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The impact of higher interest rates on European listed real estate and its sustainable recovery

Due to numerous factors, the past eighteen months have brought turbulent times for the European listed real estate sector. For a.s.r. real estate, as a representative of real estate investors, this period has been an interesting one and a learning experience, after which we still see enough opportunities for the sector ahead of us. In the analysis below, a.s.r. real assets investment partners gives its view on recent developments and on where we think the European listed real estate sector is going.

The European listed real estate sector can now be regarded as an established sub-sector within broader equities. This sector has seen exponential growth in the past two decades. The European listed real estate market grew from a market capitalisation of approximately € 115 billion in 2000 to approximately € 230 billion at the end of 2022, with the highest growth occurring in the period from 2010 to 2022. While the European listed real estate market predominantly consisted of the traditional real estate sectors in the earlier years, it is now more diversified. For example, there has been substantial growth in the residential, logistics and health care markets within European listed real estate.

Listed real estate is real estate

From 2014 to 2021 (there is no alternative era), when interest rates on US and European government bonds reached record low levels, investors flocked to both listed and non-listed real estate. This included investors with both a long-term and a short-term investment horizon.

An important reason for the increased interest in listed real estate was the high direct returns that real estate companies generated compared to other sub-sectors within broader equities. The attractive direct returns for listed real estate can be attributed to reasons including:
- Favourable tax regimes for direct returns (REIT-regime);
- Inflation correction in leasing contracts;
- Favourable socio-demographic developments for real estate.

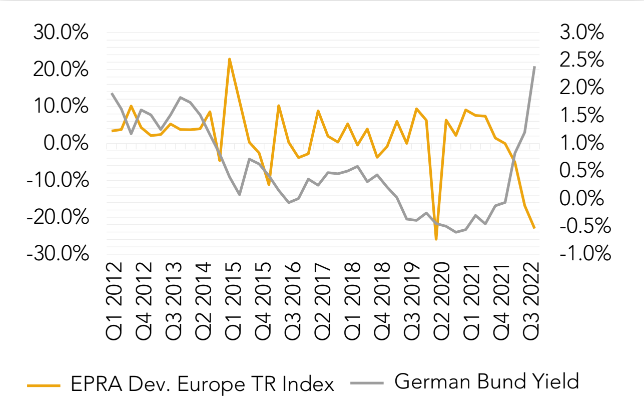
Critical readers might have noticed that these could apply for both listed and non-listed real estate. Which brings us to a very old question: 'Can listed real estate be seen as real estate?'. After examining numerous research documents and studies by MSCI[1], EPRA[2] and Green Street[3], we share the conclusion that listed real estate should be seen as real estate, mainly due to the longer term correlation between both listed and non-listed real estate. We are also of the opinion that an investor which specifically chooses to invest in listed real estate should be classified as a real estate investor. The manner in which it chooses to invest in listed real estate can of course vary. It could opt to invest in an active or a passive manner, either by investing directly in listed real estate companies or investing indirectly through a fund, a mandate and/or an index tracker.

In the current challenging context we see additional reasons to classify listed real estate as real estate, which we will share in this article.

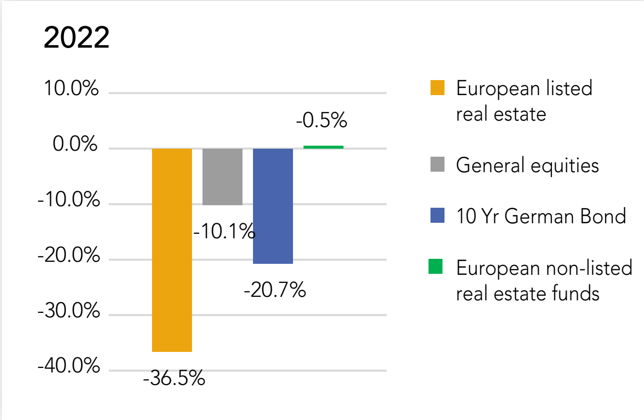
1 MSCI: Listed and Private Real Estate: Putting Pieces Back Together. https://www.msci.com/www/blog-posts/listed-and-private-real-estate/0629647090
2 Hoesli, M. & Oikarinen, E. (2021). Does Listed Real Estate Behave Like Direct Real Estate. Brussels: EPRA.
3 Green Street (2019): Listed and Private Real Estate. Madrid: EPRA

Trend reversion in cohesion of performance of listed and non-listed real estate

With rapidly rising interest rates in 2022, the performance of European listed real estate showed a very different pattern compared to the period in which interest rates steadily decreased (Figure 1). In 2022, European listed real estate significantly underperformed German government bonds, general equities and European non-listed real estate (Figure 2).



(Figure 1. Source: Datastream)



(Figure 2. Source: Datastream)

If we focus on the difference in the 2022 returns for European listed and non-listed real estate, it could be suggested that neither type of real estate shows cohesion when it comes to performance. However, we would like to focus on the difference in the 2022 returns for European listed and non-listed real estate in order to point out the cohesion of listed and non-listed real estate. We admit that at a first glance this cohesion is not easy to spot in the 2022 returns and current valuation discrepancies between European listed and non-listed real estate.

Supporting point 1: real estate ratios as leading indicators in a rising interest rate environment

A ratio frequently referred to during the 'There is no alternative era' is the so called 'yield spread'. This is the difference between the direct return on, for instance, 10-year German government bonds and the direct return of another asset class. In the years when the yield on 10-year German government bonds reached historic lows, the yield spread of real estate increased. During 2022, when the yield on 10-year German government bonds rapidly increased, the yield spread of real estate rapidly decreased over a relatively short time period (Figure 3). Especially during periods of excessive interest rate rises, we noticed unusual behaviour among European listed real estate investors.

What stood out the most for us were the share price developments of listed real estate companies with relatively highly leveraged balance sheets (>45%) and historically low yields, such as some German and Swedish listed real estate companies. 'Yields of listed real estate companies' refers to the direct returns made with the investment portfolio: i.e. the operational returns compared to the book value of the real estate portfolio. Companies that saw excessive increases in their yield spreads during 2014 – 2021 tended to be punished the most in 2022, when interest rates rapidly rose.

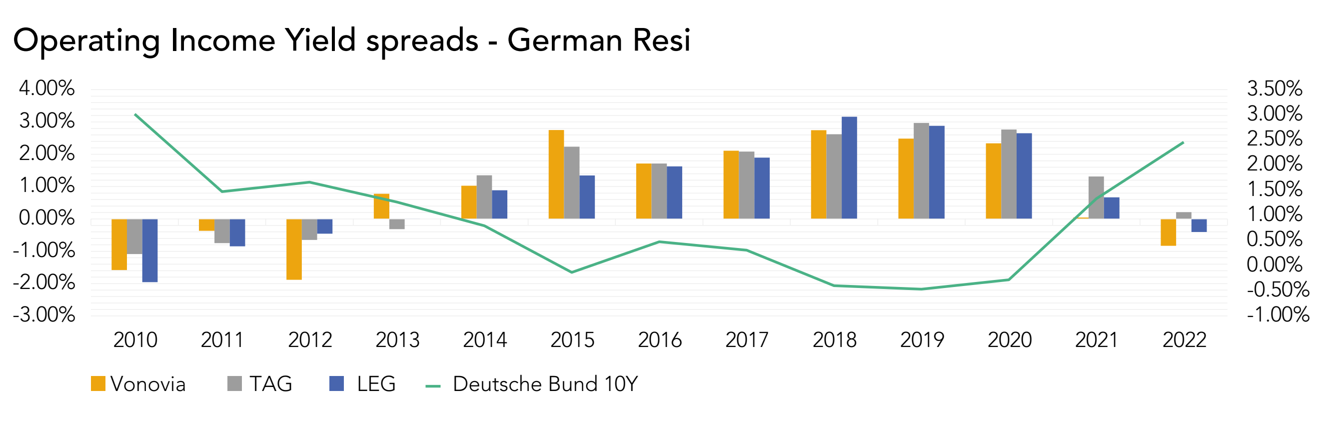


Figure 3. Operating income yield spreads (Datastream, 2023)

The share price movements of certain companies during 2022 seemed to imply that the market felt that underlying real estate portfolios should be revalued in order to have a healthy 'yield spread', being the 'yield spread' based on the direct returns that are made with the real estate portfolio. If listed real estate investors were not guided by real estate ratios but mainly by general financial ratios, we believe we would probably have seen a quick recovery of listed real estate share prices in 2022/2023. Dividend yields, rather than operating income yields, stood at attractive levels throughout 2022.
If that is combined with the discounts-to-NAV seen throughout 2022, one could see attractive entry points for European listed real estate (Figures 4 and 5).

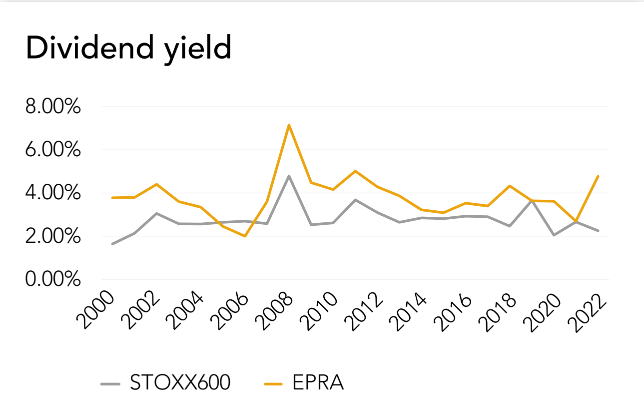


Figure 4. Dividend Yields (Datastream, 2023)

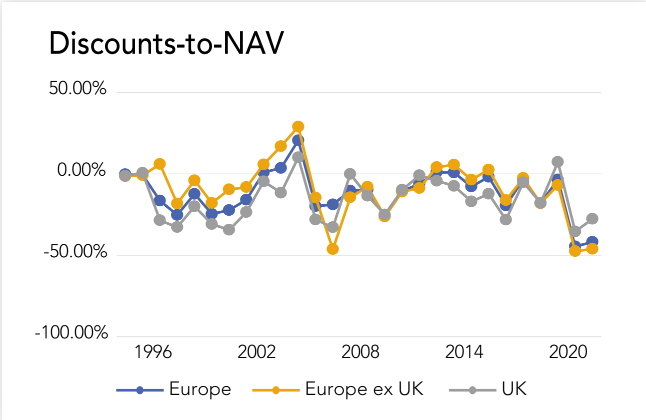
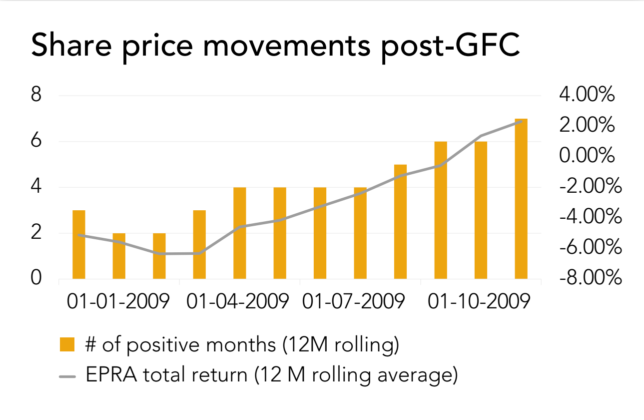
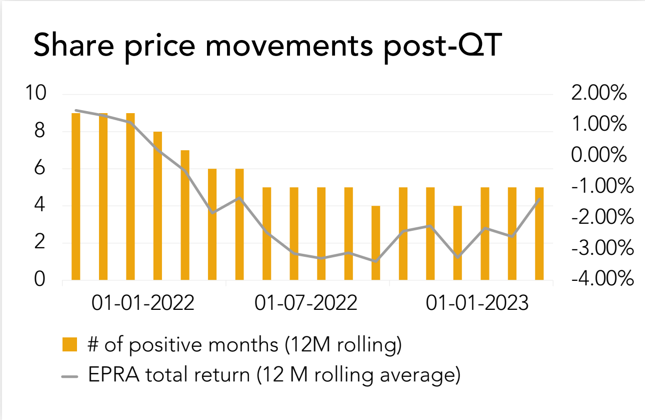


Figure 5. Discounts-to-NAV (EPRA, 2023)

Supporting point 2: postponed share price recovery, despite historically attractive valuations

Six months into 2023, despite historically wide discounts-to-NAV and attractive dividend yields, we have yet to see a structural share price recovery for European listed real estate. For example, right after 2008 we saw comparable discount-to-NAV levels to the ones we saw mid-2023. Whereby share prices of European listed real estate companies made a swift and strong recovery (Figure 6a). As research by Morgan Stanley[4] pointed out it is for the first time in history that 12 months after extreme wide discounts-to-NAV (>40%) were noted, European listed real estate showed a negative total return.





(Figure 6a-b. Share price movement European listed real estate post-GFC and after quantitative tightening (Datastream, 2023)

This brings us to the question: 'Why have we yet to see a structural recovery for European listed real estate share prices, after a historically negative year of total return?'. We could perhaps debate for months to find an answer satisfactory to all parties. However, yet again we see an answer in the European direct real estate market.

Companies that are relatively highly leveraged, which also saw a surge in their yield spreads, are currently seen as companies with balance sheet issues. Investors expect these companies to de-leverage their balance sheets as soon as possible. The companies in question are generally intending to sell parts of their real estate portfolio to de-leverage their balance sheets with the sales proceeds. In the cases whereby these companies fail to sell their earmarked portfolios they have chosen to postpone or cancel dividends, and in some cases announced equity rights issues. Equity rights issues are generally seen as a less favourable option with the current level of share prices (mid-2023).

What we currently see on the European direct real estate market is a lack of large real estate transactions. For example, the H1 2023 investment volumes for the European direct real estate market were 56% lower compared to the same period twelve months prior. On the one hand, we did not see a huge need to sell fundamentally attractive real estate in Europe. Whilst on the other hand, we see that the parties that are willing to sell their real estate assets are struggling to find an agreement on pricing with potential buyers. Whereby we think that the envisaged yield spread of potential buyers plays a role.

The two abovementioned supporting points are additional reasons for us to believe that the European listed and non-listed real estate market are (heavily) cohesive with each other from a performance perspective. In summary our view is supported by:

- The current discount-to-NAV levels (mid-2023) implying that investors think the underlying real estate portfolios should be revalued;
- The pricing mismatch between current sellers and potential buyers for real estate assets disrupting the ability of companies to de-lever their balance sheets, without having to raise new equity.
- The seemingly 'wait and see' approach of investors until the implied re-valuations are proven otherwise (for example by less negative re-valuations and transactions against acceptable valuations)

4 Morgan Stanley Property Equity Research (2023): There is a first time for everything. London: A. Escalante

A realistic view on the valuation of listed real estate companies

Based on recent history, as seen in figures 4a-b, it isn't difficult to guess that there could come a point where European listed real estate share prices show a sustainable recovery. It is very well possible that at the moment of publishing this article we will have seen a remarkable share price recovery, due to less negative than expected re-valuations of underlying real estate portfolios. However, at a.s.r. real assets investment partners we think that the years ahead of us will be different for European listed real estate than the period of ultra-low interest rates.

The period of higher interest rates, and therefore changed return assumptions of investors, could eventually lead to the disappearance of listed real estate companies with less appealing strategies. For instance, some companies that were relatively highly leveraged with a fundamentally less appealing strategy were amongst the companies that showed record high share price returns over the past years.

We think that investors in listed real estate in a higher interest rate environment will almost be forced to mainly base their investment decisions on long-term fundamentals that take place on the direct real estate market. The long-term fundamentals for the direct real estate market would then be combined with shorter term developments on financial markets. When speaking of long-term fundamentals for the direct real estate market, topics such as sustainable buildings, healthy rental markets and reasonable use of leverage is meant.

Sustainable portfolios can help sustain a share price recovery

A factor that has not yet been mentioned, but is nonetheless important for European listed real estate, is the Environmental, Social and Governance (ESG) score. Whereby, because of the urgency most attention will be paid to the E of ESG. The fact that real estate is responsible for approximately 40% of the global greenhouse gas emissions is undoubtedly an urgent matter for (European) listed real estate. Therefore, investors in (European) listed real estate will require that the underlying real estate portfolios de-carbonise. What we consider decisive in the time to come is the way listed real estate companies will have to report on how sustainable their portfolios are. In fact, this is a third point that we think supports our claim that listed real estate should in fact be seen as real estate.

Within (European) non-listed real estate, important steps have been taken with SFDR and EU Taxonomy to increase the comparability of financial products when it comes to sustainability. Similar steps are now being taken for (European) listed real estate with the Corporate Sustainable Reporting Directive ('CSRD'). Listed real estate companies that have to comply with CSRD will have to report on sustainability according to set guidelines. This will increase the comparability of listed real estate companies, but also non-listed real estate funds with listed real estate companies. According to numerous research papers, including EPRA's[5], reporting on ESG-targets and the progress of reaching these targets can have a positive impact on the share price movements of such companies.

Where in recent years there was much focus on benchmark indexes that exclude less performing companies on the topic of ESG, we at a.s.r. real assets investment partners see value in engaging with companies that perform poorly on ESG-indicators. We are of the opinion that excluding the less performing companies from benchmark indexes isn't solving the challenge of de-carbonisation, but rather feigning ignorance. Transparent reporting guidelines can enhance, improve and accelerate the engagement process. We are well aware that there are still major steps to be taken in the years to come. Albeit through joint efforts with other direct book investors in listed real estate, or through asset managers that have an active investment approach for their mandates and/or funds. In our opinion, active investing in listed real estate gives us the opportunity to address specific targets with the management of listed real estate companies when it comes to ESG.

5 Brounen, E., Marcato, G. & Op 't Veld, H. (2020). Measuring the ESG Impact on Listed Real Estate Performance. Brussels: EPRA

In summary, if we look ahead to the times where the valuations of listed and non-listed real estate are more in line with each other, we are of the opinion that:
- The European listed real estate market will be fundamentally better positioned than is the case mid-2023;
- The expectations for the underlying real estate portfolio of listed companies will become significantly more important when making investment decisions;
- ESG performance will become a significant part of the real estate fundamentals that are considered when making investment decisions.

The aforementioned points offer a healthy starting point for active investment in (European) listed real estate for the longer term. Once again, this is specifically because we believe that the long-term trends in the direct real estate market will become more important when making investment decisions. An active investment approach will enable investors to make a difference from the point of view of both returns and the ESG score. Despite the healthy starting point that we see for European listed real estate, the macro-economic and geo-political uncertainties we are currently facing will have to be addressed. Although a focus on the direct real estate market can explain and clarify a great deal, like other asset classes, both the listed and non-listed real estate market are dependent on macro-economic and geo-political developments.

This article was written by the team within a.s.r. real assets investment partners that is responsible for strategy, manager selection and monitoring for listed real estate. For more information, please contact:

Gideon Agyemang
senior portfolio manager
gideon.agyemang@asr.nl

Alexandra Heerbaart
portfolio analyst
alexandra.heerbaart@asr.nl

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