ImmoFinRE's November Outlook

Portfolio trends, market evolution and investments in sight

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As we head into the winter months, financial markets have been rocked again by the impact of the pandemic second wave, and the emerging optimism of the summer has been shaken by new restrictions and lockdowns. But with all the volatility in public markets, we are seeing some of the advantages of private markets where longer term decisions can be made amid a more stable capital base.

There are a number of recurring themes we have reported to you, our investors, since the start of the pandemic. Firstly, has our multi manger approach been resilient, due to its deep and broad diversification and locally focused managers, or will a storm of this nature necessarily wreck everything in its path? Secondly, we have focused upon the accelerated impact of structural changes in consumer and working behaviours on the retail, office and distribution sectors of the real estate market. Thirdly, we question our future expectations, and how we are planning allocation decisions and deployment of capital at present.

Resilience

Our approach to portfolio investment is to invest into real estate markets with identifiable long term fundamentals, while ensuring that our strategies have as little correlation as possible by sector, country, style, duration and leverage. This has meant limiting our exposure to the largest cap markets such as shopping centres and gateway city office towers, which tend to see the biggest impact from cyclical volatility, and focusing upon more locally driven markets and sectors.

While we have not been immune to the impact of the pandemic, there is a lot of resilience to our portfolio and we assess that 90% of our allocation is in low to medium risk strategies at present. For example, our cash flow yielding strategies in light industrial, suburban office, senior housing and grocery anchored retail are delivering real income dividends – and this highlights a real split in the real estate world at present. Assets yielding sustainable cash flows have become highly sought after, not only due to their attractive real estate fundamentals but because of their comparative value to long term bonds, and appeal to banks as lending opportunities.

As a result, the valuations of our assets are also showing resilience, as the investment market values longer term income security. We expect the market to continue to diverge, with little uniformity across sectors and geography, and asset allocation will be a key aspect of future performance as a result.

Structural changes & Sector Allocation

In contrast to the fairly consensus view on retail and industrial property, the outlook for the office sector is a source of much debate in real estate circles, and in this outlook we have looked in more detail at this market. There are a number of conclusions we draw:

- The pandemic has forced many companies to adopt remote working, and this seems likely to continue for some time – both as repeated waves of the pandemic lead to lockdowns, and due to office worker fears of mass transit commuting and a work environment often in dense office blocks not configured for limiting the spread of infection. With best estimates of a European or US regulated vaccine arriving hopefully by Q2 2021, and further time required to properly inoculate the medical professions and general public, this will impact the office market for some time to come.
  Of course there are exceptions to this – within our portfolio we have noted that suburban US office markets, for example, with low density coverage and where car travel is the preferred mode of travel; some of the Nordic markets with differing approaches to lockdown; Asian markets where they have been quick to re-customise office space and the working environment – we are still actively reviewing opportunities in these markets.

- Of equal concern in the short term is the weak outlook for employment in the service sector. With so many industries affected by the pandemic, and with government life support for businesses and individuals reaching both a time and financial limit, it would appear inevitable that demand for office floor space will take a double hit over the coming year.

- While lower interest rates are more of a stimulus than the fiscal support packages, there is little incentive for businesses in many industries, from travel and tourism to energy and hospitality, to invest for the future when they are in crisis mode. Although technology indices within the broader equity market are hitting new highs, which would bode well for economic expansion, they are not industries with enormous requirements for commercial or retail floorspace. The strength of equity markets feeding through to a recovery in the office sector will take longer than in a usual business cycle.

- It seems inevitable therefore that albeit with some nuance and geographical exceptions, the next 12-18 months will see office demand fall, leading to rising vacancy and falling rental values. This will make added value strategies difficult to execute during this period. Our concern is that the recovery after that will be slow, and the effects of remote working on the longer-term outlook are not really factored into pricing.

One subset of the office market which is seeing steady occupational demand and capital inflows from investors are the life science and medical office markets. They are characterised by a higher proportion of space for Research & Development work, with higher building and technical specification to reflect the user base. We have had positive experiences investing in the space, and last year committed further capital to this sector on the US west coast. Employment in the life sciences sector in the US is still 1% up on the year, with biotech R&D unsurprisingly leading the way in terms of growth.

Across the globe, shopping centre and mainstream retail property markets are trapped in a vicious cycle at present, with tenants in distress, rental income collection substantially reduced, and banks unwilling to extend loans to the sector. Within the European listed sector we have seen four major (and highly dilutive) equity raises come to the market to shore up balance sheets, with more likely to follow if the appetite is still there. It is difficult to draw a line under the market, as although one can make an assumption regarding a post pandemic consumer recovery, it is much harder to register the impact of the structural impacts of e-commerce on the physical retail real estate sector.

According to Greenstreet research, the e-commerce share of retail sales in the US will steadily increase to around 30% over the next decade, from 15% this year (a year which has seen a quantum jump due to the pandemic). As retailers adapt their cost base to online sales, there is no question that the level of supply of retail floor space has to reduce, concurrent with a fall in rental value, to get some equilibrium in the market. Although tourist driven city centres are likely to recover as international travel and tourism comes back to normal at some point, “main street” retail prices will see further downward movement. Land Securities, the FTSE 100 listed UK REIT, expects UK shopping centre rental values to fall a further 20-25% from March 2020 levels.

Not surprisingly, the momentum behind investor interest in the logistics and light industrial property sectors has similarly jumped in the last six months, although this trend has been in evidence for many years now. While we have been investors in the sector for many years, it is difficult to acquire new assets at attractive prices, given the weight of capital competing for assets. The listed industrial real estate companies are seeing premiums as high as 100% to NAV, reflecting the belief that valuations are light compared with the true market.

Future expectations

One of the oft talked about reasons for investing in real estate currently is the higher yield attainable at a time of very low or negative long-term interest rates. Is this a real arbitrage though, or simply highlighting that real estate should offer a higher risk premium given the material uncertainty over future cash flows?

We come back to our earlier point, that talking about the real estate market in general has become rather misleading. The changes being brought about structurally, and the impacts being wrought by the pandemic, have meant large differentials between different sectors of the market which are likely to take a number of years to play out.

Our first priority is to maintain a defensive stance in this environment and invest in markets where the sustainability of income has been tested and proven resilient. Currently, this includes residential, including multi-family and senior housing; logistics and light industrial. Secondly, we are reviewing real estate secured capital strategies, where we expect to see distress and high yields; and country strategies where the level of government support has been high, and where real estate markets have tended to recover quicker – we expect to increase our US allocation in the near term. Finally, we are considering selective managers with a proven value-add track record in more cyclical markets where we believe 2021 could be a good base year to invest.