A matter of synchronisation

The Q3 GREFI All Funds Index indicates that there has been a synchronised downturn in the performance of real estate vehicles across Asia Pacific, Europe and the USA. Across the world, rising risk free rates have pushed up discount rates and lowered capitalisation multiples. This synchronised negative performance is prevalent in other assets classes, including equities and bonds. At the same time the cost of borrowing has increased. So far, increasing mortgage debt costs are much more a reflection of heightened base and swap rates rather than a widening of credit margins.

Global real estate investors might have hoped to benefit from a policy of diversification across regions and countries at different stages in the economic cycle, so the degree of correlation is problematic.

Underneath the surface there are, however, bigger differences between the three regions than at first appear. There was a much sharper correction in the pricing of some assets in the USA and Europe than in APAC. In APAC, markets were more stable than the headline numbers, which reflect currency effects, suggest.

The UK witnessed some particularly aggressive re-pricing especially of industrial assets. This was not the case in Germany. Partly this was the result of differing underlying economic drivers and partly differences in valuation practice. In some cases, the outcome might have been similar if it was the practice of valuers to universally mark to market.

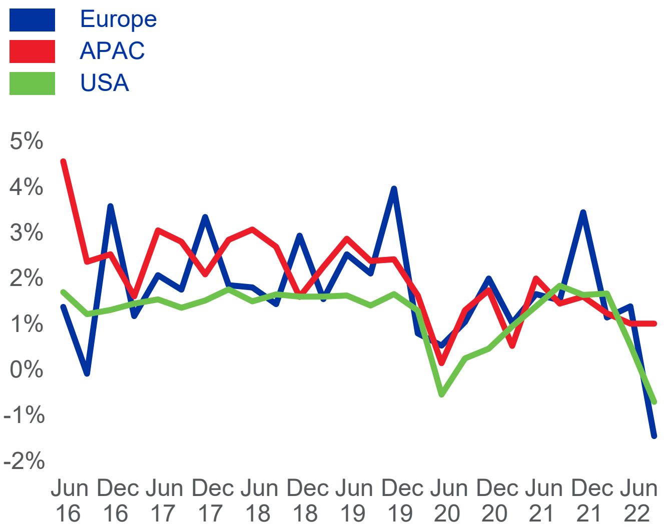
This diversity in valuation practice creates a potential arbitrage opportunity. If investors can exit without facing punitive pricing, they might consider switching out of funds where they feel that values have been maintained at an artificially high level and into funds that are characterised by aggressive re-pricing.

Compared to APAC, the performance of offices in Europe and the USA has been weaker. In the USA and Europe there is a growing feeling among investors that the office sector will require major capital expenditure if it is going to meet environmental and future tenant requirements. Consequently, investors are wary of the sector and there is a perception that values have further to fall.

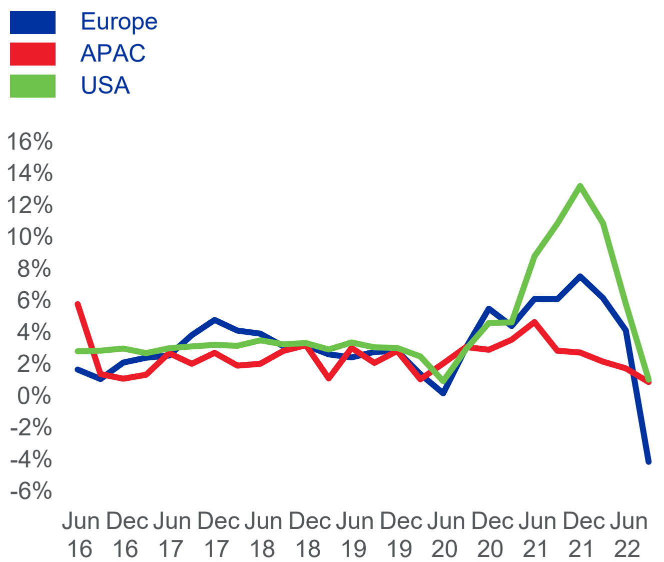
In APAC there are strong cultural factors supporting a post pandemic return to previous occupancy levels. Employees in Korea and Japan are abandoning working from home to demonstrate their work ethic in the office. But across the region there are notable differences between office markets.

Singapore is strong as businesses re-locate out of Hong Kong. Sydney and Melbourne are benefitting from a nascent rental recovery although yields have softened. And, rents in Tokyo are slipping back. It has been suggested that whilst the downturn has been synchronised, the recovery will not be. It is likely that the markets that corrected fastest will recover first. In Europe there is already some evidence of transactional activity at the new pricing levels for prime offices and industrials. Lenders are available for such stock as they still need to generate new business total return.

Office



Industrial & logistics - total return



Source: ANREV Asset level performance report for ODCE, INREV Asset Level Index and NCREIF Property Index.

Fast market correction may be needed to erode the denominator effect

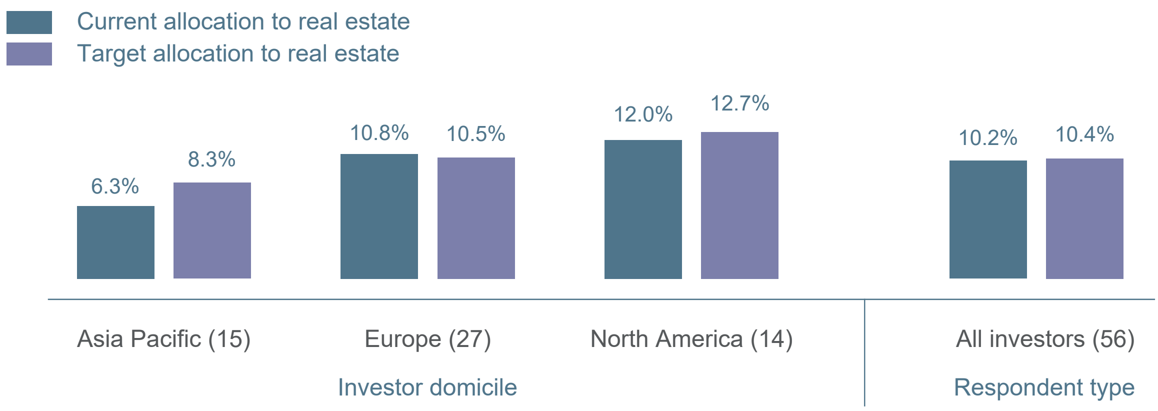
The current average allocation to real estate globally is 10.2%, only 20 bps below the average target allocation of 10.4% according to the latest 2023 ANREV/INREV/PREA Investment Intentions Survey. This is notably down from close to 100 bps reported over the years. The equivalent gaps narrowed significantly for European and North American investors, which is related to the dominator effect as values in other asset classes have fallen further than real estate during 2022.

With an average current to target allocation gap of around 200 bps, only Asian Pacific investors are taking a more positive view, with 45% investors surveyed planning to increase their near-term allocations. Structural real estate under-allocation, a more optimistic economic outlook in some parts of the region as well as looser monetary policy, most notably China and Japan, are some of the reasons for this optimism. Almost 40% of European investors are planning to decrease allocations in the 2023-2024 period, which is a lot higher than the 20% and 5% equivalent for their North American and Asian Pacific peers. A fast market correction for the non-listed real estate should help to erode the denominator effect to ensure the return to normality. Confidence in the non-listed real estate as an asset class is evident in the fact that investors were less negative when asked about their intentions to make new investments in 2023.

Investors recognize the importance of real estate's inflation hedging potential, which has risen significantly as a reason to invest in the asset class in the last two years and will remain to be an important part of the case for the asset class, especially now and in the near term until inflationary pressure subsides.

For more information read INREV snapshot or ANREV snapshot.

Average current and target allocations to real estate globally (weighted by total AUM)*



** Number of respondents in parentheses.*

Global Research Committee's view

At present, pricing in public and private markets is still diverging. European and US REITs have sold off, trading 15-20% below net asset value. Transaction volumes in the direct real estate market have declined significantly over the H2 2022. Much of this is due to dislocation in the capital markets, where the cost of debt now exceeds net initial yields in many markets following a global spike in the real risk-free rate.

To a certain extent, upwards pressure on real estate yields can be expected because of a shrinking buyer pool from lower availability of debt and negative leverage effects. In fact, the current upwards pressure on core real estate yields mainly stems from the movement in the real risk-free rate, rather than a substantial shift in the risk premium for owning it. The decompression in property yields may therefore be less than the movement in interest rates.

The 40-year average risk premium for London office amounts to around 350 bps over the real risk-free rate. In Q1 2022, the spread between London office yield and real risk-free rate stood at around 600 bps but has since moved back to its long-term average of around 350 bps when gilt yields spiked in 3rd quarter. A situation where cost of debt exceed net initial yields has prevailed for extended periods in the past when inflation was rampant during the 1970s and 1980s. Even if borrowing costs are higher than core yields, debt can still be accretive to a deal in real terms – where inflation is sufficiently high to erode the real value of debt, while providing inflationary rent growth.