At a global tipping point

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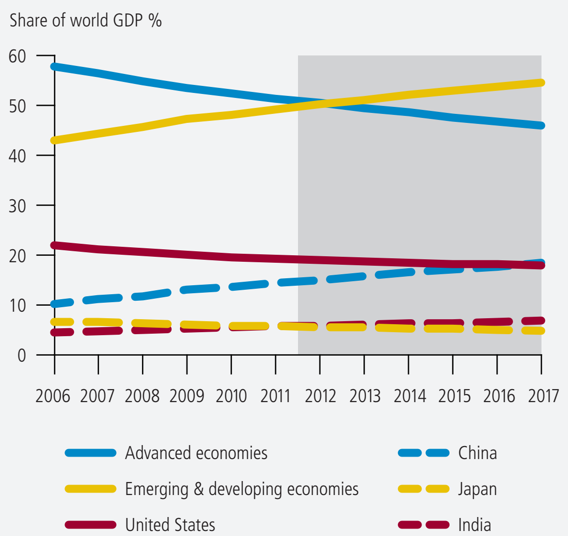
The real estate investment industry is at a tipping point in terms of its source of capital.

The shift in economic power from the more advanced economies of the G7 to the emerging and developing world has been well documented since Jim O'Neill, then the chief economist of Goldman Sachs, coined the term BRIC, in The World Needs Better Economic BRICs, a paper written in 2001 for Goldman Sachs' 'Global Economic Paper' series. What is now becoming increasingly apparent is the extent to which the years 2010 to 2015 will represent a pivotal point in this process of transition.

According to the IMF World Economic Outlook published in April of last year, developing economies are expected to have overtaken the advanced economies in share of world GDP from 2012 onwards (see Figure 1). In only a decade from 2007 to 2017, the share of world GDP of the advanced economies will have dropped from 55% to 45%, and by 2032 this will be 40%. The latest update of PwC's World in 2050, The BRICs and beyond: prospects, challenges and opportunities predicts that the seven largest emerging countries could overtake the G7 countries as early as 2017 in GDP measured under purchasing power parity terms. This rapid convergence between these two groups of economies has been accelerated by the fact that the developed countries have been much slower to recover from the recession of 2008-09, whilst the emerging economies have been relatively insulated, despite some slowdown in 2011-12.

Figure 1: The rise of emerging economies



Source: IMF World Economic Outlook, April 2012

Tipping points

We are at a tipping point in terms of the world's middle classes; the people with spending power. In North America and Europe, the number of people regarded as middle class is broadly static. The picture is very different in Asia and other emerging markets, as shown in Figure 2.

Figure 2: The rise of the middle class 2010 to 2030

Region	2010 m	2030 m	Growth %
Europe	668	679	1.6
Asia-Pacific	562	3,228	474.6
North America	342	322	-5.6
Central & South America	184	313	69.8
Middle East & North Africa	110	234	113.0
Sub-Saharan Africa	32	107	233.0
Total	**1,898**	**4,884**	**157.3**

Source: European Environment Agency; OECD Development Centre; PwC

We have also passed a tipping point in the process of urbanisation, where for the first time in human history more people live in towns and cities than in the countryside. According to the UN population statistics, the proportion of the world's population living in towns and cities reached 50% in 2010. In 1950 it was 29% and by 2050 it will be 69%. Over the next 30 years, approximately 1.8bn people are expected to move into cities, most of them in Asia and Africa, increasing the world's urban population to 5.6bn. By 2030, around half of the world's urban population will be living in Asia.

Finally, we are at a tipping point for ageing population. According to the latest UN population statistics, the median age for the advanced economies has just passed 40. For the first time there are now more people in the developed world over 40 than under 40. The developing world is ageing too, but will remain materially more youthful than the developed world throughout our lifetimes. The process of ageing in the developing world is bringing more people into the workforce rather than out of it.

The impact of a growing Asian middle class

A young, urban, middle class in developing Asia will become the dominant source of investment opportunity and capital. The real estate industry has already woken up to the fact that this new middle class will want to spend in shops, buy houses, use banks and other service providers, who operate from offices driving the demand from occupiers for buildings. They will also want to invest and provide for their old age, creating a demand for new investment products, new distribution channels, new sales and marketing needs. The broader life insurance and pensions industry will change dramatically over the next decade. The real estate industry needs to adapt too to match the changing business model of those who provide for old age.

According to PwC's Life insurance 2020: Competing for a future, urban populations tend to have a higher demand for insurance and other financial services. In the case of life and pensions, the factors contributing to this include greater exposure to financial products and the need for life cover when taking out a mortgage. Family sizes also tend to go down as people move off the land and into confined cities. This leaves people with fewer children to support them in their old age and therefore increases the need for pensions and life cover.

Many of the emerging economies have relatively low insurance penetration, thus representing an attractive opportunity for insurers at a time when they are facing challenges of a very mature market in the developed economies. The impact of ageing populations is putting significant pressures on traditional life insurance and pension products.

At the same time, regulatory change, particularly in the EU, is compounding the unattractiveness of products where the obligations and investment risk sit on the balance sheet of the provider. In the EU, the Solvency II will have a major impact on the way in which European life insurance companies consider real estate as an asset class. The impact will extend with the introduction of equivalent regulation for pension schemes in the form of the updated Institutions for Occupational Retirement Provisions (IORP) Directive. In mature markets, these pressures are driving a significant shift towards defined contribution retirement provision. In the newer markets, defined contribution is likely to prevail from the outset.

Real estate in a defined contribution world

A predominantly defined contribution world creates significant challenges for real estate as an asset class. In the UK, defined contribution retirement arrangements are invested largely in more liquid assets. Any real estate investment is generally in shares in REITs or open-ended funds offering daily redemptions. The report, Unlisted funds – lessons from the crisis, commissioned by AREF, explored the trade-off between liquidity, volatility, performance and risk. Providing investors with the freedom to enter funds whenever they wish is likely to be dilutive in terms of performance, as is the holding of uninvested cash in order to maximise liquidity for managing redemptions, although this liquidity may never be used. There is an interesting debate as to whether the apparently overwhelming urge of defined contribution retirement plans to invest in liquid assets is strictly necessary, with an even more interesting one as to whether this will be replicated in emerging markets.

A different approach to pension investment?

The 'anaemic' return available on low-risk, liquid investments is encouraging further the already developing trend for pension providers to look at managing return and risk over the lifetime of the policy. Investment in low-risk assets may be a necessity in the later years of a policy, but is unlikely to provide an attractive pension if held throughout. An approach of investing in higher-risk, higher-yielding, longer-term assets in the early years of a policy then moving to lower-risk investments later on provides a managed approach to risk and return over the life of the policy. In this scenario, real estate, is a more attractive asset for younger policy-holders further from their retirement date, and we might therefore expect policies held by the young, urban middle-class in developing Asia to be invested to a greater degree in more illiquid, higher-risk assets than the policies of the ageing populations of the mature markets.

Opportunities for real estate managers

Many of the big international insurers are looking at how to better tap into these emerging pools of capital, and this should provide opportunities for real estate investment managers. Local insurance players are also gaining in strength and looking to broaden their horizons. Increasing liberalisation of insurance regulations coupled with some harmonisation, should increase the opportunities, e.g. until recently Chinese insurance companies were not able to invest in real estate as an asset class. They are now able to invest in commercial real estate domestically and internationally. Media speculation regarding a possible acquisition this month of the Lloyd's Building in London by Chinese life insurance company Ping An is the first evidence of what are likely to be many overseas forays by Chinese insurers.

As outlined above, this economic growth and demographic change in the emerging markets will create investment opportunities, but also a pool of investment capital. Exploiting either or both creates enormous challenges and potentially requires new business models. Technological change and the demands of sustainability will create challenges, but also very significant new opportunities.

All of this raises a huge question for the real estate investment management industry in the advanced economies. If the major investment opportunities and the dominant source of investment capital will increasingly be in the emerging economies, what is the role of the real estate investment management industry in the developed world, and in the UK in particular? At both the asset level and the investment product level, the opportunity is innovation. If the industry is able to create the funds and investment products to attract the new sources of capital and is also able to channel it into innovative new investment opportunities, then we can be optimistic about the long-term future of the real estate investment management industry.