REO

Real Estate Outlook – Global

Edition May 2023

UBS

Global real estate

Price correction continues

Economies fared well in the first quarter of the year and performed better than expected. China benefited from COVID-19 restrictions being lifted and bounced back strongly, to record growth of 4.5% YoY. Initial data showed the eurozone returned to modest expansion, of 0.1% QoQ, having stagnated in 4Q22, while the US slowed to growth of 1.1% QoQ at an annualized pace. Most of the advanced economies are expected to experience some decline in output during the downturn, which started in mid-22. The US economy is on a slightly different cycle and is expected to slip into recession in the second half of the year. By this time, Europe and Japan are forecast to be in recovery mode.

The economy was buffeted in the first quarter by stress in the banking sector as three US banks collapsed and a take-over of Credit Suisse by UBS in Europe. Banking sector stress calmed in April, though resurfaced at the end of the month as First Republic Bank was rescued by JPMorgan Chase. Tighter lending conditions will impact the real estate sector in three main ways. First, by putting a dampener on the market in terms of new equity being deployed which is looking for debt to accompany it. Second, refinancing existing debt will be more difficult and costly. Finally, more defaults and forced sales are likely, resulting in property coming on to the market which will weigh on prices.

Global real estate investment activity remained subdued in the first quarter as the market continued to adjust to higher interest rates. A wedge remained between the price expectations of buyers and sellers and prevented transactions from happening. Global investment volumes were just USD 131 billion in the first quarter which, after allowing for seasonal weakness, left them broadly unchanged from the low reached in 4Q22. Retail bucked the trend of the other sectors and, after allowing for seasonal effects, investment activity rose across the regions, following a particularly weak 4Q22 for the sector[1]. We expect investment activity to gradually recover as prices adjust and buyers and sellers align.

The market repricing, which started in the second half of 2022, continued into 2023. The pace of adjustment did ease though, and across the more than 300 city-sector markets we monitor globally, yields and cap rates rose in 49% of them in 1Q23, down from 74% reporting a rise in 4Q22. In the bulk of the remainder (48%), yields were unchanged. Hence there is still widespread upward pressure on yields and cap rates, focused on those markets where valuations are adjusting more slowly. We expect yields to continue rising to embody the sharp interest rate rises seen over the past year. Given that interest rates are close to peaking, we expect upward pressure on yields to ease, but to vary by market.

Source: 1 CBRE; NCREIF; PMA; UBS Asset Management, Real Estate & Private Markets (REPM), May 2023. Note: Refers to 309 global city-sector markets.

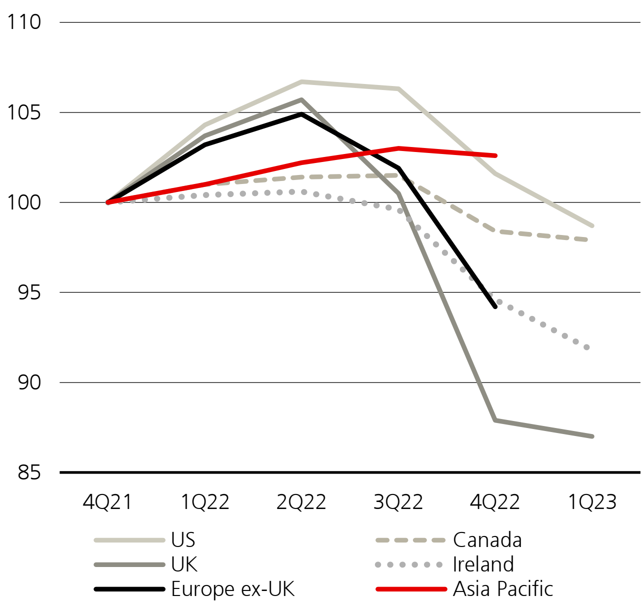
"Stress in the banking sector will weigh on lending against real estate and is likely to delay the recovery. The market has re-priced quickly, albeit at different speeds. As is normally the case, the UK has led the correction, due to its valuation practices and large and liquid market, which looks to be bottoming out."

Fergus Hicks
Real Estate Strategist

Initial data showed that capital values continued to decline in 1Q23, reflecting the rises in yields and cap rates. However, markets have corrected at different speeds. The UK has led the correction, as is normally the case during downturns. Over the second half of 2022 and during the first quarter of 2023, UK capital values fell 18% in total (see Figure 1). However, they showed signs of stabilizing in March, when they rose 0.2% MoM according to MSCI data. The rest of Europe has followed, with a quicker correction in prices than what occurred during the Global Financial Crisis. In Asia Pacific, capital values have been much more stable since Japan accounts for around a third of the market. In Japan, interest rates on hold mean that capital values there have not come under the same downward pressure from rises in yields as they have in other markets.

Listed real estate markets fell in March as stress in the banking sector weighed on investor sentiment due to its potential impact on the real estate sector. However, at the start of May, in USD terms the FTSE EPRA Nareit Developed Index showed global prices still 11% above their trough in October 2022. Overall, we think that stress in the banking sector and tighter lending conditions will delay the recovery in real estate markets and that investors should be careful in deploying capital. However, distressed and discounted opportunities should give investors attractive deal flow while there is uncertainty over when the wider market will bottom out.

Figure 1: Capital value indices (local currency, 4Q21 = 100)



Source: MSCI; NCREIF; UBS Asset Management, Real Estate & Private Markets (REPM), May 2023. Note: Asia Pacific and Europe ex UK data to 4Q22. **Past performance is not a guarantee for future results.**

Link between sustainability and tech in real estate?

Real estate is responsible for approximately 40%[1] of global energy related carbon emissions and sustainability is a major force in this space. The industry is facing heightened regulation and ever-evolving standards to adhere to, with approximately 600 green building certification systems worldwide. As a result, there is a greater focus on ensuring buildings are compliant with these certifications and other regulatory standards.

For example, one sustainability regulation in the real estate sector in the UK is Minimum Energy Efficiency Standards (MEES), which will make it illegal for landlords to sign new leases on commercial properties with Energy Performance Certificate (EPC) ratings of E or lower. An interim target was implemented in April 2023, which prohibits landlords from leasing buildings with an E rating or lower, even on existing leases. From 2027, the regulation will be amended to a rating of C or lower and in 2030, B or lower. Currently, only 23% of inner London commercial properties are rated B or above and therefore MEES compliant. Breaches may include a financial penalty up to a maximum of GBP 150,000 and publication penalty. In this case, the details of the breach are entered publicly into the PRS Exemption Register, a list run by the government on any properties legally required to have an EPC and properties exempt from meeting the minimum EPC standards.

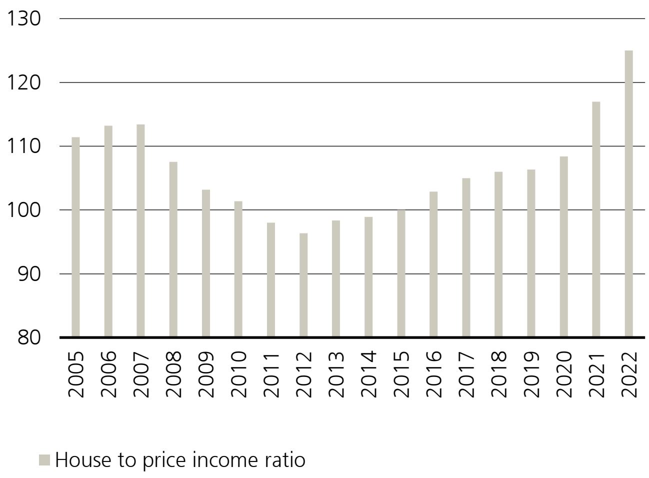
Another example is the Australian requirement for all buildings sold or leased to have a Building Energy Efficiency Certificate (BEEC) as well as a National Australian Built Environment Rating System (NABERS) rating. In the Netherlands, from 2023, all office buildings will, by law, be required to have an EPC rating of C or higher, and in 2030 hold a rating of A. New York's Local Law 97 states that from 2024, buildings over 25,000sqft will be required to meet carbon emission caps with stricter limits coming into effect by 2030.

If real estate managers do not keep up with the changing regulatory environment including net zero target commitments, real estate assets may face transition risk. If a building's future carbon emission trajectory exceeds the 1.5°C pathway, there is the risk that building will become stranded due to obsolescence and write downs in value due to changing market expectations and legal regulations.

These regulatory certifications and standards mainly relate to the environmental factors of buildings. However, there has been a shift in focus towards the social angle in sustainability, which historically has been given lower priority. Social factors include human capital, the impact of buildings on society and the wellbeing of stakeholders etc. A more recent building standard is the WELL Building Standard®, which is a performance-based system focusing on a building's impact on the health, comfort, and knowledge of occupants. This topic is particularly prevalent in today's environment, with high costs of living and levels of rental inflation leading tenants to seek more affordable housing. Additionally, the continuous hikes in interest rates and borrowing costs means that potential first-time buyers are likely to remain confined to the rented sector.

The house price to income ratio in OECD countries has increased (see Figure 2). The ratio is calculated by dividing nominal house prices by housing rent prices. This measure of affordability shows that since 2015 the growth of house prices has exceeded the growth of incomes by 25%, highlighting the challenges for first-time buyers and boosting demand for affordable housing. The UK is set to publish a Renters' Reform Bill, which will plan to remove so-called "no-fault" evictions. Other measures include rental increases limited to once a year with two months' notice and introducing minimum housing standards for the private sector.

Figure 2: Aggregate house price to income ratio in OECD countries (index, 2015=100)



Source: OECD; UBS Asset Management, Real Estate & Private Markets (REPM), May 2023.

[1] World Green Building Council, https://worldgbc.org/advancing-net-zero/embodied-carbon/, May 23.

Despite focusing on sustainability from a regulatory perspective, commercial real estate can also take advantage of new technologies to make buildings more environmentally friendly and efficient, known as PropTech. An example is Building Management Systems (BMS), a software tool which allows real estate firms to monitor and control the physical environment of a building. This includes temperature, lighting levels and air conditioning, which can ensure more efficient resource usage and help detect potential issues before they become serious.

We are also seeing the expansion of accessible AI tools such as ChatGPT, but the question is how these tools can be applied to real estate. Machine learning can be used within property valuation by predicting real estate prices and rental values by analyzing millions of data points. Machine learning combined with BMS can help professionals make more informed decisions about investments and property management. Blockchain is also transforming real estate investments as smart contracts can enable faster and more secure transactions. This technology helps reduce transaction costs and provides a decentralized way to record and transfer ownership of assets.

Unlisted real estate sector performance outlook

	Negative		Neutral		Positive
US		Office	Industrial	Retail, residential	
Canada		Office	Retail, residential	Industrial	
France		Office, residential	Retail	Industrial	
Germany		Office	Retail	Residential	Industrial
Switzerland			Office, retail	Industrial, residential	Industrial
UK		Office	Residential	Retail	Industrial
Australia			Office	Retail, industrial, residential	
Japan				Office	Retail, industrial, residential
Singapore			Office	Retail, industrial	

Source: Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), May 2023.
Note: Classifications refer to expected total returns over the period 2024-26 versus global all property. **Classifications are not a guarantee for future results.**

For more information, please contact:

UBS Asset Management
Real Estate & Private Markets (REPM)
Research & Strategy

Fergus Hicks
+44-20-7901 6022
fergus.hicks@ubs.com

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