Global Market Insights

July 2023

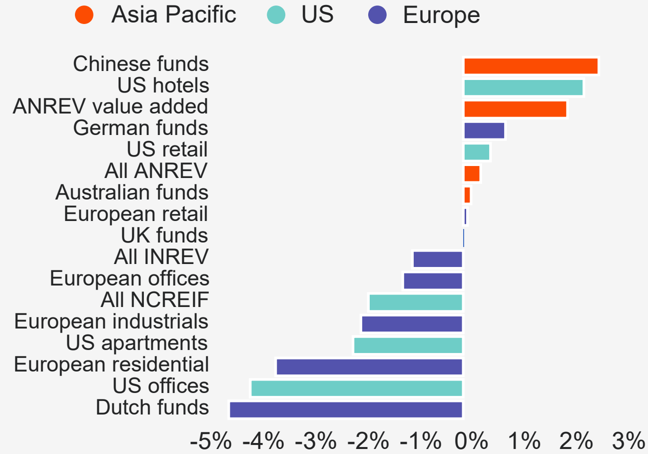
Disconnect between capital markets and real estate fundamentals continues

The macroeconomic background to the latest global real estate market performance numbers is somewhat confusing. Core inflation remains stubbornly high and central banks have raised interest rates at a record pace. Yet, across all major economies, unemployment remains low, the forecast recession has yet to materialise and the iShares MSCI World ETF is up 14% in the year to date.

As the global real estate market correction continues, performance is far from uniform across countries and sectors. Asia Pacific is proving more resilient than both Europe and the USA. Within Asia Pacific, value added funds outperformed core and closed end funds outperformed their open end peers. The Australian funds, representing 65% of the ANREV Asia Pacific Fund Index, underperformed all funds while the small minority of Chinese funds strongly outperformed, given their economic and interest rate dislocation from most of the rest of the globe (see Figure 1).

Rising risk free rates have heightened risk aversion in real estate markets and there is no consensus on valuations between buyers and sellers. Uncertainty surrounds valuations and price discovery is ongoing.

Figure 1: Global drivers Q1 2023



Source: ANREV, INREV, NCREIF, Q1 2023

Demand for real estate has weakened, particularly for US diversified core funds, as the outlook for offices, which represent 26.3% of the newly launched Global ODCE index, has deteriorated. The typical bid / offer price for units in European ODCE funds on secondary markets is NAV -10% to NAV -5%. For US ODCE funds the bid price is typically around NAV -20% and the offer NAV -10%. In Asia Pacific despite a seemingly stronger market, buyers still expect an additional discount to offer prices of NAV -2% or lower[1].

Specialist funds focused on industrial/logistics are now more favoured by investors. Notwithstanding anecdotal stories of Amazon shrinking its footprint after over expanding, resilient larger economies seem to be giving support to the industrial sector. Demand from logistics occupiers remains strong and rental values are continuing to rise.

For contrarian investors those sectors and markets that have come off furthest and fastest from their peak may offer greater opportunities. Structural shifts in consumer patterns have had a materially negative impact on retail assets worldwide. In Europe retail fund capital values have dropped 26%[2] since the middle of 2018 and in the US retail capital values have fallen by 19%[3] over a similar period. The underlying retail assets are now valued at capitalisation rates where a 25 bp or even 50 bp rise in yields has a diminished impact on valuations compared to assets in more highly rated sectors. Furthermore, a high running yield, in some cases more than 8%, offers some protection from any further fall in capital values.

Economies have so far not reacted in a textbook fashion to rapidly rising interest rates. There is a growing disconnect between capital markets and real estate fundamentals. Unexpected outcomes create opportunities for real estate investors, especially those who are prepared to move early and see value in assets that have quickly adjusted to the new market conditions.

1 www.propertymatch.eu
2 INREV Q1 2023
3 NCREIF Q1 2023

ANREV, INREV & NCREIF jointly launch the Global ODCE Consultation Index

The first Global ODCE (open end diversified core equity) fund index is aimied at enhancing the transparency of the non-listed real estate investment industry. Bringing the three regional ODCE Indices together on a global level, in an equally weighted index to reflect the relative sizes of the non-listed real estate markets in the three regions, creates a powerful benchmark. It measures the net asset value quarterly performance, net of fees and other costs with focus on a clearly defined peer-set.

The index measures performance of 50 funds, 8 from Asia-Pacific, 16 from Europe and 26 from the US, with a combined total gross asset value of $403 billion.

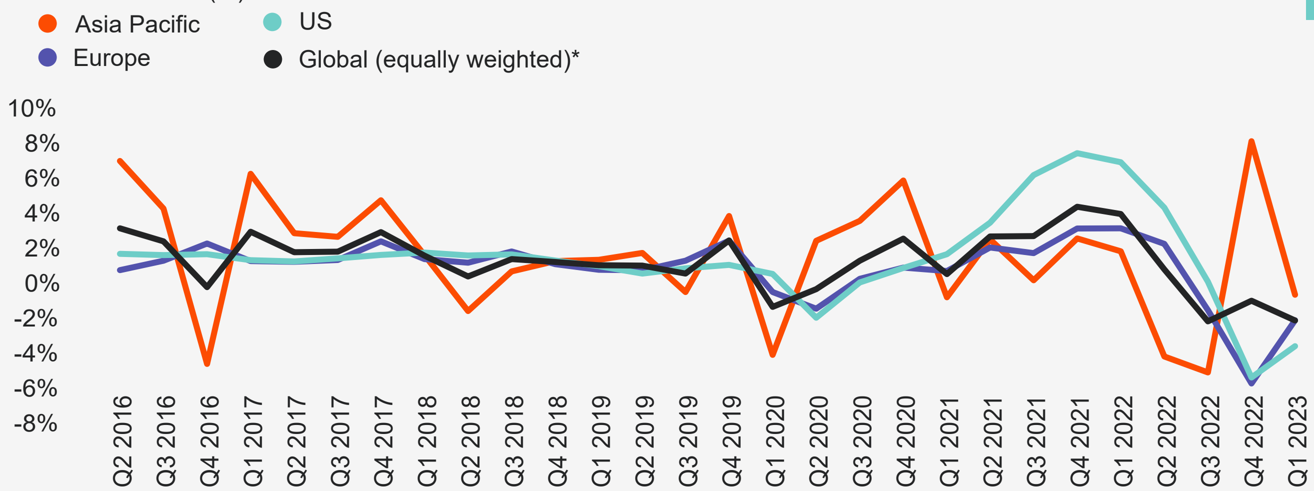
The Global ODCE reflects the evolution and growth of a peer group that is well understood across the industry.

As of Q1 2023, the Global ODCE total return* was -1.9%, marking the third consecutive quarter of negative performance. Some markets are further ahead than others in their repricing but the direction of travel is clear. All three regional ODCE indices showed negative returns, with Asia Pacific outperforming the other regions at - 0.43%, compared to -1.89% in Europe and -3.38% in the US.

On a five-year annualised basis, the Global ODCE Index shows an aggregated total return of 4.89%*. The US outperformed with a total return of 6.56%. Asia Pacific posted 4.89%, while Europe delivered 3.26%.

Further details can be found on the associations' websites.
** total returns are reporting currency returns aggregated by conversion to US*

Figure 2: Total returns (%)



Source: ANREV, INREV, NCREIF Global ODCE Index, July 2023

Global Research Committee's view

The reversal of a multi-year capital inflow trend into real estate funds has reopened the liquidity question – ie the ability for investors to retrieve their money freely. Liquidity has a price: investors know that private funds can be periodically closed to redemptions and acknowledge that publicly listed real estate is a more liquid but more volatile route. Those that opt for private real estate accept that some funds, to avoid taking a distressed valuation position, need to periodically limit or freeze redemptions when unexpected events threaten valuations. We believe that the global real estate industry is in a better position today compared to the illiquidity episodes of the 1990s and that of the GFC. Both investors and their managers are more experienced and better prepared today. Firstly, investors now look at both private and public real estate to better manage their portfolio liquidity and benefit from arbitrage opportunities. Global diversification also helps access liquidity by tapping into markets that remain liquid when others are less so or not (eg Asia-Pacific today where fund inflows exceed outflows vs the US and Europe where this is not the case). Finally, investors are adopting a more pro-active use of the secondary market for fund shares. Secondary pricing is improving in Q2 2023, with buyers becoming more aggressive as we approach the end of the rate hiking cycle. On the manager side, funds now benefit from clearer liquidity rules that allow for more transparent and systematic liquidity mechanisms, enabling orderly redemption processes. Managers are more clearly exhibiting the generally solid operational fundamental KPIs of their portfolios, whilst as the same time swiftly adjusting asset valuations to reflect higher costs of capital. The stated benefit is to discourage tactical redemptions at "yesterday's" price and encourage swifter inflows from new investors. By providing more transparency and market insights, NCREIF, INREV, ANREV are creating better conditions for increased liquidity solutions to long term investors in the sector.