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TRANSCRIPT

Real Estate Investors Brace for Bumpy 2023 Perspectives Podcast Ep 88

February 9, 2023

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Adam Bass

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 February 9th, 2023. As I'm sure you've noticed, we're still within what you might call the hangover portion of the year. That's where we're still trying to understand what happened last year.

00:00:29:05 - 00:00:39:02

Adam Bass

And how it might be different going forward. Today's topic, commercial real estate, a subject for which, as our first guest told us.

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David Green-Morgan

It was a very interesting 2022, really a year of two halves. So we had a very strong start to the year in terms of commercial real estate investment and performance, a real continuation of what we'd seen in the year before.

00:00:55:07 - 00:00:57:10

Adam Bass

That's first time perspectives guest.

00:00:57:23 - 00:01:16:02

David Green-Morgan

My name is David Green-Morgan. I'm the global head of Real Assets Research based in Singapore, covering all of the different real estate markets around the world in terms of transactional investment activity, as well as the performance of real estate across multiple property types.

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Adam Bass

In case you missed it, David mentioned that to understand 2023, you need to look at 2022 and to understand 2022. That's right. You have to look back to 2021 when.

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Will Robson

The start of the year was quite slow, but it kind of really ramped up and there were very strong returns for 2021 As we came into 2022, the first part of year was still quite strong we were still sort of near record returns.

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Adam Bass

That voice you may recognize, but in case you don't.

00:01:50:20 - 00:01:55:09

Will Robson

I'm Will Robson I'm global head of Real Estate Solutions Research at MSCI.

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Adam Bass

And as he was saying, when 2022 started

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Will Robson

It was still quite strong we were still sort of near record returns, especially for asset classes like industrial. But as we kind of went through the initial phase of the invasion through to the summer, things were starting to slow down anyway.

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Adam Bass

The invasion, of course, is Russia's invasion of Ukraine. In late February of last year.

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Will Robson

Inflation was starting to creep up. General economic environment and outlook was weakening. And then as the inflation story took hold, I saw interest rates starting to move upwards. We had the kind of mini budget debacle in the UK where interest rates really started to kind of spike a bit in the UK and that really flipped and we start to see negative total returns in the third and fourth quarter in the UK.

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Will Robson

And those kind of that kind of weakness is spreading around the world now. So in the fourth quarter you start to see things turn and all the talk is that that's going to kind of continue into the start of this year.

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David Green-Morgan

What's interesting as we come into 2023 is that after many years of fairly consistent global performance, that the regions and the major investment markets around the world have more or less been in alignment growing strongly. Most years, obviously, there's been a few road bumps and speed bumps along the way, such as Brexit in the in the UK and the European sovereign debt crisis and of course COVID, which thankfully was a fairly a small speed bump in the end.

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David Green-Morgan

But what we we can see now is that the there's a disconnect between the markets. Europe is being affected much more greatly than other parts of the world. The US and North America is just starting to adjust. And Asia Pacific really things have come more or less to a bit of a standstill. We're not really seeing a weakness in performance and an a drop in values.

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Adam Bass

So 2021, very strong performance for real estate, 2022 started strong but didn't end very well. And that's especially relative to 2021. And so far this year is not looking so great either, as will and David wrote recently in a blog post on Real Asset Trends for 2023. Quote, “It is increasingly clear that commercial real estate is experiencing a downturn”.

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Adam Bass

End quote. Now, the last time this happened, the last time a downward move was not just a speed bump was back in 2008, the global financial crisis, which of course came up during our conversations. And of course we shortened to GFC. We'll explain that the month on month and quarter and quarter numbers showed negative returns that are of the same magnitude as during the GFC.

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Adam Bass

But one important difference.

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Will Robson

The GFC had many months and many quarters of consistent negative returns. So we haven't got into that kind of sustained downturn yet in real estate valuations, but we don't know whether that's going to happen. I think what is different, I think at the start of the GFC there was a broad appreciation that real estate markets were genuinely expensive and they were starting to slow down even before you had the trigger events around Lehman and the like where things started to really accelerate downwards again.

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Will Robson

This time around you had that kind of sense that some parts of the market were quite expensive, but the speed at which can have a very strong positive returns turned into very strong negative returns, especially in a market like the industrial sector that has had such a strong tailwinds behind it that that is quite different to the GFC.

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Will Robson

And I don't think we've seen things move that quickly and turn around so quickly until now.

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David Green-Morgan

Back in 2008, at the height of the the financial crisis, we didn't know which banks were solvent, which banks were going to survive. How severe was the impact from country to country? So, you know, property investment came to almost a complete standstill at that point. And that's the big contrast to today, is that, you know, the banks are in many cases quite rude.

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David Green-Morgan

Health raising interest rates helps out with banks profitability. And so there's absolutely no, you know, concerns or worries about the integrity of the financial system. In many ways, this is more of a, I guess, what you'd call a traditional downturn in real estate markets in that as we have a higher inflation, higher interest rates, a slower economic growth.

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David Green-Morgan

So the demand for real estate starts to slow, companies cut back on the amount of space they want. Investors are much more circumspect in terms of which assets they look at. So this is a very, very different downturn, too, to the to the GFC.

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Adam Bass

Remember this line of thought about how the current situation is more of what you might call a traditional downturn. We'll get back to that in a bit. But for now, let's stay with the GFC just a little longer so we can talk about some of the similarities between today's situation and 2008, specifically how the crisis affected different parts of the world at different rates and at different points in time.

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Adam Bass

This same type of dynamic appears to be happening today.

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David Green-Morgan

And it kind of springs back to what we saw in the aftermath of the GFC, where by the quickest correction in real estate activity of pricing came in North America and in Europe and Asia Pacific took a much longer time to adjust. There was a, I guess, a greater reluctance to acknowledge the scale of the impact that could it could affect commercial real estate and hence the impact of the GFC kind of went on for much longer than what we saw in Europe and in North America.

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David Green-Morgan

It seems as though we're in a similar situation. What we've seen previously is that those markets that are just the quickest tend to recover the quickest. And it really wasn't until sort of 2012 or 2013 that Asia really started to stage a recovery.

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Adam Bass

So let's dig in a bit more as to why this downturn has more of the earmarks of being a more traditional downturn.

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David Green-Morgan

Typically, real estate cycles are driven quite in sync with the macro economic picture. So when the economy is growing, you know, the demand for a space increases, rents tend to go up and values of the buildings go up and performance looks very good. And what you tend to have historically is at those times, developers build more office space, they build more shopping centers because they see the demand increase in supply tends to come in just as the economy is maybe starting to weaken a little bit.

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David Green-Morgan

So you have an increase in space availability, but a weakening demand for that space. And so rents start to drop, you start to drop performance dips and then you go through the cycle again. But of course it's the ups and downs of the of the market cycle that that makes investment possible because, as values dip, you tend to get more investors coming into the market to look for opportunities.

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David Green-Morgan

And so the ups and the downs continue.

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Will Robson

Investors are trying to understand where the price is now, where where value is. And typically everyone just kind of sits on their hands until they kind of feel confident about whether that price is. So you need to see transactions happening to take over what where the price should be for these assets and typically for real estate, when things start to move and sentiment changes, you tend to have a bit of a slow up in activity.

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Will Robson

And that's what we're seeing at the moment. There's a deal transaction activity that we track with RCA data is it's kind of dropped like a stone. It's very, very quiet. And so when things start to seize up like this, it really affects transactional activity, the confidence of investors kind of move money into a fund and not sure whether it's take money out of a fund at a kind of rate valuation level.

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Will Robson

The activity slows up most in the smaller scale investors, smaller deals, particularly those that are more reliant on debt financing. There are a lot of real estate investors are dependent on the financing and the debt as part of the capital structure. So depending on the kind of financing they've got in place, whether it's fixed or floating or what can the maturity as they come up to the end of these loans and look for be financing it, depending on how much equity is left in the deal and how much kind of income coverage there is to meet loan covenants will determine how available financing is for that particular type of building.

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Will Robson

So you can imagine with interest rates increasing, the interest rates on the real estate loans have increased the willingness of the lenders to lend certain LTV levels, loan to value ratios has kind of kind of become more restrained. And so less of those players are able to be active in the market, whereas the bigger, more institutional, particularly international owners, asset owners are more able to operate during these kind of environments and tend to have a longer term view as well.

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Will Robson

On the other side in terms of stopping people from sitting on their hands on the selling side of things, people tend to hold on to what they have unless they are forced to execute a sale in this kind of market environment.

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David Green-Morgan

Some people are probably going to be forced to sell because of those higher interest rates. The increase in debt costs combined with a drop off in maybe rental income and a slowdown in demand for their space will make it will make the building uneconomic for them.

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Will Robson

And that tends to come from distressed loans where they're unable to get refinancing and needs, but they're the asset, the market or perhaps in open ended funds with liquidity provisions and redemptions being kind of requested from funds causes of a major to sell assets. So there's a kind of like things that force an owner to sell and those might force the kind of crystallization of losses that provide that evidence.

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Will Robson

The value is then the valuation is down, and then as valuations move down, it encourages more people to either act, either buying or selling at that kind of lower price point.

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Adam Bass

David picked up on that point.

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David Green-Morgan

One person's view is very different from another person's view, and they will. If the price adjustment is large enough, then you will get groups of investors who will say, Actually, I think the opportunity here is good. And if we can pick up the building at this price, then I think we can, you know, make a success of it.

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David Green-Morgan

And we've actually started to see that in the retail space, ironically, kind of post-COVID, when obviously retail really suffered because none of us were allowed to go to the shops for a very long period of time or only to the grocery store to pick up the essentials that we needed. We so we've seen over the last ten years, retail prices really adjust quite markedly.

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David Green-Morgan

And that's at this point in time with rising interest rates because those retail prices have adjusted. We've seen investors now look at retail as a potential investment opportunity with the expectation that, you know, they can do a good job of repositioning, of attracting tenants and generating returns, whereas, you know, some investors have completely turned away from retail over the last ten years and you know, dismissed it as an investment class within real estate.

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Adam Bass

As surprising as investors seeing opportunity in the retail space may be the biggest story and in many ways the biggest unknown is the office sector. Now we've spoken before on the program about what the future of work may look like and how that might affect real estate investors. But in many ways, the future it's arrived.

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Will Robson

I think most people agree that the absolute amount of office that exists today is probably too much. You don't need quite as much of that space. And the main debate is on that is what is going to differentiate those offices that will survive and continue to attract demand from tenants versus those that won't. I think at the very least, it begs questions on what is the right type of an office building to maintain demand from tenants in this new hybrid working environment.

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David Green-Morgan

When we were forced into the first lockdown here in Singapore, we were thinking, okay, maybe three, four months, then we'll all be back in the office. And here we are, three years later. And when we do come into the office, they're obviously much quieter with much fewer people around. So the impact of this lack of demand, I guess, for office space is only just starting to play out in the investors thinking at the moment and it is different from country to country.

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David Green-Morgan

I would say in Asia where it's more typical for you to go into the office and to be seen and to interact with your your peers and with your team occupancy level is just slightly higher, but it's definitely having an impact even on a city such as Singapore, which is relatively small, very easy to commute, quite easy to, you know, to use the public transport to come into the office.

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David Green-Morgan

Even even here, you know, we've seen occupancy levels drop quite considerably. And this is a big issue because the majority of real estate investment or holdings is within the office sector. So if you go big, the really big asset owners, they would have 40, 50, 60% of their investments in the office sector.

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Adam Bass

Even the lowest percentage David just quoted is striking. If even nearly half of a real estate portfolio is allocated to the office sector and demand is already low, what happens with these properties as we move forward? But wait, there's more.

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Will Robson

On top of the working from home challenges. We've also got the kind of climate change in that there are commitments of businesses that are right across the spectrum. But all those businesses that Occupy office buildings are looking for a more efficient space in terms of carbon emissions. And so another aspect of this will be the buildings that are more able to be retrofitted to make them efficient and comply with all these climate change demands will also be at the top end of the performance spectrum versus those that are much more difficult to reposition as there's a huge effort around data and just understanding the the profile of your own portfolio, whether it's offices or retail

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Will Robson

or industrial or understanding the air climate risk exposure across the portfolio, a lot the focus at the moment is around kind of transition risk and the emissions intensity of of buildings because they're associated with both the investors and the ultimate tenants that there are commitments and the emissions intensity of these buildings are quite complicated for an owner that may only have direct control over the common parts of the building.

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Will Robson

But when you go in the building, you go in the reception area and the lift lobby is typically the landlord that will be in control and pay the bills for energy in those areas. But a lot of the time the tenants themselves will pay for the energy and be responsible for the emissions of the kind of rented out areas of the office building.

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Will Robson

But for the owner though, they want to understand the emissions of the whole building because it's those emissions that affect the profile of their investment. The whole building, the portfolio construction process is something that all clients are grappling with at the moment.

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Adam Bass

And yes, there is still more.

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David Green-Morgan

We're seeing a very big switch in terms of investors very focused on the newer, the best quality buildings within a market. There was a very interesting article in the F.T. about a New York landlord who has basically decided to give some of the buildings back to the bank because he's come to the conclusion that actually the demand for the some of the offices that he owns is dropping so significantly that they're not buildings that he's he's interested in owning.

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David Green-Morgan

But I think that's a mixture of again, the work from home but also the quality of the buildings he felt were not the ones the tenants were demanding from it, from a whole range of perspectives, one of them being the environmental qualities that the tenants are demanding these days.

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Adam Bass

And is that something unique to that situation or is that is that happening elsewhere?

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David Green-Morgan

Well, I think this is the could be the tip of the iceberg. I think many owners of properties, especially if they're not the top quality buildings in the city, will be starting to see that, you know, the tenants that they've had maybe for many years are beginning to take number were beginning to take their space because there's less people coming to the office or demanding higher environmental standards from the building, which, you know, if it's a building of probably more than ten or 15 years old, could be very different, difficult and expensive to retrofit our building to bring environmental standards up and the emissions down.

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David Green-Morgan

And we know that, you know, real estate is a big contributor to global emissions. And you know, how much how many buildings could could we be looking at here in terms of vacancy and in terms of the need to change the use of those buildings to something that the tenants and investors will want to look at in the future

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Adam Bass

Yeah, How many buildings are we talking about? That seems like some important information. But David also did say something there about changing the use of these office buildings. Now, that's an idea that's been proposed in some cities, including New York City, where I live. And am recording this right now. I asked him whether this is the panacea that some politicians think it is.

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David Green-Morgan

It's not as simple as it seems. Unfortunately, because converting an office building, particularly a big office building into a residential building, is very typically very expensive. You know, So while on the one hand you may say, well, we've got all these empty buildings in terms of office space and we've got a real shortage of housing, particularly affordable housing, let's just make the switch, put some put two bedrooms in and make it an option to to absorb some of this housing demand that we've got in the majority of cities around the world.

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David Green-Morgan

We're in a similar predicament as New York in that they need a big increase in affordable housing. But if you're an investor, obviously you need a return on that investment. We have seen some occasions where office buildings have been converted. They've tended to be much smaller office buildings where it's been potentially slightly easier to convert them and a many of them may have been residential dwellings in the past and have been converted into offices, are now being converted back into residential dwellings.

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David Green-Morgan

But I'm not really aware of a major office building being converted into residential and it being a kind of a successful transformation in that regard. But I can see why politicians and city planners would be looking at this with some interest, because we could be looking at a situation where, you know, 20 or

30% of office buildings in the major markets around the world become obsolete over the next 15 or 20 years.

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David Green-Morgan

So there is a social dimension.

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Adam Bass

If the ebbing tide is beaching all boats, you need to find yourself some water but quick. And that's when you go back to basics. Or as we say in the investment, is the fundamentals

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Will Robson

When you think about real estate tax returns, you've got your income return which is paid for by rent from the tenants, and then you've got capital growth. And that's driven by two main areas. One is the growth of the income, the willingness of tenants year on year to pay higher and higher rents. And the ability of the landlord to collect fill up space.

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Will Robson

And that empty space kind of goes through to the bottom line and that gets capitalized and drives the value of a building. The other side of things is yield compression. So it's just that the willingness of an investor to pay a bigger multiple of the rental income that's coming from a building and that side of things is being a big driver of returns for quite some time in real estate, particularly even for the industrial sector that was so strong the last few years.

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Will Robson

There's been some significant income growth there, but there's been a lot of yield compression that's driven that. So what we're saying is in the kind of market reversal where capital value start to fall and the contribution from your compression turns negative to get a decent total return, you've got to look for other ways to push the value of the asset.

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Will Robson

And that's all around the fundamental side. So whether that is looking for types of buildings or locations where we expect rents to grow or doing something physical to the building to raise the rent or value of the building, that's going to be more and more important going forwards.

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Adam Bass

Will continued.

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Will Robson

We've looked historically around the kind of factors that perform well or badly in the early stages or a downturn and then through a recovery. And so two factors that are particularly interesting are a yield and also leasing profile, which we've calculated as a 5050 mix of occupancy and remaining lease terms that how how many years of income have you got left on the rental contract And you find that leasing profile is something that performs very well during a risk off phase where there's a flight to safety, people look for kind of more secure and longer income profiles and they tend to get bid up in price and perform well as you come out

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Will Robson

the other side and the economy starts to perform better and the red start rising as you go about leasing, profile factor starts to weaken in performance and actually sometimes turns negative. When rents are growing fast. You want short income and vacancy so that you can kind of get into the opportunity and rent out space in the rising market.

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Will Robson

And yield is a similar one. So is a yield. High yielding properties tend to be in less well-located areas. That's quality assets. The yield factor tends to perform pretty well over the whole cycle. But during a downturn there's a flight to safety away from those kind of higher yielding properties. And so they tend to underperform, though, looking at the exposure of a fund to these kind of factors or indeed the exposure of individual assets to these benefactors can help in understanding how to position or enter these opportunities or exit at different phases of the market cycle.

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Adam Bass

That's all for this week. A big thank you from Joe, Phil and me to David and Will and of course, to all of you for listening on our next episode. We'll take a look at how the investment markets have changed since the Russians invaded Ukraine last year. We'll do so with a panel of MSCI experts across asset classes and different parts of the world.

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Adam Bass

Until then, I'm your host, Adam Bass, and this is MSCI Perspectives. Stay safe in.

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