FINDING THE VALUE HOTSPOTS IN EUROPE

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With the strong economic recovery in continental Europe, investor interest has followed suit and demand has been strong for core assets in well-connected locations. Value has therefore, on the whole, become harder to find in Europe. However, there are still opportunities to find long-term value in select markets, especially in CBD and edge of CBD office markets where rental growth is strengthening, based on current pricing, says ***David Jackson, Fund Manager, at M&G Real Estate****.*

Investor confidence in continental European real estate makes perfect sense when taking into account the strong macro backdrop, with attractive GDP growth and falling unemployment. Throughout 2017, economic growth in the Eurozone consistently beat expectations. Following growth of 0.7% in Q3 and 0.6% in Q4, Eurozone GDP reached 2.5% in 2017 overall, well above the ECB's forecast of 1.7% at the start of the year. This marks the fastest pace of growth since 2007. The European Commission's sentiment indicator also reached 116 in 2017, the strongest result since 2000 when the Euro was first introduced.

Monetary policy in Europe is set to remain accommodative to growth, as weak inflationary pressures continue to hold back the ECB's decision to lift rates. Core inflation still lags in Europe, having fallen back from 2% in February to 1.4% in December 2017. The ECB's hope is that strong economic growth and a rise in job creation will ultimately stimulate inflation and more sustainable wage growth. Eurozone unemployment fell to 8.7% in November 2017, a nine-year low. Whilst still above the previous cycle's low of 7.2%, this marks a 1.1% y-o-y decline. Southern European markets have shown significant improvement, with Portugal's unemployment rate now at 8.2% (down from 17.5% in 2013). As a sign of how far the Eurozone has come since the 2011 debt crisis, it was also announced that Greece could exit its bailout programme by the end of 2018.

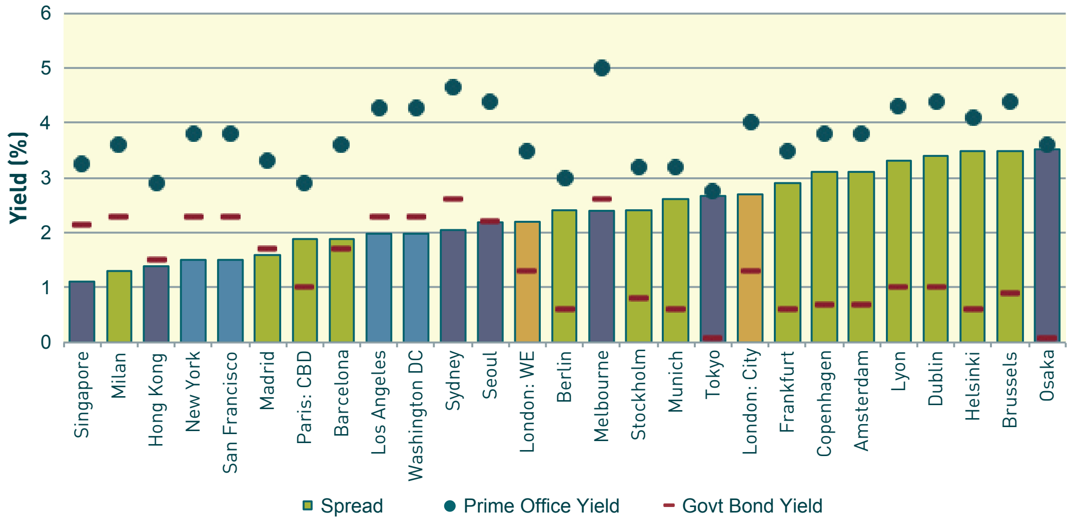
Nevertheless, where the Eurozone has come from is not to be forgotten and ECB rhetoric has been focused on "patience" to wait for price growth to return to avoid any potential disruption of the region's accelerating economic recovery. The economic upturn is broadening across Europe and thus, as a whole, the region is likely to cope with a gradual removal of policy support.

Positive sentiment has filtered through into the investment markets with buyers keen to access diversification benefits by adding European real estate to their portfolios. On an annual basis, European investment volumes reached a record high in 2017 (€213bn), up 8% on 2016. Investor interest in Europe remains strong, with INREV's Investment Intentions Survey suggesting 41% of global capital will be deployed there in 2018. However, demand at the prime end of the market has restricted the availability of core real estate. Lower levels of global capital raising and additional restrictions on capital outflows from China could see volumes start to taper off from their highs.

Strong investment volumes have continued to add pressure to prime yields over 2017, with many markets now at or below 3.5%, including Paris, Stockholm and the majority of German markets. The logistics sector saw the greatest yield compression in 2017, tightening by 47 bps on average, with investors attracted by comparatively higher yields and the ongoing structural shift towards e-commerce. Retail shops' yield compressed on average by 36 bps and retail warehouses by 33 bps. The largest market-sector yield movement q-o-q came from French and German industrials where yields compressed by 25bps to 4.75% and 20bps to 4.5% respectively (as at Q4 2017). Further yield compression is expected over 2018, albeit at a slower pace, with consensus pencilling in -20bps on average for the majority of markets.

For investors wishing to tap into the economic

SPREADS ABOVE BOND YIELDS IN EUROPE ATTRACTIVE RELATIVE TO OTHER GLOBAL MARKETS
Spread of Prime Office yields above government bond yields



Source: PMA Autumn 2017

BRINGING ESG TO THE FOREFRONT OF INVESTING

Nina Reid
Director, Responsible Property Investment

We believe that sound investment decisions do not solely focus on financial factors. By integrating environmental, social and governance factors into our investment thinking we are able to better future-proof our portfolios. In addition, our fiduciary responsibilities give us an important and influential role to play. We can use our resources to enrich the lives of people and communities by creating and managing world-class places to live, work and play. This brings positive value to our investors, to society and to the environment.

In 2017, we undertook an extensive review of our RPI strategy, and engaged with our investors, occupiers and employees to understand what should be our priorities. As a result, we launched a revamped strategy focusing on four key impact areas, described as Socio-economic Benefit, Environmental Excellence, Health, Wellbeing and Occupier experience and Smart, Secure and Connected. We have set a series of 2025 objectives to drive progress against our strategy. For example, in relation to Environmental excellence by 2025 we are seeking to:

- Achieve a 25% reduction in energy and GHG emissions intensity (compared to 2012/13)
- Achieve a 50% green building certification (by value)

Integrating environmental features into the asset build can reduce occupier costs and better future proof the investment, which ultimately translates into better returns over the long term. To help minimise the environmental impact of our portfolios and to increase energy efficiency, we now purchase or generate enough renewable energy globally to power the equivalent of 6,000 homes for a year. Also at our shopping centre LuisenForum in Wiesbaden, Germany we completed our first contract for clean energy outside the UK in 2017.

At No 2 Forbury Place, a 17,750 sqm office development in Reading, UK, we achieved a BREEAM 'Excellent' rating and an 'A' Energy Performance Certificate rating. The development features energy efficient design, photovoltaic panels, a green roof and rainwater harvesting to achieve these high environmental performance standards. The health and wellbeing of our occupiers has also been an integral part of the powerhouses of Europe, such as Germany and France, where there is less scope for property market yield compression going forward, the search for value has been pushed to wider afield. One approach is to focus on the rental growth potential, as a key driver of total returns. In the office sector, only five out of the 21 markets, as classified by Property Market Analysis, are forecast to have net additions of stock over 2018 to 2022 above their historical averages. Limited stock and low yields in CBDs are likely to persuade investors to search wider to find value. Edge of CBD submarkets, for example, continue to offer more attractive pricing, and also benefit from low supply and strong prospects for rental growth.

With transport links improving across European cities, as governments invest more into both physical and digital infrastructure, submarkets deemed to be non-core are increasingly becoming core. Given the discounts on offer, edge of CBD submarkets with strong occupier fundamentals and greater urban connectivity can provide opportunities to secure higher returns.

This rationale is evidenced in M&G Real Estate's latest research into the Paris office market. Yields in the Paris CBD stand at a record low of 3% and more attractive value can be found in alternative submarkets, particularly those benefitting from infrastructure development driven by the Grand Paris Project, which will add a further 200km to the capital's transport network. Within the next five years, Saint Denis and Saint Ouen could offer the highest return prospects for the least risk, according to the research.

Given the expected moderate yield compression going forward, an increasing part of overall returns in Europe will come from rental growth. This has already come through in high street shops on supply-constrained prime pitches particularly in major European cities benefitting from strong tourist spend, such as Copenhagen, Milan and Madrid. Retail was the first sector to recover post Global Financial Crisis. As labour markets have improved, rental growth has spread to offices and now industrials. The office sector saw rental growth of 4% on average across 23 cities in 2017. Whilst logistics rents have lagged the other sectors, a significant pick-up is expected, driven by rising online sales, stronger consumer and manufacturing confidence and digital and physical infrastructure improvements on a pan-European level.

Artist's impression of the forward-funded office development in Düsseldorf

Driving returns through development

One way to capitalise on supply-constrained markets is to forward fund development to maximise capital growth and total returns. Earlier this year, M&G Real Estate completed on a deal to forward fund a prime office development located on the edge of the Düsseldorf CBD for a purchase price in excess of €100m. It will be built to high specification and will provide over 15,000 sq m of office space with completion expected for mid-2019. It is 33% pre-let on a 15-year lease to Design Offices, which offer innovative office, co-working, conference and event space, with a rental guarantee of 3.3 years on the remaining space post-completion. The growth of co-working is accelerating the demand for quality office buildings across Europe. In addition, we are targeting a green building rating of LEED Gold, as the highest environmental excellence standard.

Düsseldorf is the capital of North Rhine Westphalia, the largest German federal state by inhabitants and economic power, and has high transport connectivity. It has the third busiest airport in Germany by passenger numbers. Looking at office market fundamentals, healthy demand has pushed take-up in 2017 to well above the 5-year average. Limited completions going forward will continue to weigh down on vacancy rates in the medium term. The City Sud submarket, where the asset is located, has strong market fundamentals and a current vacancy rate of 4%, all of which point to robust rental growth prospects over the next five years.

We anticipate All Property prime rental growth to be 3.3% across Europe in 2018. This creates the opportunity for investors to tap into a strong income stream over the coming years. Over the next three years, we forecast that Europe ex-UK All Property total return will average 6.8% per annum. Coupled with strong occupational fundamentals, we believe that healthy rental growth will be the primary driver of returns. With our growing European real estate team, we have the opportunity to use our local market knowledge to uncover the value in key locations and drive rental growth through active asset management initiatives to ultimately deliver stronger returns for our clients.

development's design. No 2 Forbury Place has a series of garden spaces at ground level, facilitating social interaction and relaxation, and supportive of the well-being of visitors and employees. The basement features a range of facilities, including 225 secure cycle spaces, lockers for folding bikes, a cycle maintenance area, showers, changing rooms and lockers.

Alongside contributing positive value to the environment, the built form can also have a huge impact on factors such as economic success, social cohesion and quality of life. As a real estate investor, we can create positive socio-economic outcomes by creating high quality places where people want to be, by driving economic growth and by being an active participant in communities. Contributing to local communities through activity at our assets can have a positive impact for asset returns alongside a social impact.

Over 2017, we held over 300 community events globally. For example, Market Central Da Vinci, Milan, Italy, hosted its fourth annual "Notte Bianca" pop concert to bring members of the community together. The event attracted the highest number of visitors (32% higher than last year) and occupiers saw a 9.5% increase in turnover compared to the previous event. Our ambition is to build on these activities and create a more structured programme of community engagement activities. We also want to increase our engagement initiatives at large offices and retail parks, and will share that best practice globally across our portfolios.

To find out more about our refreshed RPI strategy and how we plan to meet our 2025 objectives, the M&G Real Estate RPI report can be downloaded from

www.mandgrealestate.com

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