REITS (REAL ESTATE DEBT): ARE THEY ATTRACTIVE IN ASSET ALLOCATIONS?

Aline Goupil-Raguénès
Developed countries strategist

André-Xavier Fougerat
Credit analyst
Real Estate

Sophie Pensel-Poiron
Credit Portfolio Manager

THE PROPERTY MARKET AT A TURNING POINT

Residential property prices in the euro area have stopped falling and rose slightly in Q2 2024 (+1.3% year-on-year). However, the situation is mixed across countries: prices are rising sharply in Spain, the Netherlands and Portugal, while they are contracting in France and Germany. Commercial property prices, on the other hand, continue to decline: -6.6% year-on-year in Q2 2024, although at a more moderate pace.

The real estate market has been affected by the sharp and rapid rise in borrowing rates, following the unprecedented tightening of the ECB's monetary policy to fight high inflation. In addition, the commercial real estate market has been penalized by the decline in corporate profitability and structural factors such as the development of teleworking and e-commerce.

Today, the horizon is brightening. The ECB has been cutting rates since June, due to the sharp moderation in inflation, and monetary easing is expected to continue. This is accompanied by a slight decline in lending rates to households and businesses, which are however still high.

The latest survey conducted by the ECB among commercial banks is very encouraging in this context. It shows a significant increase in loan demand from households for property purchases. This is a result of improved expectations regarding the market and lower interest rates. The impact of the ECB's monetary easing is expected to strengthen and support the real estate market.

THE OPPORTUNITY OF THE SCARCITY EFFECT

Between 2022 and 2024, European rates tripled, resulting in a sharp adjustment in the price of real estate, because it behaves like a perpetual bond. This is the only asset for which we are heavily indebted by playing on the gap between the yield and the cost of financing.
All sub-sectors have experienced price adjustments but to a lesser extent depending on geography and type of asset, with respect to the sector's hierarchy.
Residential property companies saw prices fall (5% to 15%) solely due to higher rates. As Europe does not build enough housing, prices should rebound modestly due to scarcity. They are certainly the most indebted but also the most stable real estate companies.
Office property companies are highly polarised. Well-located office prices moved very little (-10% -15%) while the non-premium saw sharp declines of up to -40%. The adjustment is not completed. We remain highly selective as occupancy rates are under pressure.
Then come the **commercial property companies**, our preference since 2023 because prices have moved very little. The COVID crisis had already put pressure on valuations, and valuers use high risk premiums. Added to the recent rate cut, most of them have seen their assets appreciate. To note that they have significantly reduced their debts and benefit, like the office, from the indexation of rents.
Finally, **logistics property companies** have suffered falls in valuations, but e-commerce demand remains strong, yields are good and often rise above indexation. But the best years seem behind us. Loan-to-Value remains low as the segment is considered to be the most cyclical. We remain confident.
The decline is over, but office, and the scarcity effect should play full.

SELECTIVITY AT THE HEART OF THE ALLOCATION

While the **sector's weighting in European credit indices has tripled in 10 years to reach 6%,** the sector underweight has cost to too cautious investors in the credit market this year.

After more than a year and a half of outperformance, the question is whether the Real Estate market remains attractive in terms of bonds valuations?

As most of the worst performers have been downgraded by rating agencies, credit quality in the sector is expected to stabilise for the coming year.

In 2024, the sector is back on the primary market, with more than €23Bn in new issues. Heavy order books and the erasure of premiums on the latest issues must, however, lead to greater selectivity.

A calmer period on the issue side could be observed at the end of the year, especially for the residential sector, which still offers attractive risk/reward. Logistics asset class, which is lagging behind in its refinancing programs, also remains attractive and should offer opportunities in the primary market

The premium differential between the sector and the rest of the index at 30 bp has narrowed by nearly 60 bp since the beginning of the year, **but in absolute terms, considering stabilised fundamentals, the sector remains attractive in an environment of lower rates and search for carry by investors.**

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