Morgan Stanley Real Estate Investing (MSREI)

Global real estate trends and opportunities

The global macroeconomic landscape remains in a sweet spot highlighted by accelerating economic growth, which is stronger than average, and inflation, which remains below central bank targets.

Consumers continue to fuel the late cycle expansion helped by robust job markets and wage gains. Global monetary policy is slowly turning, starting with the Federal Reserve and likely extending to Europe next year, but the pace of tightening will be modest in the near term due to weak inflation prints globally. Property market returns are expected to continue to decelerate as cap rate compression subsides, and income growth becomes the primary driver of returns. Investment markets continue to normalize from 2015 peak levels, but declining activity has not negatively impacted prices, suggesting scarcity of quality product for sale, thinner bidder pools and a wider bid-ask spread. Structural trends, most notably e-commerce and aging populations, continue to influence growth patterns, investment strategies and underwriting decisions. Morgan Stanley Real Estate Investing (MSREI) believes these themes, combined with unprecedented volatility and uncertainty in the market, continue to create a potentially very favorable environment for real estate investing globally.

CAPITAL MARKETS THEMES

Lower returns given late-cycle dynamics

From a real estate standpoint, MSREI believes returns during the past four years have been above average, driven largely by cap rate compression, and we expect returns to decelerate over the next four years as cap rates continue to stabilize, with the driver of returns coming predominately from income growth.

Regional real estate markets are expected to vary widely due to different underlying economic growth drivers and divergent interest rate policies. In fact, the trailing 5-year correlation of office market returns among major markets is –0.05, compared to a long run correlation of 0.59 (and a rolling correlation high in 2013 of 0.81).[1] While the majority of markets are late cycle, characterized by decelerating rent and value growth, MSREI believes the current cycle has further room to extend due to high occupancy levels across most asset classes and markets, functioning debt markets and continued strong liquidity/allocations to real assets.

Investment markets normalizing

Transaction activity through the first half of 2017 slowed by 8 percent to $378 billion.[2] Asia Pacific recorded 5 percent YOY growth in income-producing asset transactions during H1/17, while EMEA fell 12 percent and the Americas dropped 10 percent.[3] Counter to the global trend, the sale of retail assets supported Asian volume growth, driven by acquisitions in Japan, China and Singapore.[3] The logistics sector in each region recorded positive volume growth and declining cap rates, supported by e-commerce tailwinds and stronger global trade, while the retail sector suffered declining volumes and rising cap rates, most notably in the U.S.[3]

A common theme across global markets is the disconnect between pricing and volume. Cap rates have stabilized or even compressed, while volume has fallen for six consecutive quarters, due to a growing divergence between buyer/seller price expectations, scarcity of quality product for sale and thinning bidder pools.

MACRO THEMES

- **Accelerating, above-trend growth with below-target inflation**
- **Consumer to drive late-cycle expansion**
- **Global monetary policy slowly turning but will remain accommodative**

The level of debt used in commercial real estate transactions remains relatively low compared with 2007 levels, suggesting that the forced selling, which led to rapid price declines in the last crisis, is less likely this time around. However, while debt appears to be less of a problem, the amount of equity capital ready to be deployed into commercial real estate remains at all-time highs. Equity-rich, cross-border investors now account for up to 35 percent of global transaction activity.[4] While this capital originates from diverse sources, it is susceptible to domestic politics and may be subject to repatriation of capital (e.g., China), thereby further lowering transaction volumes.

INVESTMENT THEMES

Aging populations driving healthcare demand

Structural trends continue to disrupt each and every real estate sector. The two most significant trends impacting real estate fundamentals and investment strategies today are demographics and e-commerce.

Starting with demographics, the senior age cohort (>65) is expected to increase by 54 percent in the U.S. over the next 15 years.[5] Globally, the senior cohort is growing at 2.5 percent while the total population is growing at 1.2 percent,[6] and this trend is expected to accelerate. Aging will weigh on workforce growth as retirees exit the labor force, lowering the demand for office space relative to history. This is of particular concern in countries, such as Japan and South Korea, that do not currently openly support immigration. Older populations spend more on healthcare services and less on consumer goods. The 65+ cohort consumes, on average, nearly $6,000 in healthcare services annually,[7] more than twice the average health expenses of millennials. Aging populations are driving demand for senior living services, medical services and life science, contributing to the tight yields in those sectors.

At the other end of the age spectrum are millennials. Asia has the highest share of millennials at 32 percent versus 30 percent in the Americas and 25 percent in Europe.[5] They have contributed to continued urbanization, particularly in markets like China and India, and have driven a surge in rental housing in the U.S.. Since 2008, the U.S. has added 6.8 million renter households, while losing one million homeowning households.[8] The extent to which millennials will eventually shift preferences toward buying versus renting and the suburbs versus downtown will have significant impacts on the multifamily and single-family markets, for-sale and for-rent strategies.

Housing shortage will propel residential sector growth in Europe and the United States

The rapid growth in household formation among the millennial generation has contributed to the housing shortage faced in many coun-

tries around the world. While residential construction is beginning to recover from the housing crises in Europe and the U.S., construction volumes remain significantly below the pre-bubble average. Since 2011, housing sales in the U.S., including apartments, have averaged 900,000 per annum, failing to keep pace with household formation which has averaged 1.4 million per annum.[9] This has resulted in above-average occupancies for apartments and below-average inventory of for-sale housing, with the biggest shortage occurring in the entry-level segment, which currently has only 3.3 months' supply of inventory (compared with a normalized market of six months).[10] In Spain, residential construction is only 15 percent of pre-peak levels, job growth is creating housing demand, and prices have begun to increase.

E-commerce disrupting retail and benefiting logistics

The rapid acceleration in global e-commerce continues to threaten the retail sector, with the largest impact in countries that are the most over-retailed, specifically the Unites States, which has 24 square feet of shopping space per capita, compared with four square feet per capita in Europe.[11] Additionally, the U.S. has high department store exposure, with one department store per 62,000 people, compared with France, which maintains one department store per 777,000 people.[12] Department store sales of apparel have halved over the past 10 years, while sales by Internet retailers of apparel have grown fourfold,[13] suggesting that department stores are one of the most vulnerable formats to disintermediation from e-commerce (Amazon is effectively an online department store). As a result, it is likely that the U.S. will see additional closings of department stores, outside those already announced by Sears, JC Penney and Macy's. Other formats under threat in the U.S. include power centers, grocery-anchored centers due to likely grocer margin compression following the Amazon/Whole Foods combination, and low productivity Class C/D malls.

With goods spending moderating in most parts of the world, and e-commerce taking increasing market share, retail sector fundamentals are likely to weaken, with rent growth expected to halve from 4 percent per annum over the last five years to 2 percent per annum over the next five across major markets.[14] The greatest impact will be felt in the weakest centers, while the top 10 percent of centers will continue to outperform broad market averages. Negative impacts felt in the retail sector have been somewhat offset by the outperformance witnessed in the logistics sector, broad-based strength in e-commerce leasing, whereas global trade and higher inventory to sales ratios have driven occupancies up to record highs and yields down to record lows.

Growth opportunities in the office sector, despite moderating fundamentals

The global office sector continues to generate moderate NOI growth helped by low levels of new construction in most markets and continued job growth. Cross-border investors have contributed to the rapid increase in prices of core office assets in primary, gateway markets, resulting in yield spreads in core and non-core markets widening beyond historical averages in Europe and the U.S. For example, the yield gap between the top six office markets and the rest of the U.S. office markets is currently 82 bps versus an historical average of 38 bps. Similarly in Europe, the spread is 111 bps versus 81 bps.[15]

Additionally, given income growth will be the primary driver of future returns, investors may target markets where current rent levels remain below prior peak levels, potentially offering strong upside rent growth potential. For example, Tokyo office rents are 30 percent below the prior peak, Singapore rents are 55 percent below peak, and Madrid, Milan and CEE office remain 29 percent, 15 percent and 13 percent below peak levels, respectively.[16] Select repositioning opportunities may also exist where physical product no longer meets market needs.

Strong tourism flows creating hotel opportunities

Tourism continues to grow rapidly, particularly in countries like Japan, where foreign visitors reached 20 million in 2016, double that of 2013 levels.[17] The growth of tourism can be attributed to many factors, including the flourishing middle class in China (outbound travel from China has increased by over 100 percent since 2009)[18] and stronger travel preferences for the rapidly expanding millennial age cohort. This is creating attractive growth opportunities in markets, such as Spain, Portugal and Croatia, where revpar growth has exceeded 10 percent over the past 12 months.[19] In contrast, several other hotel markets are facing weaker revpar growth and potential distress caused by oversupply or weaker demand (e.g., New York, Miami, Paris), providing opportunities to acquire or reposition mismanaged properties at an attractive basis.

CONCLUSION

In conclusion, the combination of stronger global growth, driven primarily by the consumer, and a likely continued low rate environment will provide an attractive backdrop for real estate investing over the next several years. While returns are likely to be lower across most countries and sectors as investment markets normalize, structural trends such as demographic shifts and technology changes will continue to disrupt real estate fundamentals and impact strategies. This will likely create a new set of attractive investment opportunities across the U.S., Europe and Asia.

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The full report —
"Global Real Estate Trends and Opportunities" — including a full list of citations, can be found at
www.morganstanley.com/im/insights

[1] IPD, PMA, CoStar, MSREI Strategy, Sept. 2017
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[4] Real Capital Analytics, Sept. 2017
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[10] Source: Core Logic, MRIS, Zellman & Associates, MSREI Strategy, September 2017
[11] LCSC, Morgan Stanley Research, data as of August 2017
[12] ABS, Euromonitor, Montel, Kantar, August 2017
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[18] UN World Tourism Organization, World Bank, MSREI Strategy as of Sept. 2017
[19] STR Global, Colliers, MSREI Strategy as of August 2017