Weekly Analysis

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ATTRACTIVE OPPORTUNITIES IN VARIOUS REAL ESTATE SECURITIZATION MARKETS

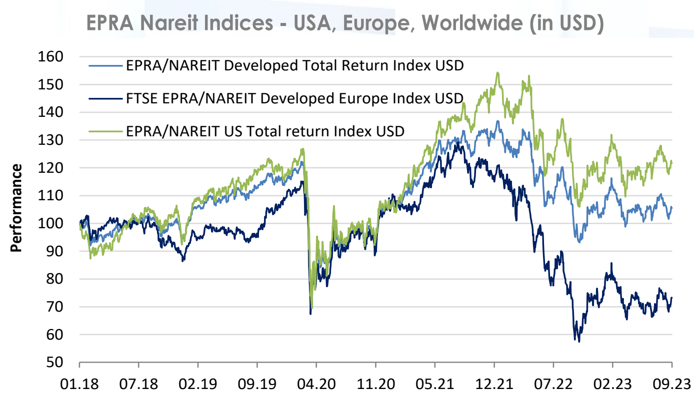
Gradual reduction in uncertainty. Positive impact of falling inflation and the end of the rate-tightening cycle. Attractive valuations of listed real estate indices in Europe and the UK. Relative yields and agios also attractive in Switzerland.

Key points

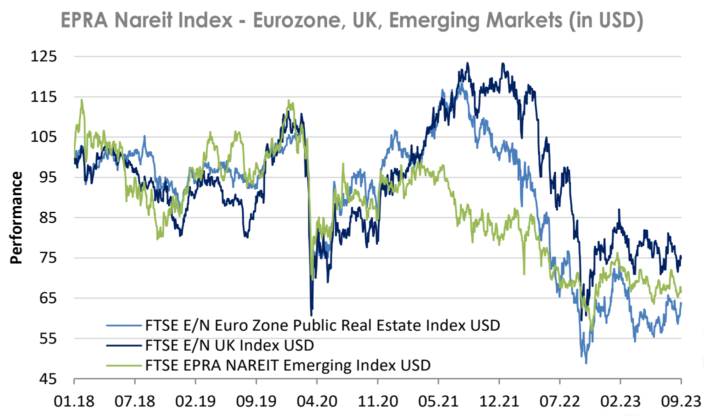
- Risks discounted, current prices represent real investment opportunities
- A particularly favorable price/net asset ratio for European real estate
- UK securitized real estate also looks close to recovery
- Swiss securitized real estate offers opportunities to be seized
- Attractive absolute and relative returns
- Positive outlook for both forms of investment in Switzerland (funds and companies)

Securitized real estate still affected by persistent uncertainty, but picks up at the end of the month

Unfortunately, the last few months haven't brought much change to investors' still mixed feelings about securitized real estate. Taken as a whole, the listed real estate market was already almost completely stable in the 2nd quarter (+0.04%), following an already rather calm and slightly positive 1st quarter (+0.51%). Over the past two months, real estate indices have recovered to some extent, without yet showing a very solid trend in an economic context rich in events likely to have a positive impact on real estate, such as falling inflation and the probable end of restrictive monetary policies. Regionally, however, we are seeing significant decorrelation and a certain volatility in monthly performances. It took a long time for prices to finally recover, first in the United States, then in Europe and in the emerging markets. These recent rebounds were still affected by interest rate uncertainty and remained volatile. In the United States, a combination of three favorable factors has begun to support a return of investor interest in this asset class and its listed stocks. In fact, it was the alignment of these three factors that enabled real estate values to begin to recover. Falling inflation, a correction in interest rates and hopes that the monetary tightening cycle would soon come to an end provided a favourable environment that pushed prices upwards. On the other hand, in Europe, persistently high inflation despite a clear downward trend, and a monetary policy resolutely geared to the continuation of the tightening cycle, did not yet provide sufficient reasons for investors to favor real estate investments in August, after a marked recovery in July. British property values fell by a further -4.5% in August, after rebounding by +5.1% in July. Overall, securitized real estate indices are continuing their consolidation phase as they await better visibility in their respective regional markets. The uncertainty that is holding back the revaluation of real estate assets is largely due to the problems associated with rising interest rates, increased financing or refinancing costs, and access to credit. In recent weeks, these factors have had a further negative impact on the conditions for assessing risks and opportunities. The recent rebound in financing costs in the US in particular has had a negative impact on risk perception and on current valuations of real estate assets, often pushing REIT and real estate company prices down until recently. However, the end of August seems to present some interesting developments. Indeed, the positive recovery observed for some weeks now could well herald the start of a new upturn in the value of listed real estate companies and REITs, with the probable end of the monetary tightening cycle in the United States.



Sources: Bloomberg, BBGI Group SA



Sources: Bloomberg, BBGI Group SA

Risks discounted, current prices represent real investment opportunities

The fall in listed real estate stocks has now reached levels which, in our opinion, already reflect the risks associated with a possible increase in debt refinancing difficulties for many real estate companies. For many of these companies, current share prices do not reflect their true financial situation. In fact, real estate valuations have recently been trading well below their book values, often falling back to the price levels of early Q4 2022, and sometimes even significantly below them. It is thus not uncommon to see emblematic market leaders trading at less than 60% and 50% of their intrinsic values, reflecting in our view an overly pessimistic view of both the value of the real estate investments held, and the estimated excessive effects of rising financing costs on their results.

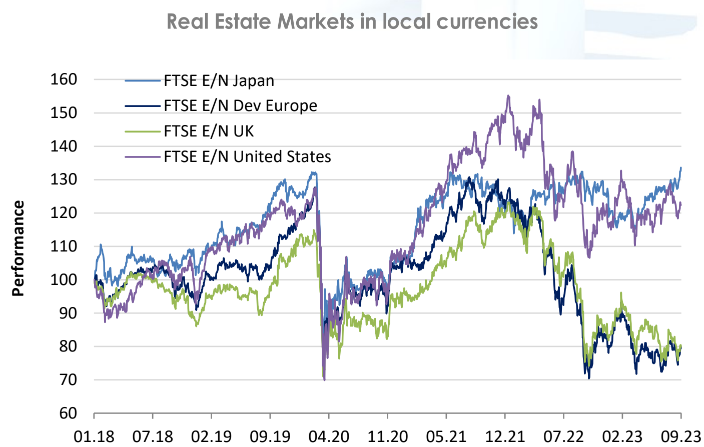
Unlike all other asset classes, securitized real estate has not yet reacted positively to the improvement in the global economic scenario, nor to the decline in financing costs now underway in the US, which will have a significant impact on real estate too. As a result, this asset class did not really benefit from a positive revaluation of the factors that had previously triggered waves of sales. In Europe, the rate hike is indeed not over, but expectations of tensions have largely preceded the monetary tightening cycle, which already suggests that European real estate values have also reached their nadir in recent weeks.

The macroeconomic scenario of a global soft landing, accompanied by sharply declining inflation, should provide a favorable environment for the evolution of interest rates and a return of investor interest in this asset class, which is currently grossly undervalued. As a result, we believe that securitized real estate represents a diversification opportunity that merits an overweight allocation.

Favorable situation for direct and securitized real estate in the US

The US direct real estate market continues its recovery phase in 2023 after a few difficult months in mid-2022. House prices, which were recording monthly declines between February and December, are now on the rise for the fifth consecutive month, driven by a growing number of buyers and reduced supply. Inventories are low, with the number of properties for sale now half what it was in 2019. The +0.5% rise recorded in April is part of a rather solid trend in which we are seeing a growing number of buyers ready to offer higher prices than those posted to secure a transaction. The current upturn seems to be affecting all regions. On an annual basis, price trends are now stable (-0.2%). Mortgage rates continue to fluctuate, but financing applications were up slightly at the end of August (+2.3%). Despite this, financing costs are limiting demand. Less than 10% of loans are above 6%. The real estate market is adjusting to higher financing costs and a doubling of mortgage interest rates. While some people's ability to purchase a property has been reduced by this rise, the reduction in supply and inventories is stabilizing the market, without having a significant impact on price levels for the time being. Three months ago, we mentioned our anticipation that the market was stabilizing, and today we believe that this trend should even be reinforced by the expected positive trend in interest rates.

As far as securitized real estate is concerned, there still seems to be some uncertainty. We believe, on the contrary, that inflation, monetary policy and yield curves are already on a path that will prove more favorable to listed real estate investments, which therefore seem to us to have already incorporated risks, which will not fully materialize, and probably offer opportunities for repositioning in the medium term.



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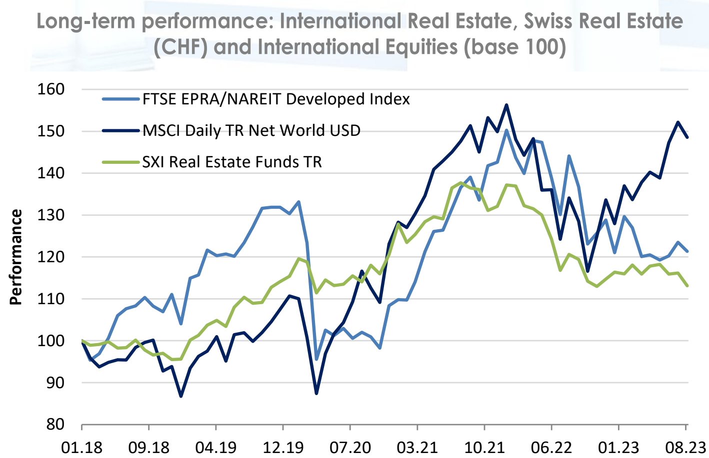


Sources: Bloomberg, BBGI Group SA

A unique price/net asset ratio of 0.54 for European real estate

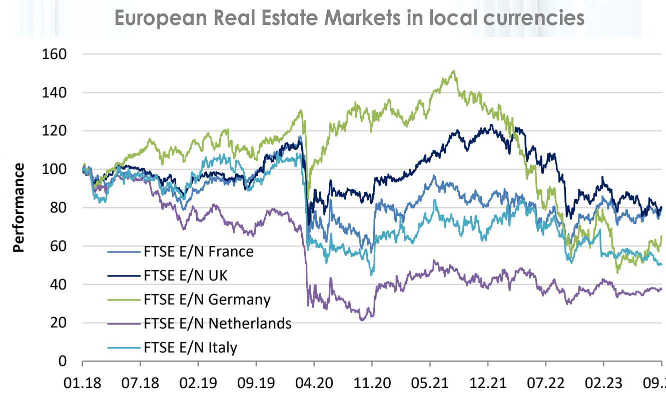
Securitized real estate has already taken on board the risks of interest rates and rental vacancies, with a fall of -53% recorded between August 2021 and October 2022. After the recent price recovery of +14% following the banking crisis in March and the volatility that characterized its evolution in July and August, it is still 46% down on its cycle peak of 2021. Securitized real estate in Europe is still suffering from the effects of inflation, the ECB's restrictive monetary policy and interest-rate tensions over the past twenty-four months. The risks of instability in the financial system caused by the bankruptcy of the SVB have once again created uncertainty, damaging the valuation of securitized real estate investments by increasing the difficulty of accessing credit. The EPRA Nareit Eurozone index is struggling to stabilize after falling -28% between February and March, but investors are beginning to take into account the likelihood of an end to rate hikes in Europe, as well as the attractive valuation levels. The upturn in prices at the end of August bears witness to this renewed interest, which has enabled the flagship European real estate index to move away from its low, which has now been tested five times in the space of a year. The collapse in listed European real estate prices, which remains very significant, seems to us to be clearly excessive, even in the context of the continued rise in interest rates mentioned above. The EPRA Nareit Eurozone index has an average yield of 5.23%, 6.69% for 2023 and 7.02% for 2024. It has a total debt/total assets ratio of 42.8% and a price/net assets ratio of 0.54. At less than 50% of their book value, some European stocks have already taken these risks into account, even though their financing and rental income are not really threatened. In our view, the European real estate market offers rare investment opportunities.

British securitized real estate in the early stages of recovery

Annual house price growth continues to consolidate sharply in 2023. After reaching +14.3% year-on-year in July 2022, the year-on-year rise in house prices was now -5.3% at the end of August. The decline is clear across all regions of the UK. Prices have now been in monthly decline for over a year, with the exception of short periods of slight recovery. The property boom is therefore showing tangible and persistent signs of weakness. Since peaking in July 2020, prices have fallen sharply. Although financing rates have eased in recent months, households are facing a shock when it comes to renewing their mortgages. The fall in mortgage financing approvals has stabilized, but is now almost 50% below the level of summer 2022. This indicator points to a further fall in house prices over the coming months. The already difficult situation of households due to rising inflation will be further exacerbated by the increased cost of mortgage financing on their budgets. Average two-year mortgage rates have risen to 4.7%, and five-year rates to 4.3%. Around 1.7 million households are directly affected by short-term interest rate trends. Financing costs are likely to rise above 5.5% to 6%, making mortgage financing and property purchases particularly fragile. In 2023, the UK property market is likely to feel the effects of a decline in households' ability to invest, or even to maintain their property investments. Against the backdrop of an expected economic slowdown in 2023, we believe that a decline of around -10% in house prices, less severe than the -16% fall in prices in the wake of the 2008 financial crisis, is likely. UK securitized real estate, already down -43% from its peak in December 2021 to its low point in September 2022, and retouched in June 2023, now looks set to benefit from a change in perception of risks and opportunities. Negative expectations linked to the prospect of higher financing costs also seem to us to be well integrated into the current levels of listed real estate stock prices. While we believe that the fall in the price of direct physical real estate has not yet reached its equilibrium point, we feel that the same cannot be said of securitized real estate, which already seems to be presenting opportunities for repositioning due to its already attractive valuations. The EPRA Nareit UK index has an average yield of 4.67%, a total debt/total assets ratio of 27.7% and a price/net assets ratio of 0.74.

Attractive discounts in Europe and the UK

The new inflation regime that seems to be taking shape may now have a positive influence on monetary policy. This new investment climate will be conducive to a reduction in interest-rate tensions and a new assessment of the risks and opportunities for securitized real estate markets. We still believe that this asset class is under-represented in a diversified asset allocation. It should benefit from investors' desire to build more balanced portfolios. We recommend an overweight tactical allocation, and in terms of regional positioning, we feel that investments in the eurozone are likely to be upgraded, given their attractive financial ratios.



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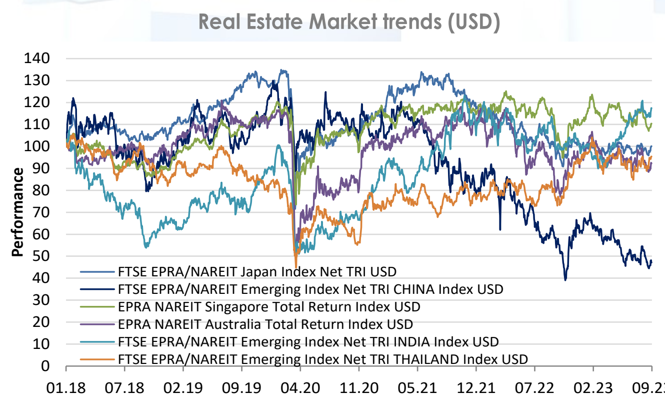


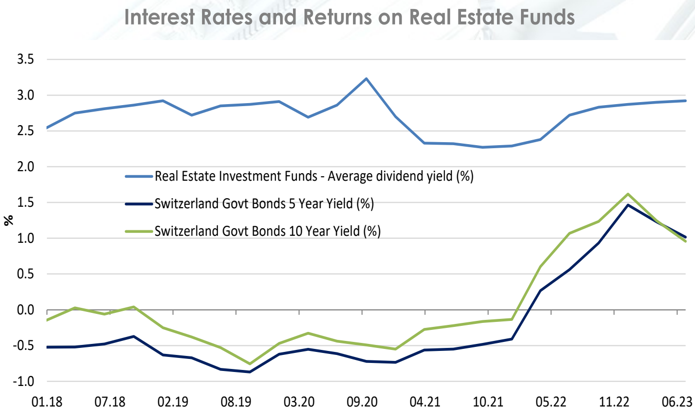
Sources: Bloomberg, BBGI Group SA

Positive outlook for Swiss securitized real estate

Despite the tightening of monetary conditions in Switzerland over the past year, and the latest 25bp increase in key rates in June to 1.75%, Swiss securitized real estate remains relatively stable. As the 250 bp increase and subsequent yield curve adjustments in Swiss franc bond yields also raised the cost of credit, securitized real estate investments remained relatively resilient. The index of Swiss real estate investment trusts nevertheless suffered further weakness in August, after having shown relatively little volatility since the start of the year, and having been relatively unaffected by the negative international environment for real estate values. This relative stability nevertheless masked short-term volatility in investment funds, which were also affected by changes in risk perception over the period. Following a +0.46% rise in the first quarter, the SXI Real Estate Funds index recorded a further +2.16% increase in the 2nd quarter, which was offset by a -2.4% decline at the end of August. Listed real estate companies followed a slightly more positive path, with an initial rise of +1.54%, followed by a further gain of +2.73% in Q2 and a recent rise of +6%. Real estate companies are thus benefiting more widely from the improved stock market climate. The current context of the Swiss securitized real estate market presents a very special situation in terms of the valuation of listed funds.

While the average agio exceeded 40% at the start of 2022, it has now slipped below the 10% threshold last reached during the 2008 crisis. The current agio level is clearly below the historical average of close to 20%. Commercial funds are already in disagio and virtually at their 2008 lows. For listed real estate companies, the average discount is now -6.6%, its lowest level since 2010. With ten-year federal government rates hovering around 1%, financing conditions in Switzerland have not deteriorated as much as in other countries, and are therefore not having a significant impact on the valuation of securitized real estate.

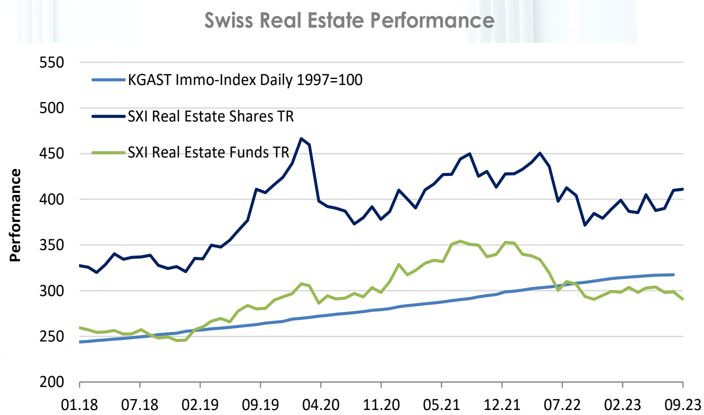
Historically, financing costs have had to exceed the return on funds for the average agio to fall below 15%. Only financing costs in excess of 4% have led to a sustained fall in agio to zero and potential disagio conditions. We believe that interest rates in Switzerland are unlikely to rise above the current real estate fund yield of around 2.8%, which eliminates the risk of a fall in prices sufficient to lower the current agio level, while average indebtedness is below 25%.



Sources: Bloomberg, BBGI Group SA

Attractive absolute and relative returns

The yield on real estate funds is 2.8%, and that of real estate companies is even 3.8%. Given the relatively flat yield curve for federal government yields of around 1% over 10 years, we consider the profitability of listed real estate investments to be very attractive in both absolute and relative terms. The risk premium for real estate companies is even close to 280 bps, which represents an attractive premium in the present context.



Sources: Bloomberg, BBGI Group SA

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