

Kempen Global Listed Real Estate

FEBRUARY 2021

2022 – THE GREAT REIT-SET

It would be an understatement to point out the obvious, 2020 saw everyone get introduced to something few of us have experienced on a large scale - a shocking pandemic which wreaked havoc in people's lives. Equity markets and listed real estate equities suffered tremendously initially as central bankers around the globe rallied to extend life-lines to the economy. Once initial successful vaccines were introduced, and the staggering levels of emergency liquidity was fully absorbed, we saw 2021 as one of the greatest rebounds for real estate share prices.

As we stay in a dynamic technological race versus COVID's new variants via new vaccines and measures we can probably begin to see the light at the end of the tunnel. Even though listed real estate returns experienced significant volatility over the last two years (down 16% in 2020, up 37% in 2021¹), the returns on an annualized basis over the period came in-line with our underlying real estate expectation of 6-7% per annum. We have every reason to believe that our underlying return expectations should continue to materialize, but possibly with significantly less volatility.

Therefore, we ask ourselves the question again. What would it all mean for real estate markets in 2022?

Inflation infatuation

Since the stronger than expected vaccine led economic recovery out of the pandemic, the understandable worry has been whether inflation can be controlled, and if so how one must be positioned. Whilst we are not infatuated with inflation, unlike many peers, we recognize that it can not be ignored. There are many short-term inflationary pressures weighing on the economy including labour shortages. The list is high and not exhaustive and it includes: labour reclassifications to growing industries (and away from declining ones), many leaving the labour market altogether to begin reclassifying their skills for new jobs, and others. Supply chain issues are often one of many consequences of the above, and when all of these combine we have seen prices rise well above pre-pandemic levels. However, there are also structural longer-term deflationary trends such as ageing populations and historically high debt levels which leads us to believe that the outsized inflationary pressures are more likely to be temporary.

Historically, real estate investments provide a level of inflation protection when positioned in the shorter-end of leases or within attractive clusters experiencing market rental growth. As an example, free market residential real estate (such as in the US or the UK) generally has annual rental re-sets to benefit from increasing inflation. Even regulated residential often has an inflation component. Hotel operators can have nearly daily re-pricing of their average daily rates, which can also allow them to respond quicker to a changing cost environment. Additionally, when looking at standard lease contracts in various countries in

¹ FTSE EPRA Nareit Developed return in Euros



Europe, there is a clear and explicit annual Consumer Price Index-based “CPI” lease re-adjustment. More important than explicit inflation-based lease links is the demand and supply environment on the ground. And this is where logistics real estate, as an example, can continue to provide inflation or above-inflation based growth. The options to position tactically for a temporary increase in inflation are vast in the space, and an active manager can ensure the portfolio is as resilient and opportunistic as possible.

ESG – companies more constructive than ever before

At the beginning of 2021, we stated that the year would be centered around S “Social” in the ESG “Environmental, Social and Governance” acronym. It appears we were a little bit early. The previous year instead really ended up being the year where the sleeping giant – that is the United States – woke up from its deep slumber and provided strong direction from the top on environmental emissions cutting commitments. Therefore we believe that 2022 needs to be a year of less words but more action. Whilst European Union regulators lobby on what to consider green we believe that the private sector can continue to pull ahead without having to wait for bureaucrats to finalize rules that fit their countries’ economies best. We share this observation on the EU Taxonomy developments with disappointment and call for further unity and action. We fully understand that various countries have different interests (economically, but also in terms of independence) hence it was never going to be straightforward, but if there is common trust that everyone is working towards the same goal then it should make a cohesive roadmap clearer. Contrary to the policy makers disappointment we are very encouraged with the developments of some industry-leading real estate companies in Australia. The disastrous forest fires of the nation ended up accelerating private sector commitments despite top-down hesitation in the country. This is something we hope to see happening elsewhere too as this really is a wholesome effort.

The challenge of working through greenwashing and other sub-optimal ESG initiatives is enormous and it is every active investors’ responsibility to challenge that. For example, the Prime Market segment index in Japan is being launched in an effort to improve corporate governance based on global investors feedback. Upon our review however, it appears that the criteria is very low so most real estate companies in Japan will be in the index. However, Japan scores below the global average for corporate governance and thus it shows us that this looks more of a marketing exercise than a real improvement in governance practices. Without strong governance practices, it is unlikely that environmental or social initiatives can receive the necessary progress and accountability that they require. As we have called upon numerous times in the past, we really do not believe investors have the luxury to remain passive in the face of this colossal human challenge.

Offices are showing a tale of two worlds

Once again, the work-from-home “WFH” office debate continues raging at full speed. We have seen certain employers in the US, for example, going fully remote. Others have reduced urban space to build campus-style offices. Yet most are playing a wait-and-see game and using the opportunity to extract the best deal terms from their landlords. However, in other markets around the globe, taking Sweden as an example, the negotiations have not been nearly as intense. By and large many developed real estate office markets outside of North America are playing “wait-and-see” and not fully using their bargaining power to squeeze out landlords. In that way, they are hoping to strike a better longer-term relationship with their landlords (and vice versa) and saving short-term costs has not been a top priority. The verdict is still out on which way

this goes but we reiterate our previous views of the increasing demand for flexible formats, urban-fringe locations and ESG friendly characteristics. It is certain that utilizing an active manager who can evaluate and price-in these trends is going to be increasingly important as benchmarking solutions may point the investor towards a large but structurally challenged weight in offices.

Physical retail shows signs of life for certain formats

Whilst the secular trends are not in favour of physical retail, it is worthwhile to point out that value can be found in this segment still. For example, in 2021 we saw consolidation in the US strip center (unenclosed shopping center) space as customer traffic levels, commonly known as footfall, remained resilient. This goes as an attestation that with the right tenant mix, right location, and a fresh look, certain physical retail formats can continue to perform. Whilst grocery-anchored tenants are showing strong investment demand (and yield compression) due to growing necessity-based profits, it is looking more and more difficult for enclosed malls. Regional differences will allow different timelines on how long a certain landlord has to upgrade or reconvert if necessary. For example, the US has consistently had amongst the highest retail square footage per capita. This is why we saw outright bankruptcies in the space not long ago, and regional malls transactions are few, far, and in-between and anecdotal evidence points us to capitalization rates in the high teens or often in the twenties.

This is different in certain regional European or Canadian malls where valuation discussions are still in the high single-digit or low double-digit end. Population growth, liquidity in consumers' hands, and less retail space per capita result in more resilience in those regions. In China, due to strong government interference, we are seeing an effort to repatriate luxury consumer retail spend back on-shore. In addition, urbanisation and middle-class growth are still very strong in the region despite lower population growth and are forecasted to quadruple by 2025. This makes us reasonably constructive on malls in Hong Kong and we find the current share price reaction very disconnected from performance on the ground.

Residential going global?

We outlined previously that residential, unlike other sub-sectors is often seen as a social good and can be thus heavily politicized. After all, everyone needs a place to live. Historically, running a multi-country or multi-continental residential real estate platform has been nearly impossible. Different countries, governments, cultures and legal systems make this space an extremely local business. We have seen certain players have selective success abroad (Canadian headquarter CAP REIT as one). And last year we saw Swedish private players buying German residential. We also saw German mid-size players like TAG Immobilien go materially further into Poland. We also saw Akelius selling European residential to likely expand its Canadian platform where initial yields are higher and strong immigration trend resulting in steady population growth is very constructive for the long-term. Additionally, European industry giant Vonovia had already made jumps across the border into Sweden, Austria, the Netherlands and had been exploring France for some time. We believe we can see more and more brave scalable moves as the aforementioned mainly driven by the seeking of global financing and return arbitrage in this ever-growing and core real estate sub-sector.

Other forms of residential are gaining more attention and attracting stronger pricing – and for good reason. In North America, single-family-rental housing is gaining in popularity. Generally speaking, if a certain part

of the population is going to be working from home more often, then doing it in a larger house makes all the sense in the world. And living in a world of uncertainty - be it personal/pandemic related or economically related – renting in general is still seen as a good way to maintain flexibility in one's life. Additionally, the affordability of housing is an ongoing theme, and the Americans here have an interesting solution that has been around for a while but is gaining even more traction and that is the manufactured home communities. The landlord often owns the land only and therefore the rent is quite low, and maintenance capex de minimis. With such low rents, it is easier to pass through rental growth and achieve strong cash returns whilst providing a clever affordability housing solution. With the theme of residential growing global, we can see certain formats and residential solutions crossing borders faster than ever before. This can allow us to invest in even more structurally growing sub-sectors of real estate which would have inflation beating characteristics, in our view.

Logistics still in vogue

It is safe to say that logistics real estate is continuing to showcase strength. Despite some minor concerns about increasing supply and muted rental growth in certain regions, this sub-sector's demand seems to far outweigh these issues. It is almost irrelevant which geography we zoom in on, the strength is evident and broad-based. Whilst some regional locations do not yet show above-average real rental growth (suburban Nordics, Eastern Europe, regional North American/Asia), the strength there is rather experienced through strong leasing demand or via the landlords' ability to negotiate new fixed contractual leases at higher than previous levels. The areas where supply is constrained - such as urban in-fill locations next to large population centres or geographically constrained (close to the sea or mountains) are seeing real rental growth at several times that of the already elevated inflation rates. And whilst it's always a question of price, seemingly low initial yields on real estate can often appear extremely aggressive, given high single-digit or in some cases double-digit annual rental growth, then reversionary yields appear more appropriate on the back of a still favourable financing environment.

Looking forward to 2022

Whilst 2021 was one of the best years ever for listed real estate, we believe that the upcoming year will see the sector re-set to a level of normality. We define this as a relatively attractive single digit return per annum in aggregate across listed real estate. As we find current portfolio holdings valuations at a high single-digit discount to our estimated net asset values, it is clear to us that the sector still has value, in addition to its inflation protection characteristics. However, one must continue to be active as dispersion will continue to be plentiful in terms of growth, inflation exposure, valuation, and increasingly-so commitments to ESG practices.

As we come out of two of the most volatile years for listed real estate on record, we expect that going forward real estate fundamentals will drive share price performance once again. With several sub-sectors in real estate offering further opportunities to create value we trust that the prospects to create alpha remain plentiful. Most importantly, odds are increasing that we can begin to put the worst of the global pandemic behind us and can look forward to a more predictable new normal for real estate.

**Important Information**

As at 31 December 2021, the Kempen Global Property Strategy held shares in Vonovia but not shares in TAG Immobilien or Canadian Apartment Properties REIT. As at 31 December 2021, the Kempen European Property Strategy held shares in Vonovia and TAG Immobilien.

The views expressed in this document may be subject to change at any given time, without prior notice. Kempen Capital Management N.V. (KCM) has no obligation to update the contents of this document. As asset manager KCM may have investments, generally for the benefit of third parties, in financial instruments mentioned in this document and it may at any time decide to execute buy or sell transactions in these financial instruments.

The information in this document is solely for your information. This article does not contain investment advice, no investment recommendation, no research, or an invitation to buy or sell any financial instruments, and should not be interpreted as such. This document is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such.

The views expressed herein are our current views as of the date appearing on this document. This document has been produced independently of the company and the views contained herein are entirely those of KCM.

KCM is licensed as a manager of various UCITS and AIFs and to provide investment services and is subject to supervision by the Netherlands Authority for the Financial Markets.