



Listed Real Estate: There's still time to buy into the sector's rerating!

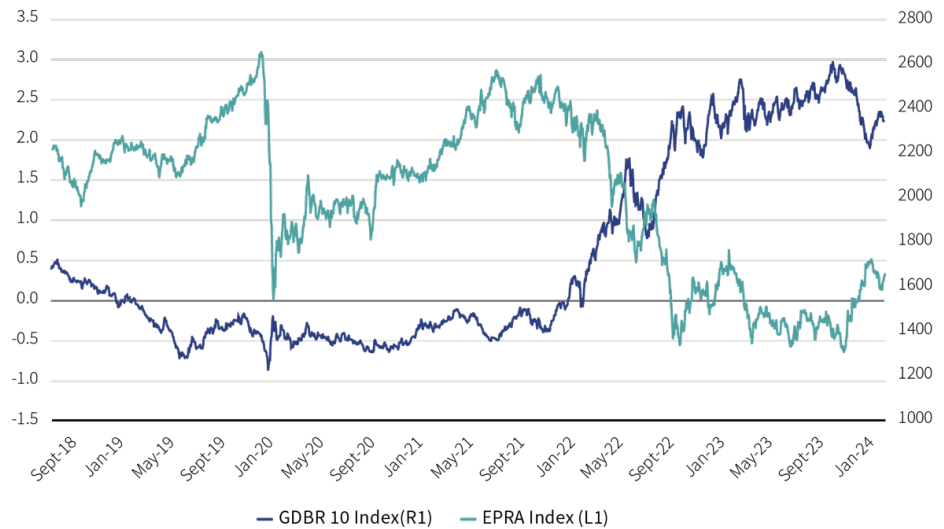


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Late 2023 featured a rerating of real estate companies, as the pivot in monetary tightening came into view. As 2024 begins, the entire sector, as well as long-term rates are in a wait-and-see stance.

Sector volatility is being stoked by uncertainty over exactly when initial rate cuts will occur and how there will be in all. However, correlation with interest rates, which has been high since the start of monetary tightening, is likely to gradually fade – barring an additional, substantial cut, but that would be unrealistic, given the outlook for a soft landing – and to give way to fundamentals:

Trends in interest rates and the property sector in the euro zone

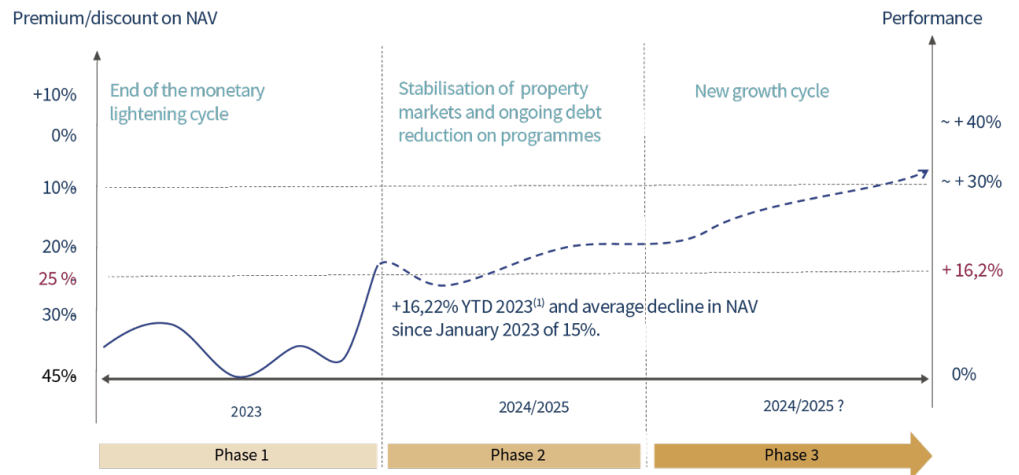


In other words, listed real estate prices will continue to be driven up as the impact of easier financial conditions gradually spreads to property markets, thus driving up risk premiums (i.e. the gap between property yields and long-term rates) and bringing back buyers. Private real estates prices can probably be expected to bottom out in the second half of 2024 or first half of 2025. As usual, the equity markets will price this in beforehand (see our November 2023 sector update, "[Liquidity crisis and price adjustments, what's the current state of real estate markets?](#)").

Moreover, the wall of debt is going to benefit from the fall of interest rates and the improvement of the investment market. The cost of financing has already fallen significantly in the fourth quarter of 2023, from 5.5% in October in the case of Carmila (BBB, €500m) to 4.1% in early December for Unibail (BBB+, €750m)², even before interest rates pulled back in December³.

What level of rerating can we expect?

Listed real estate companies are still trading at an especially high discount of about 30% of their estimated end-2024 net asset value, even after pulling back from their peaks by an average 15%⁴. While there is still a little additional depreciation to come, a return to the 10% historical average discount will be driven mainly by an **upward adjustment in share prices**.



(1) IEIF EURO Eurozone Index net dividends reinvested at 31 December 2023

How R-co Thematic Real Estate's portfolio is positioned

In light of the above, **the portfolio's main allocation is still the German residential sector**, which remains excessively underrated (trading at a 45% discount)⁴ and whose rental fundamentals are excellent, as they are driven by strong indexation and the collapse in new housing stock after developer setbacks (exacerbating the already severe housing shortage). Moreover, the sector offers an attractive defensive profile in the event that the economy was to turn down more severely than expected.

The portfolio's second largest exposure is retail property (trading at a 30% discount)⁵, which has achieved a remarkable post-Covid-19 recovery. Moreover, rising interest rates have actually benefited shopping centres by evicting unprofitable e-commerce models (whose development had come at a very low cost of capital) and in promoting omni-channel brands (i.e., both brick-and-mortar and online). Some brick-and-mortar brands, which had been distressed for several years and kept on life-support by "whatever it takes", have also paid the price of higher interest rates leading to cascading bankruptcies (Camaieu, San Marina, Pimkie etc.). However, landlords were quickly able to rent out those locations, demonstrating the quality of their assets, and were able to continue renewing their commercial offering (with a significant decline in exposure to the clothing sector). All this has kept occupancy rates at about 95%³. Moreover, the adjustment in asset values, which got off to an early start (in 2018) has limited interest-rate sensitivity, unlike other asset classes (logistics, for example).

While the post-Covid catching-up effect is likely to fade in 2024, consumption should get a boost from the increase in real household wages. A marked slowdown in the economy, however, would be bad news. Nevertheless, the sector's valuation is still undemanding (9x cashflows⁶ vs. an average of 15x)⁷.

And, lastly, 15% of the portfolio is exposed to office companies possessing prime properties (in which higher rents limits the impact of capitalisation rate decompression)

that are mostly invulnerable to remote-working. 11% of the portfolio is invested in logistics, 8% in undervalued multisector companies, and 6% in retirement home operators⁶.

The effects of the end of monetary tightening will gradually spread to real estate markets and help bring buyers back. Valuations will most likely bottom out in 2024 for buildings whose rental situations still looks good. As usual, the markets will price this in beforehand, thus shrinking the discount towards its historical average.

It is therefore in the interest of investors having a medium- / long-term investment horizon to grab the current entry points caused by inflationary disruptions (note that the US consumer price index has fallen almost straight down, from 9.1% in June 2022 to 3.1% as of the end of January 2024(2)) and/or by a less strong than expected economic slowdown, in order to take on exposure to the sector in the unlikely event that these factors do not cause an official shift in central bank pivots.

Completed writing on **16 February 2024**

Learn more about the fund(s)

R-co Thematic Real Estate



Check this document on our website



(1) Source: Bloomberg on 31/01/2024

(2) Source: Companies, February 2024

(3) Source : Sociétés on 31/01/2024. This does not represent an investment recommendation or investment advice from Rothschild & Co Asset Management.

(4) Source: Sociétés and Bloomberg, 31 January 2024

(5) Source: Rothschild & Co and Bloomberg, 31 January 2024

Risk SRI : 5/7

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