A Good Time to Invest in Emerging Markets Listed Real Estate

CITY OF LONDON
Investment Management Company Limited

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Executive Summary

- *Real estate is attractive to investors concerned about inflation risks*
- *REIT pricing indicates valuations to physical real estate are attractive*
- *Long term structural tailwinds for EM Real Estate remain intact*

As I put pen to paper I have a distinct feeling of 'Groundhog Day'. I wrote a piece titled 'An Opportune Time to Invest in Emerging Markets Listed Real Estate' in early February 2021, and with the pandemic lasting longer than most people envisaged I feel this observation still holds.

At the forefront of investors' minds today, almost inconceivable twelve months ago, are the inflationary pressures driven by higher commodity prices and supply bottlenecks. Developed Markets (DM) were much quicker to rollout vaccination programs allowing, in most cases, their economies to reopen faster than their Emerging Market (EM) counterparts. This in turn led to a surge in DM consumer demand that was unable to be met by the EM manufacturing economies that remained under significant restrictions. However, vaccination levels in EMs have at last caught up - this is gradually alleviating supply bottlenecks.

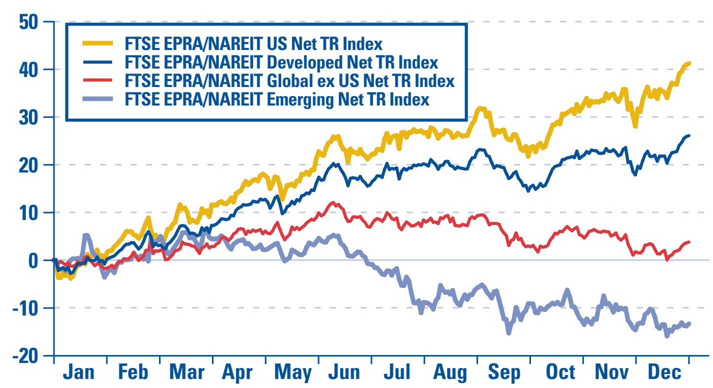
Twelve months on, EM real estate has remained subdued as wave after wave of COVID-19 hampered the recovery. However, as vaccination levels reach meaningful levels investor confidence in a sustainable reopening of emerging markets will ensue, leading to a rebound in listed real estate stocks. Meanwhile, the US REIT market has already significantly rebounded as the US economy bounced back earlier from the pandemic, and now looks relatively expensive versus history. With US monetary policy moving into a tightening cycle the outlook for US REITs is now less favourable.

Delving deeper into EMs, China has created a significant drag on EM listed real estate as the 'three red lines' policy implemented by the government at the end of 2020 highlighted risks on Chinese developers' balance sheets. The principle was right, encourage a de-risking of over-levered developers balance sheets. However, the execution was heavy handed and investors have penalised the higher levered companies, causing knock on effects that have culminated in forced refinancing and technical defaults. This led to fears of contagion across the whole Chinese banking system and residential market. Notwithstanding the government intervention we continue to believe the higher quality, lower levered developers are good value and will benefit from reduced competition going forward.

More recently we have seen the terrible events of the Russian invasion of Ukraine. The direct implications for the EMREIT Fund at present seem minimal as it has no exposure to either country. However, we don't yet know what the longer term implications will be if there is a prolonged war and sanctions against Russia continue to build. We will continue to closely monitor the potential knock on effects that higher commodity prices and slower growth might have on the world's economies, and its effects on real estate. Conversely, there would be a number of commodity exporting countries in EM that could benefit from elevated commodity prices.

Chart 1 below plots the performance of a number of listed real estate indices over 2021. The FTSE EPRA EM NAREIT index[1] fell 13.4% in US dollar terms, a significant outlier versus most risk assets and versus the US REIT index the EM index underperformed by approximately 55%. We believe this can be attributed to less EM fiscal and monetary stimulus, the slower reopening of EM economies and weaker sentiment towards EMs in general, particularly China. The difference between the US and rest of the world is also well illustrated in Unbail Rodamco's 2021 results presentation. They report their shopping malls saw no closures in the US in 2021 compared to 94 days in Europe and 69 days globally. This, in our view explains much of the difference in performance between the developed (global including US) and global ex US (international) in Chart 1.

Chart 1: Divergent Performance of Key REIT Indices During 2021



Source: Bloomberg, December 2021

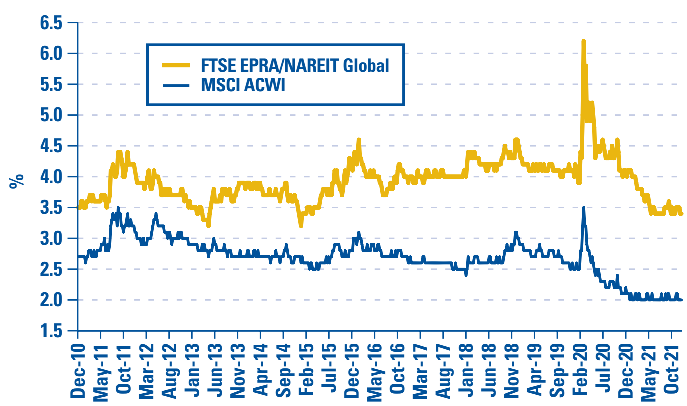
The Value Opportunity….

In the long run, listed real estate/REITs will trade in line with their underlying physical assets whilst 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 EM listed real estate companies are trading at historically wide discounts offering an excellent entry

1 The FTSE EPRA/NAREIT Emerging Net TR Index is designed to track the performance of listed real estate companies and REITs in emerging markets. The index is free-float adjusted and market capitalization-weighted and constituents of the index are screened on liquidity, size and revenue. Index returns subject to change due to restatements by index vendors in the historical index levels.

point to the asset class. Listed real estate dividend yields also look attractive compared to the broader equity market (see Chart 2).

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



Source: Bloomberg. Bloomberg estimates for forward 12M dividend yield. December 2021

In our view the most effective way of measuring the appeal of listed real estate is to look at three important elements; first, the 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 usual real estate cycle sees strong economic growth and easy money leading to over exuberance and significant levels of speculative development. Monetary tightening to cool the economy typically follows. Ultimately, this ushers in a recession causing reduced demand for space, 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. Through the pandemic we saw vacancy levels pick up globally, except for Industrial real estate. However, although supply has recently increased as developers re-start projects we have also seen increased demand for space. Jones Lang Lasalle reported positive net absorption of office space for the first time since the beginning of the pandemic in Q4 2021 across the US, Europe and Asia Pacific regions.[2] 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 EM residential prices should follow.

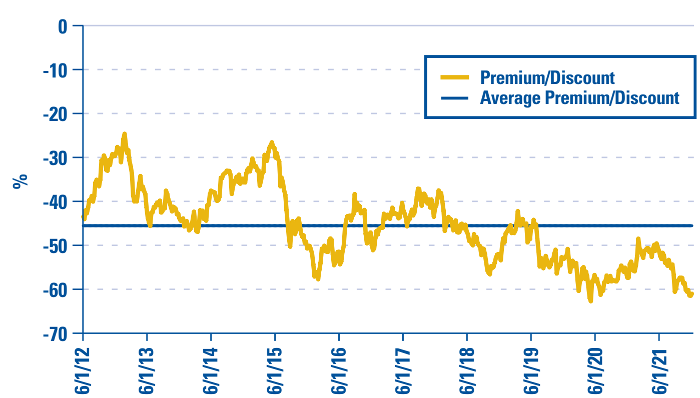
Silver Linings in the Macro Backdrop....

While the expected monetary tightening by the Fed may weigh on asset prices in general, we note a number of positive drivers to the public health and economic backdrop in EM. First, EM countries have sped up the vaccination rollout over the past six months. As of end-January, countries including the UAE, South Korea, China, Malaysia, Taiwan, Brazil, Turkey, Thailand and Saudi Arabia had administered more COVID-19 vaccine doses per capita than the US. High vaccination rates make EM economies less vulnerable to future outbreaks, lockdowns and supply chain disruptions. Second, the re-openings in Southeast Asia for example should contribute to greater emerging markets trade and economic growth in 2022. Third, China is marginally relaxing its hard-line real estate sector policy in order to contain the economic slowdown. Finally, real estate can be an effective inflation hedge with built-in annual rental escalators in a number of markets. This led to record investment into global, direct real estate in 2021 according to Jones Lang Lasalle, and they expect to see significant investment demand in 2022.[2]

Why Listed Real Estate/REITS?....

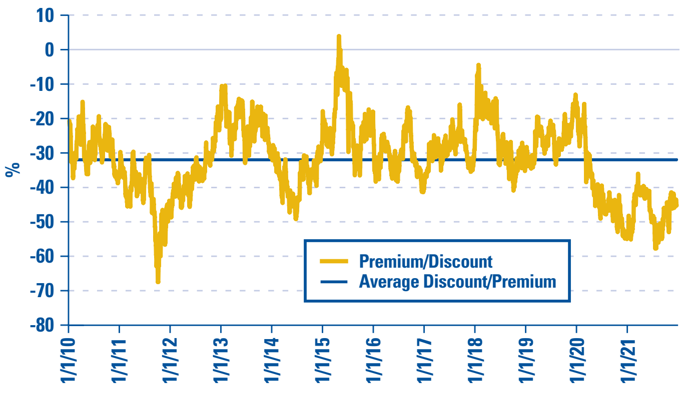
Finally, looking at the pricing of the listed sector, we still see significant dislocations between listed real estate share prices and the underlying physical real estate fundamentals. It is difficult to find a one size fits all approach for valuing listed real estate companies as each local market demands a focus on different valuation metrics. However, if we look at the trends in price to book (P/B) we note it remains approximately 19% lower today than the average in 2019. The pricing discount becomes more obvious when we examine individual countries and companies. For example China and Hong Kong stocks trade at significantly larger than average discounts to NAV. Continued COVID-19 restrictions in Hong Kong and developers' debt issues in China, discussed above have created these wider than average pricing dislocations even for the high quality names such as Sun Hung Kai Properties Ltd and CR Land (Charts 3 & 4).

Chart 3: Sun Hung Kai Properties Ltd NAV Premium/Discount



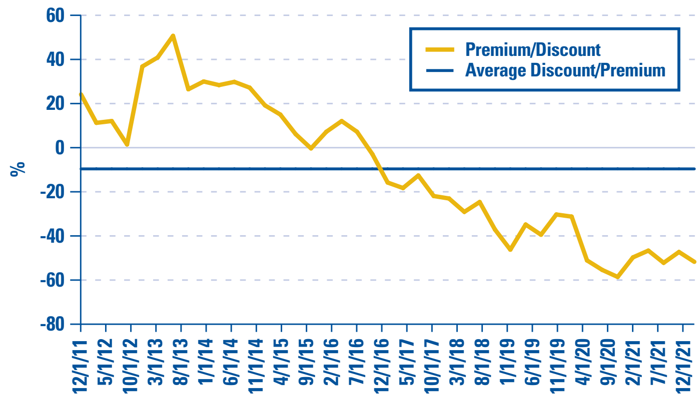
Source: DBS, Bloomberg, December 2021

Chart 4: CR Land NAV Premium/Discount



Source: DBS, Bloomberg, December 2021

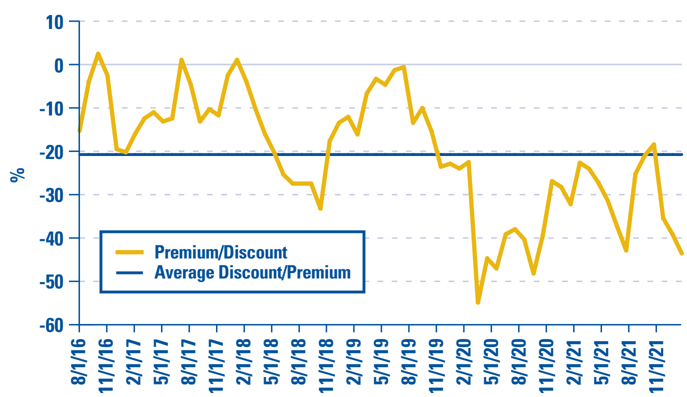
Chart 5: Fibra Uno NAV Premium/Discount



Source: Fibra Uno, Bloomberg, December 2021

It is also worth highlighting the significant opportunities we see on a bottom-up basis. Looking at Mexican REIT Fibra Uno first in Chart 5. We note it trades at a 55% discount to NAV, close to a decade high. The REIT has improved its sector mix dramatically over the last few years and is now positioned with a 32% allocation to industrial properties, 34% to high quality retail and 23% to prime office space in Mexico. Their competitive leasing strategy has resulted in excellent occupancy rates through the pandemic. Industrial has outperformed due to near shoring of manufacturing for the US, and strong growth in e-commerce. Their retail portfolio has also started to rebound as COVID-19 restrictions have been relaxed. The Office sector is the only weak spot in the portfolio due to supply issues, but they have signed a number of large tenants onto longer leases during the pandemic and are starting to see small tenants returning. With excellent economies of scale, staggered debt profile, conservative rents, attractive dividend yield and accretive development pipeline we see the company very well positioned to increase its NAV going forward, and narrow its discount to NAV. In Chart 6 we show the NAV discount of Indonesian property specialist Pakuwon Jati TBK Pt. NAV discount volatility over the last couple of years has resulted from waves of COVID-19 restrictions and re-openings weakening investor sentiment. This company is the largest Indonesian listed property company with a high quality retail portfolio and strong residential development track record. Indonesia has clearly been deeply impacted by COVID-19 and the slow rollout of vaccinations. However, it is also a beneficiary of strong commodity prices, and should benefit from the Omnibus Law passed by President Jokowi just before the pandemic hit in early 2020. Pakuwon's investment portfolio makes up half its recurring earnings, and although rents dropped by a third during the pandemic, and rental relief was given to a number of retail tenants, we see rental income rebounding strongly as a sustained reopening of the economy takes hold. We also see a continued recovery in residential sales as incomes recover given a significant percentage of the workforce benefit from strong commodity prices, etc.

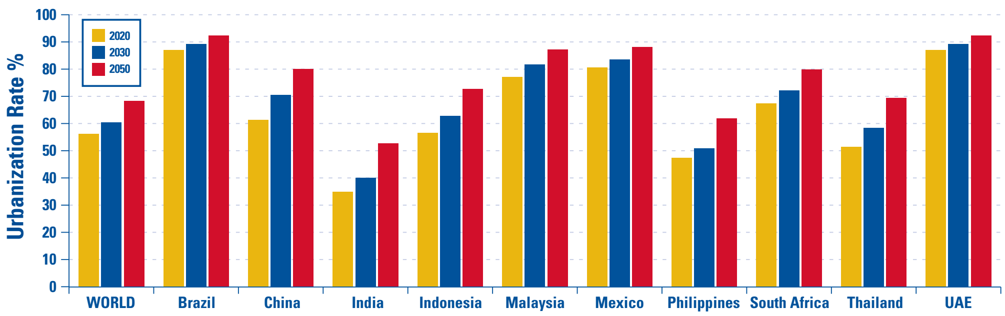
Chart 6: Pakuwon Jati TBK PT NAV Premium/Discount



Source: DBS, Bloomberg, December 2021

As the world adapts to an endemic virus we 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 56% of the global population were city dwellers in 2020. By 2050, the study predicts 68% of the global population will reside in cities. A 12% increase doesn't seem significant until we examine the underlying numbers. The UN studies estimate that from 2020 to 2050 the world's population will grow by nearly 30% with 2.3bn more people living in urban areas – an increase of over 50% from today. The majority of this growth will occur in EMs (Chart 7). It is therefore key for cities in these regions to have the right transportation, education, healthcare and housing infrastructure to ensure they attract a diverse group of businesses and global talent enabling them to become key cities of the future.

Chart 7: Rising EM Urbanization Trends



Source: UN, World Urbanization Prospects: 2018 Revision

Conclusion

In summary, 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 EMs appear to have held up better than anticipated thanks to various government stimuli. In my view listed real estate pricing has not caught up with these improving fundamentals, creating a dislocation between underlying physical real estate values and listed real estate stock prices. I believe this represents a compelling investment opportunity.

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

Guy Mountain (Head of Real Estate Investment Trusts)

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