Opportunity or caution? The outlook for European and Asian real estate

Disruption, capital market volatility, and secular demand shifts in European and Asian real estate are driving unique opportunities and growing institutional investor interest. Kevin Grundy, Managing Director, Fund Management, Europe, Invesco Real Estate, and Jason Choi, Managing Director, Senior Portfolio Manager, Asia Pacific, Invesco Real Estate, discuss the broader market environments in each region and where they are finding the most compelling investment potential.

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Key takeaways

- Disruption and secular demand shifts are driving unique opportunities and growing investor interest in European and Asian real estate.
- In Europe, investors who can see through the short-term noise may be well-positioned to realize extremely attractive valuations.
- Investment potential varies widely due to the diverse monetary policy regulation landscape within Asia.

1. What are some of the broader trends unfolding in the European and Asian real estate markets?

Kevin Grundy: In Europe, there has been a significant disconnect between two different cycles — the traditional real estate cycle, which includes areas such as supply and demand, occupational markets, rental growth, etc. and remains on pretty sound footing, and the capital market cycle, which is largely dysfunctional at the moment, starved of capital and driven by the sharply higher interest rate environment. The result has been a major pricing disconnect, and investors able to see through the short-term noise appear very well positioned to acquire some exceptional real estate at extremely attractive valuations.

Jason Choi: In Asia, current relative opportunities have been largely shaped by how countries have approached monetary policy. Korea and Australia are more correlated to the US in terms of their capital markets because their monetary policies are very similar. In contrast, China is experiencing a markedly different type of cycle, with very loose monetary policy but also considerable real estate headwinds. Japan is probably the most interesting and unique market due to its "lower for longer" monetary policy, healthy liquidity, strong stock market, and weak yen. Because there hasn't been any real change in the country's broad market backdrop over the past several years, specific investment opportunities really depend on the individual asset based on its fundamentals, risk profile and so on.

2. Where are you finding the most interesting investment potential in each region?

Grundy: In Europe, we have been seeing three broad themes of opportunity. First, there has been a **generational repricing** in reaction to rate changes.

This is a key area to watch over the next six to nine months as market participants continue to try to figure out the new equilibrium based on today's rates and where rates are headed in the future.

The second is **solutions-based investing.** It's a very powerful position to be able to provide capital in a capital-starved market, and investors able to offer funding solutions to counterparties and sponsors with performing real estate are capturing attractive pricing with limited risk.

Indeed, we have found mezzanine debt opportunities offering 15%+ IRRs at only 75% loan-to-value ratios.

The third area is a **brown-to-green sustainability investment trend.** Europe remains at the ESG forefront, and in terms of the investment market, a lot is being driven by regulation and potential opportunity, with institutional investors increasingly expected to focus on buying sustainable assets and selling those that don't satisfy sustainability goals. There's a significant focus on net zero, the carbon promise to be largely climate-neutral, emitting no greenhouse gas emissions or offsetting emissions by 2050 and being halfway there by 2030. That's only six years away and already affecting five- to 10-year real estate leases. Consequently, most European institutional investors know where their portfolios are in terms of net zero, which assets are helping their carbon curve, which are hurting, and potential cost exposures to move those assets to the right side of the curve. It also creates opportunities to buy discounted brown assets, transform them into sustainable assets and then sell them back into the market.

Choi: Looking across the Asia-Pacific markets, developed Asia — Australia, Korea, and Japan — continues to offer the strongest relative risk/return profiles. In Australia and

Korea, there's been a pullback in bank lending risk, and the non-banking lending sector remains relatively new, roughly five years old in Australia and with little to none in Korea. This has created meaningful opportunities for solutions-based private lenders, with IRRs reaching the mid-teens and higher, depending on the asset and location. From a vintage standpoint, being able to selectively cherry-pick as a lender is offering investment potential not seen since the 2008 Global Financial Crisis (GFC). Banks have lent heavily into office, residential and, more recently, logistics, and the dramatic decline in debt liquidity has offered the chance to provide solutions as these portfolios have started to come under pressure. We are also finding attractive potential in more niche sectors, where liquidity was starting to become selectively available but is now almost nonexistent.

In Japan, the wide gap in policy rates compared to the US offers fantastic cash-on-cash yields. As a result, our focus in the country has been on buying great assets in great locations in strong sectors with stable, secular growth and demand that provide attractive cash yields. However, we remain very cautious about China, continuing our call from 2015-16 that the country's risk-adjusted returns did not appear as strong as the developed Asian markets. That's even more true today.

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3. European deal activity was down about 60% for the first half of 2023 compared to the same period in 2022. How has this affected the market?

Grundy: The stall in transaction volumes has been largely in reaction to the runup in rates. On the buyer side, some investors have moved out of or lowered real estate allocations. Some don't have new funds to invest due to portfolio legacy issues, such as needing to redirect capital to assets that now have lender issues or with open-ended structures facing redemptions. Some are more core in mindset and less comfortable operating in an environment with the current lack of clarity. And a small number are waiting with dry powder for the kind of full-on distress that the market isn't showing yet.

On the seller side, real estate owners generally don't appear to be under immediate pressure to sell. It's not the same foreclosure environment as in the GFC. Hence, it doesn't make sense for many to come to market if the expected reception is mostly aggressive buyers looking for sizable discounts. And with so many buyers and sellers on the sidelines, unconstrained investors able to invest across the capital stack have been in a strong position to cherry-pick opportunities and structures.

On the plus side, the yield trend has been generally up across sectors, at times significantly (see Exhibit 1). Market yields are usually determined by transaction evidence, but the current shift upward has been driven by independent valuers estimating where the equilibrium price is between buyer and seller. A key message here is the disconnect between capital markets and fundamentals. For example, logistics has experienced some of the most dramatic repricing of any sector over the past 18 months, despite being one of the fundamentally most attractive. This was primarily because it had experienced a larger runup previously that required a bigger correction to level it out. In contrast, the rise in retail yields has been more muted since the sector has struggled for many years and has already been significantly beaten down.

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4. How are tighter sourcing trends shaping investment potential in Asia?

Choi: In this environment, people are seeking flexible capital solutions and sources to meet their needs. We are seeing more willingness to pursue unique financing situations on both the borrower and seller side. From a sourcing standpoint, this requires a lot more meetings and digging through a much bigger haystack to find that proverbial needle. That's where a private lender's size, experience and capital flexibility can offer real competitive advantages.

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5. What do you see looking ahead?

Grundy: The general perception is that Europe is a bit ahead of the US in value correction, which is unusual by historical standards. General peak-to-trough views are in the 20-30% range, and Europe is well on that journey. That being said, we think it's important not to try to be too precise in attempting to time the market and instead build enough buffer to allow for a bit of uncertainty. Overall, Europe appears far enough along to begin thinking about making those judgments, and investors can help protect themselves through structure and pricing discipline.

Choi: In Asia, we look at this next phase of investing in two parts. Near term is largely solutions-based, focused on structured opportunities, insulated debt, strong capital stack placement, and recapitalizations coming out of liquidity-driven situations. The second half generally offers a stronger basis to add more traditional growth investments. Of note, one key change that has emerged over the last few years is the drastic decrease in correlations exhibited by some Asian markets versus Western markets (see Exhibit 2). This has significantly expanded their diversification potential and highlights the benefits of working with a global platform like Invesco.

6. What differentiates Invesco's approach to real estate, especially in the current investment environment?

Grundy: It's really about experience and size. Invesco Real Estate (IRE) has been building real estate portfolios for more than 40 years and currently consists of 586 professionals across 21 global offices in key markets around the world.[1] Through the years, we've refined a rigorous investment process that always starts by taking a close look at the property to decide whether or not we like this asset. If so, we then decide how best to participate in it from a relative value perspective.

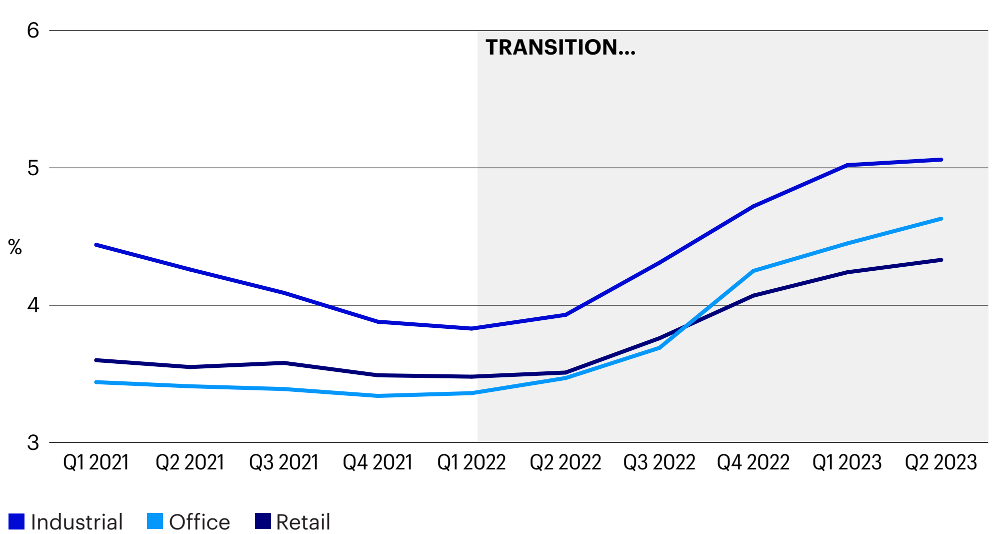
Our position as a globally coordinated business can offer an incredibly valuable perspective. When it comes to investing, however, we are very much locally focused, given that we usually find that the best ideas come from the ground up based on the insights from regional experts in the markets themselves. An example of this is how the office sector is currently perceived across various regional markets. Offices generally are not at the top of our list as an investment sector in Europe, given the segment's vacancy challenges, but in the US, the crisis seems much more acute. Indeed, we acquired a Grade A office space asset in central Amsterdam at the end of last year, where the vacancy rate was less than 3%.

Choi: Given the size and scope of our platform, we also have the flexibility to scale deal sizes up or down based on what is most appropriate for a particular mandate. In Japan, for example, land plots are very small, which means deal sizes tend to be small even though the market is extremely large. How we approach trading and transacting in that market may be very different than in markets where deal sizes can be much larger. We also have the ability to bring in co-investment capital through a network of trusted LP partners, although we always remain cautious around liquidity when it comes to larger deals, especially approaching the mega space. This combination of strong local market knowledge and ability to flex can offer meaningful advantages when it comes to navigating the types of challenges and opportunities we are seeing across the marketplace today.

For more information about European and Asian real estate opportunities, please contact your Invesco representative or visit invesco.com/realestate

Exhibit 1: European real estate yields have been on the upswing

Prime yields by sector, date-date



Source: CBRE Eurozone Prime Yields as of Q2 2023.

1. As of September 30, 2023

Exhibit 1: Decrease in Asian real estate correlations offers diversification benefits

Correlations 2008 – 2017 vs. 2018 – 2022

Correlations 2008 – 2017

MSCI real estate total returns

	US	UK	EU	APAC
US	1.00			
UK	0.62	1.00		
EU	0.76	0.92	1.00	
APAC	0.94	0.62	0.81	1.00

	SK	JP	AU	SG	HK	CN
SK	1.00					
JP	0.42	1.00				
AU	0.39	0.90	1.00			
SG	-0.09	0.48	0.66	1.00		
HK	0.18	-0.23	0.16	0.40	1.00	
CN	-0.60	0.09	0.26	0.72	0.23	1.00

Correlations 2018 – 2022

MSCI real estate total returns

	US	UK	EU	APAC
US	1.00			
UK	0.84	1.00		
EU	0.74	0.95	1.00	
APAC	0.41	0.41	0.53	1.00

	SK	JP	AU	SG	HK	CN
SK	1.00					
JP	-0.46	1.00				
AU	0.20	0.61	1.00			
SG	-0.15	0.92	0.81	1.00		
HK	-0.39	0.60	0.75	0.65	1.00	
CN	-0.36	0.85	0.83	0.85	0.89	1.00

Source: MSCI, Hines Research, Q4 2022.

Notes: Compares annual changes in total return Indices between a) US, UK, Europe and Asia Pacific and b) South Korea, Japan, Australia, Singapore, Hong Kong and China.

Past performance is not a guarantee of future results.

Investment Risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations), and investors may not get back the full amount invested. Property and land can be difficult to sell, so investors may not be able to sell such investments when they want to. The value of property is generally a matter of an independent valuer's opinion and may not be realized.

Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Generally, real estate assets are illiquid in nature. Although certain kinds of investments are expected to generate current income, the return of capital and the realization of gains, if any, from an investment will often occur upon the partial or complete disposition of such investment.

Investing in real estate typically involves a moderate to high degree of risk. The possibility of partial or total loss of capital will exist.

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