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TRANSCRIPT

Inflation Knocks on Real Estate's Door

Featuring:

- ***Jim Costello**, Executive Director, MSCI Research*
- ***Ian Goldin**, Professor of Globalisation and Development, Oxford University*
- ***Ben Sanderson**, Managing Director of Real Estate, Aviva Investors*
- ***Kiran Patel**, Global CIO and Deputy Global CEO, Savills Investment Management*
- ***Craig Thomas**, Senior Vice President, Market Research, AvalonBay*
- ***Elizabeth Szep**, Real Estate Department, ADIA*

Adam Bass (00:03):

This is MSCI Perspectives, your source for insights for global investors and access to research and expertise from across the investment industry. I'm your host, Adam Bass, and today is November 17th, 2022. Today I'd like to try something a little bit different, if you'll just bear with me. What I'd like to do is take you through the highlights of MSCI's annual Global Real Assets Conference that took place just a couple of weeks ago. And we'll also include some additional commentary on a few of the key trends that emerged. We'll talk real estate, investors and how things are going in today's high inflation environment. Spoiler alert, not great, but also not as bad as you might expect. So to get us started, let's bring in that outside commentator to get a lay of the land.

Jim Costello (01:01):

Hi, I'm Jim Costello. I'm chief economist for MSCIs Real Assets Team. A lot of what I do just involves taking the data that we have, wrapping it up into trends and telling stories about it. We're in an unusual period. There's a lot of transition underway in the economy. The signals that we've been seeing from the equity markets, from the REIT markets, from the bond markets, it hasn't fully translated over to commercial property yet. It's starting to and it looks like if we continue on the same kind of path in private real estate that the REITs have, that there are even more challenges to come into early 2023.

(01:44):

We're recording this on November 8th, and I have been out and about at the fall conferences talking to people and the mood is really off. A number of investment managers I've met with have shut down their investment committees, meaning they're not even considering new investments at this point. There's simply no point. Current owners aren't willing to move from their previous expectations on pricing. Buyers don't want to take that kind of a risk, especially with the way financing costs have moved. So things can't get completed. The macro challenge that's driving much of this disconnect is the inflation that we're experiencing and how that's reverberating through to the lending markets. We've been experiencing a higher pace of inflation in 2022 relative to the past, and the Fed is trying to fight this. It's their job. They've been raising the target fed funds rate. We've not seen this kind of a rapid pace of increase in the fed funds rate since the 1970s, like 1973, 1978.

Very different experience we're going through now than anything over the working history of most of my peers in the industry.

(03:13):

So what this is doing, it's a shock to all credit market type instruments. The 10 year treasury's going up quickly, corporate bonds are experiencing a rapid rise in rates, and so banks are looking at all this and lenders of all sorts looking at all this and if they're making a loan, they want to get compensated for some high risks that they see today. Those rates have gone up so much that in some cases mortgage rates are higher than the cap rate that owners have currently been using to value their buildings. So that means if they sell a building and they try to get the cap rate that they were just using, there's not going to be many buyers that are willing to step into that because they're going to be in a negative leverage situation, meaning that most of the free cash flow is going to pay off the loan as opposed to actually earning anything. The market is seething with firms saying that they're just shutting down their investment committees, they're telling their acquisition people, "Listen, doesn't make sense for you to go find a new deal. There's no point right now. We're just going to wait and see."

Adam Bass (04:30):

This sentiment was prevalent at the conference. In fact, it led the keynote speech by Dr. Ian Goldin, professor of globalization and development at Oxford University. We're going to skip around a bit and edit for time, but I think you'll get the idea. Have a listen.

Ian Goldin (04:47):

This is a time of incredible uncertainty, transformation and opportunity in the world economy. I don't think any of us have lived through a time which is just as turbulent. There are many things happening simultaneously. We have very, very complex and dynamic hyper connected global system. And although people are talking about de-globalization, the fact is that we see every day and in all our consumption and in all our assets the impact of flows across national borders, the inflation shocks that we feel which are ripples coming out of the invasion of Russia into Ukraine, the impact still lingering of COVID-19, a global pandemic, and of course the turbulence in currency markets, which is an outcome of the relative expectations around different economies against others.

(05:50):

There are big questions about the implications of the current interest rate hikes on multiple dimensions. My view is that we are likely to see higher interest rates for a sustained period of time. The central banks don't have much option. They have very crude policy levers in which to address high inflation and I think we'll see inflation above their target zones, which typically have an upper ceiling of 4% for a few years at least. What does this mean? It means that for those on lower incomes that require mortgages across the spectrum and middle income people, we're going to see, I think a real downward pressure on prices. Of course, this is also in the office space area where we'll see downward pressure.

Adam Bass (06:42):

Inflation was a topic that came up again and again during the conference. Understandably, I feel like every episode we've produced this year has centered on inflation in one form or another. It's clearly the elephant in the room, or the potentially civilization ending asteroid that's passing uncomfortably close to the earth. Take whichever analogy suits your mood. Anyway, two exchanges at the conference caught my eye. They illustrate just how top of mind the topic is for real estate investors in particular. The first is from Ben Sanderson, he's managing director of real estate at Aviva Investors, and Kiran Patel, global CIO and deputy CEO at Seville's Investment Management. Here's Ben.

Ben Sanderson (07:31):

We're in a cycle where with higher interest rates, higher inflation, we are going to get some real challenges for our tenants and for consumers more broadly, which ultimately leads to challenges for many businesses. And so therefore I'm worried about tenants,, tenant default rental growth, where can I find rental growth, where will I be able to keep our buildings fully occupied? Those sort of issues are really concerning me in the short term. And in a related point, to the debt issue, to the high interest rate issue, from a debt business perspective, we're obviously worried about debt service coverage and how the market will react to those higher interest rate costs, which could be hugely significant and likely to lead to lots of concerns and distress from both investors and from occupiers.

Kiran Patel (08:16):

I think we are adjusting in the capital markets from the last 10 years from a zero interest inflation environment, interest rate environment where the risk free rate was virtually zero. We're seeing that already in other asset classes like bonds, and bonds have adjusted. Everybody's talking about the bubbling bonds has burst. So going forward, we are going to live with some form of inflation, some core stable inflation, which will imply a different interest rate environment. And so this is where leverage is impacting both property prices and can impact affordability when it comes to tenant's ability to pay rent. So I think there are a lot of, unfortunately, headwinds today where prices of property will adjust just because the relative other asset classes you always compare against a risk-free rate and that's adjusting. But then I think with what's happening with the economies with higher interest rates, which is trying to curtail that inflation, but at the expense of growth will impact future affordability, tenant's ability to pay rent. Inflation has both a positive and a negative. Most leases do have some indexation and therefore you can benefit from income growth, but it also comes down to tenant margins and what they can afford to pay.

Adam Bass (09:55):

All right, so that's the first exchange. Here's the second one coming up. This one is with Craig Thomas. He's a senior vice president in market research with Avalon Bay. Now, you won't be able to see it of course, but Craig is explaining a chart that shows effective rents versus real rents in the top 20 markets since 2018. Now, starting in 2021, effective rents shot up. It's a real hockey stick here. And you'd expect the rental income from those increases to follow, right? Well, it doesn't. Income from rents actually declined beginning around six months after the initial spike. So what gives? Craig?

Craig Thomas (10:40):

From the vantage point of renters or people on the outside looking in, this looks like, "Oh my gosh, the rents are rising, this seems unfair. Rents are rising too much. Somebody's taking advantage of a difficult situation. Up, up, up it goes." And so apartments have been a bit of a hot subject throughout all this time to the present day. So what was really going on? I look at that orange line right there.

Adam Bass (11:13):

The orange line by the way, that's the real rents line that I told you about, the income from rents that actually declined during the period.

Craig Thomas (11:22):

The truth of the matter is nothing was going on. There was no magical new demand for apartments that came out of nowhere and that we needed to grasp ahold of and believe that a new golden age had begun for apartments. And there was no rapacious landlords pushing rents crazy amounts either. What we had was inflation, not generated by any of us, but rather the difficulties of COVID and supply pipeline because of significant fiscal stimulus and as a result of global monetary policy that really is not going to get any style points going forward. Nothing happened. Just normal, everyday good apartment managing, developing, investing. That's what was real and that's what led to this surreal year that we find ourselves amid.

Adam Bass (12:25):

There you have it. The next time someone says the rent is too high, you can point your finger squarely at inflation. Well, inflation and a few other factors.

Ian Goldin (12:37):

Prior to this current economic crisis that we're going through of high interest rates and reduced growth, there was already a major supply constraint on construction and contracting that we saw percolating through steel prices, through cement prices, through concrete prices into the market. My view is those supply constraints over time will reduce, demand is reducing quite significantly, but we will continue to see rather a depressed market. Rising interest rates and the turmoil in markets forcing pension funds to find new liquidity has led to rebalancing of portfolios and the need for more liquid assets. Now, I don't believe that there will be permanent scarring in the real estate sector, and that's because when you look at previous episodes, when there has been a control on redemptions, when it's been gated, it has not led to any permanent scarring. We saw this in the financial crisis of 2008. We saw this even in 2020 at the beginning of the pandemic and we can all recall how quickly the markets rebounded. People understand that real estate is an illiquid asset, and so I think responsible redemption programs will be accepted and no one wants a fire sale. However, there will be repricing coming out of this in the medium term and there will be opportunities. There will also be consolidation in the sector. I think we'll see many of the big firms finding new opportunities.

Adam Bass (14:29):

Opportunities? Jim, does that sound right to you?

Jim Costello (14:33):

Well, I think there's a whole bunch of opportunities ahead. If I am a well capitalized investor that is looking for some sort of opportunity out there, this is a golden period. That's what recessions are all about. Think about Google. When did Google get started? They got started right after the first internet bust. And why did they grow? Well, they had some smart leaders and all that, but there were a lot of really talented developers and engineers that were tied up in crappy companies that were delivering no profits. That was one of the hallmarks of that bubble period of the first part of the internet boom. It's a painful period to go through for sure, but for the economy overall, eventually those people get reabsorbed into something productive that generates some growth. And for the investors that fuel that, it could be a great opportunity.

(15:34):

Think about the building investors and people just buying commercial real estate. If you have some owners who were very highly leveraged and have a loan coming due in 2023 or 2024, they're going to need some help next year with the cost of capital being what it is. And that might mean a distressed debt situation popping up, or it could even mean some sort of preferred equity solution for investors to come in and help them. So I think people are taking a pause on some of their acquisitions right now. At the same time, they should be planning for what happens in 2023 and 2024. I think there are going to be some tremendous opportunities that come out of this. Any disruption, there's always tremendous opportunities that come out of it. If you follow some of the acquisition people that I follow on Twitter, they've been talking about some early signs of deals starting to fall apart, of distress opportunities that are popping up, and I think that's just going to grow.

Adam Bass (16:41):

Let's switch now to another key point of discussion at the conference, and that is the future of cities.

Elizabeth Szep (16:49):

So the pandemic fueled a lot of debate around the future of cities. We all saw the headlines, "Cities are dead," "New York is over," that was my favorite one by far.

Adam Bass (17:02):

That's Elizabeth Szep. Elizabeth works in global research and public markets for the Abu Dhabi Investment Authority.

Elizabeth Szep (17:09):

San Francisco is the poster child, I would say for the end of city narrative. The Bay Area did see massive out migration. It lost about 5% of its total population during 2020 and 2021. A lot of tech jobs in the area obviously were able to easily transition to remote setups, and so that facilitated a lot of people exodusing from the area. But now that the pandemic dust has somewhat settled, what we're seeing in trends is pretty clear. Residents actually are returning to cities, they're just not returning to the office. At the onset of the pandemic, what we saw was vacancy rates for both office and resi rise in tandem. As people were leaving, there was less need for housing. There was also less need for offices to work in, so you saw that vacancy rise.

(18:04):

But then sort of in 2021, what we saw happen in the residential market was apartment vacancy take a bit of an about face. We saw vacancies begin to drop for residential properties. And now, according to MSCI data, they're sitting pretty close in line, if not even a bit below pre pandemic levels. At the same time, what we saw is office vacancy continue to rise. And this is also sort of a global national trend. We saw office vacancy, according to MSCI data, increase 5% between Q4 2019 and Q2 2022. And how is this happening? Like I said, people are returning to San Francisco but they're keeping their flexible work arrangements. It's especially important to think about, there is a narrative around, in cities and especially in Asian cities where your residents might be very small, there's maybe a theory that in these places people will work from offices because your homes are too small to work from. But really if you think about it, in this day and age, all we need to work from home is maybe a cell phone and a laptop. So that makes it really easy to set up shop no matter where you are, if you're in a small apartment in Tokyo, if you're in San Francisco. And we've also seen those work from home trends just be very sticky post pandemic.

Ian Goldin (19:33):

We've moved from a new equilibrium on work where people had to come in five days a week, in particular times nine to five or whatever it was to work. That was broken, very healthily so by COVID-19 and the pandemic. We now have much more flexible work arrangements. This is great. It's great for the individuals and it's often very beneficial to firms too who can save on their office space and on other costs. But it comes at a great risk. If people stop coming in? What happens to the many, many services around our offices, which depend on the footfall and what happens to the creative sparks that happen in offices?

(20:19):

The office of the future I think is a vibrant hub. I think of them as a beehive or some sort of place where people come together for common purpose in it. You need some quiet. You need some quiet for your remote calls, you need some quiet for quiet meetings, you need some quiet thinking. But so there will be quiet spaces, but I think the general assumption should be people are coming to the office in order to interact. Increasingly, if people come into the office, they want to come in for the experience, for this connectivity, for the experience of being together. If you're going to sit on your computer at a desk, you might as well be in a local cafe or at home. Why come into the office if it's not going to be an interactive experience?

(21:04):

And so rethinking office space to be a more pleasurable one, a more interactive one, a less isolated one is part of that. I think we'll see a growing differentiation therefore between the highest quality office spaces and those of lower quality. I think many lower quality spaces will need to be rethought of and move to residential as has happened in the past. It's already happening in many, many cities. I think local authorities should get behind this big time because we have a critical shortage of space that offices could serve.

Adam Bass (21:41):

The idea of offices transforming from cubicle gardens to social hubs, that's something we've discussed on the program before, with Jim, in fact. It's episode 80 if you'd like to go back and give it a listen. But today, we're talking about a real assets conference, so that means investors. If you're investing in a building, what kind of building would be at the top of your mind, even in today's current economic environment?

Jim Costello (22:08):

There are demands for certain types of space. We see stories about the office market not seeing as much investment today, but there still is some leasing. Some of the firms that are out there tracking leasing and the brokerage reporting leasing, they'll tell stories about how even with the challenges that firms have, thinking about back to the office, thinking about how they structure things, there's still some leasing happening. But it tends to be, and this is what we've seen in previous down cycles to recoveries, it tends to be a bit of a flight to quality issue, where firms say to themselves, "Okay, gone through some sort of change. We need to lose some space now. There's a lot of availability here. Let's trade up to the best of the best."

(22:59):

But the best of the best these days is not just about location and the bragging rights of saying that you're in a particular floor in a particular tower. It's also about how firms will maximize the utility they get out of it by getting better carbon issues out of the building. A lot of firms have net zero carbon requirements and so they're trying to find buildings that give them a better chance of meeting those goals. Real estate is a huge consumer of energy and heating and cooling. So to the extent that firms can use their real estate as a tool that can help them benefit from that, they're going to move towards some of these more efficient buildings. If I see that a big developer is coming in and building a brand new tower in a place like Manhattan, it'll probably look a lot like the One Vanderbilt building, but with all new electric boilers and heat resistant glass. And so it's a net zero carbon building from the get go, at least scope one and scope two. That will be a very attractive building for leasing for folks who need to deal with all those issues.

Ian Goldin (24:24):

This must be one of the biggest growth sectors. Having a low energy environment which rates very high on ESG is what all top global firms want wherever they are in the world. Listed firms will have to report all of this in their annual reports, what their carbon footprints is, what their water usage is and other dimensions of it. And obviously they all want to look good and they'll pay for that. So I think we'll see it and it will also be a way in which global firms will define themselves, their brands, the ability to retain and attract people. The ability to sell their products will depend on what people perceive them to be and this will become increasingly transparent, what they perceive them to be on ESG. So I think it's going to be a massive opportunity. Obviously a very small share of the existing footprint of real estate meets the best standards, and so there's going to have to be a lot of renewal, there's going to have to be a lot of refurbishment, a lot of retrofitting and a lot of new build.

Adam Bass (25:33):

That's a sentiment that Ben Sanderson from Aviva Investors, you heard him earlier, Ben endorsed this idea as well.

Ben Sanderson (25:41):

The investors who price carbon risk best will outperform in the next 10, 20 years. That's what we're trying to get our heads around and trying to price best. There's obviously that dimension which has been quite not priced that efficiently and effectively in my view. But what is being priced very efficiently and effectively, I think of as growing evidence of it, is assets that have sustainable characteristics. So call it being on a pathway to net zero and whatever definition of net zero you want to use. But those assets are on that pathway to net zero and display better, more sustainable, more energy efficient characteristics, definitely trading at a pricing premium. And they definitely have better tenant preference and better retention rates and lower vacancy. That's my strong belief and I think it's coming through in the data.

(26:32):

And I think that is what is going to happen especially in the next phase because we have seen a lack of discernment in pricing. We have seen all parts, say, of the industrial sector repricing strongly. I think we're going to see big differences in the assets that are good and bad. And one of the big features of good and bad will be its transition to net zero pathway status. And I think that's going to be a massive part of the office story too going forward. Huge amounts of office stock all over the world that won't meet the regulatory requirements for net zero and it's going to be a huge thing.

Adam Bass (27:10):

So what have we learned? First, on a personal level, I've learned to be wary of taking on real estate conferences as source material for podcasts. There's just so much to go through. And in fact, I encourage all of you to go check out the replay on msci.com's event page. There was a lot there, I tell you, we barely scratched the surface today. Second, we've learned that while the situation for real assets is looking grim, there may still be opportunities not only on the horizon, but in the here and now. The trick is knowing where to look, and isn't that always the case with investing? That's all for this week. Our special thanks to Jim for helping us sort through it all, and to Ian, Ben, Kiran, Craig, Elizabeth and everyone else whose insights helped make the conference such a success. And as always, our thanks to you for listening. We'll be back next time answering the questions investors are asking. Until then, I'm your host, Adam Bass, and this is MSCI Perspectives. Stay safe, everyone.

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