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A snapshot of real estate between today and tomorrow: risks and opportunities for investors

Real estate

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Davide Girino

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1. Introduction

Historically, the real estate industry has been often seen as one of the slowest when it comes to react to disruptive changes and demand for innovation (Forbes, 2022). Nevertheless, the test bench provided by the last recent years have inevitably forced the sector to come up with smart solutions to avoid big losses and staying on track with pandemic concerns and the changes in stakeholders' needs and perception of value. This report aims to introduce real estate as an asset class while discussing its current challenges, trends and possible opportunities.

2. Real estate investing until today

There are different ways to invest in real estate and, likewise, more subclasses of real estate as well. As for these latter, a common classification (source: Corporate Finance Institute, 2022) distinguishes between:

- Land: the basic. It's the term used to refer to investing into undeveloped, vacant lands, combine them with others next to those and eventually "rezoning"[1] the resulting property. By doing so, investors aim to increase the value and marketability of the land.
- Residential: core business is the provision of housing in different forms (single-family homes, flats etc.) to cater to the demand of one of more segments of the market (e.g individuals, families, students)
- Commercial: it regards any building businesses may use to deliver their product/service to end-users (retail real estate), and offices. Some examples are hospitals, hotels, parkings, stores.
- Industrial: for lands and buildings used by industrial businesses for production, R&D, logistics, warehousing and any other type of intermediate activity.

Similarly to stocks of companies from different economic sectors, also these categories of real estate have their own specific drivers behind their performance. A clear example is offered by the consequences of the pandemic: as work-from-home became necessary during lockdowns, real estate investors with a strong exposure to offices have had to quickly find a new tenant base or otherwise

[1] In jargon, to rezone means to assign a land or property to a different category of restrictions on use and development

suffer considerable losses (Forbes, 2022). The same applied to retail stores landlords, due to a shift towards online shopping which has been accelerated by the COVID-19 outbreak and is still persistent, at least partially. By contrats, instead, industrial properties benefitted or at least recovered from the shock more rapidly, with those plants and spaces left unused promptly converted in storages for delivery businesses (Forbes, 2020). Figure 1 highlights this.[2]

Even today, with the pandemic hopefully fading, the currently spreading transition from 5- to 4-days workweek and a more hybrid working regime is likely to favor relatively new players such as suppliers of flexible workspaces, for example IWG or WeWork, provided they manage to keep an optimal occupancy rate and acceptable running costs to overcome periods of lower demand in a more volatile market. Industrial real estate performances may be further fueled by the rise of "gig" economy businesses and companies in need for large spaces, such as warehouse buildings, for their core operations. For example, dark kitchens and storage demanders such as Deliveroo or Gorillas are a new type of customer for commercial real estate firms, which add heterogeneity to the clientele base and may also put upward pressure to rental prices and offset a possible fall in demand by giants such as Amazon, should a decrease in online shopping occur (Financial Times, 2022).

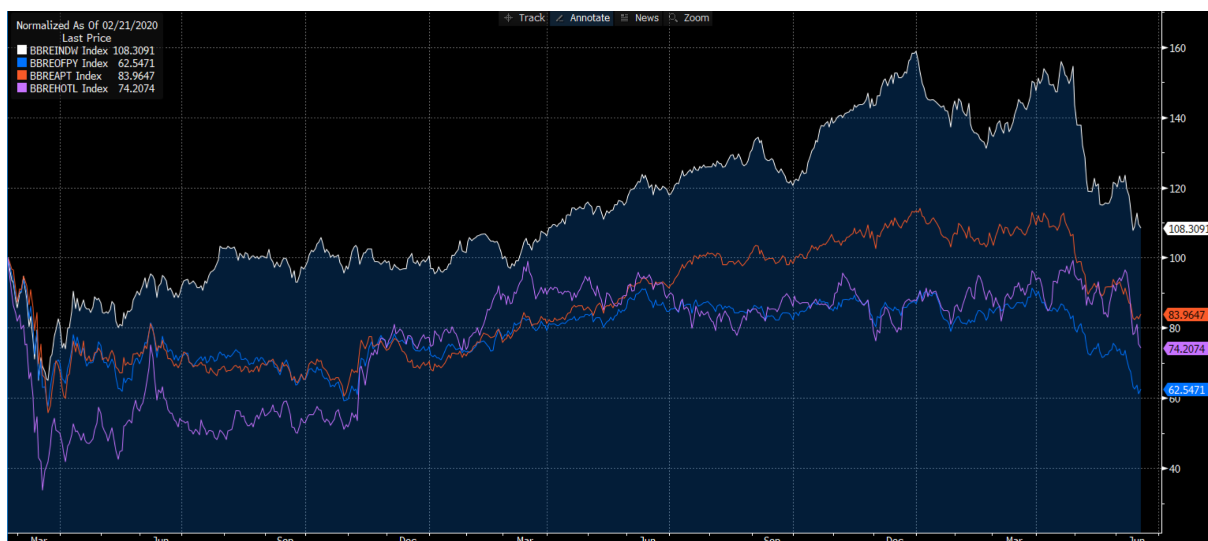

Figure 1. Source: Bloomberg.

[2] The white, blue, red and purple lines are respectively the returns of the Bloomberg REIT Industrial/Warehouses, Office, Apartment and Hotel Indexes, normalized as of February 21st 2020, one of the last days before the start of the crisis.

Besides type of property, real estate investing can also be divided into equity and debt, direct or indirect and securitized versus unsecuritized. While “equity” refers to having control over the ownership of a property and is probably the most well-known way of investing in real estate, debt real estate defines the investments in mortgages and mortgage-backed securities issued to finance the purchase or construction of a building by a third party, either an household or another entity (source: Nareit). This difference is also they item to distinguish between equity real estate investment trusts (EREITs) and mortgage REITS (mREITS). These are companies that, by abiding by specific regulatory requirements, can act similarly to mutual funds, with a specific focus on property. They can be classified as a form of indirect, securitized real estate asset: their shares are usually traded on public exchanges, and thus get investors benefit from a generally higher degree of liquidity compared to far larger-scale investment in a directly owned building. Thus, REITs represent a way for both large and small investors to manage risk more effectively through more marketable assets. According to Nareit, they historically provided competitive total returns thanks to dividends and long-term capital gains.

REITs Provide Competitive U.S. Returns over Extended Historical Periods

	1-year	3-year	5-year	10-year	15-year	20-year	25-year	30-year	35-year	40-year
FTSE Nareit All Equity REITs	32.80	11.97	8.10	10.29	7.67	10.48	10.59	11.13	10.20	11.51
FTSE EPRA/Nareit Developed	34.83	7.39	5.97	7.29	5.32	8.83	7.97	8.80	N/A	N/A
Russell 1000 (Large-Cap Stocks)	43.07	19.16	17.99	14.90	10.89	8.90	9.96	10.95	10.95	11.81
Russell 2000 (Small-Cap Stocks)	62.03	13.52	16.47	12.34	9.51	9.26	9.33	10.65	9.64	10.46
Bloomberg Barclays US Aggregate Bond	-0.33	5.34	3.03	3.39	4.43	4.56	5.14	5.65	6.10	7.58

Figure 2. Source: Nareit.

REITs also prevent investors from being burdened by administration, maintenance and contract enforcement-related duties which, together with illiquidity and higher financing risk, are the biggest drawbacks of direct property investments. By contrast, choosing REITs over direct ownership comes at the cost of renouncing to a range of possible tax deductions for taxpayers owing a building. Moreover, shareholders do not have control over the investment strategy of the trusts, which usually make use of a quite high degree of leverage. The current rising rates environment may be harmful especially for those investments with higher debt-to-equity ratio, and Figure 3 seems to show that the downward pressure on real estate returns by a tighter monetary policy is indeed get the better of inflation, against which this equity real estate is commonly considered an effective hedge.

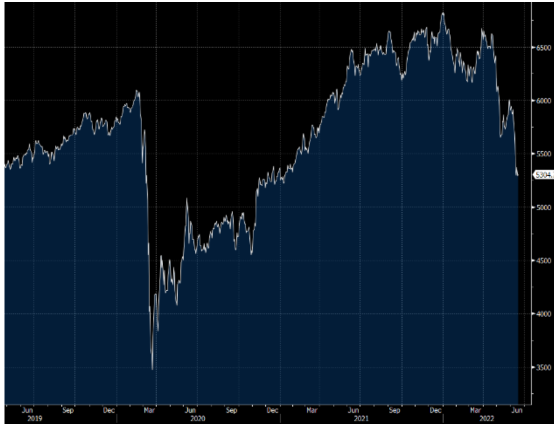

Figure 3. FTSE EPRA NAREI Developed USD Total Return Index. Source: Bloomberg.

Given that Salisu et al. (2020) confirm that, differently from gold, real estate proved to be a good protection against increasing prices even after the Great Financial Crisis, a possible reason for this lack of protection todays is provided by Hudson-Wilson et al. (2003,2005). According to them, a) this hedge exists only against *unexpected* inflation, different from the one today's market has probably fully priced in, and b) a distinction must be made between past and current inflation: the former should generally benefit all the real estate markets, as building end-users have the time to get their income adjusted for inflation, too. The latter, on the other hand, will positively impact only those markets in which current higher financing costs can be most passed through to end-users of the building. This happens especially in the retail markets, where eventually sale prices of products can be adjusted more rapidly by private companies compared with the salaries with which households could, for example, afford a higher rent in the housing real estate market.

Hudson-Wilson et al. and Seiler et al. (1999) point also out that there is difference in the degree of hedging benefit between direct investments and REITs, with this latter being less effective because they are more linked and influenced by the broader stock market.

Lastly, from a portfolio management perspective, Young and Graff (1995) suggest that the distribution of returns in the real estate market is not Normal: skewness and magnitude of real estate asset specific risk changes over time, and proper diversification is far less easily achievable and would require holding way more properties than in the case of stocks and bond portfolios. Seiler et al. (1999) add that direct ownership returns are indeed low correlated with other asset classes and, due to lags in valuation caused by lower liquidity, can be predicted by REIT returns.

3. New opportunities: proptech

We have discussed examples about how economic cycles, one-off events and financial markets condition can affect the profitability of investing in real estate. These three factors have already been

covered by extensive research: besides inflation, from the studies by Case et asl. (2000) and Zhu (2003) it results that real estate are both determined and a determinant by/of the state of the economy, and thus are generally characterized by a large amount of systemic risk too. Changes in gross national product values turn up to have a deciding role in them and are also responsible for most of the high correlation between international property markets: despite properties around the world are not perfect economic substitutes due to locational specificity, real estate thus seems to be a bet on fundamental economic variables which are correlated across countries. Today's degree of securitization likely contributes to this comovement. Real estate itself, then, influences the economy due to the usual high exposure commercial banks have to it, by issuing mortgages and loans backed by real assets.

Nevertheless, a unique and potentially disruptive change in this asset class in currently in place and is still to completely understand. The rise of emerging technologies also touched this sector, and this resulted in proptech, the real estate branch of fintech. Industry stakeholder may benefit from massive implementation of home matching tools, drones, virtual reality, building information modelling (BIM), data analytics tools, artificial intelligence (AI), Internet of Things (IoT), whose combinations have the potential to improve productivity and competitiveness and to better shape the sector in line with growth and even sustainability goals. The possible consequent increases in transparency and informational efficiency can enable buyers, tenants and investors to make better allocational decisions and by sellers, builders and tenants again (Siniak et al., 2020).

For investors, platforms run by startups like Cadre and Walliance lever on the growing interest in crowdfunding and act as a point of contact between companies in need for money to finance their deals in properties and investors willing to finance them in return for a good profit. These platforms' role is to improve transparency by providing the broadest set of information possible to investors. A potential positive externality of theirs is to become an alternative to traditional bank, bond or equity funding for capital takers, and at the same time a new way to invest even affordable, small sums in real estate while avoiding the cross-asset correlation that characterizes REITs but without renouncing to a satisfactory level of liquidity provided by secondary market services offered.

This report offered a snapshot of the state-of-art of real estate in terms of current market conditions and research. Less widely known than equity and bonds, this asset class has the advantage of offering good protection to inflation and being low correlated with the former two, under certain conditions. The rise of proptech can improve accessibility to the purest kind of these investments also to small investors. Despite this evident benefit of technology, also some concerns should be taken into account at the end: as for the labour market, an increased use of the human workforce demand, e.g. as for property valuators if artificial intelligence becomes more used. Still to verify, moreover, which steps will regulators make to protect small and non-professional investors from inadvertently taking too much exposure to an asset class they may be poorly informed about.

Similarly to many other applications of fintech, the future is still very unknown, but surely interesting.

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