

Real Estate: pricing in a changing interest rate environment

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Key takeaways:

- Interest rates fell steadily in many developed economies during the four decades from the early 1980s.
- Talk of 'lower for longer' interest rates morphed into the possibility of a 'lower for ever' interest rate environment.
- However, 2022 saw a dramatic change as policy rates were increased to curb inflation, putting pressure on risk assets including real estate.
- Despite moderating inflation and stabilising central bank policy rates, there is little expectation of a return to the ultra-loose monetary policy of the last 10-years.
- In addition to the general impact of higher rates used to discount future rents, direct property markets have been impacted by higher debt financing costs.
- But direct property markets are diverse and heterogeneous. We see wide differences in the prospects for low-yielding 'core' real estate, which has been slow to react to higher rates, compared with parts of the market that have re-priced more quickly.
- As a general rule, we expect superior long-run returns from higher-yielding segments of the market through careful building selection and active asset management.
- Such buildings, the values of which have been more rapidly marked down relative to lower-yielding core assets, should benefit from a re-pricing as interest rates fall combined with higher income growth through active management.



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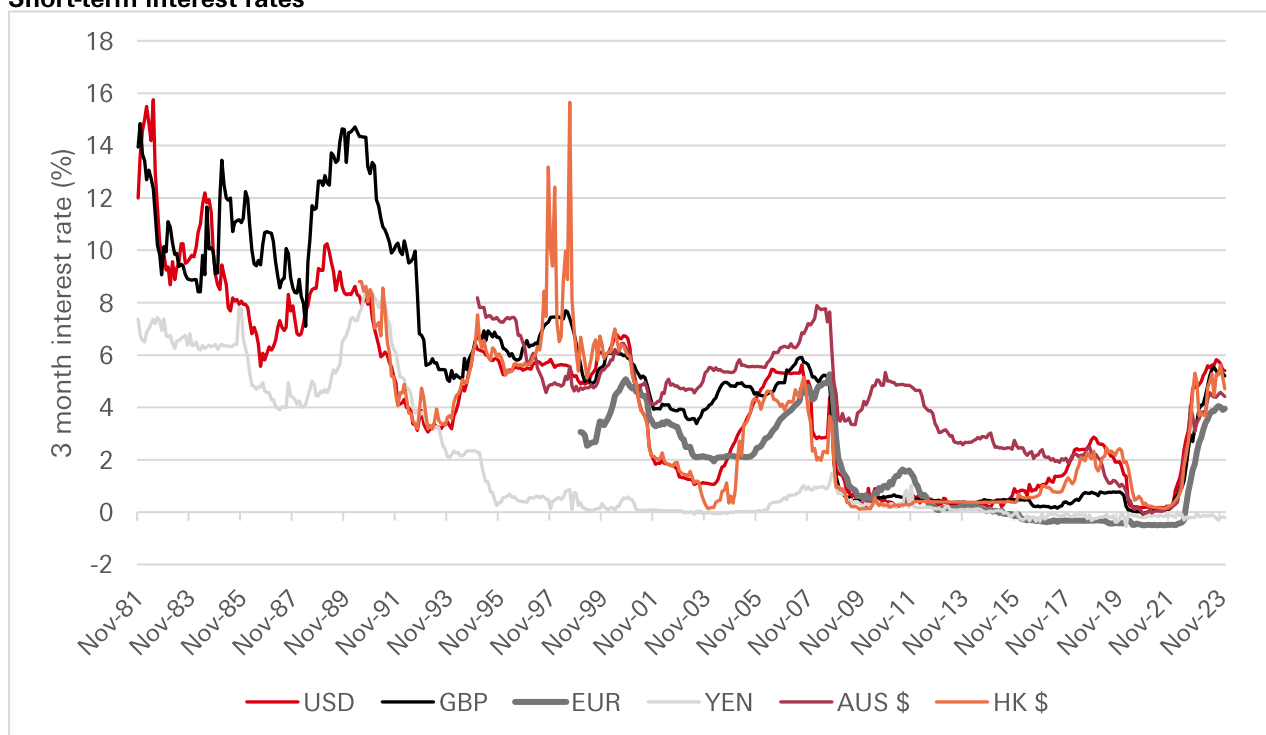
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Interest rates over the last 40 years

In many developed economies interest rates fell steadily from the early 1980s until the Global Financial Crisis of 2008 after which they fell close to zero for much of the next decade as the chart below shows. For a long period, therefore, investors have experienced a prolonged period of falling inflation and inflation expectations. Talk of 'lower for longer' interest rates morphed into the possibility of a 'lower for ever' environment, in which interest rates remain at extremely low levels.

However, triggered by the COVID-19 pandemic, a combination of supply chain disruption and fiscal largesse prompted a surge in global consumer prices which triggered a global synchronised response from central banks that raised policy rates to curb inflation. Japan remains a notable exception to this pattern, as interest rates fell close to zero in the mid-1990s from which they have barely moved.

Short-term interest rates



Source: Refinitiv Datastream as of January 2024.

At the time of writing, central banks in the US and Europe have paused their cycle of raising interest rates as headline inflation has fallen towards (but still remains comfortably above) target and economic activity is showing signs of slowing. Indeed, after its December decision to hold interest rates again, the US Federal Reserve indicated that its policy of monetary tightening was over. US equity and Treasury markets reacted positively, implying that the benchmark rate could fall in the first half of 2024 despite Federal Reserve officials' attempts to dampen expectations. Beyond the US, central banks have offered little prospect of a rapid decline in policy rates. Investors' interest expectations can perhaps be best described as 'higher for longer', with little expectation they will return to the pre-2022 levels.

Changes in interest rates impact the pricing of all asset classes. So, do we see value in today's real estate markets and, if so, where should we be looking?

The anatomy of markets: falling and rising markets compared

Falling interest rates

The fall in inflation expectations enabled central banks to reduce short term interest rates. This was accompanied by a decline in government bond yields and, in some countries, nominal government bond yields turned negative.

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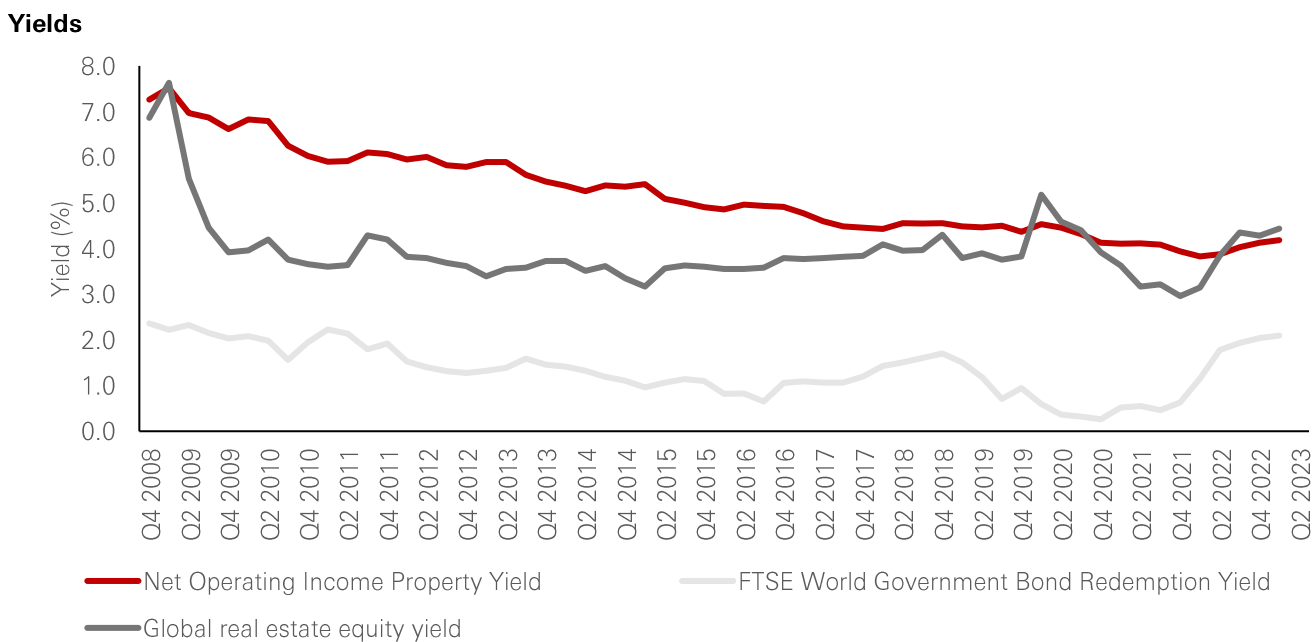
Lower interest rates pushed down discount rates and pushed up the value of many asset classes. This is particularly the case for real estate (commercial and residential) due to their being significantly influenced by borrowing costs for investors financing through debt, these changes pushed up market prices. In most sectors and geographies, driven by lower interest rates, property yields declined, and was the dominant driver to capital growth until mid-2022.

The following chart plots the global yields from direct property, real estate equities and government bonds since Q4 2008 (the earliest date for global direct property data). It illustrates nicely different market dynamics. For most of the period, the following occurred.

Government bond yields, which had declined post the Global Financial Crisis, continued to fall between 2008 and 2020, reaching a low of 0.3% at the end of 2020.

Direct property markets adjust slowly, partly because the performance of physical properties is based on valuers' assessment of value which relies on transactional evidence. The chart depicts a slow and gradual decline in global property yields, from early 2009 until mid-2022, largely due to the reduction in government bond yields. Investors seeking high yielding assets were attracted by physical property and the wide margin that existed relative to government bond yields.

Real estate equities, by contrast, reacted quickly after the end of the Global Financial Crisis. Unlike direct property, indices of real estate equities are based on traded prices rather than valuers' appraisals. Over the 5 years from Q4 2008 to Q4 2013, real estate equity returns averaged 16.1%pa¹. The biggest driver of returns was the effect of the re-rating of dividend yields, which fell from 6.9% to 3.7%, more than off-setting a decline in dividends per share over this period.



Source: MSCI for MSCI Global Quarterly Property Index, USD, Refinitiv Datastream for FTSE World Government Bonds and FTSE EPRA Nareit Developed Index, Q4 2008 to Q2 2023

Rising interest rates

Since the beginning of 2022, however, the situation has changed. Global government bond yields have risen sharply in response to higher inflation, from 0.3% at the end of 2020 to 2.2% in Q2 2023, following significant falls in bond prices. In some countries, the change has been more dramatic: 10-Year UK Gilt yields rose by 4.15% points to 4.39% over this period whilst 10-Year US Treasuries yields increased by 2.90% points to 3.81%². Listed real estate equities responded quickly and yields rose as prices fell. However, given the lag that is characteristic of direct property markets, property yields continued to decline until Q1 2022, despite rising government bond yields.

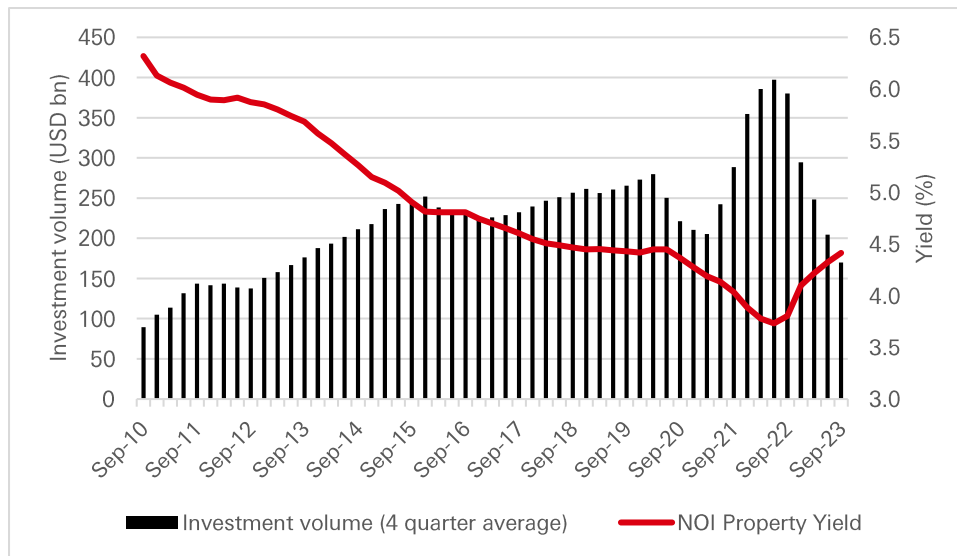
1. FTSE EPRA Nareit Developed Total Return Index in USD
2. Refinitiv Datastream as at end January 2024

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The delayed reaction of property yields to rising interest rates can partly be attributed to valuation-based ‘smoothing’ that leads to serial correlation, meaning that the returns in one period are positively correlated to the returns in the following period. Another factor is the nature of real estate decision-making and the lag between the allocation decision to invest in property, the deployment of capital and the consequential impact on market prices.

This is illustrated by the following chart, which plots global property yields and investment volumes over time. There is a strong negative relationship between the volume of transactions and the change in yields. Transaction volumes rose sharply in the 12-months to Q3 2022, compressing property yields (and pushing values up). This coincided with the start of the rise in bond yields. Only as investment activity moderated did property yields start to rise.

Global property yields and transaction volumes



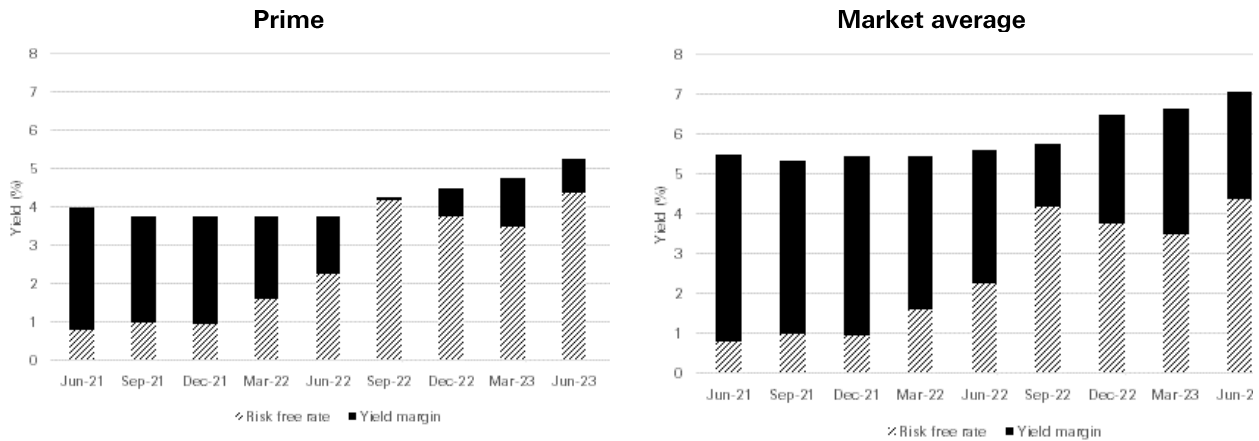
Source: Real Capital Analytics 4-quarter rolling average investment volumes (USD bn, left axis), MSCI for MSCI Global Quarterly Property Index Net Operating Income Yield (right axis), as of January 2024.

Direct property markets are diverse and heterogeneous. Buildings vary not just by property type and geography, but by other factors, such as age, condition, tenant profile and so on. These differences will be reflected implicitly in the yield (net income over capital value) that investors are prepared to pay for a building. And it is helpful to examine the impact of rising interest rates on low-yielding ‘prime’ or core properties relative to the wider market.

Due to the availability of data, the information is based on the City of London office market although it illustrates a more general pattern for low yielding assets. The left chart shows the yield on CBRE data for prime City offices, which stood at 3.75% in December 2021. UK 10-year gilt yields at the time stood at 0.97%, providing investors with a margin of 278 bps over risk free assets. Following the 240bp rise in gilt yields, the margin halved to 1.37%.

The right chart, by contrast, shows the equivalent yield on all City offices, including higher-yielding buildings. Over the same period, the margin over 10-year gilt yields narrowed from 450 bps to 320 bps, a far healthier margin than is offered by prime buildings.

The narrowing yield gap (City of London offices)



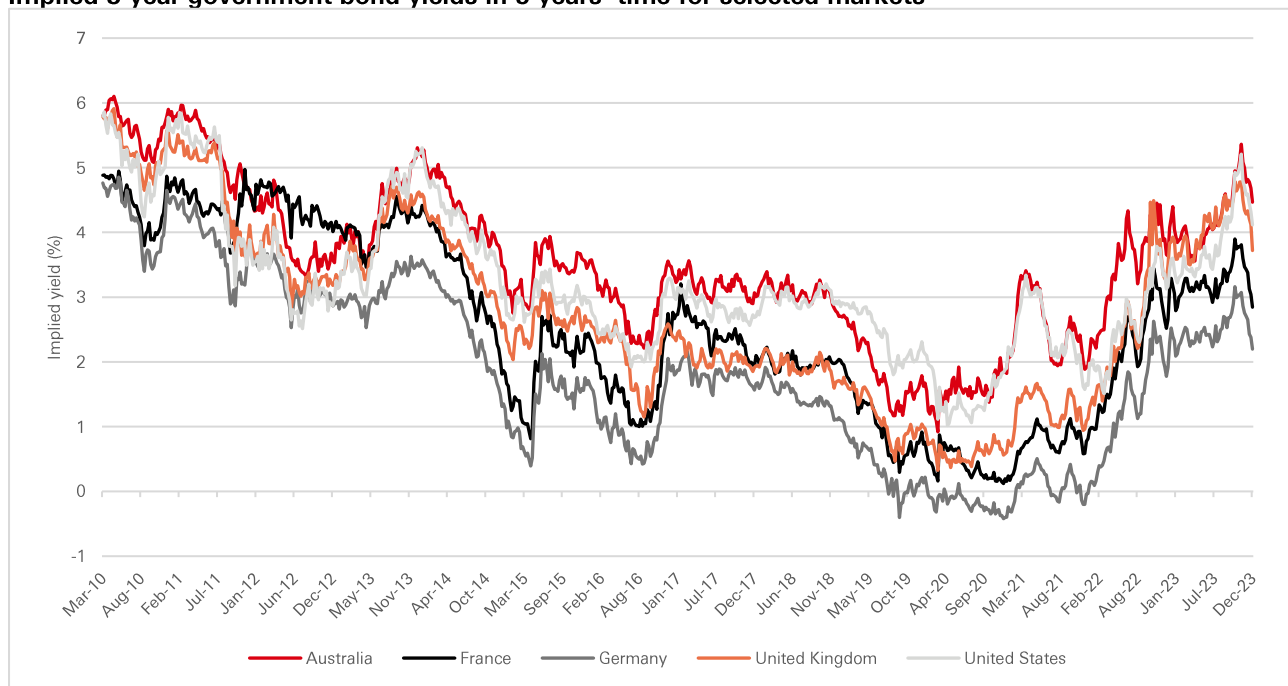
Source: CBRE (prime yields), MSCI UK quarterly Index (equivalent yields), Refinitiv Datastream for 10-Year UK Gilt Yields, as of January 2024.

The yield reflects the market’s implied views about future returns and growth. We would expect equivalent yields to be higher than rack-rented (prime) yields due to the difference between passing rents and those that can be achieved at rent review or lease renewal. But this example illustrates that either rental growth from prime offices would have to significantly out-pace that of the overall City office market, or investors should be prepared to accept a lower return based on the same growth assumptions. The next section sets out our views on where we see value in today’s market.

Where is there value in today’s market?

The sharp rises in interest rates and government bond yields have left many direct property markets exposed. The attractive positive margin that previously existed between property and government bond yields has narrowed dramatically. Forward pricing from government bond markets indicates future bond yields expectations have fallen as inflation has declines. However, the market still anticipates bond yields will be at the top end of levels seen over the last decade (see chart below, which shows the implied 5-year yield in 5 years’ time for selected government bond markets). According to current market expectations, therefore, property investors are unlikely to benefit from a return to the period of ultra-low government bond yields of recent years.

Implied 5-year government bond yields in 5 years’ time for selected markets



Source: Refinitiv Datastream as of December 2023, implied 5-year government bond yields calculated from 5- and 10-year bonds

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Whilst prices of listed real estate equities have fallen significantly, unlisted (direct) real estate is unlikely to decline to the same extent. Many investors will be wary of crystallising losses. As a result, we expect the volume of transactions over the next 12 months or so to remain well below the 10-year average. Investors who are not motivated to sell are likely to face a prolonged period of unattractive returns. Within this overall picture, however, we expect prospects to vary.

For low-yielding property 'prime' or 'core' properties, we expect a prolonged period of disappointing returns. Investors holding such real estate tend to be the least motivated to sell and will be wary of crystallising losses. Such acquisitions were often financed without debt, protecting the owner from more expensive refinancing costs as interest rates rose. The lack of transactions is likely to mean yield movements are sluggish despite the fact that a rise in risk free rates tends to have a disproportionately large valuation impact on low-yielding properties.

Moreover, the impact of higher interest rates is unlikely to be offset by stronger rental growth given the weak near-term economic outlook. So, whilst further dramatic falls in values are unlikely, lower-yielding 'core' assets are, in general, unattractively priced in our view.

By contrast, we expect superior long-run returns can be achieved from higher-yielding segments of the market, often referred to as value-add real estate, although careful building selection and active asset management will be required to generate such performance. The rationale for our view is as follows:

- **Capital market re-pricing:** The wider market has adjusted more rapidly to higher interest rates. Owners of 'average' quality property may be more motivated to sell, particularly if the original acquisition had been financed with debt and owners are faced with more expensive refinancing costs. With transaction volumes declining, opportunities exist for purchasers to secure deals at attractive prices, taking advantage of the market dislocation.
- **Income growth:** Careful building selection should enable opportunities to generate superior rental income through active asset management. Sharp increases in borrowing rates can often lead to a shelving in expenditure projects as some owners find they are unable to secure the necessary finance. This provides the opportunity to acquire buildings with a view to carrying out improvements and enhance income over time.

It is worth examining historic data to explore whether higher-yielding investments have outperformed lower-yielding assets in today's market conditions. MSCI provides detailed information for the UK for the main seven UK segments dating back to Q1 2001 for buildings that fall in the upper and lower yield quartiles; lower quartile assets generally indicate higher quality real estate. With quarterly data over more than 20 years, this produced 630 observations. This enables the excess return (which can be positive or negative) between higher- and lower-yielding properties to be calculated.

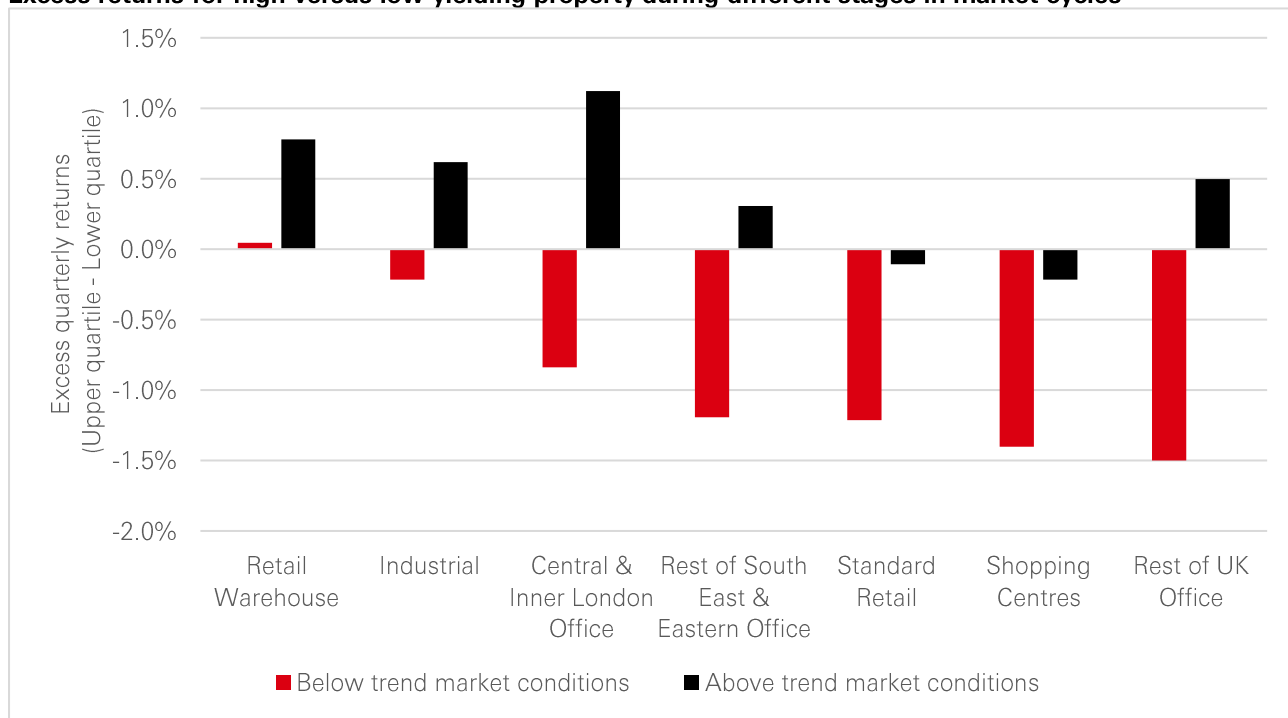
Though the relationship was not overwhelming, the stage in the cycle indicated whether higher or lower yielding property would outperform the other.

1. In falling markets, when total returns were negative, higher-yielding buildings were generally associated with weaker performance than lower-yielding properties.
2. By contrast, when the mean total returns were positive, higher-yielding properties were associated with higher total returns.

In other words, during downturns, core property tends to hold its value better than lower quality properties, but when returns are improving, core property lags the wider market.

This is illustrated by the following diagram. The vertical axis shows the excess return (that is, the difference in return between higher and lower yielding properties); the horizontal axis shows the mean absolute return for that sector.

Excess returns for high versus low yielding property during different stages in market cycles



Source: MSCI, data based on quarterly returns from Q1 2001 to Q3 2023

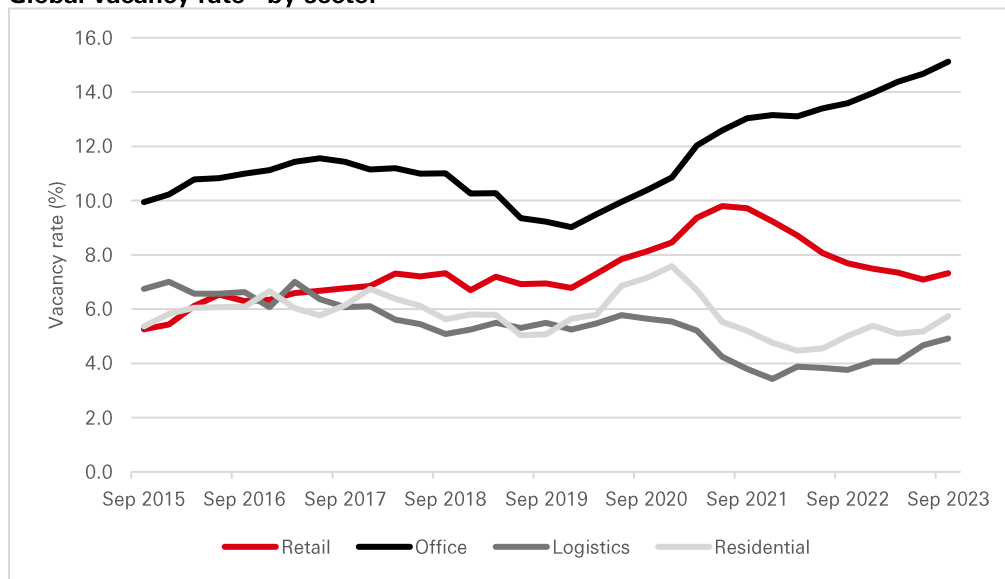
This pattern is consistent with the suggestion above that non-core buildings tend to re-price more quickly than low-yielding core property during market downturns. But, having re-priced during declining markets, higher yielding investments tend to perform more strongly during periods of above trend market returns. Whilst past performance is, by itself, no reliable guide to the future, this analysis is supportive of our forward-looking views, which is that higher-yielding 'value-add' investments are expected to deliver stronger risk-adjusted performance than prime, core buildings as we go through the next stage of the cycle and returns improve.

Our central economic scenario is that the economic activity in the US and Europe will slow (and possibly fall into a recession) in 2024 as higher interest rates weaken the labour market and depress consumer spending and business investment. Whilst Asian economic activity is also anticipated to slow, policy support for the faltering Chinese economic recovery should support the wider region.

Our base case is that policy rates will start to be eased at some point during 2024, prompting bond yields to decline. Declines for the risk free rate would be expected to support property yield declines and strengthening property market returns.

The drop in economic activity points to weakness for fundamentals for some property sectors, potentially putting downward pressure on the ability of property to sustain income levels. However, it is worth remembering that occupier fundamentals today are in reasonably good health, as illustrated by the chart of global vacancy rates below, with the exception of the office sector. Thus, assuming a sharp recession is avoided, net rental income should remain resilient.

Global vacancy rate - by sector



Source: MSCI for MSCI Global Quarterly Property Index as of December 2023.

Summary: focus selectively on 'value-add' but be wary of 'core'

Most property markets benefited from the sustained reduction in interest rates that took place between the early 1980s until 2021. Direct property yields fell – relatively gradually compared with other asset classes – as investors sought a positive yield margin over very low government bond yields.

The subsequent recent sharp rise in interest rates has put pressure on risk assets. Direct property markets have been exposed both due to the general impact of higher rates used to discount future rental income and because many property acquisitions are funded with the help of debt finance, the costs of which have risen.

Unlike public equity and fixed income markets, direct property tends to react slowly and sluggishly. The time delay between the allocation decision to invest in property and the deployment of capital, combined with the 'smoothing' of direct property valuations as valuers seek evidence before adjusting valuations, lead to delays in the market's re-pricing in a higher interest rate environment. Low-yielding 'core' property is often less responsive during periods of re-pricing than the wider market as investors tend to be least motivated to sell and transaction evidence is sparse. The recent decline in bond yields is not expected to be ushering in a return to ultra loose monetary policy, though it may support some pick up in liquidity and, potentially, the prospects of further valuation declines as transactional evidence is gathered.

Whilst there will be exceptions to this generalised outlook, we expect unattractive returns from core property as rental growth fails to make up for low yields. By contrast, higher yielding assets can offer superior returns because they have been re-priced more quickly and aggressively, offering the prospect of superior income growth through active management.

Key Risks

Risk Considerations. There is no assurance that a portfolio will achieve its investment objective or will work under all market conditions. The value of investments may go down as well as up and you may not get back the amount originally invested. Portfolios may be subject to certain additional risks, which should be considered carefully along with their investment objectives and fees.

- ◆ **Illiquidity:** An investment in the strategy is a long term illiquid investment. By their nature, the Strategy's investments will not generally be exchange traded. These investments will be illiquid.
- ◆ **Long-term Horizon:** Investors should expect to be locked-in for the full term of the investment.
- ◆ **Economic Conditions:** The economic cycle and prevailing interest rates will impact the attractiveness of the underlying investments. Economic activity and sentiment also impacts the performance of underlying companies, and will have a direct bearing on the ability of companies to keep up with interest and principal repayments.
- ◆ **Valuation:** These investments may have no or a limited liquid market, and other investments including those in respect of loans and securities of private companies, may be based on estimates which cannot be marked to market until sale. The valuation of the underlying investments is therefore inherently opaque.
- ◆ **Strategy Risk:** Investments into this Strategy may, among other risks, be negatively affected by adverse regulatory developments or reform, credit risk and counterparty risk. The credit market bears idiosyncratic risks such as borrower fraud, borrower bankruptcy, prepayment risk, security enforceability risk, subordination risk and lender liability risk.
- ◆ **Investor's Capital At Risk:** Investors may lose the entirety of invested capital.
- ◆ **General Real Estate Risk:** an investment in real estate may be affected by various matters, including, but not limited to, vacancies following expiry or termination of leases or licenses leading to reduced occupancy rates, the property manager's ability to collect rents or license fees, competition for tenants, fluctuating local real estate conditions, changes in government regulations relating to land use and zoning, environmental, occupational and safety matters, existence of uninsured or uninsurable risk, natural disasters, acts of war or terrorism. Property markets can be cyclical.
- ◆ **Third-Party Risk:** governance of underlying assets remains the responsibility of third-party managers. Regular assessment is undertaken for third-party manager approval.
- ◆ **Exchange Rate Risk:** investing in assets denominated in a currency other than that of the investor's own currency perspective exposes the value of the investment to exchange rate fluctuations.
- ◆ **Concentration Risk:** funds with a narrow or concentrated investment strategy may experience higher risk and return fluctuations and lower liquidity than funds with a broader portfolio.
- ◆ **Real Estate Risk:** property can be difficult to buy and/or sell quickly and the Fund Manager of underlying investments may apply a deferral on redemption requests. The value of property is generally a matter of the valuer's opinion rather than fact.
- ◆ **Derivative Risk:** the value of derivative contracts is dependent upon the performance of an underlying asset. A small movement in the value of the underlying can cause a large movement in the value of the derivative. Unlike exchange traded derivatives, over-the-counter (OTC) derivatives have credit risk associated with the counterparty or institution facilitating the trade.
- ◆ **Operational Risk:** the main risks are related to systems and process failures. Investment processes are overseen by independent risk functions which are subject to independent audit and supervised by regulators.
- ◆ **Leverage Risk:** Where leverage is used, it will be subject to the risks normally associated with debt financing, including the risk that cash flows will be insufficient to meet required payments of principal and interest and the risk that indebtedness will not be able to be refinanced at all or on favourable terms.
- ◆ **Credit Risk of Tenants:** Adverse changes in the operation of a real estate asset, or the financial condition of any tenant, could have an adverse effect on the ability to collect rent payments and, accordingly, on the ability to make distributions to Investors
- ◆ **Exit Risks:** Investments are made with the assumption that an exit will be made through a sale. There is no guarantee that favourable market conditions will prevail when a sale is contemplated. The process of exiting from an investment may take longer than anticipated.
- ◆ **Tenure Risk:** An investment in real estate has a long investment period and is only suitable for investors who have a long term investment horizon.

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