HSBC Asset Management

Real estate:

Capturing opportunities amidst market volatility and price dislocation

June 2024

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This is a marketing communication.

Executive summary

- Following the market downturn across 2022/23 that ended the decade-plus real estate bull run, we believe pricing appears to be at or near the bottom for most sectors, with transaction activity showing signs of improvement.
- Global economic headwinds and capital markets volatility have dislocated current market pricing and created opportunities for experienced and well-capitalised investors to acquire high quality real estate assets on a value basis.
- We anticipate compelling opportunities emerging, but varying across asset, sector and geography:
    - **Asset level:** We see the bifurcation between prime and secondary assets widening, with good-quality assets with strong environmental, social and governance (ESG) credentials set to outperform.
    - **Sector level:** We favour sectors that are underpinned by strong thematic tailwinds, such as the logistics, residential and certain alternative sectors (such as data centres and life sciences).
    - **Geographic level:** We prefer regions that have either repriced the fastest, or where regional economies are set to outperform.
- HSBC Asset Management has a high conviction in opportunistic real estate strategies. We favour large, experienced managers with strength in depth, active asset management capabilities and proven track records of investing in times of volatility, as they are best placed to take advantage of the current price dislocation.

Market context

Subsequent to an era of loose monetary policies that stretched back over a decade following the Global Financial Crisis (GFC) in 2008/09, the rising interest rates seen since 2022 have presented a shock to the system. The commercial real estate sector's bull run came to an abrupt halt, as rising interest rates led to significant deterioration in values, investor sentiment and transaction activity.

The global decline in real estate capital values from their peak the end of Q4 2023 amounted to -14%, according to MSCI. Figure 1 shows that the decline varies across countries and, at a regional level, has been the deepest in Europe (-18%), followed by the U.S. (-15%). The correction has been significantly slower in Asia Pacific (-1%), which largely reflects the prolonged period of negative interest rates in Japan.

However, as the pricing correction appears to have almost entirely played out, we are anticipating the start of a recovery phase, with steadying yields in sectors with strong fundamentals and resilient occupier markets (for high quality assets).

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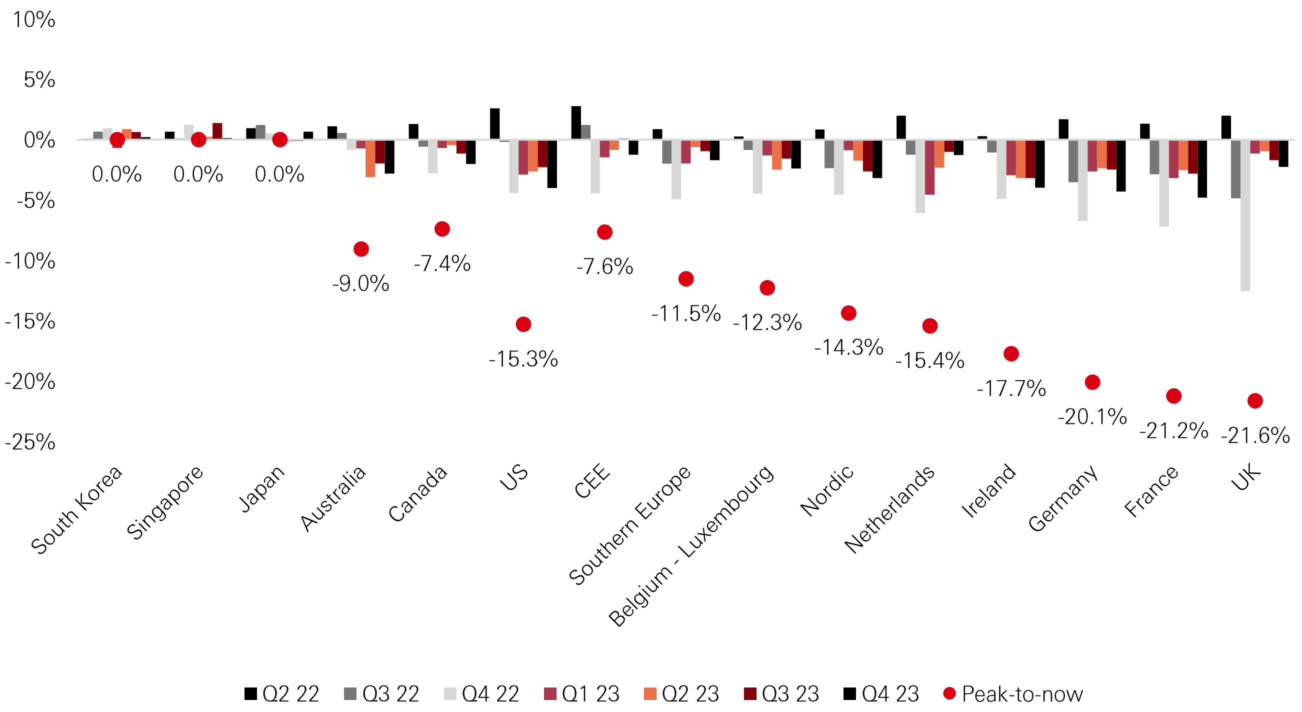
Although financing may remain a constraint on investment activity, the level of distressed sales is far from that seen in the GFC. Leverage has been more conservatively used by owners and credit has become more readily available thanks to the increase in alternative lenders.

On the supply side, COVID-related disruptions, rising construction and financing costs, labour shortages and falling asset prices have resulted in a significant decrease in new construction starts. In terms of quality, there is a general undersupply of prime assets. This is still driving rental growth and we see this trend in the residential, healthcare, logistics, data centres and other sectors. Of course, this differs by region and market, as we will dive into greater depth in the following sections of this paper.

Figure 1: Real estate capital value declines across countries



Source: MSCI, as of December 2023.

Market outlook

As we move towards the second half of 2024, there are early indications that investment activity will start to accelerate: bidder pools are deeper, the availability of debt has increased, and the bid-ask spread (though still wide) has narrowed. Moreover, some recent M&A deals in the listed real estate sector indicate improving investor sentiment.

The bifurcation between good- and poor-quality assets is becoming more pronounced, as investors continue to target grade-A assets with strong ESG credentials, whilst avoiding secondary assets where future retrofit costs are rising. Poor-quality assets are likely to underperform, with those in sectors with weak fundamentals, such as secondary offices and retail, being the most likely to bear the brunt of any further corrections in value.

Despite higher interest rates, most economies appear to have avoided recessions, and where GDP has declined, it has been modest. Low unemployment is supporting rising household incomes and future interest rate cuts may boost economic activity, though central bankers are wary of stoking inflation. Although interest rates are expected to decline across 2024, few expect rates to return to pre-pandemic levels. With a higher cost of borrowing, active asset management alongside rigorous sector and asset selection remain key to delivering income growth and capital gains.

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Construction activity has been subdued as a result of significant inflation in development and financing costs. Against a backdrop of healthy underlying fundamentals, we anticipate the potential shortage in supply should sustain above average rental growth over the coming years.

Snapshot on global and regional outlook

Global Trends	▪ With capital values at or near the bottom, we expect investment activity to pick up in H2 2024. ▪ Ongoing bifurcation in occupier preference in favor of high-quality, sustainable space in the best locations. ▪ Future supply is moderating, pointing to continued rental growth for prime properties. ▪ Skilled asset management will be increasingly key to driving performance.
Europe	▪ Europe's economic prospects are subdued, though prime assets should continue to benefit from declining future supply and occupier preference for high quality space. ▪ Future returns should be stronger than recent years, following a sharp re-pricing. ▪ Logistics, residential (including student accommodation) and some select office markets are anticipated to outperform.
North America	▪ The US economy is expected to continue outperforming other developed markets, which should support rental growth across most sectors. ▪ The best-returning prospects are expected to be property sectors with strong rental growth, such as logistics, residential and alternatives (including data centres and life sciences), followed by higher yielding sectors with stable fundamentals, such as retail.
Asia Pacific	▪ Leasing momentum is the strongest for the retail sector, as rebounding tourism supports prime retail locations. ▪ Property yields have been relatively stable, limiting capital value declines, but relatively low property yields point to lower future returns compared with other regions.

The importance of sector selection

HSBC Asset Management believes sector selection is crucial for investors to capture return potential, especially in the current environment of elevated interest rates. We see opportunities in sectors that are supported by secular tailwinds, most notably the logistics and housing sectors; whilst sectors and assets that are unlikely to benefit from structural or thematic tailwinds can be particularly vulnerable.

Logistics

Despite showing signs of a slowdown in 2023, the logistics sector is still well positioned to benefit from the growth of the e-commerce sector. The long-term consumer preference shift away from physical retail spending to digital sales was catalysed by the pandemic, which forced occupiers to frantically develop their logistics networks. Whilst these pandemic-induced measures have since retracted, the desire to re-shore production has grown stronger, as companies reduce their reliance on international supply lines, further supporting the need for logistics facilities. Therefore, whilst logistics demand softened slightly last year, the long-run outlook for logistics remains strong, with rents forecast to continue increasing throughout 2024, though at a more moderate rate than previously experienced (see Figure 2).

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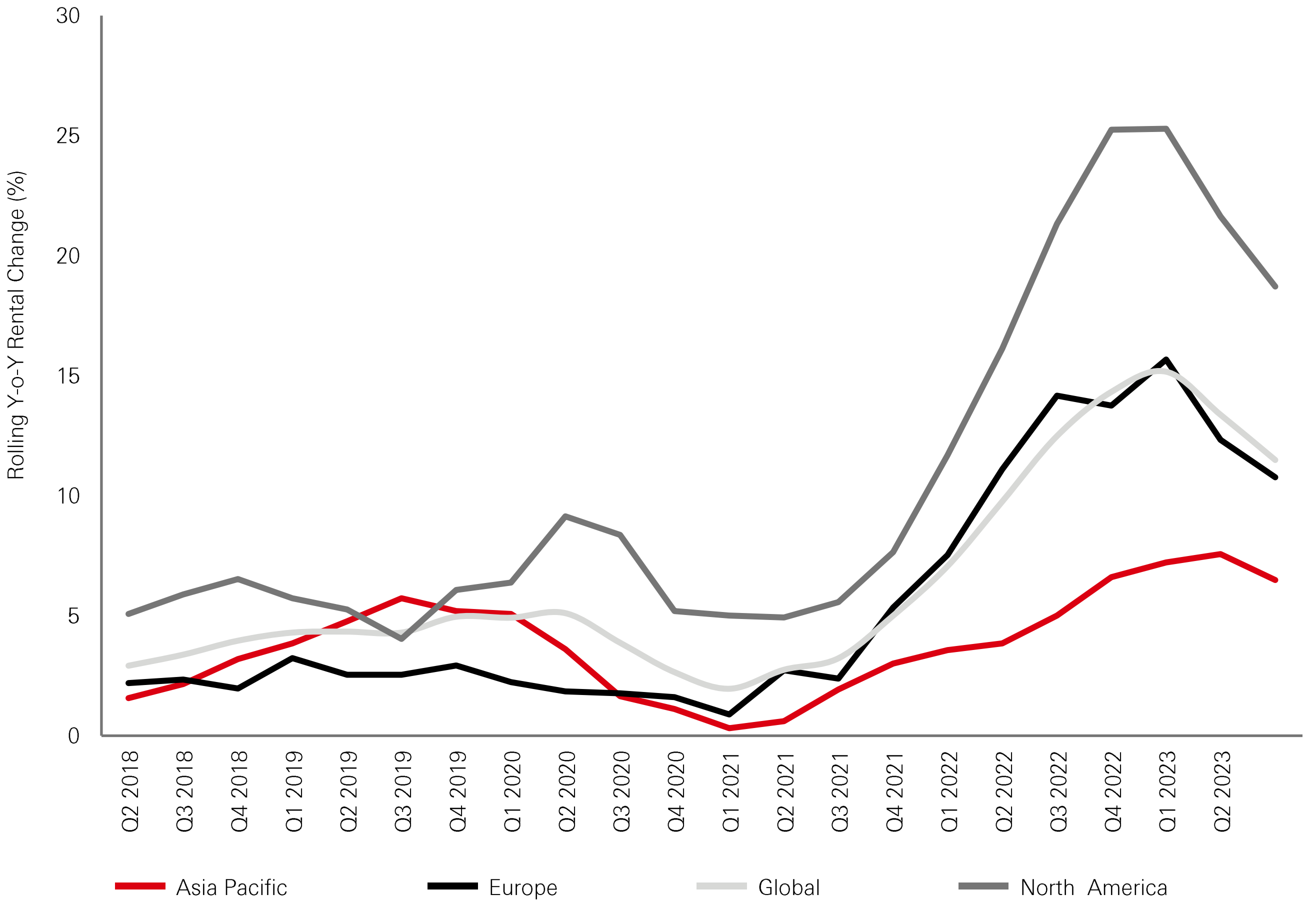
Figure 2: Rental growth has begun to stabilize but remains above historical levels

Logistics annualised rental growth rates (Q2 2018 – Q2 2023)



Source: CoStar, CBRE, JLL, SIILA/Buildings. Q2 2023 figure is annualised for comparison.

Housing

The housing affordability crisis is pushing many into the rental market, as the possibility of purchasing a home grows out of reach for vast pockets of the global population, particularly in the US (see Figure 3). There is a chronic lack of supply in many markets, which is expected to worsen in 2024, as the already constrained development pipeline is expected to shrink due to the impact of higher interest rates on development funding. Demand in some markets is being driven by increased household formation, migration and the return to urban centres. This demand-supply dynamic and affordability constraint is driving accommodation seekers to rent residential property rather than buy, which in turn should support future rental growth in this sector.

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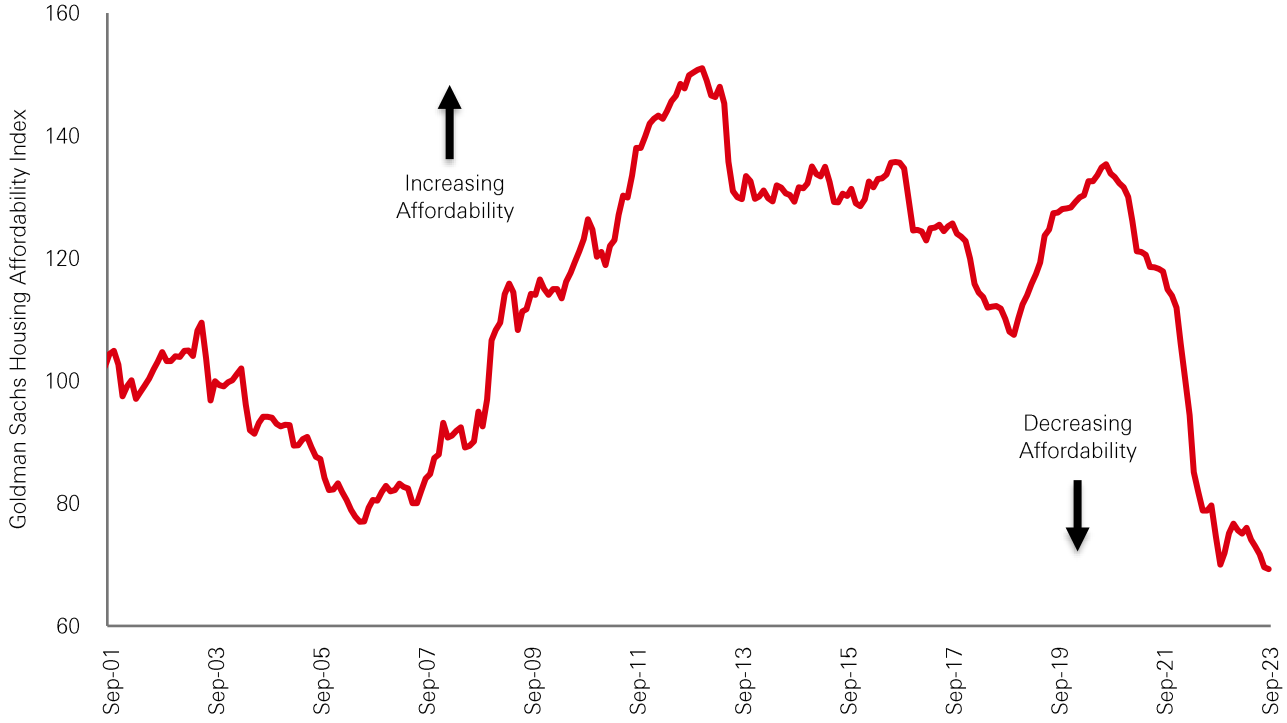
Figure 3: U.S. Housing affordability at historic lows, supporting rental growth in the housing sector(median monthly income vs. median monthly mortgage payments)



Source: Goldman Sachs Research, as of September 2023.

Hospitality

The hospitality sector suffered during the pandemic, as lockdown measures restricted global tourism activity, but it is now returning to pre-pandemic strength – as demonstrated in Figure 4. Markets like London, New York and Tokyo are expected to lead global revenue performance in 2024, as travellers continue to return to cities. In Europe, domestic and short-haul leisure travel is expected to drive hotel demand in the region, further supported by the return of long-haul travellers from Asia Pacific. Intraregional tourism within Asia Pacific surged through 2023 and the removal of China's group travel ban is providing an additional boost, particularly to Australia and Japan. The growth in demand for hotels is expected to outpace supply, as the development pipeline has been constrained by higher construction and borrowing costs. Again, bifurcation is expected in the hotel market, with the most popular tourist destinations expected to experience the most robust demand.

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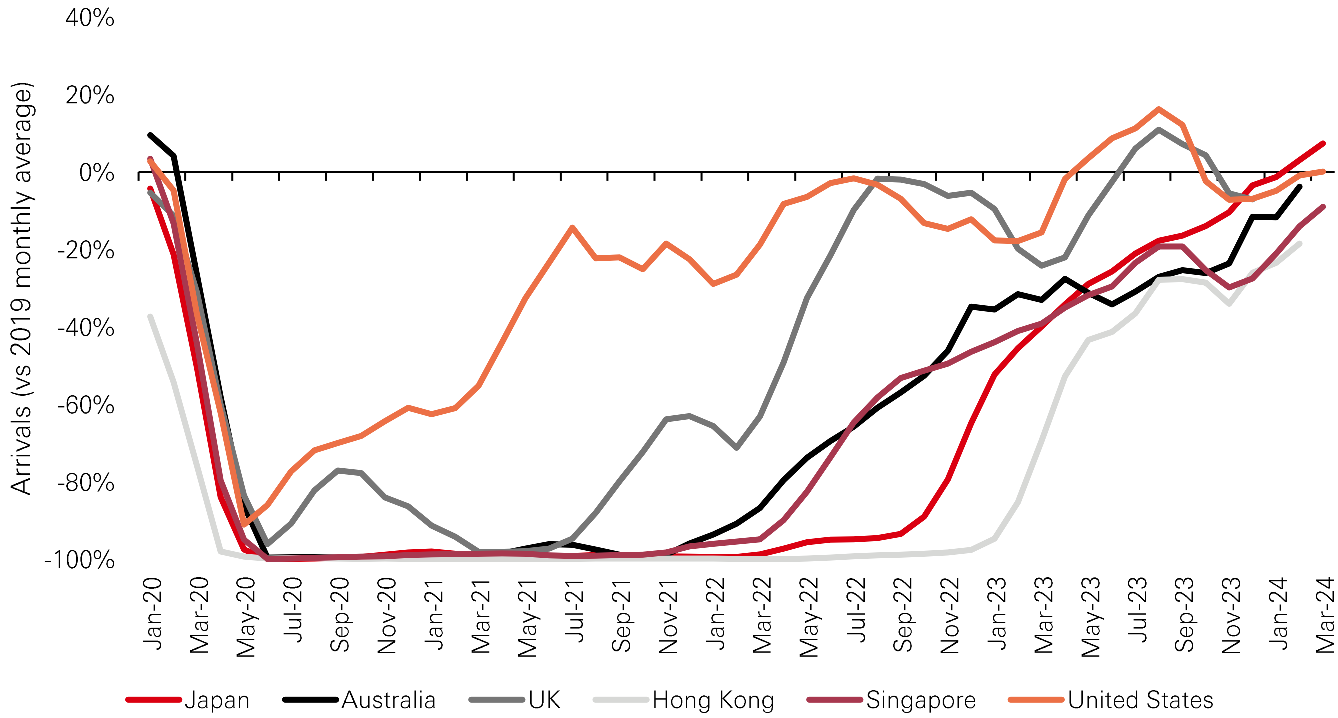
Figure 4: Global post-pandemic recovery in tourism arrivals



Source: LSEG Datastream. Data to March 2024

Office

The office market continues to be influenced by the work from home trend, as many companies have shifted away from an office-based to a hybrid working model. However, whilst occupiers are demanding less space compared to the pre-pandemic period, higher quality space is in demand. This is expected to continue widening the bifurcation between best-in-class assets and secondary stock. High quality modern offices located in the most desirable locations with amenity offerings and sustainability credentials are set to outperform in terms of leasing and rental growth, compared to older, poor-quality stock facing heightened vacancy and obsolescence risks. Opportunities exist for investors that are willing to acquire and refurbish secondary assets, repositioning them to the quality demand from tenants. However, investors must be careful in selecting the right asset, in the right location, following the right strategy.

Retail

Despite the growth of online retail activities, physical retail space remains highly valued by shoppers who desire an in-store experience over a virtual experience. Prime rents are forecast to grow across the retail sector, as demand has continued to improve with both sales and footfall rising during 2023. As with logistics and office assets, the dispersion between prime and secondary assets is widening, with evident differentials in both rental growth and occupancy. This trend is supported by retailers choosing to focus on the retail locations where recovery has been the strongest.

The importance of geography selection

Geography selection matters as much as sector selection when it comes to achieving superior returns in real estate. Some geographies, such as the UK and Europe, have repriced faster than others, creating opportunities for investors to acquire high-quality assets at a discounted price to their intrinsic value. Additionally, in other geographies, such as the US, the economic outlook is more positive due to outperforming regional economies, again presenting opportunities for investors to gain exposure to high growth markets.

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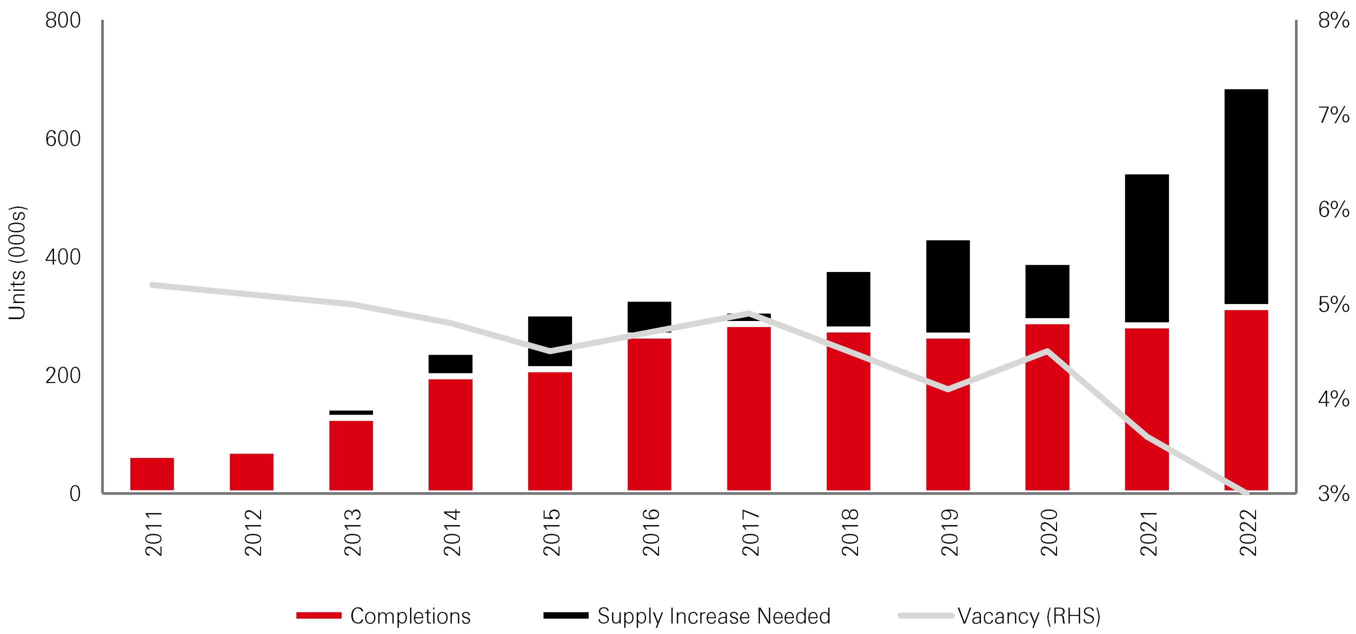
North America

In North America, the US economy is expected to continue outperforming other developed markets, which should support rental growth across most sectors.

We see opportunities for investors in the residential sector, where there is a critical undersupply of housing, which has been further exacerbated by the recent increase in construction and mortgage costs, as demonstrated in Figure 5. We also see opportunities in the growing life sciences sector, where strong demand is underpinned by aging populations, competition for drug discovery, and the development of innovation clusters. Other sectors we believe have strong momentum in North America include the logistics market, which continues to gain from the increasing penetration of e-commerce, and the leisure market, which benefits from the rebound in tourism and demand for entertainment venues.

Figure 5: Residential supply in the U.S. has failed to match demand every year for the past decade

U.S. multifamily stock



Source: Dodge Data & Analytics, RealPage Inc, CBRE Econometrics Advisors, 2022.

Europe

Whilst the outlook for economic growth within the Eurozone is weak compared to other regions, Europe remains an attractive destination for real estate investment due to the speed and completeness of asset repricing in the region. Such price adjustment creates vast opportunities for investors to acquire assets at attractive prices and reposition them to best-in-class standards.

The logistics sector is particularly attractive due to embedded "mark to market" underpinning income growth, which should continue to drive healthy performance. There are also opportunities for investors in the residential and life sciences sectors, which are supported respectively by decreasing affordability of housing, and advancements in medical research and development.

In general, the office sector remains unattractive for investors, given lower occupier demand and expensive capital expenditure requirements for older buildings. However, in supply constrained markets like central Paris and London's West End, a lack of future supply, combined with strong demand for high quality space, is supporting the outlook for prime rental growth.

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Asia Pacific

The healthy economic backdrop of low unemployment and steadily rising income across Asia Pacific has encouraged consumer spending and retail sales. This has been supported by the recovery of international tourism and the pivot in consumer behaviour back to physical stores (as opposed to online). As a result, retail leasing sentiment has been notably healthy with occupiers having a thirst for more space.

Whilst the relative stability of property yields has limited capital value declines, lower yields point to lower future returns. Moreover, despite the stronger outlook for economic growth, rental growth is not expected to compensate investors for lower yields.

However, the diversity of the region's property market means there are opportunities. For example:

- In Tokyo and Singapore, the rebound in tourism is supporting prime retail locations, where rising tourist spending has been accompanied by higher rents.
- In Australia, urban logistics remains attractive around Sydney and Melbourne, where vacancy rates, according to CBRE, remain close to zero and rental growth remains strong, with significant embedded growth. Furthermore, yields have risen from 3.75% to over 5.5%, significantly higher than the regional average.[1]

HSBC Asset Management's conviction in opportunistic real estate strategies

What is opportunistic real estate?

Investors can access real estate through a variety of different strategies that accommodate their risk and return preferences. At opposing ends of the risk-return spectrum, we have:

- **Opportunistic –** Opportunistic strategies are higher-risk and offer investors higher potential returns, mainly comprised of capital appreciation with little income streams provided. The focus lies more on redeveloping and repositioning, along with ground-up development of assets. The use of leverage is typically higher (60%+), commensurate with higher target returns of 15%+ internal rate of returns (IRR) in general.
- **Core –** Core strategies are lower-risk and offer investors lower potential returns, driven predominantly from income as opposed to capital appreciation. Core properties require very little asset management and are typically occupied by strong covenant tenants on long leases. Leverage is on the lower end, typically up to 40%, with target total returns of 6-10% IRR, inclusive of the income component.

HSBC Asset Management has a high conviction in opportunistic strategies, as we eye opportunities in various real estate sectors, driven by the following considerations:

Investor appetite for higher returns

- During times of market dislocation, investors tend to favour opportunistic strategies.
- Appetite for such strategies aiming for higher risk-adjusted returns has increased, as core strategies are delivering returns barely above the risk-free rate of many government bonds.
- In our view, investors are looking for compensation with a healthy spread versus base rates and see opportunities to take advantage of distress situations to acquire high-quality assets at discounted prices.

1. Source: CBRE, as of December 2023.

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Taking advantage of market dislocation and stressed capital structures

- Increased cost of bank financing and lower capital values are stretching loan-to-value covenants.
- Liquidity-constrained borrowers with near-term loan maturities may be forced either to recapitalise, seek equity infusions, or sell attractive assets to support capital needs.
- This creates a very attractive buying environment for well-capitalized investment managers with access to liquidity, such as committed capital in drawdown structures and strong lender relationships.

Operating fundamentals remain robust

- Underlying demand fundamentals remain attractive for high quality assets, while supply is often insufficient, therefore driving rental growth.
- Undersupply is expected to continue to support above-inflation rent growth for the foreseeable future.
- These trends have presented opportunities to acquire high quality, operationally sound real estate assets at attractive prices. In particular, we are seeing opportunities in the residential, healthcare and logistics sectors, along with the communication infrastructure of fibre networks and data centres.

Active asset management and value creation

- Well-capitalised managers with strong balance sheets and trusted relationships with lenders are able to complete large, creative, and complex transactions, where competition is limited.
- Having deep local teams across the globe allows managers to keep a close "ear to the ground", allowing them to source deals across their target markets whilst ensuring asset management initiatives are executed to the highest standards.
- A manager's value-add proposition hinges upon its ability to renovate, reposition and re-lease underperforming assets. Managers with a strong focus on active asset management are expected to deliver cash flow growth and value creation.

Conclusion

Global economic headwinds and capital markets volatility have dislocated current market pricing and created opportunities for experienced and well capitalised investors to acquire high quality real estate assets on a value basis.

We anticipate compelling opportunities emerging but varying by asset, sector and geography. At the asset level, we expect prime assets to outperform secondary assets as the market bifurcates further. At the sector level, we favour the logistics, housing and certain alternative sectors (such as data centres and life sciences) for their strong secular and thematic tailwinds; hospitality and retail for their post-pandemic rebound; and the repositioning opportunity within the office sector. At the geographic level, we prefer regions that have either repriced the fastest, or where regional economies are set to outperform.

HSBC Asset Management believes that managers with a global reach and access to large scale capital and operating platforms will provide a clear competitive advantage. Their size allows them to carry out large scale, complex transactions across sectors often with little competition. Furthermore, active asset management will be increasingly key to driving performance going forward and, therefore, allocating capital to managers renowned for their operational capabilities in redeveloping and repositioning assets will be an essential approach to deriving returns from the real estate asset class.

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Key Risks

There is no assurance that a portfolio will achieve its investment objective or will work under all market conditions. The value of investments may go down as well as up and you may not get back the amount originally invested. Portfolios may be subject to certain additional risks, which should be considered carefully along with their investment objectives and fees.

- **Illiquidity**: An investment in the strategy is a long term illiquid investment. By their nature, the Strategy's investments will not generally be exchange traded. These investments will be illiquid.
- **Long-term Horizon**: Investors should expect to be locked-in for the full term of the investment.
- **Economic Conditions**: The economic cycle and prevailing interest rates will impact the attractiveness of the underlying investments. Economic activity and sentiment also impacts the performance of underlying companies, and will have a direct bearing on the ability of companies to keep up with interest and principal repayments.
- **Valuation**: These investments may have no or a limited liquid market, and other investments including those in respect of loans and securities of private companies, may be based on estimates which cannot be marked to market until sale. The valuation of the underlying investments is therefore inherently opaque.
- **Strategy Risk**: Investments into this Strategy may, among other risks, be negatively affected by adverse regulatory developments or reform, credit risk and counterparty risk. The credit market bears idiosyncratic risks such as borrower fraud, borrower bankruptcy, prepayment risk, security enforceability risk, subordination risk and lender liability risk.
- **Investor's Capital At Risk**: Investors may lose the entirety of invested capital.
- **General Real Estate Risk**: an investment in real estate may be affected by various matters, including, but not limited to, vacancies following expiry or termination of leases or licenses leading to reduced occupancy rates, the property manager's ability to collect rents or license fees, competition for tenants, fluctuating local real estate conditions, changes in government regulations relating to land use and zoning, environmental, occupational and safety matters, existence of uninsured or uninsurable risk, natural disasters, acts of war or terrorism. Property markets can be cyclical.
- **Third-Party Risk**: governance of underlying assets remains the responsibility of third-party managers. Regular assessment is undertaken for third-party manager approval.
- **Exchange Rate Risk**: investing in assets denominated in a currency other than that of the investor's own currency perspective exposes the value of the investment to exchange rate fluctuations.
- **Concentration Risk**: funds with a narrow or concentrated investment strategy may experience higher risk and return fluctuations and lower liquidity than funds with a broader portfolio.
- **Real Estate Risk**: property can be difficult to buy and/or sell quickly and the Fund Manager of underlying investments may apply a deferral on redemption requests. The value of property is generally a matter of the valuer's opinion rather than fact.
- **Derivative Risk**: the value of derivative contracts is dependent upon the performance of an underlying asset. A small movement in the value of the underlying can cause a large movement in the value of the derivative. Unlike exchange traded derivatives, over-the-counter (OTC) derivatives have credit risk associated with the counterparty or institution facilitating the trade.
- **Operational Risk**: the main risks are related to systems and process failures. Investment processes are overseen by independent risk functions which are subject to independent audit and supervised by regulators.
- **Leverage Risk**: Where leverage is used, it will be subject to the risks normally associated with debt financing, including the risk that cash flows will be insufficient to meet required payments of principal and interest and the risk that indebtedness will not be able to be refinanced at all or on favourable terms.
- **Credit Risk of Tenants**: Adverse changes in the operation of a real estate asset, or the financial condition of any tenant, could have an adverse effect on the ability to collect rent payments and, accordingly, on the ability to make distributions to Investors
- **Exit Risks**: Investments are made with the assumption that an exit will be made through a sale. There is no guarantee that favourable market conditions will prevail when a sale is contemplated. The process of exiting from an investment may take longer than anticipated.
- **Tenure Risk**: An investment in real estate has a long investment period and is only suitable for investors who have a long term investment horizon.

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