FUNDS ON FRIDAY
by Glacier Research

glacier
by Sanlam

8 December 2023
Volume 1210

Real Estate's Great Divide

Author: Hubert Weyers, Global REIT Analyst, Reitway Global

> *"In my 53 years in the investment world, I've seen several economic cycles, pendulum swings, manias and panics, bubbles and crashes, but I remember only two real sea changes. I think we may be in the midst of a third one today."*
>
> **Howard Marks, 2022**

A sea change can best be thought about as a paradigm shift that requires a change in investor mentality. In mentioning the sea change, Marks has a tighter capital environment in mind. This article will expand on and apply the idea to real estate investing, owing to its status as an inflation hedge and portfolio diversifier.

With the advent of inflation, ushered in by pandemic related developments, the notion of a cheap money era is progressively dissipating. The Goldilocks period is becoming something of the stale past, a fireside story, and investors are being introduced to the revelation that it is time to leave the nest built by their guardian angels, the central bankers.

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
Glacier Management Company (RF) (Pty) Ltd is a registered and approved Manager in Collective Investment Schemes

This document is intended for use by intermediaries. The information contained in this document has been recorded and arrived at by Glacier Financial Solutions (Pty) Ltd in good faith and from sources believed to be dependable, but no representation or warranty, expressed or implied, is made as to its accuracy, completeness, or correctness. The information is provided for information purposes only and to assist the financial intermediary to submit an investment proposal to the client and should not be construed as the rendering of investment advice to clients.

Departing from the nest is a petrifying prospect for any nestling. For investors, it requires an overhaul in thinking and portfolio construction.

As the market slowly passes through the limen, one must wonder what the other side might look like, and how to position before opportunity has become history.

The nub of the problem is inflation. Its reawakening has been a stark reminder that inflation is not down and out and will likely caution stimulative policies in the future, barring severe recessions. Interest rates will likely settle at a new mean, and money will be treated with a new kind of respect.

There is a plethora of prospects that loom on different layers of our future that radiate inflation.

Supply-chain disruptions, hot labour markets, an energy crisis, and climate calamities have all been contributing drivers to elevated and volatile inflation since the onset of the pandemic.

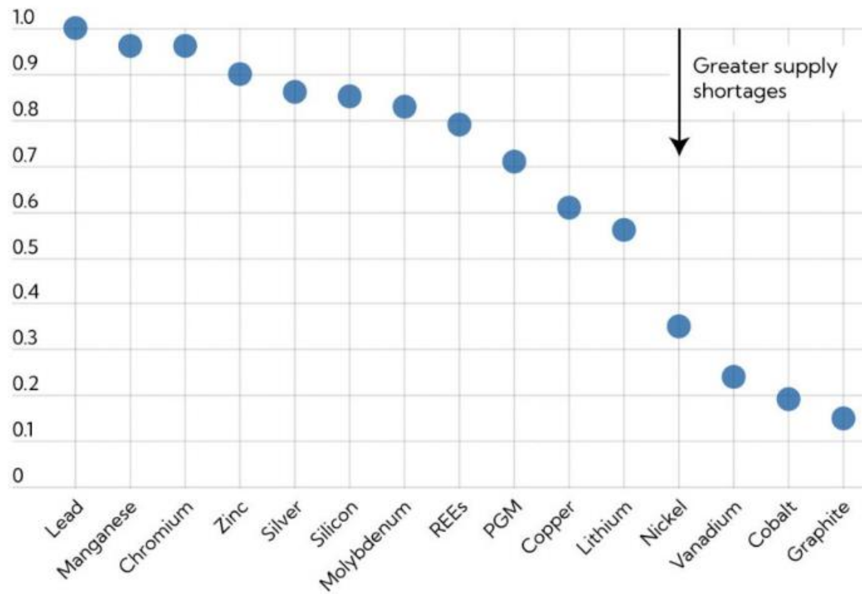
With inflation showing signs of abating and the forces behind some of these drivers settling, investors may be tempted to put them out of sight and out of mind. Five-and ten-year inflation expectations at ~2% and the recent full disappearance of the US ten-year term premium seem to suggest investors have been moving in that direction. But it would be remiss of investors not to consider these drivers for the precursors they may be.

Potential Future Inflation Drivers

Declining fertility rates and the **progression of large cohorts to older ages** are threatening the labour supply of developed countries. These developments will likely lead to labour shortages which are conducive of wage inflation. **Social security spending** (a large part of government expenditure), paired with a shrinking tax base as retirees take a more significant portion of the population pie, will compound the problem, if it leads to debt monetisation. Pro-immigration policies can combat shortages, but a skills gap may quickly take shape when trying to tap into emerging markets' unadvanced human capital pool.

The **clean energy transition** is another prospect that carries inflationary pressures. Key metals have already come under supply pressure and are expected to continue to experience supply deficits. Considering the current early phase of the sector's lifecycle, the typical trajectory suggests an upcoming acceleration that would put immense pressure on the metals supply. The limitability of key metals and the significant lags of industry supply in response to demand will result from volatility, while sustained deficits can result in entrenched inflation.

Exhibit 1: Metals in a Net Zero Scenario



Source: International Energy Agency, US Geological Survey 2021, and IMF staff calculations. Note: Supply = cumulative production volume for 2021-2050, fixed at 2020 output level. Demand = total metal demand 2021-2050 for renewable energy and other uses.

It is not only the response side of climate change that carries inflation risk but also the natural effects. Consider the following noteworthy examples: 1) The Rhine dropping to water levels unsupportive of full capacity loads, leading to surcharges; 2) the Texas freeze that disrupted oil, petroleum, and natural gas supplies; and 3) the disruption to crop yields that have been contributing to today's food inflation. These types of events are set to increase in severity and frequency until net zero is reached.

The combination of nearshoring/onshoring and global polarisation in geopolitics synthesises a different DNA for the corporate cost structure. Counterbalancing corporate profits (a standalone consideration in the past) with political agendas and security jeopardises the bottom line. Any attempt at preserving the bottom line could be inflationary.

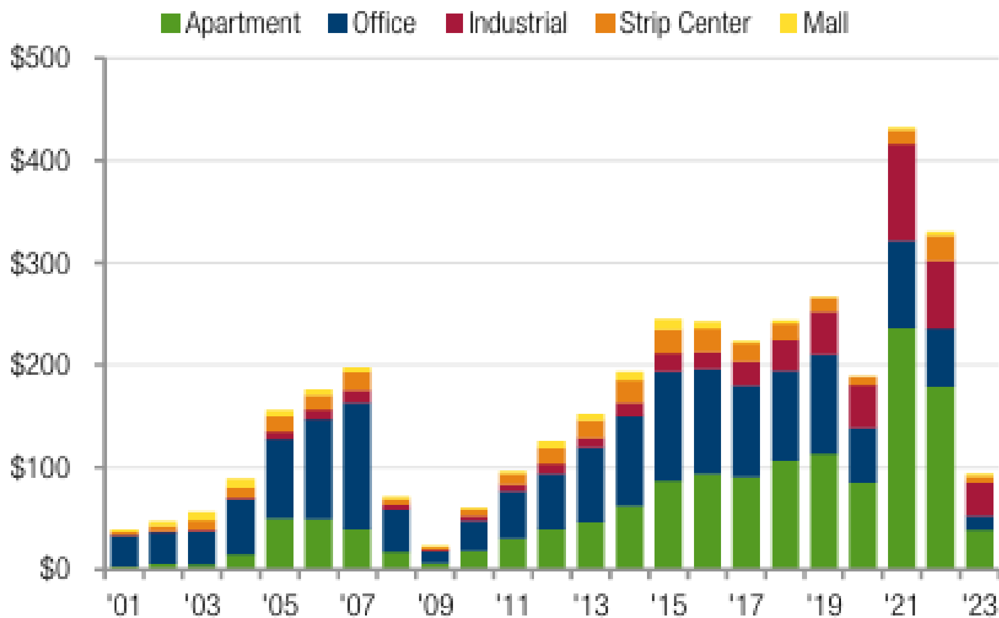
Considering the strong possibility of the different timelines of the aforementioned phenomena overlapping, it is likely that the future holds a combination of elevated and volatile inflation. Elevated and volatile inflation translates into elevated and volatile interest rates by the nominal yield equation.

Private vs Public

What becomes of paramount importance in a volatile inflation and interest rate environment is the ability to remain nimble, the presence of fair prices, liquidity, and the execution of optimal risk management—all of which can bring a sense of comfort in disconcerting times.

Recent events have shown us that said features become compromised in the unlisted real estate space when in the presence of rate volatility. Following the onset of the global rate hiking cycle, real estate transaction volumes have plunged, bid-ask spreads have blown out, and public market prices have trekked south to ~20-30% below private market prices.

Exhibit 2: Sales Volume by Property Type ($BIL.) YTD as of 11/02/2023



Source: Green Street

Causes of the symptoms include underwriting difficulty and tight capital markets, inhibiting the repricing of private real estate assets. A weakening transaction market becomes a vicious cycle in that the commonly used *sales comparison* valuation method becomes compromised.

The sales comparison method requires recent transactions of similar properties to commence from. As transaction volumes decrease, even fewer transactions occur, and the difficulty of pricing starts to compound, setting a vicious circle in motion.

During this circulation, liquidity dries up, and prices turn stale at a time when their functionality is needed most. Secondary effects include owners locked into their properties, real estate scarcity, and portfolio risk and performance measurement distortion.

Measuring and managing risk exposure becomes easier in the public market, not only due to greater liquidity but the accessibility of derivatives. Exchange traded derivatives for public market real estate are much more targeted and readily available. For the private market, exchange traded derivatives are mainly limited to private real estate indices and sub-indices.

Conversely, over the counter derivatives can be structured to a private investor's liking, making it more targeted. However, this customisation (especially with such an obscure asset as the investors' private real estate portfolio) shrinks the counterparty pool in which the investor can be matched.

There are consequences for investors who choose to abstain from the public market, regardless of whether the investor is buying or selling.

Sellers/owners face the danger of getting locked into loss-making properties, negative leverage from refinancing, or a failed refinancing leading to a forced sale and resultant haircut.

Buyers face the same prospect of negative leverage as sellers become reluctant to budge on cap rates, making the investment over-reliant on the riskier growth component of returns. For most buyers, the unreachable asking prices make these assets unattainable, ushering a scarcity issue that severely complicates the ability to capitalise on desirable assets.

REITs have always been good conduits to scarce real estate, such as manufactured housing communities and telecommunications towers**, both sectors we have favoured in our portfolios for extended periods.** The conduit feature is enhanced in an environment where private real estate is not transacting.

Development is a natural alternative to acquisition. However, it introduces a different risk profile and set of expertise, not to mention its reliance on financing and long lead times, creating additional complications. In response to a scarcity issue, there could be an influx of development, exacerbating the lead time and financing issue. There is also the likelihood of a glut arising, owing to both elevated development and the inevitable reopening of the transaction market.

Conclusion

A new investment environment calls for assessing what will be required to navigate the real estate arena and the dangers to be vigilant of. In this arena, investors need to stay dexterous and nimble.

These qualities are best obtained by leaning into the public market as it enables investors to effectively manage the risk of their real estate holdings and better take advantage of any market dislocations that may arise. It also offers a quick exit when things get a little hairy.

The last thing an investor wants is to be paralyzed – a sitting duck getting rifled down by the market.

Naturally, the future is uncertain. We know that the volume of potential inflation drivers is great, and that real estate is an effective inflation hedge. As a powerful portfolio diversifier, real estate becomes instrumental in dealing with uncertainty, and in the perils of market instability, listed property exposure eclipses unlisted property exposure.

Glacier Research would like to thank Hubert Weyers for contributing to this week's *Funds on Friday.*

Hubert Weyers
Global REIT Analyst
Reitway Global

BComm (Hons) Financial Analysis

Hubert holds an honours degree in financial analysis, which he obtained from the University of Stellenbosch in 2019. He has passed all three CFA examinations on his first attempt and scored in the top 10% of all participants in the CFA level II examination. He is currently adding to his work experience in the field to become a CFA charter holder.

From September 2020 to December 2021, he worked for The Burgiss Group, where he quickly made his way up the ranks from junior analyst to auditor and then to building and co-leading the hedge fund transparency team.

He wrote about financial topics for The Urban Writers for three months before joining Reitway Global in September 2022.

Hubert is responsible for covering the specialized, storage and residential REIT sectors, globally.