

We'll always have Paris? Assessing the future of global gateway cities

Featuring: **Will Robson**, Executive Director & Head of Real Estate Solutions Research

Adam Bass ([00:03](#)):

This is MSCI Perspectives. Your source for weekly research insights as investors respond to the COVID-19 pandemic. I'm your host Adam Bass, and today is October 15th, 2020. This week, Paris London, Hong Kong, New York sounds like a great post-pandemic vacation. But it's also a set of cities where corporate office space has generated strong capital growth for real estate investors. Of course, many of the workers at those companies have been home for a while and it's unclear just how many will come back or when.

Adam Bass ([00:42](#)):

To assess the effects that COVID has had on these Global Gateway Cities. We welcome back MSCI's Global Head of Real Estate Solutions Research, Will Robson. Will welcome back to the program. We're going to have to reserve a chair for you if this keeps up. We love having you back so often.

Will Robson ([01:01](#)):

Thanks Adam. It's good to be here. Thanks.

Adam Bass ([01:05](#)):

So let's start today by defining terms specifically Global Gateway Cities which is our topic. What do we mean when we talk about these types of cities and why is this important for real estate investors?

Will Robson ([01:19](#)):

Global Gateway Cities, there's no one kind of perfect definition of them, but they tend to be the biggest, most globally connected cities in the world. So the likes of London, New York, Paris, Tokyo. They're

kind of like the super-cities that attract a lot of companies to locate there and a lot of investment capital.

Adam Bass ([01:42](#)):

And from what I was reading in some of the research, these cities became even more important following the 2008 financial crisis. Is that correct?

Will Robson ([01:53](#)):

Yeah. Well, I think in the group recovery since the financial crisis, you've had a lot of capital flow into real estate as an asset class more generally. And also just generally over the last 10, 20 years, institutions that invest in real estate have been doing so more internationally and they've been eroding their kind of home bias in the portfolios. And when you do that, you tend to go to the most familiar, biggest cities. And so those cities tend to be at the top of the list. They've had a long run of good performance and have attracted a lot of institutional investment capital

Adam Bass ([02:30](#)):

Has this run of performance been steady that is, do these types of investments where have they fallen over the last 10 years or so in terms of volatility?

Will Robson ([02:41](#)):

If you look for a longer time series through the financial crisis, in some markets we can go all the way back to the early 1980s. These cities tend to form pretty strongly. They have very high returns, mainly driven by capital growth. The income returns tend to be a bit lower in these kinds of cities because they're generally expensive and they attract a lot of capital and investors are willing to pay for the growth expectations that are in those cities.

Will Robson ([03:12](#)):

Because a lot of the return is coming from capital growth, capital growth tends to be more volatile than income returns. And so in general, they tend to be more volatile than the absolute returns. If you think these cities are attracting capital from all around the world. So the relative pricing of one city versus another plays into that volatility a little bit.

Will Robson ([03:34](#)):

Also, these cities tend to be very large and dense. So the natural kind of rental growth cycles in a city like London or New York, a strength of it and rental growth signal to developers to make it worth kind of knocking down or refurbishing a big office tower has to be pretty strong. But once you start doing that activity, it takes some time to fulfill that. And therefore you have these kinds of overshooting trends in rental growth. So both from the capital market side and the real estate fundamentals, these markets tend to swim more violently in performance than lower secondary-tier city-markets with higher income returns.

Adam Bass ([04:13](#)):

And that idea of assessing the situation is like so much gotten harder since COVID, working from home. There's been a lot of research lately. I know MSCI did some polling as well as, I saw this week in the Economist, some surveys referencing, yes, there were differences when they asked people in the US and European workers, "How do you feel about returning to the office on a regular basis?" There were differences at the extreme, but about 20% of these workers in the US and Europe both said that they expect to work from home about one or two days per week once this pandemic is behind us. Referencing the polling that MSCI did that align with what you saw or were there differences?

Will Robson ([05:06](#)):

I think broadly aligns. So this poll we did was just one of our webinars over the summer. And a lot of these people were from the real estate investment market. So if anything, if there was any bias in this kind of sample, you'd expect them to be supporting the future existence of offices. But even within that sample, a good chunk, I'd say 75% of the audience were looking for some kind of hybrid solution of returning to the office one or two or three or four days a week. There was only 17% of that audience that wanted to return to the office full time.

Adam Bass ([05:45](#)):

And as you said, if anything, you would think the bias in this group would be toward returning if for no other reason, their own self-interest

Will Robson ([05:53](#)):

Yeah, to support their industry.

Adam Bass ([05:55](#)):

Exactly, so turning back to that, turning back to these investors, we talked before about the income growth within these cities. The question of whether they were for lack of a better term built on a solid foundation, right? We're the fundamentals sound, and I believe that's where your latest research started. What specifically were you looking to discover though?

Will Robson ([06:23](#)):

Well, we've had a number of client conversations over the last few weeks and a few questions have come up around what's driven office demand or performance for the last 10 years? Because these Global Gateway Cities they've outperformed, but they seem to have attracted the bulk of investment capital over that time as well. And so a couple of clients were asking as well, how much of that outperformance was driven by... And we found that generally actually the outperformance of these cities was justified. There was a fair amount of yield impact. So the kind of yield compression, but also a significant amount of income growth impact in the cities and not so much in the second-tier city. So on a relative basis, these Global Gateway Cities seem to have kind of justified their dominance over the last 10 years or so.

Adam Bass ([07:21](#)):

So, even if it truly was the fundamentals driving the growth, there's still the issue that we see across asset classes that after a while, as investors converge or their money converges valuations rise. Are we seeing any of that in these cities?

Will Robson ([07:40](#)):

Yeah. I think you have seen that and actually in terms of investors response to that, if you focus in on the US we looked at kind of investment activity across these different kinds of cities. So we looked at the top five cities and then the next 15, and then the rest to look at purchase activity, purchases expenditure.

Will Robson ([08:04](#)):

And for two or three years, there has been a rising trend away from the global gateways to, well, not away from the global or gateways, but there are a more emphasis on the secondary cities. And that might be a response to the kind of high pricing that you're seeing in these Global Gateway Cities. If a low of a capital flowing into a real estate market since the financial crisis, a lot of that's been driven by a search for yield as yields kind of come down generally and more so in those Global Gateway Cities, that search for yield might be spreading further down the tiered list of cities to find that yield. I suppose, all the questions investors are asking themselves at the moment is to what extent COVID

could be changing those trends are accelerating those trends? And disrupting the strong income growth potential that we've typically seen in the cities in the past.

Adam Bass ([09:01](#)):

Right? That is of course the logical next question. Is it too soon to tell, or have we seen some of the money shifting to the secondary cities?

Will Robson ([09:12](#)):

I think we've seen that trend tentatively before COVID. I think it's too early to tell whether COVID is accelerating that trend or not. If you think about the real estate markets more generally outside of office, the most severe impacts on returns and valuations have been in those kinds of property types where they really felt that fundamental impact of lock downs and social distancing. So hotels, where there isn't a long lease. You basically the income kind of varies day by day depending on the occupancy.

Will Robson ([09:48](#)):

Those have been the worst impacted retail where the value generation of the retail business is driven out of the shops in the main, those have been impacted very severely where, although there is a lease agreement in place, many of those retailers just simply been unable to pay that rent and have either just not pay the rent, or they've agreed with their landlords to kind of defer that in some way. When you think about office markets, there's a much more diverse range of office occupants and so many more companies that have been able to kind of exist and kind of go about their business with employees working from home.

Will Robson ([10:30](#)):

But there are big sort of questions around how much office space do I need as a corporate occupier. Those questions are being asked at the moment, but I think the impact of those decisions you won't see for some time as the corporate occupiers come towards the end of their leasing agreements and choose whether or not to renew or to move to a different space or different kinds of space. It's just going to take more time for those decisions that are being made at the moment to flow through in touch or surrenders of leases or different leasing decisions and therefore into cash flows and therefore into returns.

Adam Bass ([11:06](#)):

So if I recall correctly Will, you were working from home most of the time, even before the pandemic, am I remembering that correctly?

Will Robson ([11:14](#)):

I wouldn't say most of the time but a good chunk of the time. Yeah, two days a week.

Adam Bass ([11:18](#)):

So let me ask you, given the surveys we were talking about earlier, have you changed your mind about where you work post-pandemic?

Will Robson ([11:25](#)):

I've really enjoyed working at home and being kind of closer to the family and being more involved, but I really am starting to miss the social interaction at the office and just the change of scenery rather than being kind of stuck in one room. So I reckon ideally I'd like to go back to the office two days a week. I got a long commute, so maybe stay one day, one night and have that balance there.

Adam Bass ([11:49](#)):

That's all for this week. Our thanks to Will and to all of you joining us. Remember it takes just a moment to subscribe to the podcast, leave a comment or share with a friend. Until next week I'm your host, Adam Bass and this is MSCI Perspectives. Stay safe everyone.

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