WORDS **OLIVER SALMON**

ADJUSTING TO A NEW WORLD ORDER

The Covid-19 pandemic kickstarted a new era of higher interest rates and increased macroeconomic volatility. How have real estate investors responded to this inflection point? And what comes next?

In years to come, the decade leading up to the Covid-19 pandemic will probably be viewed as a golden age for commercial real estate (CRE) investing. Capital was cheap and abundant, and the macroeconomic backdrop was stable.

Many of the largest, most creditworthy global institutions raised capital at rates below inflation – effectively getting paid to borrow money. For CRE investors, very low real borrowing rates supported leveraged property returns and supernormal profits.

At the same time, low levels of macroeconomic and geopolitical volatility provided little structural change to disrupt a relatively passive buy-hold-sell investment strategy.

As a consequence, the popularity of CRE as an asset class grew rapidly. Yield-hungry investors had relatively few income-producing alternatives, given that global central banks, grappling with secular stagnation, were suppressing interest rates.

Halcyon days

"Too much money chasing after too few goods," is how Nobel Prize winning economist Milton Friedman described the cause of inflation – and this is exactly what happened in the CRE sector during this period. Institutional target allocations to CRE rose by around two percentage points and

GETTY IMAGES

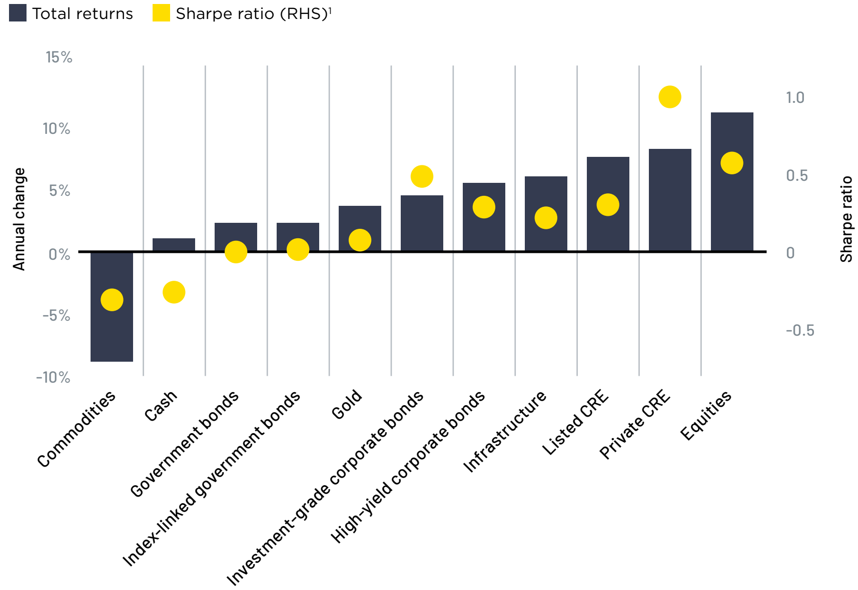
a glut of global savings was channelled into the few markets large enough to absorb it. In the decade ending 2019, the amount of capital raised globally by closed-ended CRE funds quadrupled – equivalent to growth of more than 15% per annum.

All this money flowing into the sector pushed up asset values and encouraged greater risk-taking as investors chased returns in more nascent sectors and markets. Increasing risk appetite and falling barriers to global capital flows encouraged growth in cross-border transactions, which peaked at around 30% of global CRE investment turnover in 2018.

Throughout this period, CRE occupied a favourable position in the hierarchy of the investment universe. It sat comfortably between listed equities and fixed income in the returns profile, supported by an elevated risk premium (the difference between the property yield and the risk-free rate). This was true for both listed and private markets, the latter benefiting from much stronger risk-adjusted returns, due to the illiquidity – and consequent lack of volatility – of direct markets.

In recent years, however, the underlying conditions that supported this golden period have largely dissipated, replaced by higher interest rates and increased macroeconomic volatility. In both cases, there are good reasons to expect some permanence.

US asset comparative returns: annualised total returns, 2014-2019



Source: Savills Research using Macrobond and S&P Global. Private CRE based on unlevered returns.

Higher forever?

Interest rates have risen sharply over the past two years, with major global central banks unwinding pandemic-era largesse in response to a surge in global inflationary pressure. We have seen a generational shift in policy during this period; interest rates in the G7 economies (excluding Japan) have risen by nearly 500 basis points (bps) on average since the end of 2021 – the most significant tightening cycle since the 1970s.

Policy rates are currently too high to sustain stable economic growth and will come down as inflation returns to target levels. It is merely a question of whether we'll see a gradual decline – in line with expectations of "higher for longer" – or a negative shift in inflation and growth dynamics, warranting more expedient action from central banks.

Regardless of the short-term dynamics, it is generally accepted that we are in the midst of a transition to a higher cost of capital – as interest rates rebase at a higher level over the long term – underpinned by secular trends in geopolitics, demographics, climate change and technological advancement.

When the dust settles, long-term bond yields across advanced economies are expected to stabilise at levels above pre-pandemic levels – by 50-100bps in Asia Pacific, 100-150bps in North America and as much as 150-200bps in Europe.

This will impact the return profile of all asset classes. At the crux of the capital asset pricing model is the

WE ARE IN THE MIDST OF A TRANSITION TO A HIGHER COST OF CAPITAL… UNDERPINNED BY SECULAR TRENDS IN GEOPOLITICS, DEMOGRAPHICS, CLIMATE CHANGE AND TECHNOLOGICAL ADVANCEMENT

[1] The Sharpe ratio is a commonly used indicator of risk-adjusted returns in financial markets, benchmarking the excess returns over the risk-free rate, relative to the volatility of those returns.

concept of the risk-free rate of return, which provides the benchmark from which all asset pricing is based. A higher risk-free rate of return, therefore, implies a higher hurdle rate for more risky investments.

In the short term, the adjustment to a higher rate environment is driving a reset in valuations. We can see how this has impacted prime CRE in Europe via an outward movement in yields. While recognising some dispersion – the “best fit” line explains around 32% of the variation of data – in aggregate the tightest-yielding properties at the beginning of the policy-tightening cycle have seen the largest outward shift over the past two years.

This has supported a greater adjustment in office and logistics values, whereas the higher-yielding retail sector has been better placed to accommodate the rise in interest rates.

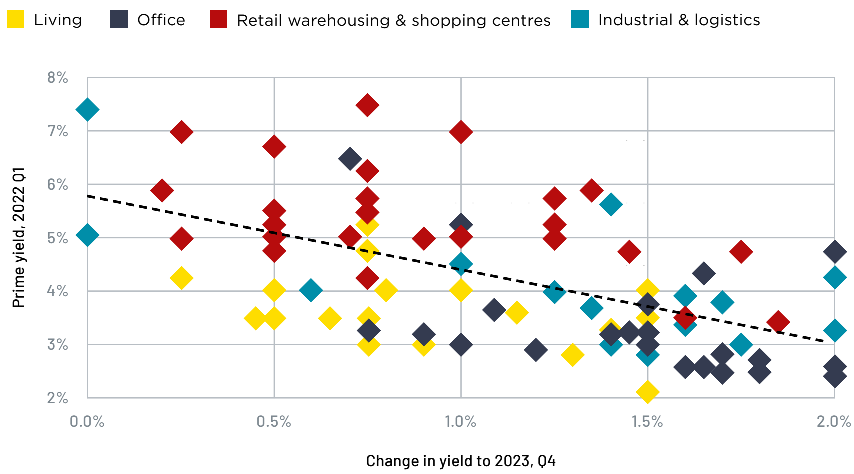
Despite this adjustment, it is evident that the outward shift in property yields over the past few years does not fully accommodate the rising risk-free rate of return. In Europe, the average outward shift in prime yields ranges from about 80-100bps (for retail warehousing and shopping centres) to 140bps (for offices). Compare this with the 250bps rise in the average Euro area 10-year government bond yield, and it’s clear the risk premium on CRE has been squeezed.

Yields provide a point-in-time estimate of returns that’s comparable across different properties, sectors and regions. In simple terms, it is the rental income divided by the current value of a property. All else being equal, rising property yields are, therefore, indicative of falling property values.

However, one of the enduring appeals of CRE is that it exhibits both fixed income- and equity-like characteristics (hence sitting between the two in the return profile). Both the numerator and denominator can vary according to underlying supply and demand fundamentals.

These fundamentals have largely mirrored the wider resilience of the global economy. The current cycle is unique in so far as while capital values have fallen, rental growth has persisted in many sectors throughout the downturn, particularly in the prime segment of the market. This has helped offset some of the impact of interest rate-driven yield expansion on values and partly explains why many investors have continued to buy through this period, despite a lower risk premium. It is also worth noting that, compared with other asset classes at this point in the cycle, aggregate CRE is, once more, broadly filling the gap between equities and fixed income.

Change in European prime commercial property yields (selected cities) Q1 2022 to Q4 2023

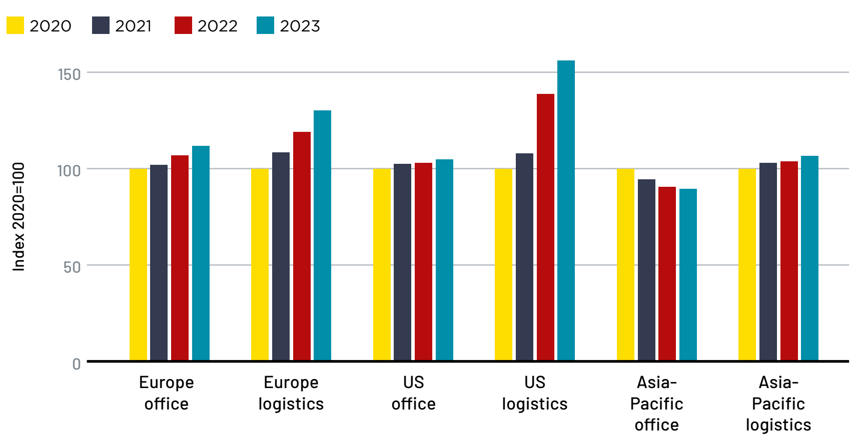


Source: Savills Research

Great volatility

With a permanently higher interest rate comes regime change; the two not being mutually exclusive. The era of ‘Great Moderation’, spanning the past 40 years or so – albeit briefly interrupted by the global financial crisis – was characterised as such due to relative stability in the macroeconomic and geopolitical environment. This followed

Average commercial prime property rents



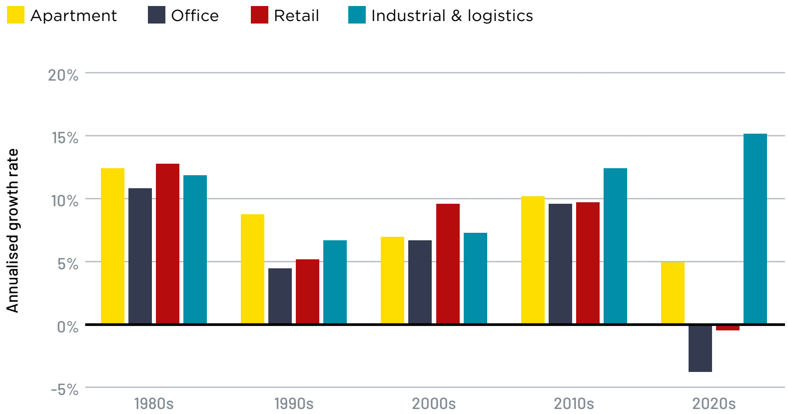
Source: Savills Research. Average rents based on a simple average of major regional markets.

a period of volatility through the 1960s and 1970s, posthumously coined the era of 'Great Inflation'.

From 1985–2019, the average deviation in annual US GDP growth was around half the level of the previous four decades following the Second World War. Throughout much of this period there was little dispersion in returns across core CRE sectors.

Now, the same structural trends driving up interest rates – geopolitics, climate change and technological advancement – are responsible for wider regime change. This is causing increased volatility in returns across core CRE sectors – as well as driving the emergence of new fledgling sectors such as data centres. The average deviation in annual returns across the four core CRE sectors in the US over the 40-year period to 2019 was 2.8%. Since 2020, this has increased threefold.

US CRE total returns by sector



Source: Savills Research using Macrobond. Based on unlevered investments.

A zero-sum game

Structural change for CRE is, to some extent, a zero-sum game. A downturn in one sector tends to drive strong returns elsewhere. CRE's value as an asset class is derived from its ability to support economic output; as the economy changes, so does the type of CRE needed.

Growth in ecommerce – a key driver behind the 'retail apocalypse' that blighted physical retail across the US and, to a lesser extent, Europe – has provided a significant tailwind for the industrial and logistics sector over the past decade. Remote working has pushed office occupancy rates lower and supported a recovery in out-of-town physical retail in some markets – a hollowing out of urban centres referred to as the doughnut effect.

These trends are further facilitated by the advancement of technology, requiring more facilities for processing and storing data. Meanwhile, climate change is driving differential outcomes within sectors, supporting returns for best-in-class green-certified buildings at the expense of older, less environmentally sound property.

In this new era of 'Great Volatility', stock selection is crucial. This is already feeding into investor behaviour. Fundamentally, there is no indication that global investors are reducing their allocations to CRE. Instead, they seem to be shifting them across different types of CRE to align with these big thematic shifts in the macro-environment. Ten years ago, the office sector accounted for about 40% of global CRE investment, followed by retail at 22% and living at 20%. Last year, 22% of CRE investment was in offices; the living and industrial & logistics sectors accounted for more than half. Investment intention surveys suggest this reallocation will play out further in the coming years.

IN THIS NEW ERA OF GREAT VOLATILITY, STOCK SELECTION IS CRUCIAL. THIS IS ALREADY FEEDING INTO INVESTOR BEHAVIOUR

Inflection point

The halcyon days of CRE investing are likely behind us, replaced by a new era of higher interest rates and more macroeconomic volatility. On the evidence of recent years, the market is fast accommodating this new normal.

Valuations have already adjusted, quite substantially, to the higher interest rate environment, underpinned by an outward movement in property yields. The key question, as we look to the future, is: when interest rates do rebase, where will the market price the risk premium going forward? There is an argument that the past decade is not an appropriate benchmark for risk premiums, given the various tailwinds supporting strong returns.

However, volatility implies more risk, for which investors will want to be compensated. Increasing market volatility is driving a greater dispersion in underlying returns, across and within sectors. CRE will be as relevant in this new era as it always has been – but

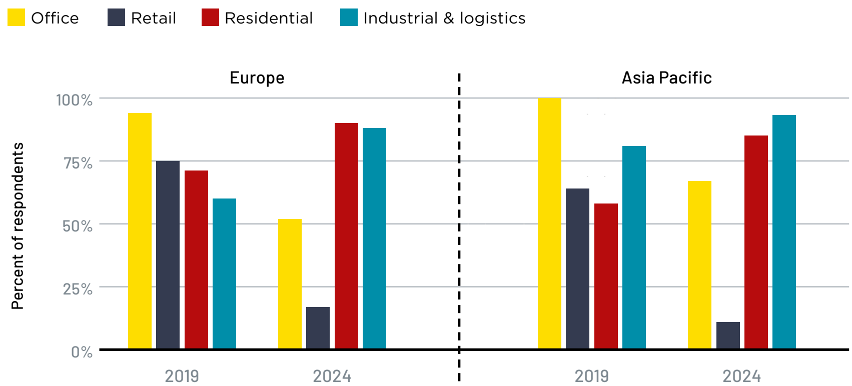
THE HALCYON DAYS OF CRE INVESTING ARE LIKELY BEHIND US, REPLACED BY A NEW ERA OF HIGHER INTEREST RATES

investors are responding to the volatility by shifting allocations towards those sectors that better align with long-term structural drivers of growth. They are exploring more nascent areas of CRE and becoming more operationally savvy to reduce obsolescence risk.

In years to come, the market of the 2020s will surely be defined by how it responds to this inflection point in the investment landscape.

Meanwhile, as we sit in the midst of an adjustment, we are reminded of the words of English poet and artist William Blake: "Hindsight is a wonderful thing but foresight is better". ■

Investment intentions: preferred sectors for investment in the next 12–24 months



Source: Savills Research using INREV/ANREV investment intentions survey.

ADAM IRÁNYI
HEAD OF INVESTMENT MANAGEMENT GLOBAL AT UNION INVESTMENT REAL ESTATE

The extended boom cycle in our industry has come to an abrupt end, due to the steepest increase in interest rates in 60 years, combined with wars and high inflation levels. The trigger for the current challenging situation is not the "real estate" asset class itself, but a consequence of wider macroeconomic conditions.

Capital markets are seeing very low transactional activity, while occupier markets have been moving in a different, much more positive direction. Rental performance has been very strong, albeit with a variance in sector and by geography.

From an acquisition perspective, we continue to be highly selective and are choosing to keep our powder dry, in order to invest countercyclically and benefit from market dislocations. Our focus continues to be on highly resilient asset classes such as logistics, residential and food-anchored retail, which offer high stability, diversification and granular cashflows.

We continue to believe in the office sector, which is witnessing strong bifurcation and is facing challenges caused by work-from-home concepts implemented during the pandemic. Best in class, ESG-compliant, well-connected and highly amenitised offices continue to benefit from strong rental performance. With companies strategising to bring their workforce back to the office, we see continued attractiveness for the "right" office properties within our funds.

Despite fairly dysfunctional investment markets, we have been active on the sell side, exiting non-strategic assets or properties where business plans have been fulfilled via very selective processes or on an off-market basis and adding the sales proceeds to our liquidity positions.

Currently, there is a paradigm shift in the real estate market. In recent years, we focused on new developments via forward transactions, but investments into existing properties are now becoming standard again. Our focus is increasingly on the conversion of existing properties, to increase scale and improve amenity and ESG credentials in order to attract and retain a high-quality tenant base.

Asset management has become significantly more demanding and also, as a result, more important. Workplaces, shopping centres and hotels need to offer new services if they are to satisfy users' needs. The integration of user demands and sustainability, in particular, requires creativity.