The Fry Group
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Real Estate

low-interest rates provide ongoing support

With the growing list of cash deposits and government and corporate bonds that offer negative yields, investors are looking into every corner of the investment universe for income. Real estate is an obvious asset class for income seekers.

Residential

In the broad spectrum of real estate, to us, residential real estate still looks to be generically the more expensive and at risk of more burdensome taxation on returns in the future. As we wrote last year, governments remain short of revenues and taxes on wealth via the real estate market are a very real risk. In any case, residential prices remain beyond the means of many ordinary people, which must weigh down prices.

However, the residential real estate area does offer some niche opportunities.

Build to Rent (BtR)

BtR is described as "purpose-built units designed specifically for long term rental occupation". The concept is hugely popular with younger generations due to the amenities offered such as fibre optic, smart home and home automation, to name just a few. These units are built with the target market in mind to push the properties for a specific consumer. The product is highly popular with Millennials and Gen Z's who find the

old housing stock too expensive and lack the means to purchase housing and hence prefer to rent. In the UK, a first-time buyer would need to find a deposit equivalent to 71%* of yearly income. As such, it is extremely difficult to get onto the housing ladder. *Source: Financial Times

Although a relatively new concept in the UK, the idea had its beginnings in the multi-family housing concept in the United States some two decades earlier. The concept has gained more traction in recent years given the preference of Millennials and Gen Z's to live in urban areas with a sense of a community as opposed to Baby Boomers who prefer to live out of town. As an example, Grainger (the UK's largest private landlord) signed a deal with Transport for London in April 2019 to build 3,000 properties above and around Underground stations. Greystar launched a £750m fund to target the UK BtR sector with around £2bn to invest in BtR projects. In the first quarter of 2019 over £1.0 bn was poured into BtR schemes, quadruple the amount invested in the first quarter of 2018. The BTR model attracted £2.4bn in 2017 and is forecast to grow by a further 180% over the next six years.

Commercial Real Estate

In commercial real estate, yield-seeking institutional investors will continue to provide support. Indeed, we suspect there could be a new wave of money that is attracted to commercial real estate as investors recognise that central banks could be running zero to negative policy rates for some years to come.

The experience of Japan, when monetary policy was set at zero to negative interest rates is that real estate, even through the form of real estate investment trusts, tends to outperform the broad equity market index. All major regions broad REIT Indices have yields comfortably above their respective 10-year bond yield to maturity.

Table 1: **REITs offer significant income pick up over government bonds**

Region/Country	REIT 12-month yield	10-year government bond yield	REIT yield pick up
UK	3.81%	0.73%	3.08%
US	3.85%	1.75%	2.10%
Japan	3.41%	-0.12%	3.53%
Europe	4.44%	-0.34%	4.78%

Source: Bloomberg

European Commercial Real Estate

With negative interest rates and bond yields in the Eurozone, there is a clear reason for interest in real estate to grow. Pension funds and insurance funds are desperate to invest in long term assets that can mitigate some of the challenges of having a bond portfolio that provides little by way of return.

One of the anomalies in the asset markets at present is that an investor can invest in the corporate debt of a major German company at a 10 year yield of 0.4% or achieve a 4-7% return by leasing a building to the same company. It is, in a sense, the same credit risk but very different returns for around the same time horizon. Such a large gap between the yield on the long-term debt and the yield on a building where the company is the primary tenant looks anomalous. On paper, there appears to be a lot of value; however, in reality, it is difficult to find quality buildings to invest in. Total real estate investment in Europe in Q3 2019 was €69.5bn, a 4% fall over the same period last year. Analysts comment that there is a deep pool of available capital; however, there is a limited number of investment opportunities of scale and quality.

One factor which could change the availability of commercial real estate in Europe would be a trend for companies to make a sale and leaseback of their buildings. Europe is relatively unique in having a large number of owner-occupied commercial properties last estimated at 60% compared to 30% in the UK.

Building New Communities

While Baby Boomers may prefer to start their retirement in a remote part of the countryside, eventually, they begin to need a more supportive environment, they will seek to live closer to others and with door-step support.

Millennials have already shown a preference for living in urban areas. This puts them closer to their work and allows them to live without the need for a car.

Developers have also been trying to find ways of tapping into the desire to build communities. As malls have struggled to keep footfall, developers are applying to re-zone areas such that residential property can be incorporated to build a community rather than just a barren retail development. Brookfield Property, for example, is transforming one of the US's largest shopping centres (Ala Moana) into a small city with the addition of as many as ten residential towers. The template that is building for mall redevelopment is based on providing a community of entertainment, health, eating out and shopping experiences together with some significant multi-family developments.

> The impacts of climate change have already influenced real estate markets at the global scale. 35% of REITs' properties are exposed to climate hazards. Of these, 17% of properties are exposed to inland flood risk, 6% to sea-level rise and coastal floods and 12% to hurricanes or typhoons
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> *Source: Bloomberg*

ESG – Ignore at Your Peril

One factor to keep in mind into 2020 is the impact of ESG on real estate companies. The sector is still searching for the right structure and metrics to analyse the impact of ESG on real estate investment. The sustainability accounting standards board (SASB) provides the industry with guidance on how to determine financial materiality concerning ESG factors.

Another evident materiality comes from the fact that commercial and residential real estate companies account for approximately 40% of total global energy consumption. The real estate sector will increasingly be called to task to design buildings to the highest energy-saving standards. Furthermore, property owners may be pushed to refurbish buildings to meet new standards of efficiency. Further taxes on energy prices will have tenants looking for low cost, well-maintained buildings that are up-to-date with energy efficiency.

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