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TRANSCRIPT

How COVID-19 is Affecting Private Real Estate Markets

*Featuring **Jay McNamara**, Head of Real Estate and **Will Robson**, Executive Director & Global Head of Real Estate Solutions Research*

Jay McNamara: Today Will and I are going to be discussing a number of things that we're observing from our clients around the globe. The ways that we're helping clients navigate the immediacy of the crisis that we're seeing as well as anticipate coming out of this crisis in ways that helps them position their portfolios to help their underlying stakeholders.

Will Robson: Thanks Jay. I'm Will Robson. I'm Global Head of Solutions Research for Real Estate at MSCI.

Jay McNamara: What we're finding is that many of our clients, as we all have been reading are focused intensely on the tenant landlord relationship, the idea of income, which many investors are allocating to core real estate four, income is becoming a number one focus for our clients. Equally, we're seeing a lot of focus on the valuations and the process. We at MSCI had been spending a lot of time working directly with our partners in various local markets, including the valuers, so as to ensure that the data that our clients and we at MSCI receive are reflective of the market conditions at that present time.

Will, do you want to talk a bit about some of the ways that we're providing new and exciting analytical tools to clients?

Will Robson: So from a research point of view, most of our clients will know that the indexes that we publish are evaluation based, but with private real estate, one of the key characteristics is the kind of, the smoothness in valuations. And so we've been doing a lot of work to help clients understand the extent to which, and speed with which, valuations may adjust to what we're seeing in the markets today. So as Jay mentioned just then, a lot of them are seeing short term disruptions to their cashflows. So lots of tenants are seeking rent holidays or rent referrals or are just not able to pay their rent in the short term and so evaluators are really grappling with how they can factor those in to the evaluations and the investors and managers are trying to understand how that will flow into their performance numbers. Today we've just published the first quarterly numbers and you're seeing single digit adjustments to valuations. But we've created an evaluation scenario model that allows our clients to think about the assumptions that are going into those valuations to understand over time how these valuations might adjust to those assumption changes, whether it's the short term cashflow implications or much longer term impacts of the virus crisis on long term income growth or discounting, which could see much bigger impacts to evaluations.

Jay McNamara: And Will, when we think about MSCI being able to provide an investment decision making tools across the asset classes, how do you think that maybe clients could be incorporating some of the public real estate tools that we're able to provide them alongside decades of private real estate data, indexes, analytics?

Will Robson: Well, obviously the listed markets react much more quickly to these kind of events than the private markets do. And so you're seeing pretty substantial movements in the values of the real estate companies. And so we have a number of indexes that track reap performance and so you're seeing movements over the first quarter of 2020 in the region of 20%, 30% or more percent on those kinds of indexes. The thing with those indexes are they are listed real estate. They're measuring the performance of companies with leveraging and so it's very different to the private indexes that we track just looking at unlevered core real estate. So we also have liquid real estate indexes which try and take the information in the listed markets. But do you leverage the property companies and tilt towards those that are just holding kind of stabilized real estate, give it by their indication. And so, there's some interesting insights from looking at those indexes that has to be used to infer what might be going on in the private markets or could be going on as the valuations adjust to the new regime.

Jay McNamara: Yeah, it's been interesting because as we talk to our clients, and again I think this is a global phenomenon rather than specific to one region or market, as we talk to our clients, obviously kind of the brass tacks, the management of their assets, the collection of rent and the engagement with the tenants, you know, whether they be on the retail side or in other sectors, is at the forefront of everyone's mind. But equally we're also seeing a lot of interest in new and exciting ways of looking at portfolios, taking on what we would describe in other asset classes and more of financial risk modeling view. Obviously, we, you know, some of the tools that we're providing our clients as it looks at income and rent rolls and things of this nature, cause collecting data at the tenancy level is something we do and in a number of markets around the globe. But equally the idea that you would be able to stress test the portfolio that many investors are so used to doing in other asset classes, it's something that we've been able to provide clients some insight and some tools in the recent weeks that we think will actually advance many of our client's abilities to have a deeper understanding of their portfolio.

Will Robson: Yeah, that's right. So, we have, MSCI has a risk modeling framework called Barraone and within that we've got the private real estate module that leverages the private real estate data we have at MSCI Real Estate, but also combines that with public real estate information and it allows you to do just that in the modeling framework. We published the blog a couple of weeks ago that looked at this in a private equity context. So we're using that model to now cast private equity evaluations. There's some work going on behind the scenes to see what we can do in that area for private real estate. That tool is available to clients today and people can think about how real estate sits in that multi asset class portfolio, whether it's stress tests like you described or just understanding how correlations with other asset classes are changing. So, that kind of modeling solution is often used by our asset owner clients in the multi-asset risk teams. But increasingly we're getting questions from the asset managers that may focus explicitly on real estate, but they're having lots of questions being asked of them by their clients and so they're asking for this kind of information to help them better communicate. So we're exploring ways that we can take the insights from that kind of modeling and package them into fixed format reports that the asset managers can leverage to.

Jay McNamara: Yeah, it is one of the interesting things because of the extent and the breadth of the data of assets that we, that we have at MSCI, we're able to provide clients with some analysis that can highlight differences. For example, in the retail space, not all retail assets are the same. Do you want to talk a bit about what we've looked at in the Dutch market, for example, one of a few different studies that we've already done in the last month or two?

Will Robson: Yeah. The interesting thing about the Dutch market is we have a segmentation there that allows us to segment retail properties by the catchment area that they're within. So whether they're of largely comparison goods, so kind of fashion retail versus convenience goods. So the essentials, and we've read a lot in the press about how the broader retail market is much more exposed to the controls around social distancing. Whereas the convenience sector, the supermarkets, the food shops or the essentials have been faring pretty well through this crisis. And so we have data for the Netherlands market, they show it's kind of a divergence of performance between these two parts to the retail market, for quite a number of years from about 2013-2014, it was really driven by online retailing and I think this kind of crisis is really exacerbating a lot the trends that you saw developing around online and retailing before the crisis. And I think many have the expectation that this will kind of just force that trend faster and more impactful over time.

Yeah. It reminds me of the paper you and the team wrote on gateway cities. Just trying to draw out that it's not a one size fits all. That top down approach does not always provide the real insight and you know, the differentiators in a portfolio, either an existing set of assets or a potential addition to a portfolio.

Yeah. So, a lot of analysis of real estate is along the sector and geography lines. We published a blog just as this crisis kind of unfolded, around how lease length or income duration is a good explanatory variable for performance over the crisis. So you tend to find the assets with longer leases outperform during a market where the rental market's weaker. So through the financial crisis, long leases outperformed but as the market recovered and rent started to grow the assets with shorter leases outperformed as they were benefiting from rising market rents and the reversion into market. We already saw in the UK just before this crisis hit, that shorter leases were starting to underperform and long lease is coming back. And as we enter this kind of environment with more weakness in the lettings market then you might expect that to revert to trend. The interesting thing about this is this crisis, there's lots of tenants that are in secure leases that had good tenant strength and ratings that are still struggling and so there's a combination of lease lengths not going to be the be-all-and-end-all, it's the tenant strength and a deeper understanding of the drivers of that business model and how resilient to this crisis individual tenants are.

Jay McNamara: We at MSCI, it's been interesting in these conversations we've been having with clients because in markets where capital values, asset prices are just going up, up, up and up, many of our clients were quite comfortable being able to just simply take whatever the managers of their assets were giving them in the terms of analytics or transparency and whatnot. And so the dedicated teams we have at MSCI focused on the pensions, the sovereigns, the investment consultants are getting a tremendous amount of inbound requests. We've been quite active on our outbound outreach to the clients, but it's been interesting to see the inbound requests. A number of the owners of the assets, the institutional asset owners seeking better clarity on the portfolio that they have, seeking to improve and in a more sophisticated way, engage with their managers knowing that it is not a one size fits all approach but actually will get them through this period and then obviously no one really knows what it will be like as we come out of it and obviously there will be significant differences, but what those are, we tend to think that the types of analysis and transparency that are provided by indexes as well as analytics and the types of research that Will and the team are writing, we're going to be in even more demand going through this crisis and coming out of it.

Will Robson: Yeah, I think it's an interesting point. I think there is a perception in the market that a lot of what we provide is around performance measurement and reporting and telling the asset owners whether their managers have done a 'good job' in inverted commas. I think what our analysis allows asset owners to do is across the funds that are invested or the direct portfolios, having a roll up and understanding how their risk exposures are either being diversified across funds or whether they're concentrating and having a global view of what they're exposed to, how it combines across the portfolios within real estate, but also across multi asset class context is really important. And that's the real focus. And you see that come out in a crisis like this. The question is about where's my exposure really come to the fore? And people want quick answers in a consistent way.

Jay McNamara: Right! And even accepting that the nature of private real estate and the nature of the data involved in private real estate tends to be a bit slower moving than let's say our listed asset classes, that many of us are also invested in. Do you want to talk a little bit about some of the valuation scenario models that we've been building in the last couple of weeks here to try to help clients bridge that gap between one period of evaluation and another?

Will Robson: Exactly. So the model is relatively simple in concept, but it's designed really for clients to kind of role play in scenario model, different kind of impacts on valuations. So as I said before, a lot of what we're seeing on the ground at the moment is around short term disruption to cash flows. And so whether that is giving tenants three months rent free or deferring that rent for six months, or it's a tenant that's gone bust in those three months and it's a bit more of a longer term issue. It allows you to play with the kind of assumptions around those scenarios in evaluation compared to a baseline and understand if you tweak assumptions around income growth or vacancy or indeed discounting and the risk appetite that's around at the moment, what that would do to an evaluation. And this isn't kind of a forecasting model to tell you what's going to happen quarter by quarter, the idea of it is to allow clients to understand what the overall impact of this crisis could be and what that would look like in terms of their valuations.

And the interesting thing is that if you look at the results from a short term, cashflow disruptions are pretty small impact. So 3% to 5-6% impact on portfolios, which is way smaller than what we're seeing in listed markets. So some of what's going on in listed markets will be about risk appetite and sentiment and discounting of cash flows or longer term impacts around income growth. So thinking through which parts of the portfolio will be exposed to those longer term impacts or is going to be interesting to apply this model to. And then in terms of the discounting side of things, understanding how much of that is short term fear in the markets that you may want to hold through and how much of that is going to be a longer term shift in investors appetites, is going to be an important thing to think about through the use of this model.

Jay McNamara: One interesting thing that we are hearing from our clients as well is the continued interest in ESG environmental, social, governance views of their portfolio including and specifically climate. You know, we at MSCI have been providing for a number of years solutions across equities, fixed income indexes, ratings, these sorts of things and we've started to extend our ESG particularly in the climate space into the real asset space and we'll be coming out with climate related tools for our clients, which even and despite the crisis that we're navigating in real time, remains the topic of discussion with clients, both the managers and the owners, who are seeking, and to my earlier comments around the idea of a financial risk modeling mindset being introduced into real estate, the idea that you could have a value at risk calculation in the real estate space is quite groundbreaking. It's something that we're quite excited about. And then continuing to extend these offerings which clients are telling us. And you know, as they focus intensely on income and collecting rents and tenant relations, climate and other environmental, social, governance factors remain at the forefront of their thinking and incorporated into how they construct and evaluate portfolios and assets.

Will Robson: Yeah, that's right. I think, the interesting thing about this crisis is that it is so immediate and there's a ton of problems that investors and managers need to solve, they still have one eye on this climate change issue, it's a massive thing for them. And they're very interested in modeling this. There's this kind of risk that is going to exist after we come out the other side of this crisis. In fact, there was some interesting research written by our colleagues, behind that climate risk model, looking at the impact of the coronavirus on climate change. Because there's been a lot of speculation around how the short term impacts of this crisis reduced travel, reduced emissions from industrial activities are actually helping with the carbon emissions problem, and they're asking the question whether that will be a longer term impact on climate change. So, look at our website for detailed analysis of that, I think we'll be discussing that topic with those guys in a future edition of this broadcast.

Jay McNamara: Yeah, we are seeing too, you know, some of our clients most definitely are freezing activity trying to renegotiate transactions that might've been in the works, but a number of our asset owner clients, the pensions and the sovereigns, despite some sort of impact maybe, you know, some have referred to it in the media as the denominator effect. Despite that we are still seeing then a number of our pension plan and asset owner clients continuing to look at their real estate portfolios, continuing to try to capitalize on opportunities that they see as a result of this crisis. So, you know, while yes, a number of our clients are slowing things down, hunkering down, focusing on the core, whether it be, you know, collecting rents in the income generation from their portfolios, we are still seeing a number of clients eagerly trying to position their portfolio, in ways that takes advantage of buying opportunities or other disconnects that the crisis has caused.

Will Robson: Yeah, it's interesting to see the impact on capital raising because, ahead of a crisis like this, often the client's investors into funds will look for an existing portfolio to invest in that will grow over time. So they've got initial exposure from day one and in this kind of environment, I think you tend to see more of an appetite for blind pool funds where there are no assets that could be impacted by this kind of climate crisis. And, looking for that kind of dislocation and looking for the distressed assets there, to kind of help with kind of rescue capital in some of these situations.

About MSCI

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 45 years of expertise in research, data and technology, we power better investment decisions by enabling clients to understand and analyze key drivers of risk and return and confidently build more effective portfolios. We create industry-leading research-enhanced solutions that clients use to gain insight into and improve transparency across the investment process. To learn more, please visit **www.msci.com**.