Top 10...

Real estate questions for 2020 with Paul Guest and the research team

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For several years, we have looked ahead to the key questions facing our industry. In 2019, we – and much of the financial market – were wrong-footed by the abrupt, global reversal in monetary policy. We anticipated a small, but continued rise in interest rates and an adjustment "with some delay" in property yields. This was not the case and instead, rates have gone the other way. We were not so far off on other vital matters. We said that political risk in the form of the US-China trade dispute would have a negative effect on growth and on real estate demand. We called the peak of the bull run in logistics, and while it has remained the top performing large sector, the pace of yield compression and of rent growth have slowed. We were confident in the continued expansion of the sharing economy, a trend that can survive a single player's woes, while our forecast for retail was that "2019 would mean more innovation, forced or unforced, for all". The year certainly marked a turning point in retail performance. Finally, on capital flows we were, and remain, persuaded that Japanese pension funds will become major cross-border investors, but in 2019 it was the Koreans making their mark, not their neighbors. Looking ahead to 2020, our key questions are as follows:

1. As interest rate policies increasingly test the Zero Bound, what is the floor for property yields?

Over the past decade central banks around the world have injected large dollops of policy stimulus into their economies to perk them up. Indeed, the policy rates of several of the world's major central banks are already below zero and unlikely to rise any time soon. Against this backdrop, and with investors continuing to be attracted to the asset class, how low could property yields go? Looking across markets globally the lowest yields we have seen reported have been in Hong Kong (prior to the political protests), where office and retail yields reached 2%, and Singapore where luxury residential yields fell to just 1.5%.

In France, Paris office yields are now just around 2.8%. Arguably, index-linked bond yields are the best comparator for property yields given expectations for inflation to push up rents. French index-linked bond yields are currently below -1%, giving a spread of 400 basis points to Paris office yields. During the Global Financial Crisis (GFC) this spread briefly fell below 120 basis points. A comparable spread would put Paris office yields at around zero, though that seems highly unlikely. A 200 basis points spread does not seem so outlandish and would push those Paris yields below 2%. In a number of markets, we expect further yield compression in 2020.

2. How should property investors position themselves for an economic recession?

In the past, recessions often combined the peak of development activity with a drop in tenant demand. Real estate used to be more highly levered and declining capital values led to defaults. As a result, investors were advised to de-risk by moving towards core and long income streams. Despite the economic recovery since the GFC office development remains relatively muted, and the current supply shortage limits the downside risk of a widespread rental fall. As businesses are likely to focus on their core activities while incorporating tighter ESG standards at the same time, investors should de-risk their office strategies to core locations and ESG-compliant assets. As the retail sector is in structural flux, leading to shorter leases at a time of slower growth, it has become more difficult for investors to de-risk, leading to historically low allocations. Logistics benefits from the challenges in retail, but is challenged itself by the decline in manufacturing. The evolution of supply chains supports investment in more recession-resistant urban sites. Investments like residential, senior housing and medical offices play on the more predictable demographic developments, and despite increasing regulatory pressures provide more predictable income during an economic downturn. As real estate as a whole is less levered than pre-GFC, interest rates remain low, and the banking sector is more tightly regulated, lower risk debt can also provide recession protection.

3. Now that industrial returns are starting to slacken, which sector will take over as the outperformer?

This answer may seem controversial but 2020 could be the year that some retail starts a comeback. This needs some very heavy caveating. Any outperformance from retail will be exclusively on an asset-level basis, and not a market level. And also given the stages of retail value decline to date, it is only the US and possibly the UK where values have dropped to a point that opportunistic buys may make sense. But in these markets, for very selective assets which demonstrate all the right attributes of tenant mix, dominance and sensible rental levels, the substantial discount which can now be achieved on the purchase price means that much of any future decline in values and rents has already been absorbed. And with retail parks/neighborhood retail in particular delivering very high income yields off the discounted price, in a period of relatively low growth in other sectors this could be enough to deliver outperformance despite all the obvious challenges. But we must emphasize: we are talking about very selective assets and not the sector as a whole!

4. Will climate risks get increasing consideration as an ESG investment criterion?

Amidst increasing pressure from global cooperation (Paris Agreement) and, more recently, public opinion (global climate strike), ESG is being progressively integrated into the operational processes of nearly all economic sectors. The property investment industry is no exception. Year after year, ESG assessments in the real estate asset class are increasing in complexity and comprehensiveness, with social and governance factors now complementing a former energy-centric approach. It is not only the case that properties impact the environment. They might also be the victims of environmental degradation. Besides the obvious flooding risks from rising sea levels, dynamic or localized heavy rainfalls, as well as the impact of severe winds (tornados, typhoons), physical and operational aspects of a property can be disrupted by prolonged drought events; i.e. soil subsidence, freshwater shortages, or in certain cases devastating wildfires. Furthermore, building and urban design will be influenced by the intensification of microclimate anomalies, such as urban heat islands. In addition to new requirements in building structure, the increasing intensity of natural hazards will likely lead to changes in risk mitigation measures, such as a surge in the level of property insurance premia. As extreme weather events are showing increasing occurrence, it's likely that their negative impact on property will gain more and more attention from both the investor and investment manager community in the near future.

5. Retail is going through a major transition. What are the best examples of successful adaptation?

It is no secret that it has been a tough year for retail. This is not necessarily a sign of crisis, but as we argued in last year's report it is a process of reinvention. Most company failures come as no surprise as those with outdated business models and large legacy store portfolios fall by the wayside. There are, however, examples of successful adaption. Ecommerce has freed consumers from the necessity of shopping so retailers have to make them want to shop. "Experiential retail" has become something of a buzzword, but there are clear signs of robust sales in stores and schemes that invest time and money in the retail environment. Some of the most successful retailers are those that fuse their online platform with their physical stores. This does necessarily mean less stores but it means the right stores in the right locations, especially as bricks and mortar can form a pivotal part of the online fulfilment process. Finally, an important element of revitalizing retail is recognizing that there is simply too much space and that some of it has to be converted to other uses. We are aware that in various UK locations private equity is targeting the conversion of low value retail warehouses into urban logistics, while in Asia and the US similar investors have retrofitted urban retail into offices and hotels.

6. Is core overpriced relative to value-add, or is levered core a safer investment strategy?
This question typically arises after a period of high returns, as performance starts to "normalize". This time there are also very low absolute yields across assets. Investors are drawn to any undertaking with expected returns closer to recent history. Often, risks are dismissed because they are hard to measure and economic weakness is a distant memory. Value-add investments typically trade away current yield for higher capital growth. It should be noted that the volume of value-add available at any given time is a small portion of the core volume available. Furthermore, value-add is project specific. There can be a wide range of outcomes depending on individual conditions. UBS's current outlook is that interest rates, and thus required yields, will remain low and economic growth will be positive but also low. As such, we might expect that core investment will be low yielding. Although future returns in our sector will likely be lower than recently, this expectation is consistent across asset classes. Value-add tends to be more successful in a high growth environment. Investors can successfully execute value-add in today's environment but conditions will likely lead to a wide range of outcomes. Selection will be harder than during a growth phase. Thus we argue that core is not over-priced relative to value-add. Rather, both strategies are responding to the current environment. Investors should anticipate low yields paired with modest growth and a wide range of value-add outcomes.

7. Supply gaps and deteriorating affordability have boosted multifamily. Is this an investment opportunity or a social risk?
Multifamily investment is on the rise, going from 13% of global transaction volumes in 2009 to 23% in 2018. Interest is supported by structural demographic changes such as growing urban populations and delayed family formation. These facilitate the growth of the rental market. Rising home prices and declining affordability further support renting over buying. While the investment case is strong, home price growth has outpaced income gains, putting homeownership increasingly out of reach. This could foment social tension given that housing is considered a basic necessity. As it is, rising rents and the lack of affordable housing are increasingly part of the populist agendas in many countries, exacerbated by slow policy responses on the supply side. For the multifamily investor, changing government policy is a key risk since lawmakers have an incentive to tackle this issue; e.g. through the rental caps imposed in Berlin, Dublin, and parts of the US. Conversely, it also points to potentially favorable policy responses, such as in Australia, where the government increased the capital gains tax discount to investors in affordable housing. Seen from a positive angle, this underscores the role that the private sector can play in addressing a pressing social need, if handled appropriately.

8. Allocations to real estate remain high. What is the next source to drive global capital flows?
Dry powder for private equity real estate was estimated to be in excess of USD 320 billion at the start of 2019. This sum is unlikely to reduce much in the year ahead, particularly in a low rate environment where real estate is relatively attractive vis-à-vis other asset classes. We expect cross-border investors to remain active in 2020. The key market participants remain the insurance companies, pension funds, and sovereign wealth, with most taking a long-term view on core investments. The growing fiscal burden of deteriorating demographics across the globe is hastening the search for higher yielding income producing investments. This is unchanged from recent years, with the subtle difference being an ostensible urgency to deploy into real estate. We anticipate that Japanese pension funds will dip their toes deeper into direct real estate in 2020. This has been a very gradual process. Anecdotal evidence suggests that Japan's institutional funds have made substantial allocations and are focused on the mature core markets of the US and Europe. In addition, the tremendous wealth creation experienced in the last decade has led to many family offices, particularly in Asia and the Middle East, looking to deploy systematically into global real estate. We believe this will continue in the year ahead.

9. What do public real estate markets suggest for private market performance next year?
2019 was positive for listed real estate, in line with equities overall. Performance was comfortably into double digits thanks to resilient market fundamentals and accommodative monetary policies. However, not all sectors and regions performed equally, which provides some useful pointers for 2020. In terms of geographies, the outlier was, unsurprisingly, Hong Kong where returns were negative and the discounts to NAV were close to 50%. In contrast, Japan REITs are trading at double digit premia, which point to a high level of investor confidence in this market. In terms of sectors, not surprisingly, many of the retail specialists recorded negative returns and are closing the year with discounts to NAV (suggestive of further struggle). However, retail performance varied significantly: investors are not punishing the sector irrespective of the underlying portfolios. In the US, for example, REITs focused on regional malls suffered much more than those investing in shopping centers. Office-focused firms provided positive returns in most cases, although prices were at a discount to NAV in both the US and Europe, which suggests a cautious outlook. This is not the case for industrial and residential specialists, which typically trade at a premium, pointing to further outperformance for these segments. Finally, niche sectors are often easier to access in public markets and these specialists performed well in 2019, data centers in particular.

10. Demand for flexibility is changing real estate usage; eg. ecommerce or flex office. How will this spread to other sectors?

Corporates and end users are increasingly rejecting the notion that real estate is a fixed cost, and are embracing the concept of space-as-a-service, enabled by shifts in technology. This has manifested itself in self-storage, co-working and short-term accommodation, amongst others. From the landlord and investor point of view, the commercial viability of flexible solutions is debatable, at least for now. However, the real estate industry has always been quick to respond to the changing needs of end-users and this cycle is no different.

Looking ahead, we expect the retail and logistics sectors to accelerate the adoption of plug-and-play formats. The retail segment was the first to be affected by technology and changing consumer habits, but landlords are now offering excess space on short leases. There are already aggregators that serve to link up landlords and transitory tenants, and we can expect this trend to pick up as retailers adapt to smaller footprints. In the logistics sector, pop-up supply chains are evolving. Especially for smaller ecommerce players, temporary and on-demand logistics provide a solution for expanding fulfilment capabilities during peak periods. The logistics sector will see a slight shift from build-to-suit towards a build-to-serve model.

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