GLOBAL REAL ESTATE SECURITIES INFECTED BY CORONA VIRUS.

IS THERE A REMEDY FOR THE SECTOR?

AN ACCUMULATION OPPORTUNITY?

April 6th, 2020 – by Jana Sehnalova, CEO of La Francaise Forum Securities

In the below article La Francaise Forum Securities provides a perspective on what happened during Q1 2020 in global real estate securities asset class, where are current valuations, opportunities and how this crisis may represent a new buying opportunity.

During the past month or two, most of us have entered a once in a life-time paradigm, where we are witnessing an unprecedented time in the world economy and in our lives. While our ancestors may have lived through many periods of such disruptions, for our generation this is a new experience and an unchartered territory. Every sector of the global economy is to a larger or lesser extent impacted by the spread of coronavirus. Every single government is tackling the crisis, whether they reacted early or with a delay. Every single individual had to somehow alter the daily life as a result. Most importantly, it is a crisis that has not only healthcare, political, economic / financial and social impacts, it is a crisis where every loss of life is a sad and painful outcome for mankind.

Unlike in the previous 2008 crisis, we have not seen a lot of global co-ordination, pointing to the fact that the world is now more focused on the protection of national interests. Lot has been written about the impact on wealth, on unemployment, growth retracement, fiscal burdens, monetary lending, mental health issues and potential social outbursts. The real damage will depend on how long the crisis lasts, which is still beyond anyone's ability to predict at this stage despite of all efforts.

The sharp decline in prices for real estate securities has responded to this uncertainty, which in turn has offered a new opportunity to accumulate companies at large discounts. As is always the case, the public market responded fast to this healthcare and economic crisis, repricing real estate securities globally very efficiently and quickly. In the private real estate sector liquidity dried out quickly, many private funds had to stop redemptions as their liquidity was not sufficient to service these outflows; the direct real estate market has yet to enter into a period of valuation adjustments, lasting potentially a few quarters. The public sector was trading at a 27% discount to last published asset values as of end of March 2020 and in other words is under-priced by the same magnitude to the direct real estate market on average globally. Needless to say, these discounts are backwards looking not forward looking, hence, may not be representative of the "real opportunity" in the sector and hence there is some degree of overstatement, but an investment opportunity, nonetheless.

It is indisputable that all real estate sectors are somewhat temporarily impacted, while in certain sectors we will see a more structural shift in valuations, such as lodging, mortgage REITs and retail, and others may be less structurally impacted – and rather witness just a cyclical move. It is still too early to know what the exact repercussions will be, but it is clear that no single company is pandemic proof: companies will come short in their rent collection process as a result of lockdowns, bad debts will rise, some businesses will not survive, leading to tenant losses / income losses for landlords, dividends are already being cut, some companies will suffer liquidity issues, some companies will turn into interesting consolidation / privatization opportunities, while other listed REITs may see management change. However, at a certain - hopefully not too distant - point these risks will turn out to be efficiently priced in; the focus should be on resilient companies, which seem to start to offer interesting entry points for savvy investors. The key in this bottom fishing process will be focus on quality of assets, quality of managements and underpriced, resilient business models. When this temporary event goes away, these companies will still be needed. This disruption is not going to make the sector obsolete. In summary, there are opportunities in the midst of the chaos. Let us explore them.

HOW HAS THE ASSET CLASS FARED IN THE FIRST QUARTER OF 2020?

Let's look at what happened in the global real estate securities sector over the past quarter in greater detail. Global real estate securities were hit harder than general equities. While general equities lost 21.1% in USD in the quarter, global real estate securities depreciated by 28.5% in USD. Global fixed income was most resilient, down only 0.3% in the quarter in USD. Despite falling bond yields real estate securities sector underperformed, as the immediate stability and visibility of cash flows disappeared and subsequently, the sustainability of dividend payments in the sector was left with a big question mark.

Index	2020 YTD performance (USD)
Global Real Estate Securities (TRNGLU Index)	(28.5%)
Global Fixed Income (LEGATRUU Index)	(0.3%)
Global Equities (NDDUWI Index)	(21.1%)

Source: Bloomberg, as of March 31, 2020.

The real estate securities industry is not a homogeneous set of companies. The performance differs by region and by sector. Looking at Q1 2020 performance, you will notice that Hong Kong has been the "most resilient" geography (a reversal of its underperformance in 2019), down a bit less than 20% in USD. On the other side, Australia was most vulnerable, losing almost 48%. Having said that - no market was spared – and every single market deflated.

Country	2020 YTD performance (USD)	2020 YTD performance (EUR)	March 2020 performance (USD)	March 2020 performance (EUR)
United States	(29.3%)	(27.6%)	(23.7%)	(23.6%)
Canada	(34.4%)	(32.9%)	(32.2%)	(32.2%)
United Kingdom	(32.2%)	(30.6%)	(20.6%)	(20.6%)
Western Europe	(25.9%)	(24.2%)	(21.6%)	(21.5%)
Japan – Developers	(26.6%)	(24.9%)	(18.7%)	(18.6%)
Japan REITs	(24.2%)	(22.4%)	(20.8%)	(20.7%)
Hong Kong – Developers	(19.6%)	(17.7%)	(9.8%)	(9.7%)
Hong Kong REITs	(19.3%)	(17.4%)	(8.2%)	(8.1%)
Singapore – Developers	(30.2%)	(28.6%)	(20.9%)	(20.8%)
Singapore REITs	(21.4%)	(19.6%)	(17.7%)	(17.6%)
Australia	(47.9%)	(46.7%)	(42.0%)	(42.0%)
Global Real Estate Securities	**(28.5%)**	**(26.9%)**	**(22.8%)**	**(22.7%)**

Source: La Française Forum Securities Research, Bloomberg. TRNGLU Index. As at March 31, 2020.

When considered on sector basis, hotels – the most cyclical sector of all – lost close to 55% in USD in the quarter, whilst retail (already at previously low levels) lost another 46% of value in the quarter. Specialty (represented by data centers), storage and industrial sectors were the most resilient.

Sector	2020 YTD performance (USD)
Office	(27.3%)
Diversified	(29.2%)
Storage	(9.4%)
Industrial	(11.3%)
Retail	(45.6%)
Residential	(20.7%)
Healthcare	(36.9%)
Specialty	(4.8%)
Hotel	(54.5%)

Source: La Française Forum Securities Research, Bloomberg. TRNGLU Index. As at March 31, 2020.

WHAT ARE CURRENT EXPECTED RETURNS / OPPORTUNITIES?

If we look at the current valuation slides, we will see that the valuations are in territories below their long-term averages. Discounts point towards an oversold territory, with around 25-35% levels around the bottom of the historical range and P/CF multiple below the long-term average of around 15-16x. Current price-to-cash flow ratio stands at 12.4x, however, cash flows will have to be adjusted going forward.

Country	Premium (Discount) to NAV (historical)*)	Price-to-Book (P/BV)	Current Price-to-CF Ratio
United States	(18.9%)	1.7	12.4
Canada	(20.3%)	0.7	11.8
United Kingdom	(26.9%)	0.7	16.3
Western Europe	(23.7%)	0.8	13.7
Japan – Developers	(63.6%)	1.0	10.1
Japan REITs	(2.5%)	1.2	12.3
Hong Kong – Developers	(53.7%)	0.5	9.7`
Hong Kong REITs	(24.0%)	0.7	22.5
Singapore – Developers	(45.1%)	0.6	7.2
Singapore REITs	(1.8%)	1.0	11.8
Australia	(31.6%)	0.4	8.8
Global Real Estate Securities	**(26.6%)**	**1.1**	**12.4**

Naturally, the underwriting assumptions in the forward-looking models had to be adjusted to reflect at least partially the changed reality. In our modelling exercise, the debt spreads have widened, in an exponential way for companies with more leverage, the equity premium came up, growth assumptions / growth premiums were reduced, thus bringing cash flow valuations down. The cap rates will have to be adjusted too, but the direct estimate of cap rate expansion would be too theoretical at this point. It is simply too early to tell with no guidance from valuers and any transactional evidence – it would be more of a guessing exercise. But yes - there will be a negative impact as a result of expanding cap rates.

In our estimates we believe that the global real estate sector's forward- looking return is now around 20% p.a., thus at a level when investors should be prompted to establish or increase allocation to the asset class. I would caution that some of the dividend yields projected below (taken from Bloomberg) will see downward adjustments as many companies have already withdrawn guidance, reduced or suspended dividend payments – which may not yet be reflected in the below statistic; however, even the dividends are not disappearing in their totality and this attractive feature of investments in REITs will be simply just lowered, not eliminated during the transition period.

Country	Dividend yield (gross p.a.)	10-year sovereign yield	Spread (basis points)	Expected return
United States	5.5%	0.7%	480	23.8%
Canada	6.2%	0.7%	550	6.8%
United Kingdom	4.5%	0.4%	410	19.0%
Western Europe	4.8%	(0.5%)	530	20.1%
Japan - REITs	4.7%	0.0%	470	1.7%
Japan – REOCs	2.2%	0.0%	220	30.0%
Hong Kong – REITs	4.6%	0.6%	400	30.7%
Hong Kong – REOCs	5.1%	0.6%	450	36.1%
Singapore – REITs	4.7%	1.3%	340	13.5%
Singapore – REOCs	3.5%	1.3%	220	28.3%
Australia	8.8%	0.8%	800	24.3%
Global Real Estate Securities	**5.2%**	**0.5%**	**470**	**21.3%**

Source: La Francaise Forum Securities Research, Bloomberg. As of March 31, 2020.

We are currently focused on holdings of high quality, with strong balance sheets and strong management. While some beta may have a place in the portfolio, it should be carefully analysed. As retail and hotel sectors may continue to be still under pressure in the second quarter, we are in no hurry to be fast accumulators in these two sectors. Even though more volatility in the markets can not be excluded, gradual purchases into market weakness will help establish an average entry pricing level at discounted values.

CONCLUSION

In conclusion, every crisis offers new takeaways, new opportunities, new ways of thinking and new lessons learnt. It is not going to be different this time around. While the losses of life that the world is suffering today are the worst outcome of this crisis, the efforts of all the healthcare workers around the world and solidarity shown by the broader society are the most admirable representations of what we as mankind stand for. The improvement of the general environment and reduction of emissions is one of the few other positive externalities. If every single company reflects upon how to be a better corporate creature, be it in relation to the environment, to its employees, to its customers and to the general public, we have already made another small progress and step forward. If governments can reflect upon how to improve cooperation and focus on the common goals of mankind, not just national interest, we will have progressed too. If we all stop to review what are the most important values to every one of us and how we can be better citizens on this planet, that will yield some positive outcome too.

Please stay healthy and safe. We can beat corona virus and come out of this crisis – even though initially weaker and beaten down, over time hopefully stronger. And yes, there will be a remedy for the global real estate securities sector. It will come in the form of interesting risk adjusted returns from specific listed real estate companies.

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