly optimistic about some of the strategies and geographies that fell relatively out of favour in recent years. For one, as we wrote back in 2021, value-focused investing is due for a comeback. This is already starting to happen. Moreover, we think that Europe will provide an excellent place to hunt for value in the coming years. As we wrote last summer, European real estate has a strong decade ahead, particularly given its insulation (relative to US real estate) from sectors of the economy that have long relied on cheap capital. In short, although macro uncertainty abounds right now, we see compelling opportunities ahead.

Michael Kovacs	Adam MacLeod	Evan Garnick
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