Fidelity Connects

Global Real Estate Outlook

Steve Buller, Portfolio Manager

Pamela Ritchie, Host

Voiceover: Hello and welcome to Fidelity Connects – the Fidelity Investments Canada podcast – connecting you to the world of investing and helping you stay ahead.

In this episode, Portfolio Manager Steve Buller discusses the impact of COVID-19 on global commercial real estate since the year began, as well as the catalysts to look for as we head into the second quarter.

Steve says retail, office and hotels were the most affected during the COVID-19 pandemic, but these spaces are slowly re-opening, and he anticipates it will continue.

He says global mall stocks are recovering after the vaccine came out in November, but his focus is on industrials and data centres. As the demand for e-commerce increases, there will be demand for providers around the world. He believes there will be more onshoring of manufacturing and storage of goods.

As for office spaces, Steve says the work-from-home environment will stay put in North America and London, but not in Asia. He estimates over the next 5 to 10 years, the demand for office space in North America could rise 15 to 20 percent.

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[01:59]

Pamela Ritchie: Steve, I wonder if we can begin with you situating us a little bit on where global real estate fits into this reopening trade.

Steve Buller: It has actually a very strong position within it. Many of the sectors themselves got hurt tremendously by the lockdowns or the pandemic. We've seen retail, office, hotels, those sectors kind of die, if you will. They're starting to reopen, and we do anticipate they will, but we also are very cautious that they've been impacted and that future demand will be quite different from what it was previously. The good sectors, data centres, industrial, towers, they actually benefitted perversely enough from the pandemic and they continue to be quite strong.

[02:56]

Pamela Ritchie: I almost don't know where to begin because there's so much discussion as many of us think when do we go back to an office. There's also so much discussion about everyone wanting to travel and do leisure of some sort. I want to hit them both. Let's begin with office space. How will we go back to work? How might this look according to what you see in the market, what's been priced into the market about how we will go back to workplaces?

Steve Buller: Very similar to bricks and mortar retail. I remember this discussion 10, 15 years ago. The office is not going away, but the demand for office space will be less than it was pre-pandemic. It will matter a little bit by geography. You will see, probably in North America the most permissive, that is, with work from home. Also probably in London. A little less so in continental Europe, and actually in Asia we think it's going to be not as much impactful. One reason, most Asians, they live in very small apartments or homes, so working from home has been extremely difficult. You also have cultural differences. For example in Japan, face time at the office has the utmost of importance, and we don't think that part is going away.

We estimate over the next 5, 10 years that the demand for office space because of the work from home phenomena, primarily in North America, could be anywhere between 5 and 15%. It will be a slow bleed though because a typical office lease in North America is 10 years. So that means 10% of the leases come due every year, so it's not going to be this immediate impact, but it will impact what we think future rental rates will be in many major cities.

[04:37]

Pamela Ritchie: Just to dig a bit further on the office side of things. I think you've mentioned before that the tech sector has been one of the big spenders within the office space for instance. We've seen that the tech sector particularly can actually do a lot from home. What are the nuances within office that you see?

Steve Buller: That's an excellent point you bring up. The technology sector over the last decade has been one of the primary sources of incremental demand for office space around the world. We find 1) they're in the tech sector, so they've proven that they have the ability to work remotely or from home. We think that many technology companies will be at the forefront in allowing some employees to work from home permanently, or more of a hybrid model. This all feeds in though over the longer term that demand will be impacted.

[05:31]

Pamela Ritchie: It's absolutely fascinating. Tell us a little bit about this idea of office and big cities perhaps versus small cities. There's a suburb discussion about where people want to live and have a patch of grass, but can small cities actually be looked at quite differently going forward?

Steve Buller: I think within the pandemic that what we've seen in the last year people have flocked out of major urban centres: the Torontos of the world, the Londons of the world, the New Yorks of the world. With the reopening though you're going to start to see people come back because offices will start to reopen and people want to go back. It will be fascinating, and unfortunately we won't know immediately. I think you're going to have to look back in 5 or 10 years and say, "What was the impact of pandemic on these large urban areas?" I think that goes back to the discussion from work from home or work remotely. That some people, huh, I can live in a smaller town and generally speaking there's lower cost of living and perhaps actually make the same salary that I made in Toronto. Hm, that's a good trade, maybe I'll do that. That's good for my pocketbook. I think you'll see a little bit of that, but within the next 6 or 12 months I think you're going to see a lot of stories, and you're starting to, how the cities become more vibrant again.

[06:48]

Pamela Ritchie: A big discussion right now. We're on our way to International Women's Day, so it's becoming even more of a discussion and rightly so, is that in many cases, not in all cases, but in many cases. And the home is a tough place to work. It can be. I'm just wondering how much that discussion you notice and goes into the office return to work, if at all. I'm curious.

Steve Buller: You do see … one thing, if you look back on the pandemic where we, I think collectively, society got wrong of when people are going to return to the office. It was a little bit too much focus on just when the pandemic was going to subside. But it was also tied into other things. For example, when schools were going to reopen. We're also seeing at the element too, if you're taking care of elderly people which before they maybe would've gone to an assisted living home or nursing home, but they stayed then within their home because they had caregiving and the fear of pandemic. Right now at the margin we're starting to see that open up. If acuity levels are quite high, there's really pent-up demand within assisted living and nursing homes actually for elderly people to go into.

[08:00]

Pamela Ritchie: Very interesting pieces that are moving around here. Let's go to travel and leisure, the discussion of everything from Vegas opening up again to people trying to hop on a plane and go to hotels. How does that area look? It's almost a question of when we get back at it, but how does it look to you right now?

Steve Buller: Without a doubt there's huge pent-up demands, especially on the leisure side for travel. You're going to start to see very robust tight numbers from leisure-type destinations and hotels. One thing though that's interesting, for example, the hotel industry, which is primarily in the world here in North America. Many of the hotel REITs, they own more large urban business-oriented hotels, which I think are going to be some of the last to come back. If they are filling their rooms up with leisure, that's more lower-cost type thing. So it would be interesting enough whether or not their cash flows get back to pre-pandemic levels.

The hotel REITs right now are actually very close to their pre-pandemic stock prices which is very interesting because it's going to take a couple years for them to get back to the business they were doing, but there sure is a lot of excitement out there.

[09:19]

Pamela Ritchie: We have so many questions coming in here. I want to get to the inflation story. Obviously we're all watching what's going on in bond markets. We mentioned in the intro. What does, in a nutshell, a rising inflation rate do for real estate trade?

Steve Buller: One, inflation is generally good for real estate over long periods of time. That is the value of the building itself that is to be replicated goes up. Rebuilding a building it just costs more and/or the land part of it. If you want to take the inflation and interest rate, which is obviously on everybody's mind now, and there is this assumption, it's actually one of my pet peeves out there, that listed global real estate is a bond proxy. If you look at any of the statistics, it actually is not a bond proxy. It actually has a slight positive, but somewhat close-to-zero correlation of the return of global real estate securities and the movement of interest rates. And people go, huh, how is that? That's because, as you may have heard me on previous presentations here, it's a tug of war that goes on between the fundamental side, which are good usually in inflationary or improving economic environments, and the interest rate side of things because it is a capital-intensive industry. A tug of war goes on whereby one of them wins for one period of time, the other one wins, and then over longer periods of time the actual correlation is close to zero.

[10:52]

Pamela Ritchie: Very interesting. So then if we're looking at bond markets, there does seem to be some diversification now. But we talked a lot about correlation between equities and bonds for a long time, so real estate, the diversifier, just kind of speak to that effect.

Steve Buller: It's been proven in many studies the inclusion of global property securities in a global portfolio does what it's supposed to do. It increases the return potential and decreases the risk. More specifically, and I should expand upon your interest rate question, people go, well, what do interest rates mean for the returns of global property securities? I say, "Well, tell me what global equities are going to do too because that matters." Two periods of time where actually global property securities during the TMT bubble, way back when you were probably a young person in school, but that is in 1998, 1999 whereby people only cared about things that went up every day, the tech telecom stuff. Global property securities did awful. When the bubble burst one of the best performing sectors was actually global REITs.

The same was kind of in the global financial crisis where, prior to that, global REITs weren't doing too well especially within the global financial crisis, but thereafter they're actually one of the best performing sectors once again. So, and I'm not predicting this, nor am I hoping for it or anything like that, but I do find that the defensive qualities, the income qualities, the real property qualities of global property securities are good defensive mechanism versus some of the growthier side of the stock market.

[12:37]

Pamela Ritchie: Some of the investors joining us right now might be … within the global dividend or an income strategy. What you do is effectively a sleeve of what they're investing in. Can you just speak to the importance of that sleeve, where it fits essentially?

Steve Buller: Once again, some of the highest dividend-yielding stocks around the world are global REITs. The structure themselves make them higher dividend yielding, whereby a typical REIT structure you have to distribute the majority of your cash flow out in the form of dividends. Hence you have higher-yielding securities. That's one reason why it's in a global dividend strategy because of that income component or the force distribution of the cash flows itself which is, once again, very beneficial for many income strategies and you see then inclusion of REITs in them.

[13:30]

Pamela Ritchie: A few questions I'll put to you as they're rolling in here. Do you think there will be demand for warehousing space, data farms? You spoke a little bit about qui bene, who benefitted during COVID, and some of that was data and inventory and so on. But the place for warehousing space, data farms and also malls is also included in that question. Is there a repurposing?

Steve Buller: It is. And it has been very sector-specific. We've seen a recovery of global mall stocks since the November vaccine announcements. Per the end of the year I am underweight retail. I just think that even the impact of the pandemic, but prior to it, you still see the advent of e-commerce. It's just going to continue to chip away at bricks and mortar retail, and I don't think you're going to see much rental growth in any malls around the world. I am overweight per the end of the year a lot of industrials and also data centres. Industrials three-fold. One, you have the converse of that bricks and mortar retail trade, that is e-commerce. We're seeing tremendous amount of demand for logistic space from e-commerce providers around the world.

Second, and most of my fund is in the developed world, I think you're going to see more onshoring of manufacturing, and also storage of more goods because a just-in-time inventory system got slightly pulled, or I wouldn't say broken, but it's been stretched, and that means people will need to keep more inventory closer to the consumer or the end user. That's only beneficial for logistics facilities.

The last, data centres, the pandemic just increased the digitalization of everything whether it was personal, whether it was corporate, and that demand, anything from your phone to the internet, it all eventually runs through a data centre. We're seeing tremendous demand for data centres on a global basis.

[15:41]

Pamela Ritchie: Just bring the development, the further move into 5G. Does that just increase with that trend increasing, or do you look at that specifically?

Steve Buller: 5G actually impacts more the tower REITs of which there are some within the U.S. and a few within Europe. So that 5G implementation should have future demand for space on towers, which is essentially the conduit for all the mobile and cell phone use throughout the world.

[16:15]

Pamela Ritchie: Amazing how that is expected to increase. Other questions rolling in here, does the Global Real Estate Fund include facilities like personal care homes? You were mentioning that, that there may be a time for more of, people moving back in essentially. Do you invest in that? How does that work?

Steve Buller: The fund does have exposure to, and it's a variety of different types, independent living, assisted living, nursing homes, and they're somewhat different categories as you go around the world. It does have exposure in North America, Europe and Japan to these facilities. One, you just have an aging demographic, so that's obviously one part, and the second is it depends on the payer system throughout the world. European and Japanese, you're essentially all government paid for any of this type of care, so they're very safe and secure. Here within the United States whether it's right or wrong we have a private/public pay model depending on income levels and where you live.

The private pay model has been hurt quite a bit in the assisted living facility area, but we do start to see a rebound. One, it was impacted by COVID. No one — and I'm not trying to be sexist here, but 85% of people in assisted living facilities are females — so no one wants to move their mother during COVID into an assisted living facility. We're starting to see that reverse because here in the United States some of the first people that got the vaccinations were in assisted living facility, and secondly there's just the pent-up demand as I alluded to earlier. Their acuity level is high, and they need some type of formal care that they can't get from home.

[18:01]

Pamela Ritchie: You've mentioned global a number of times, and you're referenced places around the world, but let's broadly … we talk a lot about EM and getting exposure. I'm curious whether you can talk about how real estate fits into an EM perspective, or maybe it's much more thematic. But internationally how do you look at the real estate nuances?

Steve Buller: This fund primarily invests in the developed world. At times it does and can invest in some emerging-market type companies. Within real estate most of the emerging market companies are more residential development companies than what I'd call REITs. That is the ownership of buildings and collecting rental streams themselves. Right now we find enough opportunity in the developed world, so we don't have that much exposure to emerging market real estate companies. That's not to say we don't look at them, and we at times find them attractive, but rather stay in the developed world without taking the currency or the country risk that you do have with emerging markets.

[19:06]

Pamela Ritchie: Inflation and the discussions around inflation. Really countries that have pumped money into their system recently, they fall in the developed world side of things generally. How does the inflation global story look to you? Is it any different than it is here?

Steve Buller: I think inflation is going to be potentially a global story. I think it's been enhanced in some of the developed world whether it's here in the United States with the stimulus, in European countries with many of the packages that they had within COVID. With the pumping of the central banks around the world, there's just so much "money supply" out there that it's leaking through and creating inflation in one sense, monetary-type inflation, which, as I alluded to earlier, isn't necessarily a bad thing for global real estate stocks.

[20:04]

Pamela Ritchie: If there's sort of a kernel that you want people to think about within real estate right now, is that it? Is it this global picture?

Steve Buller: That's part of it. I would also say there's a lot of sectors within real estate that have done well pre-pandemic, in the pandemic and here post-pandemic, or as we get to the new normal, and I think people always a little too much focus on the old, I could say a little bit dying or troubled sectors of retail and office, and not enough on the good sectors. The good sectors by market cap and weight within a lot of the benchmarks have become so large that they kind of overwhelm those more troubled sectors within the listed space.

[20:56]

Pamela Ritchie: So we're going back to logistics, data centres, towers, is that [audio cuts out]?

Steve Buller: And growthier sectors within that. We will see pretty consistent earnings, dividend, cash flow and net asset value growth out of the good sectors.

[21:15]

Pamela Ritchie: Does it matter from here to the next year or two what sort of further stimulus is pumped in? It's all connected to the inflation story that we're talking about right now, but in orders of magnitude where does it either become concerning, or is it the pace at which you see more money pumped in, for instance? Can you comment on that?

Steve Buller: Yeah, but I'm not a macro economist, but obviously it's part of my job to know what's going on, to look at what's going on. Obviously the fear that if inflation genie gets out of the bottle, it's very hard to put back in the bottle. I think that's the uber focus right now on the markets and starting in the United States that are we setting ourselves up potentially for a dangerous situation that it gets out of control like we had in the 1980s. It's very difficult to then put a cap on that. I think that's kind of the fear that the markets have been expressing more recently.

[22:22]

Pamela Ritchie: The discussion around ESG is very much about the consumers of energy, and we talk about it a lot in terms of EVs. Buildings are massive consumers of energy, and there are new building standards. If there are new types of reporting that are necessary, if there are all kinds of new disclosure things coming, what do you look for in terms of either interrupting or perhaps accelerating into certain real estate opportunities?

Steve Buller: As part of a broader Fidelity effort, and our ESG effort, we have looked at all the listed real estate companies, and we've put a rating on the majority of them. Interestingly enough listed real estate or REITs around the world actually have higher ESG ratings. If you look at many ESG diversified funds, they're overweight REITs or real estate because they have better ESG ratings. It's primarily driven by the E, the environmental. Remember, many of the owners of the buildings, these are large companies, they have hired people that their only day job is to try to save energy or do better than they have versus an individual owner. I actually think real estate, you're right, real estate overall is a huge carbon producer throughout the world. The listed space which owns approximately 10% of all commercial buildings around the world does a much better job than the other 90%. Hence why you see their ESG ratings be higher than many other sectors in the equity world.

[24:01]

Pamela Ritchie: When you think of the lead standards that people have been trying to aim towards, and it's very much people want to live in buildings that have such things top of mind. It's an interesting thing that seems to have been ongoing for some time. Sorry to go back to the old world of real estate here, what will all the malls be used for?

Steve Buller: Like everything, it's hard to generalize here. There'll be situations where — and I'm not going to say malls, I'll just say old retail 'cause for example in North America we simply have too much retail space, and many of it's going to die and some of it's going to get converted. It all depends, once again, where it's located. If it's located in downtown Toronto at a great location and the math works, it's going to be converted to residential. That's what you'll start to see. If it's in the middle of nowhere North America, and it's a retail thing, and it's dead and there's plenty of land around it, it's just going to be a write-off.

So once again it does depend on the location and HBU as it's called, higher and better use. In many instances you start to see the math work, i.e. it's worth the land value, it's worth the ability to tear it down, it's worth the time to do it to convert it to something else, and hence you'll see more and more of that in the future especially if it's well-located property or land to begin with.

[25:34]

Pamela Ritchie: In Canada we do watch the oil price carefully, even if those want it to change to a better model. There's lots of discussion about energy transitions and so on. All that said, I'm curious about the real estate markets that surround certain industries, certain industries that are going up, certain industries that are going down. How does it look for real estate more generally in oil-producing provinces, and states in the United States as well?

Steve Buller: It's always Calgary and Houston that come top of mind when it comes to the energy cities within North America. One, both of those cities, I'd say Houston has done a little better job, but Calgary has done a respectable job of diversifying their economy. Second, these cities have gone through so many downsizings within energy that it's not like it's excessive employment within the energy sector right now. I don't think, this is my opinion, you're going to see this huge hiring binge just because we've seen an uptick in oil and natural gas prices around the world. I'm a little like there's not going to be this huge energy recovery play. I don't think there's money going into Houston to buy real estate because they think it's going to be an energy recovery play. We don't see that. It's going to be because it's the fourth largest city in the United States, it's a low cost place to do business and it's diversified. That's where you'll see more of it than an energy play.

[27:04]

Pamela Ritchie: Like San Francisco Heights or Silicon Valley moving to various parts of Texas and so on. Any comments on that? Just on these … I think it's largely economic and maybe moving to the sun a little bit, but you see New York moving to Miami or at least the discussion around it. I don't know how much of it is real or not, but what do you think about those migrations, if they exist?

Steve Buller: It gets to our previous discussion a little bit on big versus going to smaller cities. Most people go to the big city because they want to get X, Y, Z job that pays very well, and it's a vibrant place to live from culture, to restaurants to just nightlife, etc. But at the same time if these jobs are going to be more dispersed, that is the employment base can get a similar type of employee in Austin, in Nashville here in the United States, they're going to eventually go there. It's going to be leaking at the margin. That gets into once again the office discussion we had earlier. Work from home can also mean work from remote, or from those types of places. So I think at the margin you're going to see that, and hence why I have very, very little exposure within the fund to landlords that own offices in major cities in North America and/or in the UK, i.e. London. I do have office exposure still in Asia and a little bit in continental Europe where I think the impact won't be as drastic.

[28:45]

Pamela Ritchie: I love the way you bookended that 'cause that's kind of the way we began. Just one final question rolling in here, what is your turnover like? The concentration, just a couple of comments on what the universe is that you're working with.

Steve Buller: Typically my turnover, and I've managed this fund for more than 15 years, is anywhere between 20 and 30-ish per cent on any given year. So let's just take 25% for argument's sake, which means if you invert that, that's a four-year hold. Real estate is a long-term asset, so I view it as such. This isn't like the biotech sector, cure cancer, not cure cancer, and I can see then managers of funds like that should have higher turnover. I'm investing for longer-term trends, which real estate typically has, and not chasing the next thing. Right now we have had the beaten down sectors of retail, hotels and office which I had some exposure for, but I'm underweight, have done very well since November vaccination date. But more recently I'm going back to the sectors, as I alluded to earlier, that are long-term consistent growers which I think will be the ones to own for the next 3, 5 and 10 years.

[30:01]

Pamela Ritchie: Completely fascinating to talk to you, Steve, about things that really affect our daily lives, so it's been walking around and seeing the world. Thanks so much for joining us.

Steve Buller: Thank you.

Ending: [30:12]

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