The Investment Podcast

Real estate series

Episode 1: A closer look at 2021
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Jose [00:00:01] Buenos Dias everybody>. My name is Jose Pellicer and I'm the global head of investment strategy, real estate at M&G Investments. Welcome to episode one of The M&G Investments Podcast, which will focus on the real estate sector. In this episode, we will cover the usual narratives about 2021. And how much reality is there about the hope for a better year than last. We also cover the eternal Brexit topic and we will also cover other narratives within the real estate sector. Is this the end of offices as we know them? Is retail doomed forever? And are opportunities in the industrial sector the best on a risk-adjusted basis? In order to cover these topics, I have with me Tony Brown, who is the global head of real estate at M&G, who previously was at Lend Lease and before that at Schroders.

Jose [00:01:12] And also I have Richard William, who is a total veteran at M&G with 15 years experience with us. Richard is the head of research real estate at M&G. So welcome, Tony and Rich.

Richard[00:01:29] Hi Jose.

Tony[00:01:29] Hi Jose, Hi everyone.

Jose [00:01:31] OK, so let's go to the first narrative, which is about the recovery in 2021. So 2021, started with a new outbreak of the virus that has spread pretty much globally, which probably will follow with another period of economic pain. But we have a vaccine. We actually have three of them with a number of them in the pipeline. And therefore, the usual narrative on this is that by the end of the year, by, you know, a period in which enough people have been vaccinated, the re's no reason why economic activity and real estate activity shouldn't go back to the levels in 2019. So Rich, to what extent do you think this is the case?

Richard [00:02:28] Thanks. Jose. Undoubtedly there is some good news coming from from the vaccine, but I think it's probably premature to pop the champagne at the moment. I think we have to be aware that the vaccine is not a panacea that will just simply return us to where we left off a year ago. There are risks that remain. There will still be near-term weakness. I mean, for a start, we've got to get through these lockdown's first. We're sat here in the UK talking about this - we're in the midst of a lockdown here. There are lockdowns in other parts of the world. And as we know from last year, lockdowns and restrictions, the suppression of economic activity is clearly very damaging to the economy. More job losses are on the cards. More business failures are on the cards. The accumulation of debt is on the cards. Then there are risks around the vaccine itself and how successful it will be. It will take time to roll it out. It will take time for sufficient numbers of people to be inoculated, enabling authorities to ease restrictions. What about anti vaxers who refuse to be vaccinated and how long does immunity last? What about mutations and further strains emerging that maybe the vaccines won't be effective on future new strains? And then there's the economic ramifications. So the savings ratio has soared during the pandemic and people have effectively been building their wealth rather than spending it. But, more and more people will have reduced income and so they won't be able to spend money because they simply won't have money coming in. So there's a lot of concern out there. Yes, it's great news that we can kind of look forward to in due course, but there’s some pretty tough times we've got to undergo first.

Jose [00:04:09] Yeah, exactly. And do you feel also that there are risks for unemployment? So clearly a part of the corporate sector is pretty bruised at the moment? No. You know, the retail sector, the hospitality sector. So do you see unemployment down the line?

Richard [00:04:25] Unemployment has already increased. I think it is pretty likely it will increase further. I mean, the government policies, generally speaking, have helped keep the unemployment rate down or not rising as much. So there's been job support schemes, furlough schemes, the support of businesses more generally. That has certainly helped to bridge the gap to the end of the pandemic. But that in its own right raises two questions. How long is that support going to be provided for? It's going to be tapering off at some point and stopping ultimately. And secondly, what's the implication for public sector finances? There's been a huge amount of debt that's been put onto the balance sheets of central banks and governments, that will have long-lasting consequences.

Jose [00:05:13] Yeah, I think that's right. But nevertheless, I think it does make sense that public sectors keep pouring money into the economy because the lessons from the global financial crisis is that when the tap is cut too quickly, then you get rises in populist themes and you get, you know, second aftershocks of the crisis, like the euro crisis, etc. Now, Tony. And how about the real estate industry taking into account what Rich has said? Do you feel that he's a little bit too pessimistic? And what do you think the consequences for real estate are?

Tony [00:05:54] Thanks Jose. I mean, I think, you know, as human beings, we're all conditioned to react to the circumstances we find ourselves in. I'm actually sitting in my home in London right now and I haven't been into our office in London for nearly nine months. So you kind of react to those circumstances that you're in. And in reality, in many real estate markets around the world, there's a need to focus on the basics, such as rent collection and tenant relationships and just dealing with the physical limitations on travel and being able to go and look at assets either to underwrite them, DD them or to manage them. So that's the reality that a lot of people are currently finding themselves in. But I think it's also important to understand that real estate is generally a long term asset class, certainly compared to a number of other asset classes. So being a long term investment is really important to look through the reality of today and consider the structural and cyclical impacts that covid will have and also look beyond covid. Once this is behind us, my expectation is that whereas the last decade was characterised by, you know, the phrase rising tide floats all boats in me, in reality, all real estate perform well in the last decade pretty much. But I think, you know, in 2021 and going forward, we'll see a much greater dispersion of returns from real estate, both by sector, by country and by risk profile with a much wider range of winners and losers starting to emerge during this calendar year.

Jose [00:07:28] Yeah, I think it's totally true. I think that equally in the same way as after the global financial crisis, parts of the real estate market recovered very quickly, like, you know, central London and, you know, the big gateway cities. Others took a bit longer. And actually, you know, talking about contrasting parts of the real estate sector, I would like to move to the second narrative pretty swiftly, which is about the fortunes, the respective fortunes of the retail and the industrial sector. So the narrative is generally as follows. So e-commerce is rising inexorably. Retailers were slow to adapt and the population expanded by the pandemic has grown even more accustomed to shop online. So retail as the real estate sector has a green future and industrial is the big winner, particularly, you know, this particular name, the last mile logistics is the number one winner from this pandemic and has been the winner from the last 10 years. So, I'm going to start with Tony now. The retail sector, is retail doomed?

Tony [00:08:52] Well, I think it is certainly true to say that retail generally in most markets around the world has limited investment demand or certainly less investment demand than other asset classes such as logistics and you are right to identify that. But, I think we have to be quite careful in assessing what this means longer term, because there are quite big differences between countries and types of retail. For example, in Southeast Asia, in a country in cities such as Singapore or even in Tokyo as an example, suburban convenience shopping centres really provide a community service almost because people live in quite small apartments, certainly in the tropics where it's obviously hot all year round. A lot of apartments don't have air conditioning. And so families actually go and meet in the relative comfort of an air-conditioned shopping centre to eat and to enjoy their leisure time together. And certainly our experience in Singapore, for example, even during this last 12 months of the pandemic, we've seen pretty robust levels of footfall in those types of suburban convenience locations and then can in contrast to a country like Germany. A lot of retail in Germany is anchored by food stores and there we haven't seen rents rise significantly over the last 15 years. So rents are still relatively affordable. And therefore, that type of retail model is likely to be more robust going forward than, say, in the U.K. shopping centre market, where the model is really dominated by department stores anchoring those locations. And the department store model is probably the most challenged by the prevalence of online retailing. So these are really quite big differences as you know, when you travel around the world in terms of retail and I think it's really important to understand those differences when thinking about what the future retail investment looks like.

Jose [00:10:40] Yeah, that makes a lot of sense. I think that in the convenience certainly has a future. It's the very prime retail that I think there is a question mark. I think that we might be suffering from a little bit of present bias because the shopping centres are closed. But I think that there is a big question mark about the big prime shopping centres hosting 120 shops or something like that. I think that's a trend that we should watch. Moving into industrial Rich. It is the big winner. So is all industrial good?

Richard [00:11:21] Well, I mean, there are certainly a lot of good reasons to believe that industrials, generally speaking, will continue to do well. And, you know, let's be frank here. If you've been on on the industrial or logistics train for the last few years, you've had a pretty good ride. It's been a healthy, fun journey to have been on. Tony's phrase earlier about rising tide, floating all boats. I think, generally speaking, pretty much all industrial has.

Jose [00:11:47] Richard, really I've got no idea what that expression means, anyway, moving on.

Richard [00:11:53] So the market has risen pretty much all assets within industrial. Now, I think this is where I'm going to inject a dose of reality and maybe concern and pause for thought. I think it is dangerous thinking to assume that going forward, any old industrial will do well just by virtue of being the sort of the right to property type. So e-commerce is clearly a big driver, but it's not everything. Many industrial assets are let to tenants which have nothing to do with e-commerce, and those types of tenants are suffering by dint of being in a really weak economy at the moment. Some distribution warehouse of logistics assets are let to retailers for e-commerce purposes. But many retailers, as we all know, have been going bust. Just because they engage in e-tailing doesn't mean that they will thrive as a business. So I think we need to ask ourselves when thinking about assets, industrial assets that we own or potentially want to buy, how secure is the income? What is the risk of vacancy and what is the likelihood of re-letting a particular property? If it's old, poor spec, ill-suited for modern occupational requirements, is it in the wrong location? What about ESG characteristics of that asset? So I think investors need to focus on which are going to be the right industrial assets which tick the boxes that we believe will be important going forward, not just necessarily historically, but going forward. So logistics markets in good proximity to end consumers that have low availability of space, such as, you know, London and the South-East in the UK or big urban centres more generally, I think they will be the biggest winners. And with that in mind, actually, we're likely to see this trend towards increasing densification. The phrase was used earlier, last mile, urban logistics and last mile. And I think that that is likely to continue being a relatively big winner in the years to come. And actually, that could lead to multistorey logistics warehouses, which have been seen in some markets, notably in Asia. They will probably become more commonplace in the UK and Europe, too.

Jose [00:14:08] Yeah, I think I think that makes sense. And also there is the other point about the pricing. You know, the level of rents and the yields which industrial has reached. Sometimes it's eye-watering. And if the tenant is one of those bruised companies in a bruised sector that may entail a number of risks as well. Anyway. So let's move on to the next narrative, which is the end of offices. And the narrative goes like this. Technology works. We have gotten used to working remotely. Companies are awash with debt and need to cut costs and a good way of cutting costs is to have employees work from home three days a week and reduce their office space needs by 40 percent. Do you think that offices are doomed because tenants are not going to need offices 10 years from now? Rich, what do you think?

Richard [00:15:14] Well, I think that there is a fairly high chance that, you know, 10 to 15 years from now we will be saying things similar to what's being said about retail in recent years along the lines of we simply got too much office space. But I think it is really important to note here that there will be winners and losers. So in their approach to occupying offices, businesses will effectively have less people using more space. So it is all about trying to identify those office assets that will continue to attract offices going forward. I mean, I think we have to acknowledge that there are the sorts of features that occupiers will be after. They will be different going forward to what we were kind of used to, to feeling as being attractive features in the pre-pandemic era. So I don't think we're going to be emerging from the pandemic and simply going back to where we were before, where we left off. What attracts employees and occupiers more generally to go into an office to work is going to be different in the future compared to previously. I mean, a lot of different aspects factor into this. So where do you live? If you're living in a relatively cramped, high rise apartment, which is commonplace in many Asian cities, for instance? Well, that doesn't really lend itself to being an attractive place to work in compared to some European cities, for instance, where flatter living and gardens are more common. There are also differences in cultural phenomenon's to do with, say, presenteeism. It's more prevalent that people feel they have to show their face in the office compared in some countries or markets. Take Japan or Germany, for instance, compared to other markets. But at the same time, we need to be careful not to overstate that. I think big changes are still likely to occur in those markets too. But you know, the pandemic will pass, but part of its legacy will be flexible working. Now, flexible working was certainly a trend that was growing pre-pandemic. The pandemic has massively accelerated that trend. And I think post-pandemic, the average going into the office type of frequency will be maybe two or three days a week for most people. Now, that raises another question. If employees aren't in the office for those days that they're not there, then basically the office isn't needed. So flexible working means that this new normal around going into the office means that offices need to provide what the home can't. So successful offices, therefore, will be those that best enable interaction, collaboration, fostering of relationships in innovation and productivity. So office assets, office buildings need to be able to provide amenities, collaboration space, the ability to network and have that physical interaction, facilitating meetings rather than simply providing a desk to sit behind.

Jose [00:18:24] Yeah, exactly. I don't think I have anything to add. I would just say, as we say in Spain, Amen, because it's important to take into account all these other variables, density, culture and type of activity that's done in the office to understand this topic in a more nuanced way. So I'm going to move to the last narrative now, which is inevitably about Brexit. I would like to ask you, Tony, we now have a Brexit deal, the Brexit deal, the usual narrative is now there is more clarity. So the UK should stop being the laggard relative to continental Europe that it has been in the last five years. Do you think that narrative has merit, Tony?

Tony [00:19:31] Yeah, I mean, I think if you look at pricing, I mean, it all comes down to pricing ultimately in all asset classes all the time. If you look at pricing, there's a crossover in yields, say, for example, say London office yields and major European capital office yields in 2016. That really coincided with the EU referendum in the UK. And since that point, we've seen a large differential in pricing between, say, London offices and Paris offices. You know, the yield differential currently is probably around 200 basis points, which is much more significant than I can ever remember actually during my career, to be honest with you. And a lot of that is because of the uncertainty that was caused through the Brexit negotiations. But as we all know, that's behind us now. And therefore, my expectation is that we'll start to see on a relative value basis a lot more interest in UK real estate and particularly London, the London office market, as a major international centre for cross-border capital, because the arbitrage that exists in yield is probably too great given the underlying economic circumstances of the relative countries around Europe being not that disimilar to each other. And so, therefore, to my mind, one of the biggest opportunities over the next couple of years is probably going to be start to be seen taking some risk in the London office market. Obviously, we are in a risk-off environment currently. But sometimes when everyone's looking left it pays to look right and at some point we will transfer from a risk off environment to more of a risk on environment. And it's worth thinking about London and the London office market in relation to when that crossover occurs.

Jose [00:21:05] Yeah, I, I tend to agree it is hard to justify why the yield in London is so much higher than in other in Frankfurt, Paris, Amsterdam and other cities. Anyway,so I think we've gone slightly over time. But I think this is has been a fascinating discussion. So Rich. Tony, thank you.

Richard [00:21:27] Thanks Jose.

Tony [00:21:28] Thank you everyone.

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