CITY OF LONDON
Investment Management Company Limited

An Opportune Time to Invest in Emerging Market Listed Real Estate

January 2021

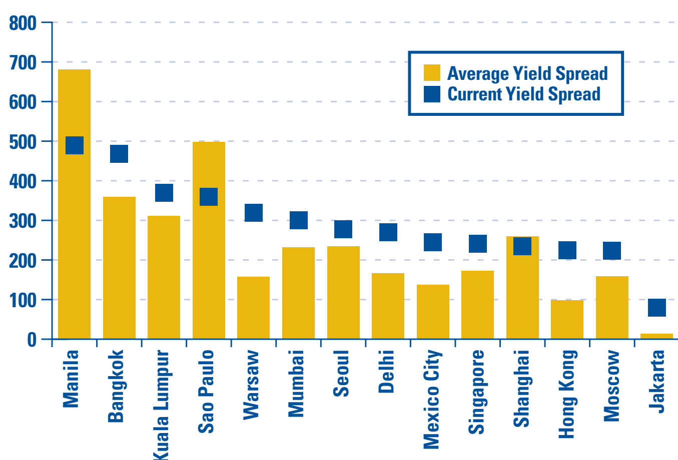
Executive Summary

- *Real estate yields now exceed sovereign bond yields by a significant margin*
- *REIT pricing indicates valuations to physical real estate are near multi decade lows*
- *We believe that these COVID-19 inspired dislocations are transitory*
- *Long term structural tailwinds for EM Real Estate remain intact*

The Value Opportunity....

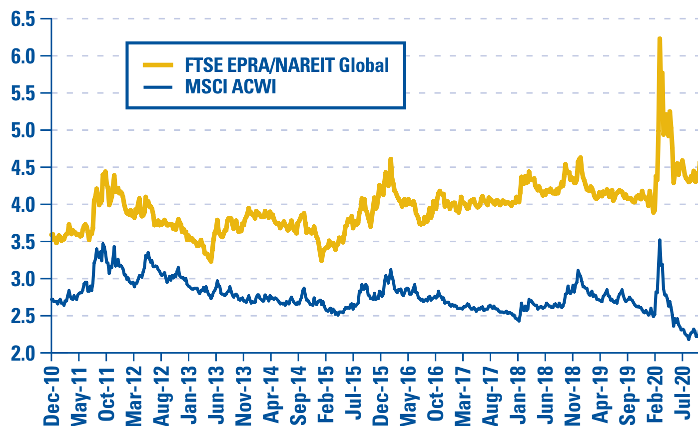
In the long run listed real estate/REITs will trade in line with their underlying assets. Over the short to medium term pricing volatility affords the active investor opportunities to benefit from short term dislocations between share prices and intrinsic value. Currently many listed real estate companies are trading at historically wide discounts offering an excellent entry point to the asset class. Chart 1 below highlights the attractiveness of the prime emerging market office sector in many key centres relative to the low yields from bonds and cash. The blue square is the current spread of office property yields versus the local 10 year bond. The gold bar is the 10 year average spread. In most markets the current spread is higher than the 10 year average. This demonstrates ample room for values to increase in the direct market or conversely a valuation cushion should bond yields rise. In Chart 2 we see that the yields on REITs versus the broader equity market are the widest for a decade.

Chart 1: Current Local Prime Office Yield Spread vs 10-Year Average



Source: JLL Q4 2020

Chart 2: Listed Global Real Estate Versus Global Equity Dividend Yields



Source: Bloomberg. Bloomberg estimates for forward 12M dividend yield. November 2020

In our view the most effective way of measuring the appeal of listed real estate is to look at three important elements; first direct real estate market fundamentals; second the macro outlook focusing on expectations for local interest rates, bond yields and inflation; and third listed market pricing with respect to this information.

Attractive Real Estate Fundamentals....

The second half of a typical real estate cycle sees strong economic growth and easy money. This typically leads to over exuberance and significant levels of speculative development coincident with monetary tightening to cool the economy. Ultimately, this ushers in a recession causing demand for space to plummet, just as supply starts to peak. Rising vacancy levels, lower rents and lower values ensue. This time around the pandemic has cut short this prolonged real estate cycle creating a short term demand shock without the usual oversupply as developers have remained relatively prudent since the GFC. A number of projects have also been delayed or postponed indefinitely during the pandemic. Thus, (in many markets) with supply in check as the virus is brought under control economic conditions and demand for space will slowly rebound. A stable and improving rental outlook for commercial real estate, and upward pressure on residential prices should follow.

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Favourable Macro Backdrop….

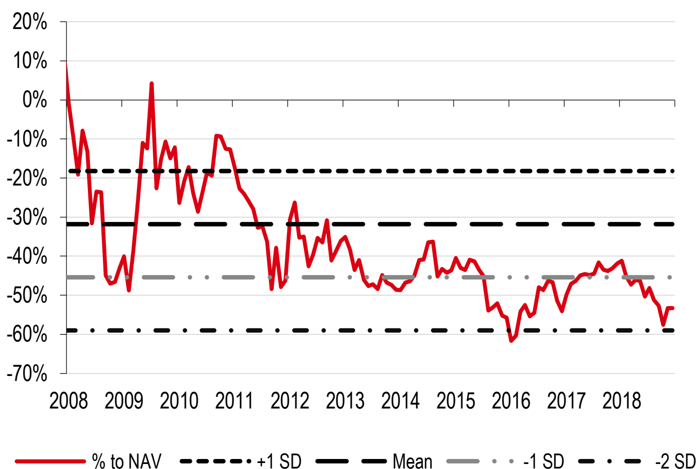
We note a number of positive drivers to the geopolitical and economic backdrop. Firstly, as Biden assumes the presidency we should see a return to more predictable trade and FDI policies. Fewer trade barriers, and stronger multilateral organisations are supportive for emerging market trade, growth and currencies. The level of public sector debt also introduces constraints to higher rates. Combined with subdued inflation and a multi-year downtrend for the US dollar this creates a 'Goldilocks' scenario for emerging market real estate.

With cash rates and bond yields at multi-decade lows, pension funds, sovereign wealth funds, insurance companies and private investors are likely to find real estate yields increasingly attractive. In a number of markets built-in annual rental escalators may also provide a reasonable inflation hedge. Demand for housing will also pick up due to more attractive mortgage rates.

Why Listed Real Estate/REITS?…

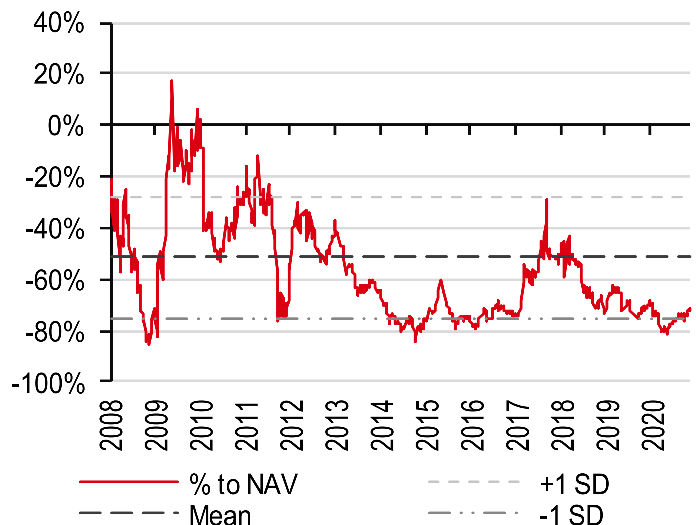
Finally looking at the pricing of the listed sector, we see significant dislocations between listed real estate share prices and the underlying physical real estate fundamentals. It is difficult to find a one size fits all approach for valuing listed real estate companies as each local market demands a focus on different valuation metrics. However, if we look at the trends in price to book (P/B) recently we note it remains approximately 21% lower today than the average in 2019. The interesting aspects of the pricing discount become more obvious when we examine individual countries and companies. For example China and Hong Kong stocks trade at larger than average discounts to NAV, especially the developers as noted below in Charts 3 & 4.

Chart 3: Hong Kong Developers NAV Premium/Discount



Source: HSBC, December 2020

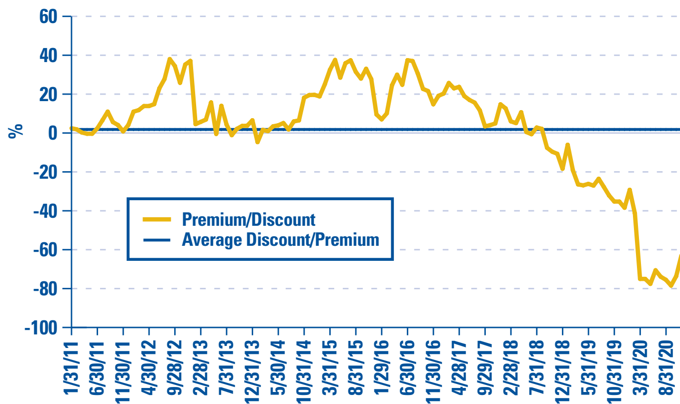
Chart 4: China Developers NAV Premium/Discount



Source: HSBC, December 2020

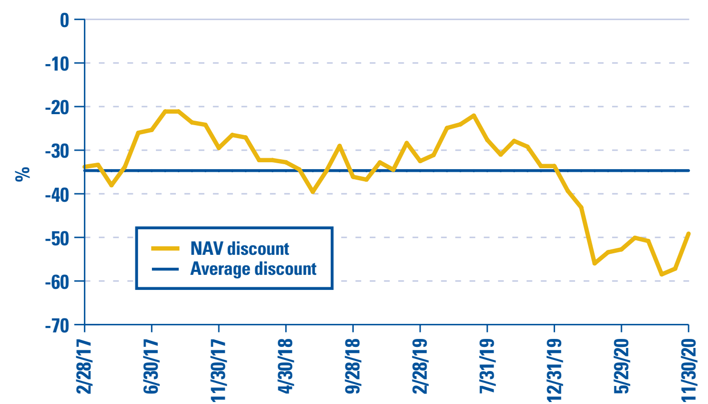
At the micro level we highlight Link REIT. A local retail landlord in Hong Kong, Link REIT, owns ground floor assets in residential towers within walking distance of over 40% of the population. Its tenants generally provide necessities as opposed to luxury goods. They also have an impressive track record of renovating assets, improving their tenant mix and adding value. It has historically traded at a premium to NAV. At the time of writing due to the local political situation and COVID-19 it trades at a 17% discount to conservative NAV estimates. Its dividend yield is estimated to be 4.4% for 2021 - 350bps above the local 10 year government bond compared to the 5 year average of 175bps. The dividend grows in line with earnings and has delivered CAGR of 8.5% over the past 5 years. Although it is unlikely to see that level of growth this year it should still be an attractive option for pension funds and insurance companies that demand yield. Another good example of value is HYPROP Investments Ltd - a high quality portfolio of South African malls with some exposure to prime Eastern European shopping centers. The company brought in new management in early 2019 after a number of missteps from the previous team. Pre-pandemic they were focused on exiting a Central African portfolio and reducing leverage deemed excessive by ratings agencies. The company share price fell over 80% in USD over Q1 20, it still remains 50% below end 2019 levels, and trades at a substantial discount to NAV (Chart 5). It remains a high quality play on prime South African shopping centers and with further asset sales we are confident management can bring this company back to full health.

Chart 5: HYPROP Investments Ltd NAV Premium/Discount



Source: Bloomberg, November 2020

Chart 6: Ayala Land NAV Premium/Discount



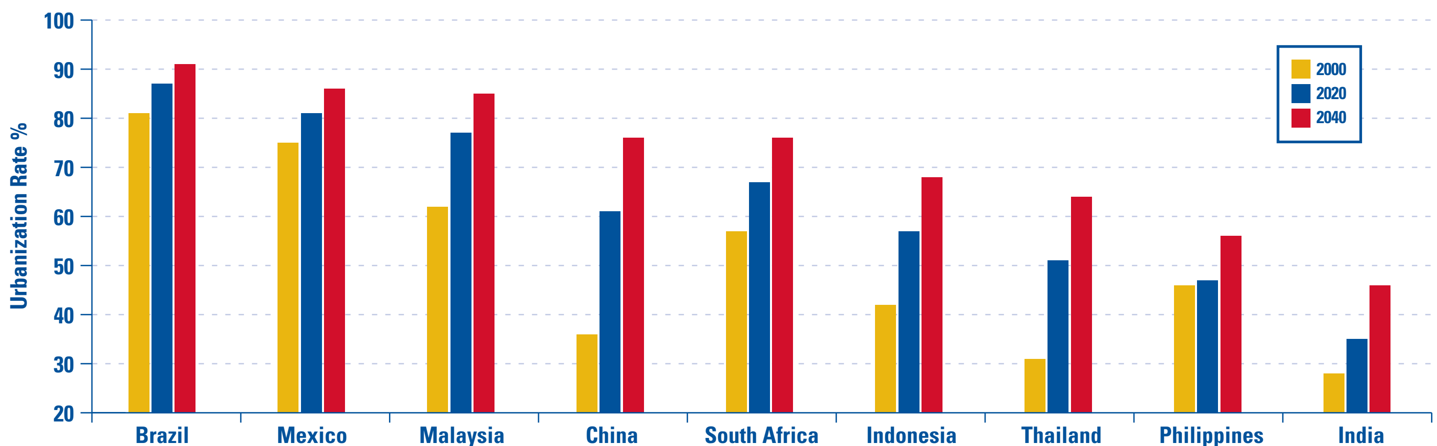
Source: . Daiwa, November 2020

Finally, Ayala Land is one of the oldest developer/landlords in the Philippines with high quality assets and a well located land bank. At present the uncertainty due to the pandemic leaves the share price at a substantial (almost 50%) discount to NAV (see Chart 6). Even after a recent rally this is around 1 standard deviation wider than its 14 year average.

The COVID-19 pandemic initially raised concerns over the ability of occupiers to pay rents or even remain solvent. This lowered cash flow growth forecasts and values. As economies have gradually re-opened rent collections in emerging markets appear to have held up better than anticipated thanks to various government stimuli. As noted from the examples above this has created a dislocation between underlying physical real estate values and listed real estate stock prices that remain depressed. Real estate is one of the more COVID-19 sensitive sectors which explains why listed emerging market real estate remains 20% below end 2019 levels.

In November emerging market real estate started to recover in relative terms as vaccine prospects improved. If the vaccine rollout is a success then the real estate sector should continue its relative outperformance. Whilst it would be foolish to become completely complacent given the risks to a successful global vaccine rollout, we continue to believe that current values are compelling. This is particularly so when one considers the long term tailwinds for the asset class, namely urbanization and a growing middle class remain intact. Studies by the UN show that approximately 55% of the global population today are city dwellers. By 2050, the study predicts 68% of the global population will reside in cities. A 13% increase doesn't seem significant until we examine the underlying numbers. The UN studies estimate that from 2017 to 2050 the world's population will grow by nearly 30% with 2.5bn more people living in urban areas – an increase of 60% from today. The majority of this growth will occur in emerging markets (Chart 7). It is therefore key for cities in these regions to have the right infrastructure from a transportation, education, healthcare and housing standpoint to help them attract a diverse group of businesses and global talent to enable them to become key cities of the future.

Chart 7: Rising EM Urbanization Trends

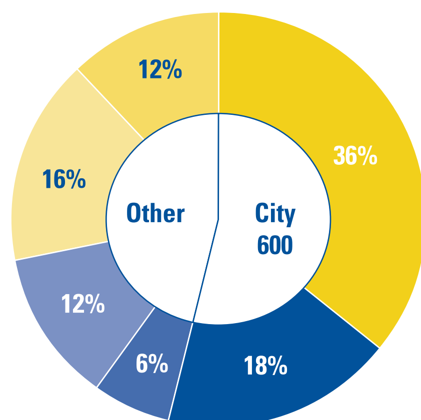


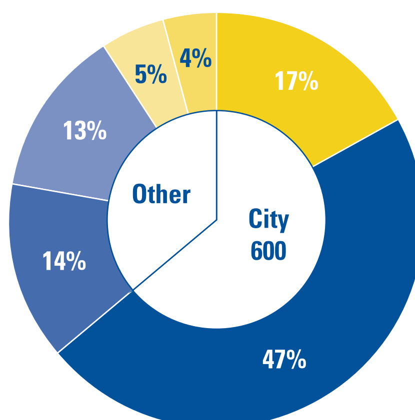
Source: UN, World Urbanization Prospects 2018 revision.

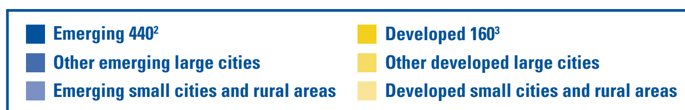
A past study by the McKinsey Global Institute also highlights the importance of emerging markets in the future (Chart 8).

Chart 8: Emerging 440 Cities are Poised to Deliver Close to Half of Global GDP Growth

Contribution to Global GDP and GDP Growth[1]







[1] Global GDP and GDP growth figures include 2,600+ large cities in Cityscope, as well as smaller cities and rural areas.
[2] The Emerging 440 is 443 emerging market cities in City 600.
[3] The 157 developed market cities in City 600.
[4] Real exchange rate (RER) for 2010 is the market exchange rate. RER for 2025 was predicted from differences in the per capita GDP growth rates of countries relative to the United States.

Source: McKinsey Global Institute Cityscope 2.0

The title in Chart 8 is highly relevant. It shows that although 64% of GDP in 2010 was generated by developed cities, between 2010 and 2025 it is estimated that 74% of GDP growth will come from emerging cities. This reinforces our view that we will continue to see emerging market cities enjoy faster growth than their developed equivalents. This in turn will drive international recognition of their property markets, leading to above average rental and capital growth from relatively low levels. A good example of this is Mexican industrial real estate where a significant amount of prime assets are leased to multinational companies paying rents in US Dollars. However, rents are significantly behind those in US urban centres (CBRE Q3 2020 data shows rent per sq ft in the Greater Los Angeles area at $10.92 compared to Mexico City at $6.46). The value of the assets also differ significantly with the LA area priced off cap rates (yields) of 3.75% to 4.25% compared to 7.0% in Mexico City (CBRE Q3 2020). Therefore, over time as the trends between developed and emerging countries converge there is a greater opportunity for rental and value growth from emerging markets.

Conclusion

In summary, we remain cognisant that vaccine deployment may take time, and the pandemic may still restrict mobility for a number of months. However the end game is within sight and we believe the disconnect created between listed and physical emerging market real estate represents a compelling investment opportunity.

CLIM is well positioned to take advantage of the prevailing value with an experienced REIT Team and a strong track record in both International and Emerging Market REITs.

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