# The Investment Podcast

M&G Investments

**Episode 35: The Investment Podcast: A brief history of real estate – and what's back in fashion**

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**Speaker 1:** *The Investment Podcast*, brought to you by M&G.

**Speaker 2:** This podcast is for investment professionals only.

**José Pellicer:** Welcome to another episode of *The Investment Podcast*. This time, co-hosted by me, José Pellicer, Global Head of Investment Strategy at M&G Real Estate, and my colleague, Rich.

**Rich Gwilliam:** Hi, everyone. [I'm] Richard Gwilliam, Head of Research at M&G Real Estate.

**José:** We're here today to talk about our *Global Outlook*. This is a document that we produce roughly every six months. We want to address a number of the topics that the *Outlook* is talking about this time. I wanted to talk about that important topic that we set out there: the four phases of investment. I want to talk a little bit about offices, and I want to talk about Japan, which is a country that rarely features in our podcast. I think you wanted to talk a bit about development as well?

**Rich:** That's right. Some interesting things going on in a cyclical sense for development, so yes, it's right that we talk about that too.

**José:** Okay, cool. Therefore, let's start with the four phases of investment. Rich, we started by saying that the 2020s are going to be very different from the 2010s. Do you want to summarise a little bit the key conclusion of that aspect of the *Outlook*?

**Rich:** Yes, certainly. Obviously, the 2010s, it was characterised not just in real estate but financial markets generally by the world of lower for longer, rock-bottom interest rates post-GFC. For that 10 or 12 years post-GFC, in the real estate industry, it became normal to experience and demand a quite wide spread of property yields over bond yields. That was justified, I suppose, by the fact that bond yields were so low, but that was not always the case. You only need to go just a few years prior to that to see the pre-GFC world. For a good decade or 15 years or so, you had actually quite different dynamics.

**José:** Yes, exactly. You had your property yield higher than your interest rate, so you could still use that, but the levels of that that you used back then in the 2000s were completely different to the ones you used in the 2010s, right?

**Rich:** Yes, absolutely. The high leverage that the property industry was using pre-GFC was one of the reasons why the fallout was so dramatic during the GFC itself. Yes, you had leverage being used to generate returns, but actually, again, that wasn't the norm for the whole of history. You go back a few years prior to that and into the 1980s, and it's a different dynamic again. You had a high inflation world, persistently high interest rates in order to try and tackle that inflation. What happened with the spread of property yields over bonds? Very, very different. You actually had a sustained negative yield spread, i.e. you had property yields on average being lower than the risk we raised for a prolonged period.

**José:** Yes, exactly. Of course, the reason people invested in property at the time was because of high inflation and because of growth. My boss at the time, I wasn't around in the '80s, obviously, you can see!

**Rich:** You were around, you were just a young boy [chuckles].

**José:** Exactly. Yes, exactly. I was enjoying the 1984 Los Angeles Olympics at the time, but my former boss, who was a property investor in the '80s, he used to say that the property yields which he used to buy were relatively low, but he just invested for rental growth. That was a very different dynamic to the 2010s.

**Rich:** Absolutely. In that high inflation era back in the 1980s, real estate is a real asset, and that therefore feeds through into high nominal rental growth. You're effectively generating cash flow growth because you're passing through that inflation onto the rental income side. I think today we're seeing exactly the same thing, at least in parts of the real estate market. As an example, logistics and industrials, as an example, the residential or living sector, these parts of the market have been seeing very strong rental growth. In a high inflation world, or going forward with the supply demand dynamics within these markets, you should expect to see quite strong rental growth continue.

**José:** I think that the key about the 2020s – and that's one of the key conclusions from the *Outlook* – is that the old-fashioned investment skill and real understanding of property fundamentals is going to come back into fashion, and that it is the type of buildings where you can pass on inflation to your occupiers [which are] the ones that will offer an attractive return. There will be plenty where you are not able to pass on inflation to your occupiers, where things can be problematic.

**Rich:** Yes, I think that's right. It's too simplistic to say that real estate – all parts of real estate will be able to generate strong growth. It's clearly not going to be the case. We've been seeing that in some parts of real estate, as an example, secondary offices, as an example, the retail sector for a good decade or so. However, you do have the possibility of a high yield from some of these markets.

**José:** Yes, exactly. The 2020s will be different. Another thing in which the 2020s will be different is about offices.

**Rich:** I think that's right. We're making the distinction between different phases of history. I think the pandemic is a good cut-off point to distinguish between what was normal, the pre-pandemic world, where pretty much everyone was going into the office every single day, compared to now. Clearly, post-pandemic, we're in a very different world. Who goes into the office five days a week? Some people do, but certainly not the case everywhere.

**José:** No, that's fair enough. I am actually coming every day this week, but that's a bit of an exception. There are two key dimensions that differentiate potentially successful offices in the 2020s versus completely unsuccessful offices in the 2020s. I think dimension number one is geography. There is a big difference between the US, Europe, and Asia. If you take the US, the fabric of the American city works against the office.

In a typical American city, you've got a central business district, so what the Americans call downtown market. Then around the downtown, you've got the fringe city, where you've got quite a lot of low-rise residential. Then you have the suburbs, where most office workers live. Therefore, all those office workers, they commute to work and often without public transport. Commuting into an American city is actually a horrendous experience and particularly long, but because many Americans live in the suburbs, their dwellings are big, so they can work from home.

**Rich:** Yes, and I think this has materialised into a distinct difference with the US market or North American market compared to other parts of the world. Post-pandemic, the levels of sort of attendance in the office from the average employee, it's still only about 50% of those pre-pandemic levels. Now, that is distinctly different to other parts of the world. In the UK and Europe, it's 75% up to 80% in some countries. Over in Asia, it takes Seoul in South Korea, for instance, and it's actually above those pre-pandemic levels.

**José:** Exactly. If you look at the old-fashioned measure of vacancy rate, so that's the amount of space that is not under rental contract, that it's empty or unoccupied, so in American cities, it's generally higher than in European or Asian cities. At the moment, in places like San Francisco, Dallas, Houston, these are very close to 30%. There is this phenomenon, which is not seen before, where the downtown, where the vacancy rate in the CBD, in the Central Business District, the downtown is higher than the average vacancy rate in the city.

Now, that's really rare. That basically suggests that many people living in the suburbs, they would rather have a little office space next to where they live so that they can get out of home rather than commute all the way into downtown, which I wasn't a believer in that system at all, but it seems that is well suited to the, let's call it American way of life for lack of a better option. Let's just take Asia, right?

**Rich:** Yes. This has materialised into vacancy rates and differences across different markets. It's not just CBD versus city-wide or even out of town. It's the vacancy rates themselves in parts of Europe, in parts of Asia. You mentioned double digits and even up to 30% vacancy rates in some US markets. Very different across Europe and most of Asia, where it's single digits, and particularly for the CBD – the top spec prime best-in-class type office space, where you're looking at vacancy rates sub-5% in quite a few of these markets.

**José:** I said one dimension was geography. The second dimension is quality. An office building that has the right ESG characteristics, that is new, that has sufficient amenity space, that is probably the office space of the future. Actually, if you take every European office market and every Asian office market, I think Tokyo is a bit of an exception, but prime rents, i.e. the rent of the top 10% most expensive offices is actually still growing in a period where everybody doubts the future of the office. That's another big change in the 2020s. You want to talk also about development. Even though that's not a structural change, that's cyclical, but I think it's quite important.

**Rich:** I think that's right. There are obviously structural dimensions to it in the residential sector, for instance, structurally, there is an undersupply of housing in most economies, but cyclically, what we've been through recently, a big increase in the cost of financing through mortgage rates, effectively, it's more expensive to build and there's less appetite for developers to do so, factoring in the cost of inflation, higher cost of materials and higher cost of labour, construction labour, etc. It's all factoring into a cyclical reduction in the supply pipeline coming forward, particularly in the residential sector, but that's also the case across real estate, including say, offices.

**José:** Actually, during the global financial crisis, the same happened, and even during the crisis of the mid-90s, the same happened. It's a typical cyclical thing that happens in property markets and the lack of new space that is triggered by lack of development basically turbocharges the next wave of rental growth in the next cycle.

**Rich:** I think that's right. We've already seen pretty dramatic rental increases in residential, in logistics. You mentioned just a minute ago about the best-quality office space – that is seeing rental growth. In part, that's because there hasn't been a huge amount of supply. Now, in the future, we might see in the years to come after the cycle has been worked through, that that's where the next pinch point is, that there's a cumulative lack of supply being built up for the type of space that the occupiers want. That might be the big opportunity of the future later on in the 2020s.

**José:** In 2013/2014, that's the way I used to pitch new value-add funds. I would have taken it from your rule book, Rich! The other thing I want to talk about in this episode is about Japan, which it rarely features in podcasts like this. Japan, as you all know, has been a country that in the last 30 years has had pretty much zero interest rate, pretty much zero wage growth, hardly any productivity growth. Everybody saw Japan as a dormant economy throughout all of our working lives. We saw Japan as somewhere to sleep, somewhere to go on holiday, somewhere to enjoy good food, but actually, Japan is changing.

**Rich:** Yes, so the phrase "the lost decade for Japan" is in common parlance. Actually, it was the lost decades, two or three lost decades, 30-odd years of basically stagnant economic growth. It's not been a fantastic story for Japan. Do you think times are changing?

**José:** Oh, yes. I think the beginning of the whole story started with Shinzo Abe, the former prime minister who was assassinated, but Shinzo Abe basically coined “Abenomics”. Abenomics had basically three, what he called three arrows. One of them was aggressive monetary policy. Second, a big government spending in infrastructure. The third one was structural reforms.

The first two are easy to implement because it's within the government and central bank's gift to start implementing. The third one's harder. Actually, the Western press was disappointed about lack of progress in structural reforms – but the Western press doesn't seem to be very aware of Japanese history. When Japan basically decides by consensus in the elites that change is needed, change happens – and change happens decisively.

Over the last 10 years, there have been a number of very important reforms that have begun to bear fruits. For example, Japanese companies are beginning to distribute dividends – this was pretty unprecedented before. Japanese companies have begun to do share buybacks – that was very rare before. Japanese boards are beginning to be more diverse. Female labour participation in Japan now is higher than in France, it's higher than in Italy, it's almost as high as in Germany. Everybody thinks of Japan as a patriarchal society, that is beginning to change.

Then the other important thing is that salaries are beginning to rise. Now, it looks like I am pitching for Japanese equities, but I'm not because this will have its effects on real estate as well.

**Rich:** That mention of wages increasing, that is a seismic change. The Japanese economy has been crying out for inflation for decades. It's been battling deflation or disinflation for a long, long time. In the last couple of years, the global inflationary pressures have been coming through. That seems to have, at long last, fed through into the Japanese economy as well. Wages, on average, have been increasing at long last. That's got to be a positive, right?

**José:** Exactly. When wages increase, then this means that Japanese consumers will consume more. This probably might have a positive impact on retail rents. If Japanese youngsters start earning a little bit more according to their skill rather than to their age, then they will want to live in more expensive accommodation and the most attractive areas will enjoy rental growth, so these things are beginning. I think that that's something that we need to watch very closely because it is possible that Japan is back.

**Rich:** Japan could be the next opportunity then. Is that what you're saying, José?

**José:** Japan could be the next opportunity, but we also have to be careful that property prices are priced for a world of low interest rate. Therefore, whilst there is an opportunity, there is also a risk.

**Rich:** I think that is a very important point, that the world of the next few years, we have to have a different mindset. What we had in the 2010s and up until 2022, when we saw inflation come through and high interest rates come through, we're seemingly in a world of higher for longer now rather than lower for longer. We have to adopt a different mentality.

**José:** Exactly. This is the motto of the 2020s, a different mentality. With that, thank you, Rich, for joining me in hosting this podcast today.

**Rich:** My pleasure. Thank you.

**José:** Thank you all for listening. Please join us next time.

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**Speaker 1:** 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 because 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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