Global Capital Markets

Global Real Estate Insights

The global pricing reset: key trends

October 2022

What to expect during the reset

The real estate market is now in a phase of pricing discovery in the face of continued interest rate hikes. This will lead to a reduced pace of investment activity until inflation is under control and interest rates revert back to more sustainable norms, allowing market pricing to reset. This could take **6 to 24 months for global markets to fully adjust**. It took 18 months for yields/cap rates to fully 'bottom-out' in the aftermath of the global financial crisis (GFC), but some market pricing settled after 8 months.

North America will adjust first, with the Fed decisions key to global interest rates. Australia, the UK, Singapore and South Korea will be next, followed by continental Europe. During this time we expect market activity to be driven by a combination of the following factors. The mix of activity will vary by location according to local real estate market composition/fundamentals, depth of liquidity and speed of pricing adjustment.

Market inertia as pricing recalibrates.

Until there is a value correction and bid-ask spreads shorten, markets will see lower levels of investment activity. Valuations will catch up – at time of publication, anecdotal information is suggesting some book value write-downs are imminent - but it will take six months for consensus to be reached on where pricing should be. Refinancing requirements will kick in on an ongoing basis, driving these valuations, which will ultimately support further activity and opportunities for debt placement.

Cash is king.

Equity-driven investors, notably private buyers, can be less hindered by market forces and will continue to be active. The opportunity to bid for assets in an environment with limited buy-side competition will see sustained activity from such investors. Markets offering a long-term haven and 'trophy asset' status such as the London West-End will be the most active.

Contracyclical investment – primarily sale and leasebacks.

Many opportunities will arise to buy assets from companies who need a cash injection, or see an opportunity to upgrade existing assets in partnership with investors e.g. energy efficiency upgrades to reduce occupancy costs and conform to ESG strategies.

Working the capital stack.

The annual requirement to refinance assets creates an opportunity for the creation and deployment of debt funds, especially given the higher returns generated by financial markets.

Limited loan covenant breaches.

In Europe, loan to value (LTV) ratios are significantly lower than during the global financial crisis, at 30% on average. Yields would need to move by well over 200 basis points for this to become problematic.

Defensive assets in favour.

Industrial & Logistics (I&L) and residential assets have the strongest capacity for rental stability and growth, alongside core offices. Be wary of incoming rental caps for residential in Europe. For I&L, low vacancy, digitization and just-in-case demand growth will support stable rents short-term and a quick turnaround in rents when economies respond.

Closed-end fund terminations will see assets come back to market at fund expiry.

There will undoubtedly be some extensions to original deadlines, but assets will need to be sold, driving some activity.

Beyond the initial recalibration of markets, **the significant weight of capital looking at real estate and real assets will re-engage with markets.** We also expect a continued, long-term push into assets tied to new, energy-efficient infrastructure.

Key Macro Trends

Context: the inevitability of an asset pricing reset

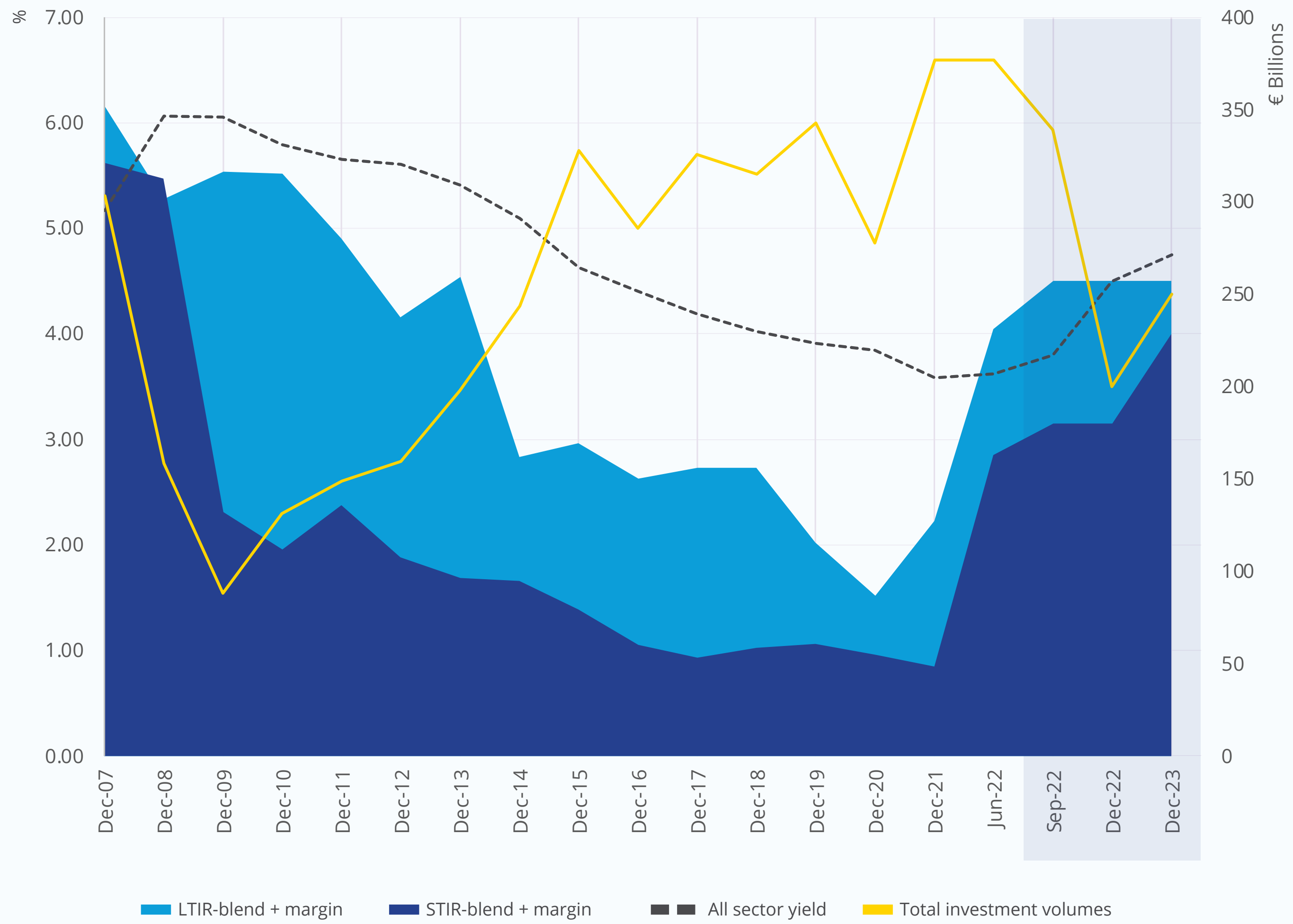
What we have witnessed across global and European markets in the last three years has been relatively unprecedented. The pandemic brought the previous cycle back down to earth with a bump, resulting in huge changes to the way we function and interact with the real estate environment. The government intervention that followed the onset of the pandemic resulted in even further quantitative easing resulting in record low interest rates to allow the economy to recover. This meant that the anticipated correction in asset pricing required at the end of 2019 moved in a different direction.

When it comes to real estate, despite the slump in investment volumes during the global lockdown days of Q2 and Q3 2020, activity picked up significantly in Q4.

This fed through to a record year for global and European investment volumes in 2021 as economies bounced back. This coincided with record low yields/cap rates across markets, reflecting very low interest rates **[see figure 1]**.

By Q3 2021, however, it was evident that inflation was building across global economies, reflected in higher energy prices and construction costs. There was a clear need for interest rates to rise, but the market consensus on inflation was relatively benign - reflected in our global investor outlook survey results of November 2021. The onset of the war in Ukraine and subsequent global supply-side shocks have, of course, accelerated and exaggerated the inflationary shift. Monetary policy decisions to raise interest rates during Q3 2022 have now come to bear on global real estate activity, which slowed markedly in Q3 2022.

Figure 1. European investment market: yield spreads and volume correlation



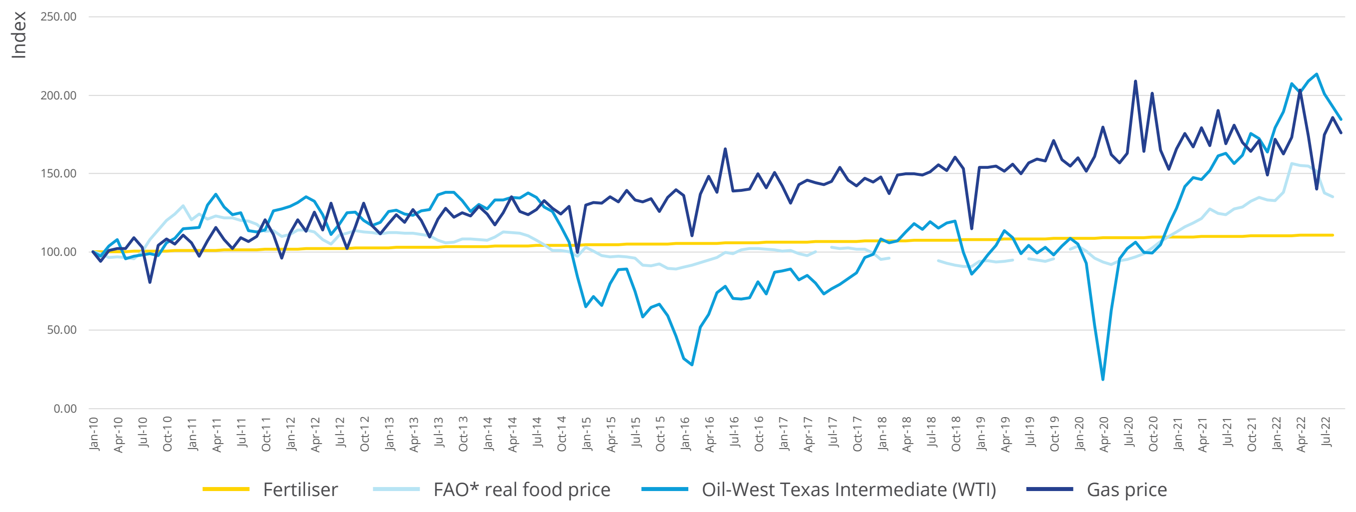
Source: Colliers, RCA, Factset, OxfordEconomics

External headwinds diminishing into 2023

Key commodity prices have finally started to drop from their peak rates of Q2 2022.

The war on Ukraine that began in February, and the subsequent supply-side shocks that followed, resulted in huge hikes to the price of basic commodities, including fertilisers, food, oil, and gas **[see figure 2]**.

Figure 2. Global commodity indices

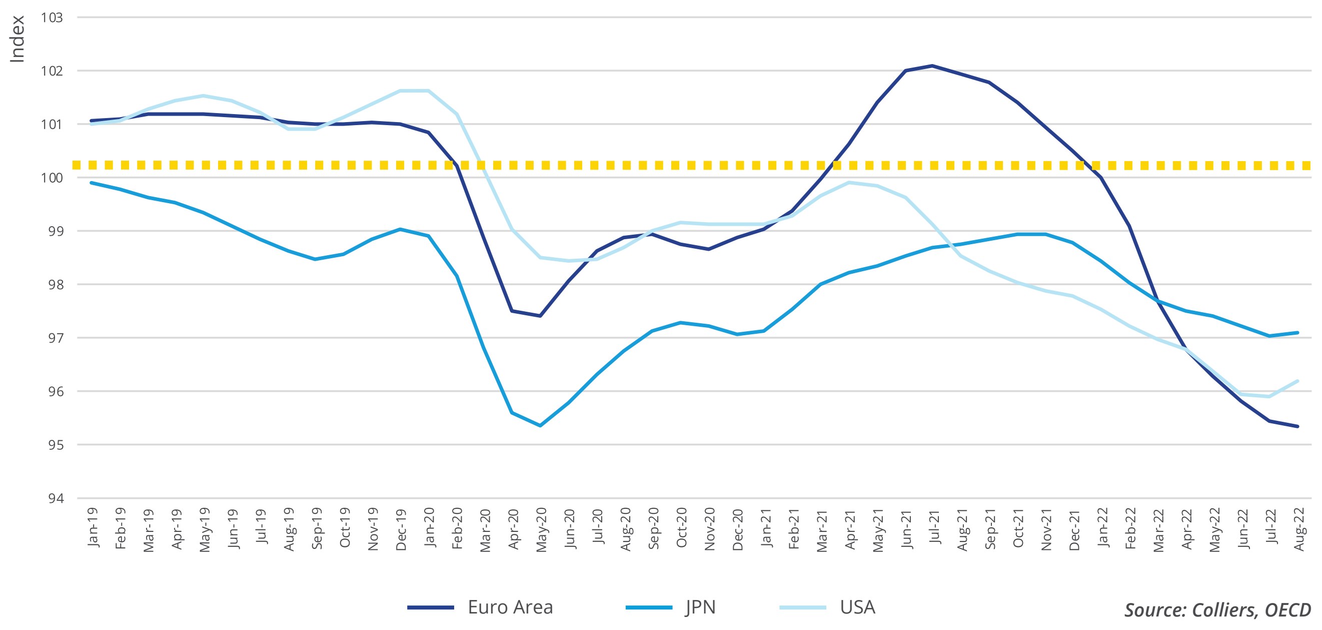


*Food and Agriculture Organization of the United Nations

Source: Colliers, Factset

Thankfully it looks like 70-year high inflation rates are being wound back in. Demand for global energy is diminishing as economic growth slows, primarily a big drop in demand from China, which is set for a 25-year low rate of economic growth at just 2.8% for 2022. The alleviation of supply chains is supporting lower commodity and food prices, despite the ongoing war in Ukraine **[see figure 3]**.

Figure 3. Consumer confidence indicator: OECD

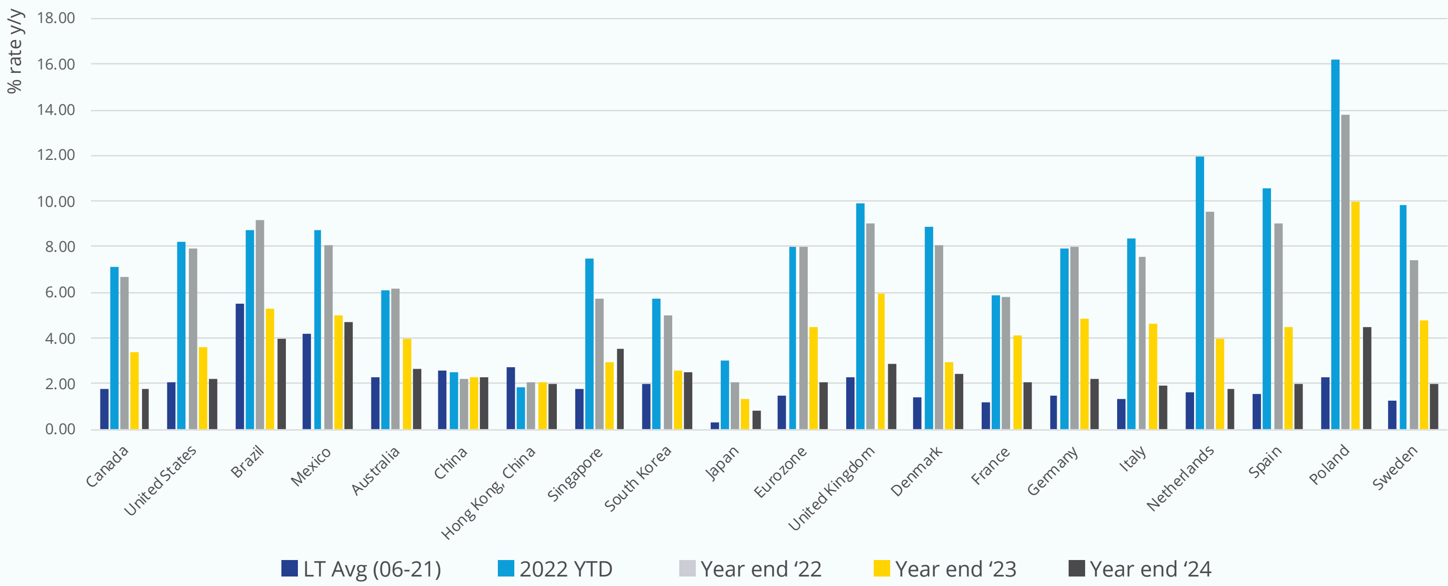


Source: Colliers, OECD

This appears to be have a positive impact on consumer sentiment, which has started to bottom out across the globe. Government intervention is playing its part, with energy price caps and financial support - such as those recently announced by the UK and German governments - having a positive impact. That said, European consumer confidence has further to run before stabilising, given the potential costs of getting through the upcoming winter. Inflation levels are finally looking like they will pare back in Q4 2022 and drop back more significantly in 2023.

Although the inflation outlook is improving, inflation levels are set to remain much higher than their long-term average during 2023. Despite energy prices and commodities coming down, core inflation pressure has been growing with wage rises and mid-term shifts in the price of goods/services expanding. Equally, the recent OPEC decision to reduce output in order to drive a higher oil price will add inflationary pressure to markets. More sustainable levels of inflation are not expected until 2024 **[see figure 4]**.

Figure 4. Consumer Price Index: Long-term Average, YTD & 2 Yr Forecast



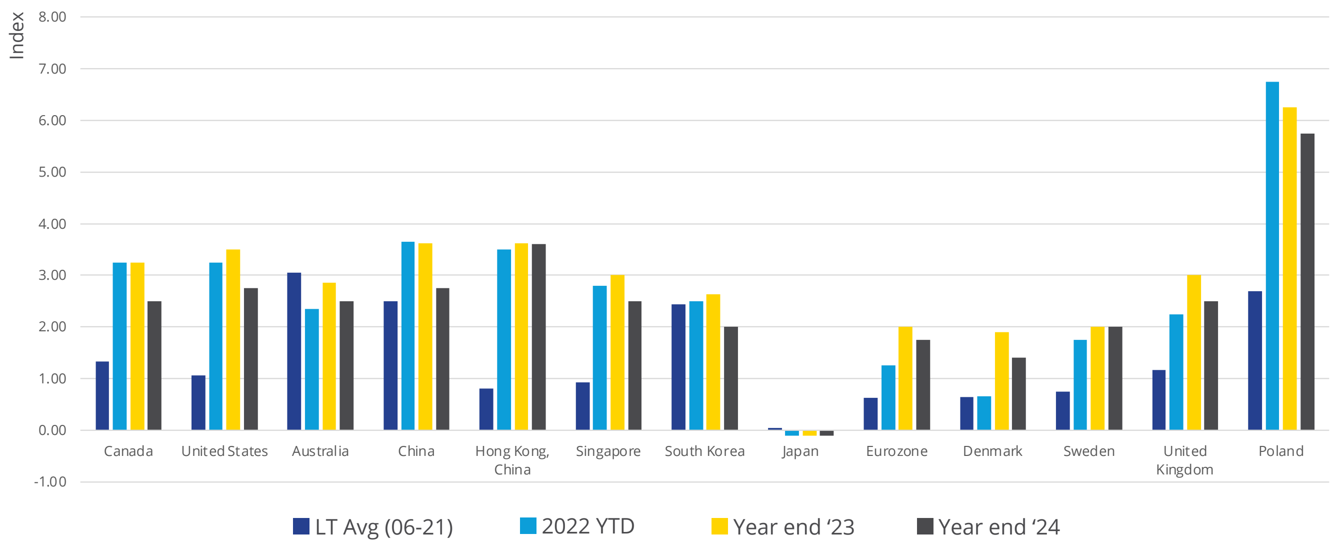
Source: Colliers, OxfordEconomics, Factset

The volatility vortex: Quantitative tightening & asset pricing impact

Monetary policy committees across the globe have begun the quantitative tightening process. The rate and speed of tightening picked up markedly during the summer of 2022. July, August and September saw significant rate hikes, to manage inflation and distill volatility in currency markets, with the safe-haven US$ appreciating against other currencies globally **[see figure 5]**.

Short term interest rates (STIR) have moved (28th September 2022), more decisions to come.

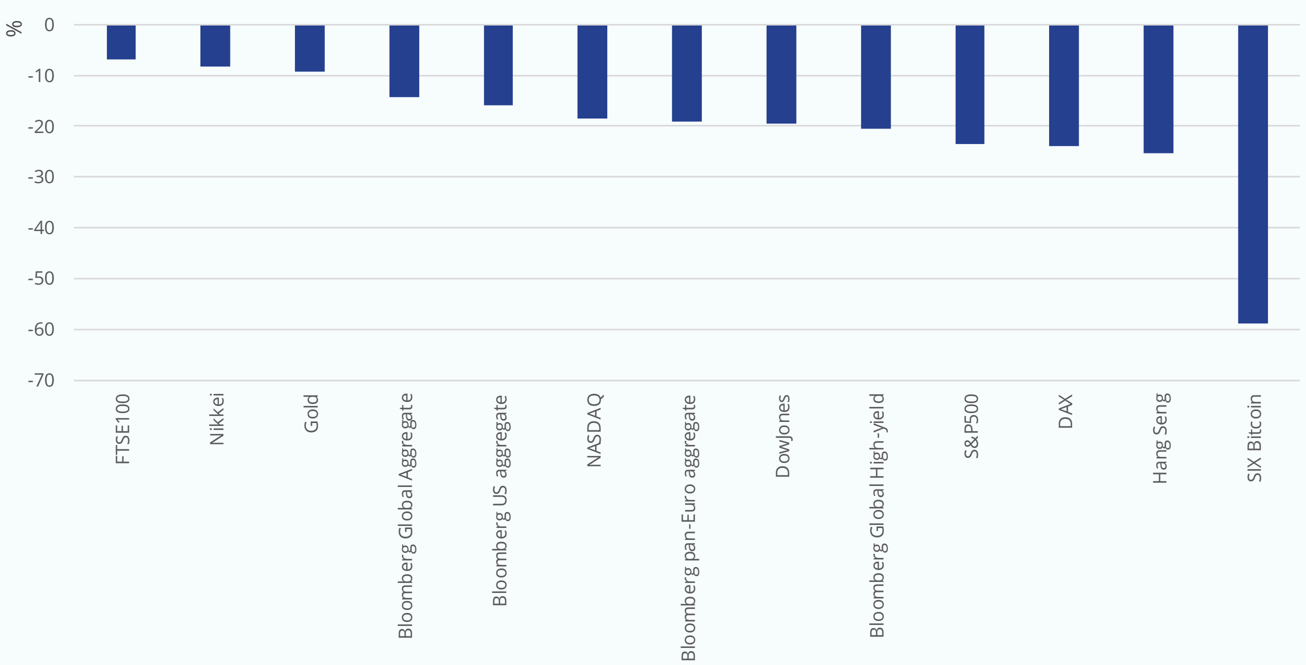
Figure 5. STIR: Long-term Average, YTD & 2 Yr Forecast



Source: Colliers, OxfordEconomics, Factset

This has put financial markets into a re-pricing vortex **[see figure 6]**. Corporate bond rates, short and long-term interest rates are up to 10-year highs in some locations. The expectation of further rate rises is playing havoc with asset pricing and SWAP rates. Global equity and fixed-income markets have seen prices drop year-to-date by up to 30%. SWAP rates are trading well over 100 basis points (bps) above forecast short-term interest rates.

Figure 6. Global Asset Pricing: Equities, fixed-income, bitcoin and gold - YTD %



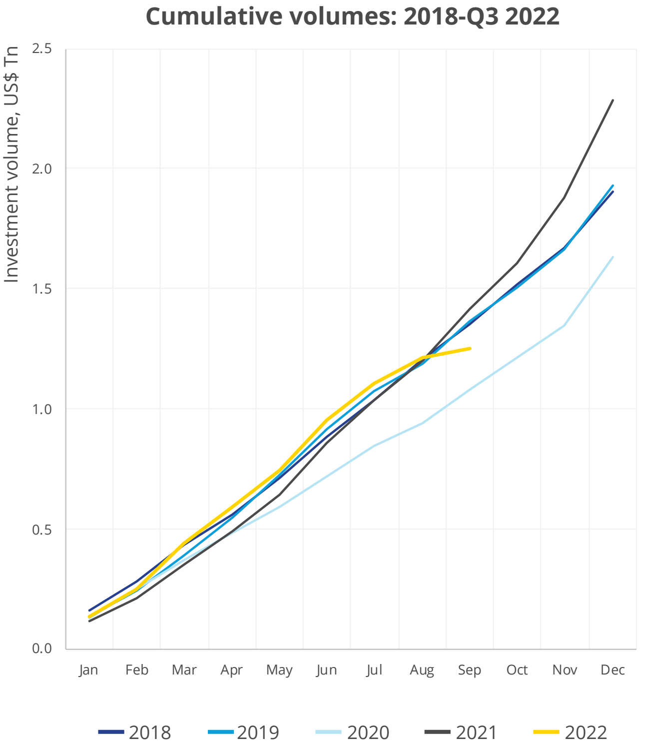
Source: Colliers, Factset

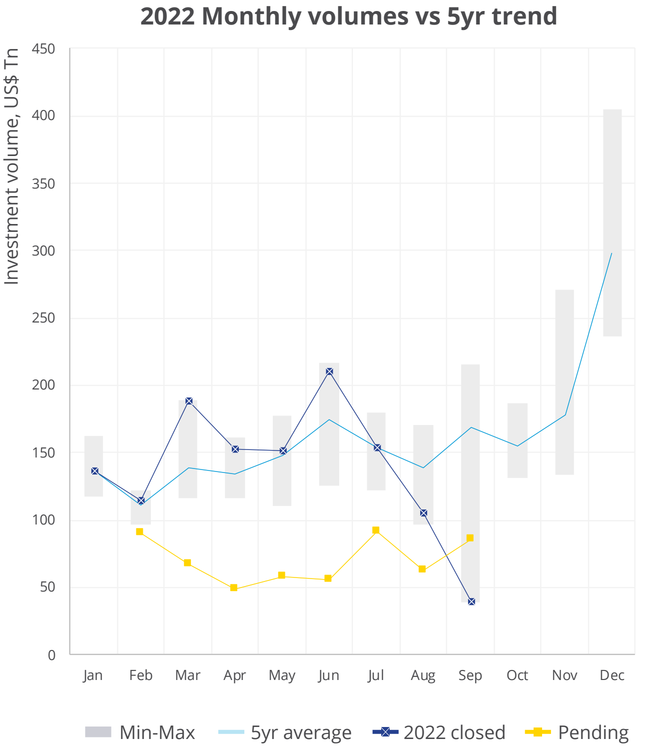
Key Real Estate Market Trends

The real estate market: journey to new, sustainable pricing

Real estate markets are clearly spooked, with investment volumes dropping to a new monthly low in September 2022, lower than during the COVID year of 2020. While the market witnessed a strong first half to the year, the drop-off in activity in the second-half of 2022 is likely to see investment volumes drop below 2020 levels. Activity will not return to normal until pricing resets **[see figure 7]**.

Figure 7. Global volumes

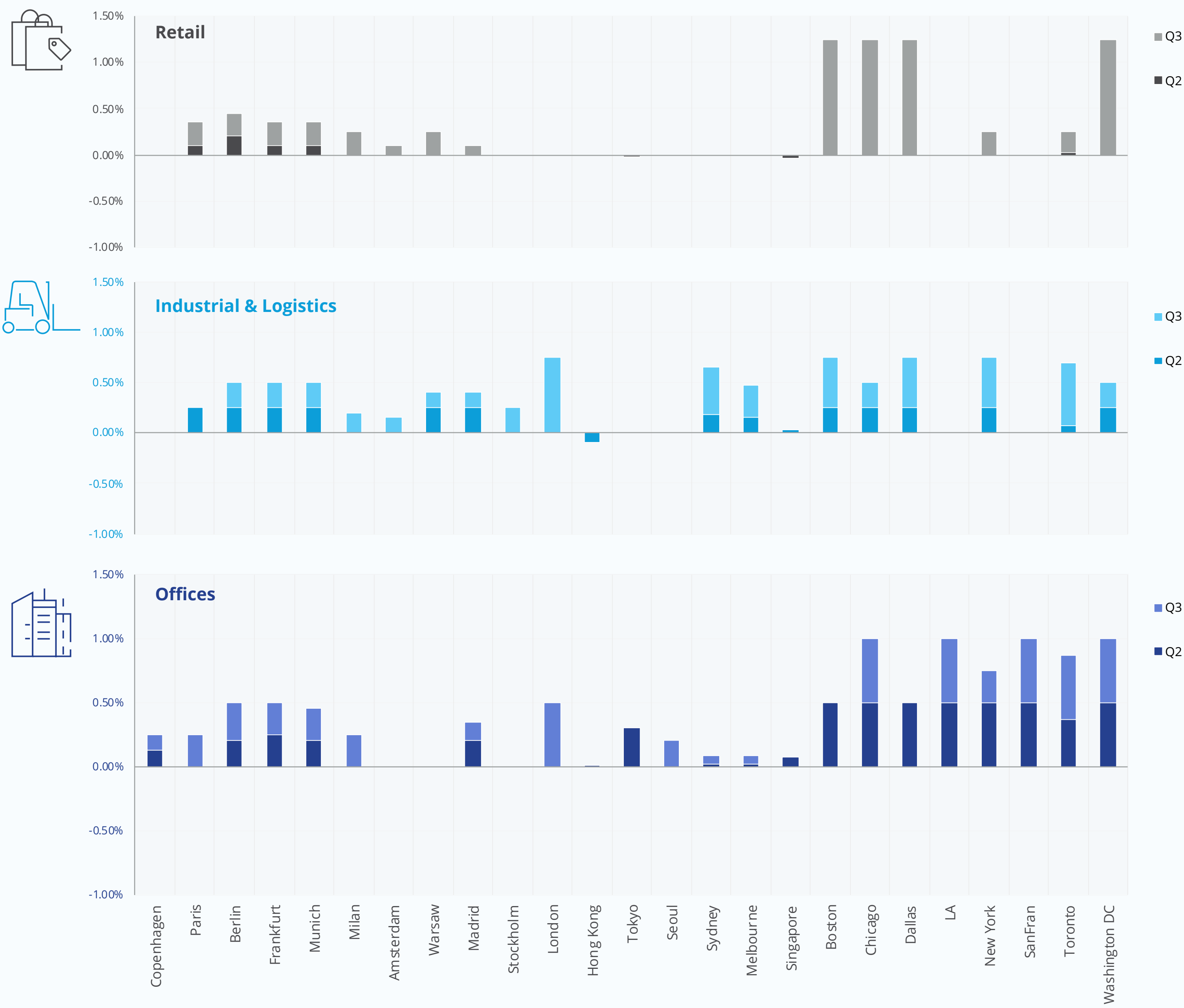




Source: Colliers, RCA

Although real estate yields/cap rates have started to move out across Europe and the world, commercial real estate markets will witness a significant pricing correction in the face of continued interest rate hikes over the next 24 months. The journey to more sustainable pricing will differ markedly across locations due to the speed and extent to which interest rates are changing. This change in pricing will also reflect variant local real estate fundamentals, market sentiment and behaviour. We can see how markets have already moved in the last two quarters, with U.S. markets undertaking the most significant cap rate shifts **[see figure 8]**.

Figure 8. Global yield chart - Yield changes, Q2 & Q3 2022



Source: Colliers

Despite these movements, yields/cap rates will need to move out by a further 75bps, on average. This converts to a 15% correction in capital values, which could be higher, and we expect a range of at least 0%-30% as other factors come into play. The timing at which these changes unfold will vary from 6 to 24 months. **By the end of 2023 we should see investment activity bottom out and recover.**

Global relativity

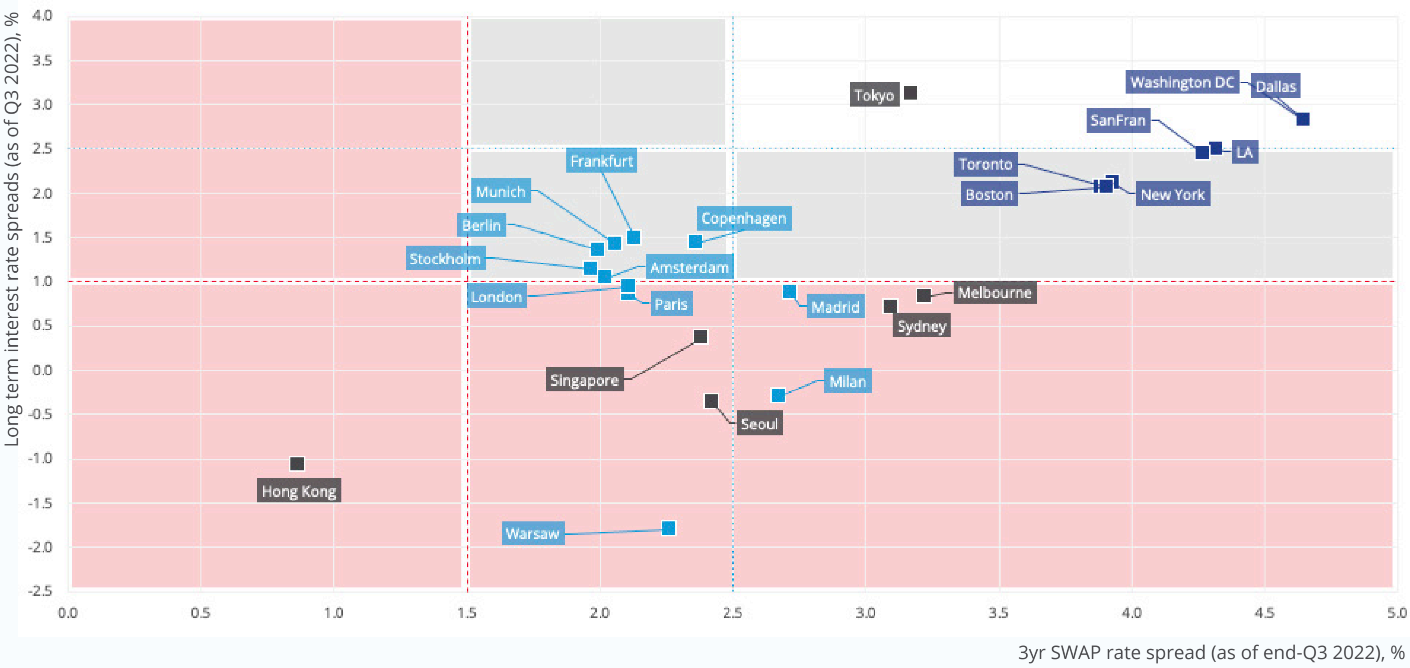
Tokyo remains the stand-out global market in terms of relative pricing, and where we expect limited downward movement in capital values. With the Yen at historic lows to other currencies it looks even more attractive to the global investment community.

For Europe, given current debt funding rates and margins are now closer to 250bps, and 10-year bonds have also moved out, yields are clearly under the most pressure to shift. The major APAC markets of Australia, South Korea and Singapore are also in this position **[see figure 9]**.

While **U.S. markets have moved most, and are now in a much more attractive pricing position, investors must recognize the real estate fundamentals and changing occupier demand factors in play.** Major U.S. metro office markets are going through a significant repositioning, with structural vacancy risk a reality. CBD vacancy rates are up to around 15% on average, sub-leasing and incentive levels remain very high and the impact of hybrid working is yet to really work through the market. Attracting workers and employees back to cities is a big challenge, yet headline rents are yet to reflect this.

Arguably, the well-priced U.S. markets reflect this structural pricing risk, but lower office capital values in these major markets seems inevitable. This picture differs to APAC and Europe. In the latter markets, average office vacancy is just 8.6%. It is also worth noting that those locations hindered with structural office vacancy post-GFC have been turned around. **Amsterdam has become Europe's best-performing core office market in terms of total returns over the last 10 years.**

Figure 9. Global offices - Current NIY vs 3yr SWAP & LTIR



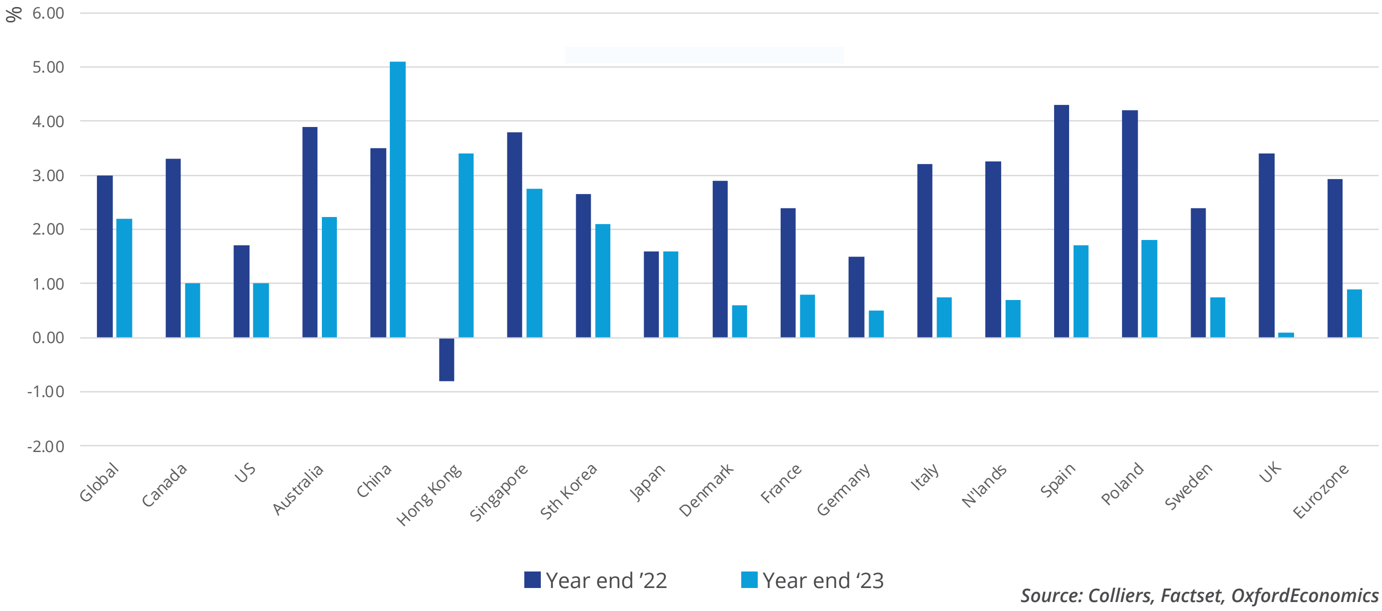
Source: Colliers, Factset

Economic outlook is weakening: 2023 looking tougher than 2022

While the focus of discussion has been on the capital side of the equation, having one eye on the demand-side factors that will support pricing and a recovery in markets is equally important. Inevitably, higher prices and finance rates are impacting corporate and household budgets, reducing spending forecasts for the year ahead. So while inflationary factors are coming under control, there is clearly a lag to the real economy as the consequences of this broader pricing shift take hold.

It is clear that the economic outlook for 2023 is weakening, but there is still no forecast recession. At least not yet. Global growth is expected to drop to around 2% in 2023, with many major global economies at, or less than, just 1% GDP growth **[see figure 10]**. All of which makes decision making more complex. **Investors are having to sharpen their pencils to pick markets, sectors and strategies best suited to take advantage of these new market dynamics, both short and long term.**

Figure 10. 2023 GDP outlook



Source: Colliers, Factset, OxfordEconomics

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