

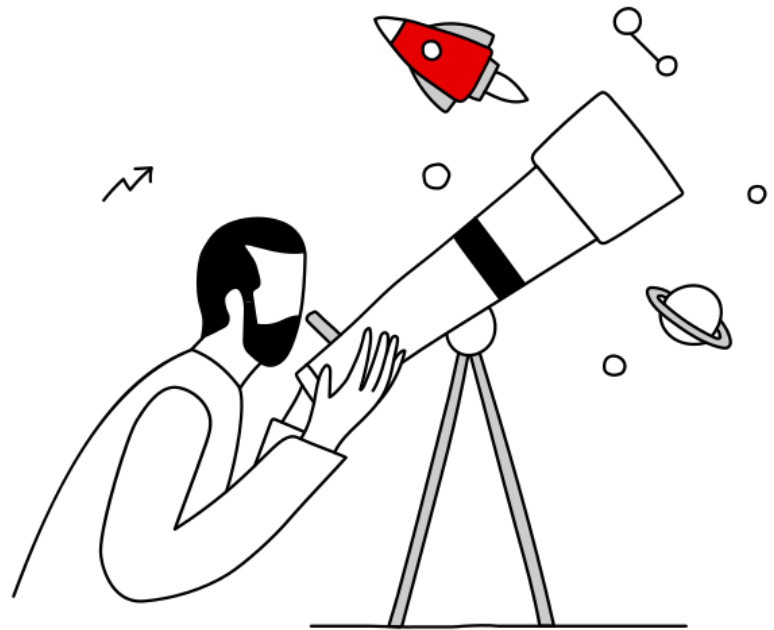
# Top 10 questions

for real estate markets in 2023 | December 2022



## What lies ahead?

# We've narrowed it down to...



## Our research team gives answers to some key questions facing real estate investors.

A year ago, the world remained in the grips of the COVID-19 pandemic and the Omicron variant had just emerged. 12 months on and the pandemic has largely subsided, only to be replaced by a brutal war in Ukraine and inflation reaching multi-decade highs. This prompted central banks to make aggressive interest rate hikes in 2022, with more expected in 2023, along with a mild recession in the economy.

Looking back to our [2022 predictions](#), in general they proved prescient. We expected hybrid working to weigh on the office market and that the polarization between the best and worst assets would continue, which has been the case. We expected retail capital values to bottom out, which they had started to, but are now likely to be impacted by weakening consumer spending. We said that property investors would no longer be able to rely on market-driven yield compression to drive returns, which has certainly proved accurate as the market adjusts to higher interest rates.

In 2023, the environment for real estate looks set to be more challenging, with headwinds coming both from higher interest rates and a weaker economy, which will impact on occupier demand. Against this backdrop, we look at 10 key questions for real estate investors at the turn of the year and how we would approach them. We address [ESG questions](#) in our separate publication.

To start with, we look at whether real estate prices currently fully reflect the move to higher interest rates and what prospects are for the market going forward. We also highlight opportunities for investors in the current environment, and what their strategy can be. We discuss how they can position their portfolios, and which sectors we think are the most defensive.

We then look at prospects for the life sciences sector against a backdrop of slower VC funding. This follows a period of strong growth in the sector and a lot of investor interest. We also dive into student housing in the US, another sector booming among investors, and what impact demographic trends might have on it.

In addition, we analyze how opportunistic and value-add managers will need to adopt their strategies now that interest rates are higher, and how their ability to generate out-size returns simply by adding leverage is gone.

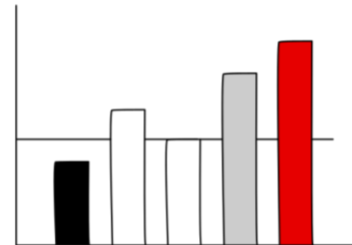
So, a number of important topics for us and investors to consider. We hope you find our answers insightful and useful in determining your strategy and thinking about some of the key questions in real estate as we move into the new year.

# 1

## Do real estate prices currently reflect the rapid shift to higher interest rates?

It takes time for real estate markets to fully reflect changes in the economy, particularly during downturns. This is because market participants must assess what prices should be, made more challenging by uncertainty over the future path of the economy. Buyers and sellers gradually adjust price expectations, and transaction activity slows during this process. This is the situation we see moving into 2023, in the wake of aggressive interest rate hikes in 2022 as inflation hit multi-decade highs. We have already started to see cap rates and yields rise in many markets, with the most rapid adjustment taking place in the UK. However, we do not think that prices fully reflect higher interest rates yet.

To assess when values might bottom out, we can look to past downturns and the listed market for guidance. In the Global Financial Crisis, for example, global capital values bottomed out in 4Q09, while GDP across global real estate markets troughed three quarters earlier, in 1Q09, as did global listed real estate prices<sup>1</sup>.



The early 1990s downturn was longer, with US capital values continuing to decline into 1995. We expect modest declines in GDP in the first half of 2023 before growth resumes. Overall, we think that global capital values will bottom out in the second half of 2023, with the timing dependent upon how the economy fairs and a longer adjustment possible.

<sup>1</sup> According to MSCI Global Quarterly Property Index and FTSE EPRA Nareit Developed Index in USD.

# 2

## What opportunities exist for investors in 2023?



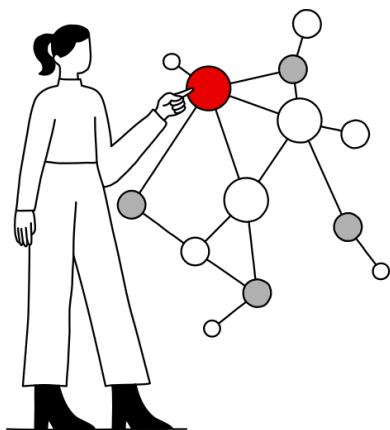
Market downturns usually present opportunities, and one we expect for investors in 2023 is a correction in pricing as the market adjusts to higher interest rates. Although we do not expect large amounts of distress in the market, we do expect some, already apparent in parts of the UK market. This should allow investors access to assets at attractive pricing.

For example, owners who are forced to sell assets because they are unable to refinance debt or need to sell for other reasons, such as generating liquidity quickly. In such situations, sellers may be willing to accept below-market prices, or indeed have to, in order to facilitate a sale. For investors wanting to deploy capital now, holding off for a few months as pricing adjusts is probably the best strategy.

Given the higher interest rate environment, we also think that floating rate real estate debt is an attractive way to achieve strong inflation protected returns and generate a good income return from real estate. Finally, looking across the globe, another potential opportunity for investors in 2023 is Japan, due to accretive hedging gains for investment into this market. Indeed, investors need to be mindful of large differences in monetary policy as interest rate differentials between countries determine the cost of hedging. Currently, Japan is particularly attractive on an after-hedging basis, since interest rates there are lower than in other markets.

# 3

## Which markets and sectors are the most defensive?



There are two schools of thought in answering this question. One would argue that higher yielding assets offer greater value protection as they have a wider spread to the rising bond yields, and in some cases leverage can still be accretive.

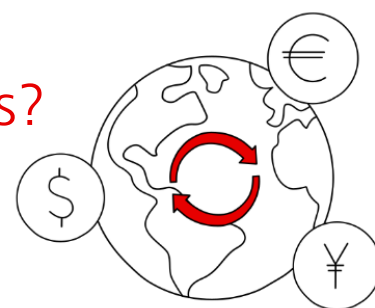
The other would focus on fundamentals, and argue that even at a lower entry yield the potential for income growth over the investment period can mitigate some of the value depreciation from rising rates.

We would side with the second argument. First, risk should define the yield. This means that assets with a higher risk profile will need to adjust to an even higher yield to maintain a risk premium over more core assets. And second, in a period of high inflation, the value of the income of an asset will erode unless it can generate rental growth.

Higher yielding assets generally come from sectors with weak occupational demand, hence the risk of void periods and negative rental growth are much higher, particularly during a period of economic stress. Sectors including life sciences, student accommodation, cold storage logistics and self-storage where there are strong structural drivers to support rental growth, are expected to see the greatest value protection.

# 4

## Will Japan remain an outlier market with low interest rates?



Yes, we think so. Japan's economic recovery has lagged. The labor market improved in 2022, but is still soft relative to 2019. October inflation at 3.6% was the highest in four decades, but modest versus other countries. The pressure was also largely imported while domestic inflation stayed benign.

In that context, maintaining the loose monetary policy appears the right thing to do. However, something has to give due to this diverging policy stance versus elsewhere. JPY succumbed to market forces and fell to a 32-year low as a result, putting pressure on the Bank of Japan's (BoJ) decision. In reaction, the Ministry of Finance intervened in the FX market for the first time since 1998 to stabilize the currency.

This was welcome news for markets. While unlikely to change the JPY direction, we take comfort that both the government and the BoJ are on the same page. First, this helps to buy time until the US Fed softens its hawkish stance. Second, there is also a positive implication that the next BoJ governor due to be appointed in April 2023 will not deviate materially.

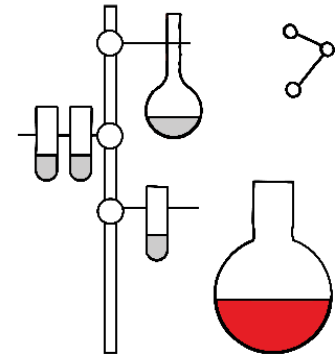
To be clear, an exit from the ultra-loose policy is possible in the medium-term. However, it will most likely be done in a gradual manner. For 2023, at least, the current policy should stay and the chances are even higher now that the peak of global inflation and interest rates are drawing close.

# 5

## With VC funding slowing, what is the outlook for life sciences real estate?

Based on data from Pitchbook, global venture capital invested into life sciences companies in 2022 is set to fall by around 25% on the volume recorded in 2021. With so much hype around the sector, we need to consider what the potential implications are for life sciences real estate markets.

2021 was a stand-out year when a perfect storm of ultra-cheap capital fueled a boom in risk asset investments. At the same time, the spotlight was on the healthcare sector as the pandemic raged on. But despite the financial market turmoil, based on data from the VC funding level in 2022 is still on track to be the second highest on record. There is still liquidity to support growing life sciences companies, but the investment criteria is more stringent. Companies with strong data sets that can demonstrate a clear path in their R&D or progress in trial phases to unlock returns for investors at the next funding round are still finding financial backers.



The supply side still lags well behind the level of demand in most markets. There are significant pent-up requirements which haven't been satisfied by the volume of supply coming through. In the UK's Golden Triangle for example, based on data from JLL there is 3.7 million sqft of active lab requirements against a vacancy of just 50,000 sqft. During a period where pricing power will be key in protecting investments against inflation, this is exactly the supply-demand dynamic investors want to be facing.

# 6

## How will demographic trends affect the US student housing market?



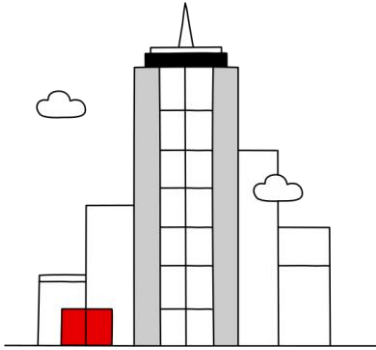
A demographic cliff is looming for college-aged Americans, which stems from a plunge in birthrates during the Great Recession. In four years, marking 18 years since the Global Financial Crisis, colleges and universities will begin to feel the impact of this population decline.

The impact, however, will vary across university tiers. Top-tier universities, generally with sub-10% acceptance rates, will fare well, and student housing adjacent to these highly demanded institutions is expected to remain resilient. For mid-to-low tier universities, the current demographic trend is expected to drag enrollment rates.

Though universities may seek to increase international student enrollment to offset some of the expected slowdown on the domestic side, immigration is heavily tied to politics and is difficult to predict. Therefore, strategically investing in student housing opportunities near highly sought-after universities should insulate investors from the demographic cliff that is approaching.

# 7

## What's next for real estate tech?



The adoption of technology in the real estate market continues to evolve in this challenging environment. Technology provides real estate owners, developers and operators with the ability to improve operating efficiencies, lower capital cost and improve quality of living and working. Macro factors like COVID-19 and supply chain disruptions thrust the need of using PropTech in 2021. Going forward, net-zero policies and regulatory requirements will augment the current universe of startups with *Green Tech* for the built world. Electric vehicles in operation in the US are expected to grow at a 47% average annual rate through 2030, according to UBS Evidence Lab, and less than 0.5% of public parking spots are currently equipped to provide charging.

A wave of charging options paired with renewable energy storage methods will impact multifamily and retail in the coming years. Net-zero disclosure requirements are expected to increase, which will put pressure on landlords to offer ways of tracking energy consumption and carbon emissions by tenant. To do this, asset owners may opt to develop a digital twin of their asset that collects real time information from thousands of sensors in the building.

Governments will ramp up subsidies to incentivize less wasteful development (e.g., embodied carbon) and greener buildings. The largest government programs spend subsidies via the private lending community that will do a green assessment in exchange for lower financing costs at origination. However, we may see increased pressure by regulators to also monitor the asset during the loan's life, further increasing the need for a standard tech solution.

The sector is also captive for taxation when governments eventually look to pay down debts built up over the pandemic. We think that caution is needed to ensure that investors do not pay excessive prices, as strong investor demand has driven risk premiums lower, and to be sure that rental growth assumptions are achievable. Overall though, we think the party for industrial investors will continue into 2023.

# 8

## How should investors position their portfolios?

To set the scene, UBS Investment Bank expects a historically weak macro outlook in 2023, and that the advanced economies will suffer a shallow recession. Their annual GDP is forecast to grow just 0.4% – the weakest since 1982 excluding the pandemic and Global Financial Crisis. Recession will likely be focused on the US and Europe, while growth in APAC slows but remains in positive territory. Global inflation should peak in 4Q22, while interest rates could top out in 1H23. Thereafter, we see potential for rate cuts in 2H23 as the narratives shift to reinvigorating growth.

Against that backdrop, we expect volatility to stay elevated. More attractive deals could emerge, and investors should stay nimble. We think a slight geographical overweight on APAC would be beneficial for portfolios.



That said, we are not bullish, mainly because valuations in this part of the world have yet to adjust meaningfully. Cap rates have only expanded less than 50bps so far compared to up to 100bps in the US and Europe. We expect more rises to come in APAC though the growth buffer should mitigate them. We think the best strategy for real estate investors is broad diversification, both across countries and the different real estate sectors. We think the logistics and residential sectors with positive fundamentals, will continue to outperform, but only by a small margin. Hence, we favor a marginal overweight.

# 9

## Does real estate still provide protection against today's elevated inflation?

Inflation is at a multi-decade high across the advanced economies due to strong demand and bottlenecks, as they emerged from the pandemic, and the energy crisis prompted by the Ukraine war. Looking back at previous eras of above-average inflation, there have been limited cases of negative real total returns for real estate. Additionally, during stagflation, data available for the US market in the late 1970s and early 1980s show that real estate outperformed equities and bonds.

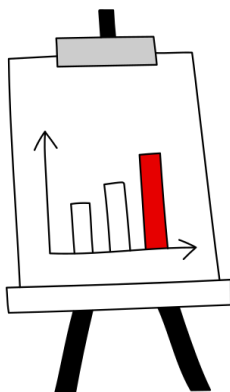
Inflation provides protection when it feeds through to rents and the income that landlords receive. Short leases which allow for rents to be re-gearred in line with higher inflation is one protection, while within-lease rents linked to some measure of inflation is another way of protecting income. Furthermore, real estate sectors with lower capital expenditures and triple net leases (ie. where expenses are passed through to tenants) are best positioned.



The most exposed properties are those with short leases where weakness in the occupier market means that rents cannot be increased when renewing the lease and may even fall in a weaker economic environment. Those on long leases, which do not have any mechanism to increase rents prior to the expiry of the lease, will also likely be less resilient. Properties at notable risk of return erosion (due to rising expenses) are ones whereby labor is a higher portion of expenses such as senior housing and hospitality.

# 10

## How will opportunistic and value-add managers adapt their strategies to higher interest rates?



Value-add and opportunistic real estate managers typically use high amounts of leverage and low interest rates to generate out-sized returns. In the post-Global Financial Crisis period this proved to be a particularly effective strategy, as interest rates were held at record lows and even negative in large parts of the market.

However, with interest rates now rising and expected to continue to do so, the returns which can be generated from leverage alone will dwindle. As a result, managers will need to amend their investment strategies and focus predominantly on the real estate angle to achieve higher returns. This will mean efficient and effective asset management initiatives, such as refurbishing assets, reducing vacancy and growing rents. And also a laser focus on construction and labor costs given sharp rises in them. And ensuring buildings meet ESG criteria.

Managers will also likely be able to generate higher returns by harnessing their skills in sourcing distressed opportunities which become available at discounted prices. As well as finding such deals, managers will need to be able to assess what the appropriate pricing is for them. In particular, they will need to ensure they do not buy an asset at a seemingly attractive price, only for the market to subsequently weaken further. This requires a specific skillset and expertise to source and secure assets at the right price in order to generate value.

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