Investment Strategy Update #137

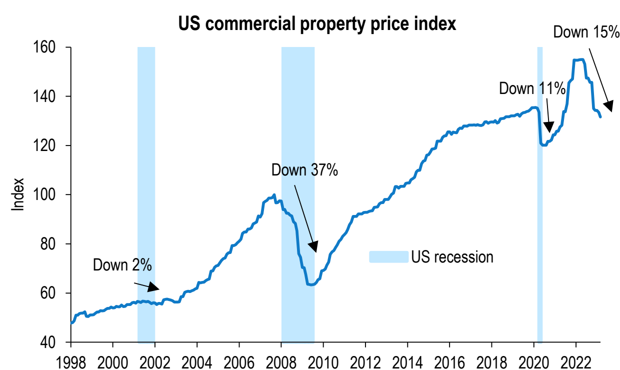
Cyclical headwinds for commercial real estate

- Commercial real estate (CRE) is being hit by the sharpest rise in interest rates in decades, with building owners struggling to refinance loans that were taken out at rock-bottom interest rates.
- Interest rate rises affect CRE in two ways: 1) raising borrowing costs and 2) lowering building values as discount rates rise. In addition, the recent developments in banking is driving a further tightening of lending standards among US banks, particularly small banks, who happen to be the biggest lenders to US CRE.
- On top of cyclical headwinds, some real estate sub-sectors are also under pressure from structural shifts such as: 1) the shift away from office to "Work from Home" and 2) the decline of 'bricks and mortar' retail due to the rise of e-commerce.
- Unlisted property fund returns lag actual transacted property values and are likely to post further negative returns as their valuations play 'catch-up' to the fall in property values. We think this adjustment has further to run with the impact continuing to linger as economic growth (and final demand) weakens in the months to come.
- While the outlook is fragile, a GFC-style property collapse (where prices fell 37%) is unlikely given relatively low leverage and credit markets which continue to function.
- Ultimately lower rates are needed to help put a floor in asset values and stabilise the economic outlook. It's possible that this happens earlier than expected given recent financial stress due to the failure of a number of US banks, but there is limited certainty around this. For now, we don't fight the trend given the drivers are pointing to more downside.
- Australian CRE will not be immune to a domestic economic downturn but will likely fare better than overseas markets given: 1) domestic CRE lending appears to be on a more solid footing and 2) Australia's relatively strong growth backdrop supported by a solid consumer, a strong labour market, ongoing commodity strength and a strong rebound in immigration.
- We think real estate is a relative play. Performance is likely to be wedged somewhere between bonds which are trading defensively and equities which are vulnerable to rising growth risks. Within real assets we maintain a preference for infrastructure over real estate, as it is a better hedge against inflation (even though it is falling) and has relatively more defensive cashflows as the economy weakens.

How far have US property prices fallen?

US commercial property prices, as measured by the Green Street Index of monthly *actual transacted* prices, are down 15% (as at 28th February) from their peak in April. A similar index for Europe is also down 15% from its recent peak (no such index exists for Australia). The current fall is already larger than the (very brief) COVID-related fall of 11% in 2020 but still well short of the 37% fall during the GFC.

US commercial property prices down 15% so far

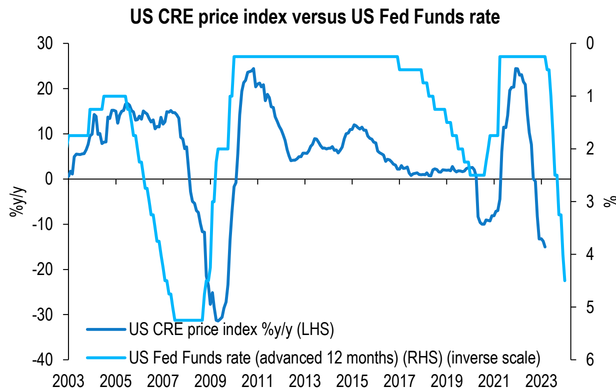


Source: Green Street, NBER, Factsett, MWM Research, March 2023

Why have property prices fallen?

The cause of falling property prices has been the sharp rise in interest rates. Rising interest rates affect CRE in two ways: 1) raising borrowing costs and 2) lowering building values as discount rates rise.

Sharply rising rates cause CRE property prices to fall

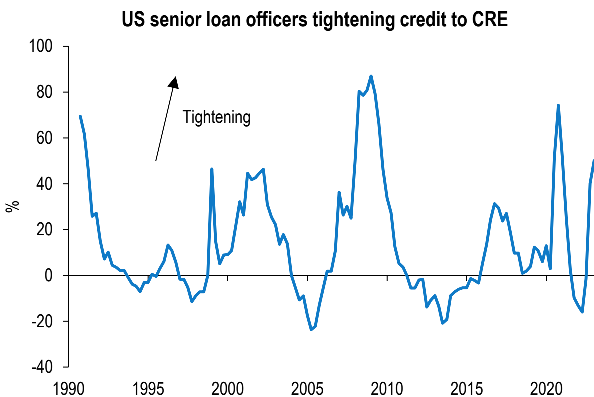


Source: Green Street, NBER, Factsett, MWM Research, March 2023

It's likely to get worse

Property sector fundamentals continue to deteriorate and it's likely that price declines get worse. Lending standards have already been tightening and this is expected to continue post the recent bank failures. Approximately US$270-450 billion in commercial mortgages held by banks are set to expire this year, according to Trepp, out of around US$2.8 trillion outstanding. While this is small relative to the total, it still represents a significant absolute amount.

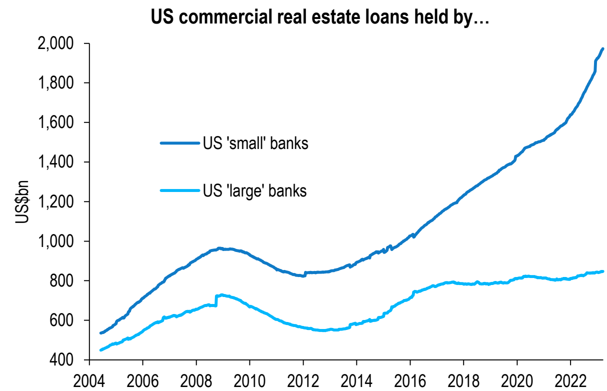
Sharp tightening in lending standards recently



Source: US Federal Reserve, Factset, MWM Research, March 2023

The recent failure of a number of small US banks has the potential to cause a further tightening of lending standards, particularly among other small US banks, who happen to be the biggest lenders to US CRE.

'Small' US banks did the lion's share of CRE lending



Source: US Federal Reserve, Factset, MWM Research, March 2023

What puts a floor on further downside?

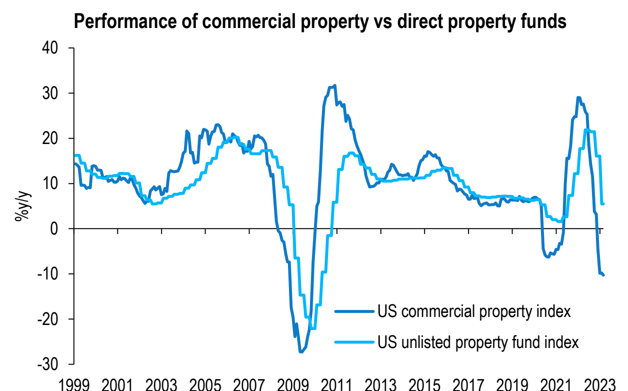
While the outlook is fragile, a GFC-style property collapse (where prices fell 37%) is unlikely given 1) relatively lower leverage for the property sector this time and 2) functioning credit markets. Ultimately lower rates are needed to help put a floor in asset values and stabilise the economic outlook.

What about unlisted property funds?

According to the most recent available data, US unlisted property funds reported a 3.5% fall in the Q4 22. This is well below the 7.8% fall in *actual transacted* commercial property prices over the same period (which was followed by a further 2.0% fall from 31st December to 28th February).

Unlisted property returns trail actual commercial property returns, which is not surprising given the lagged nature of underlying property valuations (generally yearly or bi-annual) for a typical unlisted property fund. We expect further negative returns for unlisted property funds as their valuations play 'catch up'.

Unlisted property funds lag actual property prices



Source: Factset, MWM Research, March 2023

How will Australia fare?

Australian commercial real estate will not be immune to the impending downturn. However, Australia will likely fare better than overseas given domestic commercial real estate lending appears to be on more solid footing.

- ‘Small’ (i.e., non-major) Australian banks held only 27% of total CRE loans, compared to 70% for ‘small’ US banks.
- According to the RBA in its most recent Financial Stability Review (October 2022) Australian banks’ overall commercial property lending exposures were low, at around 6% of assets, compared to 13% for big US banks and 43% for small US banks.
- The RBA also said that near-term increases in financing costs for A-REITs (which directly own around 60% of retail shopping centre space and roughly 10% of total office space) are likely to be manageable, as most have either fixed-rate debt or use interest-rate swaps to hedge interest rate exposure and only a small share of debt funding is due to roll off over the next year.

Additionally, Australia’s near-term growth prospects will be supported by improving population growth, driven largely by immigration, with the number of temporary visa holders in Australia reaching a new high in February.

Industrial/logistics remains a bright spot

All areas of real estate are likely to face some pressure from rising borrowing costs, tighter lending standards and a slowing macro backdrop, but amongst real estate sub-sectors, industrial/logistics remains a bright spot. The fundamentals for the industrial/logistics sector remain exceptionally strong, with a 0.6% (Australian) national vacancy rate driving prime rent growth of 21.6%y/y as at 31st December, according to Colliers, which should help to preserve asset values as cap rates rise. This compares to office CBD vacancy rates of 14.2% and retail vacancy rates of 6.8% (CBD retail 15.6%) with both office and retail recording flat to low single digit rental growth.

Investment implications

Within real assets we maintain a preference for infrastructure over real estate, as it is a better hedge against inflation and has relatively more defensive cashflows as the economy weakens.

We recommend waiting until we see a stabilisation in property prices, which in turn will require at least a pause in rate hikes, and more likely a beginning of a rate cut cycle. It’s possible that this happens earlier than expected, but there is limited certainty around this. For now, we don’t fight the trend or the drivers of more downside across the sector.

For those investing in property we recommend exposure to the industrial/logistics sub-sector and higher-grade ‘prime’ office/retail which will likely outperform (relatively) due to a ‘flight to quality’.

Macquarie WM Investment Strategy Team

Investment Strategy Update #137 finalised on 29th March 2023.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return

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