Research Blast

Global Real Estate, December 2018

Top 10 real estate questions for 2019

We expect the cycle to continue to mature in 2019, with the trends already underway gradually accelerating.

Higher interest rates, tighter spreads, and slower growth will make for a more challenging operating environment.

This time last year, our Research Blast sought to answer the forward-looking real estate questions as we saw them. Overall, the trends have been in line with our advice to clients, despite our prudence in some areas. Our assertion that 2018 would be a year of stability was correct: yield premia narrowed as expected, offset by continued rental growth and new capital entering the sector. As we foresaw, it was not yet the turning point for yields. That said we saw limited room for further yield compression, so we clearly underestimated the logistics sector. We were optimistic: we forecast "exceptional rental growth", but falling yields drove even better returns than we expected. Our call for investment volumes "slightly ahead of the long-term average" was correct, as was the tapering of activity in the US and the levels of competition in continental Europe. Speaking of the US, supply and rent dynamics have evolved in line with our expectations, but our ~6% total return call was too conservative. The culprit? You guessed it: logistics. Similarly, we forecast a "meaningful deterioration" in Japanese returns and this has not materialized. Tenant demand has been very strong amidst continued central bank stimulus. In Europe, we were right about the sustained lack of supply and its influence on, in particular, office rents. Our view on the increasing importance of serviced office providers has also rung true. Finally, we said that "retail's evolution should accelerate" and this has certainly been proven, with valuations under major pressure in North America and parts of Europe as retailers become more proactive in responding to changing consumer preferences.

1. Why should anyone invest in core real estate today?
Despite the evolution in the market economy, the justification to include core real estate in a mixed-asset portfolio is unchanged. Diversification, periodic income, relatively low price volatility and contracted rents are characteristics that real estate exhibits in all typical environments. When growth is slow and yields are low, there is a tendency to make investment changes: either avoid risk altogether or chase returns up the risk curve. To take either of these actions makes a statement that one knows more about the future than the market overall. Current real estate yields are being set by the market in comparison to all other assets, for the consensus view of future conditions. A core strategy suggests holding a consistent position to capture current yield plus expected and unexpected gains, recognizing that at times "gains" can be negative. The very essence of this strategy is the building and holding of income properties to stabilize the more price-driven listed assets. Regularly trading in and out of private real estate, based on a perception that deviates from the consensus, is a more aggressive strategy which violates the core concept. The current level of slow growth may persist for years, inflating the opportunity cost of staying out of the market. Alternatively, the possible loss exposure of a higher risk strategy could become a reality in the event of an unforeseen shock. A core real estate strategy is a hedge against these extremes, allowing investors to collect current income regardless of the next pricing shock.

2. What can we learn from the spread between real estate and bond rates? What do we expect?
Prime yields have been at record lows in many markets for some time, raising the question whether or not current premia to bonds rates are appropriate. Today, the world is split into two different environments. In Europe and Japan, with few exceptions, spreads are still above their long-term average, while it is the opposite in much of the rest of the world. In Japan, there is no evidence of an increase of bond rates in the short term and the current real estate premium may be a new normal. Bonds rates in the US have already increased during the last few years and real estate yields will likely adjust with some delay thanks to positive expectations on rental growth. In 2019, European markets may start to look similar to the US: the expectation of monetary policy changes could push bond rates upward and property yields will likely follow more slowly. Consequently the spread between the two may shrink closer to the historical average. Alternatively, Europe could start to resemble Japan with a "lower for longer" scenario in bond markets. This becomes more likely if 2019 is not the turning point in European Central Bank (ECB) monetary policy, as broadly expected. This could extend the competitive investment market in Europe for another year, but it is not our central scenario.

3. How will political risk influence real estate investment decision-making?
Perceived “political risk” has been a dominant theme for the past few years, yet global property returns and liquidity levels have remained exceptionally strong. This is largely because the risks did not translate into a substantial threat to the underlying fundamentals which, in turn, supported strong returns during this period. In short, a relatively robust period of economic growth coinciding with low interest rates supported asset values. So will 2019 be another year of noise without consequence? It may not be the case this time. The ongoing US-China trade dispute is likely to have some negative impact to global economic growth, which will have indirect knock-on effects on real estate. In Italy, the direction of the coalition government has spooked investors. Long term government bond yields are now above prime property yields, and we question whether a negative risk premium will be sustainable going forward. And with Brexit, whilst we hope that a no deal scenario can ultimately be avoided, there will clearly be direct consequences for real estate markets should we end up in this scenario in April 2019.

4. Will the industrial Bull Run finally come to an end?
Industrial has been the favored segment recently and yields have compressed to record lows in most markets. Indeed, the historically high yielding sector now offers only a slight premium to the global all property average, giving rise to concerns that prices have become unsustainably high. However, rents are rising globally as occupier demand catches up with investor sentiment, particularly as retailers and online operators look to optimize their networks. This is particularly apparent in the urban logistics sector where the distinction between industrial and other sectors is becoming more blurred; e.g. mixed use industrial-retail and -residential schemes in major cities. That being said, industrial real estate performance is still mostly about distribution and production. Over the past 15 years there has been a strong correlation between industrial yield compression and the share price appreciation of global logistics companies. These prices have softened recently as the outlook for global trade has deteriorated. Investors should consider shifting from "buy" to "hold" as some pricing looks tight even against optimistic rent growth assumptions. We expect that those already invested, should continue to see strong demand and solid rent growth.

5. How will Asia's outbound investment influence global capital flows?
We expect a normalization of flows as cross border investors pay more attention to hedging costs amidst a rising rate environment. In 2018, we saw flat US capital volumes and next year should see key markets further entrenching the home bias. European markets will stabilize even as UK and German investors continue to prop up intra-regional capital flows. Chinese outbound capital, arguably the protagonist in the global cross-border story, has met its match in the form of enhanced capital controls. The immediate impact on residential markets in London and key markets of Australia was felt throughout 2018, and will likely persist. We believe Chinese capital will also continue to be redirected towards Hong Kong, and increasingly albeit gradually, into the logistics and alternative sectors in Europe. A wildcard is the emergence of Japan's massive pension funds into cross-border real estate. Given persistently low domestic returns and growing pension liabilities, the largest public pension fund in the world, Japan's Government Pension Investment Fund, has notably increased

its investment allocation to global real estate in 2018. As others follow suit, 2019 could see billions of fresh Japanese capital looking to test the water and allocate gradually across major real estate markets globally.

6. Have niche property types become the new normal?
The last few years saw an abnormal environment where yields breached historical lows in most property markets amidst ultra-low interest rates. This became the standard operating environment to which investors acclimatized, and we saw the inadvertent rise of money flowing into alternative real estate segments. While interest rates are expected to normalize, the pace is likely to be gradual. We can almost guarantee that novel investment themes and sectors will be a mainstay in 2019 as yield-hungry investors look for relatively attractive returns. At the same time, major structural changes in technology and demographics have altered the way real estate is utilized. Data centers and senior housing, for example, are supported by fundamental drivers and have displayed signs of institutional maturity. Certain niche property types, such as student housing, could thus shake off the 'niche' label and simply become part of the institutional investment universe. However, not all alternatives are created equal and most require investors to commit to longer term investment horizons or to accept higher operational risk. Investors should be appropriately compensated for these risks and that becomes less clear the more yields compress.

7. Will the Sharing Economy be an important source of occupational demand yet again?
Once a niche theme, real estate concepts linked to the sharing economy have gained traction over the last five years to become a major source of demand. We are confident that this trend will continue in 2019. In the office sector, the increasing need of flexibility by tenants is induced by cost-efficient strategies is supportive of co-working models. In 2018, WeWork became the largest private office tenant in Manhattan and serviced office providers now account for over 10% of total take up in Europe's urban centers, with an accelerating momentum. The re-urbanization trend and the high representation of one-person households in large cities leading to affordability concerns, constitute strong fundamentals for small rental dwellings in dense urban regions. This market ranges from functional micro-apartments to co-living complexes, which combine private rooms with spacious common areas shared by residents. The sharing economy is also making its mark in the industrial space. The emergence of shared warehousing, which enables a more efficient use of storage, illustrates this evolution. While offering opportunities, demand from those new actors also brings challenges for investors, i.e. more intensive property management and/or reduced transparency of underlying asset performance once operational activities are outsourced to a specialized service provider.

8. Is this the end of retail as we know it?
There is absolutely no question that the sector is going through transformative structural changes. Evolving consumer preferences, technological change and globalization, to name a few, are all factors driving consumers to spend their money on different things and experiences in different places. These features are not new, but it is a fact that some retailers and investors have been slow to adapt. This, of course, is not true of all tenants or landlords. The coming year will neither mark the end of retail, nor its full transformation. The blurring of boundaries between traditional real estate sectors will mean that what used to be logistics and leisure will now be part of retail. In addition, parts of what was previously lower-quality retail will become office, residential, or something else entirely – we have heard of one case where the upper floor of a mall was converted to laboratory space. 2019 will mean more innovation, forced or unforced for all. The sector will remain an important, albeit reducing part of portfolios, but what we call retail may well be different in the years ahead. 2019 is a step on that road, but not the final destination.

9. How will a weaker operating environment affect the spread of ESG best practice?
During the past few, favorable years for real estate owners, many Environmental, Social and Governance (ESG) factors have simply become part of best practice, as had long been anticipated. There is always room for improvement, even in the most obvious areas of waste, water, and energy management. For the leaders in this area the focus has shifted to working ever more closely with tenants and putting increasing emphasis on the social aspects. A tougher operating environment, higher interest rates, and lower returns, much less an outright correction, could conceivably put the brakes on seeking the more qualitative investor benefits. However, there are well documented bottom line gains from so-called ESG policies such as energy reduction and tenant retention via social practices, not to mention the reduced obsolescence of assets. Our view is that any coming disruption will reinforce the conviction of the leaders in this field, while the late adopters will find it increasingly difficult to engage with capital sources who have made ESG a priority.

10. How will technology influence real estate values?
The evolution of technology will continue to have a big impact on real estate markets in 2019. It is altering the way we live, shop and work. Across property types technology is also impacting the building specifications that occupiers need to remain competitive. This is important since it means more capital expenditure will likely be needed to keep buildings current and in a lettable condition. For example, technology is facilitating easier and increased remote working and we are seeing a big rise in short term flexible office space in cities around the world. More footloose tenants can quickly relocate if premises are not up to spec, which will likely put pressure on traditional landlords to keep their space at the frontiers of technology. We think the same is true of logistics, where we are starting to see fledgling flexible warehouse space being offered. Overall we believe that underlying technological evolution will tend to push CapEx requirements higher. Although there will be some offset in operational costs through tech solutions, investors will ultimately require slightly higher yields if they are to maintain their returns.

Real Estate Research & Strategy Team

Melanie Brown
Adeline Chan
Christopher DeBerry
Kurt Edwards
Nicola Franceschini
Kara Foley
Zachary Gauge
Tiffany Gherlone
Paul M. Guest
Gunnar Herm
Brice Hoffer
Amy Holmes
Samantha Hartwell
William Hughes
Joshua Rome
Sean Rymell
Shaowei Toh

For more information please contact

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

Paul M. Guest
+44-20-7901-5102
paul.guest@ubs.com

Follow us on LinkedIn

www.ubs.com/repm-research