Resilience in the listed real estate sector

Listed real estate stocks, as with many equity sectors, have evidently had a volatile few months since the invasion of Ukraine, which derailed their strong recovery post the Covid-19 pandemic. Nevertheless, the underlying fundamentals of the sector, especially when compared to other asset classes, clearly demonstrate a resilience and an industry much better prepared to weather the economic headwinds than in the past.

Economic headwinds

In the short term, rising inflation, higher interest rates and weaker economic growth have led to volatility, but many listed property companies across Europe have taken significant steps during the last 15 years to improve their balance sheets and debt profile. Today the vast number of European property companies have less leverage with the average LTV below 36% and the UK's standing at 28%. Compare this to 2007/8 when LTV levels stood at 49%. Around 85% of outstanding debt is contracted at a fixed-interest rate and with maturities above 5 years, meaning most companies are not compelled to refinance for several years. As a consequence, debt issued by listed property companies has become less sensitive to changes in nominal interest rates. Increasingly, a portion of the debt is issued in the form of green bonds underlying the sector's strong commitment to, and performance, in terms of ESG credentials.

The low debt levels also provide a generational opportunity for companies to deploy capital and take advantage of distressed assets without significantly impacting their debt profile.

Whilst real estate bond yields have increased over the past 9 months, as one would expect in changing economic times, the spread versus government bonds stands at only 45bps, demonstrating that markets have faith in the underlying fundamentals and balance sheets of the companies.

Even in this inflation spike, there is not an axiomatic implication of an increased risk for property investors. In EPRA's latest inflation report we discussed the issue companies see that "property companies see changes in both revenues and expenses when inflation rises. In the case of European listed real estate companies, there is evidence of a strong and positive correlation between corporate profits and inflation as well as shareholders' returns and inflation" (EPRA, 2022)[1].

In addition, rents are index linked in many jurisdictions ensuring a continued rental growth for most companies, which will underpin corporate profits, asset valuations and in return should help maintain the strong dividend pay outs that REITs are renowned for.

Listed real Estate in comparison to other equity sectors

In terms of corporate profits, listed real estate shows a return on assets (ROA) of 8.07% compared to 5.56% for all equity sectors, with communication services the highest (10.40%) and utilities the lowest (3.55%). We see a similar story if we look at return on equity (ROE) with listed real estate showing 13.21% and the average for all the sectors 12.67%. Simultaneously, property companies show the lowest Debt/Assets ratio (42.7%) and the second highest earnings yield (17.2%) across all the comparable sectors. However, all these positive figures are not properly reflected in market valuations, where listed real estate shows a modest P/E ratio of 9.42x compared to 25.32x for all the sectors and even below industries like financials 12.87x, materials 16.97x and real estate services 11.06x.

These numbers come on the back of a very strong H1-22 reporting season, albeit with forward guidance not be a bullish as at FY21, companies still expect to see growth in H2-22 and into 2023. Dividend payments also remained resilient as REITs are obliged to pay out a high percentage of their profits.

Even demand for development land remains strong with Savills reporting London transactions up 143% y-on-y and 2022 take up will be in line with the long-term average. Nevertheless, it is likely that tenants will seek less space but of a higher quality, especially in ESG terms.

With such strong underlying numbers it is therefore, just a matter of time before property companies receive re-ratings and see their market valuations aligned with the other sectors. This represents a significant entry point for investors with a long-term perspective aiming to get positive returns in a dynamic, resilient and stable industry.

Listed real estate re-inventing itself

As well as rebuilding and defensively strengthening their balance sheets, listed real estate companies have also been diversifying into new sectors that have not traditionally formed part of the listed sectors' asset base.

In 2008 the FTSE EPRA Nareit Europe Index consisted of 21% retail companies and 14% office companies with residential representing only 3% and healthcare even less at 1%. Fast forward 14 years and retail represents 8.5% of the index and offices 10% with residential having grown to a massive 24% and healthcare approaching 5% and industrial space accounting for nearly 20% of the index.

Even within these sectors there is diversification with social housing and student accommodation forming significant proportions of the residential sector and growing niche sectors like self-storage increasingly on investors radar. It is also surely only a matter of time before we see listed data centres entering the index.

Industrial sectors companies have been impacted by recent profit warnings from Amazon, but even here the sector is resilient. There is a chronic undersupply of land for industrial development and governments are increasingly restricting planning permits, especially on edge of town sites. This will naturally have an upwards impact on rents but many companies have significant land banks with planning already granted, allowing them to take advantage of the under supply.

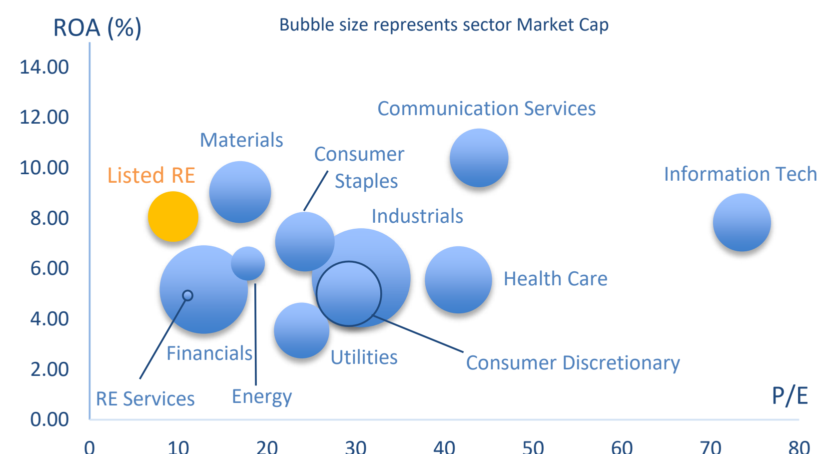
Retail's resilience

Retail is often cited as one of the most impacted sectors and the rise of internet shopping combined with falling footfall in some high streets was a trend already observed before the pandemic. Europe, though not fully sheltered, was in a better starting position than the US. To begin with, there is about 25 square feet of retail space in the US for every citizen, compared to 2-6 square feet per person in the European Union. In addition, gross lettable area respectively per inhabitant and for department store is five times lower in Europe than in the US. All of this means that there was less oversupply of retail space in Europe.

Even where there is an oversupply of retail space, listed companies are imaginatively repurposing the spaces into other land uses such a residential. In August, Unibail Rodamco Westfield announced the Westfield Garden State Plaza in the US will be transformed with the construction of 550 luxury apartment homes integrated with the shopping centre via a one-acre green town. The development will transform the shopping centre into a true town centre where the local community can come together to live, shop, work and play. Similar schemes have already been announced across Europe where large department stores have vacated malls.

In conclusion, then there are multiple reasons why the short-term volatility in the listed sector is likely to be time limited and the companies remain resilient and well placed to face an economic downturn and changes in the way we live, work and play.

Share prices vs earnings and assets



Source: EPRA Research and Refinitiv. Data as of 29/07/2022

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