CATELLA

The Epsilon – Great Transformation of Real Estate Markets

European Residential Vision 2023

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Cover image: innovative energy efficient Elithis Tower in Le Havre. The building has a bioclimatic design with on-site renewable energy production through photovoltaic panels on the roof and façade.

Preface

By Xavier Jongen, Managing Director, Catella Residential Investment Management

The catalysts of the energy crisis, surging inflation and geopolitical turmoil ignited by the Covid pandemic and war in Ukraine are forcing an acceleration in the pace of economic transformation needed to confront two of the greatest challenges of our age: climate change and the poor-rich divide. While the former needs global solutions around the political centre, the latter feeds into populism, which produces precisely the opposite effect: domestic and international polarisation. This is feeding through into mounting pressure for a more rapid evolution in housing markets, the largest single source of global capital formation.

In the European residential investment sector, investors and managers are struggling to reconcile their previous business models with the new reality. Firstly, these were formed in the era of cheap money and cheap energy, whereas they are now confronted with a poly crisis of a financing market radically transformed by soaring interest rates, climate change, the tightening of environmental regulation and partial de-globalisation.

Secondly, the emergence of radical new 'impact' business models where 'dual materiality,' or the equal weighing of financial and climate/societal returns in investment decisions, is increasingly taking centre stage in business strategies. For a real estate industry that has grown to institutional scale under Nobel prize-winning economist Milton Friedman's doctrine that "the only social responsibility of a company is to create shareholder value," this is a profound challenge to existing strategies, cultures and benchmark performance metrics. The property sector is driving into this new world when the market's generally accepted ESG valuation and benchmark performance structures are yet to be framed, and where financial returns for a great swathe of assets held in portfolios that do not pass these opaque investment tests look set to fall off a cliff.

The Great Transformation

Perhaps we are witnessing the prolongation of the outcomes of Hungarian economist and Columbia University professor Karl Polanyi's predictions in his Great Transformation (1944) historical and anthropological treatise. Polanyi's studies of the market economy's development in the 19th century led him to conclude that it was so socially divisive it had no long-term future as then configured. The Industrial Revolution produced the unbedding of the market from society and wide divisions between rich and poor, with the impact on the external environment undiscounted. This produced strong opposing social counter currents in the 20th century with the rise of the totalitarian regimes and, subsequently, the gradual gravitation of the political centre around the concept of the social welfare state.

In the 21st century, we are witnessing the biophysical limits of the market economy model with the collapse in biodiversity and onset of climate change. We now need to do what it takes to embed the market back into its biophysical context, into ecology. That is both an inflationary (energy transition) and deflationary (limits to growth) long-term secular process, until a new equilibrium is reached in the new 'great green growth world'. The main goal of the EU's decarbonisation transition 'Green Deal' is to achieve a carbon neutral Europe by 2050, but that is only an intermediate step towards the Great Transformation.

The Energy Transition and Waiting for the Return of the Residential Cycle

The transition of economies away from fossil fuels towards green renewables has been accelerated by the war in Ukraine, as governments and consumers have rushed to diversify their energy supply in the face of soaring prices and a surge in inflation to the highest levels in decades. European residential markets have also come under pressure with the ramping up of interest rates by central banks driving up financing costs, alongside higher material prices and labour costs, as well as tighter environmental regulations adding to the potent headwinds facing the sector. Investors and managers have responded by moving to the sidelines, if they can afford to 'wait it out,' until they have clearer visibility on valuation levels and the position of European residential markets in the cycle.

So far, so cyclical. But what if this is not cyclical at all? The energy transition seems to be leading us into a real estate 'Reformation,' or the realignment of market cycles on the journey to the biophysical Great Transformation, where the world in which we end up will be fundamentally different to the one we are departing. Projecting forward on how that world might look, rather than extrapolating from the past, will make more sense than plugging in the parameters of mean reversion that were valid for the 1945-2022 period.

Positioning oneself on time for the realisation of the Paris climate accord targets within the real estate industry – the largest single collective source of greenhouse gas emissions and capital formation on the planet – will be the key to creating stakeholder value.

Our economic growth for the past 200 years has been closely correlated with access to low-priced and efficient fossil fuels. We are now reaching the

hard biophysical limits of that 19th century 'Industrial Revolution' model.

If our economic productivity is based on cheap coal, oil and gas as inputs, when those props are removed and aren't replaced fast enough because we are not making the necessary investments in renewables, then GDP, one of the main drivers of property markets, will contract correspondingly.

The price paid for fossil fuels only included the work put in for excavating, refining and transporting them – not for the millions of years they took to be formed, nor the consequential costs generated by the high CO_2 emissions produced by burning them. The Great Transformation rectifies that 'free lunch' humankind has enjoyed for centuries, as the true costs for the planet

start to be felt, and the market price for decarbonisation becomes established. We will be forced to move from a high Energy Return on Investment (EROI) environment, by excavating cheap fossil fuels, to a low EROI.

The intense political debate in the densely-populated Netherlands on the sustainable limits of growth compatible with the country's greenhouse gas emissions commitments in sectors from construction to transport and agriculture is likely to roll out across other European states, and have a profound impact on the EU's direction of travel on climate change. It is becoming clear that the old models of economic growth cannot continue for very long into the future.

When we start to understand the non-cyclical situation we are in, then we can see that climate change and real estate market mispricing are actually connected in many ways, including through physical climate risk, transition risk and adaptation risk. Once we connect those dots, our analyses take us to climate gentrification and the potential mass migration of people seeking to escape the effects of global warming, which will set into motion another series of societal events which also have a pricing and investment impact.

In the coming new world, we are not necessarily damned like the biblical '10 plagues of Egypt' imposed on the Pharaoh for thwarting God's will in enslaving the Israelites. We need, however, to accept hard limits to growth as this is based on hard science crossing over into economics, finance and politics, and can't be changed in the boardroom. The 'tipping point' in Catella's view is well within the next years, which is the industry standard investment horizon for the European residential market, and is why the Great Transformation lies first and foremost in our strategic planning for the future.

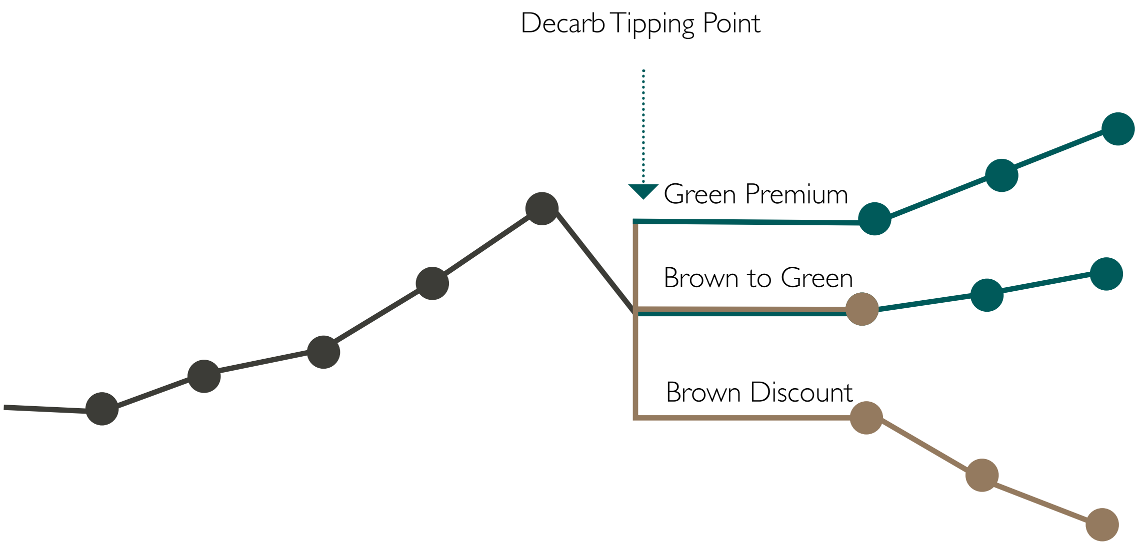
The Tenth Plague of Egypt, exhibited 1802; Joseph Mallord William Turner 1775-1851; Tate, Accepted by the nation as part of the Turner Bequest 1856; Photo: Tate

The Epsilon Investment Market

The extraordinary low interest rates of the last decade will not return in the long term, while global climate targets will remain and significantly influence investment behaviour in real estate investment markets.

We believe the real estate realignment is underway as markets start to understand that the era of low-cost financing is fading, and that the valuation gap will continue to widen between assets with a 'brown discount,' which are not sustainable in their current composition, and those with a 'green premium,' or the highest decarbonisation and increasingly societal well-being credentials. In this new paradigm, the European residential transaction market will not revert to a cyclical form, but become more a transformational 'curve,' dividing into a Greek letter Epsilon shape: E/ε.

Catella decarbonisation market development



Source: Catella Residential Investment Management

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Please get in touch by email for a full copy of the report.