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MARKET COMMENTARY

The opportunity of EM real estate

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Institutional investors have increased exposure to real estate since the Global Financial Crisis. Despite the increasing focus, the asset class remains dominated by developed markets.

This paper discusses the global real estate market, with a specific focus on the case for EM real estate.

Introduction

Low rates have increased the affordability of real estate, a USD 220 trillion asset class

Lower interest rates in the aftermath of the Global Financial Crisis are increasing the affordability of real estate while rendering conventional liquid fixed income in developed economies (DM) less attractive. Real Estate is therefore becoming an increasingly important allocation in institutional investors' portfolios.

At nearly USD 220 trillion, the global real estate market is the largest market in the world, dwarfing both conventional fixed income and equities.

Emerging Markets (EM), which make up about 55% of the global real estate market, is supported by strong fundamental and idiosyncratic drivers. EM real estate offers significant diversification benefits in the context of global real estate portfolios due to intra-EM diversification. This, alongside high real yields, means that EM real estate can have superior investment performance to DM real estate.

The main risks associated with EM real estate – transactions and macroeconomic risks – can be mitigated with specialist asset management skill, and diversification.

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This paper analyses the opportunity in EM real estate.

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Section 1.

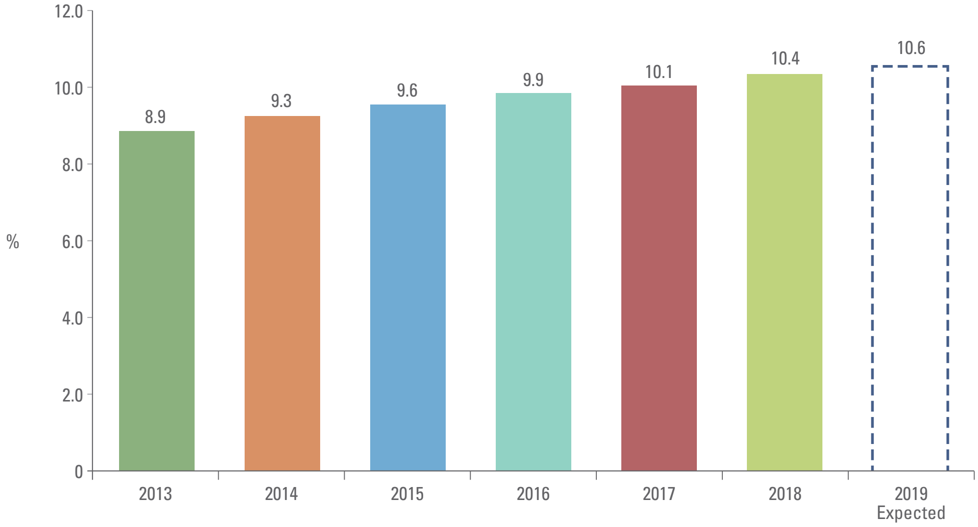
The growing appeal of real estate in a low interest rate world

The Global Financial Crisis, and the subsequent decade of hyper-easy monetary policies changed the way institutional investor portfolios are constructed. Lower interest rates are making conventional liquid fixed income investments in developed economies less attractive, while at the same time making real estate more affordable.

Figure 1 shows the growth in allocations to broad real estate. In 2013, institutional investors allocated on average 8.9% to real estate. This allocation has since increased by nearly one fifth and is expected to reach 10.6% by the end of 2019, according to the Cornell Real Estate Review of April 2019.[1] With developed economies slowing and interest rates likely to remain low, the shift towards real estate from conventional fixed income is likely to continue, in our view.

Exposure to real estate has increased by nearly 20% in institutional portfolios since 2013

Fig 1: **Weighted target allocation to real estate**

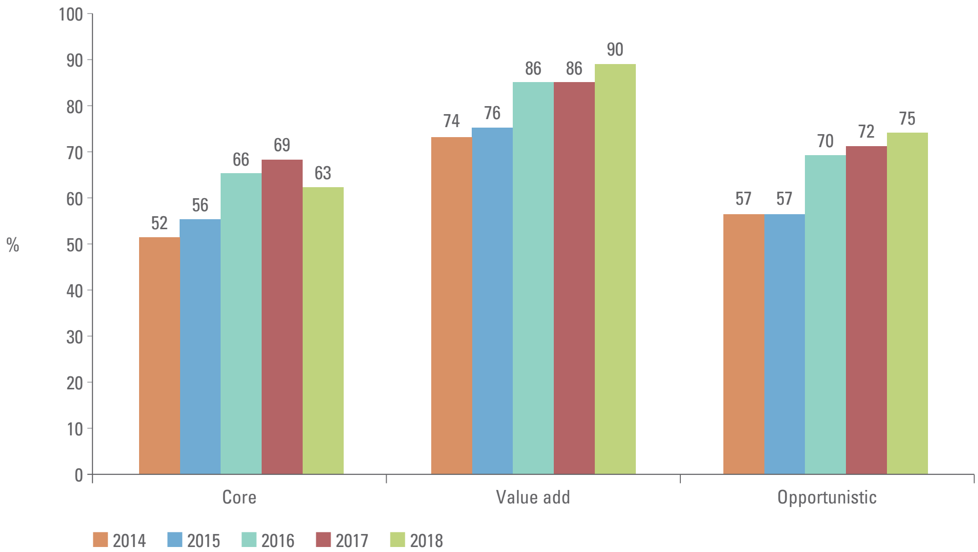


Source: Cornell University, Ashmore.

As exposure to real estate has increased broadly, investor focus has also expanded across a wider range of real estate strategies as shown in Figure 2. While all strategies have seen increased attention since 2014, there has been more interest in opportunistic real estate strategies (high growth oriented) relative to core strategies.

Investors are increasingly focused on high growth real estate strategies

Fig 2: **The shift from core to opportunistic strategies within real estate**



Source: Cornell University, Ashmore.

[1] See: https://scholarship.sha.cornell.edu/cgi/viewcontent.cgi?article=1267&context=crer

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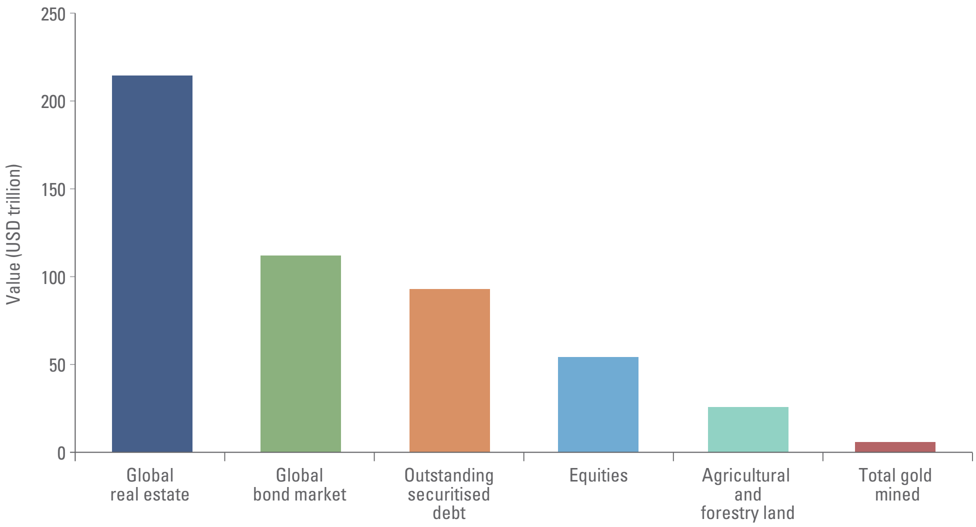
Section 2.
The global real estate market

The global real estate market was worth USD 217 trillion at December 2017, of which USD 162 trillion was residential real estate. The global real estate market is twice as large as the global bond market (USD 113 trillion) and four times as large as the global equity market (Figure 3).

The global real estate market is larger than the combined size of the global bond and equity markets

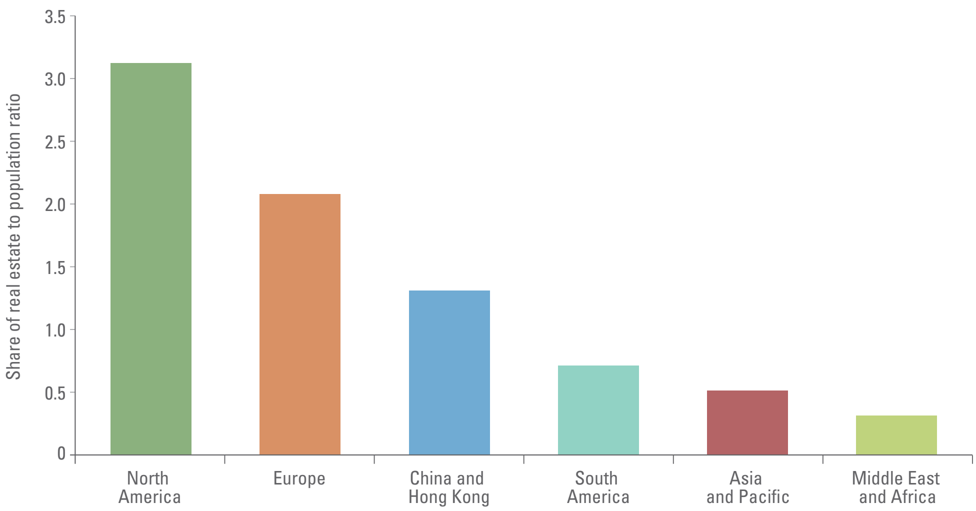
Fig 3: **The global real estate market versus other major asset classes**



Source: Ashmore, Savills Research.

Europe and the US account for 45% of the world's residential real estate value. The remaining 55% is split mainly between EM countries with 25% in China and Hong Kong, 19% in the rest of Asia, 6% in the Middle East and Africa and the balance in Latin America (5%). Over time, EM's share of the global real estate market is likely to rise both in absolute terms and on a per capita basis, since the richer regions tend to account for larger shares of the global real estate relative to their population shares (Figure 4).

Fig 4: **Richer countries account for greater shares of global estate and smaller shares of population than poorer countries: ratio of global real estate share to population share, by geographical region.**



Source: Ashmore, Savills Research.

Section 3.

Structural and cyclical drives of EM real estate

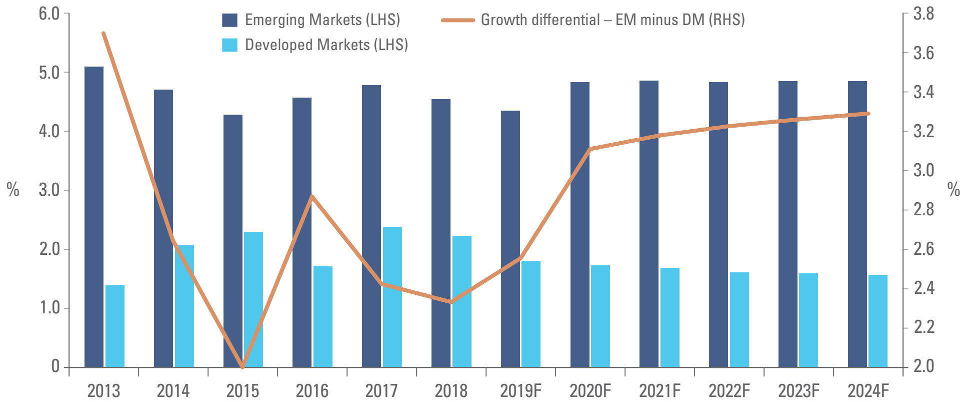
EM real estate is highly dynamic with a number of cyclical and structural factors driving the market. The six main market drivers are:

a) Stronger economic growth

The most important long-term driver of real estate is economic growth. Growth is widely expected to be significantly stronger in EM than in DM over the coming years. According to forecasts published by the International Monetary Fund (IMF), EM economies will continue to grow at roughly 5% real GDP growth per annum over the next five years, while DM growth rates decline every year over the next half a decade. EM relative growth is therefore set to rise every year for the next five years (Figure 5). This also implies that on a PPP-adjusted basis, EM will contribute more than 80% of all growth on the planet by 2024.[2]

The IMF projects Emerging Markets will contribute more than 80% of global growth by 2024[2]

Fig 5: **Real GDP growth**



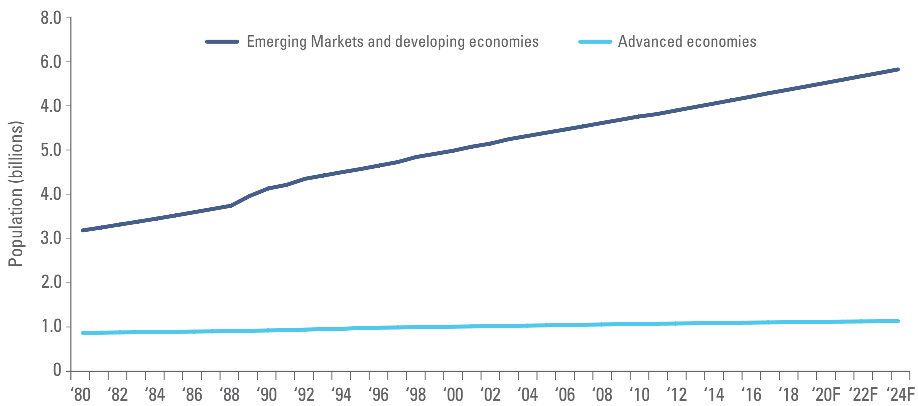
Source: Ashmore, IMF.

b) Better demographics

Demographics also supports real estate to a larger degree than in DM, particularly in terms of demand for housing. Many EM countries are moving through the high growth stages of the standard demographic profile, while most developed countries are already past the peak. This means that EM population growth rates are, and will continue to be, far higher than in developed economies for many years to come. Indeed, by the end of this century, Europe's population is likely to be smaller than today, while the population of North America will have stagnated. On the other hand, Latin America's population will rise quicker than the population of North America, while eight out of every ten persons on earth will be from Asia and Africa by year 2100.[3] The difference in population growth rates is clearly visible even in the relatively short time frame of the next five years as per Figure 6.

EM have a favorable demographic profile

Fig 6: **Populations (millions of people)**



Source: Ashmore, IMF forecast (2019-2024).

[2] For a more detailed explanation for the sharp differences in the growth outlook for EM and developed economies, see '*EM versus DM growth (2019-2023): How global is 'global' growth really?*' The Emerging View, 26 February 2019.

[3] See: https://ourworldindata.org/world-population-growth#future-population-by-region

c) **Cyclical upside in EM real estate versus late cycle slowdown in DM**

Years of Quantitative Easing (QE) policies in DM have pushed real estate prices towards the highs with little additional upside left. Interest rates are also at or near their lower bound. By contrast, EM never did QE and most EM countries still have high interest rates. As inflation continues to trend lower in EM, central banks will cut interest rates further. Therefore, EM real estate prices will benefit from the twin cyclical tail winds of lower funding costs and stronger relative growth.

d) **Special roles of real estate in EM**

EM real estate benefits from a number of special demand drivers, which are unique to EM economies. First, real estate is an important means of saving given limited access to financial instruments. Second, real estate is a way to protect value when inflation goes up. Finally, real estate has the potential to deliver large capital gains during temporary commodity booms, when demand for real estate – a type of non-tradable investment – rises sharply.[4]

e) **Technological disruption favours EM real estate**

Like other sectors, real estate is currently subject to a number of disruptive technological advances (smart houses, etc.). EM is in a far better position to adopt technological advances, both in the office and residential space, at lower cost than DM. This is because rapid technological advancement can more easily be incorporated into brand new real estate and in housing, which starts from a lower level of technological sophistication.

f) **Home bias**

DM investors tend to believe that EM is far riskier than it actually is in reality. The perception of EM riskiness, which is a corollary of DM home bias, ensures that EM real estate offers an attractive premium. Moreover, as the bias gradually erodes over time investors can expect capital gain.

Section 4.

Diversification benefits

Historically, the primary motivation for holding real estate was to capture the benefits of diversification associated with alternative investments. Indeed, direct global real estate exhibits low correlation against public equities, listed global REITs as well as fixed income (Figure 7).[5]

EM real estate exhibits low correlation against DM real estate

Fig 7: **Correlations of global real estate and other asset classes**

Market sector index	Custom IPD Global Property index	MSCI World index	FTSE EPRA/NAREIT Developed index	Barclays Global Aggregate Bond index
Custom IPD Global Property index	1.00	-	-	-
MSCI World index	0.30	1.00	-	-
FTSE EPRA/NAREIT Developed index	0.25	0.85	1.00	-
Barclays Global Aggregate Bond index	-0.26	-0.24	0.08	1.00

Source: Ashmore, IPD.

The inherent diversification benefits of real estate can be enhanced by adding EM real estate to a global real estate platform. The correlation between EM and DM residential real estate is just 0.24, based on data from the Federal Reserve from December 2008 to March 2019 (Figure 8).

Fig 8: **Correlation of EM and DM real estate (local currency returns)**

	Emerging Markets (aggregate)	Developed economies (aggregate)
Emerging Markets (aggregate)	1.00	0.24
Developed economies (aggregate)	0.24	1.00

Source: BIS, St. Louis Fed. Correlation Matrix reflects real YoY price change in residential real estate from 31 March 2009 to 31 March 2019.

4 See: https://global.oup.com/academic/product/trade-shocks-in-developing-countries-9780198293385?q=collier&lang=en&cc=us

5 Investment Property Databank, subsidiary of MSCI. Direct global real estate is measured using the Custom IPD Global Property Index, which has been reweighted to 40% North America, 35% Europe and 25% Asia Pacific).

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The diversification benefits arising from adding EM to global real estate portfolios stem, in part, from the fact that correlations between real estate markets *within* individual EM countries are generally low as shown in Figure 9. In other words, what drives real estate returns in Brazil does not drive returns in, say, Mexico, Russia or China.

Fig 9: **Intra-EM real estate correlations (local currency returns)**

	Brazil	Mexico	China	India	Russia	Turkey	UAE	S Africa	US	Germany	Japan
Brazil	1.00	-	-	-	-	-	-	-	-	-	-
Mexico	(0.67)	1.00	1.00	-	-	-	-	-	-	-	-
China	0.05	(0.08)	(0.08)	-	-	-	-	-	-	-	-
India	0.12	(0.39)	(0.39)	1.00	-	-	-	-	-	-	-
Russia	0.04	(0.35)	(0.35)	0.14	1.00	-	-	-	-	-	-
Turkey	(0.16)	0.01	0.01	0.23	(0.29)	1.00	-	-	-	-	-
UAE	(0.21)	(0.22)	(0.22)	0.41	0.22	0.22	1.00	-	-	-	-
S Africa	(0.50)	0.12	0.12	0.40	0.02	0.22	0.43	1.00	-	-	-
US	(0.72)	0.21	0.21	0.18	0.15	0.23	0.51	0.85	1.00	-	-
Germany	(0.90)	0.66	0.66	(0.30)	(0.02)	0.06	(0.02)	0.29	0.49	1.00	-
Japan	(0.44)	0.39	0.39	(0.03)	(0.11)	0.03	(0.09)	0.62	0.54	0.45	1.00

Source: BIS, Ashmore. *Correlation Matrix reflects real YoY price change in residential real estate from 31 March 2009 to 31 March 2019. Country markets for EM real estate reflect the two largest economies with available data from each of the following regions; Latin America, Europe, Middle East/Africa and Asia. For DM economies, the three largest with available data were chosen.

The universe of EM real estate is large, diverse and distinct. Inter-country correlations between EM real estate markets are low and offer additional diversification benefits

Finally, the EM real estate asset class offers exposure to four quite distinct real estate sub-themes:

i. **Non-residential (office)** real estate is supported by the steady rise in capital-labor ratios associated with the wider development process. This process involves a steady expansion of industry, manufacturing and services, which requires high quality office space as multinational corporations expand their presence within EM.

ii. **Residential real estate** is supported by the rise of the middle class and the gradual broadening of access to mortgage financing, which enables ever larger numbers of families to move into the formal residential real estate sub-sector, whether in for-sale properties, for-lease single family housing or multiple-family solutions.

iii. **Retail real estate** rises rapidly as per capita incomes increase. The rise in disposable income paves the way for expansion of consumption, which in turn requires retail units and mixed-use developments.

iv. **Logistics-related real estate** becomes ever more important with rising internet penetration and the expansion of e-commerce. Infrastructure, as a close complement of construction, is also supported.

Section 5.
Investment performance of EM real estate

EM real estate provides a cushion against economic fluctuations by paying stable cash flows backed by long-term leases.

The attractive risk-return profile of EM real estate is illustrated in Figure 10, which shows local currency returns in real terms (adjusted for inflation) and volatility for a diversified portfolio of EM real estate, based on ten years of quarterly data from the Bank of International Settlements. The table also shows local currency real returns for real estate in developed economies (DM RE), also in local currency. Over the last decade, the inflation-adjusted return in EM real estate ('EM RE') has been almost twice as high as in DM real estate with about half the volatility.

Fig 10: **Local currency returns and volatility**

Local currency returns	EM RE	DM RE
Annualised return	6.9%	3.5%
Annualised standard deviation	3.7%	6.7%

Source: Ashmore, BIS, JP Morgan, Bloomberg.

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Section 6.
Risks in EM real estate

Like all investments, there are risks associated with EM real estate. In our view, these risks can be substantially mitigated by active decisions and thorough diligence. Investors must have the ability to distinguish between attractive opportunities underpinned by structural safeguards and investments that should be avoided. The two main, but interrelated, sources of risk associated with EM real estate are transactional risks and macroeconomic/political risks.

Consider each in turn:

a) Transactional Risk

Transactional risk refers to the potential problems associated with the acquisition and construction of real estate within specific markets.

Examples include:

- **Construction permits:** processing applications, efficiency of procedures, transparency on fees, centralization of processes
- **Property registration:** administrative infrastructure for registration and transparency of information
- **Tax regime:** efficiency and reliability of fees and tax regimes
- **Legal rights of borrowers and lenders:** priority to secured creditors or allowed out-of-court enforcement, exemptions to secured creditors from automatic stay in insolvency proceedings; scope of information collected and reported by credit bureau or registry and liquidity risk.

Risks associated with investments in EM real estate can be substantially mitigated with active decisions and thorough diligence

Given that EM is a large and diverse universe, the ease of doing business varies considerably from one country to the next. This variety is richly illustrated in the wide range of scores awarded to different countries in the World Bank's country rankings (Figure 11). For example, dealing with construction permits is considerably easier in Chile and Peru than in Brazil. Registering property in China is easier than it is in the United Kingdom and the United States. Minority investors are far more protected in India than in Russia. The best way to mitigate transactional risks is therefore to understand the local markets extremely well and utilise local specialist asset management skills.

Fig 11: **Ease of doing business (selected countries)***

	Dealing with construction permits	Registering property	Protecting minority investors	Paying taxes	Resolving insolvency
Brazil	175	137	48	184	77
Chile	33	61	64	76	51
China	121	27	64	114	61
Colombia	89	59	15	146	40
Germany	24	78	72	43	4
India	52	166	7	121	108
Japan	44	48	64	97	1
Peru	54	45	51	120	88
Russia	48	12	57	53	55
South Africa	96	106	23	46	66
UK	17	42	15	23	14
US	26	38	50	37	3

Source: Ashmore, World Bank. *All countries are ranked for each category on a scale from 1 (best) – 190 (worst).

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b) Macroeconomic and socio-political risks

All investments, across asset classes, in all countries, are subject to macroeconomic and socio-political risk. FX movements affect Dollar returns, political sentiment impacts volatility and access to liquidity determines the ability to execute transactions in the short term. Regulations can and do change, sometimes with high frequency. Similar to transactional risk, mitigating macroeconomic and social risks requires local knowledge. Specialist EM investors, especially those with a local footprint, are therefore best placed to assess such risks and to manage portfolios during periods of stress.

Colombia is a case in point. After decades of internal conflict and drug-trafficking, the country has emerged as one of the most stable in Latin America. There are three independent branches of government, a stable democracy and a mature regulatory framework, which has been tested over various market cycles. Today, an investment in a mature and stable democracy like Colombia provides a cushion against macroeconomic or socio-political risks.

Finally, country-specific differences are not just a source of risk, they are also a source of opportunity. In a recent study, IPD compared returns associated with pure domestic real estate investments with global real estate portfolios.[6] They found that it is significantly easier to pick winners and losers within portfolios of national real estate markets than within purely domestic real estate portfolios with intra-country sectors.

EM real estate is positioned to deliver returns which far outweigh risks

Section 7.

Conclusion

Looking forward, as global interest rates continue to decline, the real estate market gains in attractiveness. With EM rates having more room to decline than DM rates, real estate in EM is positioned to perform relatively and absolutely better than real estate in DM. EM real estate is also supported by superior long-term macroeconomic trends, including demographic tail winds and higher economic growth.

The findings in this report echo those of the recent IPD study that domestic real estate portfolios can produce enhanced and sustained excess returns by adding global real estate exposure. Exposure to individual EM real estate markets not only enhances performance, but also increases diversification and reduces volatility.

EM is perceived to be far more risky than it is in reality. As long as this misperception persists, the above mentioned long-term structural drivers and unique features of EM real estate investments are likely to deliver returns which far outweigh the risks.

[6] See: https://www.msci.com/documents/10199/239004/IPD+Private+Real+Estate.pdf/25b7023d-5706-426d-823c-e2132378c8f1

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