M&G Investments

November 2022

Global Real Estate Outlook

Steering through volatility in the search for value

Contents

Foreword

With rising economic headwinds and significant uncertainty around the path of bond yields, steering through market volatility will require skill and perspective.

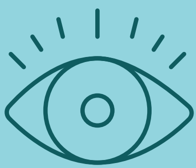
Real estate yields are under pressure globally – a product of central banks' endeavour to tackle higher inflation by raising interest rates. When comparable bond yields have gone up significantly, justifying low property yields in some sectors could become more challenging.

Risk aversion is increasing among investors, yet many parts of the real estate market continue to reflect attractive structural drivers, supporting prospects for income and growth and helping to counter the impact of narrowing spreads of property yields over bonds.

Revaluations will naturally take time to play out, but as yields reach stabilisation, we believe assets are likely to reflect an attractive long-term value opportunity, with improved performance prospects.

With economic headwinds rising, steering through market volatility will require skill and perspective. History shows that it is often in the years after recession that real estate delivers, with the potential for repricing to create the next best vintage of investments.

Key trends



All eyes on the price

Asset repricing is a key factor impacting global real estate markets and investors in the near term. A price correction is likely to lead to variation in performance of portfolios, depending on quality of assets. But it is also likely to create new investment opportunities.

Core and inflation-linked property at rebased yields is likely to offer improved longer-term value, while 'brown' discounts for older assets look set to accelerate. Undertaking comprehensive refurbishment to meet modern occupier requirements could therefore offer attractive risk-adjusted return potential, post-recession.

Portfolios of the future

With traditional property investments such as offices and logistics facing structural and/or cyclical challenges, portfolio allocations are likely to rotate. Assets that provide an essential function such as residential and student housing are a top focus, underpinned by a long-term supply and demand imbalance.

The sector is not immune to the impact of rate rises, however – investors will need to consider pricing and construction costs, as well as issues around tenant affordability.

Creating a positive impact

At a time when households are struggling with the cost of living, creating a positive social impact is an increasing priority for investors. The need for affordable homes is pressing, though the public sector is challenged in bridging the supply gap.

Similarly, regulatory and occupier requirements are becoming more stringent. Despite higher construction costs, achieving ESG-compliant assets is non-negotiable. Careful consideration of ESG standards and the best use of capex we believe will remain critical to investment strategies as real estate markets transition to the next cycle.

United Kingdom

Economic highlights

Labour market dynamics could ease recessionary headwinds

As households cut back spending and focus on essentials like food, fuel and housing, the effect of higher inflation and interest rates on consumers and businesses alike, is plain to see.

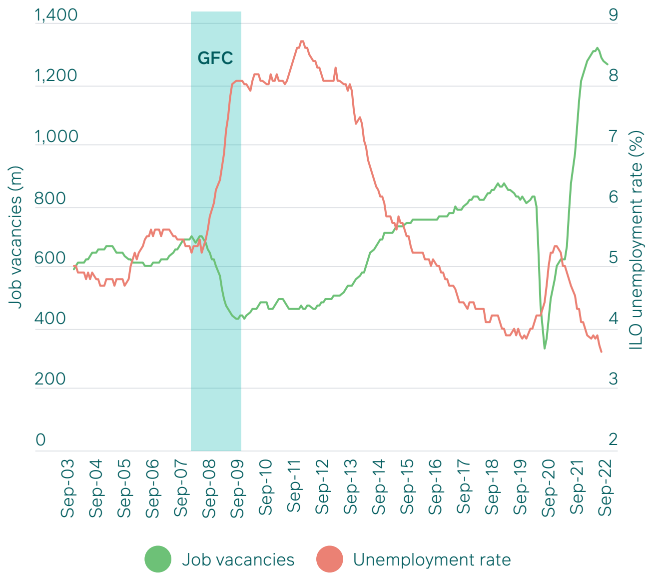
Added political upheaval and bond market volatility may weigh further on sentiment and economic activity in the short term.

The UK is likely now in recession, but the country's labour market dynamics could help cushion the blow.

A shortage of workers post-Brexit, and since furlough in industries like aviation, means employers are eager to retain staff, providing support for households and the economy.

Balance sheets also look healthier compared to the GFC, which should position the market to recover more quickly, once current headwinds recede.

The labour market is far more robust this time around



Source: ONS, October 2022

Higher bond yields may increase pricing pressure

In keeping with central banks across the world, the Bank of England has increased UK base rates from historic lows.

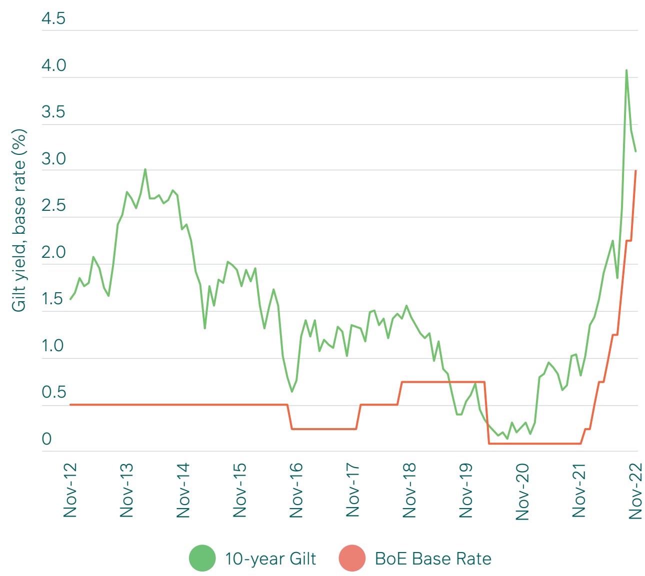
A tight labour market and strong wage growth may sustain inflation at higher levels however, even as food and fuel price growth eases.

A greater rise in rates may be needed, to compensate, with the UK trajectory likely to be closer to the US than Europe, in our view.

Higher gilt yields, as a result, are likely to increase pressure on property pricing.

As yields reach stabilisation, assets should reflect an attractive long-term value opportunity, with better performance prospects.

Interest rates and bond yields have risen sharply



Source: Macrobond data as at 21 November 2022.

Past performance is not a guide to future performance.

Real estate themes

UK property could offer a growing value opportunity

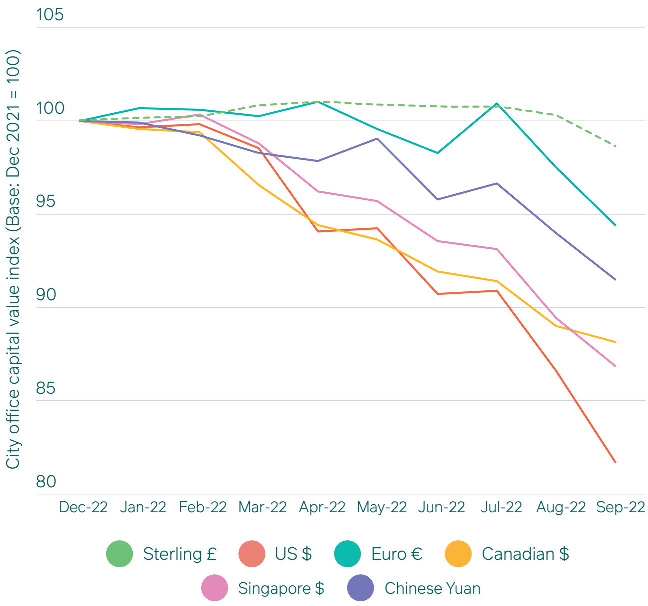
Higher economic and valuation volatility versus other markets is likely to prompt more rapid repricing and higher available yields.

The currency advantage available to some investors is unlikely to erode in the short-term, offering attractive investment potential.

Early repricing evidence is starkest for property that is interest rate sensitive, including bond-like real estate that aims to tap into long-term cash flows.

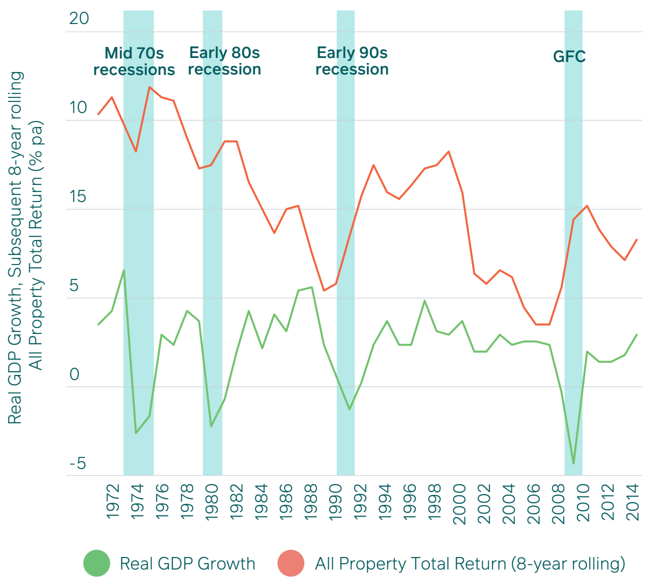
As increased risk aversion filters through valuations, core, inflation-linked property at rebased yields is likely to outperform secondary assets in our view, which could be vulnerable to vacancies in a recession.

Sterling's depreciation makes UK property cheaper for foreign investors



Source: Macrobond, October 2022.

It's often in the years after recession that real estate delivers



Source: Macrobond, MSCI Annual Index (data to end-2021).

Living is set to form a larger share of portfolios

With structural headwinds facing parts of the office sector and significant repricing on the cards for logistics property, portfolio allocations to these sectors are likely to shrink, and will need to be replaced.

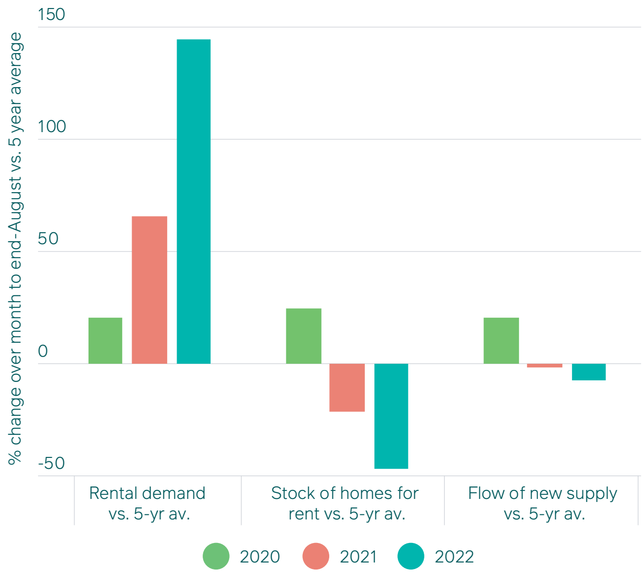
Real estate Living sectors have shown continued appeal from a cyclical, structural and Environmental, Social and Governance perspective.

A fundamental need for housing continues to support occupancy, with rental growth potential for Build to Rent housing and Purpose Built Student Accommodation, even as the economy slows.

The UK remains structurally undersupplied, while existing stock is far from compliant with net zero carbon targets.

The need for affordable homes is increasingly pressing as households contend with the cost of living crisis – a gap that institutions can help to fill, whether through social rented or Shared Ownership housing.

Pressure on the availability of rented housing is rising



Source: Hometrack, UK Rental Market Report, Q3 2022.

Retail looks set to outperform logistics

'In with logistics, out with retail' has been the mantra in recent years, however sentiment is changing.

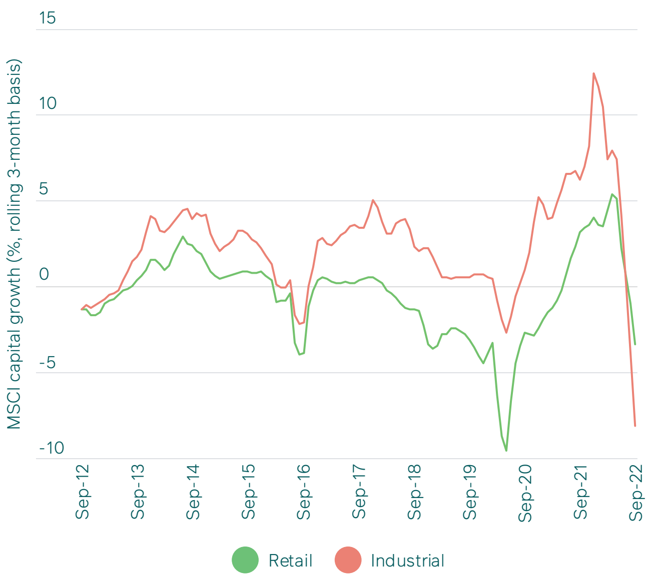
Low real estate yields are harder to justify, given rising bond yields. Investors are therefore seeking to re-establish a risk premium for logistics, impacting performance.

In contrast, UK retail property has already been through a pricing adjustment, offering a spread over gilts, and attractive income potential in parts of the market.

We believe retail is likely to outperform logistics as markets reprice.

Long-term, underlying structural trends are likely to restore the status quo.

Retail looks set to outperform logistics as markets reprice



Source: MSCI Monthly Digest, October 2022.

Strategic calls

Resilient

Retail warehouses in affluent locations

Structural change means that retail warehouses could enter a downturn in a strong position. Rents have rebased, therefore yields currently reflect a healthy margin over historical lows, while investors are attracted to the sector's alignment with e-tailing.

Pressure on consumers could impact occupancy in weaker locations but we believe quality assets in affluent locations are likely to hold up in the face of headwinds.

Living sectors

A roof over our heads is a fundamental need – whether long-term in private rented or affordable housing, or shorter-term in Purpose Built Student Accommodation.

Past downturns have shown the defensive nature of residential. In the coming period, capital values are likely to be supported by rental growth, particularly for Build to Rent housing where affordability is typically less stretched.

Tread with caution

South East offices

The rise of flexible working is likely to have a much greater impact on offices in the South East given greater reliance on back-office functions, especially where stock is non-ESG compliant.

There are exceptions – Oxford and Cambridge, for example, should continue to thrive, benefiting from strong and unique links with life science and tech industries.

Non-core property

At the centre of major headwinds, non-core property could face short-term occupier weakness and long-term divestment as net zero carbon targets hone focus on better quality, ESG-compliant stock.

Facing more significant repricing than prime property, acceleration of brown discounts may mean well located, non-core assets offer improvement opportunities.

Longer term opportunities

Forestry/agriculture

Offering defensive, diversifying and inflation-protection characteristics alongside high sustainability credentials, expect to see a growing focus on carbon-positive natural capital investments like forestry and agriculture, underpinning the potential for healthy returns over the longer term.

Social housing

A fundamental supply and demand imbalance for affordable housing becomes more pressing at a time when households are struggling with the cost of living, yet the public sector is increasingly underequipped to bridge the supply gap.

Offering stable and defensive income streams with potential inflation protection, the sector is attractive to investors with an increasing focus on social impact.

Prime London & South East logistics

While the sector is facing cyclical headwinds, structural tailwinds underpinned by e-tailing mean well located urban logistics property offers significant longer-term appeal.

Given still-healthy rental growth prospects, London and South East logistics look to offer performance potential once pricing has adjusted.

Continental Europe

Economic highlights

Temporary inflation drivers may be moderating

The war in Ukraine is still playing out on Europe's doorstep, stoking ongoing uncertainty. The impact on energy supplies and prices will be felt more intensely as we head into winter.

Central banks continue to tackle inflation through interest rate rises, in turn slowing economies.

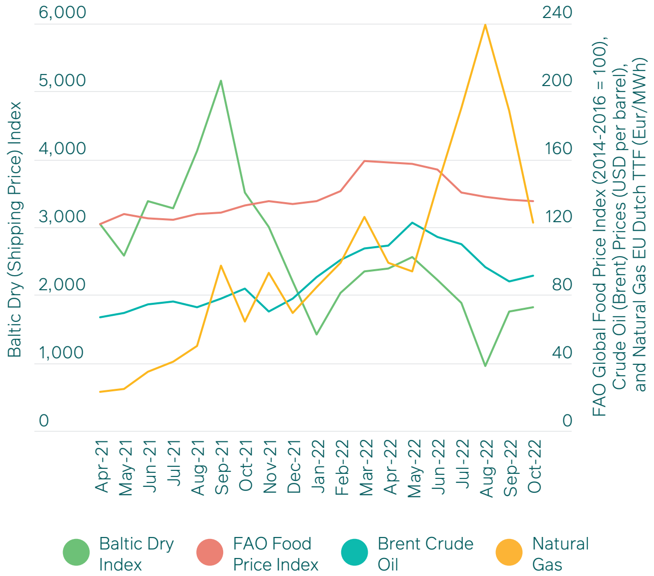
Some temporary drivers of inflation have begun to moderate or reverse, however, as market forces swing into action.

With the flow of Russian natural gas disrupted and Europe seeking much less dependence on it, other suppliers like Norway have been turned to and substantial stores have been built up.

Given lags in how price changes are passed on to end consumers, and the backward-looking nature of inflation numbers, it could take time for recent commodity price falls to bring down headline inflation.

Yet long-term factors which kept inflation low historically, including globalisation and inequality, could be changing, which may imply a new regime of higher structural inflation.

Shipping, oil, gas and food commodity prices have fallen in recent months



Source: Bloomberg, October 2022.

Higher bond yields are no match for the US or UK

Base rate rises in Europe have arrived later, and from a lower level, than in the US or UK.

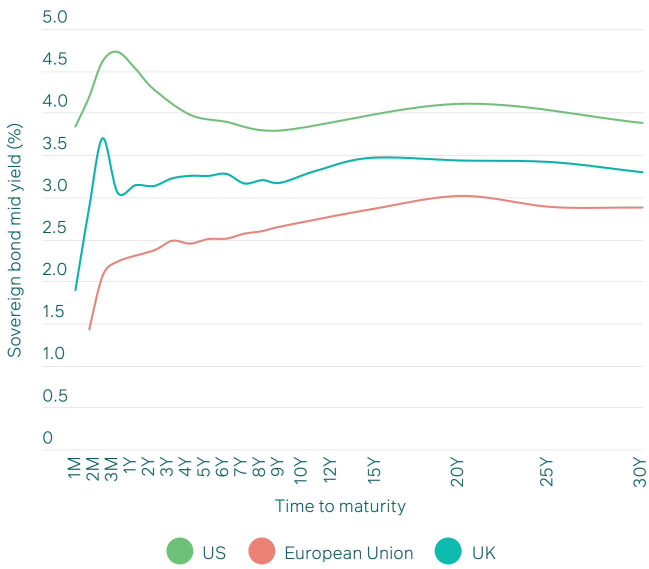
Rates are also expected to peak at a lower level, owing to Europe's relatively lower inflation prospects.

Bond yields have risen accordingly, narrowing the risk premium of property over bonds.

Yet the yield spread was wide to begin with, given that some European interest rates and bond yields were until recently in negative territory.

It therefore seems likely in our view that property yields will need to expand by less in Europe than in the US or UK to restore a healthy spread over bonds.

Yield curves signal Europe's rates are likely to reach a lower peak



Source: Macrobond (yield curve data as at 21 November 2022).

Past performance is not a guide to future performance.

Real estate themes

Only best-in-class offices will perform

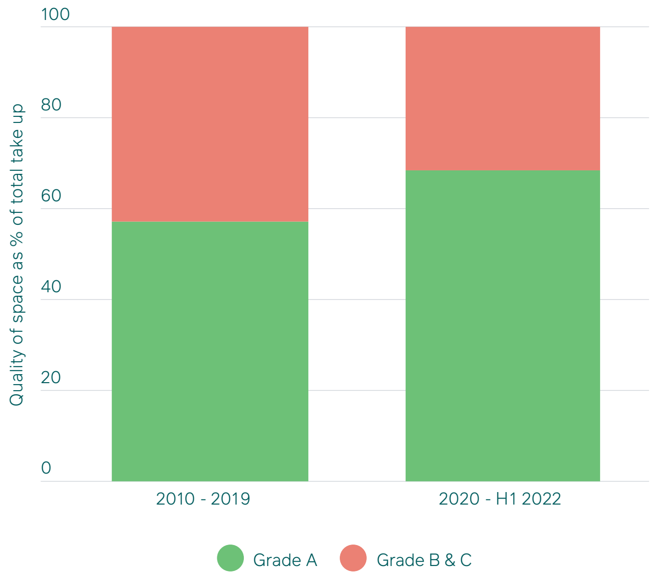
Employment has been growing over the last 20 years – but office stock has not kept pace in many European cities.

With occupiers recalibrating their requirements and increasingly focused on high quality space, offices that fall short run the risk of fading into obsolescence – akin to parts of the retail property sector in recent years.

Regulation is also becoming more stringent, led by the Netherlands, where office buildings must reflect an energy label of C or above from 2023.

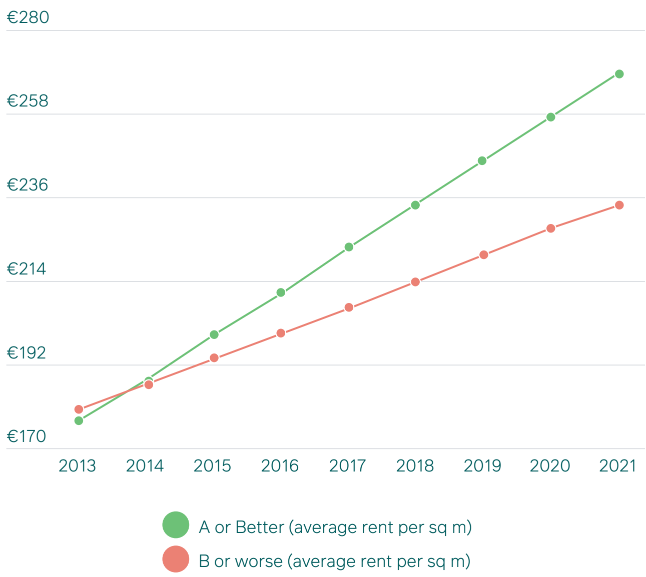
Despite the high cost of heavy retrofitting for older assets, delaying works could (at best) be a false economy. Occupier preferences continue to evolve, therefore light improvements may not serve long-term needs.

European office demand is refocused on quality



Source: JLL, September 2022

Divergence of rents is growing between energy label A and B offices in Amsterdam



Source: Savills, June 2022.
Note: Based on 1,500 transactions.

Residential: not immune, but defensive

Higher interest rates are making mortgage costs more expensive, initiating the potential for falls in European house prices, which could negatively impact investment values for rented residential property.

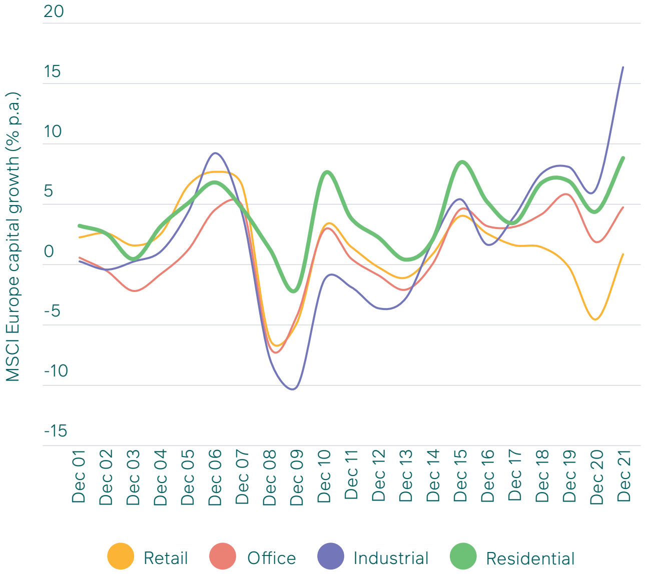
However, an offsetting factor is the potential for increased occupational demand for rented housing, particularly in markets where house prices are least affordable, such as the Netherlands, Sweden and Denmark.

Residential rent controls in European markets help with affordability for tenants, and could provide stable and secure cashflows to investors.

In addition, with allocation to the residential sector growing in real estate portfolios, upwards pressure on investment yields may be reduced.

These supply and demand dynamics and defensive qualities support the sustained resilience of capital values, as seen in previous downturns.

Residential capital values can offer relative resilience during a downturn



Source: MSCI, October 2022.

Banks' refinancing restrictions could create distress

Although aggregate loan to value ratios are lower today than during the GFC, some debt-backed property investors face potential for distress as interest rates go up.

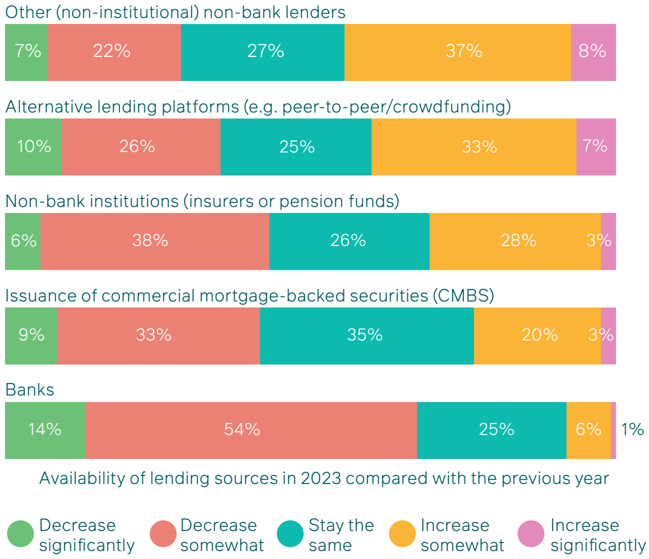
Banks, including conservative German Pfandbriefs, may be unwilling to refinance leveraged assets, or at a lower debt quantum only, owing to the potential for loan covenant breaches – particularly interest coverage ratios.

Forced sellers may therefore bring assets to the market, creating a potential opportunity for investors to acquire real estate at attractive, discounted pricing.

Though volatility is likely to prevail in the short term, these assets could offer strong return potential thereafter.

The gap created by banks' retreat could also enable non-bank lenders to capitalise on higher lending yields and margins.

Debt funds are expected to increase market share as banks retreat further



Source: PwC/ULI Emerging Trends in Real Estate Europe 2023.

Strategic calls

Resilient

Food stores and retail parks

Food retail is inherently more defensive during times of economic weakness, given its essential nature.

The sector is also more resilient to e-tailing, given a lower level of online food shopping compared to other retail goods.

Private rented residential

Investors in this sector may benefit from high stability and security of cashflows. Though yields may come under pressure, the rented market is likely to be supported by weakness in the owner-occupied market due to a decline in economic sentiment and the higher cost of mortgages.

Furthermore, rent controls in many residential markets across Europe could help affordability for renters, while encouraging tenants to remain for longer.

Tread with caution

Older offices in high vacancy markets

Prime offices in Central Business Districts across Europe's major cities generally have low vacancy rates currently.

The same cannot be said for grade B or C offices in many peripheral markets.

Investors tasked with making them ESG-compliant face significant costs; these assets are therefore vulnerable to falling rents and values.

Low yielding high street retail

Though the post-pandemic return of shoppers has boosted high street retail, assets still face the ongoing structural challenge posed by e-tailing. Consumers are also likely to cut back discretionary spending amid the cost of living crisis.

Upwards pressure on low yielding property is another threat to city centre retail property.

Longer term opportunities

Student and senior housing

Purpose-built student accommodation near strong universities is sought after, but undersupplied in many European markets.

Meanwhile, with ageing populations across Europe, high quality senior living accommodation in affluent areas is in demand from retirees seeking community living and amenities, with the option of additional support.

Assets in need of improvement

With repricing leading to bigger discounts for older assets, investors willing to engage in heavier asset management may be able to acquire assets at attractive pricing, inject capital to create ESG-compliant buildings, and generate strong potential returns in the process.

Asia Pacific

Economic highlights

Not in the eye of the storm, but economic headwinds blow

Higher cost of commodities and energy imports have led to inflationary pressures in most developed Asia Pacific (APAC) economies, driving up wages and construction costs.

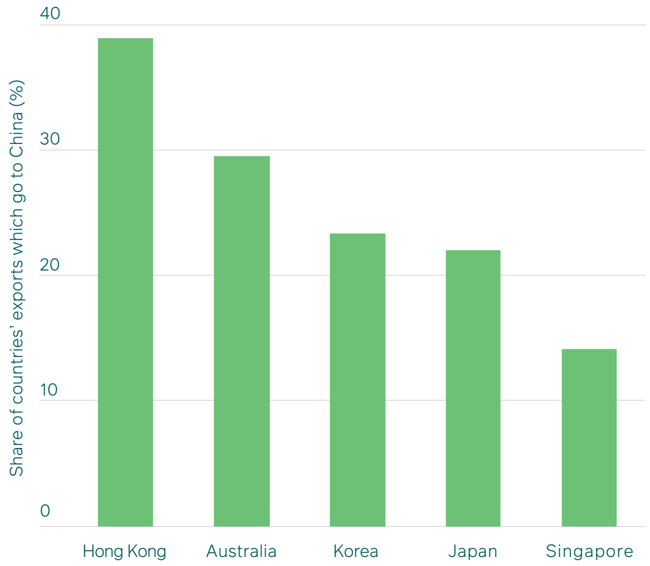
Most central banks in APAC have moved in lockstep with the US Federal Reserve's hawkish rate hikes; higher debt costs as a result are likely to affect the bottom line for corporates and investors in the region.

Headwinds to the Chinese economy, including continuation of a zero-COVID strategy and deepening weakness in the real estate sector, could further weigh on domestic consumption and manufacturing, adversely impacting regional trading partners. South Korea's exports dropped by 15.7% year-on-year in October[1].

With COVID restrictions largely eased across the rest of Asia, however, gateway cities and tourist destinations are likely to benefit from demand for goods and services.

While far from immune to global economic weakness and risks, the APAC region has more resilient growth projections in the medium term, buoyed by its growing middle class.

Many APAC economies are heavily reliant on exporting to China



Source: Multiple government sources, Bloomberg, November 2022.
Note: Volumes for Hong Kong, Japan and Singapore relate to 2021; Korea as at May 2022; Australia as at October 2022.

1 South China Morning Post, "South Korea's China exports plunge 15.7 percent, underscoring drop in semiconductor demand", November 2022.

Diverse APAC economies reflect varying prospects

Developed APAC markets have different economic structures, depicting unique market fundamentals.

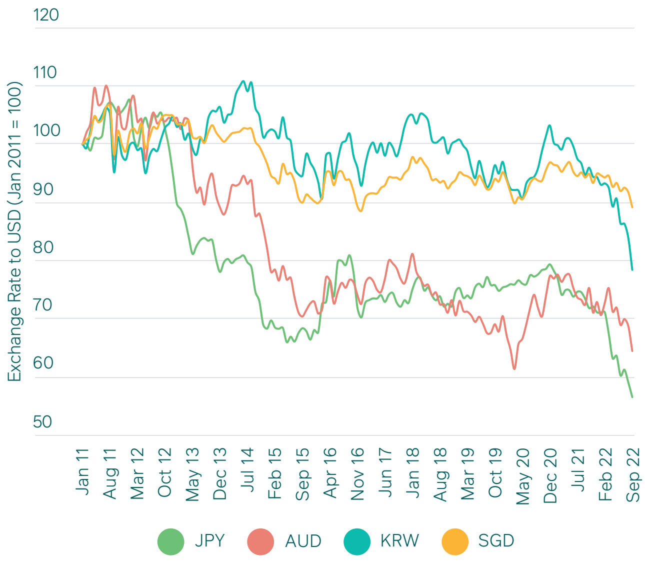
Singapore and Hong Kong are gateways to Southeast Asia and China, respectively. Meanwhile, Australia is characterised by high population growth and inflation – in contrast to Japan.

These differing characteristics present opportunities to diversify across developed APAC and tap into the unique value proposition offered by individual markets.

Local currency discounts against the US dollar could also present cheaper buying opportunities (acute depreciation has occurred in the Korean won and Japanese yen since 2021).

A repricing of real estate assets, combined with the potential to capitalise on the differing prospects across APAC markets, could appeal to overseas capital, in our view.

Currency movements could present opportunities for investors



Source: Bloomberg, as of October 2022.

Real estate themes

Will Japan's appeal remain underpinned by dovish monetary policy?

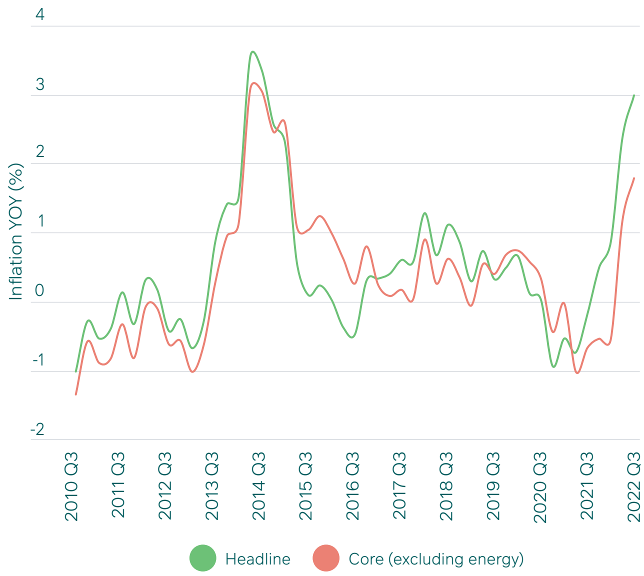
Japan's interest rates and long-term bond yields have remained relatively flat and very low compared to other markets, offering attractive property yield spreads and limited likelihood of repricing.

This environment has led to a substantial depreciation in the yen, reaching a multi-year low against the US dollar.

As such, the rising cost of imported goods has driven headline inflation above the Bank of Japan's 2% target.

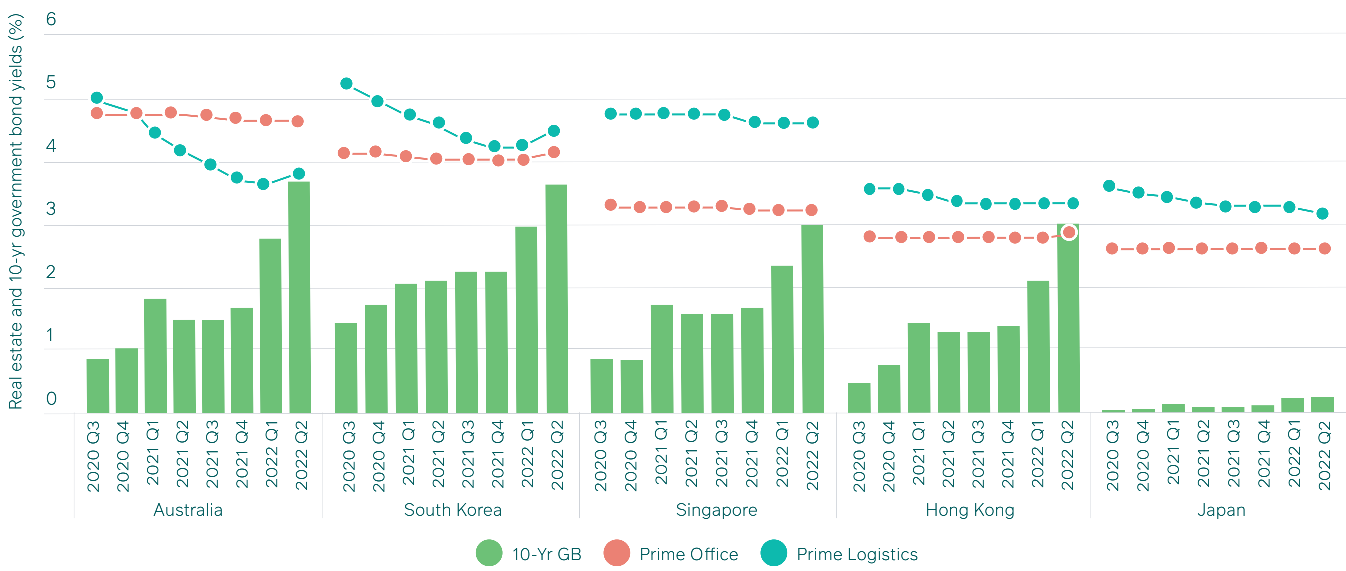
Should these headwinds continue unabated, consumers' purchasing power, as well as corporate profits, could wane, increasing pressure to pivot away from a dovish monetary policy stance.

Inflationary pressures have been rising in Japan



Source: Oxford Economics, as of October 2022.

Japan offers attractive property yield spreads



Source: PMA, as of October 2022.

Past performance is not a guide to future performance.

Australia's Build to Rent sector could offer portfolio resilience

Higher interest rates and weaker growth projections relative to other APAC economies, could position Australia's real estate market for more significant repricing.

House price falls could take some heat out of the housing market, though the relative unaffordability of home ownership and rising urbanisation will continue to drive demand for rented property.

While the nascent Build to Rent (BTR) sector is not immune to the impact of rate rises, it is typically more resilient than other property types during market downturns.

Occupancies in Sydney, Melbourne and Brisbane remained consistently higher than 95% throughout the pandemic, while rental growth in Sydney and Melbourne has shown relatively lower volatility.

The benefit of potential steady income streams could help to support property values, with the aim of enhancing portfolio resilience.

Build to Rent reflects lower volatility in occupancies

Source: PMA, SQM, as of October 2022.

Repricing could amplify ‘brown’ discounts

APAC economies are ramping up their commitment to net zero carbon targets, with cities setting targets to decarbonise buildings[2].

While national power grids have been decarbonising in recent years, this will need to accelerate substantially to meet ambitious targets. For example, just 29% of Australia’s total electricity generation in 2021 came from renewable sources[3].

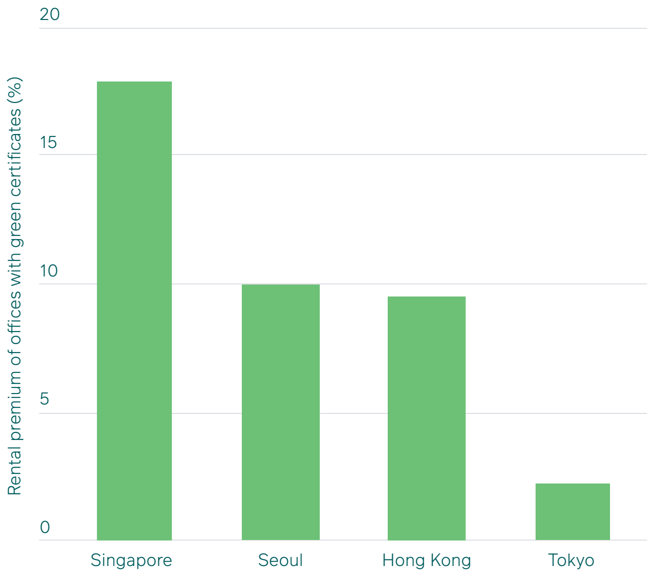
Though the region’s real estate stock is generally newer compared to western markets, a potential challenge to progress could arise from the fragmentation of property owners.

The rental premium between green buildings and older assets remains difficult to pinpoint, as green buildings tend to be more modern and would naturally command higher rents.

However, with increasing focus on ESG by both occupiers and investors, buildings without green credentials are at risk of lower occupancy.

Older assets may also be subject to ‘brown’ discounts, amplified by the likelihood of wider repricing.

Green office buildings can command a rental premium



Source: Savills, Asia Pacific ESG report, May 2022.

2 Buildings account for about 60% of overall carbon emissions in cities. Source: JLL, “Decarbonizing Cities and Real Estate”, May 2022.
3 Australia’s Department of Climate Change, Energy, Environment and Water, https://www.energy.gov.au/data/renewables, as at November 2022.

Strategic calls

Resilient

Multifamily/Build to Rent (BTR) housing

Japan's multifamily sector has remained resilient through the pandemic, with stable demand for inner-city living in capital cities such as Tokyo and Osaka driving the potential for further rental growth.

Australia's BTR market is positioned to mature over the medium term, backed by positive demographic fundamentals and continued affordability constraints in major cities.

Modern logistics

Leasing market fundamentals remain healthy overall, underpinned by the shift towards online shopping. Markets with limited availability of modern logistics, such as Nagoya and Osaka in Japan, could therefore offer investors attractive relative value and development opportunities.

A build-to-suit approach for high quality tenants could help investors both control leasing risks and benefit from resilient income streams over the medium to long term.

Tread with caution

Older offices in secondary locations

With an increasingly polarised outlook for the office sector, driven by quality, ESG credentials and location, older assets in non-core locations face rising risks of obsolescence and underperformance.

Stranded retail assets

The retail environment remains challenging, with higher input costs for retailers, for example, and pressure on economic momentum.

Older retail assets with poorly curated trade-mix in less accessible locations are likely to face difficulty and become increasingly irrelevant in an omnichannel retail era.

Longer term opportunities

South Korea Living sectors

Home prices in Seoul doubled between 2017 and 2021, resulting in the average price of an apartment rising to more than $1million[4]. As such, home ownership has proven increasingly difficult.

Coupled with a lack of professionally managed rental housing, institutional investors could target attractive risk-adjusted returns by delivering high quality, affordable homes via partnerships with local developers.

Hospitality sectors

Hospitality assets in key Japanese cities, such as Tokyo, Osaka, Kyoto and Fukuoka, could become a major beneficiary of a post-pandemic recovery in travel demand, since Japan ranks first for travel and tourism competitiveness globally[5].

Markets that are underpinned by long-term travel demand growth, such as Hong Kong and key tourist cities in Australia, could also offer relative value amid potential repricing.

4 Forbes, "Meet the Korean apartment startup disrupting a red-hot housing market", September 2022.
5 World Economic Forum, Travel and Tourism Development Index 2021.

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