The Investment Podcast

Episode 20: The Investment Podcast: How much inflation protection can real estate offer?
27 July 2022

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Romil Patel: Hello and welcome to this episode of The Investment Podcast. My name is Romil Patel and joining me today is Jose Pellicer, head of investment strategy for real estate at M&G Investments. Hi, Jose. Great to have you back on The Investment Podcast.

Jose Pellicer: I'm really glad to be here, Romil.

Romil: [chuckles] Jose, the big themes of the year are inflation, rising interest rates, and the wider economic outlook. Like every asset class, the real estate sector is also grappling with the impact stemming from these issues, from rising construction costs to ESG refurbishments in order to reach net zero targets. In times like these, real estate as an asset class has traditionally been seen as a hedge against inflation. How much truth is there in that? Does it still hold true in the context of what has driven today's inflationary picture?

Jose: That's a very good question because traditionally, people talk about real estate as a hedge against inflation, but in reality, it is not always a hedge against inflation, and it's not a perfect hedge either because you don't get perfect change in the value that is linked to inflation. Let me just give you a couple of examples, if you are managing an office building and the office building is only 80% let, well, it's not a hedge against inflation because 20% of the building is not giving you income.

Not just that, if inflation rises and interest rates rise, the capitalisation rate on the asset is also under pressure just like every other asset class. Not just that, if you are going through a lease negotiation with a tenant, with a commercial tenant of yours, will you be able to increase rent exactly by the inflation rent?

This depends on the market and the tenant might not be willing to pay higher rent, and the tenant might have 10 other buildings to go to. It is not obvious at all that it is a hedge against inflation. However, historically over the medium term, the income growth that real estate has enjoyed over say a 5, a 10-year period, has been mildly correlated with inflation. Therefore real estate offers you a little bit of inflation protection, but it is not a perfect hedge against inflation.

Romil: Jose, you mentioned a few pressures there. Speaking of pressure, we've seen big price corrections in a number of asset classes, but how has real estate fared when it comes to value?

Jose: So far, if you look at the data, there hasn't been any change. Rents are still broadly growing and yield cap rates haven't started to increase, so there hasn't been any value decreases as yet. What I can say is that an anecdotal evidence suggests that prices are under downward pressure and that buyers are offering lower prices.

Also, what we can see is that liquidity has slowed. For any industrial deal in the past, you had 10 bidders. Now, you may have two. That really shows a difference in buyer's attitude.

All the leveraged players are now either out of the market or in wait-and-see mode. This is the typical cycle. First, you have a period of uncertainty, that's where we are now, then you have a period of illiquidity. Buyers and sellers have different expectations, so the price of an asset, and then you get a value correction, but the value correction hasn't yet materialised.

Romil: Jose, with fewer buyers, what does this mean for exits?

Jose: It's exactly what I said. Initially, you get a period of liquidity, but because there are fewer buyers, if you get a seller that has to sell and only one buyer, and the seller decides to sell at the buyer's price – at the lower price – that's market evidence already. If you have three, four situations like this, these feeds into market values across the board, and that's what always happens.

You do have first a period of momentum, you create a bit of market evidence of lower values, and then valuations change. As you know, real estate as an asset class, because transactions take a while to complete, their values adjust with a lag relative to equities and bonds or all the public assets.

Romil: Let's turn our attention to the global context. What are some of the key commonalities and differences in what we are seeing when it comes to real estate as an asset class in the UK, continental Europe and Asia?

Jose: This is about how strong inflationary pressures are, and I think that we can talk about two extremes here. On the one hand, you've got Japan. In Japan, despite the depreciation of the yen, inflation is higher than what it was but still within 2%, and the Japanese Central Bank is still doing accommodative monetary policy – still buying bonds. As a consequence, Japanese interest rates and bond yields remain low and property yields – the gap between bond yields and property yields – remains healthy, so Japan is pretty much like it was before.

Now take the other extreme, countries like the UK, the US, and Australia, countries with very flexible labour markets that have enjoyed or suffered depending on what part of the fence you are, the great resignation, are now suffering labour shortages. There, inflationary pressures are higher, bond yields have increased the most, and therefore, that's where property yields are most under the pressure because that's where central banks are most under pressure to raise interest rates.

As a consequence, banks are most risk-averse, so margins are under upward pressure. Therefore it's those countries, UK, US and Australia where the uncertainty is bigger and the downward pressure on valuations is the highest. Japan is the most stable one. Then the eurozone is a little bit in between with some countries being closer to UK, US, Australia, and some countries being slightly closer to Japan, but in reality, no country is anywhere close to Japan at the moment.

Romil: An interesting global picture. Jose, we can't ignore the phenomenon of rising costs, this is a theme that we look at closely in our mid-year global real estate outlook. When it comes to construction, this can be a double-edged sword given that higher costs can mean new supply is less feasible, but it can also lead to higher values for investors who are looking

to develop. What does this all mean? Which assets within real estate will be the most impacted by rising construction costs in your view?

Jose: Rising construction costs at the moment for investors is not a good thing in the short term. If you want to develop or you want to refurbish, it is more expensive. In the race to achieve net zero, it is more expensive to do the right retrofitting to get your existing assets to the right place. That's not good for investors. The good thing that you have said is that over time, over the next couple of years, there will be less development and that once the economic recovery comes back in 2024, 2025, you'll probably get a good run on rental growth.

Also, the other point is if you have to refurbish your existing assets, what is the low-hanging fruit? What are the levers that you can pull that don't get your costs too high and make an asset lettable, sustainable, and sellable? I think that that requires a very careful look at each asset, and it requires a very technical but also pragmatic strategy at an asset level and not everyone has that capability in the real estate industry.

The last thing I'd say about construction costs is that if you are developing an asset, you are refurbishing an asset, it costs you more. You have to charge a higher rent in order for the numbers to work. Now, are the tenants willing to pay that rent? That's a supply-demand imbalance. If your asset is unique, has a very good location, and has a very good quality and many tenants want to occupy it, then you'll be able to pass those costs to tenants but that doesn't always happen.

Romil: Quite a multitude of factors to consider there, Jose. Let's look ahead to the next 18 months then with all that in mind. Let me ask you, what is your overall outlook looking ahead to the next 18 months?

Jose: I wish I knew and I wish I had a crystal ball and I could tell you exactly the timing of things, but what I can tell you is number one, that in the short term, we'll face a period of illiquidity then shortly after, there will be some repricing. But then the next thing that will happen, depending on whether the economy goes into recession or not, is that there will be a differentiation between good assets and bad assets, bad assets suffering more than good assets.

That is the point in which we will see – I think Warren Buffett has this quote that ‘when the tide goes down, we will see who is swimming without their trunks’. I think that the point here is that the portfolios that have been amassed over the last few years, the ones that are not of the right quality are the ones that will suffer the most. That's where you will get the big variation of performance.

Romil: Thanks, indeed, Jose. Unfortunately, that's all we have time for in today's instalment of The Investment Podcast. We hope you enjoyed today's show. Jose, I'd like to thank you once again for sharing your insights and indeed to you, our audience as ever for tuning in. We look forward to seeing you next time. Until then, it's goodbye for now.

Jose: Thank you so much, Romil.

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