Morgan Stanley
INVESTMENT MANAGEMENT

After Trough NAV Discount Comes Trough NAV

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Historically, the trough in European listed real estate NAV discounts has preceded the trough in values and NAVs by around six to nine months. We think this time is no different, and that now we're at—or very close to—trough NAV for the sector.

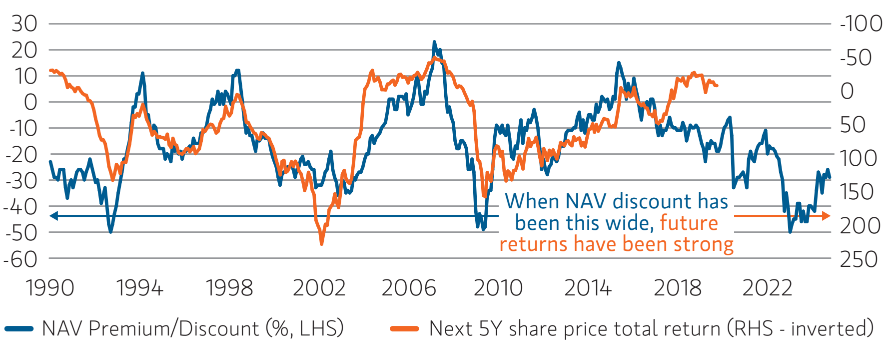
The Re-Rating from Trough NAV Discount Is Playing Out

Back in October 2023, we noted in our white paper "Record Wide NAV discounts: Time to buy listed real estate?" how listed sector discounts to direct market NAVs had rarely been so wide. We also highlighted how investing in European listed real estate at such wide discounts historically had almost always delivered attractive returns over five years, as investors captured the benefit of positive underlying property returns from a cycle trough, together with the recovery of NAV discounts *(Display 1)*. But since the share price trough in October, European listed real estate stocks rallied roughly 30% on an absolute basis by the end of May *(Display 2)*, outperforming European stock markets by 7.5% and global listed real estate indexes by 12.5%. So where do we go from here?

DISPLAY 1

NAV Valuation and Long-Term Share Price Returns Are Correlated, With Historically Attractive Returns When NAV Discounts Are Wide

Pan-Europe listed real estate NAV valuation vs. next 5-year share price return



Source: Bloomberg, Datastream, Company Data, Morgan Stanley

Positive Market Signals Are Accumulating

Since October, we have seen several encouraging developments that support our thesis of a trough in NAVs:

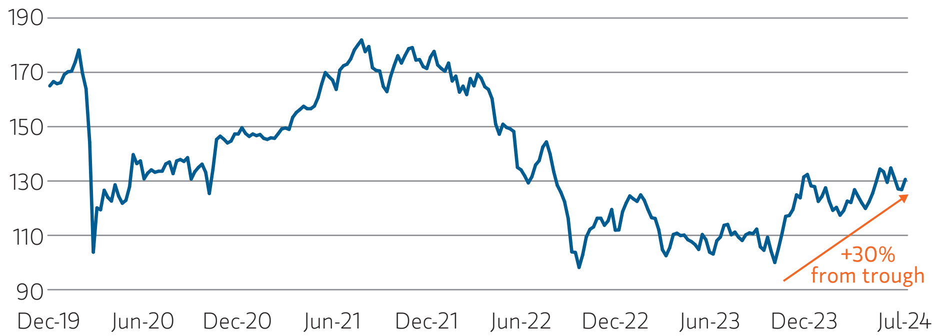
1. The European Central Bank has started to cut interest rates
2. Companies continue to decrease leverage, as Net Debt / EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) levels are now much more manageable than they were in 2022, especially in continental Europe *(Display 3)*
3. Credit spreads have continued to normalize *(Display 4)*
4. Companies are reporting a slower pace of valuation decline, and, in some cases, see 2024 as the year of a capital value trough
5. A sharp slowdown in development activity since 2022 will start to constrain the supply of newly completed stock in the next few years; this should also help drive rental and capital value resilience
6. Finally, we have also seen companies raising and/or seeking to raise funds via "front-footed" equity issuance, to take advantage of attractive market pricing. This is something we have not really seen since the start of the last property cycle in 2009.

There are still material risks in play, not the least of which is the trajectory of interest rates, which remains critical to a capital-intensive sector like real estate. But as noted above, many of the market signals on our "checklist" for a value trough have been falling into place.

DISPLAY 2

We Have Already Seen Strong Absolute Returns From the Trough of Values in October 2023

European listed real estate (EPRA Developed Europe Index, total share price basis)

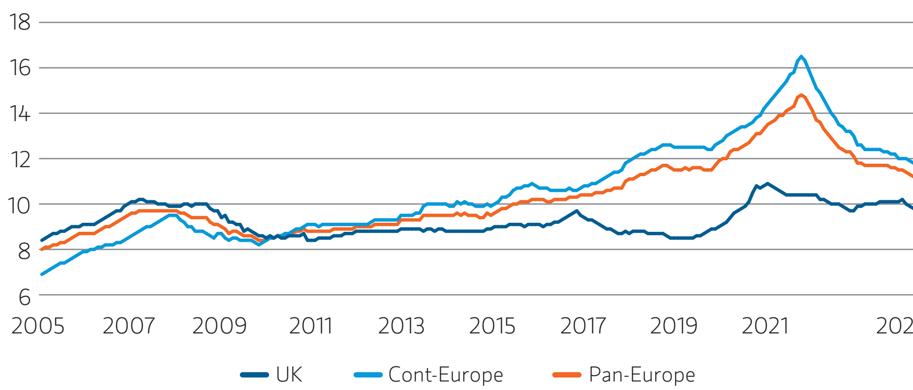


Source: Bloomberg, Datastream, Company Data, Morgan Stanley. Indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

DISPLAY 3

Leverage Levels Have Continued To Fall Relative to Cashflow…

Net Debt / EBITDA (x, market cap weighted)

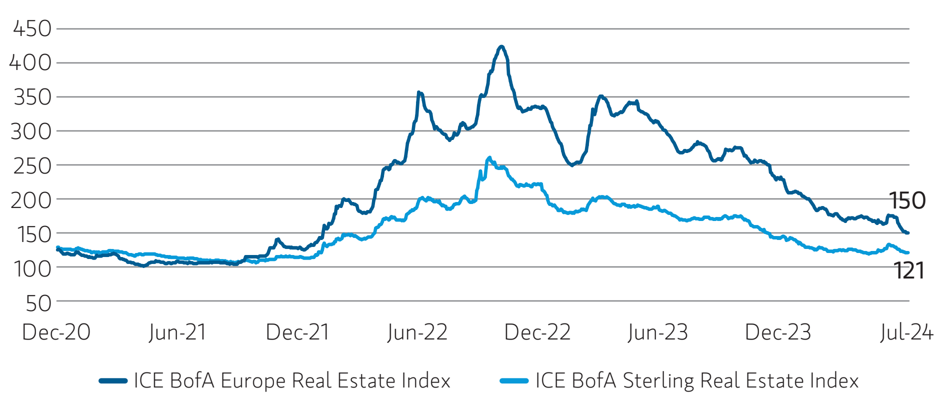


Source: Company data, Morgan Stanley. The series shown are compiled from company reported data published by the largest listed real estate stocks in the sector (by market capitalization) rather than an exhaustive list of index constituents, with the split based on country of listing. Continental Europe is defined as companies listed in Europe excluding UK and Ireland. Pan Europe includes the UK and Ireland. Net Debt to EBITDA is weighted by market cap.

DISPLAY 4

…and Credit Spreads Have Narrowed, Reflecting the Reduced Risk of Financial Distress

Real Estate: Corporate Bond Yield Spreads (basis points)



Source: Bloomberg, BofA, Morgan Stanley. Indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index. Index definitions can be found at the end of the paper.

We Think Trough NAV Is Here Now

Historically, the trough in NAV discount has preceded the trough in NAVs by around six-nine months. We think this time is no different. Our historical series of NAV growth shows that overall, the rate of NAV decline in European listed real estate has moderated; and although some half-year results continue to show lower NAVs compared to December 2023, we think that, on average, NAVs will be higher in a year than they are today, absent any external shocks. Furthermore, providing that values don't simply move sideways (which would be very unusual at a value trough), the historical correlation between NAV valuation and NAV growth still suggests room for further re-rating of listed share prices, as indicated in *Display 5*.

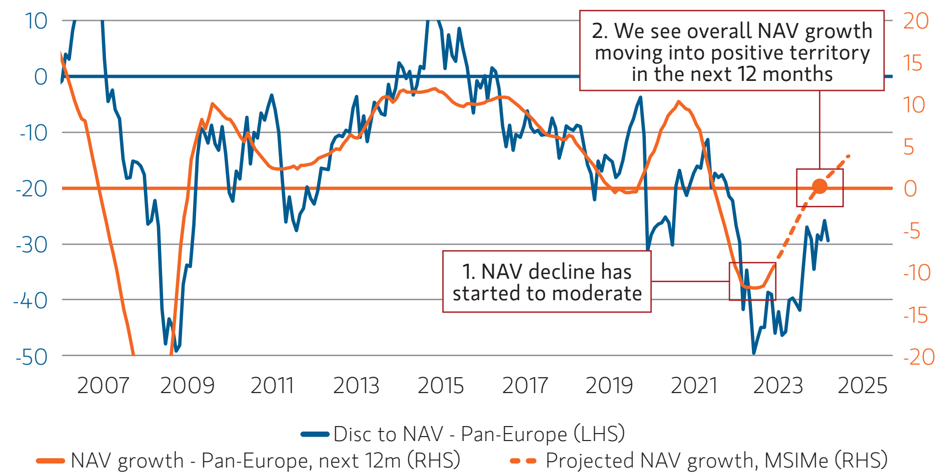
Not Just an NAV Trajectory: Earnings Yields Are Still Attractive

We are still more encouraged in our constructive view on share price trajectory by the fact that earnings yields remain at attractive levels in historical context. Part of this is the result of companies' in-place cost of debt being well below current refinancing rates, and still with a weighted-average debt duration of roughly four years to run; though this remains a headwind to earnings growth, we still see positive top-line growth driving positive earnings growth overall, together with an attractive earnings yield (*Display 6*).

DISPLAY 5

NAV Valuations Still Have Further To Re-Rate, Especially if NAV Growth Moves Into Positive Territory

*Discount to NAV (left axis) vs. **NEXT** 12-months NAV Growth (% - right axis)*

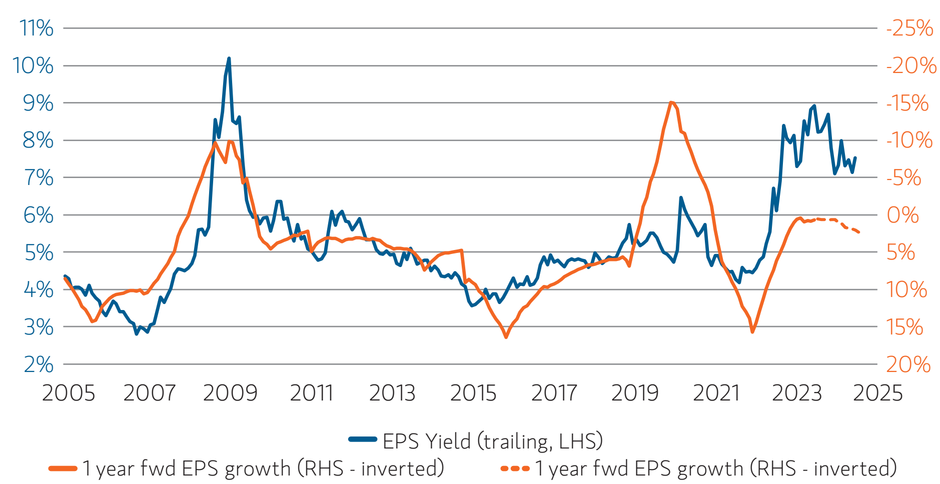


Source: Company data, Morgan Stanley. Forecasts/estimates/projections are based on current market conditions, subject to change, and may not necessarily come to pass. The series shown are compiled from company reported data published by the largest listed real estate stocks in the sector (by market capitalization) rather than an exhaustive list of index constituents, with the split based on country of listing. Continental Europe is defined as companies listed in Europe excluding UK and Ireland. Pan Europe includes the UK and Ireland. NAV valuations are weighted by net asset value in Euro terms.

DISPLAY 6

Earnings Yields Still Look Attractive in Historical Context

Pan-Europe EPS trailing yield (left axis) vs. 1-year forward EPS growth (right axis)



Source: Company data, Morgan Stanley. Forecasts/estimates/projections are based on current market conditions, subject to change, and may not necessarily come to pass.

Risk Considerations

The value of investments may increase or decrease in response to economic and financial events (whether real, expected or perceived) in the Europe and global markets. The value of equity securities is sensitive to stock market volatility. **Real Estate Risk**: The risks associated with ownership of real estate and the real estate industry in general include fluctuations in the value of underlying property, defaults by borrowers or tenants, market saturation, decreases in market rents, interest rates, property taxes, increases in operating expenses and political or regulatory occurrences adversely affecting real estate. **Real estate investment trusts (REITs)** are subject to risks similar to those associated with the direct ownership of real estate, and they are sensitive to such factors as management skills and changes in tax laws. **Concentration Risk**: Concentration in a single region may make the portfolio more volatile than one that invests globally.

INDEX DEFINITIONS

The **FTSE EPRA Nareit Developed Europe Index** is an equally-weighted index designed to reflect the stock performance of companies engaged in European real estate markets. The performance of the Index is listed in U.S. dollars and assumes reinvestment of dividends.

The **ICE BofA Europe Real Estate Index** is designed to reflect the performance of European listed real estate. The performance of the Index is listed in U.S. dollars.

The **ICE BofA Sterling Real Estate Index** is designed to reflect the performance of listed real estate in Great Britain. The performance of the Index is listed in U.S. dollars.

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