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NAVIGATING EUROPEAN REAL ESTATE MARKETS

IN THIS Q&A, PAUL STEWART, HEAD OF EUROPEAN REAL ESTATE RESEARCH & STRATEGY, DISCUSSES HOW INVESTORS IN THE ASSET CLASS CAN ALLOCATE CAPITAL IN AN UNCERTAIN INTEREST RATE ENVIRONMENT, WHILE FACING POTENTIAL HEADWINDS SUCH AS BREXIT AND THE THREAT OF TRADE WARS.

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How long can investors rely on low interest rates and inflation when it comes to future-proofing their real estate investments?

Today's financial climate is not necessarily the consequence of extraordinary monetary policy and the associated debt overhang following the financial crisis—the decline in global interest rates is actually a trend that can be traced back to the 1980s. The developed world now has a low dependency ratio (large workforce relative to children and retirees), which generates an excess of demand for savings over the supply of suitable investment assets. Moreover, inflation is being suppressed by a large workforce competing for a finite supply of jobs, bidding down wages. These interest rates mean lower risk-free rates and thus property yields have fallen to record lows.

However, with baby boomers now nearing retirement, concerns are emerging that the above process is about to switch into reverse. While the ageing of the population is inevitable, the precise timing of their retirement (and thus fall in the saving ratio and rise in dependence ratio) may not be. Key to this is technological change, especially in healthcare, which will increase not just overall longevity, but also productive years in later life. Although politically controversial, given the sheer weight of numbers of baby boomers, the fiscal burden on the national healthcare is such that retirement ages are likely to trend upward. Paradoxically, delayed retirement is also proven to be more likely for those at the top end of the income spectrum, those who actually do the bulk of saving.

While interest rates have begun to normalize, the latest European Central Bank (ECB) forward guidance suggests those expecting inflation, interest rates and property yields to suddenly shoot back up to pre-GFC levels in the next three to five years are likely to remain frustrated. Insulation from gently rising interest rates over the next few years can be best achieved by selecting markets where long-term rental growth rates are strongest, backed by structural tailwinds of demographics, technological change and, crucially, development constraints.

What does the end of QE mean for property investors?

This largely depends upon what happens to risk-free rates (long-dated government bond yields), the yard stick by which all investments are gauged against. Back in 2013 when the U.S. Federal Reserve announced the beginning of the end of their asset purchases, global bond investors responded with a 'taper tantrum' and bond yields surged. Five years later, their response to the ECB announcement has, so far, been calm and measured. For example, the 10-year German bund yield is currently around 0.4%. This is probably because bond investors today know that the end of ECB purchases doesn't presage an immediate central bank 'fire sale'.

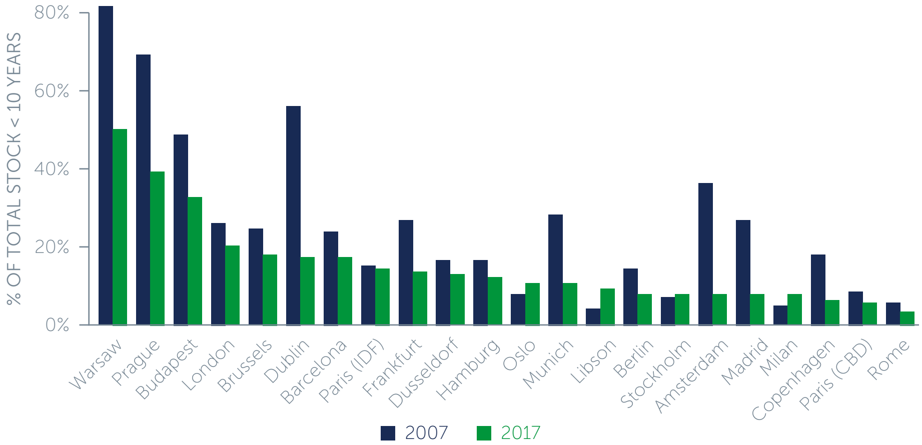
Are the Trump trade wars a serious threat to the European economy and to European real estate?

The imposition of heavy trade tariffs would clearly weigh on the Eurozone economy. A slower rate of economic growth would prompt a deterioration in letting market conditions and reduce rental growth expectations. However, financial markets are now coming to realize that a presidential tweet, may not mean action.

Could the political situation in Turkey or other factors derail the European economy and impact the real estate sector?

Political risks still overhang economic growth across Europe, including U.S. protectionism, Brexit, refugee issues, Italian public debt levels or Catalan tensions. These may have seemingly receded over the summer holiday period, but they have not vanished. The current Turkish lira crisis has worsened the country's trade balance and made it problematic for local businesses that have historically tended to borrow heavily in foreign currencies. Contagion to Europe's economy and thus property markets, will thus tend to be of the indirect kind, via impacts on trade as import spending slows—Turkey's top 3 import sources are China, Germany and Russia. The other contagion channel is via Euro-area banks who, according to The Economist magazine have "lent about US$150 billion to Turkey, amounting to about 10% of their combined equity." Rising defaults could obviously hurt Eurozone banks. Spain, and thankfully not Italy, has the most, but it is believed that this situation is unlikely to threaten Euro bank solvency.

FIGURE 1: THE QUANTITY OF MODERN OFFICE STOCK IS DECREASING



SOURCE: *CUSHMAN & WAKEFIELD. AS OF JUNE 30, 2018.*

How will Brexit affect Germany and the U.K. real estate market?

Germany: Frankfurt, as the home of the ECB, has been held as the primary beneficiary of the U.K. leaving the E.U., if the City of London loses its "passporting" rights. But that assumes that 'equivalence' cannot be achieved in terms of financial market regulation. Taking the optimistic view for London, it is obviously not in anybody's economic interest for Europe's capital markets to suffer some sort of interruption, even if only temporary. However, capacity is a major factor, and only really Paris is a genuine potential rival to London in that respect. The consumer-driven U.K. economy is also a big market for German exports, so it would be naïve to think it's a win-win for Germany.

It's also not a coincidence that core real estate investment deal flow in Germany temporarily overtook the U.K. last year. While Far East Asian capital was still flooding into London at record levels in Q2, other more return-seeking global capital sources have been much more cautious. Capital that would previously have been heavily skewed toward Europe's premier twin gateway London and Paris markets is increasingly now looking at Berlin and Munich. Double-digit rental growth in some German office markets also obviously helps.

U.K.: Economic growth has halved since the referendum, and sterling has slumped against the U.S. dollar. Besides the logistics sector, which is seeing structural transformation due to the growth of e-commerce, rental growth is hard to find in the U.K. market.

Overseas investors have been an increasingly important player in the U.K. property market over the past two decades, typically accounting for up to half of transactions, up from pre-GFC levels of around 20–30%. While the decline in sterling was not associated with a further surge in overseas investment, global capital still accounts for 40–50%[1]. Therefore, arguably currency has somewhat counterbalanced the U.K. property market's reduced rental growth prospects, due to Brexit economic uncertainty.

How are the U.K. and European property markets prepared if interest rates rise?

Both markets should be able to withstand a gradual rise in interest rates. The U.K. property market is largely deleveraged today, certainly compared with previous crises in the early 1990s and during the financial crisis. Therefore, the credit factor that precipitates borrowers' financial stress and normally amplifies real estate market downturns into slumps isn't present in the current U.K. property cycle.

1. Source: PropertyData.com, September 30, 2018.

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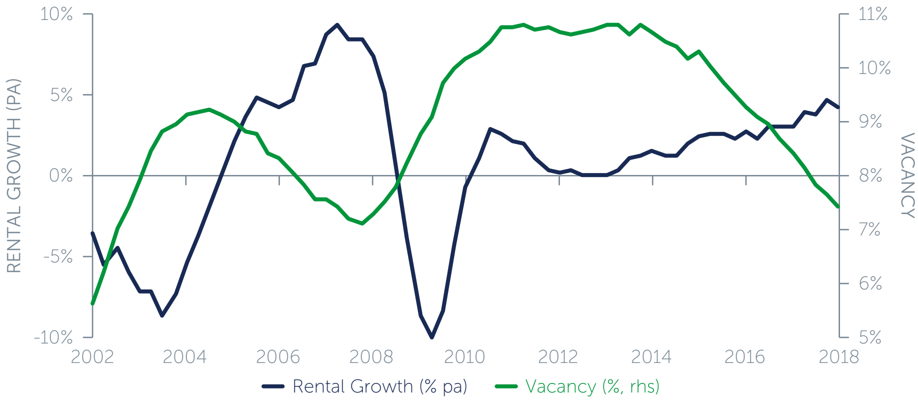
In mainland Europe, the property markets have probably not deleveraged to the same extent as the U.K., but anecdotal evidence suggests that the quality of loan books is significantly improved compared to the GFC era. The quality of the income servicing these property loans is therefore much higher now, so the market should be more resilient than 8–10 years ago. It depends on the how fast and high rates rise, at the moment we anticipate only a modest increase, at a pace that is supportable while the rental cycle remains in its growth phase.

FIGURE 2: FALLING EUROPEAN OFFICE VACANCY RATES ARE LIFTING RENTS



SOURCE: *CBRE, BARINGS. AS OF JULY 31, 2018.*

Are yield and cash flow returns the major attraction of the German and U.K. real estate markets?

Given that U.K. interest rates are higher than in most of mainland Europe, it is rational on a relative basis that U.K. property market yields are higher than their German counterparts. However, that ignores where we are in the economic and rental growth cycle. While the U.K. has had a strong run up in rents over the past five to six years, it now looks very close to the top of the cycle. In contrast, when one assesses the trajectory of rental growth and vacancy rates, German occupier markets look closer to mid-cycle with the potential for further growth for a few more years yet.

Are there any other markets for real estate in Europe that look particularly promising?

Core investors with the longest investment horizons need to be cognizant of a cyclical entry point, but they should focus most on where the long-term structural drivers look likely to be in their favor. Chief among these are demographic trends, such as population, urbanization and ageing. In the broadest terms, that will mean a bias towards Northern European cities, including those in Scandinavia, Netherlands, U.K. and the large German cities. Those with greater appetite for risk, with shorter investment horizons, should focus on the cyclical property market supply and demand fundamentals—take-up, vacancy and development pipelines. But the most agile trading operators obviously need to appreciate exit liquidity—today that means appreciating that their customer base (i.e. core investors) is increasingly hunting for assets in places where they see long-term rental growth potential, so they cannot ignore the structural trends either.

We invest in the retail property sector on a selective basis where the schemes are genuinely dominant in their catchment/trade zone and possess traits indicative of internet resilience like significant leisure offers, and other footfall generators such as food retail. Different parts of Europe are at vastly varying stages of e-commerce adoption, but levels of retail floor space are often a fraction of what they are in the much more heavily consumer-driven Anglo-Saxon economies, most of which are struggling.

There are greater opportunities for investors in both the office and logistics sectors, in our view. Many European cities face a chronic shortage of Grade A office space. Furthermore, office stock that would have been ripe for redevelopment has increasingly been converted to higher value residential use in recent years.

The growth of e-commerce means logistics is obviously of great interest to many investors now. However, we would advocate a preference for assets where we are confident that land prices make up a decent proportion of the capital value. This is because high land prices likely indicate local supply inelasticity, and therefore superior long-term rental growth potential. Further, a higher residual value will also tend to mean reduced asset depreciation rates, eliminating a perennial problem in this sector.

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**As of June 30, 2018*

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