VIEWPOINT

FOUR QUADRANTS

CBRE

EMEA CAPITAL ADVISORS

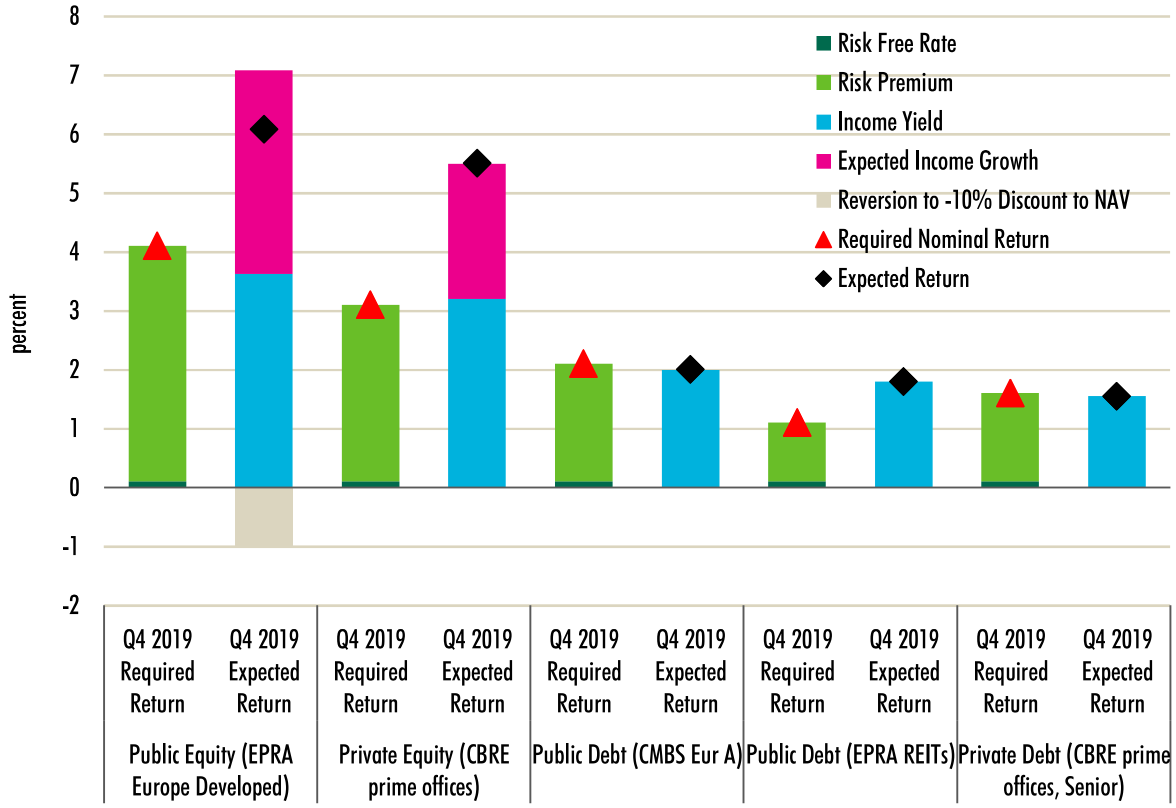
Relative Value

After an extended period of turmoil, it is now the case that across the four quadrants there is a decent level of stability in pricing, which can allow us to assess, on a basic level, the relative attractiveness of each form of exposure to real estate. Below, we show the results of a simple pricing model which uses a few basic inputs to highlight where relative value may lie.

For each of the four quadrants, we calculate required return as the sum of the risk free rate and a risk premium. This latter is somewhat arbitrarily arrived at: we begin by assuming that ungeared direct real estate should give a return of 3% above the risk free, and adjust from there with reference to relative volatility, exposure (e.g. level of LTV) and liquidity of each quadrant. It can therefore be adjusted to suit different views. The next step is to estimate expected return, which we accomplish by combining starting yield from available data, and (where applicable, on the equity side) expectations of growth, which we take from our forecasts (adjusting these to reflect the impact of gearing on public equity). Where this exceeds required return, an investment may be said to be good value; where it does not, it may be classed as poor value.

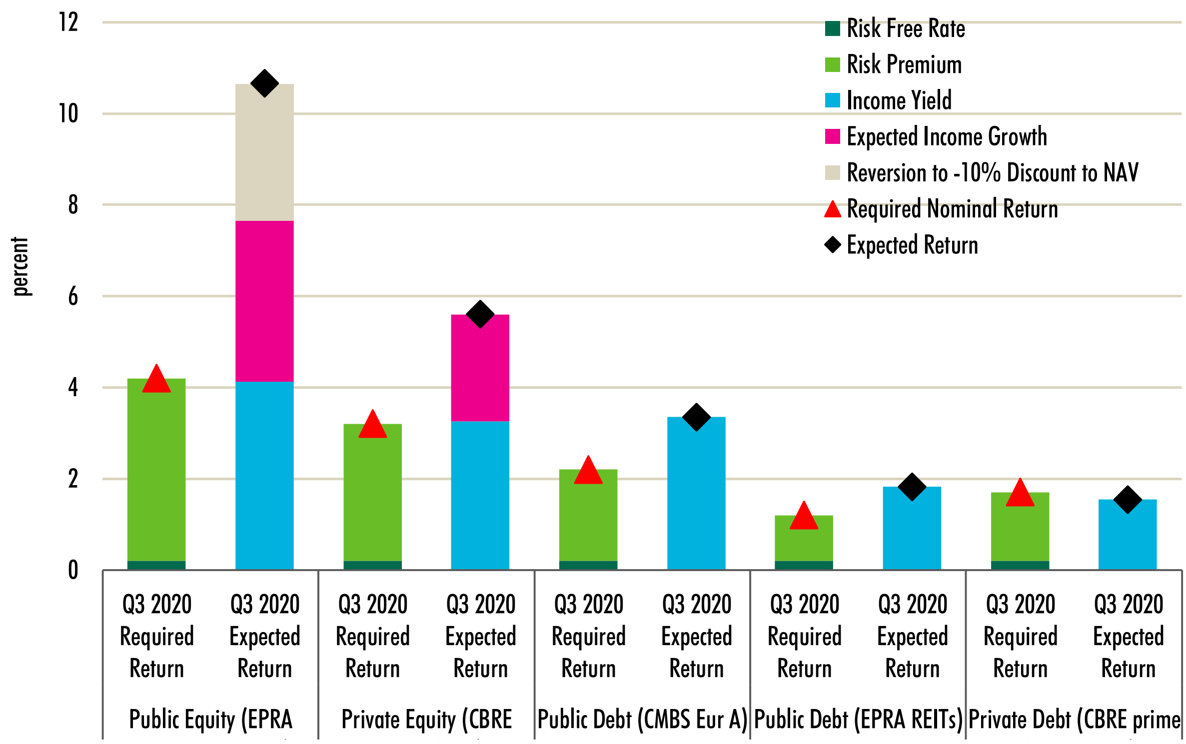
The outputs of the model are shown for Q4 2019 and Q3 2020 in Figures 1 and 2 respectively, and the relative value summary (showing expected minus required return) is shown in Figure 3. Note: we have used two methods of public debt exposure – CMBS and corporate (REIT) debt.

Figure 1: Relative value of four quadrants, Q4 2019



Source: CBRE Research, EPRA, BofA Global Research

Figure 2: Relative value of four quadrants, Q3 2020

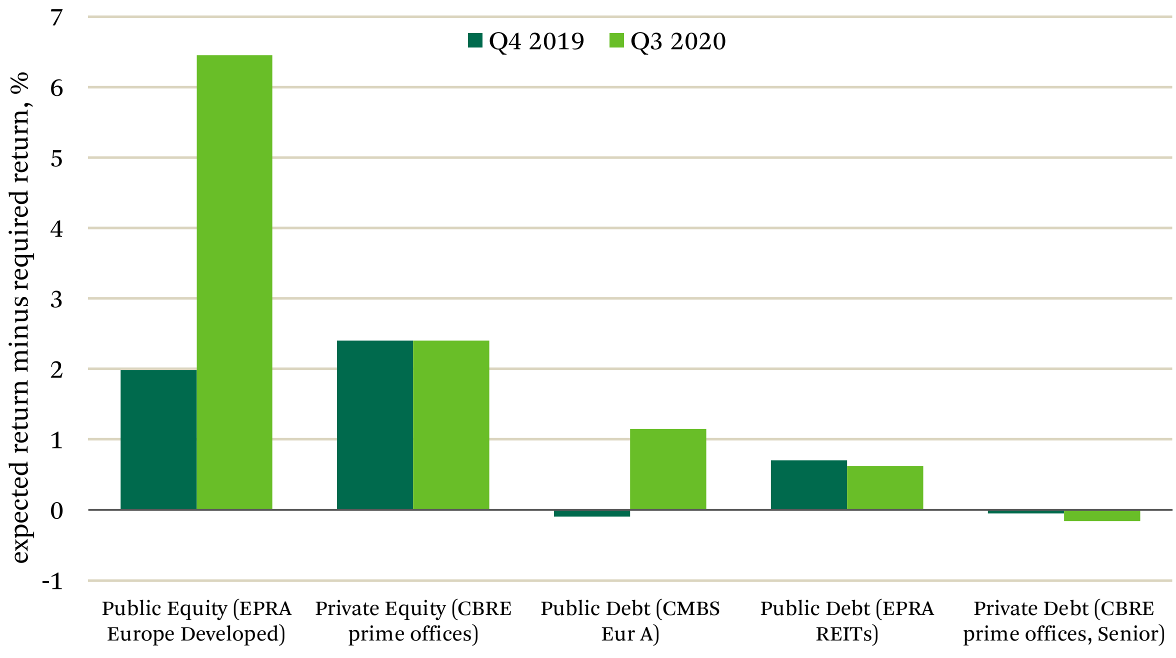


Source: CBRE Research, EPRA, BofA Global Research

As at the end of Q3 2020, our model suggests that greatest value is to be had on the equity side. Public debt also appears to offer good value, while private debt is roughly fairly priced.

- The expected return on **public equity** (here assumed to EPRA Developed Europe) exceeds required return by some 6.5% at the end of Q3 2020, up from 2% at the end of 2019. It should be noted however that the bulk of this turnaround comes from our assumption that the discount to NAV will revert to its long-run average of -10% over a five year hold period; at Q3 2020 this boosts expected returns by 3% per year, having cut them by 1% per year at Q3 2019. Without this assumption, excess performance would be 3.5% at Q3 2020.
- There has been no change in the extent to which **private equity** (here assumed to be a prime office portfolio in London, Paris, Frankfurt, Amsterdam, Madrid and Milan) expected returns exceed required returns; the level of out-performance has held at 2.4%, and is entirely a function of expected income growth, the initial yield essentially matching the required return (a comforting thought for cautious investors not willing to underwrite growth).
- On the **public debt** side, REIT issued corporate debt offers an additional return above expected return of 0.6%, half that given by A-grade CMBS, at 1.2%. CMBS's relative value position has improved (as spreads have widened) since Q4 2019.
- For **private debt** (assumed to be senior debt on a prime office portfolio in London, Paris, Frankfurt, Amsterdam, Madrid and Milan), expected returns at 1.54% are a shade below required returns at 1.70%, but the difference is marginal and given the margin of error in the model can probably be ignored.

Figure 3: Change in relative value of four quadrants, Q4 2019 and Q3 2020



Source: CBRE Research

While basic, this model should give investors across the quadrants comfort that the returns they will receive are at the very least fair and more likely better than that. Of course, this is a high level approach and conclusions may not apply in all sectors and for all assets within each quadrant. But at the broad level, now would appear to be a favourable time to consider exposure to real estate whatever the means of entry.

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