CASTLEFORGE

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THE WINNING BOOKENDS OF THE OFFICE MARKET

The London-focused office REIT Great Portland Estates (GPE) recently made an announcement that caught our attention. In a presentation of April 2022, the company declared that all its investment activities would be guided by a new mandate going forward: "**If not Flex or HQ repositioning […] [then] exit.**" GPE's latest annual report describes the company's strategic pivot in more detail: "To ensure we meet our customers' evolving needs and changing working patterns, we have evolved our strategy. […] We are now organising ourselves into two complementary, overlapping activities: HQ repositioning—delivering large, best-in-class HQ buildings; and Flex spaces—smaller fitted-out units, often with higher service levels. Both of these areas are primed for growth."

This move is telling: it represents a significant change of course for a landlord like GPE, which represents the institutional end of London's office sector (albeit, the forward-thinking element). We think it's a shift that makes perfect sense, and for exactly the reasons that GPE outlined above. (As we wrote in October 2019, we expected it, too: "We believe that eventually flexible offices will be a standard part of the repertoire of most large landlords […]."). In short, we suspect that GPE's pivot is a reaction to the structural adjustment currently underway in office markets everywhere, catalysed by the pandemic. Occupiers will increasingly seek out higher-quality and more flexible workplaces, aiming to both lure employees back into the office and optimise for hybrid work schedules. As a result, although some segments of the office market may struggle with higher structural vacancy rates, other segments will see significant demand growth.

We believe that the two segments positioned to do best going forward are precisely the ones that GPE is now doubling down on: (1) best-in-class, HQ-calibre offices in gateway cities and (2) flexible offices. Our own office investment strategies specifically target each of these segments.

In terms of the first segment, demand for best-in-class offices is starting to outstrip supply in London. A large portion of city's office stock is outdated, environmentally unfriendly, and increasingly incompatible with the requirements of present-day occupiers. One study by JLL estimates that about 90% of London's offices will need to be significantly upgraded to meet government environmental regulations or investor and occupier ESG policies. Meanwhile, demand for top-flight office buildings remains robust. Active requirements for Central London office space reached 7.1 million sq ft last year, well above the five-year average of 6.4 million sq ft, and a number of blue-chip occupiers have made long-term moves paying rents between £80-90 per square foot.

In terms of the second segment, while flexible offices are still in their early days, the segment is now seeing rapid growth. As we have suggested in previous letters, this growth is led by several underlying tailwinds. These tailwinds include new requirements from occupiers looking to accommodate hybrid workforces and changes in information and communications technologies, which have made the traditional office model unattractive to tenants that no longer install fixed IT infrastructure in their offices and therefore no longer require the assurances of long-term leases. As well, some flexible office providers are probably capturing tenants that would previously have occupied lower-quality buildings, which have now become unfit for purpose in the ways we described above.

Increasingly, we are seeing this thesis confirmed in the real world—both in our own flexible office portfolio, operated by Clockwise, and in the broader market. In July, CoStar reported that flexible office occupancy in London had already rebounded to pre-pandemic levels. At the same time, desk rates had pushed materially higher: the average cost for a private desk in flexible office space had risen to £525 in July, up 13% on the pre-pandemic average and 22% year-on-year.

In short, it's not surprising that GPE now wants to focus on flexible offices, too, and if it leads to further institutionalisation of the flexible office market, it's a change we welcome.

NEW DATA ON DEMAND FOR APARTHOTELS

As we wrote in our last two letters, we believe that workplace patterns have changed in ways that will increasingly lead both business and leisure travellers to stay at their destinations for longer durations. At root, this shift is the product of (1) new communications technologies that made remote work possible in the first place and (2) cultural and institutional changes, largely triggered by the pandemic, that have allowed for the adoption of remote work at a meaningful scale. We believe that as white-collar workers spend less time working in office buildings than before, they would spend more time working elsewhere, including their holiday accommodations. As a result, travellers would increasingly demand hotel products that provide the comforts of residential accommodations, including larger room sizes and amenities like workspaces, kitchens, and washing machines. Since aparthotels cater to this demand, we saw the potential for meaningful growth in that sector.

As we researched the aparthotel sector over the past year, we found plenty of anecdotal claims in support of this narrative, which we thought fundamentally made sense. Still, the evidence that traveller preferences had actually started to change was limited. In order to test some of these claims, we recently commissioned a survey of 4,000 adults in the UK, with the aim of understanding how travel preferences have evolved since the start of the pandemic. We share a few of the findings below.

First, the survey results suggest that people are increasingly likely to both (1) travel for longer durations and (2) work while they are away. Asked to compare their current situation with their situation before the pandemic, about 27% of all workers (and 36% of workers between the ages of 18 and 34) said that their employer was now more likely to permit them to work away from home at least a few weeks each year. With employers more amenable to allowing their employees to work away from home, 25% of workers are now more likely to extend their stays and work remotely at their travel destinations for a few days on either end of their trips. In addition, 51% of respondents said that they were now likelier to bring their partners with them on business trips, suggesting that the lines between business and leisure travel have started to blur in other ways, too.

Second, the survey data also support the idea that these new travel patterns should bolster demand for new categories of travel accommodation. For example, asked to consider how their preferences have changed since the onset of Covid, 39% of respondents reported that, for trips lasting longer than a week, they would now more strongly prefer to stay in accommodations that provide larger rooms with workspaces than in hotels with premium leisure amenities, like swimming pools. However, as we had suspected, this does not necessarily translate into higher demand for vacation rentals (even though these do typically offer larger rooms): 39% of respondents who plan to work remotely during their holidays said they would prefer serviced apartment or hotel accommodations over Airbnb rooms or other short-term rentals. (In fact, members of the younger cohort (comprised of workers between the ages of 18 and 34) were even more likely to prefer hotel or serviced apartment accommodations, with 47% holding that preference.) Ultimately, we think these results tend to support our view that the aparthotel sector is well-positioned for growth as new work and travel patterns continue to take hold over the coming decade.

INFLATION: LESSONS FROM THE PAST

Part 1: You can be right, but for the wrong reasons

In several previous letters, we have argued that the disinflationary macro-environment of the last twenty years would not last forever. More specifically, we have pointed out that as (1) globalisation slows, (2) the global working-age population enters into retirement, and (3) investment in the energy transition and domestic manufacturing infrastructure ramps up, we are likely to see a sustained period of higher inflation throughout advanced economies.

We emphasised that these structural inflationary pressures would materialise at a gradual pace. As such, these (structural) inflationary pressures should be distinguished from the more specific sources of inflation that have surfaced in the past year and a half (e.g., Covid-related supply chain disruptions, expansionary pandemic-related fiscal and monetary policies, the war in Ukraine, etc.).

This distinction is critical, since there are good reasons to believe that the specific inflationary pressures of the last 18 months have started to recede (particularly in the US) and will continue to do so, especially if the global economy continues to soften. Notably, economic sentiment has deteriorated to its weakest level in recent history by some measures, with global consumer confidence lower in early August than at the start of the pandemic or during the Global Financial Crisis. Meanwhile, energy prices have substantially declined already, as have container shipping costs. These developments should all work to bring down inflation.

If that happens, it will be tempting to conclude that inflationary pressures are completely eliminated. However, a let-up in the inflationary pressures playing out today would do little to derail the three structural trends we outlined above. All else equal, as long as those trends stay on track, we should continue to expect higher levels inflation in the longer term, if not in the short-to-medium term. (Though this does *not* mean we should expect inflation to be as high as it has been in the past year.)

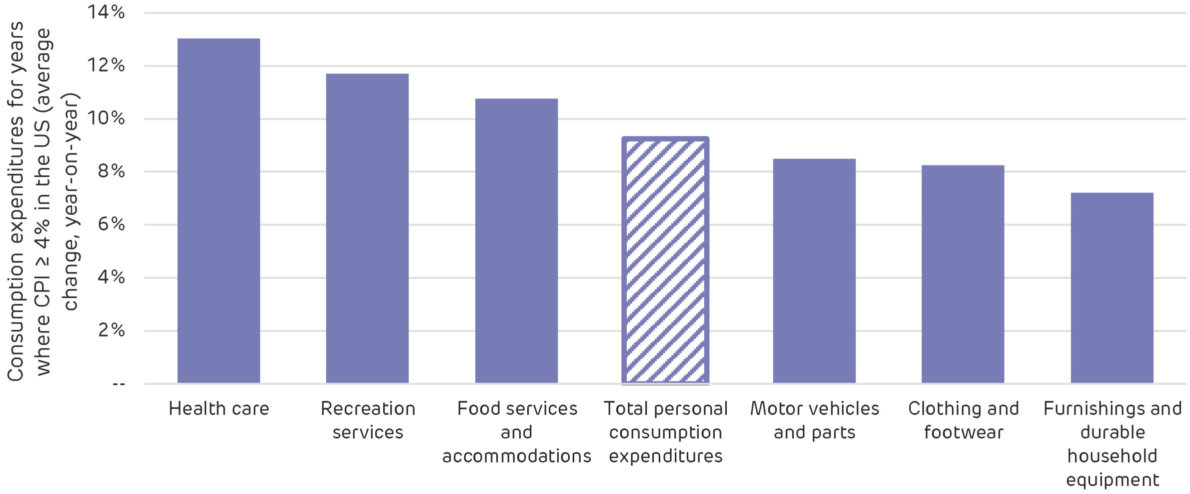
Part 2: What does that mean for real estate investors?

Unfortunately, much of the conventional wisdom about asset allocation during periods of high inflation—"buy gold, sell long-dated bonds"—has limited practical value to real estate investors. To get a better sense of how higher inflation is likely to play out in real estate markets, we examined personal consumption expenditure in the US since 1960 and measured how different categories of consumption have held up when inflation has run higher than usual. We summarise some of the more interesting findings below, but we would treat this investigation as a starting point only for thinking about these questions, not as a final word.

Between 1960 and 2021, CPI for all urban consumers increased about 3.7% each year on average in the US. This six-decade stretch was roughly equally split among three categories: (1) years where the annual rate of inflation was greater than or equal to 4%, (2) years where it was less than or equal to 2%, and (3) years where it landed somewhere in the middle. Over the 20 years where the annual rate of inflation matched or exceeded 4%, inflation averaged 6.7%. We focus on these "high-inflation years" below.

During the high-inflation years, total consumption expenditures increased in nominal terms by 9.2% on average. In general, consumers increased their spending on services (which grew by 10.1% annually) by more than they increased their spending on goods (which grew by 8.3% annually) throughout this period. Putting aside gasoline and other energy goods, the three highest-growth categories of consumption were health care (13.0%), recreation services (11.7%), and food services and accommodations (10.8%). Some of the lowest-growth categories included furnishings and durable household equipment (7.2%) and motor vehicles and parts (8.5%). See Figure 1 below.

Figure 1. US personal consumption expenditures during high-inflation years by category



These figures suggest that consumers respond to inflation by shying away from big-ticket purchases, like cars and other expensive durable goods. There are a few possible explanations for this. First, whether price inflation actually outpaces wage growth and erodes real incomes or just creates uncertainty about consumers' purchasing power in the medium-term future, it often causes households to cut back on spending. Big-ticket items make appealing candidates for cuts due to the visibility of savings available. A 10% increase in the cost of a restaurant dinner might add only a few dollars to the bill, while a 10% increase in the price of a car may add thousands. Consumers likely adjust their behaviour accordingly.

What's more, the longevity of many durable goods means that the replacement of these goods can generally be deferred to the future. On the other hand, many goods and services that must be purchased and consumed on an ongoing basis cannot be postponed without being permanently foregone. This makes it tougher for people to consume lower quantities of these things during periods of high inflation (at least in some cases, like heath care), and easier for suppliers to periodically raise their prices.

Looking at more granular categories of consumption, a few additional points stood out. First, categories of consumption tied to operationally intensive real estate outperformed across the board. During high-inflation years, spending on casinos increased by 18.6%, on nursing homes by 13.6%, on student housing by 11.7%, and on hotels and motels by 13.4%.

Although multiple causes are probably at play in each of these cases, we have a few initial hypotheses. Hotels can dynamically price their rooms, resetting rates on a daily basis, minimising friction and allowing them to stay ahead of broader price inflation. A different story probably applies to nursing homes, where demand is price inelastic for obvious reasons, especially for existing customers. If nursing home operators can raise prices during inflationary periods without losing residents, total spending in this category should increase during these periods.

All told, the real estate businesses that seem to capture the strongest revenue growth during periods of high inflation include (1) those that can frequently re-price their products, like hotels and casinos, and (2) those that deliver non-substitutable services, like providers of nursing homes and student housing. We have been positioning our own portfolio accordingly for some time now: several of our existing and emerging investment strategies—including hotels, flexible offices, workforce housing, and cold storage—benefit from one or both of those characteristics.

WHAT CAN WE LEARN FROM THE VENTURE CAPITALISTS?

Although it's clearly been a challenging year for the tech sector at large, and thus also for its venture capital backers, some VCs seem to be holding up much better than others. On this theme, we recently read an interesting piece in the Washington Post, detailing the tribulations of the Swedish fintech company Klarna and two of the large VCs invested in it. We thought the piece contained some instructive lessons for fund management businesses of all stripes, including private equity real estate managers.

Some background first. Both Sequoia and SoftBank (via its Vision Fund) are investors in Klarna. Sequoia was an early investor in the start-up, initially funding it in 2010 and then participating in several subsequent fundraising rounds, most recently in 2019 at a $3.5 billion valuation. Since then, Klarna's valuation soared—until it collapsed earlier this year, partly on the news that Apple would introduce instalment payments via Apple Pay, threatening Klarna's market share. A year ago, SoftBank invested $638 million in Klarna at a $46 billion valuation. Today, Klarna is looking to raise equity at a valuation of about $6.5 billion. This will force SoftBank, but not Sequoia, to record significant unrealised losses on its investment. Even prior to this write-down, as of March 2022, SoftBank's second Vision Fund had eked out only $800 million in gains on the $56 billion fund. Now, virtually all of the fund's returns to date are likely wiped out.

What exactly has gone so wrong for SoftBank? (It's not just the Klarna fiasco either. Recall Softbank's investment in WeWork at a $47 billion valuation.) One explanation is that SoftBank found itself outcompeted in the increasingly crowded VC landscape that took shape in recent years. The market for growth-stage technology investing has become more and more saturated with capital over the past several years, as new investors (including hedge funds that had previously not made significant VC-style investments) have deployed billions of dollars into the space. This means that SoftBank's historical competitive advantage—simply having a lot of money to invest—is no longer a meaningful differentiator.

Meanwhile, VCs with more durable competitive advantages—for instance, VCs with tight relationships with founders, or with reputations for being able to provide portfolio companies with expert operational guidance—have remained more selective, investing in higher-quality companies at earlier and cheaper stages. As valuations for many tech companies collapsed in recent months, these investors had buffers (in the form of lower cost of their investments) that helped mitigate losses. SoftBank apparently did not.

The lessons we draw from SoftBank's struggles have several parallels for all fund managers. First, when capital is abundant, as it has become in private equity real estate, simply having a lot of capital may not constitute a meaningful competitive advantage. Investors must be able to add value in genuinely differentiated ways, whether through in-house operational or development expertise or by cultivating deep relationships with third-party operators. Second, this story underscores the importance of investing in income-generating assets at an attractive basis, not just hoping for capital value growth to continue. As the SoftBank saga suggests, markets now seem to be remembering this point.

BACK TO ABUNDANCE: THE EMERGING OPPORTUNITY IN EUROPEAN REAL ESTATE

We wanted to call readers' attention to a new paper we released in June (Back to Abundance: The Emerging Opportunity in European Real Estate).The paper starts by looking back at the last decade and a half, comparing the performance of US real estate markets with that of European real estate markets, and tracing the sources of America's recent outperformance. In short, we show that, although US real estate markets outperformed at the aggregate level over that period, their outperformance was concentrated in a select group of high-growth secondary cities (e.g., Austin, Denver, and Nashville) and high-growth real estate subsectors (e.g., industrial property and various alternative property sectors).

We argue that the capital-value growth achieved by real estate assets in these cities and subsectors was dependent on a narrow set of circumstances that now seem likely to fade. These include: (1) the rapid expansion of the US technology sector, which now faces significant medium-term headwinds; (2) a wave of population growth in US secondary cities, which have consequently become much less affordable and therefore less attractive to potential newcomers; and (3) a surge of institutional investment flows into alternative real estate asset classes, which have now largely matured and therefore provide minimal return premia.

Our paper then considers Europe. Looking at the coming decade, we argue that European real estate provides a number of highly attractive opportunities for investors. Unlike US real estate markets, European real estate is (1) considerably less exposed to a slowdown the technology sector, (2) well-placed to benefit from continued migration to secondary cities, and (3) likely to see investment into alternative real estate sectors accelerate, driving capital-value growth in these asset classes.

WEWORK BULLS?

After years of sniping WeWork at every opportunity, have we really turned bullish on the company?

Mike was at a wedding this summer where half the crowd was in the public equities / hedge fund space. One of those hedgies, who covers the TMT market, told Mike that he covers WeWork (it's not a tech company!) and is thinking of shorting the equity. The thinking was that WeWork was going to run out of money and would not meet its large lease obligations. Mike replied, "Ok, but before you do:

...what if I told you there was a company that 'owned' 50 million square feet of the most newly completed office buildings in core locations of some of many of the world's gateway markets; that in a world or rising borrowing costs had 'fixed rate debt' for the next 15-20 years, would benefit from cost inflation because they could mark to market rental revenues; nearly all of the leverage was not cross-collateralised and if one building wasn't working out they could throw the keys back to the 'lender'; and since the loans were non-crossed they could just not pay 'interest' on lagging locations when short of cash; that they had just completed a restructuring where they did just throw the keys back on many underperforming assets; and finally, that these office buildings—because the company is virtually unleveraged with only limited unsecured debt and recently lost 90% of its market cap—now trade at half the implied value they did a few years back. Plus, given the equity is now so thin relative to the rest of the capital structure (capitalised operating leases = financial leverage), you could also consider it a super long-dated call option that worked out really well for others before. What would you say about that company being such an 'obvious short'?"

More next quarter...

TURNING LEMONS INTO FCOJ

Our long-time readers may recall that Mike has a penchant for older movies. In preparing for next year's 30th anniversary of arguably one of history's best films about the financial industry, *Trading Places*, Mike thought it best to re-watch the movie. The conclusion? There is no better five minutes of cinema than after Aykroyd's "Sell 200 April at 142!" shorting of that year's orange crop harvest.

Spoiler Alert: Not only did Murphy and Aykroyd know that the upcoming year would be a bumper one for oranges (thus depressing prices for frozen concentrated orange juice), but they also gave the Dukes a false crop report pointing to shortages, knowing that the Dukes would then be buyers.

When it comes to private real estate, the holy grail would be figuring out how to execute a short-sell. One of the main reasons that the private market moves so much slower than the public market on the way down is that owners simply decide not to sell, which ends up slowing down price discovery. Indeed, public markets start to change direction faster, and may even rise, while private markets are still falling. For example, while the share price for Derwent London plc (a pure-play office REIT) bottomed out at about £6.00 per share in the first quarter of 2009 before doubling within 12 months, the private-markets MSCI office capital value index lost 5-10% over that time horizon.

So how do you "short-sell" private real estate when you get the sense that private market prices may be lower in the short-to-medium term, especially when you see indications from the public markets that the future looks decidedly brighter?

In the absence of a pure-play hedge, particularly against capital values, we think the best alternative is analogous to turning lemons into lemonade. That is, you want to be the only one able to execute on a profitable operating strategy (manufacturing and selling a deliciously refreshing beverage) using an input that everyone else undervalues (a lemon) and generating attractive short-duration income returns, rather than relying on capital value growth.

As an example, take the founding of National Car Parks. It all started in 1948 when an ex-Royal Navy entrepreneur and his business partner bought an old WWII bomb site for £200, and set up a surface parking lot operation. Once they had an operation that could easily manage a car parking business (the original "operational real estate" guys?), they went on to buy other bomb sites in London or vacant sites around the country that had no use for a new building, and would be more profitable as vacant lots operated by NCP. They were quickly turning lemons into lemonade, and fifty years later, the company was sold with the founders' families taking home nearly $1 billion.

We here at Castleforge believe we've created two lemonade machines that few others in the European real estate markets possess.

One of them (Ocasa), invests in 30-to-130-unit residential blocks in UK secondary cities, typically previously converted to multifamily in the 1970s-2000s, then refurbishes and manages them to a level of fitout and service atypically high for a tenant paying average rents of less than £500 pounds per month. Often, we are the only buyer in these market for these blocks, which are too large for private individuals and too small for the rest of the private equity real estate world. We've painstakingly constructed a portfolio that will result in ~2,500 units yielding an attractive unleveraged cash flow yield on our cost basis, and we're just getting started.

The other (Clockwise), can take any old half-empty office building in a secondary city in the UK and Continental Europe and turn it into a cash-producing machine, generating anywhere from an 8% to 12% unleveraged yield on our cost basis, a basis often below construction cost. Far from facing headwinds in the office market like many other owners who would typically sell to us, we have been able to consistently fill up the Clockwise space within about 12-24 months at rents that are higher now than in 2019, pre-Covid. And that's because we provide typically the highest level of amenities, service and office quality in these markets while being able to manage a stable, short-duration cash flow consisting of mostly one-month leases.

Short-duration cash generation becomes one of the best ways to hedge against several of today's key market risks. With a slow-down in global growth, possible stagflation and lowered expectations for office demand upon us, we're going to be able to use these operations to generate solid returns for our investors.

Michael Kovacs | Adam MacLeod | Evan Garnick