



REAL ESTATE | DECEMBER 2023

Value-add real estate investors are better positioned in almost all market conditions

Mandatum Asset Management is a significant real estate investor with over €1 billion invested in both local and international markets. The team has built strong and long-term partnerships with successful and established European real estate managers focusing on value-add strategies. In our view, value-add real estate is a provider of future-proof space, particularly in this current environment, and suits a medium-term investor better than core real estate.

THE SOURCES OF RETURN AND RISK VARY IN DIFFERENT REAL ESTATE INVESTMENT STRATEGIES

Core real estate is characterized by investments in properties that generate stable cash flow income, similar to bond investments. Core properties are generally in good condition and located in city centres, and tenants under long-term lease agreements guarantee the steady rental cash flows. The most significant risk to core real estate, however, is a change in real estate yields.

In comparison, **value-add real estate** are properties that, at the time of investment, are often mismanaged and operating below their income potential thus offering opportunities via operational enhancements. Value-add investments seek to target higher returns with lower yield shift risk through active value creation measures, such as refurbishment, repositioning or redevelopment. As value-add real estate investments require active real estate and asset management by experienced professionals, the difference between managers' abilities are much more significant than in core real estate.

ADVANTAGES OF A VALUE-ADD STRATEGY

Returns for value-add real estate strategies are based on active value creation measures

As referenced, the most important feature of value-add real estate is the active management approach to develop and make changes to meet the future needs of and the current trends in the real estate market across sectors. For example, there have been rapid and essential changes in the way offices are used, accelerated by Covid-19. Additionally, the logistics sector has seen some similar developments given, for example, the growth of e-commerce. Finally, the importance of sub-sector diversification has become even more critical in building a real estate portfolio.

The return drivers for the strategy spread the overall risks

Modernization and improvements, for example, can be used to reposition a property to meet market demand, while branding and modern marketing activities can help improve a poorly managed property. Competitive advantages can also be achieved through differentiated expertise, such as building specialized platforms and earning a portfolio premium. Real estate redevelopment can include renovations or changes of use, for example, turning offices into apartments. Generally, in real estate development, any planning risk is resolved, and the risk of necessary building permits is often limited before the participation of a value-add investor. Finally, special situations offer interesting opportunities, particularly in this environment, due to failed sales processes or the liquidity concerns of property owners. Furthermore, ESG remains a critical part of the value creation process, and energy efficiency and responsibility are considered in all property improvements today.

The business plan for value-add investments is typically executed over 2-4 years, after which a sale is planned to an investor with a long-term investment horizon in search of stable cash flow. As a result, finding the right tenant for a property is critical for both value creation and exit.

FIGURE 1. VALUE ADD STRATEGY RETURN DRIVERS

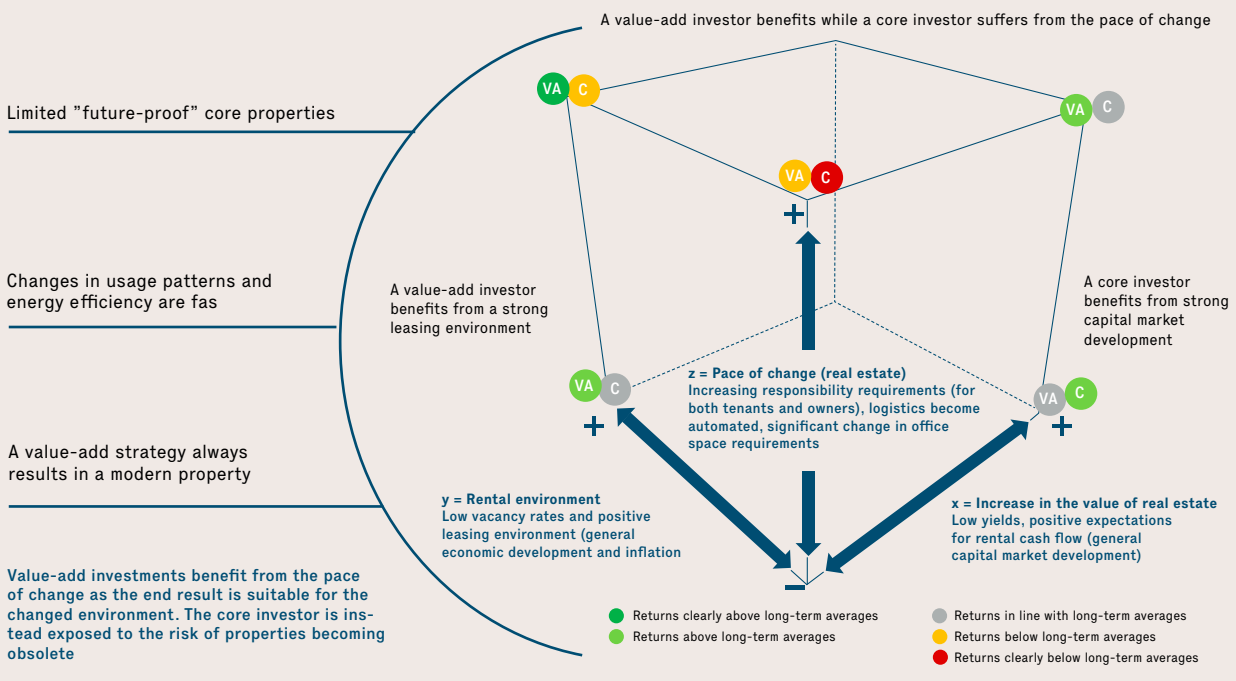
ESG – Energy Efficiency – Responsibility			
Modernization/Improvements	Competitive advantages	Real estate development	Special situations
<ul style="list-style-type: none"> • Repositioning a poorly managed property • Modern marketing and improving a building's services and amenities 	<ul style="list-style-type: none"> • Building specialized platforms • Portfolio discount when acquiring properties • Earning a portfolio premium 	<ul style="list-style-type: none"> • Renovations, change of use • Redevelopment without planning risk • Additional returns from active involvement in zone development 	<ul style="list-style-type: none"> • Failed sales processes • Opportunities due to limited liquidity • Uncertain market environment
Leasing is a key driver of returns = Attractive rental cash flow is critical for a core real estate investor			

DRIVERS OF CHANGE IN DIFFERENT REAL ESTATE SECTORS

While core and value-add real estate strategies have different return drivers, their performance is further affected by both the development of the economy and capital markets. On one hand, core real estate tends to benefit from a positive capital market environment (as yields decrease), while value-add real estate benefits from a strong economic environment (as leasing becomes easier).

In addition, several drivers of change can be seen across real estate sectors, stemming from changes in usage patterns and energy efficiency. Alongside the capital market and economic environment, this third dimension, the pace of change, has a significant impact on the returns of both core and value-add real estate.

FIGURE 2. VALUE-ADD STRATEGIES BENEFIT FROM THE PACE OF CHANGE



Changes in user preferences and energy efficiency measures across real estate sectors are progressing rapidly. Since value-add investments seek to increase the value of a property through active value creation measures, it is also necessary to understand and adapt to these drivers of change impacting the real estate market. By taking them into account in the investment strategy and value creation approach, we believe that a value-add investor is better positioned than a core investor in almost all market conditions.

Example: Shortage of modern European offices

Covid-19 accelerated a transformation in the way we use offices. Tenants are decreasing the square meters they rent, and more and more tenants are looking for office spaces that are flexible and adaptable for hybrid work – comfortable and attractive premises are a competitive advantage in a tight labour market. There is currently a shortage of modern offices in Europe to meet this type of demand, particularly as the European office market has been underinvested for a long time with growth of less than 2% per year post-GFC¹.

Example: Demand for logistics at a record high

There have been some comparable and strong developments in the logistics sector. E-commerce has seen astronomical growth historically in the United States with a similar trajectory currently taking place in Europe. Additionally, there has been a transition from just-in-time to just-in-case inventory management as a result of geopolitical risks. In this way, instead of optimizing the supply chain, the current desire is to bring warehouses closer to the end consumer and even move production to Europe. Consequently, the demand for modern logistics space is at an all-time high with availability a significant problem in Europe. Increasing the supply in Europe is also challenging due to a number of factors, including applicable land use and permit processes.

FIGURE 3. SHORTAGE OF MODERN OFFICES IN EUROPE TO MEET RECENT DEMAND

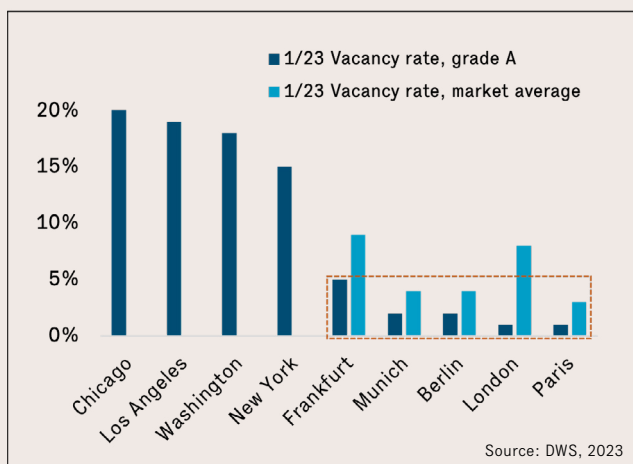
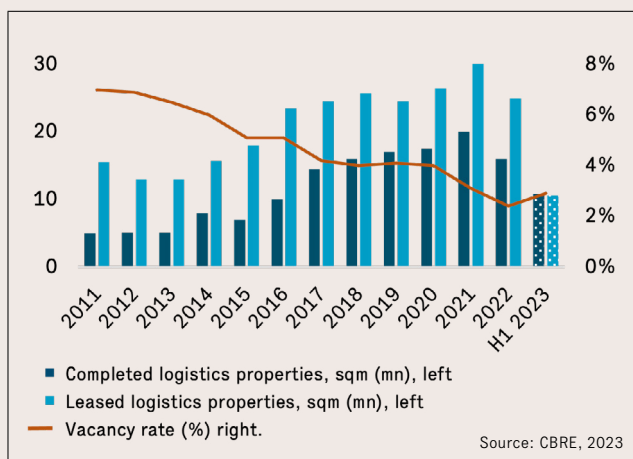


FIGURE 4. DEMAND FOR EUROPEAN LOGISTICS AT A RECORD HIGH

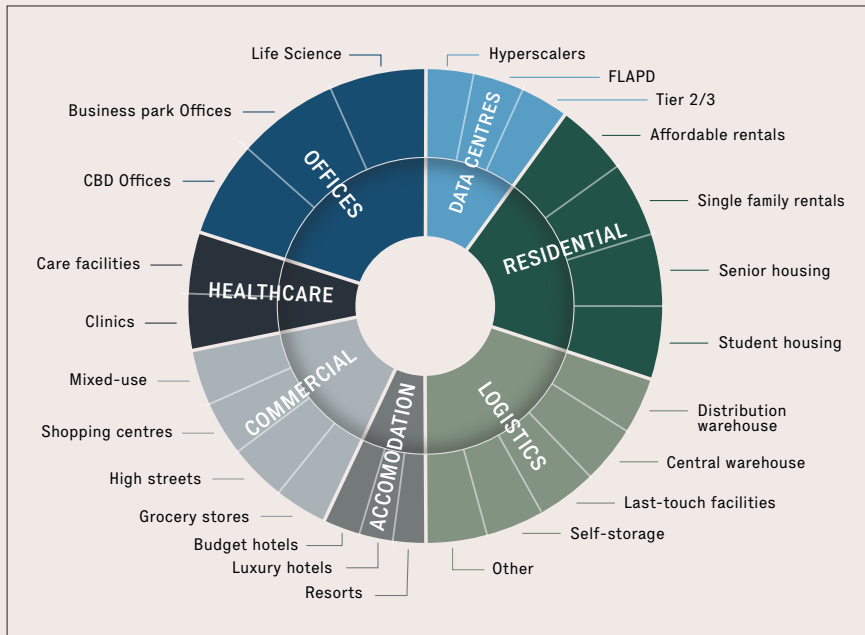


Diversifying by sub-sectors enables a successful sector emphasis

Previously, it was enough to diversify a real estate portfolio by sectors, however, it is now just as important to understand the role and weighting of sub-sectors in a portfolio. For example, the housing sector can be further divided into different sub-sectors, such as affordable housing or student housing, with trends focused on flexibility, ease and facilities that improve the quality of living. The logistics sector mentioned above can also be divided into different sub-sectors for each stage of the supply chain. New sectors may also emerge, such as data centres, where demand is constantly growing given the need for data storage.

1) Based on Europe's 25 largest markets in Green Street's pan-European market analytics coverage.

FIGURE 5. THE OPPORTUNITIES FOR SECTOR DIVERSIFICATION HAVE GROWN



The fragmentation of real estate sectors and changed needs of tenants, along with recent market dynamics, have caused a change in the way we have used and will use real estate. As a result, the correct balancing of a real estate portfolio has become even more important in order to appropriately address the changing challenges and opportunities.

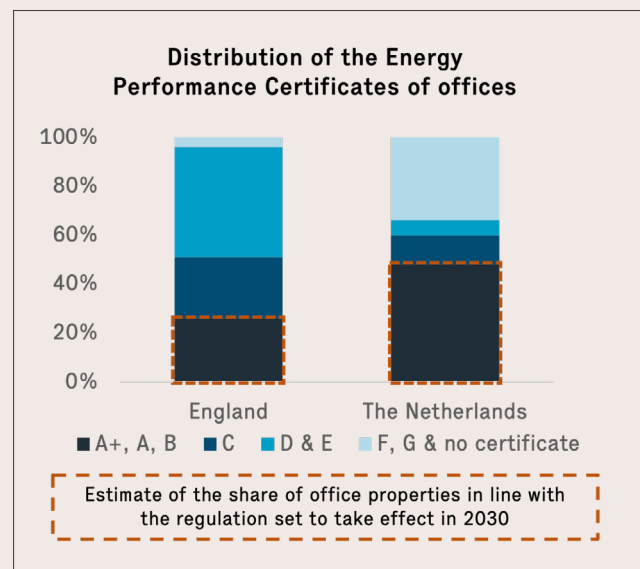
RESPONSIBILITY OFFERS MANY OPPORTUNITIES FOR AN ACTIVE VALUE-ADD INVESTOR

Responsibility affects real estate returns in a number of ways and is a vital component of generating strong investment returns.

Responsibility requirements have increased for investors, tenants and regulation alike, causing a strong distinction between green and non-green properties. Tenants' demands are focused on securing the best available offices and premises that meet the current sustainability requirements, and many tenants have set their own responsibility goals and targets. As a result, tenants are keen to understand the energy class of their rental properties and are willing to pay a higher rent to rent premises with a better energy efficiency rating.

Regulation naturally promotes green and energy-efficient solutions. In Europe, Energy Performance Certificates (EPC) form one standard that provide information on the energy efficiency of properties, and the United Kingdom and the Netherlands are leading the way in setting up EPC legislation aiming to improve the energy efficiency

FIGURE 6. REGULATION PROMOTES GREEN AND ENERGY EFFICIENT SOLUTIONS



of existing building stock. In the United Kingdom, for example, you can only rent buildings with an EPC of B or higher after 2030, whereas an EPC label “C” requirement is already in place for offices in the Netherlands. Furthermore, the availability of financing for non-green properties has tightened, with the requirements expected to further tighten. With this in mind, we believe that capital will be concentrated in green properties.

MAM’s strategy is to invest in properties, whose investment plans account for future carbon neutrality goals. In our international real estate investments, we use external partners with extensive resources and a strong track record in real estate investing.

In manager and fund selection, considering responsibility is essential in our investment analysis. As part of our investment process, each selected partner must pass a comprehensive responsibility analysis, which assesses, among other things, the compatibility of the strategy with our own responsibility goals, the role of ESG issues in the investment and risk management processes, the manager’s general responsibility expertise, ESG resources, management and relevant responsibility policies, as well as the manager’s membership in different RI organizations (e.g., UNPRI, GRESB).

CONCLUSION: THE REAL ESTATE MARKET CHANGES QUICKLY

The pace of change in the real estate market is fast, and we already see that these drivers of change will continue to affect the type of properties and facilities we will use in the future. We also believe that this pace of change also affects the returns of both core and value-add strategies in all market conditions.

Value-add investments benefit from these drivers of change as value creation measures can be quickly adapted and suited for the changed environment. Based on this, the capital market risk is smaller for value-add real estate than a core real estate investor, and the core investor is exposed to the risk that the properties become obsolete. As a result, a value-add investor is better positioned than a core investor in almost all market conditions.

Mandatum Asset Management has invested over €1 billion since 2007 in real estate investments that emphasize active ownership and management. Mandatum’s European Real Estate program targets value-add strategies across Europe and sectors with responsibility integrated in all investment activities. Our focus on future-proof properties provides clients with access to a highly diversified portfolio that seeks to generate attractive risk-adjusted returns across market conditions. This is particularly evident when accounting for the current disruption in the asset class and the pace of it.

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Mandatum Asset Management

Mandatum Asset Management (MAM), established in 2021, is a Nordic asset management company. MAM offers discretionary and consultative asset management for institutional and other professional investors and manages a variety of investment products within its core areas of credit, private equity, real estate and equity selection.

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