Schroders Capital Investment outlook: real estate

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This Investment Outlook for real estate summarises our experts' views on the risks and opportunities in real estate markets around the world. We explore conviction themes and the investment strategies we're using to exploit the opportunities that they provide.

In this edition, we find ourselves amid a period of repricing across real estate markets. We believe the unevenness of the repricing across geographies and sectors creates a window of opportunity, as it cascades through global markets in a fairly predictable manner. We also explore the real estate fundamentals that underpin our expectations and views.

What are the key risks for the real estate market? What opportunities are emerging that investors can capitalise on?

These are the questions that our Investment Outlook for real estate seeks to answer.

In this edition, investors will find local teams' updated views and insights, as well as timely key data and trends, to illustrate the shape of the real estate market.

Global real estate markets have been directly impacted by the new higher interest rate regime. Geopolitical shifts, inflation pressures and sustainability considerations have all combined to impact real estate. So have equity and debt market movements, which have impacted allocations to alternative and less liquid asset classes. Moreover, the asset class has wrestled with media-driven concerns over changing working preferences, hitting an already challenged US office sector.

However, we believe we are now materially advanced through a period of transition and opportunities are emerging.

We focus on the key fundamentals that directly and indirectly impact real estate markets, assessing the implications of market repricing since Q2 2022. We then tie it all together to offer our thoughts on investor positioning.

Key real estate risks and opportunities

Inflation has continued on a downward path in recent months and interest rates are likely to have reached or are close to peak. The highly restrictive monetary policy environment is weighing heavily on economic growth. Even so, a full-blown recession in major developed economies is likely to be avoided. While growth is likely to be below trend in the coming months, economic momentum is expected to pick up again in late 2024.

At the same time, occupational markets continue to show resilience. Demand has softened. Even so, tight supply conditions - given elevated constriction and debt finance costs - continue to support income and the scarcity of high quality ESG compliant space. We expect this to fuel renewed rental growth in the next year.

Given the extent of the repricing observed and its uneven pattern thus far, we view the asset class to be in the early phase of a broader cyclical buying opportunity. This dynamic sits alongside existing and newly emerging opportunities from structural change.

We recommend investors adopt a patient approach with what we call a "sequential playbook". This refers to our ordering of opportunities across capital structures, sectors, and geographies. Eight months ago, we favoured a balanced approach to portfolio risk. We now believe that investors could start to consider growth strategies to a greater extent.

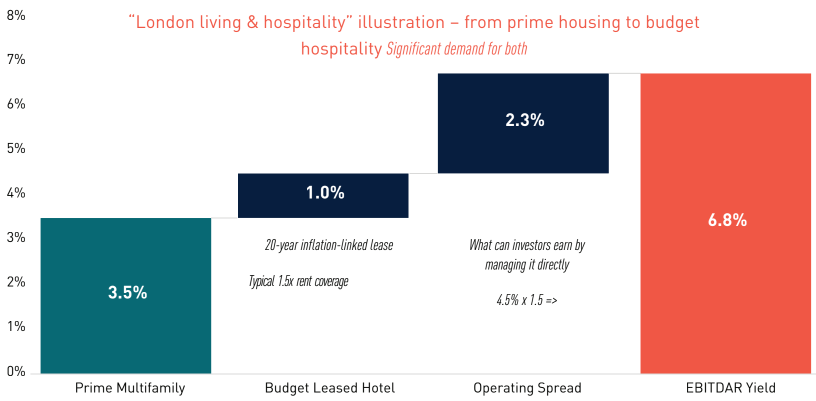
From an equity perspective, our proprietary market valuation model is indicating a materially higher number of markets offering fair or better value, having previously been much more selective. There is a natural geographic ordering to this, with clear signals for those markets that have repriced the most such as the UK.

Sector-wise, logistics assets have repriced significantly and remain supported by solid, structurally-driven fundamentals. More generally, those property types providing contractual or indirect inflation protection and where the application of operational skills can drive sustainable medium-to-long term income and value, continue to be of most interest.

We remain of the view that private real estate debt offers immediate and attractive risk adjusted value, particularly for high yield loans. We are seeing increased appetite for sustainability- and impact-focussed debt solutions. Closely related to this is a developing need for equity recapitalisation, to reinforce balance sheets and provide a base for future growth.

Garnering the "Operational Premium"

Application of specialist skills & operational excellence can unlock outsized performance



Source: Knight Frank, Schroders Capital, September 2023. The forecast should be regarded as illustrative of trends. Actual figures will differ from forecasts. Prospective returns are hypothetical and are not guaranteed to be achieved.

Key sustainability and impact considerations should be prioritised which will mean capital expenditure will also have to increase to meet evolving regulatory and shifting tenant requirements. This must be implemented by experts for risk of failure to underestimate these levels and in-turn misprice risk.

Four conviction themes creating investment opportunities:

Our preferred strategies continue to be led by four conviction themes that are driven by secular trends, as follows:

1. **Technology & the knowledge economy**
   The interface for "work" has shifted, consolidating value in those buildings which address specific needs and evolving tenant preferences, as the industry sectors continue to evolve.
2. **Individualism**
   Individual preferences with regards to "work, live and play" continue to shift, deepening disparities in demand between - and within - related sectors.
3. **Ageing populations & demographic shifts**
   Rapidly changing demographics further altering relative demand for various types of (affordable) living formats.
4. **People, places & planet**
   Increased regulatory and industry standards demand a holistic approach to the creation of value for all stakeholders, including investors and communities.

Two strategies we have conviction over:

Strategies that we have conviction over include:

1. **Private real estate debt with impact**
   We favour newly originated senior whole loans and development loans, structured to incentivise ambitious, predetermined sustainability performance objectives. This is a new private capital angle to drive positive social and environmental outcomes, leaning into a supply constrained market. The loan covenants and interest rate ratchets are also aligned to sustainability objectives as well as more common financial considerations.
2. **Operational property-types**
   We have a continued focus on living and other more operational segments, able to provide long-term resilient cashflow with outsized income growth potential, aligned with the success of tenant. This requires specialist operating expertise to deliver.

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