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MARKET VIEW

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Covid-19 crisis: impacts on listed real estate

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While the real estate sector is known by investors for its stability and predictability, it has not been immune to the various waves of the coronavirus outbreak. The pandemic has particularly challenged the fundamentals of commercial and office assets as a result of the growing trend towards *work at home*, but it has also accelerated several trends already visible in the *old world.* It has also strengthened the momentum in other segments, particularly residential, logistics, healthcare and alternative.

1. Offices: Avoid

The office segment entered the current crisis with positive trends, including rising rents in the main European countries. However, the uncertainty related to the development of home office is starting to seriously affect this segment as it leads to a decrease in demand for office space in the short/medium term. In the longer term, the good news is that tenants will be looking for new types of offices with more collaborative spaces, new services for employees, and more efficient building management (IT, security, energy efficiency). Additionally, we are seeing a growing polarization between well located assets in Central Business Districts and more peripheral offices which should be more impacted in terms of activity and valuation. Finally, the downward adjustment of rents should continue until 2022.

2. Retail market: Avoid

For several years, the sector has been facing structural difficulties linked to the emergence of e-commerce. The acceleration of this trend in response to the pandemic, combined with the successive lockdowns, put the traditional players in the sector in a difficult position. Despite apparent attractive valuations, there are still many unknowns regarding the rental business.

3. Residential: Maintain

The residential sector is barely affected by the current crisis and still offers growth opportunities, particularly in Germany. Similarly, property promoters, particularly in France, have shown good resilience thanks to sustained demand from institutional investors. The crisis does not question the theme of urbanization and supports the attractiveness of the asset class. Furthermore, we are seeing a new trend: the conversion of obsolete offices into residential space, made possible by the convergence of prices in the two segments and the densification of real estate.

4. Logistics: Buy

Logistics is the clear winner of the *work from home* situation, as the demand for warehouses is growing. This downturn has clearly highlighted the need for well-organized supply chain management, which is becoming increasingly important, particularly for urban logistics, benefiting from land scarcity. Also, consumers are likely to remain committed to e-commerce and its penetration in some European countries is still in its early stages.

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What is the impact of rising bond yields on listed real estate?

As evidenced by the recent disappointing performance of listed real estate stocks, many market participants seem to view rising rates as bad news for real estate with a simple logic: rising rates imply higher real estate yields demanded by investors (higher risk premium) and lower asset values. Yet there are a few points to temper this statement:

- Firstly, the imbalance between supply and demand seems to be ignored, along with the fact that rising rates generally indicate a rise in growth expectations, which translates positively for real estate companies. Indeed, commercial leases are usually indexed to consumer price indices or to composite indices referring to growth (as it is the case in France). Thus, an acceleration of economic growth and inflation becomes a real driver of increased revenues for real estate companies. In short, if interest rates rise due to the strength of the underlying economy and inflation, stronger fundamentals may well offset any negative impact caused by rising rates. Finally, historically, dividend growth has always exceeded inflation. Thus, in the long term, a real estate asset can limit the capital erosion caused by inflationary pressure.
- Secondly, the ECB has sent a clear signal that it is committed to preserving favorable financing conditions through a still very accommodating monetary policy. Furthermore, even with a 10-year US interest rate close to 1.75% (we are far from it in Europe), the interest rate environment would remain favorable to real estate (average 10-year risk premium at 2%).
- Thirdly, real estate companies have been able to take advantage of low rates to refinance themselves on very favorable terms. The sector's leverage remains under control, with leverage of around 44% for companies in the euro zone and an average cost of financing of 1.6%, optimized by the extension of the maturity (around 6.9 years).

Outlook - How to deal with your listed real estate equity portfolio?

The situation we are currently experiencing is not conducive to a positive performance of listed real estate. However, in the absence of an uncontrolled rise in long-term interest rates, we remain reasonably constructive for several reasons:

1. The large discounts to net asset values on office buildings (around 30%) already reflect a fall in rental values.
2. The recovery phase, characterized by an improvement/acceleration in demand, will be supported by still accommodating financial conditions.
3. We see investment opportunities in several real estate companies positioned on secular themes: e-commerce, logistics, data centers, telecom towers, forestry, etc.
4. We expect Net Asset Value growth of 2.4% + an expected dividend yield of 3.6%, i.e. a total return of 6.0%, which is a long way from the current stock market performance. Thus, let's be patient as we believe that the performance of real estate stocks should converge sooner or later with their operational performance.
5. Finally, listed real estate companies are well positioned in the long term to benefit from the urban transformation and development of the cities of tomorrow. Public investment in this area is clearly creating value for the sector.

If it is too late to sell, it is still too early to reposition on the sector. What could be the triggers? A rate stabilization and a repricing of the physical real estate prices especially on the offices would be a good start. We are not there yet.

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