27 June 2024

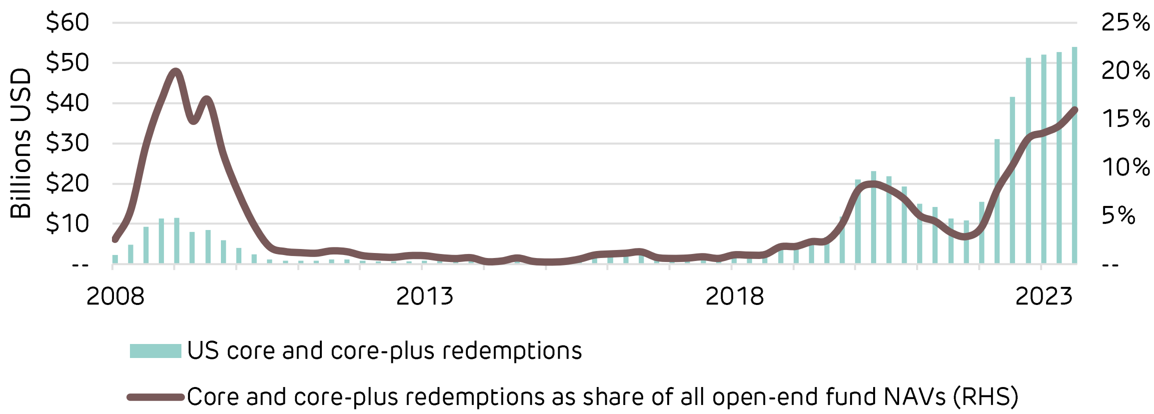
## BACK TO BASICS: THE OPPORTUNITY IN CORE-PLUS REAL ESTATE

Throughout 2023 and early 2024, real estate fund managers have witnessed shifting investor appetites toward different investment strategies, including an exodus of capital from real estate core and core-plus markets as financing situations worsened and the relative attractiveness of non-real estate asset classes improved. While this has presented challenges for the world of open-end funds, as we'll discuss later, we think that these same trends also present a cyclical opportunity to get exposure to core-plus strategies as the market bottoms out and transitions to an upswing.

As central banks hiked rates to counter soaring inflation in 2022, multiple real estate asset classes faced growing debt burdens. Investors who had gotten used to nearly a decade of rock-bottom interest rates suddenly found that the real estate "carry trade" was no longer a sustainable way to deliver long-term returns – a topic we've discussed in a previous letter. As real estate transaction volumes plummeted globally, investors sought liquidity to deploy into other sectors and strategies.

In the United States, open-end funds saw net outflows of $13 billion throughout 2023 – the highest level seen in decades.[1] Much of this outflow came from investors seeking redemptions. As the graph below shows, by late 2023, redemption queues (measured as a percentage of fund NAV) for open-end core and core-plus funds in the United States reached levels not seen since 2009.[2]

*Figure 1: Core redemption queues and open-end fund NAVs*




Investor requests have caused some large private funds, such as Blackstone REIT (BREIT) and Starwood Capital REIT (SREIT) to struggle under the weight of outflow demands. BREIT was unable to meet 100% of redemption requests for over a year until April 2024, and SREIT has recently had to use credit to accommodate its investors' demands.

The movement of capital out of core and core-plus funds toward other strategies is the result of a few factors. Elevated borrowing costs and expanding property cap rates are a major culprit. Additionally, many investors remain concerned over exposure to the office market, which has faced no shortage of negative media attention. According to McKinsey & Company, investors have been searching for

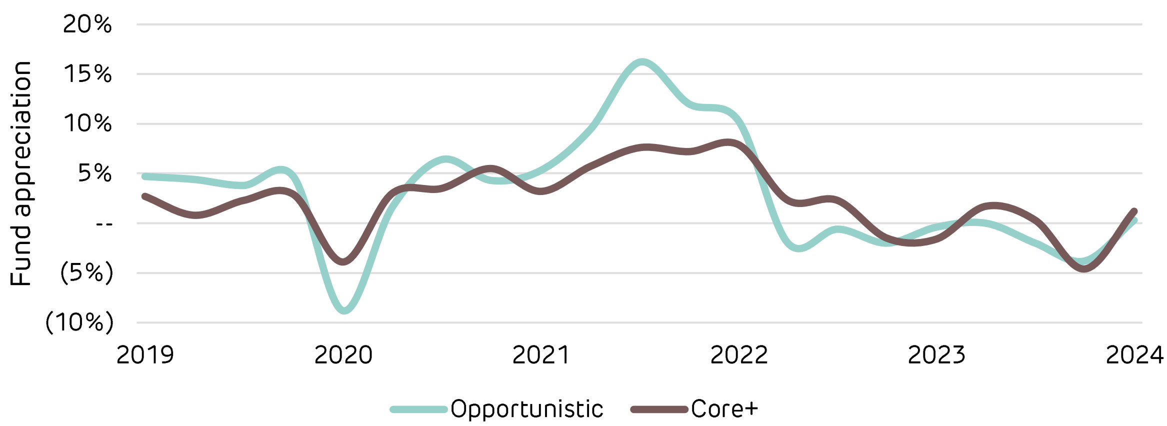
[1] McKinsey & Company
[2] Townsend Group

income generation and alternative sources of yield, leading them to shift capital toward opportunistic strategies.[3]

Despite the current set of challenges faced by core and core-plus strategies recently, there is the potential to deliver strong future returns. One reason for this is because the macroeconomic outlook has shown remarkable improvement over the past year as inflation inches closer to 2%. The ECB cut rates in June, and markets predict that the Federal Reserve and Bank of England will make modest cuts later this year. Additionally, as the investment market appears to have bottomed out in terms of valuations, we see through the benefit of hindsight that commercial real estate may not have suffered as much as one might have originally believed. Certain assets in troubled sectors, including hotels and industrial real estate, have managed to grow rents over the past year in spite of macroeconomic headwinds and a decline in total investment. The past few years have prompted top performers to separate themselves from the rest of the market.

One way we see evidence of core and core-plus returns bottoming out is by examining Blackstone's real estate investment performance breakdown, which shows a shift in results between strategies. While opportunistic real estate tended to outperform core and core-plus strategies by an average of 247 bps in the eight quarters leading up to Q2 2022, since then the trend has reversed. Blackstone's core-plus portfolio has shown better investment performance in six of the eight quarters since then, beating opportunistic real estate strategies by an average of 133 bps per quarter. KKR, meanwhile, noted both the lack of core and core-plus capital in the market as well as the strategy's strong ROE-generating potential in a recent earnings call.

*Figure 2: Real estate investment performance by strategy*[4]




Some investors may take advantage of this simply by purchasing core-plus real estate as others look for the exit.

Others (such as ourselves) may look to gain exposure by executing value-add or opportunistic repositionings where the traditional take-out is to a core-plus investor. If, for example, hotel cap rates in a strong, tourism-driven market are now at a 150-200 basis point discount to their historical averages, we think a good strategy would be to reposition the hotel at a time when the market is underwriting the existing market cap rate as the assumed take-out value in 3-5 years' time, with the

[3] McKinsey & Company
[4] Blackstone

knowledge that there is significant asymmetric upside to the business plan if core-plus investors come back into the market and drive cap rates back down to long-term averages.

The landscape of real estate investment has been reshaped in recent years, with core and core-plus strategies experiencing unique challenges. However, these difficulties should not overshadow the potential growth that lies ahead. As we see interest rates stabilizing and multiple sectors demonstrating resilience, there is a strong indication that core and core-plus real estate is on the brink of a cyclical upswing.

## NEW YORK VS LONDON OFFICE VACANCY RATES

It wouldn't be a Castleforge research letter without a mention of offices, would it? Our last few quarterlies have discussed different sides of this much-maligned real estate sector, including the role of ESG credentials, opinions on hybrid work, and needs of creative sector workers. Given how often the sector faces generalisations over its performance, we think it's more important than ever for investors to understand the nuances within this asset class.

One subject which we haven't discussed as much, however, is how office market performance varies by geography. Take New York and London, for example. With 90 square kilometres of inventory between them, their scales make them the most important office markets in the world.[5] Despite the natural comparisons between the two cities, they have shown contrasting performance lately.

This is clearest in vacancy rates – the metric that has become a shorthand for the health and future of office markets globally. Last quarter, Manhattan's office vacancy rate stood at a towering 23.4%, while at the same time, London's vacancy rate was only 9.9%. Both cities have experienced an increase in vacancy in recent years. Notably, the difference between these cities widened since the pre-pandemic period. In Q3 2018, New York had an office vacancy rate of 7.2%, while London's was 4.6%.[6]

Recent deliveries of new space contribute to this difference. In 2023, approximately 4.98 million square feet of office space was delivered in Central London. Manhattan, by contrast, likely delivered around 6.30 million square feet.[7] Of course, this figure means nothing without the context of population. Using census estimates of employee headcounts by industry, we find that New York City's metro area has about 1,499,800 office workers, and Inner London has about 1,890,000.[8]

One would expect that the city with the smaller population of office employees would also construct a proportionally smaller amount of office space. However, the data shows the opposite: despite having approximately 26% fewer office workers, New York built about 26% *more* office space than London did last year. The fundamental mismatch between potential market size and annual construction observed in the data could be a major factor in explaining the vacancy divergence last year.

This trend in vacancy rates holds when comparing Europe to North America. Europe's office vacancy rate is far below that of other global regions, and the spread has only widened since 2020. Europe's top gateway cities have also consistently outperformed North America's in terms of raising rents on offices over the past three years.[9] This suggests that even as European offices face challenges, they nonetheless enjoy better supply and demand dynamics than their North American counterparts.

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[5] Cushman & Wakefield, NYC Office of the Comptroller
[6] Cushman & Wakefield, Knight Frank, NYC Office of the Comptroller, JLL
[7] Savills, Commercial Property Executive
[8] New York Department of Labor, ONS
[9] JLL

Regulatory differences may contribute to the divergence between North American and European cities. North American cities, governed mostly by as-of-right planning systems, tend not to limit developments as long as all relevant standards are adhered to. In contrast, older European cities require more upfront approvals, dampening construction during market booms. This can make cities like London less susceptible to over-construction.

It's shortsighted to paint trillions of dollars of assets with a single brush. Legal contexts can define the trajectory of an office market, but such factors are hard to quantify. Strong planning systems might be seen as a disadvantage one year and turn into an advantage the next. While some generalisation is needed to discuss ongoing events, thinking deeply rather than broadly can help us take more realistic accounts of market opportunities as they exist between cities. A wise man once said something about location, after all.

## POWER'S OUT, PARTY'S OVER: ENERGY SHORTAGES AND AI INVESTMENT IN A HIGHER-FOR-LONGER ENVIRONMENT

It's no secret that financial markets have had a tough time in the past few years. But, if you were only looking at the performance of technology sector indices, you may not have noticed. As investors fretted over soaring interest rates and declining valuations, tech stocks seem to have missed the message as the AI boom, led by just a few American companies, broke record after record.

Hoping to cash in on this trend, AI startups have been accumulating funding to buy costly hardware and expensive cloud computing contracts. Yet, the path to generating revenue through AI products remains uncertain as expenses grow. Despite spending over $50 billion on Nvidia chips in the year since March 2023, Sequoia Capital estimates only about $3 billion in revenues were realised by AI firms.[10] Large companies are investing in AI, too, with Alphabet and Microsoft spending 50% more on capex than last year through projects such as data centre construction and model development.[11]

> *"Why would you go after revenue?... If you show revenue, people will ask 'How much?' and it will never be enough. The company that was the 100x-er, the 1000x-er becomes the 2x dog. But, if you have no revenue, you can say you're pre-revenue. You're a potential pure play. It's not about how much you earn, it's what you're worth. And who's worth the most? Companies that lose money."*[12]

In the current interest rate environment, profitability has taken centre stage among tech investors. Following the Global Financial Crisis, low borrowing costs led to massive funding for tech startups, many of which lacked viable business plans. This was satirised in shows like *Silicon Valley*. In good cases, we got companies like Uber, which finally reached profitability in 2024. In bad ones, we saw huge infusions of capital into promising, tech-heavy ideas that were not structured to execute them (we're looking at you, WeWork). As for the ugly, well, we got Juicero, a startup that acquired $120 million in VC funding before releasing an ill-fated $700 juicer to the world in 2017.[13] We've discussed the likelihood that interest rates remain elevated for longer, and this will likely curb the relaxed investment practices seen before 2021.

Profitability is thus one of the largest open questions surrounding the AI boom, and the risk of falling into a mania has not passed us. However, amid all the noise from the explosion in data generated for

[10] WSJ
[11] FT
[12] *Silicon Valley*, S02E03 – "Bad Money", 2015.
[13] CNET

and used in our newly acquired Copilots and Llamas, another sector has been growing in importance, yet has not garnered the same level of attention.

Electricity infrastructure undergirds every part of AI's future. Training large language models is extremely energy intensive, and integrating AI into tasks such as web searching or document editing will drastically increase power demands from cloud servers and personal computers alike. A recent study estimates that generating an image using AI could take as much energy as charging your phone.[14] As models become more complex, data centres may soon need their own power plants, as Amazon's $650 million acquisition of a data centre located near a nuclear power plant in Pennsylvania suggests.[15]

Yet, digital needs are not the only driver of electricity demand. They're not even the most consequential one. In the European Union, demand for electricity is expected to grow by about 168 TWh (roughly the annual consumption of Egypt) by 2026. Approximately 17% of that demand will come from data centres, but other drivers will be at play as well. These include heat pumps (11%), electric vehicles (22%), and industrial growth (43%).[16]

Despite the growing strains on power systems, Europe and the UK continue to push for rapidly cutting carbon emissions. While European countries will likely continue to use the fossil fuel supplies that they have secured in the wake of the Russian invasion for the time being, it may be much harder to expand supply in the near term to meet growing demand. As such, massive investment in the electricity grid is needed to plug the gap that will be left behind by fossil fuels.

Technology companies with deep pockets have been increasing their focus on power generation. For example, Microsoft and Brookfield Asset Management recently announced a partnership to deliver over 10.5 GW of renewable power around the globe. Other data centre operators, such as AWS, Oracle, and Google Cloud, have also been increasingly involved with power generation companies.

While on the right track, such investments may not be enough. Aside from generation, digital transformation also requires investment in energy transmission, especially if renewables are to take a greater share of the energy mix. Large power transformers have a lifespan of about half a century, and the UK's transformers have an average age of 64 years.[17] The chief executive of National Grid has thus highlighted the need to upgrade the UK's aging "supergrid," with plans to invest £60bn in the next five years.[18] That may only be a drop in the bucket. NatWest and BCG estimate that the UK may need as much as £900bn in capital investment to achieve carbon goals by the middle of the century. The European Union could require £500bn in investment for this decade alone to upgrade its grids.[19]

While the AI boom deserves plenty of attention, worrying about how to sell smart assistants before considering energy access might be putting the cart before the horse. It's becoming evident that the structures underlying digital and ecological transformation in the next few decades will require sufficient access to clean, cost-effective power. A country's success in expanding its economic and political potential will depend on its ability to keep the lights on.

[14] MIT Technology Review
[15] CoStar
[16] IEA
[17] Reuters, OFGEM
[18] FT
[19] NatWest, Reuters

## BIPOLAR MARKETS: THE ROLE OF CHANGING MEDIA NARRATIVES IN AN ERA OF ZERO-LATENCY FINANCE

Mike's head was spinning.

He had just finished chatting to a panel of mainstream media journalists about offices, where he was the least bullish person in attendance. Everyone else had been predicting prime office rents to increase by a further 25% in Central London on the back of what was probably a 25% increase since the start of Covid four years ago. The words and phrases "ESG," "sustainability," "BREEAM Outstanding," "EPC A," "best of the best" and "what tenants want" were bouncing around like pinballs.

Wasn't this the same group of journalists who had written articles with titles such as "The End of the Office" only four years earlier? And the same group that gave the all-clear when interest rates dropped to zero in the celebratory post-Covid zeitgeist and money was free? Only to then decry in 2022 that that entire banking sector would suffer a meltdown due to office values impacting balance sheets in the near-certain recession of 2023? And then to tell us in 2023 that *some* offices were great and simply had to correct in value to where interest rates would permanently settle at? And now valuations would apparently be higher on the notion that even if cap rates increased by a few hundred basis points, strong rental growth due to lack of supply (lack of supply!) would make up for the commensurate increase in cap rates?

None of the above headlines were entirely right, but then none were entirely wrong, either. We have been saying a mix of these over the past four years, all at that same time. The issue seems to be that nuance has no place in the black and white world of journalistic headlines.

*The Rise of the Narrative*

We've been tracking a lot of ongoing events over the past year. In our regular internal meetings on global affairs, we test and re-test predictions on topics such as inflation, consumer spending, and international travel. Today, it's easier than ever to access massive amounts of real-time data on any topic we could want to study. Despite the ease of accessing vast stores of information for research, it's not always beneficial due to the time required to sift through it. With internet connectivity being ubiquitous, data access no longer sets a company apart. This makes it more important than ever to create clear understandings of ongoing trends by synthesising data points into narratives.

In addition to making independent judgments about our global narratives, our understandings of events are also tested by the sentiment of the financial press. As time goes on, however, it has become more difficult to determine which narratives are worth following. In the past year, explanations of ongoing trends have changed almost as often as we could refresh our browsers. Earlier this year, the FT wrote about the challenge of tracking so many shifting ideas on why certain strategies succeeded or failed, saying that it was "almost painful to try to characterise the current market" (never mind that the FT itself was partially responsible for a number of these changing narratives).

While we agree with the FT's statement, it's worth remembering that narrative cycles have been shortening for as long as the news has existed. The incentive to cut production times in journalism has existed since the field's inception. Carrying the news over telegraphs, radio, and television are all expressions of these market forces at play throughout history. In more recent times, the onset of 24-hour news programming and the internet have allowed produces and distributors to keep the public updated on current affairs, but also limited the time reporters could spend contemplating events in context.

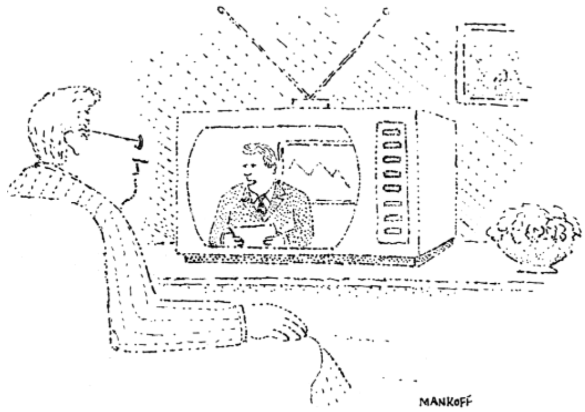
Recent adaptations, made possible by the internet, have further changed how narratives are created and shared. One example is the massive growth of data collection in recent years, facilitated by automated collection and the Internet of Things. The amount of data created, copied, captured, and consumed is expected to grow by 50% between 2023 and 2025.[20] Yet, most of the work being done to synthesise this data into actionable intelligence – such as financial narratives – is still done by human minds, the number of which is only set to grow by about 2% in the same timeframe.

The global popularisation of social media also upends traditional systems of narrative distribution. While you might consider social media as an extension of the development of internet-hosted news, there are some noticeable differences. Putting news and commentary online used to be limited to a select group of organisations with the capital, connections, and know-how to use the digital tools of the early millennium. Today, low barriers to entry for user-generated content mean that anyone can create a narrative, for better or for worse.

Better access to data probably creates more accurate conclusions in the long run, but it can also introduce short-term volatility to the financial press. We therefore seem to be experiencing faster, more frequent switching of market characterisations. The financial news cycle can be likened to the model of punctuated equilibrium in evolutionary biology. In this model, the evolution of species can be understood through the alternation of periods of genetic stasis (equilibrium) and rapid moments of evolutionary change (punctuation).

*What Does it Mean for Investing?*

In the news ecosystem, equilibrium signifies low market volatility, dominated by prevailing narratives and norms. Disruptive events, such as wars or policy shifts, force a re-evaluation of assumptions and spark new narratives to explain the world. The internet and social media amplify this disruption, increasing narrative competition and perceived market volatility. Algorithmic content delivery further complicates this by incentivising radical views that garner engagement.




> *"On Wall Street today, news of lower interest rates sent the stock market up, but then the expectation that these rates would be inflationary sent the market down, until the realization that lower rates might stimulate the sluggish economy pushed the market up, before it ultimately went down on fears that an overheated economy would lead to a reimposition of higher interest rates."*[21]

[20] International Data Corporation
[21] "On Wall Street Today" by Robert Mankoff for *The New Yorker*, 12 October 1981.

The onset of Covid is an example of a recent narrative shock. Shortly after lockdowns were first imposed in western countries, Bill Ackman famously announced that "hell [was] coming" just after making a $2.6bn return betting against the market. However, the S&P 500 quickly began to recover, and by the end of 2021, commentators declared that Wall Street had "rolled its eyes at Covid." Jubilation turned to trepidation a number of months later, when Bloomberg's economic forecasts predicted a 100% chance of recession in the US within a year, and in January 2023 CEO confidence fell to levels worse than those seen during the GFC. As we now know, a recession failed to materialise, and the S&P 500 went to the moon.

As long as narrative volatility persists, it is crucial for investors to think about the data they encounter daily and the ways that data can be interpreted to develop investment strategies. This is especially true in the world of real estate, which must have a longer time horizon due to the time-intensive processes of acquiring, building, refurbishing, and reselling assets in the field.

But what is the best way to go about this process? Some might suggest doing the opposite of whatever the media is saying to avoid groupthink. This anti-strategy assumes that once a narrative hits the mainstream, it has passed its peak. However, being structurally contrarian has drawbacks. Narrative adoption can be self-fulfilling, and if most investments favour a specific strategy (even a suboptimal one), resisting the tide is unlikely to work long-term unless you have perfect timing.

Developing robust internal frameworks to understand ongoing trends might be more helpful. These frameworks must be resilient to individual events, yet also flexible enough to adapt to counter-argumentative data. We've introduced some of our frameworks for thinking about real estate markets. One example is our explanation of economic cap rates for offices. This framework and others like it allow us to work around the hype cycles that are prevalent in current reporting.

We understand that the financial press isn't going anywhere. It will remain a crucial part of how investors understand the market. However, it's also clear to us that the proliferation of narratives, made possible by the growth of data collection and the distributive properties of social media, means that our relationship with narrative-makers deserves more scrutiny than before. After all, investors will be the ones to suffer if it turns out that nuance has no place at global investment committee meetings, too.