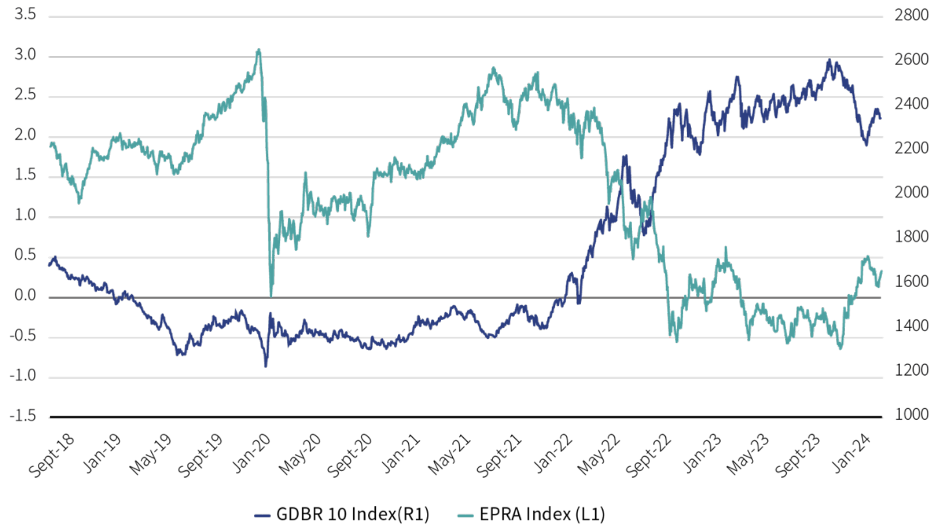
Listed Real Estate: There’s still time to buy into the sector’s rerating!

Paul Reuge
European Equities Portfolio Manager

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



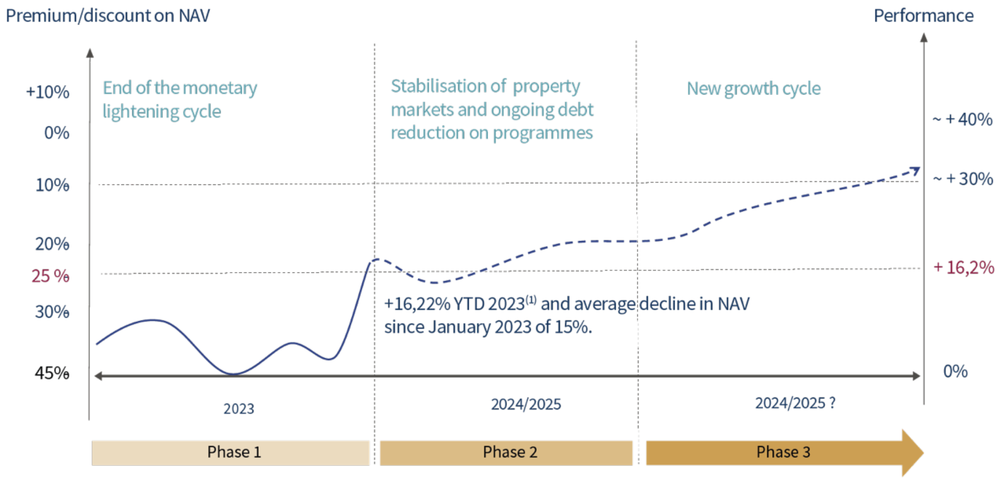
Source: Bloomberg, 31/01/2024

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 December[3].

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 cashflows[6] 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 operators[6].

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

The synthetic risk indicator makes it possible to assess the level of risk of this product compared to others. It indicates the probability for this product to record losses in the event of market movements or our inability to pay you. We have classified this product in risk class 5 out of 7, which is a medium to high risk class and mainly reflects its positioning on the French real estate and European property company stock market of shares of French companies. In other words, the potential losses linked to the future results of the product are between medium and high and, if market conditions were to deteriorate, our ability to pay you would likely be affected. The risk indicator assumes that you hold the product for 5 years; if you don't, the actual risk may be very different, and you may get less in return. Other important risk factors not adequately taken into account by the indicator: credit risk, impact of techniques such as derivatives. This product does not provide market protection or a capital guarantee, you could lose all or part of your investment. For more information on the risks, please refer to the prospectus of the UCI. Main risks: risk of capital loss, discretionary management risk, market risk, sector risk, risk linked to extra-financial criteria (ESG), sustainability risk, credit risk, interest rate risk, currency risk, risk linked to the use of derivatives. Before any investment, it is imperative to carefully read the PRIIPS DIC and the prospectus of the UCI, and more particularly its section relating to risks available on the Rothschild & Co Asset Management website: am.eu.rothschildandco.com

About the Asset Management's division of Rothschild & Co

As the specialised asset management division of the Rothschild & Co group, we offer personalised asset management services to a broad client base of institutional investors, financial intermediaries and distributors.

Our development is focused on a range of open-ended funds, marketed under five strong brands: Conviction, Valor, Thematic, 4Change and OPAL, leveraging our long-term expertise in active management with conviction as well as in delegated management. Based in Paris and established in 9 European countries, we manage more than 38billion euros and employ nearly 170 people.

More information at: www.am.eu.rothschildandco.com

France

29, Avenue de Messine
75008 Paris
+33 1 40 74 40 74

Belgium – Netherlands – Luxembourg

Rue de la Régence 52
1000 Bruxelles
+32 2 627 77 30

Switzerland

Rothschild & Co Bank AG
Rue de la Corraterie 6
1204 Genève
+41 22 818 59 00

Italy

Passaggio Centrale 3
20 123 Milano
+39 02 7244 31

Germany - Austria

Börsenstraße 2 - 4
Frankfurt am Main 60313
+49 69 299 8840

Spain

Paseo de la Castellana 40 bis
28046 Madrid
+39 02 7244 31

Visit our internet site

Follow us on LinkedIn