Global Property Securities 2016 Outlook

Global property securities have delivered strong positive returns to investors in recent years. Improving economic activity levels, accommodative central bank policies and low funding costs have provided a positive backdrop for these stable, income generative assets.

This paper will examine the outlook for the world's main listed property markets for the year ahead. We expect returns to vary by market, with some regions performing more strongly than others; global property securities have historically generated returns with low correlations between different regions.

Underlying fundamentals in the UK and the US remain supportive. Tenant demand is healthy and vacancy rates are low. Levels of supply in many markets are relatively tight, as modest rental growth and lingering global growth rate concerns have dampened speculative demand.

It is important to note that robust capital markets have inflated direct property valuations to very high levels. Direct property is currently being priced off unusually low internal rates of return. We believe the risk of direct property bid/ask spreads widening is increasing. This would lead to sparser transactional evidence, resulting in an initial flattening and then possibly a re-setting of direct property valuations.

Valuation multiples suggest that property securities currently offer higher relative returns than direct property markets. Specific instances of more reasonable risk-adjusted expected returns are becoming increasingly prevalent within listed markets. However, the outlook for property securities should be considered within this context.

US

The US represents approximately half of the global property securities investment universe by market capitalisation, making it an important driver of asset class performance overall.

The US Federal Open Market Committee raised interest rates by 0.25% in December; its first increase in nine years. Further rate rises are expected in 2016, following a cautious and gradual path. The income generative nature of property securities makes them sensitive to changes in long duration interest rates; higher rates can put pressure on property securities' capitalisation rates. However, property securities' performance is also influenced by other drivers including financing availability; the availability of assets to buy; and the increasing levels of economic activity implied by rising rates. It is a common misconception to assume property securities cannot perform well in a rising rate environment – provided that higher rates are reflective of accelerating economic growth.

US economic fundamentals are sound. GDP is forecast to grow by 2.5%[1] in 2016. Five consecutive quarters of economic growth have enabled the unemployment rate to drop to 5% as at November 2015; close to levels seen prior to the 2008 financial crisis, and a significant improvement on the near 10% rate seen in late 2009[2]. Robust employment growth augurs well for the real estate market.

Occupancy rates have improved alongside employment growth and are now at high levels. Upward pressure on rents is unlikely to moderate in the near term, due to limited levels of new supply in the pipeline. Furthermore, operating expenses on the whole are trending only slightly higher than inflation, resulting in improving operating margins and enabling average property Net Operating Income growth to outpace nominal GDP growth.
Valuations have recently become more supportive; US REITs are now trading at an average discount to Net Asset Value of around 10%, and have forecasted Funds From Operations growth of 7% and 8% in 2015 and 2016 respectively[3].

Looking ahead to 2016, the prospects for coastal office markets, Class A malls and gateway city apartment buildings appear particularly favourable. These subsectors are relatively attractively valued compared to private market valuations. They also have robust earnings growth outlooks and significant exposure to an improving U.S. economy. The office subsector is benefitting from consistent employment growth and modest levels of competitive new supply. The apartment subsector is benefitting from willingness amongst the millennial generation to rent; and from rising house prices in coastal gateway cities which make renting an increasingly appealing option. The resilience of the US consumer and enduring tenant demand for high quality sites should be supportive of Class A US malls, despite the growing popularity of e-commerce.

1. Bloomberg consensus
2. US Bureau of Labor
3. UBS

UK

Property market fundamentals continue to improve in the UK. Tenant demand in the London office market is particularly keen – anecdotal evidence suggests that it is now stronger than in recent previous property cycles – and is outpacing other UK regions. Vacancy rates in London are at 15 year lows[4], and are expected to remain at very low levels given the lack of material new supply that is anticipated before 2018-19 at the earliest.

Rental rates for 'A' grade office buildings in both the City and West End are currently growing at double digits. We believe we are only part way through the current 'sweet spot' for rental growth, due to ongoing tenant demand and low current supply of A-grade office space.

Buoyant capital markets have driven up capital values, meaning that future valuation uplifts are likely to be more modest. The vote on whether Britain should exit from the European Union may be scheduled for mid-2016; earlier than initially expected. This could represent a risk factor to London's investment case. However low vacancy rates; strengthening rental growth; and growing earnings are likely to remain supportive of UK property securities in the year ahead.

Japan

The Japanese economy remains split between the weaker household sector and the healthier corporate sector. Although GDP growth remains weak (Japan narrowly avoided recession in the third quarter of 2015), zero interest rates and a significant Quantitative Easing program from the Bank of Japan are proving supportive of domestic property securities.

Central Tokyo office markets continue to strengthen. Vacancy rates have been falling for 2 years and reached 4.3%[5] in November; with demand for space being driven by a range of industries. Occupancy rates are now reaching structurally high levels. The residential market has continued to strengthen with high contract rates throughout 2015 and inventory at very low levels. Central Tokyo condominiums are seeing sustained price growth, though suburban Tokyo prices are flatter. Importantly, developer margins have remained robust. Investment demand for J-REITs is also high as strengthening fundamentals and aggressive bank lending incentivise domestic pension funds, listed J-REITs and private funds to actively buy property.

The scope for further capitalisation rate compression appears limited from current levels given current elevated levels; however ongoing macroeconomic stimulus measures should remain supportive.

China / Hong Kong

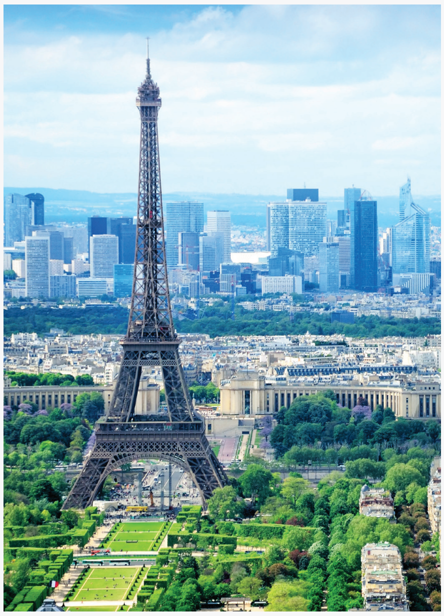
The People's Bank of China continues to stimulate activity by easing monetary policy. In October the 1-year lending rate was reduced to 4.35%; the Required Reserve Ratio for major banks was cut by 50 basis points to 17.5% and the 1-year deposit rate was cut to 1.5%. In spite of these measures the domestic economy is expected to continue to slow in 2016.

New housing sales volumes have responded positively to macro stimulus and fewer policy restrictions. However, housing price growth remains subdued in Tier 2 and Tier 3 cities, where developers are still clearing old inventory. The operating environment is expected to remain volatile for property developers.

In Hong Kong, a steady reduction in visitors from mainland China and weaker domestic consumption growth trends pose a potential downside risk to the retail sector. The Hong Kong government is expected to maintain an interventionist stance towards the residential sector. The anticipation of higher interest rates and worsening affordability has given the residential sector a subdued outlook.

In contrast, the 2016 outlook for the office market in Hong Kong Central remains positive. Unemployment is low, making the Hong Kong office market, along with the Tokyo office market, one of the few sectors to thrive despite lacklustre regional economic conditions. Vacancy levels are low, and rental supply of Grade A offices remains very tight.

4. BNP Paribas Real Estate UK
5. Miki Shoji survey



Canada

The outlook for Canadian property securities appears clouded, particularly for those with exposure to the resource-based territories of Alberta and Saskatchewan. Annual GDP growth has slowed (it is predicted to be 2.2%[6] in 2016) and employment growth appears to have dried up. That said, a weak Canadian dollar is likely to help offset the impact of lower energy and commodity prices.

While the outlook for growth is underwhelming, pockets of the Canadian real estate market do look appealing. Valuations have come down significantly in recent months, reflecting concerns about the Canadian economy. The Montreal and Toronto property markets appear relatively robust, with high quality urban retail property likely to experience cash flow growth.

Australia

Lower resources prices are also expected to represent a headwind for Australian property securities in 2016. At 88%, national office occupancy rates are lower in Australia than in other global property markets. Further, an additional 365,000m^2 of CBD office space – equivalent to around 2% of current supply – is under construction and due for completion before the end of 2016[7]. Expectations for rental growth are subdued against this background, especially as landlords of new office buildings are enticing tenants with significant rental incentives.

Other areas of the market are showing limited increases in tenant demand, reflecting softening growth expectations and fragile consumer confidence. Interest in Australian commercial property from overseas investors has helped capitalisation rates to remain reasonably firm.

Europe

Unlike in the US, where the QE tap was finally turned off nearly a year ago, the European Central Bank (ECB) continues to pump €60 billion per month into Europe via its own QE program. The program will run until March 2017 "or beyond", by which time the economy will have been boosted by more than €1 trillion of ECB support. Success thus far has been mixed.

Southern European nations (except Greece) have stabilised, with signs of growth from a low base in Spain. However, high levels of unemployment and national debt remain. Conditions in Northern Europe are more benign. German industrial production remains positive, for example, and unemployment is steady.

However, the ECB's stimulus and the continued low interest rate environment has fuelled keen investor appetite for a wide range of leased property assets, resulting in very high valuations, despite weak underlying property fundamentals. These valuations, combined with a difficult operating environment and limited net tenant demand are likely to represent headwinds for European property securities in the coming year.

6. Bloomberg consensus
7. Jones Lang LaSalle

Conclusion

The outlook for global property securities therefore remains divided along macroeconomic lines, with robust economic growth in the US and UK likely to buoy property securities in those markets. The Tokyo office and Hong Kong office markets are positive exceptions, where operators are generating positive earnings growth driven by robust tenant demand despite a muted economic backdrop. However the impact of lower commodity prices are expected to overshadow property securities in Australia and Canada, while European and Chinese property securities are expected to remain hampered by anaemic and slowing economies respectively, despite government stimulus measures.

A decline in direct property valuations from their current high levels could represent a headwind to listed property markets; however the growing pricing anomalies within listed markets suggest that these markets will continue to present appealing investment opportunities to discerning investors.