FUNDS ON FRIDAY
by Glacier Research

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by Sanlam

8 September 2023
Volume 1197

Risks and Opportunities in Global Listed Real Estate

Author: Theodore Freysen, Senior Investment Analyst, Catalyst Fund Managers

The Chinese symbol for crisis is a combination of two symbols: the symbol for danger and the symbol for opportunity. While the danger is what everybody sees; the opportunity is never quite as obvious as the danger, but it's usually present. At present, there is no crisis in the real estate market; it is well-known and documented that the pace and magnitude of interest rate increases have been a drag on real estate returns, and continues to be a headwind.

Over the last two years, the FTSE EPRA NAREIT Developed Index, a widely followed benchmark for global listed real estate, has returned c. -21%, as listed real estate securities trade daily, and prices quickly incorporate new information that affects the return outlook and valuation. The effect of higher interest rates on property valuations and an increase in funding costs, were swiftly incorporated into the listed real estate market. However, the same cannot be said for the private real estate market, where there has been a dearth of transactions, and where valuations lag due to the backward-looking nature and infrequency of appraisal-based valuations.

Glacier Financial Solutions (Pty) Ltd, I A member of the Sanlam Group | Private Bag X5 I Tyger Valley 7536 I Email: client.services@glacier.co.za | Tel +27 21 917 9002 I Fax +27 21 947 9210 I Web www.glacier.co.za | Reg No 1999/025360/07 I Licensed Financial Services Provider
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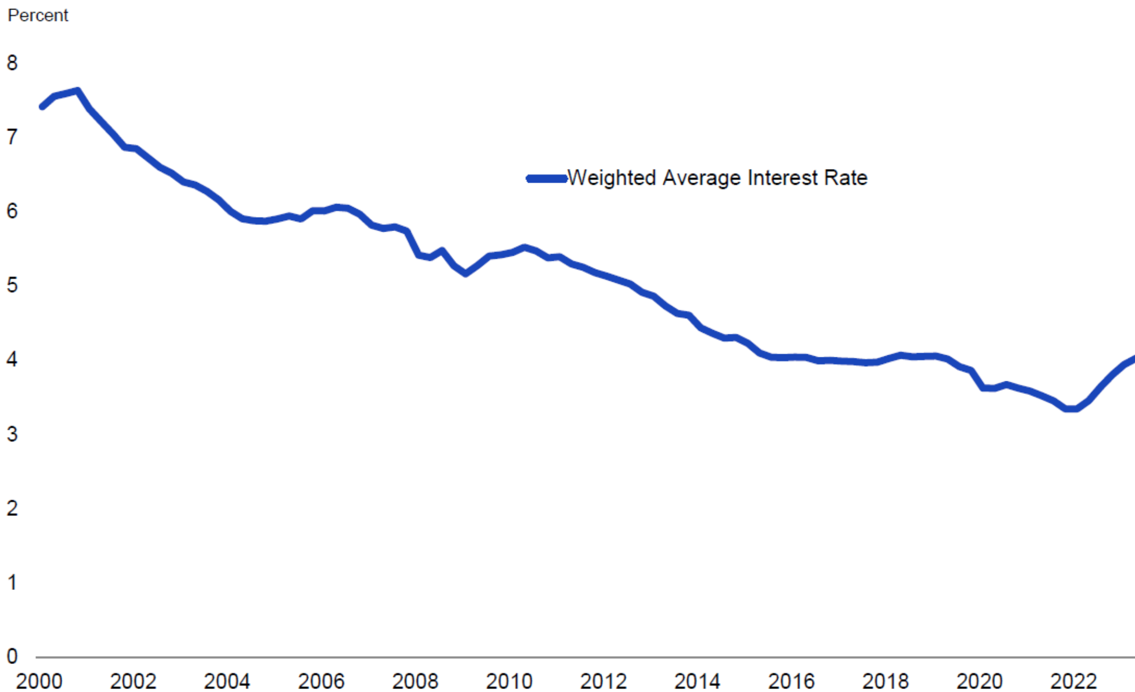
We have recently observed an increase in headlines and stories about financial distress in commercial real estate. Majority of these reports relate to office properties in the private market. The outlook for the office sub-sector is undoubtedly the most precarious out of all the real estate sub-sectors. The shift to more employees spending more time working from home (WFH) has resulted in reduced demand for office space, leading to a rapid increase in office market vacancies in almost all major office markets. This has also resulted in a bifurcation of fundamentals between the best-in-class office properties (modern, energy-efficient, well-located properties with amenities) and the others. For example, net effective rent growth for trophy office assets in San Francisco has increased by approximately 4% as of the end of 2Q23, compared to pre-pandemic levels, whereas class B office net effective rent in the same market is down by almost 35%, according to data from Avison Young.

The office market dynamics garner a lot of media attention. However, this subsector makes up only c. 10% of the global listed real estate market, and it is relatively easy to avoid exposure to this subsector. However, offices represent a substantially larger portion of the private real estate market, with the remainder primarily composed of traditional real estate sectors such as retail, industrial, and apartments. The listed real estate market also offers exposure to high quality traditional real estate sectors. However, a significant portion of the exposure today lies in the niche sectors, like data centres, gaming net lease properties (mostly casinos), lab space, manufactured housing, single family housing, storage, and cell towers.

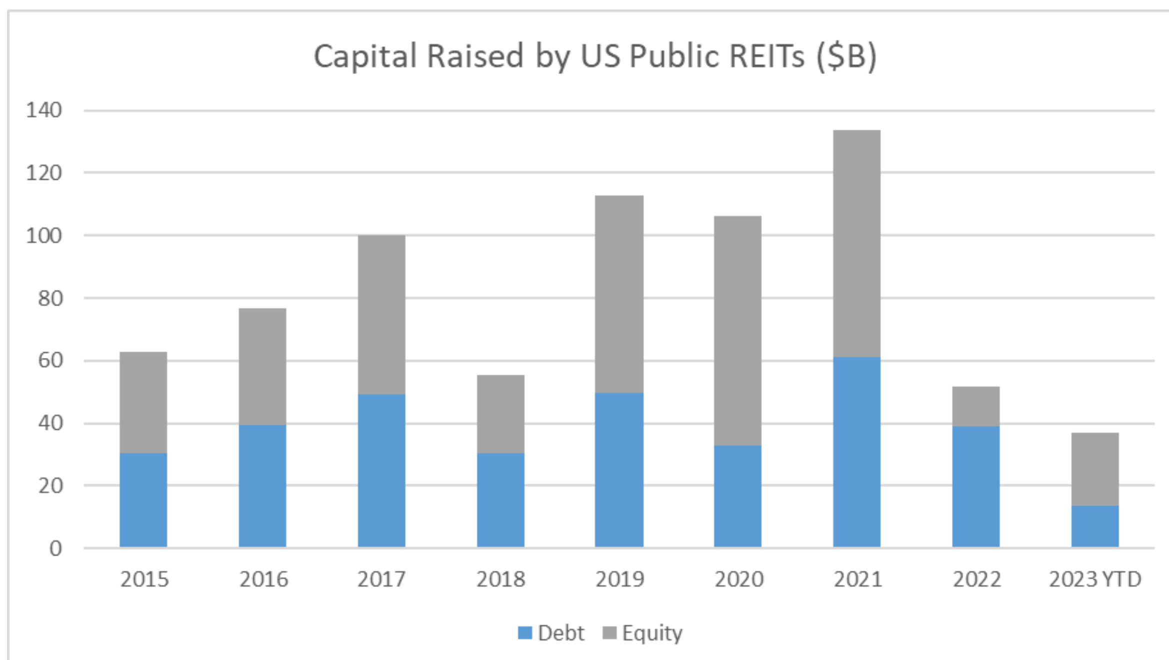
While most assets in the private real estate market are suitable to be outsourced to third-party management, assets within the niche property sector tend to be more operationally intensive. They often benefit from being run with an efficient operating platform. Listed real estate companies are not merely passive property portfolio holders; they can create and extract significant value through capital allocation decisions (buy, sell, re/develop) or through their operating platform. These types of businesses are better suited to entities with access to permanent capital, in contrast to private funds that mostly have finite lives.

Private real estate funds typically maintain leverage levels between 60% and 80%, whereas the loan-to-value ratio (LTV) for the global listed real estate market is currently stands at approximately 30%. While most listed real estate companies learnt hard lessons in the global financial crisis (GFC) and spent the past decade to strengthen their balance sheets by extending loan duration and fixing debt cost, private real estate participants have taken a different approach. According to data in the US from NAREIT (National Association of Real Estate Investment Trusts), the average maturity of debt of listed REITs (Real Estate Investment Trusts) is 6.7 years, whereas the average is around 3 years for private real estate assets. Listed REITs have nearly 90% of their debt fixed for the long term, whilst nearly 50% of private real estate debt is variable.



Source: S&P Capital IQ Pro, NAREIT T-Tracker®. Data as of 2023:Q2

Over the last decade, private real estate entities have used cheap debt and higher leverage to often outcompete their listed competition in acquisitions. However, the change in the economic environment has reversed this situation. Currently, listed real estate companies maintain more conservative capital structures, as well as access to both debt and permanent capital from equity markets, placing them in a position to take advantage of distress from over-levered property owners. At the end of July, US REITs have raised c. $37 billion in capital this year, not far off the average of $43 billion for comparative periods of the previous 8 years.



Source: NAREIT T-Tracker®. Data as of 2023:Q2

Case in point is Blackstone's flagship fund, BREIT - a private non-traded REIT, which has sold nearly $10 billion worth of prime real estate to publicly (listed) REITs this year, to meet investor redemption requests. These sales include the $5.5 billion sale of two Las Vegas casinos to VICI Properties (VICI), an $800 million sale of a holiday resort to Ryman Hospitality (RHP), a $2.2 billion sale of Simply Self-Storage to Public Storage (PSA), and a $950 million partial sale of The Bellagio Casino & Hotel to Realty Income (O).

Excluding the office sector, operating fundamentals for most real estate sectors remain healthy. Demand has been sufficient to absorb most new supply. In the US, REIT occupancy rates have rebounded from the pandemic lows of 89.9% to 93.4% at the end of 2Q23. For comparison, listed REIT occupancy reached a trough of 88% during the GFC, according to NAREIT data. Sectors that continue to experience strong demand and rental growth include data centres, industrial, manufactured housing, and single-family housing. An increase in construction costs and developer financing has reduced the supply outlook for most sectors. The exception to low supply is data centres, which are experiencing exceptionally strong demand due to increased data and Artificial Intelligence-related applications.

According to data from FactSet, S&P 500 companies reported a year-over-year earnings decline of -4.1% in 2Q23, while the Real Estate sub-sector of the S&P 500 experienced earnings growth was 10.7%. The current dividend yield for the S&P 500 is c. 1.50%, compared to c. 4.60% for the global listed real estate market (based on the FTSE EPRA NAREIT Developed Rental Index weights). Looking forward, the consensus earnings growth expectation for the listed real estate sector is above 4% for 2023, compared to projected earnings growth of 1.2% for the S&P 500 according to FactSet.

Glacier Research would like to thank Theodore Freysen for his contribution to this week's *Funds on Friday*

Theodore Freysen
Senior Investment Analyst
Catalyst Fund Managers

Theodore joined Catalyst Fund Managers in Cape Town in 2015 as an investment analyst covering global listed real estate companies. Prior to Catalyst, Theodore worked for EY Advisory in Johannesburg, consulting on performance improvement in the financial sector. Prior to that, Theodore completed his auditing traineeship at EY Johannesburg, mostly on investment banking and private equity clients. Before joining EY, Theodore worked for Pro Optima Group as an internal auditor and contract management consultant in the mining industry in Western and Southern Africa. Theodore is a qualified Chartered Accountant, CA (SA) and CFA Charter holder. He has been based in London since 2018.

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