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Listed property companies: a double whammy!

Key highlights:

- Property companies' debt-financed growth and value creation backfires
- Falling shares are pricing in a steep drop in physical real estate
- Inflation and real estate: indexation as a driver
- Is the market really always right?

Why such a drop in prices ?

We are going through very challenging times. The listed property sector, which investors regard as a bond proxy, is being hit by spiking interest rates. That being said, keep in mind that debt leverage is an integral part of property companies' business model as it allows them to do their job creating value by developing new proprietary assets, by redeveloping older properties, and by structuring specific real-estate portfolios, all while ensuring a generous shareholder return in the form of dividends. Property companies are currently benefiting from an average cost of debt of 1.7% on an average duration of seven years, and their biggest maturities don't come due until 2027 and thereafter. However, the spike in interest rates has sent the marginal cost of debt up by 450bp on average over the past 12 months. Investors have been scared away from the most heavily indebted property companies and from those with a return on assets close to or below 4%, such as German residential property and logistics. Some property companies have taken out bank debt. One French company did so at 2.5%. But even so, investors prefer to flee the sector, fearing a decline in asset values that would automatically raise debt and ultimately breach banking covenants. All this in spite of solid half-year results, with rental income up, divestment realised with capital gains, indexed leases that provide visibility on future revenue growth, and so on.

Physical real estate will adjust to higher interest rates

Central banks have halted their accommodative policies, but this sudden change of paradigm has not yet truly shown up in physical real estate, which is holding up well to the prevailing glum despite some clouds on the horizon and a likely recession in 2023 that could darken the picture. This change in environment is indeed likely to trigger higher cap rates of physical real estate. But what financial investors seem to have overlooked completely is that we probably will not have an across-the-board increase of the same extent on all markets and types of assets, as valuations adjust far more granularly and the risk premium (i.e., the difference between the risk-free rate and real estate return rate) will depend on the dynamics of each market and type of assets. Rents, vacancy rates, and future supply vs. demand are just as decisive as interest rates in pricing real-estate stocks.

Moreover, real interest rates that remain negative or close to zero are an important source of support for real estate.

Inflation and real estate: indexation as a driver

Inflation provides a boost to rental income growth, thanks mainly to indexation. However, for this to work, tenants must also have inflation-indexed income.

The interest-rate impact is immediate on debt and financing. The impact on revenue is spread out far more widely but is also more constant over time. This is what gives real estate its protective features – two opposing forces.

Let's take an example from the past, in order to project ourselves into the future. During the double-digit inflation of the 1980s and 1990s, Paris office yields were surprisingly stable, as rents accelerated, outstripping inflation. When inflation slowed slightly to a more standard level, real rents accelerated, justifying stability in yields. For, back then, expansion in office jobs triggered a supply/demand imbalance that promoted higher rents. As a result, this market had its own dynamics, with little reference to nominal rates.

Hence, in picking and choosing winners and losers, investors should now focus on potential rent growth rather than higher nominal interest rates.

Is the market really always right?

With the decline in the stock prices of listed real estate companies, the market is already pricing in an average 31% decline in asset values and, hence, a greater crisis in the sector than the 2007 financial crisis.

It is important to remember, at this stage, that during this famous crisis, no listed real estate company has defaulted and that today, they have rather globally improved the quality of their portfolios and lowered their level of debt but also that banks are in much better health than at the time. Let's also remember that the covid pandemic has accelerated structural trends, but also highlighted our human need for socialization, which will continue to drive offices and brick & mortar shops.

True, the current economic slowdown will affect rental activity and real-estate investment but, here again, unequally. For example, in the case of offices, which are the most cyclical assets, the gap will widen between "rare" properties, which meet tenants' requirements (i.e., a modern workplace that meets current standards) and those that no longer do. This gap will also increasingly be driven by the need for "green" properties in reaction to the climate and energy crisis. And this imperative will continue to provide work for our property companies, whose portfolios are well located to support the necessary investments.

But let's go back to what the market is telling us through the share price of the largest residential property owner in Germany and Europe, which has fallen by 50% since the beginning of the year. It tells us that in a market where supply is insufficient to meet demand and rents are rising, the value of its portfolio will fall by 25%. This has never happened before. Moreover, this real estate company increases its rents when it renovates apartments to improve comfort and insulation... The increase in rents in Germany has been higher than inflation so far, but also lower than the growth of disposable income! Moreover, future German retirees have at last grasped the fact that they must be homeowners. This is a fundamental change on this market.

In conclusion, the stock market performance of real estate companies already seems to reflect a very bleak scenario for the real estate markets and for the European economies. While nobody knows exactly what the future holds, as things now stand this decline looks overdone. Interest rates will soon reach an equilibrium point, and when that happens, investors will be able to take a new look at the fundamentals of the listed real estate sector.

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