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INVESTMENT MANAGEMENT

# Perception Versus Reality in Listed Real Estate: More Than Meets the Eye

**INSIGHTS** | GLOBAL LISTED REAL ASSETS TEAM | December 2023

## KEY TAKEAWAYS

- Negative headlines about commercial real estate (CRE) neglect nuance and variations
- There's a wide array of fundamentals within CRE sectors and secular drivers impacting longer-term growth prospects
- The office sector is uniquely challenged by new debt and equity capital sourcing
- CRE banking system contagion fear is overblown and underlying collateral for majority of loans is strong

CRE has been navigating a treacherous path amid rising interest rates, macroeconomic uncertainty, and stubborn inflation. To make matters worse, emerging from the COVID-19 pandemic, changes in how we live, work, and play are exacerbating problems for some types of CRE. Nonetheless, we believe some of these macroeconomic dynamics are improving and there are opportunities for investors who are willing to look more closely.

"While offices may continue to be featured prominently and negatively in headlines, they represent a small and declining part of the investment universe."

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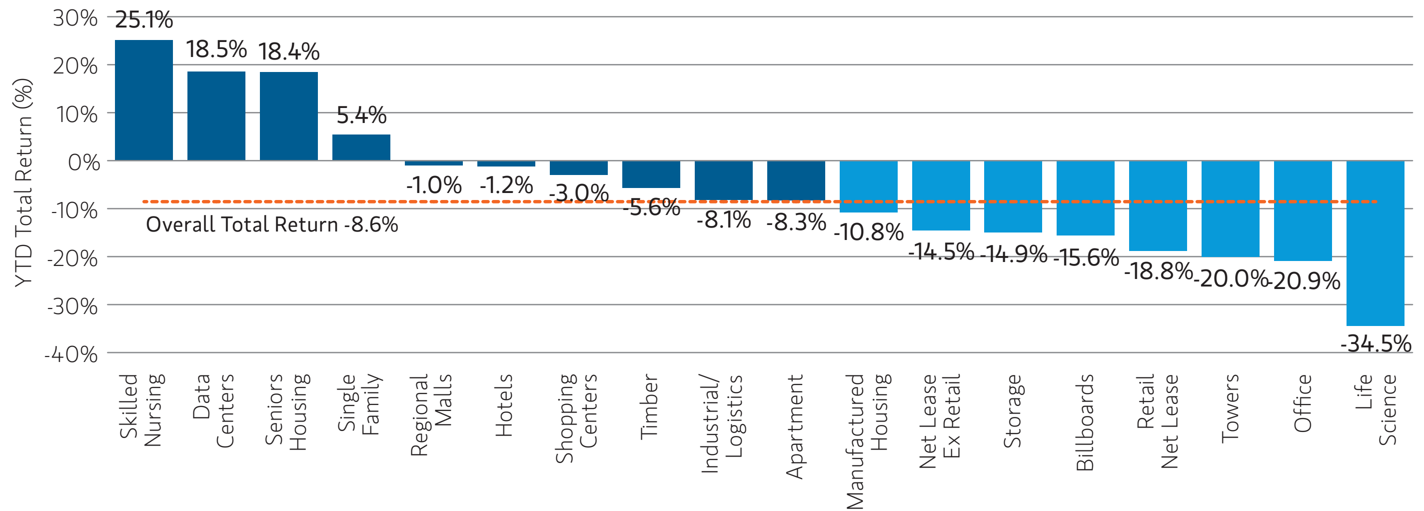
**DISPLAY 1**

**FTSE Nareit All Equity REITs Index YTD Returns as of October 31, 2023**




Source: FTSE Nareit and Morgan Stanley Investment Management

Returns provided in USD terms. Past performance should not be construed as a guarantee of future performance. It is not possible to invest in an index. Groupings are based on how the investment team views the real estate securities universe and do not reflect official groupings. Provided for illustrative purposes only.

A deeper look at sector returns within listed real estate highlights this dichotomy. The U.S. REIT market is an example of how not all CRE is created equal. While sectors such as offices may continue to struggle, many forms of real estate, including data centers, single-family rental housing, and seniors housing are thriving *(Display 1)*.

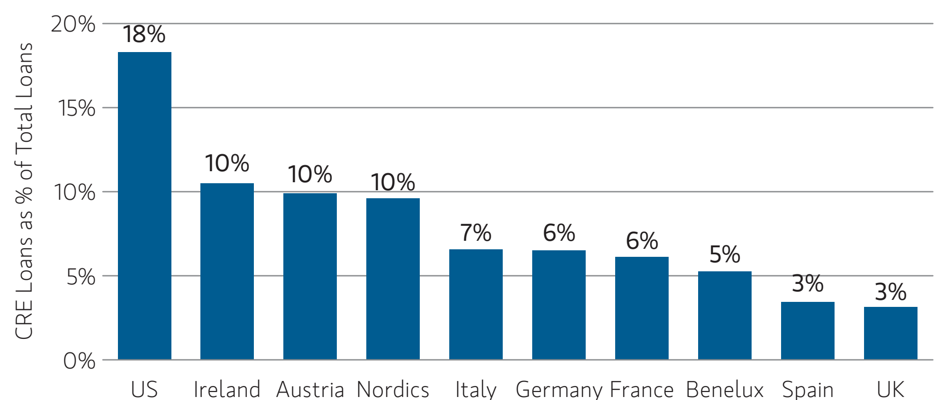
CRE continues to generate negative headlines, largely because of concern over debt capital markets and the office segment. Notably, we believe the old fears that CRE could take down the banking system are overblown. Banks are better capitalized now than during the Global Financial Crisis and, as per *Display 2*, have manageable exposure to CRE. Moreover, even the underlying delinquencies within CRE are low compared to prior levels.

In our view, the concern about office fundamentals and valuations, and offices' ability to tap the debt markets, is valid. However, the concern that office loans will cause banks to implode is not based on reality. Office real estate comprises a fraction (approximately 18%[1] in Europe and 17% in the U.S.[2]) of CRE loans, making overall office loan exposure as a percent of total loans in the low single digits, while offices represent approximately 27% of U.S. CMBS exposure.[3]

Looking more broadly at loans in the U.S., multifamily residential real estate comprises nearly half of all CRE mortgage debt. In most cases, multifamily residential is better positioned because it lacks core secular pressures that hinder some other types of real estate due to the need for shelter, creating a better store of value, and immunity from obsolescence.

**DISPLAY 2**

**Bank CRE Loan as % of Total Loan Exposure by Country**




Source: Moody's Analytics and IMF for U.S. data as of March 2023; Morgan Stanley Research for European data as of Sept. 30, 2023, or last reported based on publicly available data from listed banks.

[1] European Central Bank Banking Supervision as of August 17, 2022

[2] Mortgage Bankers Association as of April 28, 2023

[3] Mortgage Bankers Association as of September 30, 2022

Additionally, as the workplace of tomorrow takes hold, even within the more challenged office sector—which represents a mere 3.3% of the U.S. index and 13.7% of the global index[4]—there will be winners: building quality, sustainability, and location will be more important than ever.

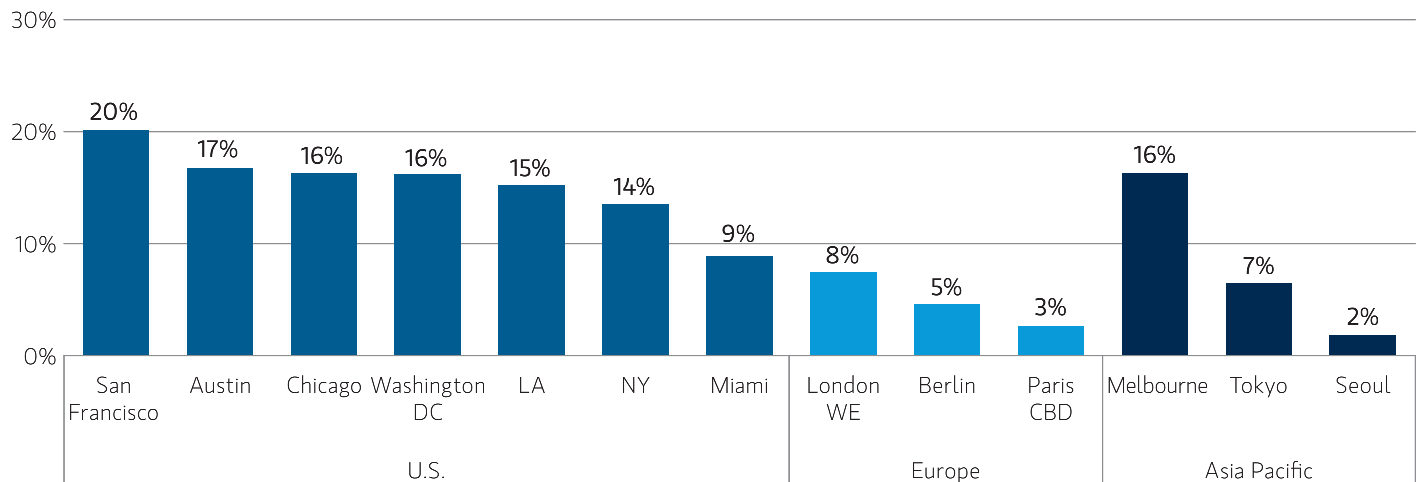
## Return to Office?

Office vacancy rates vary greatly across the globe, as do utilization rates of buildings that are technically occupied.[5] Vacancy is relatively stable in many central business district (CBD) locations in Europe, hovering around 8% in London's West End and 3% in the Paris CBD. Meanwhile, vacancy rates in most of the U.S. continue to increase, with New York at 14% and San Francisco at 20% (See *Display 3*).

Moreover, office utilization rates are around 60% to 65% in European cities with an upward bias, and have stagnated and maxed out at about 50% in coastal U.S. cities, as shown in *Display 4*.

**DISPLAY 3**

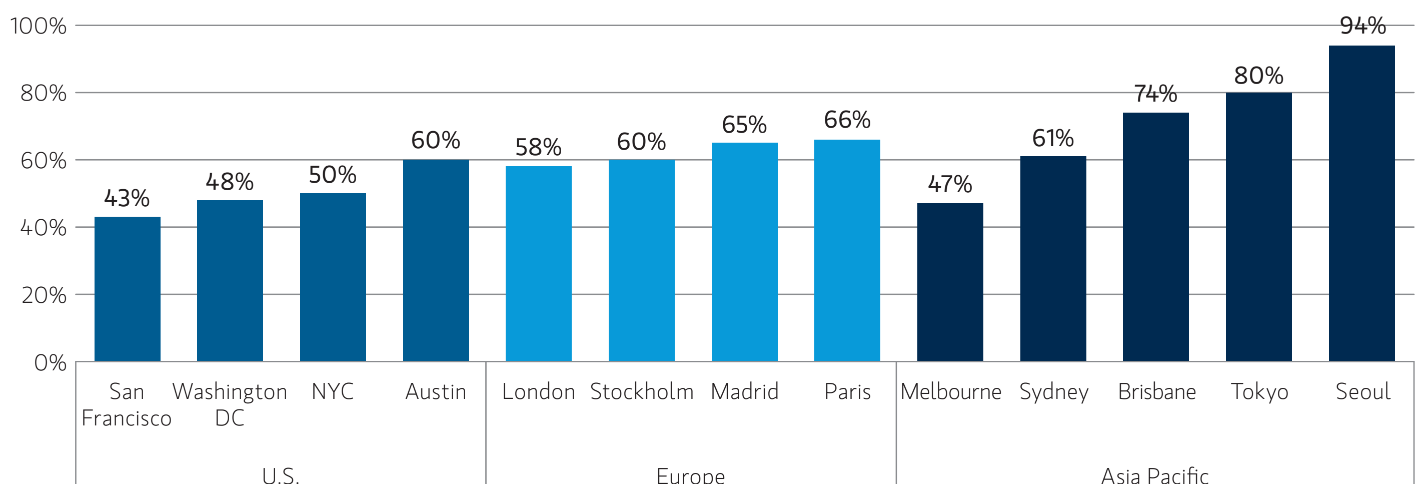
**Office Vacancy Rates by City**




Source: Costar. PMA, Morgan Stanley Real Estate Investing (MSREI) Strategy, November 2023

**DISPLAY 4**

**Office Utilization Rates by City**




Source: JLL, MSREI Strategy, as of September 2023

[4] As of October 31, 2023. U.S. Index represented by FTSE Nareit All Equity REITs Index; Global Index represented by FTSE EPRA Nareit Developed Extended Index. Groupings are based on how the investment team views the real estate securities universe and do not reflect official Index provider groupings

[5] The buildings are occupied in that they are being leased, but the office is not being utilized.

"Globally, the office market is also moving toward shorter leases with more flexibility for tenants. This increases operating risk, but offers opportunities to strong platforms to gain market share and extract higher cash returns from their portfolios."

However, even within more challenging cities, there are examples of real fundamental strength within trophy office buildings. For example, Owen Thomas, CEO of Boston Properties (BXP, the largest publicly traded developer, owner, and manager of premier workplaces in the U.S.) said on the company's third quarter 2023 earnings conference call that: "For the last 11 quarters, net absorption for the premier (office) segment was a positive 8.1 million square feet versus a negative 30.8 million square feet for the balance of the market, and asking rents are 44% higher for the premier workplace segment. Including two buildings undergoing renovation, 94% of BXP's CBD space is in buildings rated by CBRE as premier workplaces, which has been important in driving the increasing office attendance statistics in our buildings and is a critical differentiator for BXP in the leasing marketplace." Globally, the office market is also moving toward shorter leases with more flexibility for tenants. This increases operating risk, but offers opportunities to strong platforms to gain market share and extract higher cash returns from their portfolios.

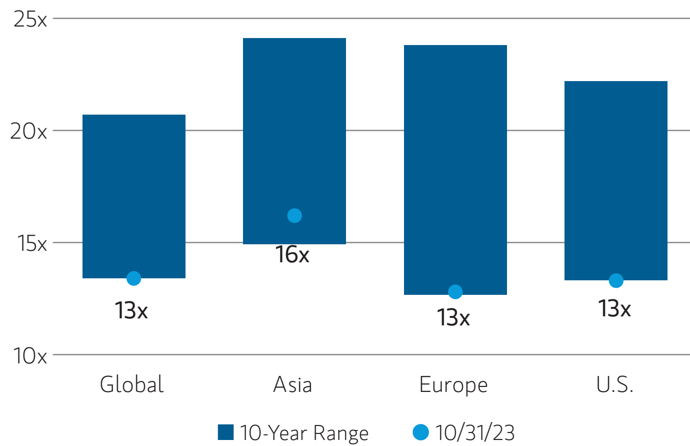
## Where is the Opportunity?

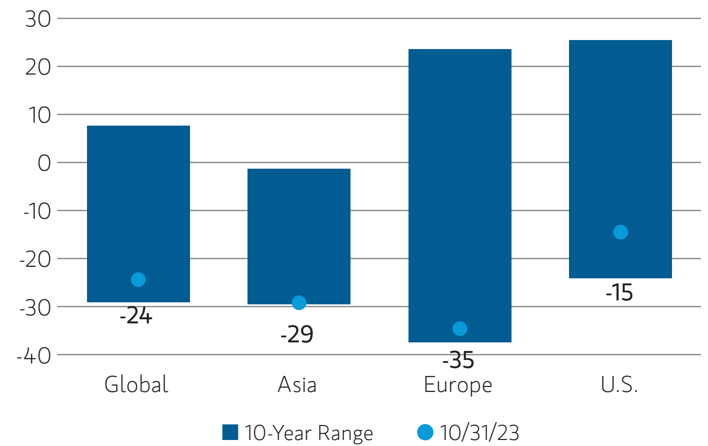
While the office sector continues to pose challenges for investors due to difficult fundamentals and continued value impairment, there are select opportunities within the sector. However, more importantly, there are multiple subsectors of real estate with fundamental strength and opportunity, including:

- **DATA CENTERS:** Data growth facilitating the digital economy and new technologies, including artificial intelligence (AI), continues to provide a robust backdrop for new data center demand. New supply is more limited than it has been historically, due to power availability challenges which have resulted in a favorable environment for landlords to increase rents. We expect these challenges to remain a critical issue going forward, and advancements in AI have been an incremental demand driver to the sector. We believe data center real estate investment trusts (REITs) provide a compelling opportunity for investors not only over the short term, but potentially for the next decade, as the sector is likely to benefit from the strongest long-term secular growth drivers within the REIT universe.
- **SENIORS HOUSING:** The necessity-based nature of seniors housing demand is anticipated to insulate fundamentals from macro headwinds. Labor shortages and expense pressures that were a problem throughout the COVID-19 pandemic, are dissipating. The aging U.S. population, as evidenced by the growth within the 80-plus age cohort, is expected to serve as a significant demand driver for seniors housing through the remainder of the decade, with a compound annual growth rate in excess of 4% through 2030.
- **SINGLE-FAMILY RENTAL HOUSING:** The undersupply of single-family homes in the U.S. coupled with higher mortgage rates should serve as a long-term growth driver for the sector. The U.S. has a shortage of approximately five million homes versus what is needed to house the current population. Additionally, home ownership affordability remains low with monthly differentials of buy versus rent at historic spreads. Lack of affordability increases demand for single-family rental homes. As the population continues to increase, demand within the sector is expected to remain strong. We believe this broader thematic trend of the undersupply of housing will fuel fundamentals for years to come.

**DISPLAY 5**

**Valuations by Region**




Source: UBS Global Real Estate Research, Datastream

## Security and Sector Selection is Vital as Valuations Remain Attractive

Valuations remain attractive with equity multiples and price/net asset value trading at or close to trough valuations globally and in each region (see Display 5), although security and sector selection are key to outperformance. In the current environment, we are underweight offices, but do have select exposure to best-in-class office landlords. Additionally, we are overweight data centers, seniors housing, and single-family rental housing. We are actively managing subsector exposures and closely monitoring valuations as we seek to identify the real estate securities with the best total expected returns for clients.

## Conclusion

The sectoral composition and differentiation among the REIT universe is vital when thinking about and analyzing the underlying risk/reward profile and performance of real estate securities, and helps to create opportunities for active managers within listed real estate investing. While offices may continue to be featured prominently and negatively in headlines, they represent a small and declining part of the investment universe. In contrast, we believe there are compelling opportunities in many other forms of CRE. The Morgan Stanley Investment Management (MSIM) GLRA Team seeks to take advantage of opportunities presented by secular and cyclical trends and attractive valuations as we ultimately strive to identify the real estate securities with the best forward total returns.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