CASTLEFORGE PARTNERS

10 November 2020

Dear All,

We hope this research letter finds you well and keeping safe. The last six months have brought a whirlwind of change due to the Covid-19 pandemic. It has also been an extremely busy period for us in terms of investment activity and our ongoing business operations.

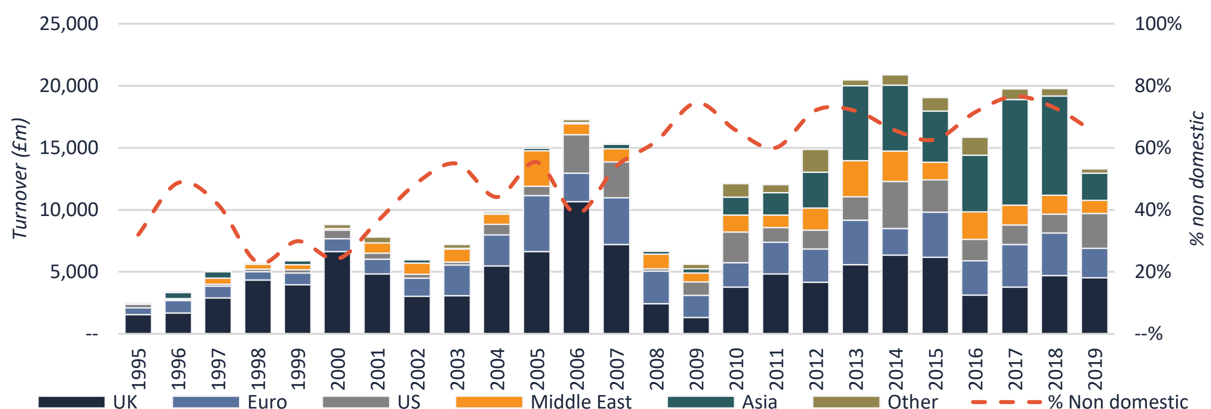
In this letter we open with a look at the influx of Asian capital into the West and what this means for the long-term prospects of the London investment market. Next, we look at how Covid-19 is likely to create a renewed opportunity for investment in offices in central London. We then explore some changes to UK legislation, specifically as these changes relate to Brexit and to the rules governing the UK's archaic planning system. We then round out with the weird and the wonderful: a discussion on the long-term effect of plagues and wars (a thousand years of history in less than 750 words!). We hope you enjoy it.

ASIAN CAPITAL – YOU (PROBABLY) AIN'T SEEN NOTHIN' YET

"Poker playing mainland billionaire can't get enough UK real estate" (Bloomberg 2020) is one of the more colourful articles we have seen recently, and one of many describing Hong Kong buyers rushing to acquire London assets in the context of political upheaval. Then again, "flight capital" to London is nothing new, and most importantly, we certainly are not prepared to rely comfortably on this trend when we underwrite London investment liquidity going forward. But there is more capital flowing in from Asia seeking income returns, than just "flight capital" looking only to preserve wealth – a lot more in fact. Asian capital averaged only 3% of total investment into the London market from 2000 to 2010, while that number had grown to 24% on average over the next decade. We believe that warrants a closer look at what is driving this increased activity in London to understand if there are structural underpinnings behind it. It would appear there are.

While billionaire poker players make great headlines, high net worth capital flows are tough to predict. Instead, we look to the larger institutional investors that can fundamentally alter markets through their allocation decisions, namely public and private pension systems. We found both long-term structural changes and policy changes have occurred recently in China, Korea and Japan. The scale of these changes suggests that the influx of capital from Asia may very well continue, in particular into alternatives – and will likely increase over the coming decade.

CENTRAL LONDON INVESTMENT VOLUME BY HOME REGION



China is a logical place to start due to its sheer size, and here recent pension reforms are changing the way overseas investment occurs. The asset management industry in 1998 had six firms managing $1.3 billion. Today it represents over $7 trillion of assets under management (AUM), according to Boston Consulting Group (BCG). The Chinese asset management industry is now the second largest globally and is projected to grow at a 10-15% CAGR over the next decade. The market for private pensions (and equivalents such as ISAs) is in its formative stages, but its size is potentially significant, as addressable retail investor wealth is estimated at $30 trillion.

And that should not surprise anyone. In as recently as 2008, at the start of the last financial crisis, the average Chinese worker earned $3,500 per year. Over the last twelve years, that number has increased to $10,300. Twelve years flies by in the West with not a whole lot fundamentally different and so, many of us forget that in the same time period nearly 800 million Chinese workers now have vast sums more that need to be saved and invested (and spent on things like leisure travel, but that's for another letter).

Moreover, in order to accommodate the needs of the pension fund industry, the government in China is changing policy in two ways that are likely to have long lasting effects on future allocations to London real estate. First, the pension system is being centralised and guided towards higher return profiles through the growth of the National Social Security Fund (NSSF), which unlike the Public Pension Fund (PPF) that can only hold government bonds and cash (to date), has no such restriction. It is growing rapidly as numerous regional pensions come under its control (50% of its mandates came in 2018), and now totals approximately $330 billion.

Second, the government is encouraging rapid development and professionalisation of the private pension industry. In April 2020, for the first time China allowed fully foreign-owned firms to directly offer Chinese pension and savings products. Aberdeen Standard Investments has begun to establish its presence in this market. Many others are following suit, and this is seen as an engine of rapid growth. According to Deloitte the asset management industry today, representing products ranging from those targeting high net worth individuals, sovereign wealth funds, insurance products, and pension savings, represents 4% of total Chinese wealth in 2017. It expects, however, that by 2030, this will increase to 10% of the national wealth in asset managers' hands, a number expected to total $17 trillion. This is roughly comparable to where the United States stood in 1990 and would make China the second largest market for asset management globally, behind only the US.

Elsewhere in Asia recent allocation decisions are also likely to result in more capital headed to London. In South Korea (a $1.7 trillion asset management market), the National Pension Service (NPS) in 2018 announced it would increase its ratio of risk assets (equities and real estate) to 60% from 50%, and overseas investments from 30% to 45%. Given the NPS managed $600 billion in 2019, this move alone represents an additional $90 billion shift to foreign markets. In Japan (a $2.8 trillion asset management market), the industry is being particularly affected by negative interest rates, while the population is the most rapidly ageing in the world. As a result GPIF, the government's pension scheme which manages approximately $1.5 trillion in AUM, was authorised to reweight its portfolio in 2014, and for the first time, in 2017, it set an allocation of up to 5% in infrastructure and real estate, representing approximately $75 billion. The rest of the Japanese pension fund industry has been moving similarly but even more swiftly, where the latest annual survey of corporate pensions showed alternative allocations are now at 20%, up from 13% in 2015, with 40% of respondents seeking to increase further.

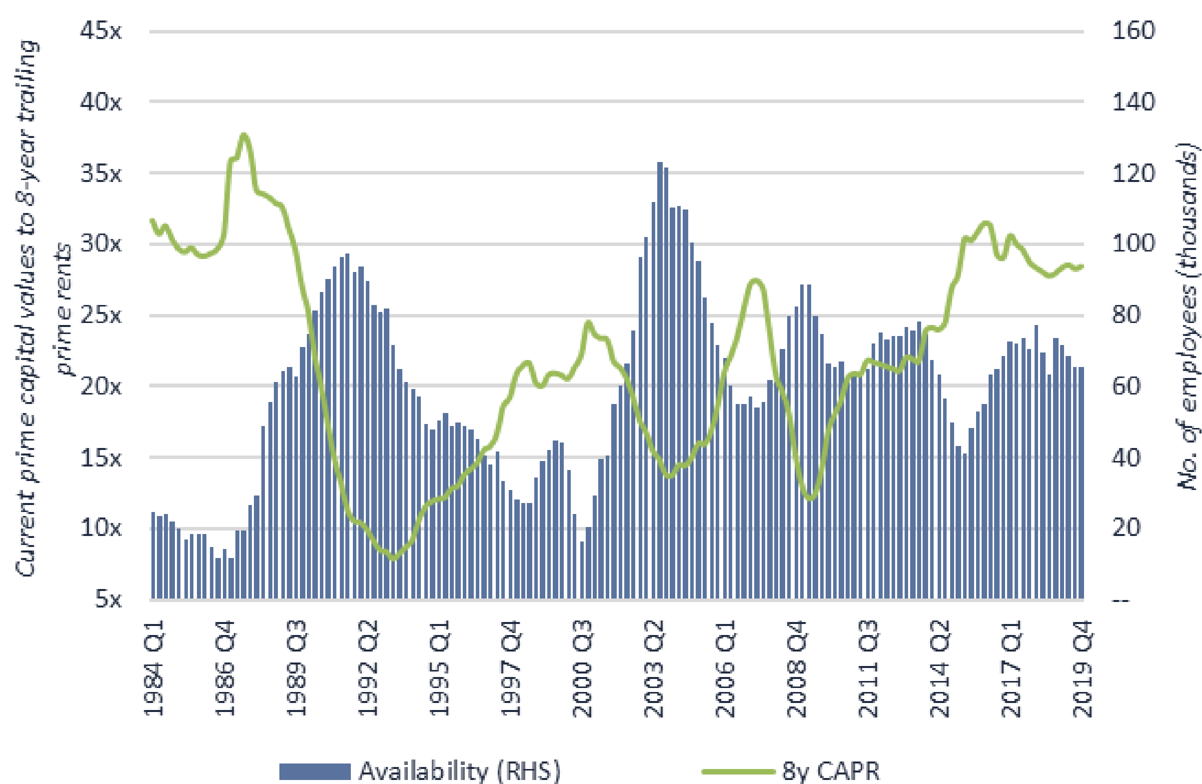
Finally, CBRE's 2019 tracker of global capital flows shows that 2.7x more Asian capital was invested in EMEA versus the US. This trend is likely to be heightened by the increasingly strained US/China relationship which recently has resulted in a noticeable drop off in Chinese investments into the US. Overseas investment can move fast to the most attractive global markets, and in the near term we think London is relatively well positioned structurally to benefit for a long time to come.

A RETURNING OPPORTUNITY IN THE LONDON OFFICE MARKET?

A recurring theme when we here at Castleforge attempt to prognosticate over the central London office investment market is that it is very hard to predict the trajectory of cap rates. On the one hand, London is a volatile market and is not immune to economic cycles that create cap rate movement. On the other hand, its status as a global city in an age of increasing global capital (see above) means that a structural shift downward in cap rates is likely to be ongoing, and where it stops is anyone's guess.

The pandemic has also changed the way people work. It is likely that the growth in home-working and more flexible working arrangements will continue, as will the evolution of the demands from employees over the type of offices and spaces in which they wish to work. However, the long-term effects of these changes, after only six months' worth of mostly anecdotes dressed up as data, are also very much unknown.

STILL ELEVATED: CFP'S CYCLICALLY ADJUSTED CAPITAL VALUE INDEX



What we do think we have a shot at predicting in the near to medium term is the movement in office space supply and demand, and the corresponding effect these factors have on forward rents. The Covid-19 pandemic has already reduced economic activity and placed substantial pressure on service sector businesses in London. The continuing economic hardship will inevitably lead to business closures and reduced office employment, and a supply-demand imbalance augurs for lower rents.

"Thank you, Captain Obvious," you may be saying.

Anyone with an ability to recall previous economic cycles will see that it is likely that tenants over the next couple of years will be dropping out of lease negotiations, re-negotiating the terms prior to actually signing or even reducing the overall amount of space they need in the first place. It is also likely that "shadow space" (available space controlled by tenants looking to sub-lease) will be delivered onto the market to undercut landlords. And then there is the forthcoming wave of construction projects which are due to be completed over the next few years: as of Q1 2020, space under construction had risen by 30% in London, just as Covid-19 struck, to within 10% of all-time highs over the past two decades. Overall,

the reduced demand from tenants and increased supply of new construction will contribute to lower office rents in the near-term.

But this is where we come to the prevailing market "narrative" and where we take a different view. One of the most powerful human motivations is to make sense of the world, and to understand why things are as they are. We believe investors will harness their innate desire to make sense of falling rents by creating a narrative around the fact that working from home and remote working will have permanently changed the demand for office space (a) in general and (b) in an "expensive" market like London, such that the new rents reached when the cycle bottoms are, or are at least close to, the justifiable long-term equilibrium rental levels. Because in this scenario, the expectation is that rents are justified as they are, valuations will reflect these rents then capitalised at equilibrium cap rates. £65 per square foot capitalised at 5% going to £50 per square foot capitalised at 5%, permanently in many investors' minds, is a nearly 25% fall in capital values.

But is that narrative likely to be fully right? We don't think so.

London is a global gateway city – by many measures THE global gateway city. It is the powerhouse of the UK and broader European economy and a major destination for investment capital, and has deep pools of high-quality talent, Europe's best universities, the highest rate of graduates in Europe, more specialised businesses, and a competitive advantage in financial services as well as other industries. Its overall structural importance, and its underlying strengths, will not have changed as a result of the pandemic in the space of two to three years.

Furthermore, we believe that many investors will be overestimating the impact that working from home and changes to the office environment will have on office space demand. Many readers will be familiar with our study of real estate spending as a proportion of employee salaries, which at 5-10% for London, may not be material enough to justify massive upheaval in firms' real estate strategies. On the contrary, comments by Microsoft CEO, Satya Nadella, and Netflix CEO, Reed Hastings, have stressed their concern regarding the health and wellbeing of their employees and also the limitations of working from home on productivity and innovation – the lifeblood of economies and businesses. Let us not forget that London (and all other cities) have been dealing with shrinking real estate requirements per employee for nearly a half-century now, with the average square footage required per employee falling **by half** from 1990 to 2015, and yet many office owners have made fortunes over that time period.

And finally, the cost of building new stock in London is at a level in which permanently lowered rents will deter investors and developers from replacing old stock or building anything new. Just like it did in previous cycles, the cut-back in building will stabilise rents and then create rental growth from the bottom.

BREXIT: A PROCESS, NOT AN EVENT

Given the impending December 31st deadline for the UK to reach a deal with the European Union, all in the midst of a UK lockdown just announced a few days ago, we thought we would return to a discussion on what has been the all-encompassing topic for the UK for the last four years.

Since the referendum, two Governments have fallen, while in the same period the UK Civil Service has been running to catch up with the demands of onshoring the EU's legal framework, updating regulation for all industries, planning for trade and service disruption and busily trying to secure new trade deals. In the wider societal discourse up to nearly the end of 2019, the UK has remained divided on this topic, with active and passionate Remainers and Brexiteers willing to fight on, robustly sticking to their views as to the best course of action. But despite the ongoing political divide, most people simply wanted to end the uncertainty. A key reason why the Conservative Party swept to victory in December 2019 was based on a simple promise to "Get Brexit Done".

However, therein lies the problem for the government and for the UK. Brexit is not a single event which will be completed on 31st December this year. Rather, it is a process of redefining the UK's identity and its relationship with the EU and the rest of the world. By the very nature of the challenge of reversing

the influence of over 50 years of European integration, Brexit is likely to be a constantly evolving process over the course of the next decade, if not longer.

One key issue is that it will take time to build the legislative capacity and framework to replace the role that many EU institutions played. For example, the UK's financial services industry has world leading regulators, but the UK Parliament will not have the same resources, experience, oversight mechanisms or level of scrutiny needed to hold regulators to account in the short-term. This remains true across the whole UK economy, from fishing to manufacturing to technology. Consequently, many of the regulations governing the UK made in Brussels will remain in place long after 31st December of this year and very likely, until the UK Parliament can build up the expertise to create and scrutinise the regulation of different economic sectors.

Another key issue, and former feature of the Brexit debate, is the UK being able to create its own global trading arrangements. To date the EU has signed over 40 trading agreements with 70 regions around the world which the UK is able to access. Since the UK voted to leave the EU nearly four years ago, the UK has rolled over 19 trade deals with 50 countries, which is not too bad even if there is more to go. The UK government is also looking at rolling over or building on the EU's agreements with Mexico and Canada as well as negotiating trade deals with the US, New Zealand, and Australia in addition to the deal recently signed with Japan. "With what immediate resources?" ask many informed parties, highlighting that the reversal will take time and many rules and regulations of the EU are ingrained within the fabric of the UK economy, and will continue to remain so for the near term.

As the title of this note suggests, Brexit is a process not an event. It will take time for the UK to reverse the integration of the EU on the UK economy. Many of the existing rules and regulations governing the economic life of the UK will remain in place in the near term and will be likely built on, in both a deal and no deal outcome. Bringing these factors together the UK is likely to continue to experience economic and political uncertainty in the near- to medium-term. As real estate investors, we aim to see the signal in the noise and remain focused on creating long term value, regardless of what the economic and political future may hold.

PLANNING FOR GROWTH?

The UK zoning system ("planning", in UK terminology) is, by many accounts, broken. According to the Prime Minister, Boris Johnson, 21st-century England is "being artificially constrained" by an "outdated and ineffective planning system" created in 1947 which "is no longer fit for human habitation."

We broadly agree with the Prime Minister. Back in 2016, Adam wrote a white paper highlighting the structural issues inherent within the UK's planning system (available if anyone wants a weekend read, plus Mike is finding that it doubles up as an alternative to the Three Little Pigs for his 5-month-old's bedtime). Because its use classes are so rigid and so hard to adjust, and because each planning permission is granted at the discretion of the local authority, the existing system has a limited ability to quickly adapt to new sources of demand: supply is thus "inelastic" in response to demand. Indeed, as a result, over the last half-century, house price growth in the UK has been faster in real terms than in any other OECD country and has far outstripped UK earnings growth.

The proposed new system will require local authorities in England to divide their areas into zones, which will then dictate what can and cannot be built in these areas. Developers of new homes, offices and shops will have automatic permission to build in so-called "growth" zones. Developments on so-called "renewal" land will receive permission in principle, while development sites on "protected" land will be restricted. The government's view is that a rules-based system will remove many of the delays to development since the starting presumption will be that building is permitted, a major change from the current system where the starting presumption is that it shouldn't be. "Why?" turns into "why not?".

Conceptually the government's proposed legislation could be a major step forward for developers in England. However, the devil is in the detail. The core assumption is that this system will bypass the local council's role in allowing or restricting development. Local authorities will now have two and a half years to review and put in place the local plans required by government to zone areas. The danger (almost certain to be the case) is that the resulting approval process is not as effective as envisioned or becomes

politically charged, which could result in similar delays and difficulties in navigating the new zoning system as seen today. It is also likely that the establishment of many of these local plans themselves will be delayed due to resource constraints, resulting in further blockages in the process of unlocking land for growth and re-development.

Bringing these ideas together, several questions regarding the future of developments across the UK can be considered. Will out of town shopping centres become new office buildings or logistics parks? Will warehouses and old offices become new residential homes? Will adaptive reuse finally be a more common path to asset repositioning than it has been in the past? The government's response is clearly, a hopeful yes, with developers and investors giving old town centres, retail parks and city centres new leases of life.

We do believe the new zoning system is a good step forward, but its success will be dependent on its implementation. We will be monitoring the outcome of the resulting legislation, since any once-in-seventy-year changes to land use policy will likely affect everything from building costs, business plan timing and development supply constraints that have knock-on effects on commercial rents and house prices.

REVELATION AND INTEREST RATES

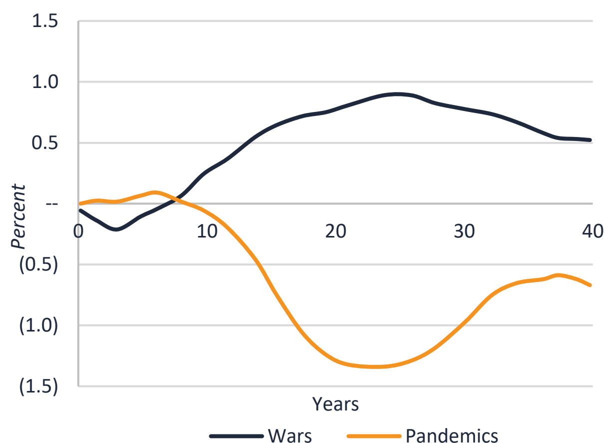
Recently, Mike was speaking on a real estate panel and one of the guests asked what his thoughts were for how Covid-19 will affect interest rates over the coming decade and beyond, and for the first time in months, Mike was left with virtually nothing to say. Moreover, the inquisitor was interested in knowing how the panel thought the answer to the first question would have an impact on real estate capital values in their portfolios. One of the panelists – this being the home of Monty Python – retorted: "African or European Covid?".

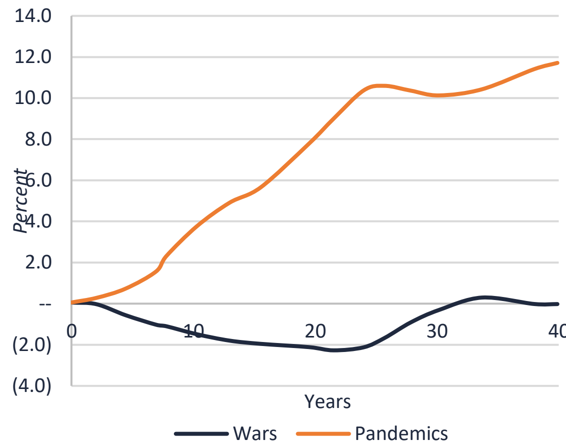
Afterwards, Adam told Mike he simply should have been a better student of history.

It is self-evident that plagues and wars have had devastating effects, have changed societies and have altered the course of history. Historians suggest that anywhere from a quarter to a half of England and Germany perished during events like Black Death and the Thirty Years War, and there have been longer-term psychological effects and changes to major institutions, such as the end to serfdom in England as a consequence of the plague. However, in keeping with the current zeitgeist (if Revelation were re-written we are sure there would now be a fifth, dark-green horse complete with a central banker sitting on top wielding a money press) we did actually want to explore how these two horsemen of the four have affected rates of return over the long run to see if we could draw any conclusions.

We can therefore thank Òscar Jordà, Sanjay Singh and Alan Taylor for an answer. The trio note in their recent working paper "Longer-Run Economic Consequences of Pandemics," from June 2020, that governments are likely to take the same response to combat the shocks of war or pandemics, namely higher borrowing and fiscal stimulus to deal with the immediate objectives, and to smooth the economic shock. What is different, however, is in the post-event phase, as the responding equilibrium on interest rates, real per capita GDP and wages vary depending on the nature of the crisis.

The authors' conclusion was that unlike pandemics, wars destroy capital, and therefore following wars, interest rates tend to rise as capital stocks need to be rebuilt. Wars tend to leave real rates of return elevated for 30-40 years in the period after the conclusion of a conflict, as seen below.





Conversely, the authors tell us that after a pandemic, the real natural rate of return on assets declines for years thereafter, reaching rock bottom about 20 years on, with returns about 150 bps lower than had the pandemic not taken place. This makes intuitive sense when one considers that a pandemic likely increases desired savings per capita, and, perhaps in response to increased level of precautionary savings measures, diminishes the opportunities for consumption.

Indeed, as the Bank of England stated in the August Monetary Policy and Financial Stability Report, negative interest rates in the UK are being considered for the first time ever.

One key point which is worth mentioning is that the Covid-19 pandemic is far different to those that have come before. Although devastating for those who have lost loved ones and the many more who have seen their lives put on hold, as it stands the death toll globally is not as significant as previous pandemics. For example, the Spanish Influenza killed between 20-50 million people across the globe and as the global population was smaller, at less than one-quarter of what it is today, the percentage difference in deaths is more significant and impactful. Consequently, the effect on labour productivity is likely to be lower relative to that from other pandemics.

At the end of the day, this is all a bit theoretical even if it is interesting and gets our brain waves moving. The number of unknowns and difficulties facing the global economy and central banks and investors is clearly vast and the right solution is far from clear. Consequently, trying to predict the medium to long term effects on rates is incredibly difficult. Instead, we at Castleforge focus on building the highest cash yield on cost possible when it comes to operating our assets. Because sustainable cash flow is the real reason long-term holders of real estate get into the game in the first place, we know that if we build that, investors will follow, regardless of where interest rates go.

CONCLUSION

We hope you have enjoyed this letter and we hope it has been informative. As always, we are delighted to discuss any of these topics in more detail, so do not hesitate to get in touch. Despite the current and ever changing economic, social, and political environment, we believe there is still some room for optimism going forward.

As Charles Darwin said, "*it is not the strongest of the species that survive, not the most intelligent, but the ones most responsive to change*".

Best Regards,

Brandon Hollihan	Mike Kovacs	Adam MacLeod
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