

From half empty to half full

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THE PROFESSOR

A previous article looked at how the generalist investors are more important in determining the price, and thus value, of listed real estate companies than, ironically, the people who know most about these companies: the specialist real estate securities fund managers.

This power asymmetry might seem counter-intuitive but arises because specialists always have to have a sector weighting whilst generalists can have a weighting varying typically from 0% to 5% up to 10%. As their weighting changes so do stock market valuations and equity fund raising possibilities.

In terms of the benchmark for generalists, UK listed real estate is one of 11 equity sectors and accounts for 2.56% of the overall equity market. A number of generalists would not hold a constant weighting of this figure, holding, say, a 0% figure when interest rates are rising and, say, 5% when interest rates are on a projected downwards trajectory, providing sufficiently powerful tailwinds to turn beta into alpha for the generalist.

Interestingly, the figure for the US is similar to the UK, at 2.24%. However, there is one crucial difference: the UK listed sector totals cUS\$86 billion, whereas the US listed real estate market totals US\$1341 billion. Therefore, it is nearly sixteen times larger than the UK, in absolute terms.

This is important, as size is one of the key criteria for attracting generalists into the LRE sector.

Honey, I shrunk the sector.

A change in allocations has one major implication, and that is for fund raising for the sector, which is crucial for growth. Over the last eight years there have been five significant periods of change for the UK listed sector to deal with, namely.

- Brexit;
- the structural change of ecommerce;
- COVID;
- increased demand for tech stocks at the expense of non-inflation linked real assets;
- rising interest rates.

Now, at least it appears that the interest rate cycle has turned, and commercial capital values have stopped falling. However, the five factors above have left the UK in a



much-weakened state. The extent of this can be seen from Chart 1 which shows the growth of the UK relative to Europe and the US.

In absolute terms, the investible universe of UK LRE is exactly the same as it was at the beginning of 2016. In contrast the US is 60% higher and Europe is 20% higher. The key question for the UK LRE is why was this and will it change?

Improving Valuations

There are three contributing components to the growth in market capitalisation:

1. Increasing underlying asset values
2. Valuation shifts
3. Equity fund raises.



Chart 1: Relative growth of LRE markets through Brexit, structural change, COVID and interest rate rises

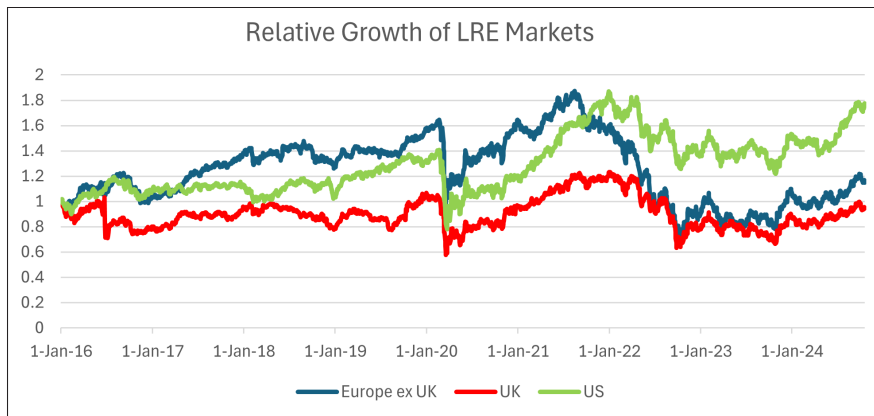
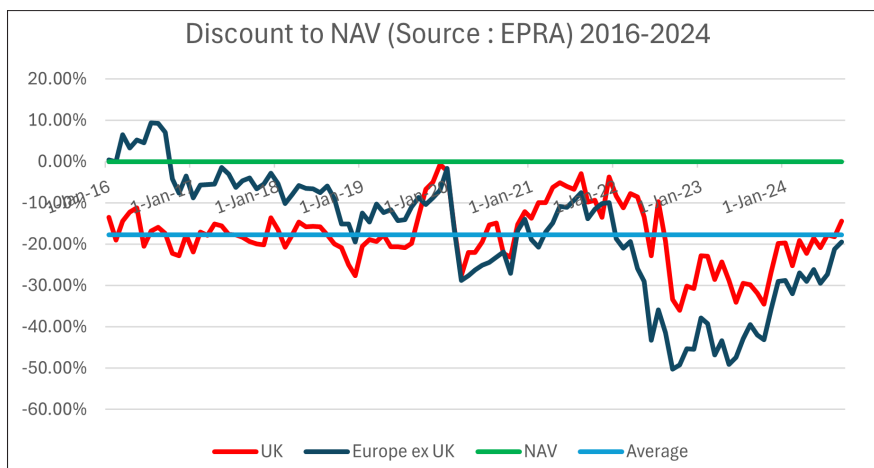


Chart 2: Relative valuation of UK and European LRE



Let's examine the latter two:

As can be seen in Chart 2, the sector suffered a negative re-rating in 2022 due to interest rate concerns which were, of course, realised. Worth noting that, since May 2023, there has been a consistent improvement in the valuation as measured by discount to NAV, although part of this is attributable to the fact that NAVs were falling and finally catching up with the share price, thus reducing the discount.

As an example, Derwent London, perceived by many to be the highest quality owner, operator and developer of Central London offices saw its NAV decline by 14% in calendar 2023.

Sentiment, therefore, has returned to the sector and it is trading now at its on-average discount over the period. Average is a dangerous metric to use in the sector at present because of the different valuations attached to different sectors.

Average values might have stopped falling but there is debate about whether they are actually rising. Therefore, without fresh equity being raised there will be little sector

growth, assuming that valuations do not improve significantly from here.

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The good news is that a number of management teams have taken advantage of the more benign circumstances to raise fresh equity, with the help of the generalists.

Notable amongst these are Segro (£1.05 billion), Merlin (€921 million) Unite (£535 million) and British Land (£301 million).

There are two key takeaways from this higher level of corporate activity: firstly, generalists are happy to support acquisitions in growth areas such as logistics, Data Centres, and Student Accommodation; secondly, shares can be issued at discount to NAV as long as earnings growth is likely. This is potentially hugely important as:

1. NAV based valuations, whilst reflecting the worth of the underlying assets have always hindered equity fund raising because of the dilution.
2. A focus on earnings has been advocated by the sector specialists for some time now and its adoption, at least in part, would be very welcome. One of the reasons why the US REIT market has grown is because they do not use IFRS and have no market value NAVs as a cap to valuations.
3. The fund raises are directing more capital towards the growth sectors, as this occurs the overall longer-term prospects of the LRE will improve.
4. By ensuring a repositioning towards growth sectors, operating at lower LTV levels, and highlighting the strong cash flow potential, the sector can make a claim for a permanent allocation from the generalists.

The combination therefore of a positive interest rate environment, a bias towards preferred growth sectors, increased allocations from generalists, and a willingness to accept some NAV dilution in return for improved income growth are all very welcome signs for a sector that needs to increase its size to retain significance and attract a permanent allocation from generalists.

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