ATLANTIC
FINANCIAL GROUP

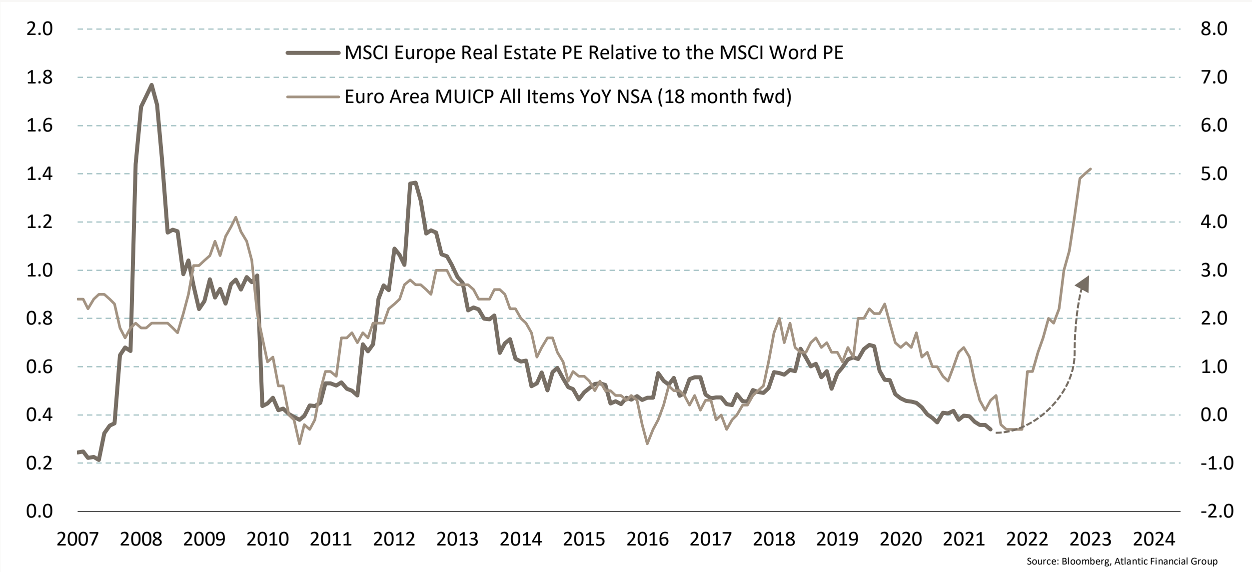
Weekly Investment Focus

14 February 2022

"REAL ESTATE UPDATE"

- Real estate in times of monetary policy normalisation
- A hedge against inflation
- Can value stocks in the sector rebound (offices and hotels)
- The emergence of virtual real estate

CHART OF THE WEEK: "Is inflation a leading indicator of performance?"



ANALYSIS OF FINANCIAL MARKETS

While unlisted residential property prices rose in Europe and the US, listed companies performed very differently in 2021. The US real estate sector (S&P500 Real Estate) was the second-best performer (+42.5%) behind the energy sector (+47.7%). The European sector underperformed by only 14.8%, well below the performance of the Euro Stoxx 600 (+22.3%).

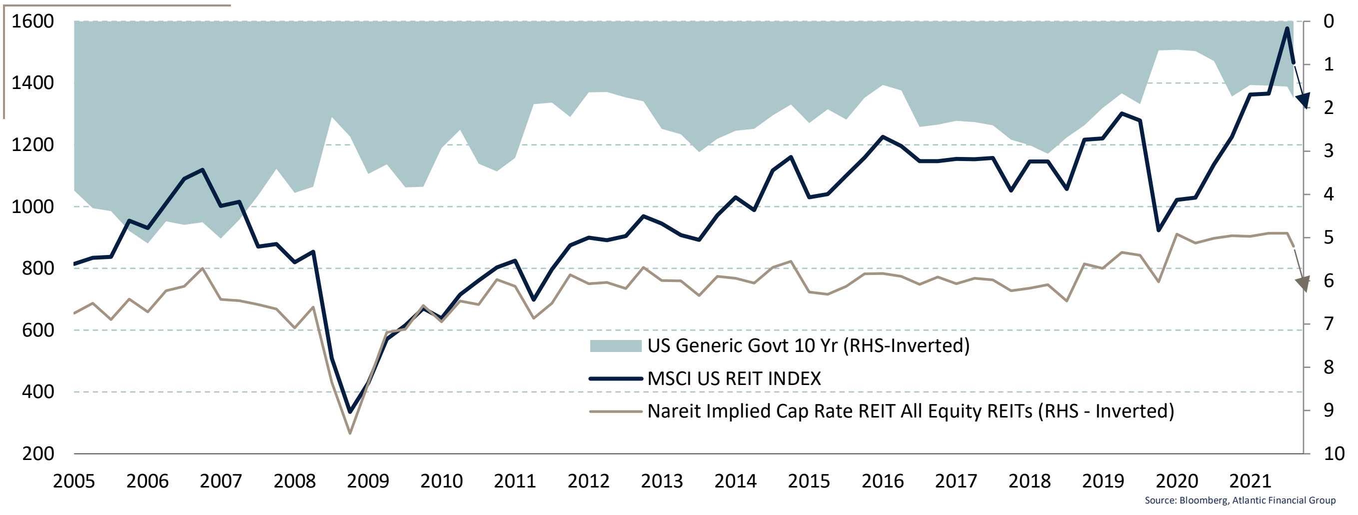
However, both regions saw property assets in the logistics and shopping malls sector break records while offices and hotels lagged. **The dispersion in the valuations of real estate companies could indicate that value stocks offer good rebound potential.**

♦ Real estate in times of monetary policy normalisation

Historically, when the FED announces that it is about to raise rates, the real estate sector tends to correct but outperforms shortly after rates are raised. Real estate companies rely heavily on the bond market for financing, so changes in bond yields have a direct impact on their financing capacity. **The sector is therefore more likely to correct if investors fear a deterioration in liquidity ratios and an increase in debt interest.**

Finally, the Cap Rate (EBITDA/market capitalisation) represents the return that investors can expect at a given time. It follows the 10-year government bond rate with an average yield spread of 350 bps. **If long rates rise too fast, the Cap Rate rises, and REITS prices fall** (see Fig. 2).

Fig. 2 - Cap rate, bond rates and REITS performance



♦ A hedge against inflation

Real estate seems to be a good hedge in case of inflation (see Chart of the week). First, the effect of inflation on debt: as the price of a house rises over time, the loan-to-value ratio of the property falls, acting as a natural discount. As a result, the value of the property increases, but the fixed-rate mortgage payments remain the same.

Inflation also benefits property investors who earn income from their rental properties, particularly in sectors where leases are short term or indexed to inflation, such as residential property. When mortgage rates are locked in for a long period of time, the duration differential between the loan and the rents can generate cash for investors.

♦ Can value stocks in the sector rebound (offices and hotels)

Some real estate sub-sectors have declined for several years. The Covid-19 crisis has precipitated their transformation. Office properties and hotel residences are among the sectors have suffered the most.

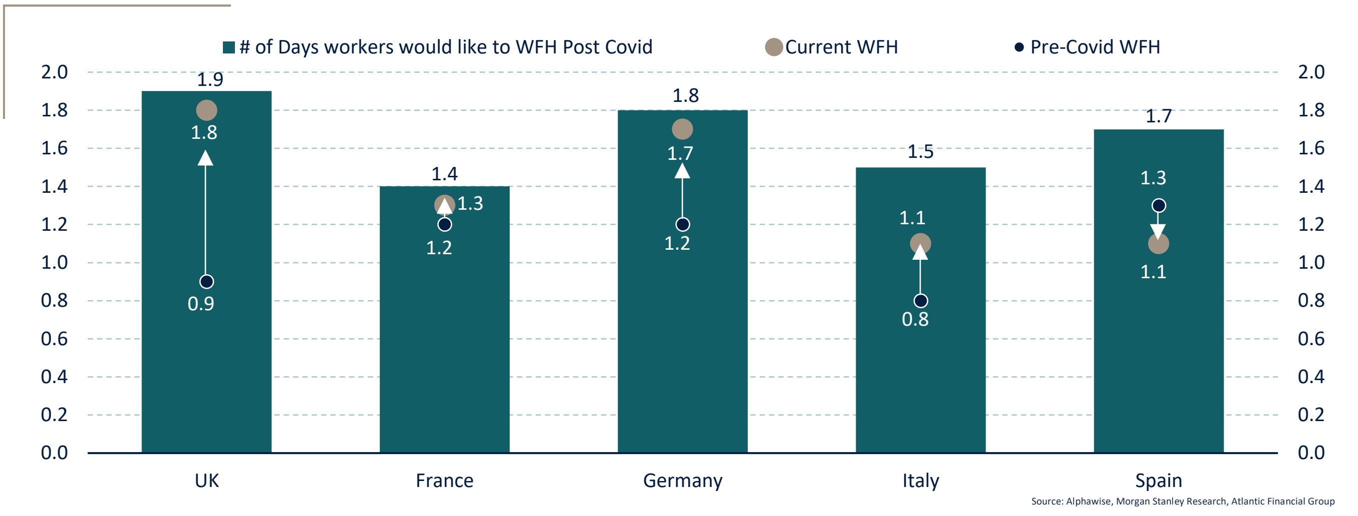
Office property

Offices emptied with the lockdown measures and in some areas, particularly in the US, employees are still working from home (WFH). The percentage of people going back to work in an office was only 22% in Manhattan and 18% in San Francisco last November. The office vacancy rate, meanwhile, is close to historical highs, at 12.1% in Manhattan and 15.3% in San Francisco. **In the past, peak vacancy rates have often been a signal to buy.**

In Europe, the situation is better. The return to the office continues as the economy reopens. **The demand for WFH has faded compared to the beginning of the pandemic, and workers seem to be settling into a more hybrid work pattern** (see Fig. 3).

Companies are reluctant to set up shared offices so as not to discourage people from returning to work and often emphasise the convivial aspect by providing larger common areas for exchange or relaxation. Moreover, they are often locked into long-term leases and prefer to delay their decision to move.

Fig 3- Survey on the number of days WFH per week pre- and post-covid



Finally, **transaction volumes have undeniably rebounded in 2021 compared to 2020,** but the figure remains lower than in the pre-Covid years. **However, the situation has normalised in Q4 2021**, with transaction volumes close to those of Q4 2019.

There is a strong private equity presence in this market. The resilience of the sector seems to be driven more by the liquidity in the market and the search for yield than by a firm view on the potential for rental growth. This comes at a time when many office conglomerates, such as Icade and Derwent, are trading on undemanding net asset values.

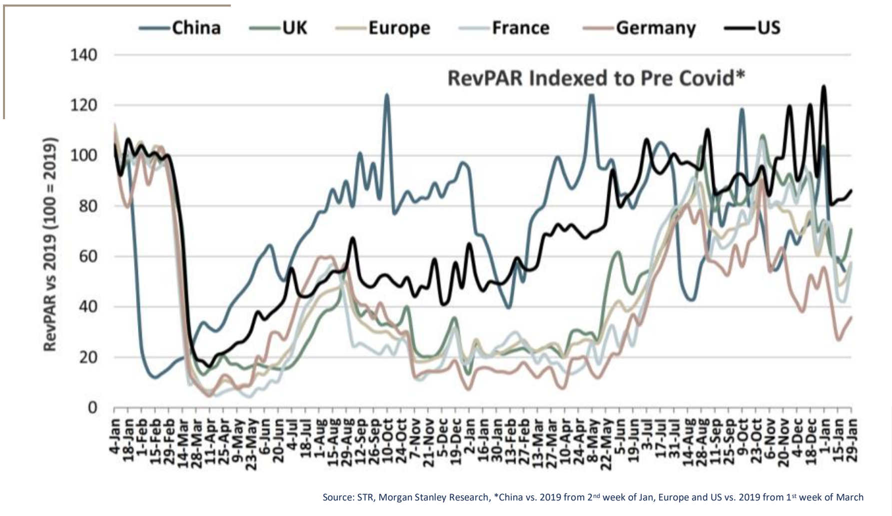
Hotel real estate

The hotel sector regained some grounds in 2021 as the health crisis accelerated the renewal of accommodation concepts. The sector has been undergoing a major transformation over the last ten years. **Generation Y has gradually moved away from traditional hotel groups towards alternative accommodations. The emergence of Airbnb has accelerated this trend, precipitating both the rise of new players** and the importance for hotel groups, such as Accor or Whitbread, to innovate and renovate in a different way and move away from the standardised model.

The fifth wave of the pandemic, the reluctance of banks and the occupancy rates - 40% in 2021, compared to 70% in normal times - have further slowed down the sector's recovery. **The lack of visibility on the evolution of the health and regulatory context has hardly encouraged investors to take risks.**

Not all establishments are in the same boat. While luxury hotels in large cities such as Paris, London or New York, which are highly dependent on an international clientele, have been hit hard, **establishments in the suburbs or in more remote places have fared well, frequented by a local clientele, oriented towards budget products, and by employees who have become nomadic thanks to teleworking.** The hotel industry shows a certain reinsuring inertia in the face of the vagaries of the market.

Fig. 4 -RevPAR: a visible improvement, if we disregard Omicron



Prior to Omicron, revenues per room (RevPAR) were rising again with an earlier recovery in China and the United States and a rapid catch-up in Europe during the summer (see Fig. 4). **A return to normal revenue is likely in 2023 or even 2024.**

Proof of resilience; the value of assets has not deteriorated. In France, business assets alone (70% of the market) sell for around 4 times the annual turnover, 10 times for the purchase of the premises and business assets combined.

- The emergence of virtual real estate

The real estate boom has also spilled over into the digital world, on metaverse platforms. As in the physical world, profits depend on footfall (location is key!) and the willingness of consumers to spend real money, and also on the hospitality of the location.

Republic Realm has become the world's largest digital real estate investment fund, following the acquisition of a virtual property worth $4.3 million in Sandbox. The company claims to own land in 23 metaverse platforms. Republic Realm also owns the largest land lots in Axie Infinity, Sandbox, Somnium Space and Decentraland, and has now purchased most of the land in the Dvision network. To reduce risk, early investors, like Republic Realm, diversify their holdings across multiple metaverse platforms.

But unlike physical lands, whose value is partly a function of their scarcity, each virtual realm is unlimited. Moreover, hundreds of aspiring metaverses already exist and more will emerge as cryptographic technology improves. There is a paradox here. **Soaring virtual property prices rely on the rise of the metaverse, which ultimately means less scarcity and lower prices.** The laws of physics may prove easier to circumvent than the law of supply and demand.

Conclusion:

Location is key in real estate and this principle has always been true in all sectors: logistics, offices, housing, retail and now the metaverse. A good location will be less sensitive to fluctuations in supply and demand and will appreciate more over time.

The covid-19 has greatly disrupted some sub-sectors, which are now trying to prove the resilience of real assets in times of rate normalisation. **The best opportunities in real estate often appear when the financial environment becomes more unstable...** so it is certainly time to take another look at some neglected players and not succumb to the mirages offered by the WEB 3.0.

RETURN ON FINANCIAL ASSETS

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2022 Year-to-Date (%)	2021 (%)	2020 (%)
Equities							
World (MSCI)	715.5	44.09	-0.4%	-4.2%	-5.1%	19.0%	16.9%
USA (S&P 500)	4 419	41.25	-1.8%	-6.2%	-7.2%	28.7%	18.4%
USA (Dow Jones)	34 738	42.71	-1.0%	-4.1%	-4.3%	20.9%	9.7%
USA (Nasdaq)	13 791	40.80	-2.2%	-8.9%	-11.8%	22.2%	45.1%
Euro Area (DJ EuroStoxx)	460.3	46.14	1.5%	-3.2%	-3.7%	23.5%	0.8%
UK (FTSE 100)	7 661	61.10	1.9%	2.3%	3.8%	18.4%	-11.4%
Switzerland (SMI)	12 232	45.52	0.8%	-3.8%	-5.0%	23.7%	4.3%
Japan (Nikkei)	27 696	50.43	1.7%	-2.7%	-3.8%	6.6%	18.3%
Emerging (MSCI)	1 241	55.71	1.6%	-0.2%	0.7%	-2.3%	18.8%
Brasil (IBOVESPA)	113 572	67.71	1.2%	9.4%	8.3%	-11.9%	2.9%
Russia (MOEX)	3 547	48.81	2.2%	-5.9%	-5.9%	21.9%	14.8%
India (SENSEX)	58 153	46.21	-0.8%	-4.0%	-0.1%	23.2%	17.2%
China (CSI)	4 601	37.47	0.8%	-4.1%	-6.9%	-3.5%	29.9%
Communication Serv. (MSCI Worl	100.99	40.07	-2.2%	-6.8%	-8.4%	10.8%	24.2%
Consumer Discret. (MSCI World)	374.8	42.40	-1.0%	-7.2%	-8.7%	9.2%	37.0%
Consumer Staples (MSCI World)	283.4	45.96	0.0%	-1.6%	-2.7%	11.7%	8.8%
Energy (MSCI World)	225.5	71.67	2.1%	9.1%	19.7%	37.5%	-27.7%
Financials (MSCI World)	157.7	59.46	1.4%	0.0%	5.0%	25.1%	-3.1%
Health Care (MSCI World)	339.3	40.15	-1.0%	-4.9%	-8.1%	18.0%	15.4%
Industrials (MSCI World)	310.3	41.56	0.4%	-5.3%	-6.5%	16.6%	11.8%
Info. Tech. (MSCI World)	511.2	40.86	-1.8%	-7.5%	-10.9%	27.6%	46.2%
Materials (MSCI World)	363.8	54.71	2.7%	-1.0%	-0.4%	15.4%	21.6%
Real Estate (MSCI World)	217.0	41.39	-0.9%	-3.8%	-7.5%	23.6%	-5.7%
Utilities (MSCI World)	155.1	40.56	-1.3%	-1.9%	-4.5%	11.1%	4.8%
Bonds (FTSE)							
USA (7-10 Yr)	1.94%	37.50	-0.3%	-1.6%	-3.5%	-2.4%	9.3%
Euro Area (7-10 Yr)	0.79%	18.22	-1.0%	-3.6%	-4.4%	-2.9%	4.5%
Germany (7-10 Yr)	0.30%	21.63	-0.7%	-2.2%	-3.1%	-2.7%	3.0%
UK (7-10 Yr)	1.55%	28.04	-0.9%	-2.8%	-4.3%	-4.9%	5.4%
Switzerland (7-10 Yr)	0.33%	25.60	-0.2%	-2.1%	-3.5%	-2.3%	0.4%
Japan (5-10 Yr)	0.23%	20.54	-0.2%	-0.5%	-1.0%	0.0%	-0.1%
Emerging (5-10 Yr)	5.41%	32.37	-0.5%	-1.4%	-4.3%	-2.3%	5.2%
USA (IG Corp.)	3.01%	31.63	-0.4%	-2.6%	-4.9%	-1.0%	9.9%
Euro Area (IG Corp.)	1.18%	17.22	-0.1%	-2.8%	-3.4%	-1.0%	2.8%
Emerging (IG Corp.)	5.13%	30.94	-0.2%	-0.8%	-3.2%	-3.0%	8.1%
USA (HY Corp.)	5.76%	23.85	-0.9%	-3.2%	-4.0%	5.3%	7.1%
Euro Area (HY Corp.)	4.48%	22.35	0.2%	-3.2%	-3.2%	3.4%	2.3%
Emerging (HY Corp.)	7.71%	41.13	-0.2%	0.2%	-2.5%	-3.2%	4.3%
World (Convertibles)	412.9	43.96	0.3%	-3.8%	-5.8%	2.4%	38.8%
USA (Convertibles)	551.6	44.58	0.4%	-4.5%	-7.0%	3.1%	54.5%
Euro Area (Convertibles)	3 878	30.01	-1.2%	-4.3%	-5.6%	-0.3%	6.1%
Switzerland (Convertibles)	182.1	18.91	-0.2%	-1.5%	-2.1%	-0.5%	0.5%
Japan (Convertibles)	199.0	53.85	0.6%	-0.6%	-0.9%	3.3%	2.8%
Hedge Funds (Crédit Suisse)							
Hedge Funds Indus.	726.7	71.33	n.a.	1.9%	n.a.	6.2%	6.4%
Distressed	966.8	75.37	n.a.	0.8%	n.a.	11.6%	3.8%
Event Driven	812.3	74.22	n.a.	0.3%	n.a.	12.6%	7.0%
Fixed Income	393.5	76.66	n.a.	1.3%	n.a.	3.9%	3.6%
Global Macro	1 205.0	67.48	n.a.	3.5%	n.a.	5.9%	6.5%
Long/Short	927.5	63.08	n.a.	3.0%	n.a.	5.2%	7.9%
CTA's	341.6	61.33	n.a.	0.2%	n.a.	8.0%	1.9%
Market Neutral	290.1	68.43	n.a.	1.9%	n.a.	4.2%	1.7%
Multi-Strategy	696.9	73.81	n.a.	2.1%	n.a.	4.7%	5.6%
Volatility							
VIX	27.36	58.12	17.8%	48.6%	58.9%	-24.3%	65.1%
VSTOXX	24.66	51.69	-6.2%	24.7%	28.0%	-17.6%	67.5%
Commodities							
Commodities (CRB)	599.9	n.a.	2.0%	3.5%	3.7%	30.3%	10.5%
Gold (Troy Ounce)	1 859	65.56	2.8%	2.0%	1.6%	-3.6%	25.1%
Oil (WTI, Barrel)	93.10	71.50	0.9%	14.6%	20.9%	58.7%	-20.5%
Oil (Brent, Barrel)	97.59	75.87	2.3%	16.6%	26.0%	51.4%	-23.0%
Currencies (vs USD)							
USD (Dollar Index)	96.082	52.77	0.6%	0.5%	0.4%	6.4%	-6.7%
EUR	1.1350	50.08	-0.9%	-0.1%	-0.2%	-7.5%	9.7%
JPY	115.42	43.97	-0.1%	-0.1%	-0.3%	-10.2%	5.1%
GBP	1.3564	54.59	0.2%	-0.5%	0.2%	-1.0%	3.1%
AUD	0.7137	48.43	0.9%	-1.0%	-1.7%	-5.6%	9.6%
CAD	1.2737	44.79	0.2%	-1.3%	-0.8%	0.7%	2.1%
CHF	0.9259	44.33	0.0%	-0.3%	-1.4%	-3.0%	9.4%
CNY	6.3546	51.55	0.1%	0.3%	0.0%	2.7%	6.7%
MXN	20.538	52.59	0.7%	-0.8%	0.0%	-3.0%	-5.0%
EM (Emerging Index)	1 743.3	58.45	0.2%	0.3%	0.5%	0.9%	3.3%

Source: Bloomberg, Atlantic Financial Group

Total Return by asset class (Negative \ Positive Performance)

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