Real estate's resilience in a higher rate regime

The post-GFC era of low interest rates is ending, with inflation persisting. Rates may stay 'higher for longer', impacting sectors like real estate without returning to 2022 lows.

By *Dmitrii Ponomarev*

Views on the outlook for interest rates are constantly changing. In mid-2024, though, the forward rate curve suggests that while central banks' policy rates will fall over the next 12 months, they will not come close to the lows of 2022.

Amid this uncertainty, real estate stocks are trading below their medium-term average valuations. The asset class is particularly sensitive to high interest rates, which can subdue demand for real estate and therefore valuations. They can also drive up the cost of debt financing. Yet stock prices may well be over-reacting to the interest rate outlook.

Why? Because real estate companies' fundamentals seem in good shape. That would suggest companies are well-prepared for a world where interest rates do not decline as far as once hoped.

Adding to this picture of resilience, the sector is diversified as never before. Reflecting the needs of its tenants in the modern economy, the sector has evolved to include many different types of real estate. This diversification makes investment vehicles such as REITs likely to be still more hardy if there are unexpected economic shocks.

Robust fundamentals: from occupancy to financial leverage

Evaluating the data from across the US real estate equity market, the world's largest, indicates that occupancy is generally healthy, while financial leverage is within sensible limits. This forward-looking analysis concentrates on the United States because it has the most readily available data. Reflecting its size, the country also tends to be by far the biggest component of broadly-based real estate investment vehicles.

The starting point for any analysis is occupancy, and this is high across almost all sub-sectors. Industrial, retail and apartments (housing) are thriving, according to the data charting US equity REITs (see Figure 1). The exception is offices, which continue to suffer from low occupancy following the lingering structural change to hybrid working triggered by the Covid-19 pandemic.

Moving on to borrowings, REITs have far more conservative finances than at the time of the GFC. The low ratio of debt to total assets indicates that they are far less vulnerable to shocks – whether from unforeseen spikes in the cost of finance or a sudden fall in occupancy.

Finally, REITs' cashflows (chiefly rents) comfortably cover the payments on their bank loans, despite the prevailing high interest rates. This is, of course, an average – there may be exceptions.

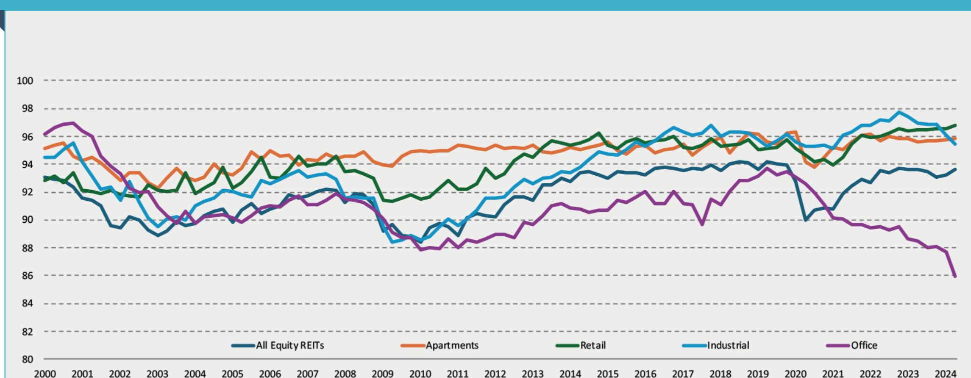
Are valuations too cheap?

Despite high interest rates, REITs maintain healthy cash flows, with rents sufficiently covering debt payments. Across various valuation metrics, the sector appears undervalued. For example, the price-to-book ratio for global REITs has recently been around 1.49, slightly above the historical averages of 1.42 (10-year) heavily affected by recent macro-ecomic and geopolitical events but lower than 1.51 (pre-Covid-19). The price-to-cash flow ratio as well as dividend yields also indicates undervaluation.

The 'free lunch' of diversification

The real estate sector's increased diversification supports resilience. As the sector has evolved to meet modern economic needs, its traditional focus on retail, residential, office, and industrial properties now includes telecommunica-tions towers, data centers,

FIGURE 1: OCCUPANCY RATES IN % (MARCH 2001 - JUNE 2024)



Source: Nareit.

‘The real estate sector’s increased diversification supports resilience.’

healthcare facilities, and self-storage, among others. This diversity mitigates risks from economic events, like interest rate spikes, that might disproportionately affect specific segments.

From 2019 to 2024, different REIT sectors faced unique challenges. Office REITs struggled during Covid-19 lockdowns, while industrial REITs thrived due to e-commerce demand. Such diversification makes the sector less vulnerable to shocks.

Here’s a brief overview of major real estate segments and their unique characteristics:

- **Industrial REITs:** Benefit from the rise of e-commerce, with demand for warehouses increasing.
- **Residential REITs:** Supported by resilient rental demand and pricing power.
- **Office REITs:** Continue to face low occupancy due to the shift to hybrid work.
- **Hotel REITs:** Rebounded with the recovery in travel post-2021.
- **Retail REITs:** Confronted e-commerce disruption and consumer behavior changes.
- **Healthcare REITs:** Vary widely, with some providing stable revenues despite economic uncertainty.

Looking back to the future

Reflecting on past performance offers additional optimism for the sector. Listed real estate has traditionally shown greater volatility in response to crises compared to private real estate, often trading at a discount to net asset values during turbulent times. These discounts, however, have historically narrowed as market confidence recovers, even resulting in premium trading periods occasionally.

Real estate stocks have also demonstrated strong performance over the long term. Since 2000, global real estate equities have outperformed the MSCI World Index, including during the pre-GFC period of ‘normal’ or higher interest rates – not just during the low-rate 2010s.

With strong fundamentals, attractive valuations, and significant diversification, real estate is well-positioned for potential future outperformance.

Historically, in inflationary environments, rents and rates have risen together, and once inflation declines, rents tend to remain elevated while interest rates fall, benefiting real estate companies’ operating incomes. This resilience underscores the sector’s value in diversified investment strategies, especially in today’s changing economic landscape. ■

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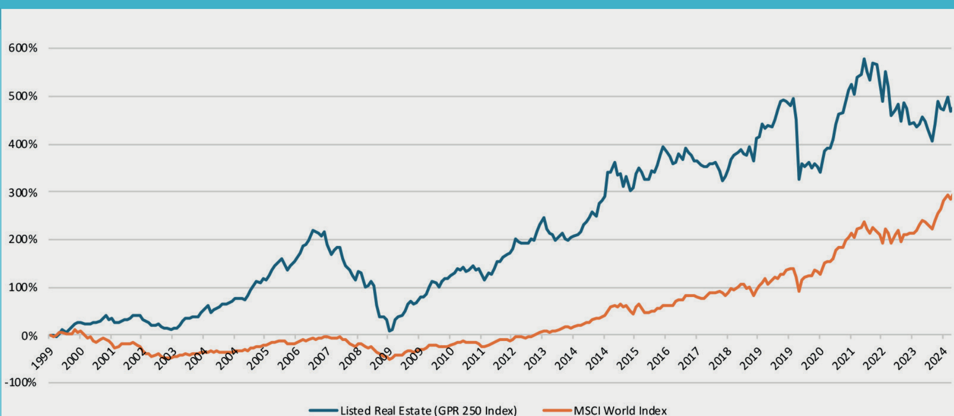
FIGURE 2: RETURN OF 100 EURO INVESTED, DECEMBER 1999 / SEPTEMBER 2024



Source: Bloomberg, listed real estate is represented by GPR 250 Index. Historical performance is not indicative of future results.

SUMMARY

Evaluating the fundamentals of real estate investment trusts (REITs) reveals healthy levels of occupancy and relatively low financial leverage.

This suggests that there may be a disconnect between REITs’ robust fundamentals and relatively low valuations.

Furthermore, the diversity of the real estate sector is likely to add to its resilience, further indicating that the low valuations may be an over-reaction.

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