ImmoFinRE Investment Outlook

July 2023

Overview

Early last year, although there was an expectation that interest rates would rise, it was widely held that this would be a limited response to the short-term supply-side bottlenecks occuring after a post covid demand surge. The outbreak of war in Ukraine and subsequent tightening of energy and commodity supplies was again initially seen as a short-term shock that would abate in time. It is now clear that inflation expectations remain stubbornly high.

To the degree that central Banks appear more concerned with maintaining their inflation beating credentials and have firmly stated as such, and will keep a hawkish response until inflation expectations fall off and the data shows a sustained drop in core inflation. We had hoped that this would mean short term interest rates peaking in the US at around 4-5% and slightly lower in the Eurozone, as much higher than that would likely cause a deep recession.

The market is accepting that the decade of low and negative interest rates since the global financial crisis is unlikely to return. Aside from the societal hazards of the quantitative easing policy – directing resources into financial assets rather than investment – it is more likely that structural inflation and negative *real* interest rates (which will help reducing sovereign debts at the expense of savers) will persist for some years. This ranges from macro issues such as the reshoring of supply chains to ensure critical inputs and energy security, to micro issues – such as tight labour markets in industries ranging from construction to healthcare due to workers leaving the sector during covid or restrictive immigration policies.

Many institutions are being pressured into real estate sales by the "denominator effect", a somewhat odd effect caused by the fact that private real estate is priced on historic valuations which move much later than the listed market. As equity and bond prices fall, the allocation to real estate becomes too high and institutions sell real assets to rebalance their portfolios, leading to further price falls as too much supply comes to the market. This has been further exacerbated by non-listed open-ended retail funds being hit by a wave of redemption requests as investors seek to exit at yesterday's value – and a queue starts to build meaning that assets need to be sold to meet those future redemptions.

In the short term there have been property markets where the supply is so tight that rents continue to increase even as demand generally slows – notable examples being multi-family in the US and Canada, as well as distribution facilities in Europe and the US. The million-dollar question is how sustainable that will be as demand slows further. Retail property rentals continue to be challenged while office markets are seeing big differentials in location and specification.

Real estate yields in the US, UK and to a lesser degree in Europe have risen and continue to rise as lending terms have tightened, both in terms of availability and requirements for ample debt service cover. For sectors such as prime industrial where yields moved below 4%, there may be some stability in values given the rising rental environment, but even so values will fall as buyers need to accept a higher cost base in terms of equity required and cost of finance, and the likely assumption that yields will stay higher for longer. In the UK, prime industrial and logistics yields have moved from 3.25% to 5% over the last year, a 35% drop in value assuming level rental values. Interestingly, retail yields were already high and less impacted currently, mainstream office yields are also sliding as will be discussed

further. Yields in prime city centres are remaining low reflecting both the dynamism and long-term stability of these markets.

The developed world portfolios of the ImmoFinRE Funds have so far been holding their value remarkably well in this new context and, with a few exceptions, the net asset values reported by our managers have not shown material degradation – largely due to the facts that the portfolios (1) are exposed to low development risk (projects which face exploding costs) (2) comprise a great majority of existing assets with value-add and / or repositioning potential (many of which are leased) and which have been acquired often off-market at reasonable or attractive prices, and (3) have relatively low leverage estimated today at some 50% loan-to-value. There might be some downward adjustments to value of these portfolios in the coming quarters but we believe they will be temporary in nature given the resilience of the underlying assets.

This environmental context also offers, of course, attractive buying opportunities in the 2 or 3 years ahead with a combination of transitional strategies enabled through distressed entry prices.

Real Estate Public Securities

The repricing in public securities markets has swept up the listed real estate sector and in Europe the fall in prices has been severe over the last 18 months. By the summer of 2022 we started to recognise that the listed real estate sector offered interesting value compared with the direct market, which had only just started to feel the impact of rising operational and financing costs, reduced investment and capital markets activity, and softening values as a result.

The big question was whether the fall in the listed market presaged the oncoming fall in the direct market, or whether there was some pricing arbitrage to capture due to the sectors correlation with the wider securities market. Another big advantage we could see in the listed market was balance sheets strength, with most companies operating off significantly lower leverage (typically 30%) as a result of resilience planning post the 2007-2008 GFC. Contrary to pretty much all of the private investment vehicles we were reviewing (seeded and unseeded) that were still seeing 60-65% leverage as a crucial part of their business plan.

Companies with low leverage are in a strategically advantageous position in the current market, as they have the cash to take advantage of distressed opportunities, to manage capex programmes, and are not under pressure with refinancings in the coming few years. In contrast, many private funds with higher leverage are finding that they do not have the budget to implement higher cost refurbishment, and may have difficulties refinancing on shorter debt durations.

There are numerous listed real estate companies which are worthy of consideration, from the larger majors with market leading assets and operational depth, to smaller companies in strong sectors well placed to ride out this downturn in the market. It looked likely to us that some of the smaller cap stocks would become targets for the larger mega private funds with unallocated capital looking for value, and perhaps the recent acquisition of Industrials REIT at a 35% premium to its market price is a marker for further activity.

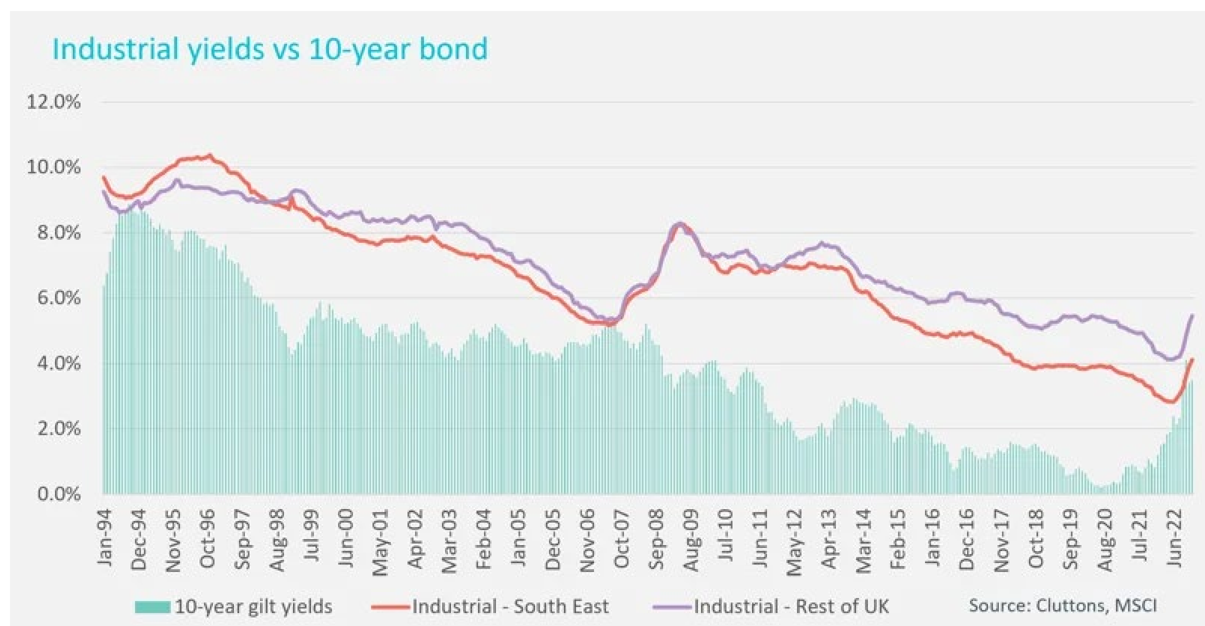
Industrial

The impact of supply chain adjustment both in Europe and the US is likely to be another tailwind for demand and rental values in the industrial market, for three reasons. Firstly, less reliance on just in time supply chains and more on inventory means additional space requirements. Second, dealing with returns from online sales is taking up an appreciable amount of space. These two factors alone are increasing floorspace demand by up to 20%, according to ProLogis.

Thirdly, as some manufacturing is re-shored from Asia to the US and Europe both for supply chain resilience and also due to political pressures – for example the extreme reliance on countries such as Taiwan for semiconductor chips is a “black swan” risk for all modern systems.

Hence although the market has repriced, it can still be considered a long-term growth sector which will limit the extent of yield softening.

The spread differential – illustrated by example of UK industrial yields to UK Gilts



Office market risks & ESG Agenda

There are few real estate markets that are immune to the rise in interest rates, which has been more pronounced in the US and UK markets compared with the Eurozone (and particularly Japan, where real estate yields to interest rates still offer an attractive margin). Office markets are under particular pressure, as the recovery from the forced “Work at Home” time has been patchy and impacting occupational demand, and we are coming to a period of refinancing based on weak revenues and higher costs. Furthermore, there is a real differential in the market – while good quality buildings in prime locations are faring well, the gap to grade B & C office is becoming markedly wider.

One of the key reasons for this is the increasing application of ESG principles into the built environment, and the complexity of office buildings make it a particularly challenging sector.

The world is changing – and the built environment needs to adapt as a consequence. This applies to both the physical and functional operation of an asset but also the infrastructure inputs into it and the workings of the tenants within it. And how do we measure the impact of development to a platinum standard with the resources used in the initial construction? Building a state of the art cold storage facility with no recognition of the power source used to power the building, or the impact of multiple vehicles using the facility, is not an acceptable option in this day and age. Investors are recognising the multiple stakeholders in an asset in a way rarely appreciated before.

We are seeing two attitudes from managers in their approach to the ESG regime. One approach is to adopt a defensive attitude, ensuring that assets are compliant with current regulations and keeping a base level of value intact. The second approach is a more active engagement with the issues at hand, to stay ahead of the curve, future proof to some degree the assets they manage, and obtain a pricing premium for the work entailed.

We are seeing an impact from the new ESG regime on the resources and asset management of direct private funds (less so of multimanager funds but with some impact). It is becoming evident that ESG reporting and coverage requires new hires and resources which are costly. As such, some smaller managers of direct funds (who may be highly competent in the old world style of investment) are being left behind by the larger managers (especially those with multi disciplines) who have the resources and strategic teams able to work out new operational and investment process. In the future we expect to include funds/property sectors such as forestry or rewilding which offer carbon offsets to some of the other positions.

The retail sector

There is a misconception that there is a simple substitution effect from physical retail to online shopping, especially visible during Covid, which may now have reached an equilibrium. It is much bigger than that, with online experiential retail unfolding rapidly, through social media apps with tailored marketing (for example the fitness app Strava has around 100 million international users, constantly being fed challenges sponsored and linked to predominantly online sportswear brands), to fashion and product placement through online media platforms such as Disney plus or Amazon prime, which users locate through interfaces such as Alexa and Siri.

Hence partly the reason for the many empty stores even in prime traditional retail areas, and desperate attempts to revitalise struggling shopping centres with leisure offer. Effectively many middle market malls will need significant conversion and capex towards mixed use destinations and values have in many cases reverted towards land value as a result.

In contrast, city centres such as London and Paris which benefit as world cities (the confluence of political, financial, culture is a powerful magnet) are seeing a significant rebound in visitor numbers as travel restrictions ease and cultural and business events open up. One of the central London stocks we are reviewing is seeing trading levels back to pre-covid, and rental levels are rapidly returning to trend. Very few locations can offer the same experience which consumers now demand when spending their more restricted income.

A note on Asia

Currency considerations have influenced US and Australian investors to invest in the UK, while similarly the fall in the Yen to the US dollar is attracting attention – particularly as inflation expectations in Japan have had little impact on short- or medium-term interest rates and as a result income cover ratios for real estate assets are still robust.

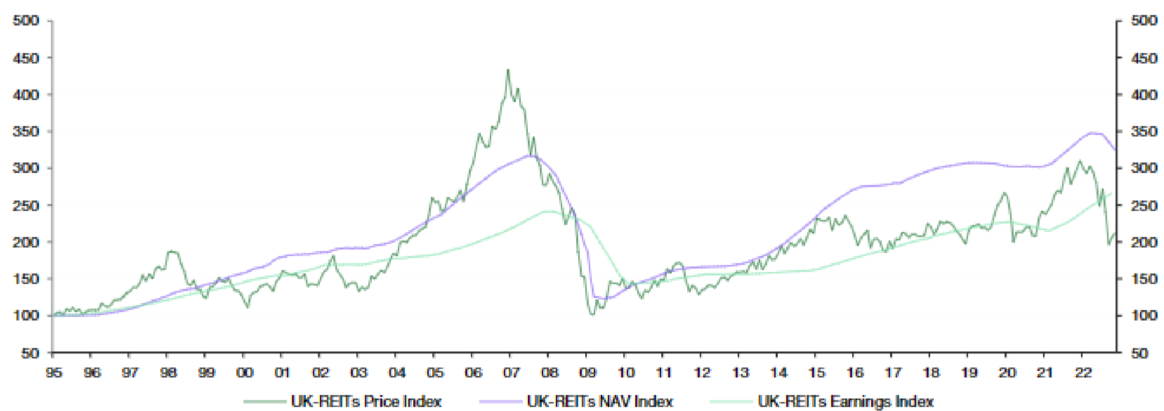
Japan is somewhat of an outlier in terms of the inflation / interest rate spiral and thus far has seen no movement in short or long rates, with inflation confined to the supply side shocks to energy and food prices rather than demand or wage inflation. Property yields have remained stable, and although rental growth prospects remain fairly subdued there is a lot of investor demand to invest in Japan – both for market stability and also as many institutional investors in Asia dial back from China and look at the other large investible markets.

Conclusions

Property values at the macro level have fallen in the second half of 2022 and are going to decline again in 2023, the severity depending on both the level of interest rates and depth of economic slowdown. This is reflected to a significant degree in both the price of real estate public security debt and equity. There will be a significant differential going forward by sector, and the wholesale repricing of the public markets has not recognised this is our view.

Office markets look most at risk from both the cyclical standpoint and also the escalating costs of the ESG agenda. There are many reports of institutional investors looking to offload office assets where they feel the capex costs of upgrading are too high, leading to further discounts on price levels. The same is true for some residential landlords but we consider the pressure to upgrade will be a longer process. To lease an office property now without green credentials is difficult given the availability of space, the same is not true in the residential sector. The cost of upgrading industrial property is meaningful but workable within current pricing levels.

Long term UK REIT prices v NTA & Earnings (Source Liberum)



Source: Thomson Reuters, Datastream, Company reports, Liberum estimates

We felt that this scenario was broadly priced into the listed REIT market, well ahead of the actual valuation adjustments in the actual market, and we approved an allocation to European REITs which was duly implemented in Q1. The sectors we focused upon included logistics and industrial, city centre London and Paris, and residential / student housing.

We believed these sectors where likely to prove resilient as the underlying fundamentals remained strong. As noted in our paper, the underlying supply side for industrial property is constrained, both in terms of new supply coming to market but also due to increased demand, as supply chains adjust to higher inventory levels, returns, as well as reshoring. While office demand in general has been weak since Covid and virtual working, key cities such as London and Paris have low vacancy levels, ongoing demand especially for modern and flexible space, while they also benefit from a rapid recovery in the tourism sector. Residential rentals have been rising owing to an undersupply of residential, in both typical rental blocks and specific subsectors such as student housing. We also are careful on residential allocation when there is increasing political pressure for interference in the housing sector, with often counterproductive measures such as rent controls.

Reported numbers to date on the operational side of these companies have all been positive. Industrial markets continue to see strong demand and take up, with rising rental values, and both company leadership and market research expect the occupational market to remain stable. Tourism numbers continue to rise and this is benefiting the hotel and retail/F&B sector in London and Paris. Residential house building in most countries is behind trend, and as a general rule overall construction levels are starting to wane as developers are fearful of the economic scenario and construction costs have increased dramatically in recent years (albeit this may now be starting to soften).

Crucially to date, labour markets have remained very resilient, and both Eurozone and US employment numbers have not only recovered but have well surpassed pre-covid numbers. However, we have seen that interest rates are veering over the level where we hoped they would peak, as policy makers are insistent that inflation be tamed even at the cost of economic recession. So the jury is still out as to whether the ongoing rate increases will in fact lead to a wider slowdown and impact on employment numbers, which would no doubt impact occupational performance in the property market. Initially no doubt this would be more impactful in office and retail markets but other sectors would no doubt also feel the pinch.

At the real estate market level the rise in rates, and also the spreads above to which new loans are referenced, is seriously limiting transactional activity, particularly in the US where loans are typically linked to the short end of the interest curve and spreads have widened to typical levels of 400 – 500 basis points for value add properties. The US office market is really suffering as US banks are reducing their typical LTV levels from 65% down towards 50% or lower, leading to defaults on refinancing.

The European lending market is far more stable at present. Firstly, post GFC European banks massively reduced the level of their loan books exposed to real estate, and wider market participants are being far more flexible on terms and refinancings. We have seen in our own portfolio ability to refinance whole loans on the private debt market earlier this year. Secondly, outside the UK where valuations tend to move on sentiment, limited transactional activity is reducing the impact of valuation decrease in the market.

Elliot Glausiusz
Chief Investment Officer
+44 75 15 58 56 79
elliot.glausiusz@immofinre.com

ImmoFinRE Group
9, Rue des Trois Cantons
L-8399 Windhof
Grand-Duché de Luxembourg