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REPURPOSE AND REVITALISE THE FUTURE OF COMMERCIAL REAL ESTATE RENTS

The global real estate market has changed, but the green transition and growing urban populations present new opportunities for investors

Beijing Central Business District

GETTY IMAGES

In the decade before the Covid-19 pandemic, it sometimes felt like ultra-loose monetary policy would never end. Now it has. Interest rates have surged over the past 18 months, stemming the flow of cheap money that buoyed the global real estate market in the aftermath of the global financial crisis. Inflation and a weaker global economy mean the halcyon days of real estate are over, and rental income is harder to find.

At the same time, disruptive structural shifts are having complex impacts on real estate use. In the new normal, investors must adjust their expectations and burnish their sector-picking skills to succeed.

GDP growth: the short- and long-term effects on real estate

Few asset classes are more closely correlated to GDP growth than real estate. The strength of the economy underpins commercial and residential rents. Demographics help determine long-term economic growth, and the world's ageing population means the long-term outlook is one of low growth and low interest rates.

Rising affluence in many quarters is stemming growth too, since lower-income groups feed more money into the economy than wealthy savers. This will affect rental income across sectors, shifting investors' focus from following the market to beating it.

It isn't all grey skies though. In the short term, sluggish economic growth may be offset by supply issues, as higher borrowing costs and tighter credit conditions dampen speculative developments.

"This is likely to exacerbate supply shortages of certain types of real estate, especially in the prime and green spaces, leading to stronger rental growth from 2024, which should go some way to improve returns," says Mat Oakley, Director and Head of UK and EMEA Commercial Research at Savills UK.

Longer-term, however, GDP also drives supply. Developers follow returns, which tends to limit a sector's spell in the limelight. The US logistics sector, for example, saw a development boom in recent years because of strong rental growth, with nearly 900 million square feet under construction at the end of 2022 – more than double the long-term average. So while long-term trends continue to support the sector, there are some markets at risk of oversupply in the short term.

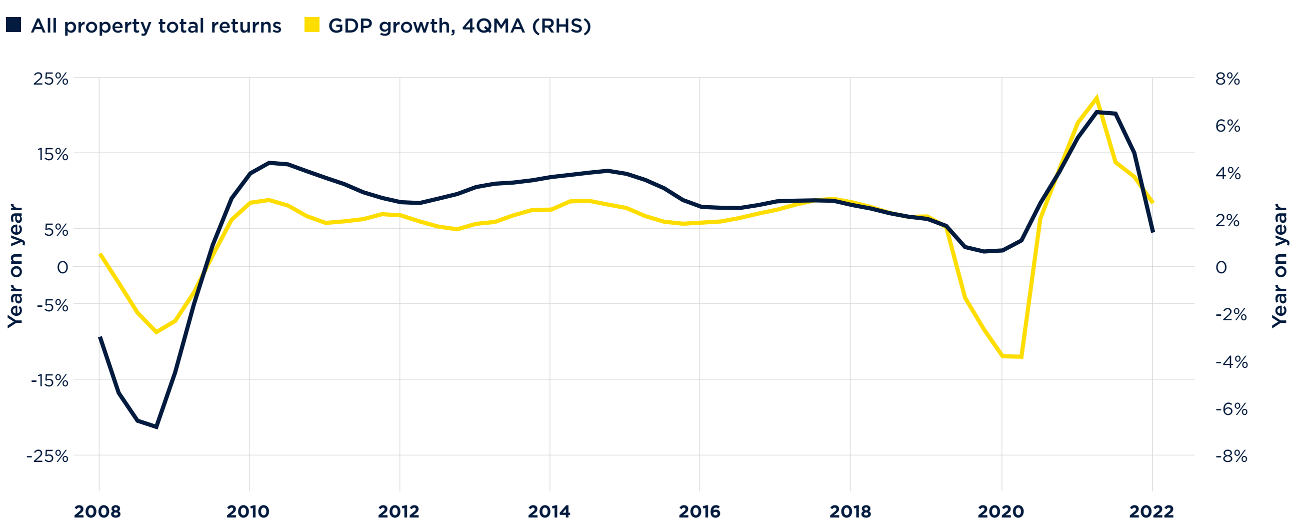
At the same time, disruptive forces are breaking traditional links between GDP growth and real estate sector growth. Hybrid working, for example, has upset the correlation between employment figures and office rents. In the US, which embraced hybrid working more readily than other regions, office-based employment is well above pre-pandemic levels, but vacancy rates are rising and leasing activity is down in some markets.

Climate change increasingly drives trends

Understanding these trends and how they interact is critical for investors. The retail "apocalypse" of the last decade provides a salutary example of what can happen if investors end up on the wrong side of disruptive forces.

As retail moved online – a trend that the pandemic strengthened – changing shopping habits in the US, UK and to a lesser extent mainland Europe exacerbated rising vacancies and lower rents in the retail sector, although retail sales

GLOBAL GDP AND PROPERTY RETURNS



Source: Savills Research using MSCI and Oxford Economics continued to rise. Now, to confuse matters, shoppers are again embracing bricks and mortar retail when many expected the relentless rise in e-commerce to continue.

It's getting harder to deconstruct trends and predict sector growth. Analysis by MSCI shows that the growth of trends such as e-commerce and hybrid working are driving increased sector dispersion in the real estate market. As well as causing sectors to diverge, this is creating new growth niches and doldrums.

In the office sector, for example, demand for best-in-class sustainable buildings is dividing the market, with tenants prepared to pay higher rents for green spaces. Some older, less sustainable buildings are facing obsolescence or repurposing, while green buildings, which are in short supply and attract much-needed employees, are at a premium.

This highlights the huge challenge that climate change poses for the global economy and real estate. Investors who do not adapt risk being left with stranded assets.

Deglobalisation: who will benefit?

Dispersion of geographic returns, by contrast, is decreasing, according to MSCI, as real estate assets become more globalised. However, this could be set to shift. Again, climate change is a big part of the reason. European, US and Asian governments are addressing the challenge at different speeds, and it is consuming large amounts of capital.

At the same time, increasing geopolitical tensions, exposed due to the war in Ukraine, are potentially pushing the world into two spheres of political influence, prompting retrenchment and putting the brakes on globalisation.

Current demographic trends and patterns of economic growth favour developing countries with accessible real estate markets. Countries with positive demographics or significant catch-up potential, or both, include: China, India and Malaysia in Asia Pacific; Mexico in the Americas; and South Africa, the Czech Republic and Poland in EMEA. However, in a fast-changing and increasingly volatile world, there are no simple geographic solutions to finding rental income.

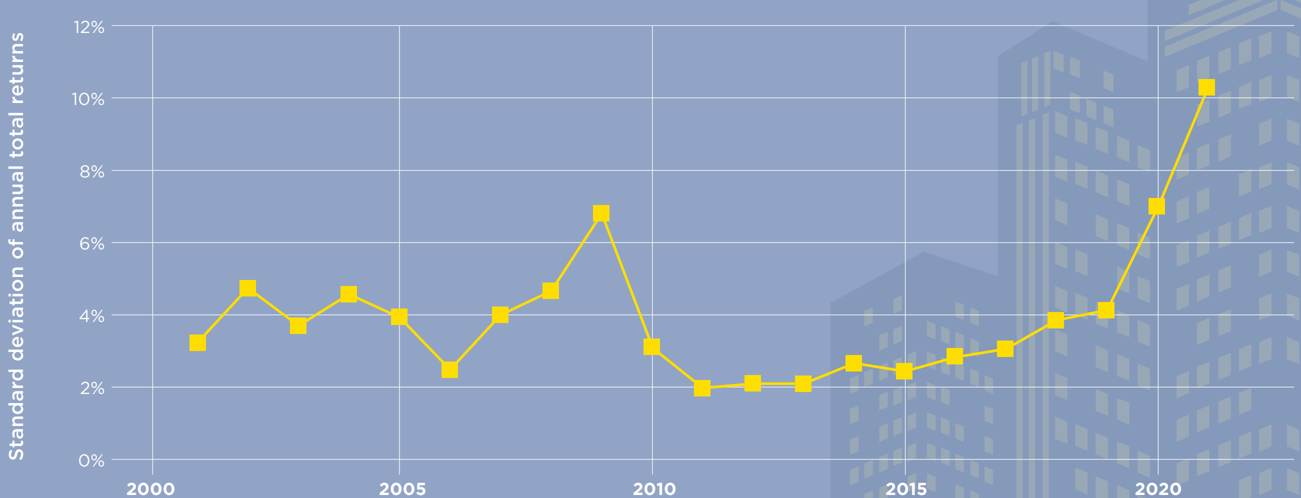
Deglobalisation could drive global capital flows in new directions and the beneficiaries could be outside these fast-growth markets. The US government is providing massive subsidies to encourage production in strategic sectors such as semiconductors back to the US, even if a complete decoupling would necessitate finding a new source for key raw materials. Nearshoring has implications for global supply chains and demand for logistics space that could benefit the US market, where e-commerce and AI are already boosting demand for warehousing and data centres.

"Despite recent economic challenges, the fundamentals support sustained growth in US industrial rents over the long term," says Mark Russo, Senior Director and Head of Industrial Research at Savills US. "These include structural changes in global supply chains bringing production home or close to home as well as consumer preferences continuing to move toward more online purchases with expectations for faster delivery."

Potential for growth in cities and across Asia

With China's population declining for the first time in six decades in 2022, even the demographic picture is no longer as clear as it once was. The US population remains relatively

DISPERSION OF SECTORAL REAL ESTATE TOTAL RETURNS



Source: Savills Research using MSCI Global Quarterly young, and there is great demographic variation among the world's cities in both developed and developing countries, meaning it often makes more sense for real estate investors to take a city rather than a country approach.

Urbanisation is a disruptive global megatrend that is playing out in many different ways. The urban population is expected to double in size by 2050, with 70 per cent of the world's population living in cities by then. In developing countries, this creates huge housing and infrastructure challenges – but it also brings opportunities for rental growth.

In the so-called developed world, large cities such as London and Sydney continue to draw younger people and have positive demographics, but in the US, there is a counter trend of people moving out of big cities into mid-tier ones.

They're drawn by more affordable housing and sometimes by centres of technological excellence based around universities. Due to hybrid working and changing retail patterns, city dwellers are also moving out of city centres into suburban areas, changing rental dynamics.

Although these powerful disruptive forces are shaping the future of the global real estate market, it still makes sense to pan out and consider economic fundamentals.

"With so much happening today, it is easy to lose sight of longer-term trends and what used to be referred to as the Asian growth story," says Simon Smith, Regional Head of Research and Consultancy at Savills Asia Pacific. "Asia Pacific's enviable growth rates, youthful demographics and rising incomes continue to drive occupier markets across all asset classes, from traditional offices and shopping malls to data centres and healthcare facilities."

The global real estate market is entering a new phase that will be characterised by greater volatility and increased fragmentation, but long-term shifts such as Asian growth remain in play. Meanwhile, disruptive forces create dangers and opportunities. Although an ageing population means slower global growth, for example, it also necessitates greater investment in healthcare and senior care. Similarly, as more local data centres are set up, rather than relying on overseas outsourcing, vacant office space can be repurposed and revitalised. To secure rental income, investors must stay abreast of these trends and remain nimble. ■

PAUL CLARK
HEAD OF EUROPEAN PROPERTY, AUSTRALIANSUPER

"We aim to achieve stable long-term income and capital appreciation by finding attractively priced investments benefiting from the structural changes driving demographics, digitisation, the net zero carbon agenda and placemaking, underpinned by limited land supply, restrictive planning and deep pools of talent.

Our approach looks through the medium-term volatility created by events like the pandemic or, more recently, localised crises such as the LDI crash. But the one issue we cannot ignore in the real estate sector is climate, which is why we have a strong focus on asset decarbonisation, with ESG at the heart of the Fund's investment assessment and asset management processes.

Whilst volatility and change may encourage near-term caution, they also create pricing dislocations. For example, although the challenges around repayments, refinancing and re-pricing across the sector are presenting significant challenges, there will undoubtedly be attractive opportunities for well-capitalised investors such as ourselves.

Drawing all this together, we believe the best opportunities are to be found in major mixed-use city-centre development and investment; pan-European logistics and industrial; and the living sector. Not every city in the world can offer the kind of large-scale investment opportunities we're seeking. We have invested in London and are examining cities like Berlin, but the exacting nature of our criteria means we focus only on the locations where we believe the best opportunities lie."

DISRUPTIVE STRUCTURAL SHIFTS ARE COMPLICATING THE FUNDAMENTALS OF REAL ESTATE