

# Finding Real Value in Real Assets

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In their search for yield in a low-yield world, institutions invested heavily in real assets in the post-recession years. Now rates and inflation are on the rise. What are the implications for real assets? Cathleen Ellsworth, Managing Director, BlackRock Real Assets, Global Energy and Power, and Ben Young, Managing Director, Real Estate, discussed the new landscape at the 2018 Canada Investor Summit in Toronto – and made it clear that higher rates are only part of the picture.

## Opportunity in rising rates

With yields on 10-year U.S. Treasuries breaking through the psychologically important three-per-cent level recently, real estate and infrastructure might be looking less attractive as sources of steady returns. But even in that environment, Ellsworth and Young said that there remain opportunities and advantages in real assets, but finding them requires close analysis and on-the-ground knowledge.

Ellsworth acknowledged that higher rates may raise the bar for expected infrastructure returns in general, yet in some energy-related sectors, “rising rates can be an advantage.” For instance, in U.S. utilities, investors might be able to secure a higher rate base as interest rates rise. As well, other benefits of infrastructure exposure “have nothing to do with where interest rates are today or tomorrow,” noted Ellsworth. “They have to do with diversification and the lack of correlation with other asset classes.”

Young noted that three key factors determine real estate values: income, income growth and capital formation. All three, he added, remain relatively stable, noting that inflation means the economy (and incomes) are growing. Meanwhile, long-term rates at around 3.5 percent are still low, and real estate trades are hovering around the 20-year average. In short, Young said, “we actually see real estate as a good inflation hedge.”

## Technological disruption

Innovation is leaving a big footprint on hard assets, Young noted, and nowhere more so than in retail real estate, where the e-commerce giants like Amazon are a disruptive force. Even as malls struggle, however, there are opportunities. For example, Young said, Amazon has begun using Whole Foods locations (it bought the grocery chain in 2016) as “phantom distribution centres” for its

e-commerce shipments. In the United Kingdom, he noted, services have arisen to rent out empty retail stores on a short-term basis to pop-up operations. "This is not your parents' real estate anymore," Young said.

In energy, technology has also "transformed the landscape," Ellsworth said. The commodity price shock of 2014 spurred innovation, which has led to cost efficiencies throughout the conventional energy value chain. Meanwhile, advancements in renewables technologies "has been tremendous, whether it's efficiency in solar or in wind turbines." Those are driving costs down, creating opportunities for higher returns.

## Demographics a long-term tailwind

More than half of the world's population now lives in urban areas, but the trend toward urbanization still has a long way to go. That structural demographic shift is transforming the energy mix throughout the world, but also in developed markets, Ellsworth said. Much of energy infrastructure is about connecting the product with the end user, and the potential lies in delivering the new energy mix to consumers. In Maine, for example, natural gas supplies only about 25 percent of power - and much of the rest is generated with wood. Urbanization, Ellsworth argued, provides "a great opportunity to bring gas in - power that is cleaner, faster and cheaper."

As for real estate, the ramifications of urbanization are clear, said Young. Because income and income growth drive real estate values, "we would much rather be in cities where you might have a little lower yield but income has upside," he added. "Key urban cities are central to the way we think."

In finding opportunities, both Young and Ellsworth emphasized the need for investors to leverage in-depth knowledge of local conditions, economics and management. "We have asset managers embedded in our team - people who come to work every day in steel-toed boots," said Ellsworth. "These are real assets, and they have to be managed well."

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