# REO

Edition March 2023

Real Estate Outlook – Global

## A rapid correction.

UBS

UBS Asset Management

**Fergus Hicks**
Real Estate Strategist

"A correction in capital values is under way. Investment activity has dried up, as usual during market downturns when prices adjust. Initial data suggest a swift re-pricing. This would allow the market to settle at new levels and give investors confidence to start transacting again."

# Market correction under way

News on the economy at the start of 2023 was better than expected. The eurozone allayed fears and grew slightly in 4Q22, while the US economy maintained a good pace of expansion. Warm weather curbed energy use in Europe and natural gas tanks remained close to full. Optimism also flowed on China following the government's rapid ditching of its *zero-COVID-19* policy. In addition, inflation has fallen globally and looks to have peaked, but remains far above the central bank's 2% target. The outlook is mixed, with UBS Investment Bank's analysis of hard data putting recession in the US within the next 12 months at a near certainty, though a strong January jobs report showed little signs of it so far. In the eurozone, the recession probability has fallen back to 25%, while China's re-opening is set to boost Asia Pacific.

Key central banks announced further interest rate rises at the start of February, with the US Fed dialing back its pace of increase to just 25bps. Moreover, we and the market believe that rates are close to their peak. What happens to them for the rest of 2023 is less certain and will be key in determining real estate performance. A stronger than expected economy and labor markets which remain tight may mean central banks have to hold interest rates at high levels for longer. And the final push to get headline inflation from 4% to 2% may prove harder than the initial squeeze back down to 4%.

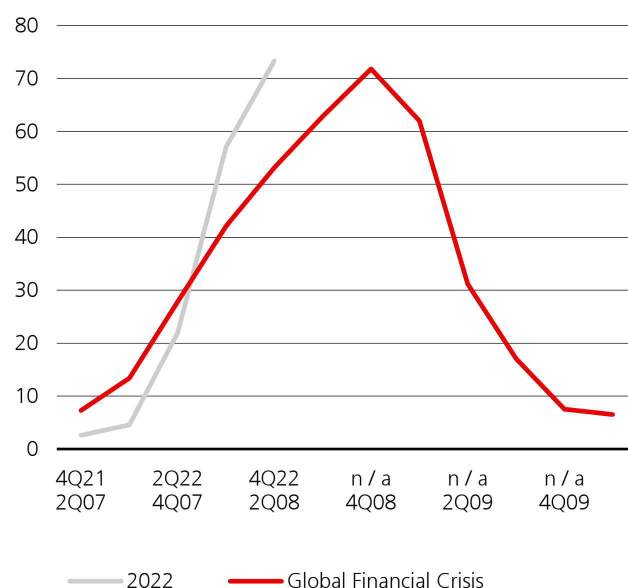
The adjustment in real estate markets, which started around the middle of 2022, has continued apace. Global investment activity slumped below USD 200 billion in 4Q22 from a peak close to USD 550 billion a year earlier when the pandemic eased and prompted a surge in deal flow. In 4Q22, investment volumes pulled back further, down sharply across all regions and sectors as uncertainty gripped the market, buyers pulled out of deals, refinancing became harder and prices started to adjust. We expect activity to remain subdued in the first half of the year, before gradually recovering as the price correction takes place and investors regain confidence to transact.

The pervasiveness of the correction in 4Q22 can be seen in cap rates and yields which rose in 73% of the more than 300 city-sector markets yields we monitor globally (see Figure 1). By contrast, they fell in just 3% of markets. The falls occurred across sectors in Tokyo and Istanbul and a couple of city-sector specific markets in the US. The drop in Tokyo reflects Japanese interest rates which have remained on hold and are not exerting any upward pressure on property yields. Zero interest rates are also generating sizeable hedging gains for overseas investors in Japanese real estate. In Turkey, runaway inflation has seen investors flock to the stock market to try and protect the real value of their savings and also to seek haven in property, given its inflation protection characteristics.

4Q22 performance data released so far showed significant capital value declines. The correction was by far the largest in the UK, exacerbated by a since withdrawn unfunded government spending program which caused interest rates to spike. According to data from MSCI and NCREIF, UK all-property capital values fell 13% QoQ, while US and Canadian capital values dropped 4% QoQ and Irish values fell 5% QoQ. UK industrial capital values showed the biggest drop of 19% QoQ, following an 8% QoQ fall in 3Q22. However, the declines followed a phenomenal run since 2Q20, when UK industrial capital values rose 55% as the boom in online retail took hold and drove strong rental growth.

Mirroring the broader equity market, global listed real estate also showed a strong performance in early 2023. If the recovery is sustained and the listed market did bottom out in 4Q22, this would suggest a trough in private markets global real estate capital values in the second half of 2023. Moreover, initial signs of a more rapid correction in pricing mean capital values could bottom out slightly sooner, around the middle of the year maybe. Ultimately, the trough in the market will be determined by what happens in the economy, which will feed through to rental income, and what happens to interest rates. If interest rates need to stay high for longer than investors expect, this could delay the timing of the trough in real estate capital values.

**Figure 1: Share of global city-sector markets in which cap rates and yields rose** (%)




Source: CBRE; NCREIF; PMA; UBS Asset Management, Real Estate & Private Markets (REPM), February 2023. Note: Refers to 309 global city-sector markets. **Past performance is not a guarantee for future results.**

# Prudent lending to cushion LTVs

Debt financing and its impact on real estate is an important topic for investors. Historically, debt has been added to equity investments to boost returns. Overall, since the millennium we think that debt financing can be categorized into three distinct periods. First, there was the pre-Global Financial Crisis (GFC) period of plentiful credit. Next, until the pandemic there was the post-GFC period of low interest rates and more measured lending. Finally, there is a new post-pandemic period which we are now entering.

Excess liquidity and credit were the primary causes of the GFC as banks lent freely across the economy, including against residential and commercial real estate. New products to collateralize debt helped boost the supply of credit, broadening it from traditional bank lending. In the case of real estate, loan-to-value (LTV) ratios were pushed sharply higher, while loan covenants were weak. Leverage on the NCREIF ODCE US fund index was 20% in mid-2007 on entering the GFC and peaked at 33% at the end of 2009. Moreover, some individual deals were transacted at LTVs in excess of 70%.

Following this period of excess, there was the post-GFC period. The transition to ultra-low interest rates boosted real estate values. At the same time lenders, having been bruised during the GFC, were much more cautious over lending terms and were also subject to much tighter regulation. Borrowers became more disciplined, particularly with regard to speculative development. By end-2017, the ODCE fund index LTV dropped to 21%. LTVs rose slightly during the immediate onset of the pandemic as capital values weakened, though the ODCE index LTV rose to just 23% by end-2020.

Leverage impacts returns for investors. At the end of 2006, prior to the GFC, the spread between global net operating income yields (NOI) and five-year swap rates plus a 150bps margin, was negative 51bps. Hence at this point, adding debt was diminutive to returns. By contrast, over the post-GFC period 2011-19 inclusive, the spread averaged a positive 216bps, meaning that debt was strongly accretive to real estate performance and boosted returns for investors.

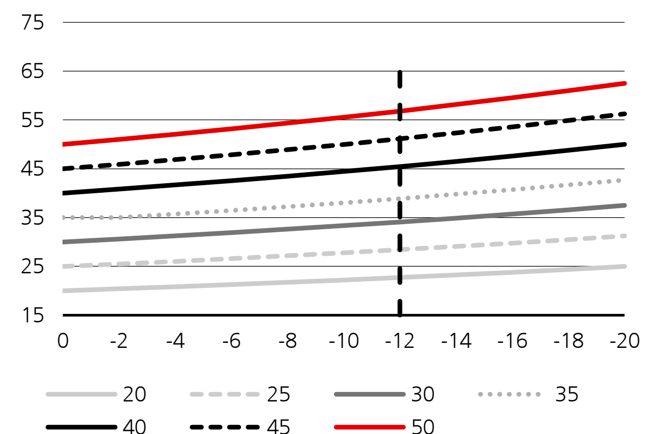
A key question for investors now is what the post-pandemic landscape will look like. The current declines in capital values will, by definition, push up LTVs. However, we think that prudent lending prior to the downturn should make loan covenant breaches less likely. For example, for an asset or fund with a 25% LTV in mid-2022 on entering the downturn, the 12% or thereabouts peak-to-trough fall in global capital values we are expecting would see the LTV rise to 28%. Moreover, even a more significant decline of 20% would only see the LTV rise to only 31% (see Figure 2).

What might be more challenging for investors is the sharp rise in interest rates over the past year. By the end of 2022, global five-year swap rates had risen to 3.3% which, adding on a 150bps margin, gives an all-in lending rate of 4.8%. This compares to an estimated NOI yield of 4.0% and means that debt is diminutive to returns again. This will make leveraged investment unattractive for the time being. Hence, in the current environment we do expect to see some distress as some borrowers default on loans or struggle to refinance them. But we are not expecting the same levels of distress that occurred during the GFC period.

In the medium term, once interest rates start to fall and the market has fully repriced, the spread should become positive again and debt should become accretive to returns again. We are not expecting interest rates to fall back to pre-pandemic levels, rather that they will be somewhat higher. Hence, we do not expect a return to the post-GFC period when debt turbo-charged returns for investors and yields trended downwards. Instead, we think debt will be mildly accretive to returns and most effective for value-add and opportunistic investments with higher projected returns.

The final area for investors to consider is whether they use fixed or floating rate debt. Fixed rate debt provides certainty for the interest expense over the duration of the loan, but the loan can be marked to market, causing fluctuations in value as interest rates change. By contrast, floating rate debt means the interest cost is related to prevailing interest rates. Ultimately, the choice requires investors to take a view on rates and assess which type of financing best suits their needs.

**Figure 2: Loan-to-value ratios versus capital value decline** (by initial LTV, %)




Source: UBS Asset Management, Real Estate & Private Markets (REPM), February 2023.

**Real estate investment performance outlook**

2022 forecast and 2023-25 outlook are measured against the country-sector's long-term average total return, with the average +/- 100bps described as "in line with long-term average". The long-term average refers to the period 2002-21. The red underperformance quadrant refers to negative absolute total returns, either in 2022 forecast or the 2023-25 outlook.

| | | LTA | Office | LTA | Retail | LTA | Industrial | LTA | Residential |
|---|---|---|---|---|---|---|---|---|---|
| North America | Canada | 8.5 | | 8.4 | | 11.2 | | 9.2 | |
| | US | 7.5 | | 8.7 | | 11.4 | | 8.5 | |
| Europe | France | 7.6 | | 9.0 | | 9.9 | | 7.8 | |
| | Germany | 5.0 | | 5.2 | | 8.5 | | 7.4 | |
| | Switzerland | 5.7 | | 6.1 | | 6.6 | | 6.4 | |
| | UK | 6.9 | | 4.9 | | 10.7 | | 9.1 | |
| Asia Pacific | Australia | 10.0 | | 8.8 | | 11.9 | | n/a | |
| | Japan | 5.2 | | 5.3 | | 6.1 | | 5.7 | |

: Forecast 2022

: Outlook 2023-25

: Underperformance (negative absolute returns)
: Underperformance vs. long-term average
: In line with long-term average
: Outperformance vs. long-term average

Source: Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), February 2023. Note: Abbreviation LTA: long-term average.
**Expected / past performance is not a guarantee for future results.**

For more information, please contact:


**UBS Asset Management**
Real Estate & Private Markets (REPM)
Research & Strategy

Fergus Hicks
+44-20-7901 6022
fergus.hicks@ubs.com

Follow us on LinkedIn

To visit our research platform, scan me!

www.ubs.com/realestate

**This publication is not to be construed as a solicitation of an offer to buy or sell any securities or other financial instruments relating to UBS Asset Management Switzerland AG or its affiliates in Switzerland, the United States or any other jurisdiction. The views and opinions expressed in this document are for informational and educational purposes only. This document is not intended to be a recommendation or investment advice, and it does not constitute an offer of, or a solicitation to buy, sell or hold, any security or investment strategy.** UBS specifically prohibits the redistribution or reproduction of this material in whole or in part without the prior written permission of UBS and UBS accepts no liability whatsoever for the actions of third parties in this respect. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith but no responsibility is accepted for any errors or omissions. All such information and opinions are subject to change without notice. Please note that past performance is not a guide to the future. With investment in real estate/food and agriculture/infrastructure/private equity/private credit (via direct investment, closed- or open-end funds) the underlying assets are illiquid, and valuation is a matter of judgment by a valuer. The value of investments and the income from them may go down as well as up and investors may not get back the original amount invested. Any market or investment views expressed are not intended to be investment research. **The document has not been prepared in line with the requirements of any jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.** The information contained in this document does not constitute a distribution, nor should it be considered a recommendation to purchase or sell any particular security or fund. A number of the comments in this document are considered forward-looking statements. Actual future results, however, may vary materially. The opinions expressed are a reflection of UBS Asset Management's best judgment at the time this document is compiled and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual security, asset class, markets generally, nor are they intended to predict the future performance of any UBS Asset Management account, portfolio or fund. Source for all data / charts, if not stated otherwise: UBS Asset Management, Real Estate & Private Markets. The views expressed are as of March 2023 and are a general guide to the views of UBS Asset Management, Real Estate & Private Markets. All information as at March 2023 unless stated otherwise. Published March 2023.

**Approved for global distribution.**


© UBS 2023 The key symbol and UBS are among the registered and unregistered trademarks of UBS. Other marks may be trademarks of their respective owners. All rights reserved.