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[INTRODUCTION]

Staci West (SW): Welcome back to the 'Investing on the go' podcast brought to you by FundCalibre. This episode discusses the basics of Real Estate Investment Trusts – or REITs as they are called. It also touches on the broadening sub-sectors in real estate, the impact of inflation-linked rentals and where today's guest is currently finding opportunities in the sector.

Darius McDermott (DM): I am Darius McDermot from FundCalibre, and I'm delighted to be joined by Rogier Quirijns, who is on the Cohen and Steers European Real Estate fund. Rogier, good afternoon.

Rogier Quirijns (RQ): Good afternoon.

[INTERVIEW]

DM: So, we thought maybe for our audience we'd take a little step back, go back to basics, and can you give us an introduction to what is a REIT? What is a real estate investment company? What sort of types they come [in] and what different areas in the property market that you can invest in via these vehicles?

RQ: Yeah, yeah, of course. Thanks for having me. So, REITs are listed real estate companies that own and operate real estate assets, call it like that. They generally give investors an opportunity to invest in real estate indirectly and also to generate, I would say a relatively good income, but also not only income, but also some value growth, if the times are good, of course.

DM: And when you say indirectly, you're buying listed companies that own assets as opposed to physically buying offices and warehouses and… that would be direct property investing.

RQ: Yes, definitely. I think the advantage of a REIT is, in a way, that you don't have to do the work yourself, so you don't have to have that much knowledge about the underlying assets, you buy a company in which the management team has the knowledge of buying the right assets and the right sector, call it like that.

DM: And it's quite a broad sector. I think maybe 10 plus years ago we would've just thought of office, retail and industrial, but the sector's broadened out over that period, would you agree? Warehouses and all those other sort of sub-sectors?

RQ: Yes, definitely. I think if you look especially to the US but [also] Europe. I think in the US it's a little bit more advanced on towers and data centres. But I think in Europe, logistics has come a long way nowadays. Hotels [are] something a little bit more recent I would say. But I think another sector I have to mention is [the] self-storage sector. That's not that much known in the direct market even to be honest, but a sector that definitely is very interesting from a long-term growth perspective. So indeed income, but also kind of rental growth and from especially in supply/demand perspective, it is something that fits very well in the recent trend of urbanisation that people get smaller houses but need more space and they kind of need a lot of storage to put their stuff in.

DM: Yeah. And like most assets in 2022 the real estate market had a challenging period as rates went up with inflation. Is it just inflation and those rising rates which caused that more challenging period over the last year or so?

RQ: I think yeah, the main challenge has been, I would say the fact that we've come out of quantitative easing into quantitative tightening and at the same time we've had a significant inflation impact. So I would say looking backwards, we could see inflation going up somewhat, which was I would say it's positive, especially for European real estate because we're linked to inflation, but I think anything going from a deflationary environment to 2% to 3% inflation would've been perfect. But we all know that didn't happen.

So, we went from 3% to 5%, from 5% to 10% and even 15% inflation in some locations. So, inflation overshot, and I think that is where the whole market came in some kind of headwind. So yes, that meant that interest rates had to increase in the fastest pace we've seen in 30 to 40 years. So, I think that has had a negative impact on especially real estate, especially the listed market first. So, the listed market will correct the quickest, the most, and then the private market generally will correct later and in a slower pace I would say.

So, I think yes. Inflation and interest rates have been the main headwind over the year.

DM: And you did mention that inflation can actually benefit real estate. Could you just give a very brief explanation as to how inflation benefits?

RQ: Yeah, definitely. I think that's also why it's called real estate in a way. It's a real return but it's important of course, a couple of things. It's do you have pricing power? Do you have a prime asset? So, I think those things are important. Demand and supply. So, I think if you look at those fundamentals they are for certain sectors and certain prime assets - even certain offices, we all know the working from home discussion - are rather favourable.

So, rents are increased with inflation and most of the rents in Europe, not all in the UK, but I think if you look at Europe, both UK and the continent, there's a fair amount of rental contracts linked to inflation. The question then is can you pass on 12% inflation? I think that's a little bit, getting a little bit tricky. So generally, what we see, they pass on around 6% to 8% inflation, but in Sweden for instance, they pass on 10% inflation.

Second question is, is that sustainable? And I think this is where we do a lot of work of course as specialists, and we think yes, certain cities, certain sectors, again, it is sustainable. So, I think that's very important. And inflation is all lagging a little bit. So, you see the rental contracts probably in 2023, still an acceleration in inflation increases. So, generally speaking, I think that's the tailwind.

The headwind is, of course, the higher interest rates, and then it's more about the balance sheets of the companies. Do they have a conservative balance sheet? Do they have long dated debt? So, I think those things, if you all put it in the mix, yes, I think, it can be a benefit, but at the same time, some companies you will see have a balance sheet, which is, you know, there's a bit too much leverage or they've short term debt maturities, and then the tailwind also, there's a headwind of higher interest rates. So, I think you have to make a good judgment whereas yeah, the tailwind bigger than the headwind call it like that.

DM: And what about recession? I mean, property generally, I mean, most asset classes don't do well in recession. Property, it is a real asset whether directly or indirectly held, and then you've got the whole working from home culture, which was alien to us only four or five years ago. Do you worry about recession? Or do you think actually across Europe, that that might just be avoided and maybe on a valuation basis we've already had some of the pain?

RQ: Yeah, I think it's important to understand we can always invest in different asset classes. So, we have defensive asset classes, which is more residential, healthcare, and we have more cyclical asset classes, which are more the offices probably, as you mentioned.

I think at this point I'm less worried about the recession to a certain extent because I think for us, recession is a little bit necessary now. You see what the central banks are doing also to reduce the inflation. So, I think it's important that the inflation peaks, the growth somewhat comes down. And then there's room for the interest rate to stabilise, if not come down a little bit. And I think our sector is less cyclical than other equities, call it like that. So, I think from that perspective, we've got generally long lease contracts still the inflation link in there. So, I think if that happens, a recession, I'm not that negative for our asset class, so we could or probably would be buying more German residential, prime retail even doing relatively well, giving out good dividend yields and probably healthcare or so instead of buying more offices.

DM: So, we've talked about some of the issues that have caused challenge to the asset class. What would be a potential catalyst? What would excite you about the real estate sector? Is it just that inflation linked rental growth that you can enjoy? And as you already have started to do, you've touched on some of the, you can move this fund around into more defensive parts of property or more cyclical as and when you see the time, what might get property motoring again in the year ahead?

RQ: Yeah, the good thing what you mentioned indeed is we move around it's liquid. So, a couple of things. I think the portfolio is very balanced. It has been since Covid because with Covid, we've had Covid, we moved around, we've had Brexit, we moved around. And I think now what do we have?

We certainly have, since Covid, a stronger focus on pure value which is mostly retail. As you know, a lot of people didn't like retail because of the obvious e-commerce reason, but I think we are kind of past that station. I think we all know there's physical retail and there's digital retail. So, if I look at the retail part and especially the prime shopping centres in Europe, we get around an 8% dividend yield, rents can increase with inflation. So, I think if a good balance sheet, I think that's a good product. It's a good product. I would say also compared to bonds. It's relatively stable even if there's a recession, I would say. So, I think that's good.

Then we have also certain growth aspects in the portfolio, which we talked about is the self-storage. That generally makes a very good total return, very strong pricing power. Look at the long-term returns, I would say of those companies, self-storage companies, you might find them on the internet. I think that's a bit cyclical. So, if the recession comes, they might pull back. We have an overweight on the sector but not a big one. So, if that happens, I would definitely look to increase that weight at the time when the price is right. We always look at relative value. So, I think that's another one that makes me confident about how to deal with the uncertainties that's coming towards us.

Then the big question is about German residential in Europe. The balance sheets are not great, but it's extremely cheap. So, we added a little bit there and I would say that's a little bit more opportunistic investing. So, we think it's oversold and we have a company that we've never owned before during the bull market, but we thought now it makes sense to own it. It's so cheap. We paid two and a half sorry, 12.5 times the rent. So that's around an 8% cap rate for German residential that's far, far below replacement costs. The company is selling assets at a relatively good price. So, repairing its balance sheet though, that's really an opportunistic thing to do. And I think that's where we get relatively cheap access to an extremely defensive asset class. So, an extreme defensive cash flow which is not fully index linked, but I think once the inflation peaks there's more room for rental growth to catch up with inflation again. So, to catch up the lost inflation increases, call it like that.

DM: And maybe just for our listenership as we're based primarily here in the UK. You talk about German residential… now, I know what you mean because I've been sitting on this side of the fence for 25 years or so. Maybe just explain to our audience that slightly different cultural renting versus owning that does go on in, not just in Germany but in Sweden and other parts of the continent.

RQ: Yeah, I would say the difference between the UK and the rest of Europe is mostly regulation. So Germany is very much regulated with the mietspiegel *[a rent index]* although, you know, the mietspiegel also goes up if there's a demand and supply imbalance, which there is. I mean the whole of Europe, including the UK, has a huge shortage of residential [property], of course.

The UK is a bit more free. I think we look at the UK PRS market, we can invest in it. We do like it, although the cashflow yield is a little bit low. But on the other hand, I think they both offer some value, I would argue, and especially if we hit a recession. I think German residential is a little bit more defensive versus the UK PRS market, call it like that, because generally because of all the regulation, the rents are relatively low, probably 25% below market.

DM: So maybe then if we could just close, you've got lots of sub-sectors and we've touched on self-storage, we've touched on German residential, where are you seeing, because you've got a lot of sub-sectors you can pick from, where are you seeing the best value? Maybe you could explain some of the areas that are genuinely exciting you as we look forward over the coming years.

RQ: Yeah, well, I mentioned retail, so I think it's a bit non-consensus. I think for now, at this time in the cycle. I would say retail. Why? I think it's a relatively high yield. So, your implied cap rate is around 7%. You have growth, you have indexation, it's not over rented, but that means you go for the higher quality retail and more on the continent than in the UK. I think in the UK, I'm a little bit more worried here with the mortgage systems and then the higher impact or the impact of higher interest rates on the consumer.

So, I think for me, that's the one where you get your 8% dividend yield, it is sustainable. You get an inflation link. I can also find a retailer on the continent that has a 10% to 12% dividend yield. Very convenience focused - so, for your daily shopping, an average basket of around €10 per customer. So, I think very inflation proof, very recession proof.

So, I think, if you say I want something that generates a lot of cash, is relatively stable between 8% and 12%, good balance sheets, you know, it won't grow a lot, but at least it's stable and it gives you what you want in this time. It's the cashflow. So, I say real estate now, it's cashflow, cashflow, cashflow. That will change when we are past peak inflation. When we go down, it'll be also, again, the growth, the total return, all the other stuff.

But today, cashflow, cashflow, cashflow.

DM: Rogier, thank you very much for discussing European real estate and giving a bit of a "learn" as to what it is and the various sub-sectors that you have to choose from.

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