Reshaping of the real estate risk premium: the move towards segmentation of the real estate market

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Despite the unprecedented shock caused by the health crisis, real estate is still as attractive as ever thanks to a high real estate risk premium, i.e., the difference between the rental yield on real estate assets upon their acquisition and the risk-free rate. With the sovereign bond rate close to zero in Europe, the European real estate risk premium stood at 316 bps [1] at the end of September, which is 68% higher than its long-term average which stands at 188 bps. European monetary policy should prolong the low levels of sovereign rates in 2021, and therefore maintain the attractiveness of real estate.

Table 1 - Risk premium in a selection of European countries

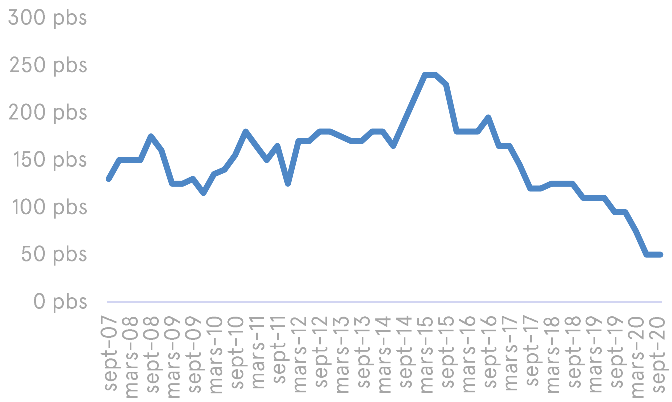
	Q3 2020	Long-term average (Q3 2000-2020)
France	304 bps	176 bps
Germany	313 bps	171 bps
United Kingdom	349 bps	135 bps
Europe	316 bps	188 bps

Source: CBRE, La Française REM Research

A new perception of the risks related to the holding of real estate assets is however emerging and it should lead to the reshaping of the risk premium in a way which is specific to each asset. Consequently, it will no longer be possible to talk of the real estate market as a whole. Significant divergences in trajectories are expected to appear between real estate asset classes and within each asset class.

Whereas up until 2019 the additional return on secondary assets diminished as the rates of return on core and secondary assets converged *(Graph 1)*, the health crisis should bring a new hierarchy of rates in its wake, highlighting the polarization of the markets between core assets and secondary assets. At the end of the third quarter of 2020, the additional return offered by secondary assets remained at a low level of 50 bps compared to a long-term average of 145 bps.

Graph 1 - Return on additional risk for secondary assets compared to prime assets



Source: MBE, CBRE, La Française REM Research

The change in outlook in the face of real estate risks has led to flight-to-quality behavior (i.e., a transfer of invested capital to the safest segments). This concentration of demand on the core segment, i.e., the highest quality assets, should keep prime yields under pressure. Investors' new expectations in terms of returns on certain types of risk should lead to a decompression of secondary asset rates and a correction of their values.

There are several types of risks that may lead to assets being classified as either core or secondary:

- **Tenant credit risk:** ***long leases are no longer sufficient to ensure the sustainability of income***

  The health crisis and the ensuing economic crisis have resulted in increased attention being paid to the tenant's credit risk, insofar as a long-term lease no longer automatically guarantees the sustainability of income. Like corporate bonds in Europe, where Investment Grade bond rates have risen by 70 basis points and High Yield bond rates have risen by 210 basis points, the risk premium for tenants with the weakest credit ratings should increase significantly – with wide differences between sectors. Consequently, open-ended real estate fund collection rates vary significantly between asset classes, with collection rates approaching 100% in logistics, 85% for offices, and 75% for shops.(2)

- **Liquidity risk:** ***the importance of domestic investors***

  The second thing to bear in mind, which is exacerbated by an increasingly uncertain environment, is the liquidity of the different real estate segments. Past crises have taught us that transactional activity in certain market segments may tend to stall due to a lack of agreement on prices between sellers and buyers. Markets with a limited domestic investor base, and which are therefore dependent on demand from international investors, are particularly badly affected because international investors tend to retreat to their domestic market. The office asset class remains the most liquid asset class, accounting for 60% of commercial property investment volumes in France, 50% in Germany, and 45% in the United Kingdom.[(3)]

Diversification by type of asset should make it possible to decorrelate a portion of income from economic cycles by relying on sustainable, long-term fundamentals, foremost among which are demographic changes and, in particular, the ageing of the population. However, the segment of diversification assets, consisting mainly of managed residential and healthcare assets, remains a niche segment with annual investment volumes of around 10 billion euros in Europe (compared with investments in offices of around 100 billion euros) with most transactions happening in the United Kingdom and Germany.

- **Risk related to the type of assets: *COVID-19 as an accelerator of the digitalization phenomenon***

The digitalization of the economy had started long before COVID-19, but its implementation has been greatly accelerated by the health crisis.

Digitalization supports logistics demand through the growth of e-commerce because e-commerce sales require at least three times as much surface area dedicated to logistics as traditional shops do. Massive demand from investors for this type of asset has led to a strong compression of yields, which no longer seem to take into account the risks of obsolescence and the need to eventually inject high levels of capex relative to the rents that are collected. Such a valuation level only seems sustainable to us if it includes a premium due to the scarcity of land – a premium that is mainly found in urban logistics.

Conversely, retail is massively neglected by investors even though its repricing – which was already underway before the outbreak of the health crisis – offers opportunities for those who are able to undertake a detailed analysis of this asset class.

It is believed that the development of teleworking and hot-desking should lead to an annual decrease in the need for office space of around 10 to 15%, with demand focused on assets that allow companies to set up hybrid organizations that combine on-site and remote working. In addition, there are forces which underpin the demand for offices: the de-densification of office space and the multiplication of collaborative spaces, as well as the creation of jobs if we look to the longer term.

The defensive nature of the residential asset class is likely to be confirmed. The development of teleworking and the various lockdowns have spurred households to take on new real estate projects. The level of supply, which is further weakened by the health crisis, could well limit transaction levels and support pricing.

- **The value-in-use risk: *from "location, location, location" to "location, sustainability, flexibility"***

The risk that is linked to the intrinsic qualities of the assets will be assessed in the light of their resilience, i.e., their ability to adapt so as to provide a new form of use as the needs of their users change. Location remains an essential criterion of user demand with a clear predilection for central locations. **Whereas previously the three golden rules for investing in real estate were "location, location, location", Covid-19 has highlighted the importance of taking into account Environmental, Social and Governance (ESG) criteria in order to analyze the resilience of assets.** The social/societal element is particularly important insofar as the fight against climate change must be undertaken by placing the user at the center of any conceived solutions. It is therefore essential that the owners of real estate assets do not limit themselves to the simple role of providers of space, but that they transform themselves into service providers by offering integrated, flexible and sustainable assets as well as a wide range of service offerings. Regardless of the asset class, companies appear to be willing to pay higher rents per m² on assets such as these which can provide better productivity for their occupants.

Assets that do not allow the implementation of new types of use run the risk of depreciating in value (via a significant increase in their risk premium) due to accelerated obsolescence on the rental market and growing illiquidity on the investment market.

Opportunities still lie ahead

Many property market segments should still offer attractive risk-adjusted returns for investors who know how to select assets matching users' evolving requirements. Furthermore, in the current context, countercyclical strategies can be implemented. Investors' relative lack of interest in secondary assets should lead to a correction in the value of these segments which would open up opportunities for investors who wish to implement value-added strategies. These strategies involve a high level of risk-taking and entail a significant asset management workload. However, so far, real estate markets have not seen sales of distressed assets, since sellers prefer to take their assets off the market when the prices offered by buyers are too far below their expectations.

(1) Q3 2020 data, PMA
(2) LFREM Research
(3) CBRE