The Pitfalls of "Peak-to-Trough" Thinking: Going Beyond Heuristics to Find Relative Value in Global Real Estate

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Which global real estate markets are ahead and which are behind in the process of repricing?

This question, along with its many variations, has been by some margin the most frequent one asked of me when presenting LaSalle's recently released *ISA Outlook 2024*. Investors understandably want to know where they can find value amid real estate capital markets that continue to adjust to higher interest rates. They want to focus their efforts on geographies and sectors for which the bulk of the price adjustment is in the rearview mirror instead of still lying ahead.

Attempts to answer this question with numbers often begin with simple comparisons of peak-to-current value declines. The implicit logic is that larger-measured to-date declines for a market indicate that it is farther along in the repricing process or, simply, that it is cheaper and thus attractive. But these sorts of analyses are plagued by a range of measurement and interpretation issues that complicate comparisons. At best, they can lead to contradictory conclusions; at worst, they may contribute to missteps in investment strategy. Some of the key challenges are explored below.

Is the Peak Correct?

The first major issue with peak-to-trough analyses emerges right away—how to measure where the peak occurred. Even in hindsight this can be difficult. If the peak is "wrong," the peak-to-trough number will also be wrong. Unlike for listed markets, evaluating real estate pricing in private markets happens through a process of periodic, incomplete sampling. This can lead to peaks in pricing being captured, or not, to varying extents across markets and specific indicators. In addition, observations used in valuation-based indicators have an inherent constraint on the frequency of observation—the frequency with which properties are valued.

Faithfully capturing a peak in the recent history is especially challenging. The year 2021 was unique, with radically different outlooks for financial conditions prevailing at the beginning versus its end. This meant peak pricing was a truly short-lived phenomenon, making its level harder to establish than if peak pricing had taken the form of an extended pricing plateau. It is a bit like trying to take a picture of a fast-moving animal with a low-shutter-speed camera. A hummingbird may not be in the frame during the moment the image is actually captured.

Is Variation in Market Practice and Transparency Muddying the Waters?

Valuation practices differ across countries, leading to different paces at which changes are recognized. These differing speeds of valuation corrections complicate comparisons across global markets when using valuation-based indicators. For example, traditional valuation practice in Germany famously responds slowly to price changes because it requires a heavy weight of evidence to make value adjustments. This leads to German indices that exhibit low volatility on both the upside and the downside. On the opposite end of the spectrum, valuations in the UK tend to be frequent, and valuers have the flexibility to incorporate proxy indicators when evidence from the direct transactions market is scarce. This tends to contribute to the appearance of greater volatility. (Differences in valuation practice should, in principle, not be a factor in comparisons of transactions-based price indices. That said, indirect impacts can be seen when bid-ask spreads linger longer because underlying valuations are stickier.)

Ahead or Behind … Relative to What?

The question of which countries are ahead in repricing and which are behind presumes that all markets are on the same path but that some are just farther along it than others. This is far too simplistic. Framing the question a little differently is more useful: How far behind changes in financial conditions are changes in real estate pricing? At its foundation, real estate pricing is tied to the price of risk, which is best observed in real interest rates. This

statement should be so uncontroversial that it borders on the obvious. But it bears repeating because during episodes of repricing, many real estate market participants hold out hope that it can levitate—like the Road Runner from Looney Tunes cartoons—even when the ground falls away.

Real estate must offer a competitive risk-adjusted return compared to fixed income, equities, and other asset classes. This manifests as "Why would I buy real estate when I can get X% return in Treasuries?" Changes in the interest rate environment also translate directly into real estate borrowing costs, impacting leveraged internal rates of return (IRRs). "I can't hit my target return because debt is too expensive."

Different countries have different financial conditions, and the adjustment process of private-market real estate pricing should follow those conditions, not real estate pricing in some other market. For example, Japan stands out as having much lower inflationary pressures than other countries, and upward pressure on interest rates there has been much more modest. The MSCI/RCA Commercial Property Price Index for Japan shows a decline of less than 5% from the most recent peak through 3Q2023, compared to double-digit declines for US and European markets.

Does that mean Japan is behind the US in repricing? Only if you believe that Japanese financial conditions are on the cusp of a radical change. That would be a macro call separate from, and much bigger than, any view on property markets. Such a change would impact assets throughout the Japanese economy beyond real estate. Our proprietary analysis suggests Japanese real estate pricing today is mostly fairly aligned with Japanese financial conditions, which is what matters. That market's smaller peak-to-trough decline versus others is another way of saying something long considered to be true: Japan is different.

All Else Is Not Equal

There is another essential but difficult-to-observe factor influencing real estate pricing that makes peak-to-trough comparisons hard to interpret. Unlike government bonds, real estate cash flows are dynamic. Depending on a sector's lease structures, cash flows can change as frequently as

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daily. Even when they don't change so quickly, changes in expectations of future market rents impact values because all leases eventually roll to market. So in parallel to the vagaries of interest rates, current real estate fundamentals and their expected paths are in continuous flux and thus also impact pricing.

If one market or sector's net operating income prospects improve relative to another's, its pricing should hold up better. Value declines from peak levels for the former market should thus, all else being equal, be smaller than that of the latter. This reflects a forward-looking view on where sectors are heading and should not be confused as a signal of lagging repricing.

All Roads Lead to Intrinsic Value

If the motivation for the original question of leading versus lagging markets is about trying to find relative value, why not ask that question explicitly? An intrinsic value approach that compares a forecast of expected returns to required returns can answer it directly. All the assumptions that go into a fair value model can be made explicit and clear, rather than implicit and hidden. This enables a robust debate over the accuracy of each assumption without getting caught by the caveats inherent in heuristics such as comparing observed peak-to-trough movements in private markets.

An expected return is an IRR forecast for a hypothetical asset that is built off a best guess of today's pricing, assumptions around short- and long-term income growth, and subtraction of an appropriate amount of capital expenditure to keep the asset competitive (to a degree consistent with the cash flow assumptions).

A required return is a discount rate that compensates the investor for the time value of money as well as risks inherent in the investment; investors holding assets with higher degrees of risk need greater margins of safety to compensate for the potential downside. There should be compensation for factors that can be observed in the capital markets (e.g., a term premium for the uncertainty inherent in long durations, economy-wide risk, and the credit cycle) as well as for the additional risk that comes from the real estate itself (geographic, sector, market, asset-specific, and strategy-related risk factors). Pricing of capital market risks can be observed in large, liquid markets, such as the bond market. Real estate risk premiums layered on top of those risks may be based on history, models, or a best guess from an informed study of historical patterns mapped onto the future expected environment.

The relationship between required and expected returns gives a relative value signal given the set of assumptions used. Sectors and geographies for which the expected return is outsized relative to the required return should be interpreted as offering better intrinsic value—i.e., they are more attractively priced—than those with a weaker or an inverted relationship. Again, any interpretation of these relationships holds weight only to the extent of agreement with the underlying assumptions.

Intrinsic Value Approach in Today's Market

LaSalle's global Research & Strategy team uses intrinsic value models across the markets and sectors in which it invests to help guide relative value judgments. Its Global Solutions team employs an equivalent approach to model value in listed and non-listed indirect real estate markets. The specific methodological choices, assumptions, and outputs behind these models are proprietary and cannot be shared in this article. But suffice to say, they are instrumental in shaping LaSalle's investment targets. They have been helpful in taking stock of key recent dynamics that are highlighted in the *ISA Outlook 2024*, such as volatile interest rates and cooling fundamentals in key target sectors such as global logistics and US apartments. And crucially, they are far more transparent and useful than simplistic heuristics like the old peak-to-trough method. ■

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