Key Private Bank

Key Questions

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Are There Real Opportunities in Real Estate?

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Given the current level of bond yields, we believe that certain segments of the commercial real estate market may offer attractive opportunities.

COVID-19 and the resulting social distancing policies to prevent its spread have disrupted many segments of the commercial real estate market, creating a sharp divergence between the favorably exposed sectors and those that are disadvantaged. Specifically, challenges besetting retail property types that were present pre-COVID have intensified and the work-from-home impacts on office-oriented real estate have been highly publicized.

Perhaps lesser known, the industrial and infrastructure sectors have benefited as result of e-commerce growth and strong demand for data centers and cell-towers due to increased data demands. Laboratory and life-science-oriented real estate have benefited as well. Another less-discussed variable is the positive impact that low interest rates have on commercial real estate pricing.

Commercial real estate exposure can be obtained in multiple ways including direct ownership of property in private vehicles and holdings of publicly traded Real Estate Investment Trusts (REITs). Each method of accessing the commercial real estate market has its specific attributes and associated costs and benefits. However, in the long term, risk and returns are driven by the attributes of the underlying assets and how those assets are managed.

Key Private Bank focuses on real estate opportunities offered through private vehicles managed by professional real estate investors and REITs, either directly or through a dedicated REIT strategy. Each strategy needs to be evaluated based on the underlying exposure in terms of sector, geography, quality of assets, level of diversification, and manager quality.

Commercial real estate is highly diverse. Well-known sectors include office, residential, retail, and industrial. However, there are numerous other segments, including healthcare, infrastructure, hospitality, and self-storage. Within sectors there can be diverse property types. For example, the office sector includes central business district (CBD) properties along with suburban office and specific office types such as space geared for creating media content. Residential real estate includes high-rise apartments, garden-style apartments, and manufactured housing.

Property performance can be highly dependent on location even at the neighborhood level. Thus, it is important to consider that events such as COVID-19 can create divergences within sectors and across locations. For example, due to social distancing demands, CBD office properties that depend on elevators may incur falling demand while suburban office properties, in which stairs are feasible, may experience higher demand. Similarly, high-rise apartment buildings may face headwinds while garden-style apartments may experience tailwinds with changing consumer preferences.

Overall, office space demand is likely to be negatively impacted given the potential for working-from-home becoming more accepted longer-term. However, some businesses may require even more office space per worker than before COVID-19 given social distancing requirements, and several employers and employees alike have expressed an interest in safely returning to the office.

Additionally, the impacts of employees who work from their homes may vary sharply across industries with factors such as the demographics of workers and location-specific attributes (e.g., the dependency on mass transit) having a significant influence on financial results.

A factor that we believe will be a tailwind to the broad commercial real estate sector is the presence of low interest rates for the foreseeable future. Federal Reserve projections suggest policy rates will remain unchanged through 2022, and some analysts think rates could remain unchanged through 2024.

Commercial real estate prices are positively impacted by lower interest rates as debt is often used to finance a portion of the purchase (i.e., mortgages) and cash flows from rents possess bond-like characteristics. Commercial real estate is estimated to have duration of about 15 years. In other words, if long-term interest rates fell by 1.0% (in percentage points), commercial real estate prices could increase by 15%, all else being equal.

Given our research on commercial real estate and the available offerings in the market, we believe a private core real estate strategy managed by a high-quality, professional investor can provide stable, inflation-resistant income to a portfolio. Core-oriented strategies focus on high-quality properties that have high occupancy and are in favorable locations; limited debt is utilized and there is a focus on stable income driving most of the returns.

Quality managers can add value through sector allocations, geographic allocations, property selection, and property management.

Recently, we added several diversified core real estate strategies to our investment platform. For long-term investors seeking alternatives to fixed income as a source of additional income or as a portfolio diversifier possessing inflation-protection attributes, core real estate may be a useful tool and offer attractive returns in a risk-controlled manner.

If you have questions regarding these opportunities or would like to listen to a replay of our recent conference call with a leading real estate investor, please contact your Key Private Bank Advisor.

For more information, please contact your Key Private Bank Advisor.

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