Global Capital Markets

Global Real Estate Insights

June 2022

Key takeaways

Markets across the globe have started to adjust to a new regime of higher interest rates, with inflation set to remain elevated until the end of 2023/start of 2024. Real estate yields/cap rates have begun to move in-line with this shift, and an increase of 25-50bps is not uncommon for core product as pricing adjusts to the new norm.

Interestingly, **some multifamily product in the U.S. has re-priced by 25bps since the start of 2022.** Importantly, this is due to higher levels of net operating income (NOI) being achieved, boosting the income return and elevating cap rates.

Higher costs for energy, base commodities, fertilisers and food driven by supply chain constraints and shortages will maintain inflationary levels short-term. Mid-term, although inflation levels will drop, they will remain elevated due to the push for decarbonisation, near/best-shoring and wage inflation. Interest rates are therefore set to return to longer-term norms of approximately 2% over the next 18 months.

Despite all these headwinds, the threat of stagflation is being held off. While all major countries have seen GDP growth forecasts cut for 2022 and 2023, and there is the distinct possibility of further cuts to growth / technical recessions this year, **the overall picture is one of economic expansion. Additionally, the risk that excessive leverage could destabilise markets is muted. Loan-to-value ratios (LTVs) across funds and investors are typically well below 50%.**

The next 6-18 months will continue to see market pricing move in relation to both interest rate rises and the prospect of higher rents/returns.

Additionally, new government policies and market movements in Europe towards the creation of ESG compatible assets will have a further impact on pricing. While there is **some evidence that energy efficient assets can achieve a rental premium of up to 10%**, the CAPEX requirement can be significant. For secondary product where higher CAPEX requirements are being factored in, movements of 100bps have been seen on bids/activity.

We may see investment volumes slow during Q2 and Q3 of this year, as the market adjusts and strategic decision-making recalibrates. But momentum in activity was maintained in Q1 2022, and the **preference for residential and industrial & logistics (I&L) assets** was visible. **Retail and hotels have already re-priced and activity has started to bounce back across all global regions.** The view on offices, however, is perhaps the most diverse by location. Whilst it remains a popular asset choice in APAC and Europe, office investment volumes as a percentage of all activity has dropped to all-time lows in North America. Rolling (12-month) volumes to end Q1 2022 saw offices gain just 18% (compared to 40% APAC, 33% Europe). The shift to agile working, the slow, post-pandemic return to cities and low density occupation of office space is clearly impacting views on the future of the office.

“Markets across the globe have started to adjust to a new regime of higher interest rates.”

Transaction volumes expanding

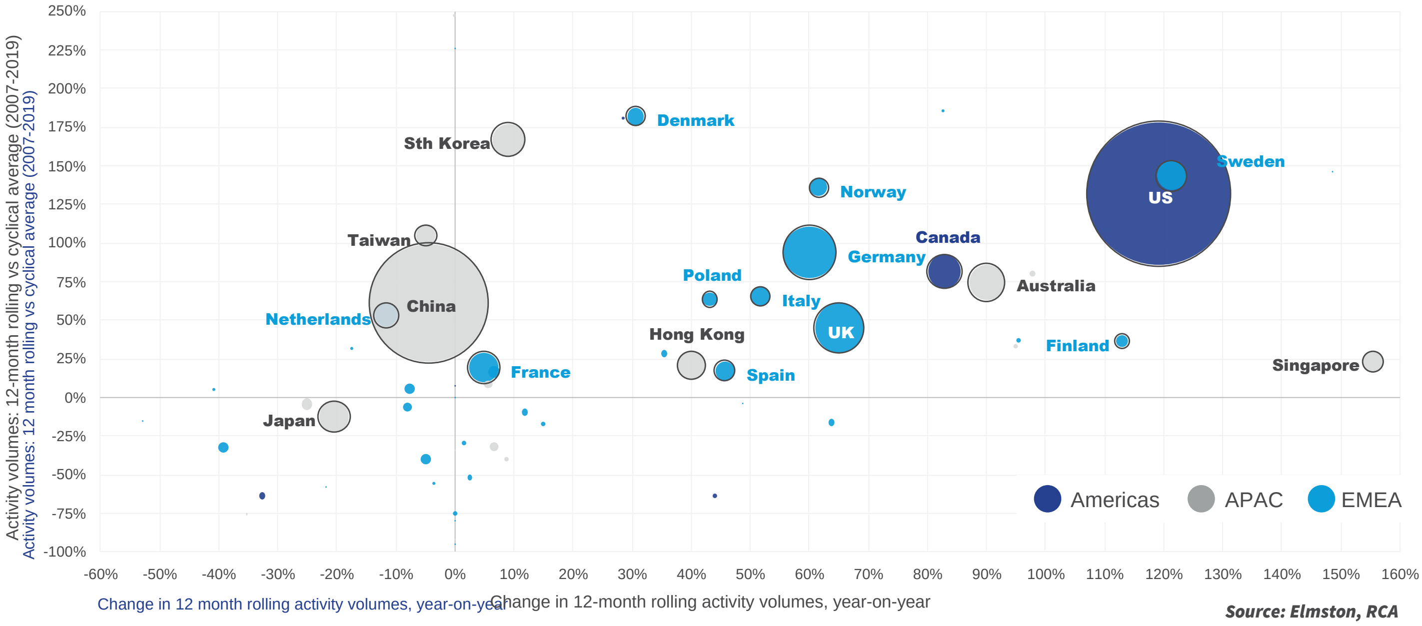
By the end of Q1, **12-month rolling investment volumes highlight that the global real estate market had maintained momentum going into 2022**. Similar trends are visible to those witnessed in 2021, with the **U.S. leading the charge in terms of volumes and the rate of expansion [see Figure 1].** Second and third tier U.S. cities continue to drive the charge, notably into multifamily assets. Offices as a percentage of market activity remains subdued, as U.S. Tier 1 cities are yet to return to pre-pandemic mobility/occupancy levels. Agile working is clearly having an impact on sentiment in a market where office space has typically been occupied at low densities (FTE/desk per sqm).

In EMEA, the picture is more balanced in terms of the distribution of spending across asset types, yet beds and sheds (residential and I&L) continue to take market share. **Most European cities are back to pre-pandemic mobility and occupancy levels**, when measured on a daily basis, certainly on the peak days of Tuesday to Thursday, which is driving office, retail and hotel demand.

In APAC, market activity continues to pick up, with **Singapore now the fastest growing country globally in the last 12 months** (rolling). Australia and South Korea are also seeing expansion in investment activity as they emerge from lockdown. China and Japan remain flat, but are maintaining very high levels of activity (given their second and eighth positions respectively in the world for investment volumes). Activity remains oriented to office. Residential remains nascent as a sector regionally, but is big in Japan, while Australia and Singapore are expanding on that front via Build to Rent (BTR).

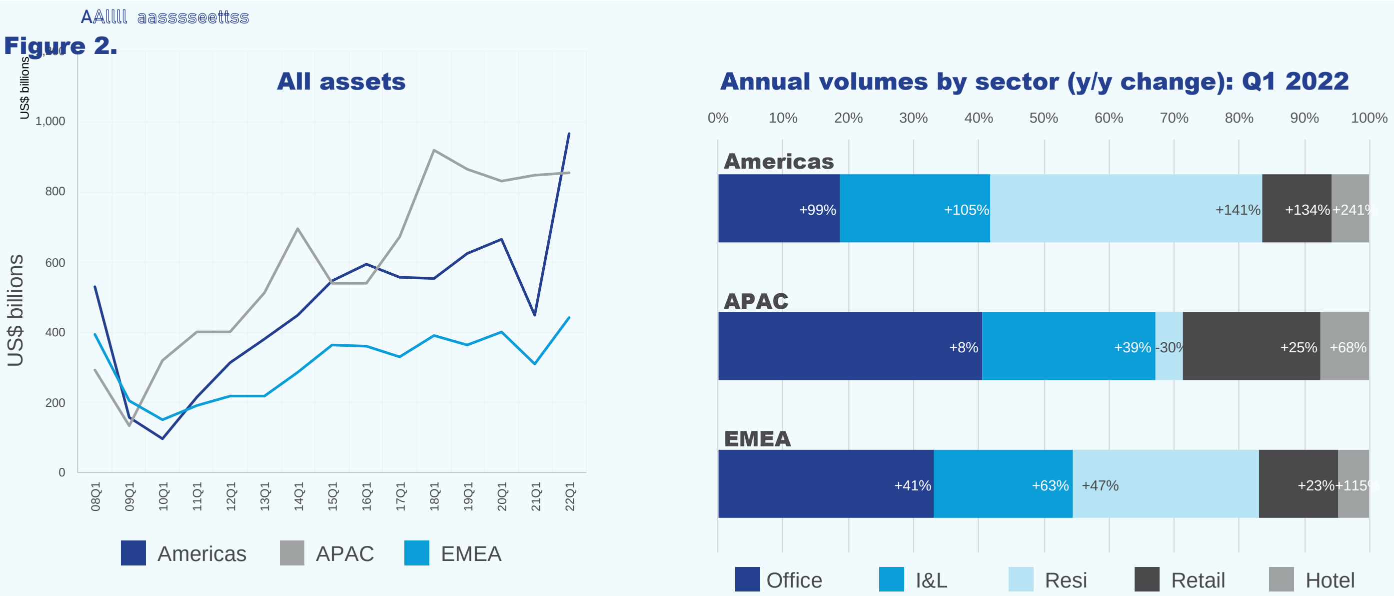
I&L has the most consistent share of activity globally in all three regions, and continues to expand steadily despite supply chain headwinds **[see Figure 2]**.

Figure 1. Global investment momentum: year-to-date
[Recent performance vs cyclical average; bubble size represents last 12 month activity volumes]



Source: Elmston, RCA

Figure 2.



Source: Elmston, RCA

Source: Elmston, RCA

Headwinds – culminating in elevated inflation and rising interest rates

Multiple headwinds are impacting real estate markets directly and indirectly. While COVID is something of a distant memory in Europe, cities across the U.S. are slow to recover in terms of occupancy, particularly the big Tier 1 cities, despite the economy being back on track. Most markets in APAC are only just out of lockdown, although China is not and looks set to remain in this position until after the Congress Party conference in October 2022. Global supply chains will remain backed-up as a result, which is adding to inflationary pressure.

Moreover, new regulations in Europe (and a shift to global standards concerning how companies declare and report on ESG credentials), are leading to a push in decarbonisation, and a de-globalisation of supply chains and production to near/best-shoring locations closer to the customer. Add the war in Ukraine and the impact on commodities, energy, fertilisers and food prices; **inflation is likely to remain elevated until at least the end of 2023**. Current forecasts of GDP and inflation are yet to reflect a prolonged period of higher inflation. This has quickly shifted the needle on short-term interest rates and longer-term government bond rates. **All major capital destinations and domiciles will see rates continue to shift until they stabilise around the end of 2023**, and adjust to longer-term norms. This rate clearly differs by location, in line with the macro-economic and demographic fundamentals of the country. In North America, long-term rates look like settling closer to 3%. In Europe, long term rates may settle between 1% (Germany) and 2% (the UK). In APAC, rates are likely to remain between 2% - 3.5%, bar Japan which continues to settle at a benign 0% **[see Figures 3 & 4]**.

Multiple factors include:

- Record levels of capital
- COVID-19
- Supply chain disruption

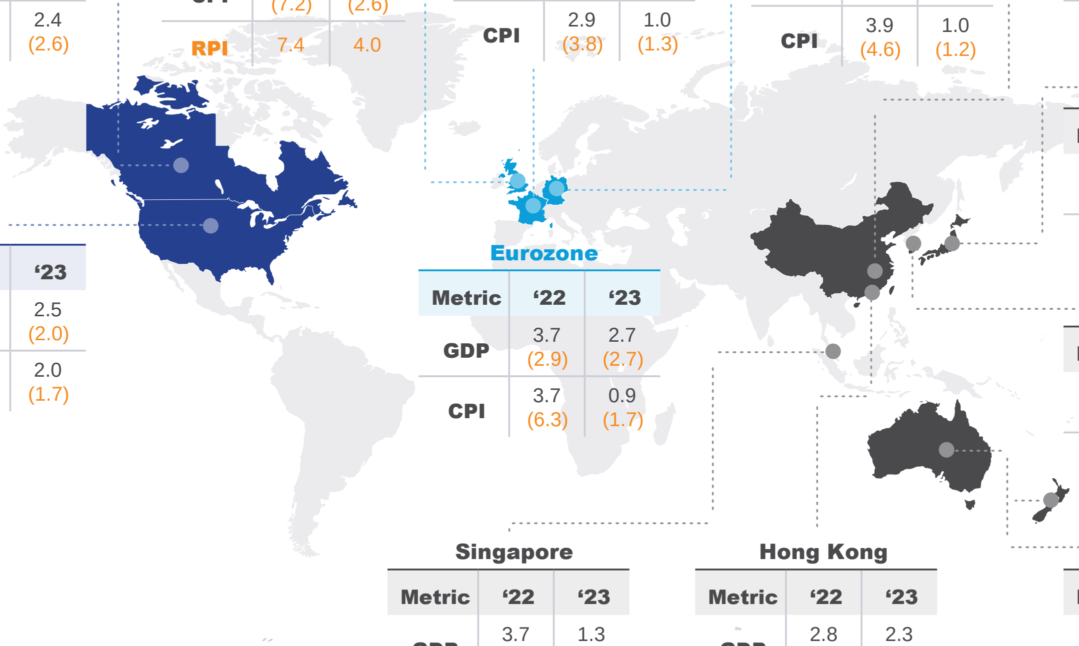
Inflation & rising interest rates

- War impact on commodities
- Climate change/ decarbonisation
- Circular economies / best-shoring

“New regulations in Europe, and a shift to global standards concerning how companies declare and report on ESG credentials, are leading to a push in decarbonisation.”

Global economic outlook: Q1 2022 *(post-invasion; May 2022)*

Figure 3: GDP (real) & CPI (%)



Canada

Metric	'22	'23
GDP	4.2 (4.1)	3.1 (2.2)
CPI	4.4 (6.0)	2.4 (2.6)

UK

Metric	'22	'23
GDP	3.8 (3.8)	2.6 (1.6)
CPI	5.8 (7.2)	1.9 (2.6)
RPI	7.4	4.0

France

Metric	'22	'23
GDP	3.4 (3.0)	2.1 (2.0)
CPI	2.9 (3.8)	1.0 (1.3)

Germany

Metric	'22	'23
GDP	3.5 (2.4)	3.0 (3.2)
CPI	3.9 (4.6)	1.0 (1.2)

China

Metric	'22	'23
GDP	5.0 (4.8)	5.5 (5.4)
CPI	2.4 (2.3)	2.4 (2.5)

Japan

Metric	'22	'23
GDP	3.1 (2.2)	2.2 (2.2)
CPI	1.1 (1.7)	-0.4 (0.1)

U.S.

Metric	'22	'23
GDP	3.5 (3.1)	2.5 (2.0)
CPI	5.1 (7.4)	2.0 (1.7)

Eurozone

Metric	'22	'23
GDP	3.7 (2.9)	2.7 (2.7)
CPI	3.7 (6.3)	0.9 (1.7)

South Korea

Metric	'22	'23
GDP	3.1 (2.8)	2.9 (2.8)
CPI	3.0 (3.4)	1.6 (1.5)

Singapore

Metric	'22	'23
GDP	3.7 (3.3)	1.3 (2.3)
CPI	3.4 (4.5)	2.6 (1.4)

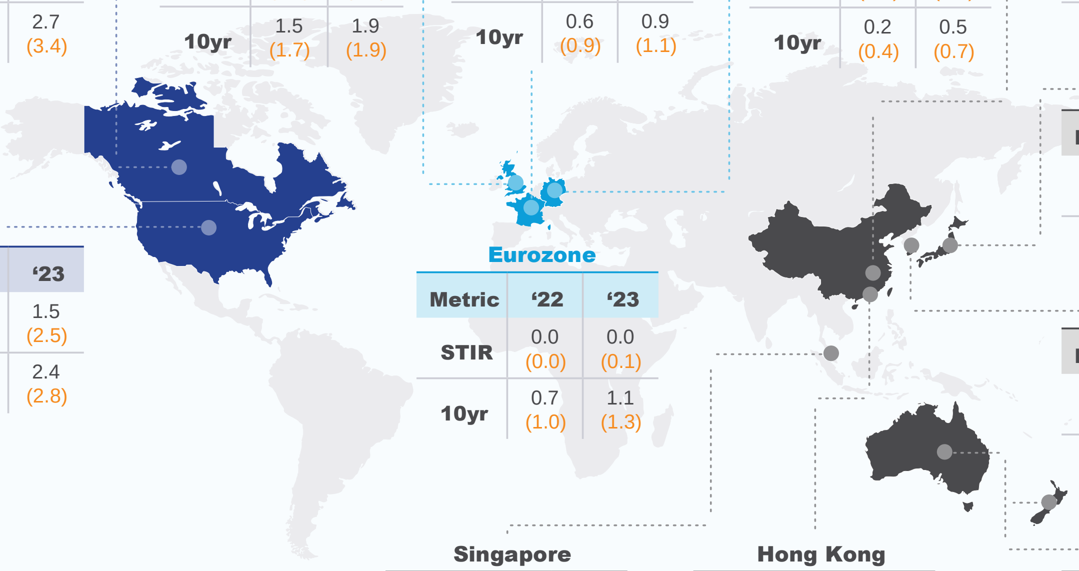
Hong Kong

Metric	'22	'23
GDP	2.8 (1.0)	2.3 (3.9)
CPI	2.3 (2.6)	2.8 (2.5)

ANZ

Metric	'22	'23
GDP	3.8 (4.1)	4.0 (3.7)
CPI	3.8 (4.7)	2.4 (2.5)

Figure 4. Interest rates: short-term & government bonds (10 year) %



Canada

Metric	'22	'23
STIR	0.7 (1.0)	1.4 (1.8)
10yr	2.1 (2.9)	2.7 (3.4)

UK

Metric	'22	'23
STIR	0.9 (1.0)	1.3 (1.3)
10yr	1.5 (1.7)	1.9 (1.9)

France

Metric	'22	'23
STIR	0.0 (0.0)	0.0 (0.1)
10yr	0.6 (0.9)	0.9 (1.1)

Germany

Metric	'22	'23
STIR	0.0 (0.0)	0.0 (0.1)
10yr	0.2 (0.4)	0.5 (0.7)

China

Metric	'22	'23
STIR	2.9 (2.8)	2.9 (2.8)
10yr	2.9 (2.9)	3.4 (3.4)

Japan

Metric	'22	'23
STIR	0.7 (0.0)	1.5 (0.0)
10yr	0.1 (0.2)	0.0 (0.1)

U.S.

Metric	'22	'23
STIR	0.7 (1.1)	1.5 (2.5)
10yr	2.1 (2.5)	2.4 (2.8)

Eurozone

Metric	'22	'23
STIR	0.0 (0.0)	0.0 (0.1)
10yr	0.7 (1.0)	1.1 (1.3)

South Korea

Metric	'22	'23
STIR	1.6 (1.5)	1.8 (1.8)
10yr	2.4 (2.9)	2.6 (2.6)

Singapore

Metric	'22	'23
STIR	0.6 (0.7)	1.2 (1.5)
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Metric	'22	'23
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10yr	1.9 (2.1)	2.3 (2.3)

ANZ

Metric	'22	'23
STIR	0.1 (0.4)	0.6 (1.5)
10yr	2.1 (2.6)	2.5 (2.8)

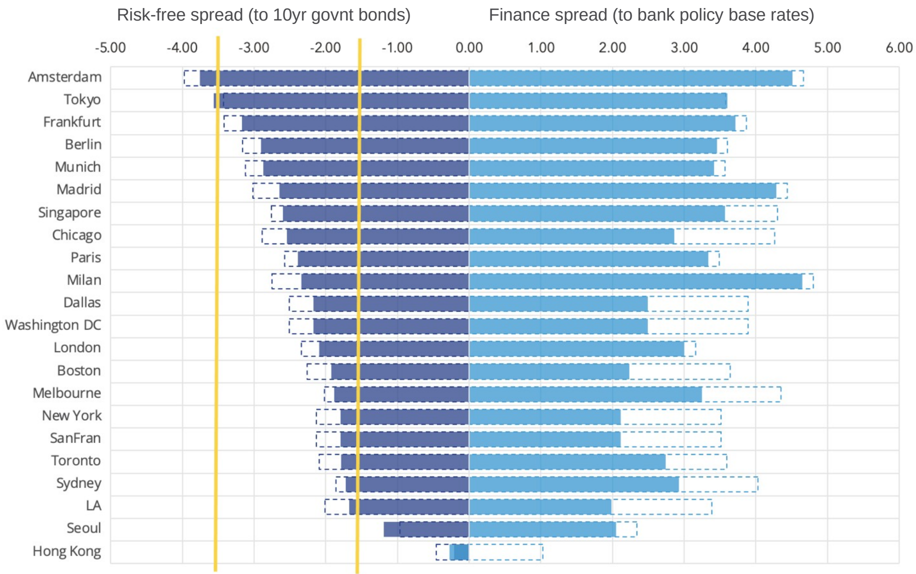
Source: Elmston, OxfordEconomics, ONS

Pricing impact

The **positive news is that the global real estate market has been quick to react, with many locations witnessing an adjustment in pricing to higher interest rates**. Current 'live' pricing adjustments as of May 2022 shows yields have shifted to sustain a healthy risk-free spread to anticipated government bond rates as of year-end 2023 **[see Figure 5].**

Given that the risk-free spread has fluctuated between a 1.5 - 3.5 % range globally over time, (typically sitting around 2 - 2.5% as a broad benchmark), the majority of locations sit above and around this threshold. This should enable the market to settle quickly, allowing capital to continue to flow across markets.

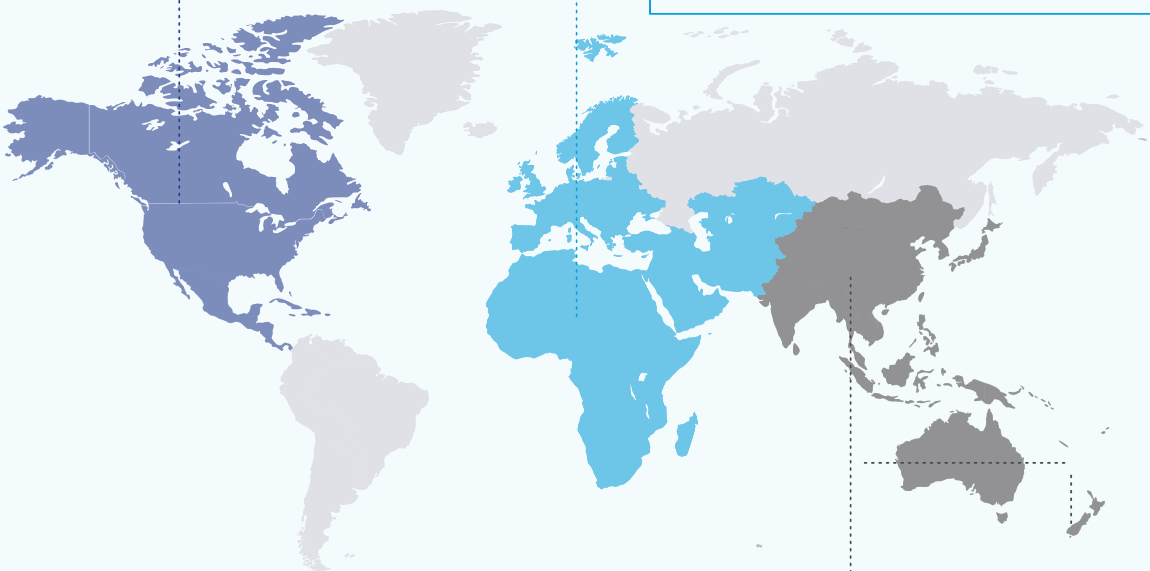
Figure 5. All sector yield spreads May 2022



Source: Elmston, OxfordEconomics, RCA

The **North American market has been the quickest to react,** with office yields trending up across major markets by around 50bps. I&L assets have re-priced by around 25bps. In the U.S., the ever-expanding multifamily sector has also seen cap rates move out by around 25bps, but for different reasons. Rental growth across multiple U.S. locations since the end of 2021 has elevated the current yield, relative to last year's purchase price, by 25bps.

In **Europe, markets have begun to adjust in a similar vein to the U.S**., but not as quickly. The UK market is generally holding firm, benefiting from a larger yield spread cushion to other continental European locations. That said, there is some evidence/discussions around a 25bps correction in yields. This is typically higher across mainland Europe where yields are adjusting by 25-50bps across sectors and locations. This is bar retail, which has already significantly re-priced.



In **APAC, the situation is more fragmented**. No changes in Tokyo, where there is no need as yields sit at a significant buffer to 10-year bond rates. Singapore rates are also relatively flat, but again it is a market with a positive spread in-situ. The major Australian markets are seeing prices adjust, even after some yield compression in Q1, as activity picked up post-lockdown. I&L yields are expected to move out by 25bps by end H1 2022 rather than end H2 2022. Retail is holding firm – again due to previous price adjustments, but with the expectation that there may be some compression later in the year as investors look for yield in sub-regional shopping centres with strong demographics and development potential. Further afield in Asia, the more insular and very strong domestic markets of South Korea and Hong Kong are yet to see any adjustment in pricing. From a global capital perspective, they will need to if they are to attract more cross-border activity.

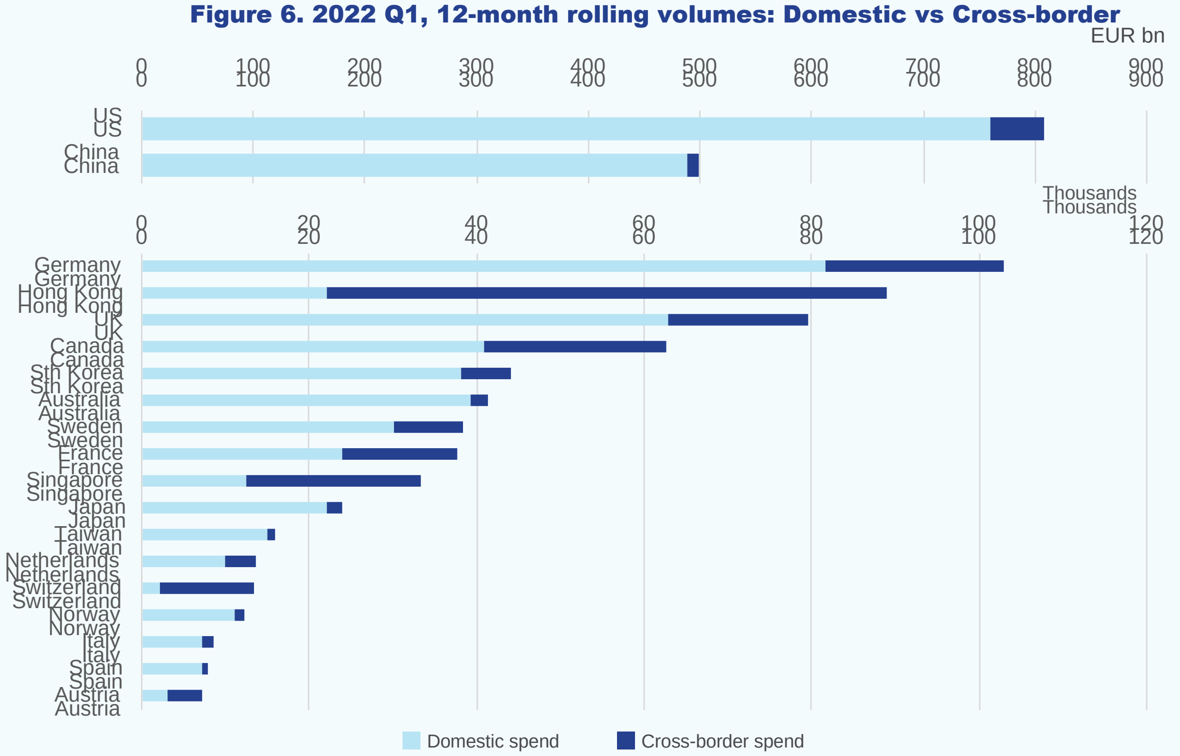
Foreign exchange (FX) rates & cross-border capital

Global and inter-regional cross-border activity is clearly a major part of investment activity (35% on average, per year) **[see Figure 6]**. So high volatility in currency movements is a short-term cause for concern, and this volatility could continue for another six, perhaps 12 months, before interest rates settle down.

When looking at the difference between five-year forward rates and current spot rates, **currencies look set to depreciate or appreciate relative to each other in-line with interest rates movements.**

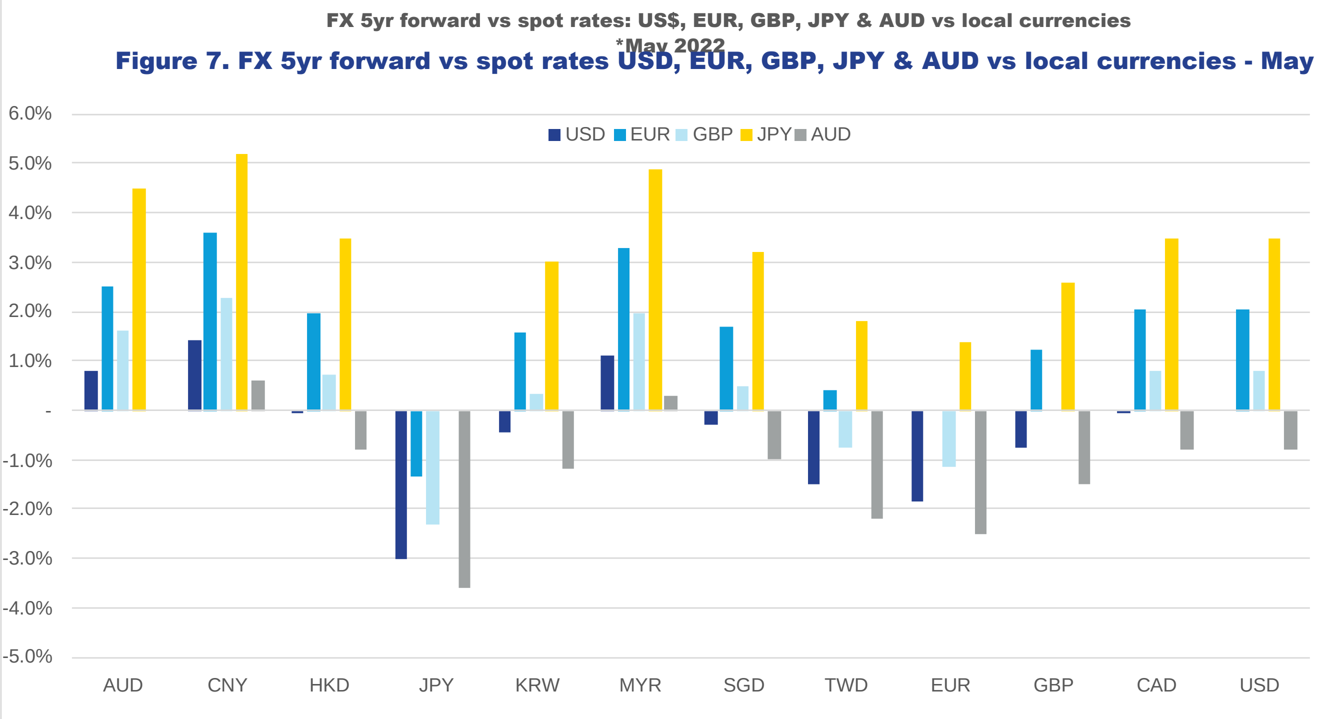
The Japanese Yen looks cheap, as does the Euro, while the USD, AUD and CAD all look set to increase their buying power. Sterling is somewhere in between. Hedging can, of course, compensate for this, but **volatile FX rates could see cross-border activity slow until rates settle down.** On the flip-side, **investors seeking to utilise a currency or hedging advantage could move into the market quickly while others take a back-seat [see Figure 7].**

Figure 6. 2022 Q1, 12-month rolling volumes: Domestic vs Cross-border



Source: Elmston, RCA

Figure 7. FX 5yr forward vs spot rates USD, EUR, GBP, JPY & AUD vs local currencies - May 2022



Source: Elmston, Chatham Financial

Summary

Despite the short-term macro-economic volatility in markets, the real estate market is showing maturity in its ability to react to new pricing norms in order to sustain investment activity. **Global capital levels remain elevated – there is US$3 trillion of dry powder available for spending into real assets**, according to Preqin **[see Figure 8]**. Much of this capital has a general outlook across all real assets, but where specified, real estate represents 35% of the total. In order for the sector to remain attractive, pricing and growth fundamentals must remain competitive relative to other real assets, even though real estate is also becoming increasingly tied to broader infrastructure, energy and debt strategies.

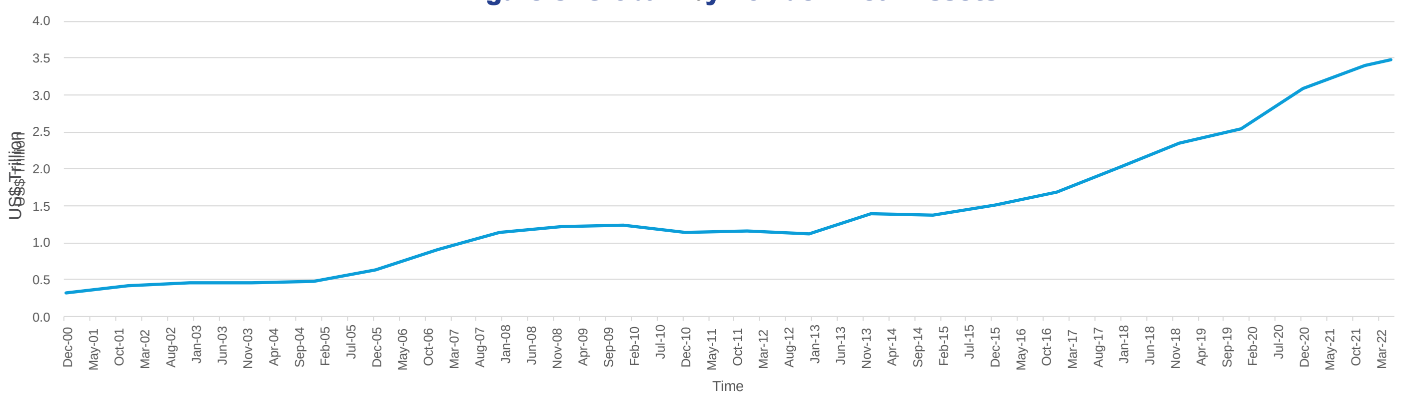
Looking further ahead, the market will see more pricing adjustments - particularly in Europe - as the market moves up through the ESG gears. New ESG compliance standards and regulations, particularly with regard to decarbonisation, is already impacting investment strategies, asset and market picks. **Evidence to date points to the average CAPEX spend required to reduce energy needs/emissions is around 25% of capital value.** We think this is the average, accounting for varying levels of quality. Thus CAPEX requirements would be much lower when it comes to retro-fitting or upgrading higher quality 'prime/core' assets, and these assets should get first mover advantage in terms of achieving higher rental levels.

For lower quality assets, it points to a further need for yields/cap rates to adjust where the rental growth capacity of an asset/market cannot match this cost. Some investors are already factoring in and accepting lower returns in order to shift the needle on the compatibility of assets to meet a broad range of ESG standards. The harder the retrofit, the bigger the pricing impact - or 'brown discount' as it is being coined. Future investment appetite is adjusting to this new ESG paradigm, with a growing bank of opportunistic and value-add players entering the market on the lookout for stranded assets. Preqin analysis suggest the **capital raised for opportunistic funds is now 36% of new capital raised**, while **value-add is 33%**, and **debt is up to 11%**. Collectively, that is 80% of fundraising and further evidence of the shift in activity to come.

Global capital significant and adaptive

- Capital raising and dry powder remains at record high. Real estate remains the most popular choice, accounting for 35% of strategies where specified
- Diversification a key driver of global flows
- Capital consolidating, especially in APAC
- Strategies shifting to opportunistic (36%) and value-add (33%) – ESG-linked; also debt (15%)

Figure 8. Global Dry Powder: Real Assets



Source: Elmston, Preqin

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