REAL ESTATE

Unique Attributes of Real Estate Investments

Discussion

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Guy Haselmann, Head of Thought Leadership at MetLife Investment Management (MIM), recently sat down with William Pattison, Head of Real Estate Research at MIM to discuss real estate investing. Will helps break down the various sectors into understandable categories and mentions some of the challenges and new opportunities of each. Will then describes some of the unique and diverse characteristics which portfolios receive through investing in some of these subsectors.

MetLife Investment Management

Guy: ***At a high level, what is the case for institutional investors to invest in Real Estate for the long run?***

Will: The track record has shown resiliency and solid risk-adjusted returns over time, but equally important has been the diversification profile. Over the long run, commercial real estate fundamentals are largely driven by inflation, whereas sectors like stocks and bonds are mostly driven by corporate profits.

Guy: ***How does that mesh with perceived higher risk levels in real estate?***

Will: Investors interpret perceived risks differently and it's at least partially due to differing portfolio mandates and investment time horizons. Over the last several quarters, one risk has been potential lags in the mark-to-market process that all private asset classes face, including real estate. There are always risks and opportunities with any single asset class which is why it is important to analyze how an investment fits within the portfolio in terms of correlation, cash flow and upside/downside potential.

Recent distress from regional banks has also increased concerns since they have historically been an important provider of commercial mortgages. In this case, lower debt availability could put downward pressure on property prices, while opportunities in commercial mortgages could emerge for non-bank lenders, given reduced competition.

The bottom line is that, like many private assets with lower liquidity and higher transaction costs, real estate investing generally works best with long-time horizons, so let me answer your question by looking at historical performance. Over the past 45 years, Real Estate has generated a positive return net of fees in all but 5 years, according to tracking by NCREIF. That is a pretty good result in my opinion and is what I meant earlier by resiliency and stability.

Guy: ***One benefit for a portfolio that you mentioned was "low correlation." Doesn't real estate basically just go up and down like most assets, albeit on a lagged basis? Stocks and bonds are basically valued by the "discounted value of all future cash flows." If you're looking at a property investment with, say, a long-term lease, then that provides long and accurate cash flow information that can be analyzed and compared.***

Will: The valuation techniques with a discounted cashflow analysis are mostly similar between real estate and stock and bond valuations, and the same is true when comparing real estate cap rates and stock price-to-earnings ratios. The underlying performance drivers are not similar though, in my opinion. Specifically, a high inflationary economy should slowly put upward pressure on real estate prices as the cost-to-build grows and the construction pipeline subsequently falls. Increases in productivity or decreases in the corporate tax rate drive sectors like corporate stocks and bonds whereas those factors are only slightly or sometimes even negatively correlated with real estate performance. In my opinion, the low inflationary period following the global financial crisis, and the reduction in the corporate tax rate in 2017, both contributed to the real estate underperforming the stock market in the 2010s.

Guy: ***When you wish to buy or sell a property or investment, how do you locate counterparties willing to transact on the given asset at your preferred and fair valuation within your desired time frame?***

Will: Let me elaborate on your question by expanding on the list of challenges beyond just the execution of the purchase or sale. Asset allocators and investors may also have to select, monitor, and manage the properties during their holding period; something which is not the case with stocks and bonds. Like with many specialized fields, understanding and managing these aspects requires experience. A single tenant warehouse investor, for instance, probably has a better expected value by selling the asset when there is at least five years of term remaining on the lease instead of trying to sell the asset when an economically significant renewal or vacancy is just a year or two years around the corner. By having both debt and equity real estate platforms we are sometimes able to better understand and locate counterparties who are willing to transact, with our equity platform and relationships sometimes helping with mortgage originations, and our lending platform and relationships sometimes helping with equity acquisitions.

Guy: ***We have been speaking about Real Estate generally, and as a whole, but Real Estate investing consists of a vast number of sub-sectors, property types, locations and investment structures; all of which can behave differently across economic conditions. Could you discuss the diversity of the sector?***

Will: Yes—with geography it could be domestic or international, or a fast-growing or slow-growing city with barriers to building new real estate. At a high level, most investors categorize market sizes as "primary," "secondary" or "tertiary." Beyond geography, there are a slew of property types that have differing demand drivers and considerations. One example that creates a potential new category is a "covered land" investment. We are currently under contract to buy a grocery store with a 15-year remaining lease for around $90 million, yet we estimate the land value to be worth a little more than $100 million. It's one of the rare cases where our investor would probably benefit if the grocer defaulted on the lease.

Guy: ***Clearly, the world has changed dramatically in the past few years. We're coming out of a decade of 0% interest rates. The Ukraine conflict has exposed and exacerbated supply chain problems. And pre-pandemic vs post-pandemic behaviors are quite different. Can we assume you see these pressures across real estate in a way that shifted relative value across sub-sectors?***

Will: Absolutely, and it is a great question and important observation. How we choose to work, live, vacation, and shop are all quite different from just three or four years ago. We are focused on questions like how much office space will be needed five years from now, and how much warehouse space is really needed for e-retailers to deliver goods in a three- or four-hour window. It also goes beyond these behavioral shifts with climate change impacting property insurance rates, and a rise in populism contributing to deglobalization and onshoring. Each of these are impacting markets, valuations, building features, and underwriting of our investments.

Guy: ***Could you provide some more granular detail or an example of some of those new preferences?***

Will: Sure. As a result of growing ridesharing services in New York City and San Francisco, apartment renters started being less willing to pay up to live near train stations, and we saw the "on-transit" rent premium decline from about 25% to around 18% from 2016-2019. When the pandemic hit that premium dropped even further as work-from-home reduced demand for apartments located at train stations. Today, we think the on-transit premium is growing as return-to-office grows. As a result, an asset located at a train station may have a materially better rent growth profile than a physically similar asset located just a few blocks further away from the train station.

Another trend has been flexible remote work schedules causing two- or three-night weekend vacations to become four or five nights for many individuals and families, and this is supporting demand for hotels. We had forecasted that this type of trend could occur when we wrote about the hotel sector in a research report in 2021, and it's being measurably realized in our portfolio today. Specifically, Thursday night occupancy rates have been especially high in recent months.

Guy: ***There is so much more to discuss, but that is great place to end today's conversation. Let's sit down again soon to dive a bit deeper into those specific topics and what your analysis is telling you.***

Will: Sounds like a good plan. Thanks.

About MetLife Investment Management

MetLife Investment Management (MIM)[1] serves institutional investors around the world by combining a client-centric approach with deep and long-established asset class expertise. Focused on managing Public Fixed Income, Private Credit, and Real Estate assets, we aim to deliver strong, risk-adjusted returns by building sustainable, tailored portfolio solutions. We listen first, strategize second, and collaborate constantly to meet clients' long-term investment objectives. Leveraging the broader resources and 150-year history of MetLife provides us with deep expertise in skillfully navigating markets. We are institutional, but far from typical.

For more information, visit: investments.metlife.com

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