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Camino Fund

May 2024

The turning point for listed real estate

In early 2022 it became clear to investors that central banks around the world would be forced to raise interest rates to combat rising inflation. What followed was a significant sell-off in listed real estate markets. The European Public Real Estate Association ("EPRA") index declined 45% from its August 2021 peak, wiping out nearly a decade of returns (share price performance plus dividends) – see Figure 1. In just the last 18 months the index suffered 4 of its 10 worst monthly drawdowns in a nearly 20-year history. So, why exactly did this happen, and could this be a silver lining for investors looking to increase their property exposure?

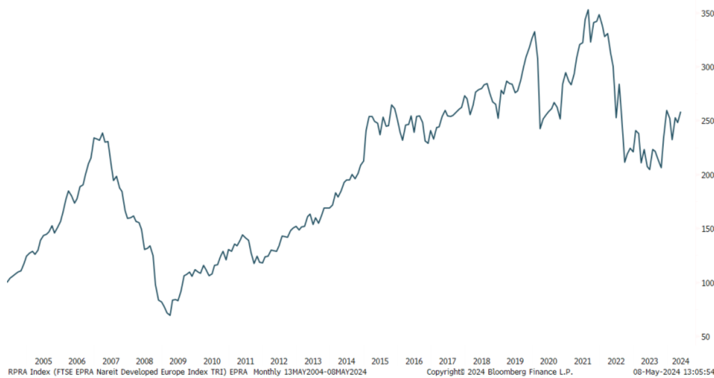

Figure 1 – The European REIT index has declined 45% over

The comedown from ultra-low rates

Real estate investors typically value real estate by simply dividing the property's net operating income by the capitalisation rate. Using this formula, we can unpack exactly what led to the decline in property values in recent years.

Starting with the numerator, net operating income, we can see that most commercial real estate businesses are not experiencing a decline in income, see Figure 2. Income has remained robust as European rental leases are typically indexed to inflation, protecting real estate owners' earnings despite rising inflationary costs. Occupier markets remain resilient too, as vacancy rates remain manageable and property developers avoid creating an oversupply.

Given that the net operating income appears strong, we can turn our focus to the denominator, the capitalisation rate. The capitalisation rate is the expected rate of return on a real estate investment and increases when the cost of capital

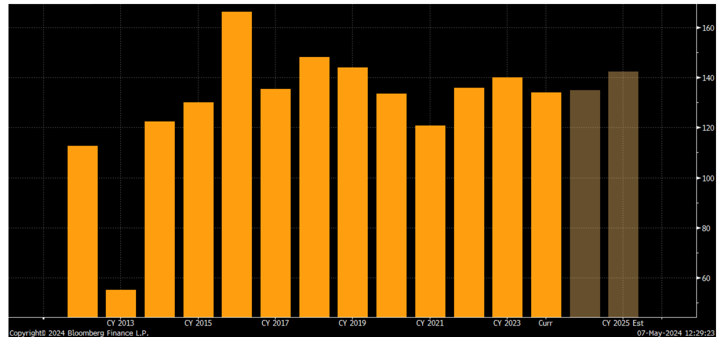

Figure 2 – EPRA earnings exhibit no signs of slowing

increases. When the European Central Bank ("ECB") hiked interest rates from their ultra-low levels in mid-2022 to 4.5% by September 2023, a 22-year high, capitalisation rates expanded materially. For mathematical reasons alone, as the denominator grew real estate values declined. Practically, property values fell because incremental buyers needed a higher income yield to cover their rising cost of capital. In other words, as the cost of capital moved higher, there were fewer buyers in the market, and with lower demand, property prices fell.

The undervaluation in listed property

As a result, many real estate values have undergone a deep correction, with some sectors such as retail, now trading at prices lower than they did at the trough of the global financial crisis – see Figure 3. Furthermore, the sectors that have experienced the deepest corrections are typically those that had the lowest capitalisation rates prior to the rate hikes. For example, prices in the industrial and logistics sector have declined 23%, despite having the most favourable long-term

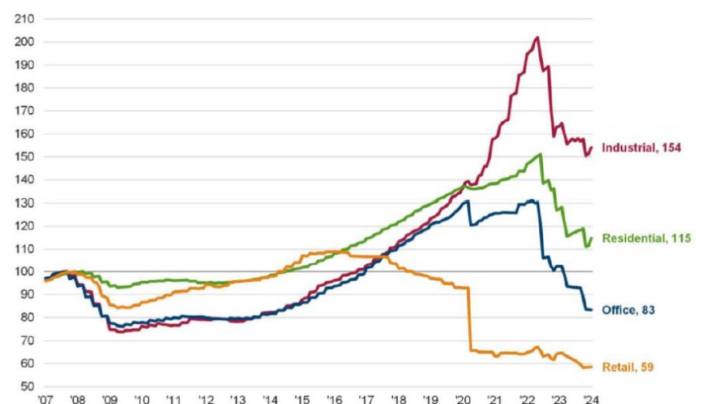

Figure 3 – Green Street Commercial Property Price index

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fundamental outlook. These depressed valuations present an interesting opportunity to the long-term investor.

As figure 4 illustrates, many REITs are now trading at a 30% discount to their underlying net asset value ("NAV"). This can occur for several reasons. One, equity markets can be irrational in the short term. Two, as REITs are publicly traded they can be repriced immediately as capitalisation rates change, whereas REIT management teams take time to revalue their underlying assets. Third, investors price in the risk that as asset values fall, REITs may become over leveraged as loan-to-value ("LTV") measures breach acceptable levels.

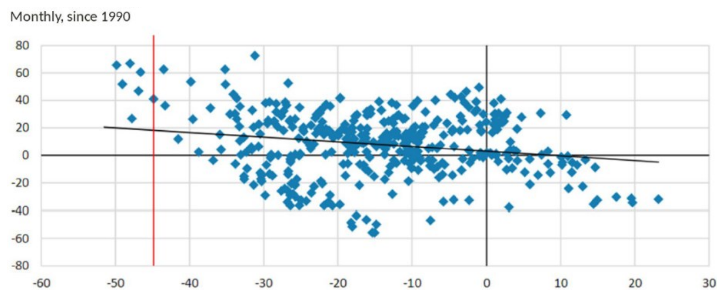
Source: Morgan Stanley

Figure 4 – Near-record discounts to net asset values

The opportunity

However, for some REITs the price correction has gone too far, with values falling below even their trough NAV. As disinflation in Europe and the UK continues to progress, central banks will look to cut interest rates from their cyclical highs to avoid a deep recession taking hold. At present, money markets are pricing in up to 3 rate cuts in both the UK and Europe in 2024 alone.

Two things will then follow. Capitalisation rates will decline, and real estate values will rebound. Lower rates will work their way through the economy to a new phase of economic recovery. As REIT balance sheets are repaired many of the same REITs that are currently trading at a discount to NAV may once again be trading at a premium. Morgan Stanley illustrates this in Figure 5 below, where the current 45% discount to NAV on Pan-European REITs has typically been followed by an almost 20% share price return over the next 12 months. In addition, European REITs currently boast attractive income yields of around 8%, levels not seen since the global financial crisis 15 years ago.



Source: Morgan Stanley

Figure 5 – Pan-European NAV valuation (horizontal axis) vs. next 12 months share price total return (vertical)

In our view, these fundamentals create a favourable deep value entry point for long term investors.

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