For Investment Professionals only

Finding the opportunities in European real estate

The value of investments will fluctuate, which will cause fund prices to fall as well as rise and you may not get back the original amount you invested.

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What opportunities does Europe offer real estate investors?

As the recovery in Europe has gathered pace, growth is now much more widely spread across the Continent, with supportive macro tailwinds on the horizon. The US and European Union have both agreed to work towards a new economic relationship, with zero tariffs implemented across a number of sectors. We expect interest rates won't be raised until the latter part of this year.

Against a supportive macro backdrop, our expectation is for all-property rental growth to see 2.2% p.a. over the next three years[1], which should boost property values in the medium term. Demand for the highest quality assets has been strong, supporting capital values and rental growth. Our expectation is that income, rather than capital growth from further yield compression, is likely to be a key driver of future European returns.

This places the onus upon asset managers to maximise a property's income profile and highlights the attraction of strategies that place income at the forefront of the strategy. For European long lease real estate, 70% of the value of a typical asset comprises the present value of the contracted income.

Where do you see value in the major real estate sectors?

In Europe's logistics sector, we see opportunities arising from the growing adoption of e-commerce, which is further behind in its cycle compared to the US and UK, while Northern Europe is ahead of Southern Europe. Given growing demand for logistics space and a shortage of good quality properties, supportive supply and demand fundamentals are expected to continue to exert upwards pressure to headline rents. As Europe catches up with its developed peers, opportunities can be found to take advantage of this ongoing structural shift.

In the retail sector, our core direct real estate strategy is focused on dominant, affluent locations with strong tourist spend and the potential for rental growth, including Milan in Italy and Madrid in Spain. This focus is complemented by supermarket food stores, which typically have long leases and are often higher yielding in comparison to smaller food outlets.

In the European offices sector, we employ a similar strategy of targeting areas with expected sustainable rental growth potential. We are focusing on Central Business District (CBD) or highly connected edge of CBD locations, moving away from out-of-town business parks.

Alternative sectors, including hotels and leisure, banks and private healthcare, continue to benefit from such trends as a growing urban population and increased tourism in certain cities. Two-thirds of assets in our European long lease strategy fall into these categories, which continue to prove popular with investors due to their diversification potential.

What should investors in Europe note at this point in the real estate cycle?

European countries are at various points of the recovery cycle, which influences our investment decisions. For the equity strategy, further acquisitions in the Benelux and Nordics over the next two to three years could take advantage of their later recovery cycle.

We invest with a strong focus on value, which is particularly important given the strength in capital values. Entry price and long-term asset potential are key factors for our long lease strategy, which invests across multiple sectors and jurisdictions. The strategy is underpinned by 15 to 20-year inflation-linked leases, providing consistently growing long-term rental income. This lowers the sensitivity of asset capital values to real estate market cycles.

For the equity strategy, a similar value investing ethos applies, while we seek opportunities to upgrade assets to maximise their return potential. For example, the purchase of an office with refurbishment potential within the CBD in Paris aims to capture the benefits of this market's rising rental cycle, where limited competing supply is likely to lead to good tenant demand. Over time, as the cycle evolves, we expect rental growth in core markets to begin to increase income returns of such "manage-to-core" investments.

Another route to capturing value is to tap into demand for the highest quality property through developing assets in strong locations with low vacancy. In the equity strategy, we are forward funding an office in Düsseldorf to high

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specification, targeting a Gold rating for Leadership in Energy and Environmental Design (LEED) certification. For the long lease strategy, we are forward funding two care homes in Sweden and each asset will be let on a 25-year inflation-linked lease. Such income streams are high quality, paid by municipalities. Demographics underpin attractive demand, with a fifth of inhabitants of retirement age alongside high life expectancy.

How are ESG factors integrated into the investment process?

While developing buildings can enable the creation of properties to the highest environmental standards, we consider the green potential of an existing building as part of our appraisal of all investment opportunities, including local certification such as LEED. M&G Real Estate's certified buildings account for a quarter of its European assets under management, with a global target of 50% by 2025. However, we do not screen-out buildings which are not 'green', as we can improve their ratings as part of an active asset management strategy.

This article presents the author's present opinions reflecting current market conditions. It has been written for informational and educational purposes only and should not be considered as investment advice or as a recommendation of any particular security, strategy or investment product.

Source:
1 Forecast as at Q3 2018.