The Investment Podcast

M&G Investments

Episode 26: The Investment Podcast: Dissecting the real estate and recession dynamic

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Speaker 2: This podcast is for investment professionals only.

Romil Patel: Hello, happy new year and welcome to *The Investment Podcast*. My name is Romil Patel, and I'm delighted to be joined by José Pellicer, Global Head of Investment Strategy for Real Estate at M&G Investments to help us kick off 2023. Hi, José, great to have you back on *The Investment Podcast* and a very happy new year to you!

José Pellicer: Happy New Year to you, Romil! I'm delighted to be here as usual.

Romil: Now, José, real estate thrived in a period where equities are expensive, bonds gave very little, and interest rates were low, which meant that the asset class had a great decade from 2010 onwards. That all changed last year when interest rates rose sharply in a bid to contain spiralling inflation. in today's environment of significantly higher bond yields, the challenge for the asset class is to match the premium relative to the risk rate. Clearly, repricing is upon us, but to what extent, and what does this mean for real estate in the context of the current developments of financial markets?

José: Well Romil, I wish I knew the answer. In a way, you're asking me how much are real estate values going to fall? Maybe 20%, 25%, 30%, maybe more, maybe less, it depends on the sector and it depends on the country. The key thing is that equities and bonds, obviously, as soon as interest rates rise, mathematically, the value of a share goes down as soon as the discount rate on that share goes up. That's mathematical, that happens immediately as soon as interest rates rise.

That's why equities and bonds have fallen in value so much this year. With real estate, it's different because real estate is illiquid, so you can only see the fall in values when transactions happen, but if transactions become rarer, then it's much harder to record the valuation. It is in countries like the UK, for example, where you do have some transaction evidence and valuers are faster in adjusting values where you have seen the biggest fall in valuations already. In countries like the UK, the technical term is liquidity brings volatility. The more liquid the market, the more transaction evidence there is, the more data points there are, and therefore, values shift the most.

That means also that when the recovery comes, the UK is also in a good position to bank a very good recovery. Now, take the other extreme examples of Portugal, or Poland, or markets that are less liquid. There, the valuation falls will probably be weaker than in the UK. If the UK, for argument's sake, falls by 20%, then Portugal will probably fall by only 10%. That is because there will be very few transactions. Going back to your earlier question, property yields need to adjust relative to the risk-free rate, as you very correctly say.

Government bonds in the UK are now trading at 3.5%, so this means that real estate yields at the very least on average need to trade at something like 5.5%. German yields are trading at 2%, so this means that property needs to trade at roughly 4%. In the UK, that has almost already happened, but in Germany, there is still some time to go.

Romil: So, a bigger repricing in the UK compared to Germany, Spain, and Japan?

José: Yes, that's correct.

Romil: Does that present greater opportunity in the UK?

José: That is correct, but that always happens. In a place like the UK, because it is very liquid, it tends to adjust faster but it tends to adjust far more sharply. This also means that during a recovery, the increase in valuations also tends to be sharper. The UK tends to be more volatile in terms of value. Does that bring an opportunity? Absolutely. Investing in the UK in 2023 will probably be a relatively good vintage.

Romil: Just staying on the theme of this year, José, just days into 2023, the IMF [International Monetary Fund] said that it expects a third of the global economy to fall into recession this year. While this doesn't make for positive headlines, it's important to drill into post-recession asset class performance and what history shows us is that often in the years after recession, real estate has delivered some of its best eight-year performances. My question to you is, what has made previously fine vintages, and how similar are today's circumstances to those years?

José: Yes, that's a very good question. If we look at history, take the recession of 1991, [when] GDP fell by something in the region of 0.5%, but then if you have invested in real estate for 8 years, in 1993, a couple of years afterwards, your total return, unlevered, per annum, would have been something in the region of 12.5%.

Take the latest recession, the global financial crisis (GFC). GDP fell substantially in 2008/2009, but if you had invested for 8 years in 2010, you would have enjoyed a total return, unlevered, per annum, of almost 11%. Just picture that for a second, 11% in a period of very low interest rates and very low inflation, that is good value. During a period of recovery, you should, in theory, ride the wave of an economic recovery and have values of those buildings go up.

Equally, something else happens. During a recession, the price of risk becomes very cheap. In other words, take two office buildings, exactly the same building, but one of them is empty, the other one is full and fully let. The empty building should be cheaper, but in periods of recession, the empty building is much cheaper. Therefore, if you take that risk at the end of the recession when nobody wants to buy an empty building during a recession period, then the recovery comes.

Romil: José, some people may say that looking at past performance is all well and good, but how are we adjusting the sails to capture opportunity and unlock value for a stock of fine vintage in this cycle?

José: At the moment, obviously, in order to bank that recovery, you need to have capital. You need to be able to buy cheap, and you need to keep bidding. At the moment, there is a lot of uncertainty, and some assets will come for sale, in particular, because there will be a lot of refinancings going on. Let me explain what I mean. If you have bought a building in 2019, and you had borrowed for five years, then after five years, so say 2024, you need to refinance, but hey, your interest rate is higher. A bank will probably want a higher premium over the interest rate, so you will be forced to sell.

For sellers that are forced to sell under those circumstances, it's important for buyers that have capital to keep bidding in order to bank on those opportunities from forced sellers. Now, when I say forced sellers, there's going to be undoubtedly some forced sellers this time around, but it will probably be fewer than after the global financial crisis. The first point is have capital and keep bidding. Second point is don't use leverage. If you can afford not to use leverage initially, don't use it.

From an asset management perspective, be prepared to sell, but don't sell yet because at the moment, whatever goes on the market for sale, there is a reason that it goes for sale.

Romil: Which countries and sectors do you think the investment community will favour the most, and where do you think there'll be less appetite?

José: That is a very interesting question because that is less of a cyclical question and more of a structural question. At the moment – and it's been like that for probably the last couple of years – everybody is favouring beds and sheds. If you look at investor intentions, statistics all over the real estate industry, everyone wants to buy more logistics and more residential. In a way, real estate portfolios in the 2030s will look, particularly in Europe and Asia, much more like American portfolios. What do I mean by this? There will be more residential for rent, less retail and less offices, and there will be quite a bit of logistics.

There will be a lot of demand for residential. The problem with residential is that there is not enough of it, so a lot needs to be built from scratch. That is a process that will take a long time, and this is unlike the US where residential already exists, so therefore, if you want to increase your portfolio of residential, all you need to do is buy assets. You don't need to build them. If you want to increase your portfolio of residential in France, you need to wait 10 years until the building is built. Residential will be favourable, but it will take time to feed into data.

The one that I think will be least favoured is low-quality offices. In your previous question, I said that in recessionary periods, the price for risk becomes very cheap. In other words, the valuation of risky assets goes down. Now, take risky offices, bad quality offices, offices that are half empty, that were built in the 1990s and are not in a prime location. I think those are the one that will be favoured the least, particularly because many real estate owners will want to offload these types of assets. Quite important to look at residential and offices in this decade. Again, that's more of a structural question than a cyclical question.

Romil: Very interesting indeed. José, this brings me to my final question, which is, after a rocky 2022, what's your overall outlook heading into the next 12 months? Where do you see cause for optimism and potential grounds for caution?

José: In 2023, and you yourself quoted the IMF, most people are expecting a recession year and therefore there will be very few transactions. Now, 2023 is an opportunity for many managers to get the house in order from an ESG perspective. What do I mean by this? Understand which buildings they want to keep in the long term, which buildings they want to invest into, and which buildings they want to sell. It's quite interesting, which buildings do they want to invest into?

As a rule of thumb, buildings that are well located, that have a location that represents a monopoly over a particular piece of land that is very valuable, but the building requires a little bit of work. That is an opportunity to explore new building technologies and to potentially increase the amount of renewable energy into commercial and residential real estate. From an ESG perspective, this is an opportunity, and I think that now is a period where there will be a lot of work in asset management, but not that much work in transactions, so redeploying transactions people to say: "Try to explore what kind of new technologies there are to refurbish buildings in a sustainable way." That is one of the key features of real estate in the future that managers like us need to explore further.

Romil: Indeed, decarbonisation is a big theme everywhere, including notably real estate. Hopefully, that's something that we can go into in more detail in a future episode. Unfortunately, that's all we have time for in today's instalment of *The Investment Podcast*. We hope you enjoyed today's show to help kickstart your 2023. José, many thanks indeed for sharing your insights.

José: Thank you so much, Romil.

Romil: Thanks to you, our audience as ever for tuning in. We look forward to seeing you next time, but it's goodbye for now.

Speaker 2: For further information, please view the notes which accompany this episode. This podcast is for investment professionals only. The value of investments will fluctuate, which will cause prices to fall as well as rise, and investors may not get back the original amount they invested. Past performance is not a guide to future performance. The information and views expressed should not be taken as a recommendation, advice, or forecast.

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