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Real estate strategy 2023: Should we switch from "direct" to listed real estate?

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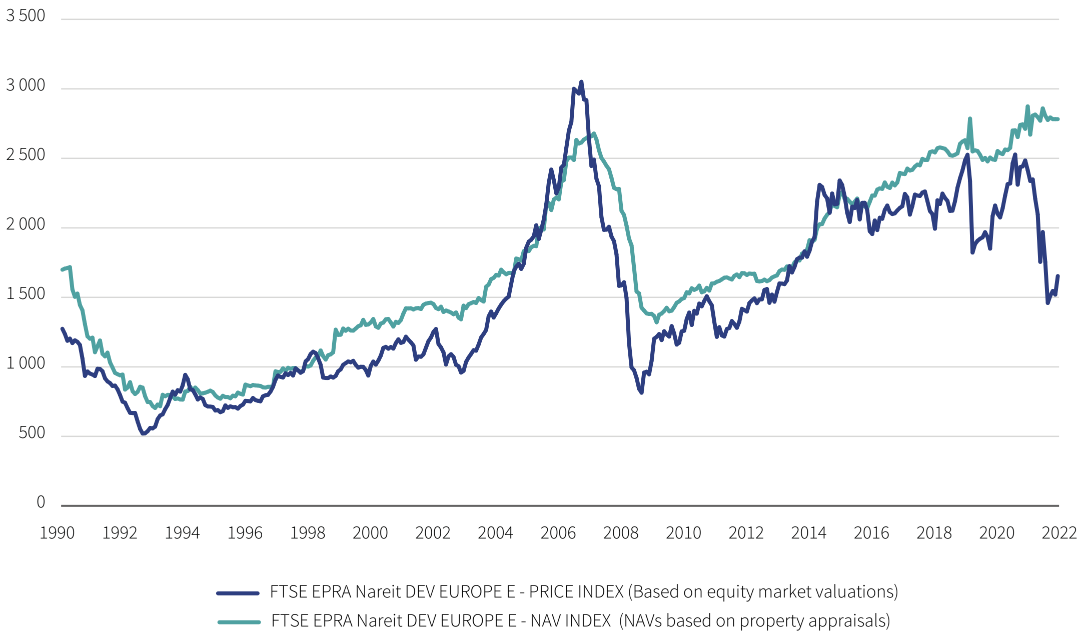
The valuation gap observed between the property markets and listed real estate companies may indeed lead to this observation. After the low point in September/October 2022, when the discount reached up to 45%, listed real estate is still cheap, even after the catch-up at the beginning of the year, with a current discount of 35%[1].

Real estate NAVs[1] based on financial markets and property capabilities



Sources: Datastream, EPRA, 28/02/2023.
(1) Building values minus debt.

Are financial markets' expectations on property prices too pessimistic?

Liquidity in European property markets dried up at the end of last year. Transactions fell by an average of 18% in 2022, with a sharp deceleration in the fourth quarter (-58%[2]). The fall in transaction volumes varies considerably between sectors, with, for example, an annual increase of 20% for retail, the only sector to rise, and a collapse of 46% for residential[3].

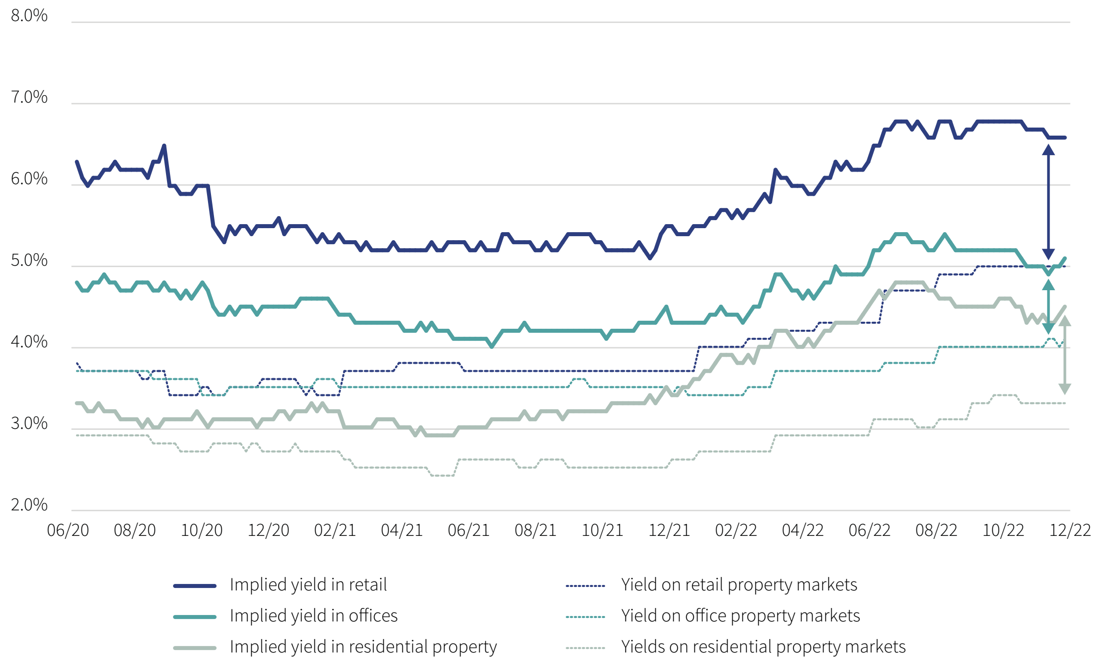
(1) Source : Companies, Bloomberg, 01/03/2023.
(2) Source: CBRE, March 2023.
(3) Source: Bloomberg, 01/03/2023.
Past performance is not indicative of future performance.

This disparity is essentially explained by the difference in yields between asset classes in a historical context of rising interest rates. The yield on German residential property fell below 3%[(4)] before the monetary cycle turned at the end of 2021. The risk premium, which was still significant when rates were negative, is currently almost zero!

Conversely, commercial yields, whose adjustment began before the tightening of monetary policies, offered a greater "cushion" to absorb the rise in rates. This heterogeneity between asset classes can be seen in the stock market performances of 2022 and, implicitly, in the declines in real estate market valuations currently anticipated.

By way of illustration, German residential property fell by an average of 50% last year[(5)], which corresponds to an implicit return on assets of 4.5%, reconstituting a risk premium of 150 to 200 basis points[(6)] ! For retail, the performance was -5%, with the implicit rate of return of 6.6% still offering a considerable margin over long rates[(6)].

Change in yields of various property asset classes



Sources: Greenstreet, Bloomberg, Rothschild & Co Asset Management Europe, 28/02/2023.

Overall, the sector's implied risk premium on current price and rate levels (Bund at 2.7%[(4)]) of 170 basis points (bps) has been rebuilt and is above its long-term average (around 150 bps from 1990 to 2008[(7)]) measured before the decade of monetary easing that began in 2008. As the fall in rates was never fully reflected in post-2008 property yields, illustrating the relative caution of investors, the risk premium has consequently increased over the period (3% on average between 2008 and 2021)[(7)] and cannot therefore be used as a benchmark. If the adjustment in the stock market seems sufficient, can we expect a similar correction in the property markets?

Probably not, as we have to take inflation into account – inflation that is now comparable to its level of the 1980s, when real-estate yields were far lower than government bond yields (with a negative risk premium). Such a situation limits the need to adjust yields as the buyer actually benefits from a much higher risk premium (taking into account rent indexation). The ability of rents to capture inflation is therefore essential, and while this is contractual, it remains dependent in the medium/long term on the situation in the rental markets.

(4) Source: Real estate brokers, March 2023.
(5) Source: Bloomberg, 01/03/2023.
(6) Source: Rothschild & Co Asset Management Europe, 01/03/2023.
(7) Source: Bloomberg, Rothschild & Co Asset Management Europe, 01/03/2023.

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What about the rental markets?

Overall, the rental markets are in good shape. Only offices located in secondary areas are facing difficulties. This was already the case before the health crisis and the rise of teleworking, and it is even more so today. There is also the problem of the obsolescence of the buildings, which can lead to the transformation of desperate cases into housing. For "prime" offices[8] the craze remains strong and rents are rising (in Paris CBD[9] the €1,000/m² mark has been passed[10]). As for shopping centres, the asset class has demonstrated its resilience. Future rental growth will continue to be held back by the fall in retailers' margins (inflation) and their need to invest in developing e-commerce. On the other hand, the physical shop remains the keystone of omnichannel strategies and offers rental protection for good locations.

The German residential sector will continue to benefit from a tight rental market with a vacancy rate in the main cities of less than 5%[10], from the influx of Ukrainian migrants after the arrival of Syrian refugees in 2015, which had "boosted demand", and also from a well-oriented indexation (the regulations will however smooth out inflation over time).

	German residential	German residential	Offices
Yields	Too low, the risk premium with long yields vanished in 2022 **(-)**	Already corrected after the sector's difficulties and the pandemic**(+)**	Too low for prime assets **(-)**
Vacancy rate	Very low in large cities **(+)**	Low in shopping centres; footfall still below 2019 levels **(+)**	A bipolar market, low in high-street areas, higher in non-prime areas (+/-)
Future supply	Limited **(+)**	Limited for shopping centres, continued reduction in unprofitable m² (other retail areas) (~)	Limited in prime areas, caution is in order on peripheral areas that have been hit harder by remote-working (+/-)
Future demand	Strong, continued increase in numbers of households, wave or Ukrainian immigration **(+)**	Stores' transition towards a winning single-channel model, replacing brick-and-mortar stores is at the centre of the strategy (~)	Strong for prime assets (+/-)
Indexation	Good but spread out over time as the market is regulated (~)	Strong **(+)**	Strong **(+)**
Our view	Solid fundamentals, coming price adjustment estimated at 10% to 15% (but already priced in on the equity markets)	Positive, as the model has been resilient after the series of temporary and structural crises. Weak to moderate rent hikes when excluding indexation but attractive valuation	The best properties are benefiting from remote-working, as strong growth in rents in prime markets limit the impact of higher yields on assets. In non-prime areas zones, declining or flat rents, higher yields limiting the impact of interest rates.

In the end, taking into account inflation and the state of rental markets, the ongoing revaluation of yields in property markets (due to falling prices) may be much less than that anticipated by financial markets. In other words, rising rents will moderate the effect of the decompression in yields on asset values.

(8) Buildings of the latest standard in a central location.
(9) Central Business District.
(10) Source: Property brokers, March 2023.

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What are the counterforces likely to allow a revaluation of real estate companies?

There are three main ones arising from each other:

- Increased visibility on the macroeconomy
- The return of transactions in the property markets
- The deleveraging of real estate companies with too much debt.

Regarding the first criterion, buyers need to have visibility on the landing level of interest rates and inflation. Reaching the pivot point(11) will, from this point of view, be good news for the sector. Buyers should regain visibility and be in a position to value assets, which will mean a gradual return of liquidity to the property markets. Real estate companies with too much debt will then be able to start reducing their balance sheets. In this perspective, the attractive carry of the sector with a yield of 5%(12), allows the patient investor to wait for its revaluation and/or to protect himself against a fall in the property markets.

Completed writing on 2 March 2023

(11) Point haut atteint par les taux directeurs lors d'une phase de resserrement monétaire.

(12) Source : Bloomberg, 01/03/2023.

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Performance	Since the beginning for the year	2022	2021	2020	2019	2018	Volatility 1 year
R-co Thematic Real Estate C EUR	10.2%	-23.5%	6.6%	-22.8%	21.6%	-7.5%	24.1%
IEIF Eurozone coupons nets réinvestis[1]	9.4%	-34.6%	2.1%	-10.7%	21.5%	-9.9%	25.4%

(1) Benchmark index
Sources: Rothschild & Co Asset Management Europe, 28/02/2023.

Risque SRI : 5
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ISIN code	FR0007457890	FR0010680553	FR0013293925	FR0007474028	FR0011361062	FR0011885789	FR0011885797	FR0013293909
Dividend Policy	Capitalisation	Capitalisation	Capitalisation	Distribution	Distribution	Capitalisation	Capitalisation	Capitalisation
Subscribers	All subscribers	Institutionals	See below[1]	All subscribers	Institutionals	All subscribers	All subscribers	See below[1]
Minimum amount of initial subscription	5 shares	1 000 000 €	1 shares or 500 000€ for institutionals investors	5 shares	1 000 000 €	1 share	1 share	1 shares or 500 000€ for institutionals investors
Maximum Management fees	1.50 %	0.75 %	0.95 %	1.50 %	0.75 %	0.75 %	2.10 %	1.25 %
Subscription fees (max)	3.0 %	3.0 %	3.0 %	3.0 %	3.0 %	5.0 %	2.5 %	3.0 %
Redemption fees (max)	-	-	-	-	-	-	-	-
Transaction fee	1.03 %	1.03 %	1.03 %	1.03 %	1.03 %	1.03 %	1.03 %	1.03 %
Performance fee	15 %	-	15 %	15 %	-	-	-	-
Country of registration	FR - AT - BE - DE - ES - IT - LU	FR - AT - BE - DE - LU - NL	FR - AT - BE - DE - ES - IT - LU - NL	FR - AT - DE - ES	FR	FR	FR - ES - IT	FR - NL

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