

# The Magic of Real (Estate) Diversification

Stockholm (HedgeNordic) – Real estate is increasingly becoming a significant element of asset allocation among institutional investors with long-term focus. “Even before the Covid-19 crisis, institutional investors had seen real estate as an integral part of their portfolios,” says Jarkko Lehtonen (*pictured*), portfolio manager at Finnish real assets-focused asset manager United Bankers. “I believe that this trend will continue,” he adds. “The investment appetite is definitely there.”

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Relying on an open-ended structure, UB Nordic Property Fund has built a well-diversified portfolio of core plus commercial properties across all Nordic countries to provide investors the opportunity to enjoy real estate returns. “A core plus strategy involves taking a bit more risk than a core strategy and going up the risk curve by investing in secondary locations,” explains Jarkko Lehtonen, portfolio manager of the UB Nordic Property Fund. “The additional risk associated with these secondary locations is counterweighted by long-term leases with very good tenants,” adds Lehtonen.

## Diversification Source One: Geographies

UB Nordic Property Fund owns a well-diversified portfolio of 46 different properties that generate steady cash flows for the fund and its investors. “In our core plus strategy, we want to give our investors the stable rental income the properties in our portfolio generate,” says Lehtonen. The stable return source has been an important marketing point of this fund, as was diversification. “When UB Nordic Property Fund was launched in 2016, the fund was meant primarily for Finnish non-professional and professional investors, who already had exposure to Finnish real estate,” explains Lehtonen. “The idea was to provide these institutions exposure and diversification to the other Nordic real estate markets.”

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UB Nordic Property Fund’s property portfolio, which has a market value of €330 million as of the end of September, has an exposure of 49 percent to Norwegian properties. Danish, Finnish and Swedish properties account for 24 percent, 15 percent and 12 percent of the portfolio, respectively. “The Norwegian property market has been interesting to the fund for many reasons,” points out Lehtonen, one of which revolves around the difference between the economic landscapes of Finland and Norway.

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“Looking at the macro picture, the Norwegian economy is very different from the Finnish,” argues Lehtonen. “While Sweden, Norway, Denmark and Finland appear to be fairly similar, the figures of the Norwegian economy are by far the best in the Nordics,” he continues. “Norway, therefore, provides the best diversification for our Finnish investors and the same logic applies for Swedish and Danish investors.”

## **Diversification Source Two: Property Types**

“We hold different types of commercial properties, that is the whole idea behind a very well-diversified portfolio,” says Lehtonen. The fund has roughly 51 percent of its portfolio invested in logistics properties, 37 percent in office properties, nine percent in retail properties and the remainder is invested in one plot. “During these past two years, we have been most active in the industrial segment, consisting of logistics and production facilities, which turned out to be great, especially in light of the ongoing pandemic,” asserts Lehtonen. “Investors are focusing on logistics, that’s the golden egg.” According to Lehtonen, the need for modern logistics facilities is pressing in the Nordics.

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The retail segment of the property market, on the other hand, has been under stress for much of the past decade. E-commerce has been steadily growing over the past decades and the Covid-19 pandemic has accelerated the shift. With an increased share of work being done remotely, property investors are also worried about the impact of the pandemic on office properties. According to Lehtonen, however, “offices have been under change all the time and the work-from-home trend has only added to the headwinds in the short-term.”

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The future of offices is still under debate, considers Lehtonen, who questions the notion that Covid-19 will “kill” the office. “This pandemic overemphasized the change that would come,” points out Lehtonen. “Of course, one may observe a change in how a customer uses office premises, but in the longer term, I do not expect to see a future where companies do not need offices anymore. These trends had been there before, they just gained more speed during the coronavirus pandemic.”

## **Open-Ended Structure, Liquidity Mismatch and No Speculation**

Institutional investors tend to have an extended investment horizon and real estate properties are often suited for such long-term-oriented investors. Occasionally, however, cash is scarce and there is great demand for liquidity. The open-ended structure of UB Nordic Property Fund enables investors to exit investments on a quarterly basis. “These open-ended alternative investment funds in Finland are attractive because they offer liquidity to investors,” asserts Lehtonen.

“The higher liquidity is a good thing for investors but represents a bit of a challenge for the fund managers. Because real estate is not a very liquid asset class, there is some degree of liquidity mismatch there,” points out Lehtonen. This liquidity mismatch, however, did neither pose a problem for UB Nordic Property Fund during the cash-strapped environment in the first quarter, nor during the uncertain period that followed. “In the Covid-19 crisis, our worst quarter in terms of redemptions was the end-of-June quarter, but we only had a few million euros in redemptions,” says Lehtonen. “We managed to communicate to our investors that our vehicle is a long-term investment and there is no point in worrying about short-term fluctuations.”

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The open-ended structure also enables Lehtonen to build a growing, more diversified portfolio of properties with an attractive risk-return profile. “In a closed-end structure, you are quite exposed to

timing [the market]: you have to start buying immediately after raising the capital and then required to sell all the properties at some point," says Lehtonen. With an open-ended fund, both new and existing investors have the opportunity to get exposure to an increasingly more diversified property portfolio. "A bigger fund size definitely helps, in the eyes of the property sellers, the brokers and other actors in the market," acknowledges Lehtonen.

A bigger fund size also helps fundraising, Lehtonen points out. "Attracting investors with this kind of diversification is easier," he continues. "It is less of a leap for the investor to make that investment decision. I would not mind the fund to be twice as big, as it gives added value to both existing and new investors to have a larger, hence more diversified portfolio."

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In terms of what investors should expect from an investment in UB Nordic Property Fund, Lehtonen says that "every year we aim at paying out an annual dividend of up to five percent." The team running the fund has managed to pay out a that successfully for the previous two years. "That is something we want to continue on." Lehtonen and the team have managed to "build a very interesting portfolio," which has a weighted average unexpired lease term of 8.7 years. "Our initial yield is 6.3 percent, which is remarkably high. Once we leverage up, with our loan-to-property portfolio now leveraged up to 54 percent, we get a nice return on equity percent of 9 percent."

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"In our core plus strategy, we want to give our investors the benefit of stable income, without hard assumptions on the future value of the property," asserts Lehtonen. "We want to stress that your returns from this fund come from the real rental income rather than value appreciation," he continues. "Speculation is not how we play the game. We do not buy properties for an expected value uplift; we buy properties for their rental income potential."