News release

M&G Investments

M&G's 2023 Global Real Estate Outlook report highlights continuing opportunities despite fundamental shifts in economic backdrop

- ***Asset repricing will create new investment opportunities***
- ***Traditional sectors facing structural and cyclical challenges prompting shifts in portfolio allocations***
- ***Social impact is a growing priority for investors***

London/Amsterdam/Frankfurt/Milan/Paris, 29 November 2022 – Despite property yields under increasing pressure globally in the wake of rising interest rates and evident investor risk aversion, much of the real estate market is offering prospects for income and growth, according to M&G's end-of-year Global Real Estate Outlook report published today. Key takeaways include:

- The need for awareness between the differences in pricing changes driven by factors such as rising rates versus those influenced by changes in projected rental income streams.
- Asset repricing will lead to greater variation in the performance of portfolios, and is likely to accentuate the divide between prime and lower quality assets. But it will also create new investment opportunities, particularly for investors willing to engage in heavier refurbishment in order to target attractive risk/adjusted returns, post-recession.
- As traditional commercial sectors face structural and/or cyclical challenges, allocations to alternatives such as residential and student housing will increase, offering relative resilience, underpinned by chronic supply/demand imbalances in many markets.
- The cost-of-living crisis in the UK and Europe is emphasising the importance of investments with a positive social impact and well-defined ESG-compliant portfolios.

A breakdown of the issues and opportunities is noted below for the UK, Europe and Asia:

- **In the UK**, (which is likely in recession) strong labour market dynamics and low unemployment combined with Brexit-related worker shortages suggests households are better cushioned from some of the harsher effects of economic downturn, but a tight labour market with strong wage growth adds fuel to inflation. Further interest rate hikes are likely, but **rapid rises in property yields are making real estate assets cheaper, leading to them offering improved, long-term value.**
- Increased risk aversion suggests that **core, inflation-linked assets at rebased yields will outperform secondary assets**. Portfolio allocations to Offices and Logistics are likely to shrink while **a fundamental need for housing – especially when existing stock is far from compliant with current net zero targets – is likely to drive growth in Living sector investments** with an increasing focus on the provision of affordable homes, either through social rented or Shared Ownership.

- With low yields harder to justify against a backdrop of rising bond yields, Logistics pricing is correcting rapidly, driving underperformance. In contrast, Retail, having already undergone a significant pricing adjustment, offers more attractive yields and the potential for outperformance in the short term.

- **In Europe,** the war in Ukraine makes its impact felt through uncertainty, energy supplies and pricing. Interest rate rises have arrived later – but at lower levels than the US or UK – and are likely to reach a lower peak. As a result, **property yields will need to expand by less in Europe to restore a healthy spread over bonds**.
- Some temporary inflation drivers, like the spikes in shipping costs, energy and food may be moderating, which could ease pressure on central banks to keep hiking rates. Other long-term factors which have traditionally kept inflation low may be shifting in favour of higher structural inflation.
- Amid wider repricing, increasing occupier standards means **best-in-class office assets reflect improved prospects** while 'brown' discounts for older assets are likely to accelerate, mirroring the trends seen in parts of Retail in recent years. The report also notes an example of the growing pressures from regulation – in The Netherlands all office buildings will need to qualify for an energy label of 'C' or above from 2023.
- **Investment values in the residential sector** are not immune from higher interest rates, but defensive qualities, rental prospects and growing allocations should support relative resilience.

- Across much of **Asia Pacific**, wages and construction costs have generally been driven up by higher costs of commodities and imported energy. Except in Japan, central banks have raised interest rates resulting in higher cost of debt for investors.
- Weaknesses in China's economy (including the real estate sector) is impacting on domestic consumption and manufacturing, but also on regional trading partners which are heavily reliant on exporting to China, such as Australia, South Korea, Japan and Singapore.
- The varied economic structures of developed APAC markets offer diversification and opportunities to tap into the individual value propositions. Acute depreciation in the value of the Korean won and Japanese yen since 2021 present cheaper buying opportunities and combined with asset repricing, is likely to appeal to overseas capital.
- **Australia's Build-to-Rent sector** could offer particular portfolio resilience for institutional investors. The relative unaffordability of home ownership set against a growing demand for rental accommodation means that this nascent, but fast-growing sector, is an attractive investment prospect – already backed up by evidence of resilient income streams in major Australian cities even during the pandemic.
- **Sustainable office buildings** are increasingly commanding a rental premium across many APAC markets as economies start to ramp up their commitment to net zero carbon targets. The growing

focus on ESG credentials by investors and occupiers means that assets lacking in strong sustainability credentials will fail to attract tenants.

Commenting on the findings, Jose Pellicer, Head of Investment Strategy at M&G Real Estate, says: "Unsurprisingly, risk aversion is more pronounced globally as inflationary pressures cause higher interest rates and borrowing costs and European investors in particular question how long the war in Ukraine will continue, along with its effects on the global economy.

"Many parts of the real estate market continue to be sustained by attractive structural drivers, which will support growth and the generation of income, and the strength of these drivers will also counter the impact of narrowing spreads of property yields over bonds.

"Experience shows that in the years following recession, real estate tends to perform strongly. There will always be shifts in the nature of the assets making up portfolios in particular markets, but the underlying indicators for renewed performance and growth will remain strong, with real estate continuing to play an important role in multi-asset portfolios."

For further insights, please access the full report here.

M&G Real Estate is part of M&G plc's £76.7 billion private assets and alternatives division*.

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Notes to Editors

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