Spring 2018

The case for Europe: UK investors should look to expand their property exposure onto the Continent to increase their diversification

We at DTZ Investors are forecasting total returns from UK real estate to moderate in the near term and such a market outlook is encouraging an increasing number of traditionally domestic-focused property investors to consider opportunities overseas, with a resurgent Europe closest to home. This has become more pertinent when considering the perceived risk to returns when Brexit finally comes to pass. While 2017 showed little Brexit impact in the property markets, the political environment remains fraught and political risk will persist especially when the chance of a "no deal" is still high. Timing might be ripe for some continental diversification.

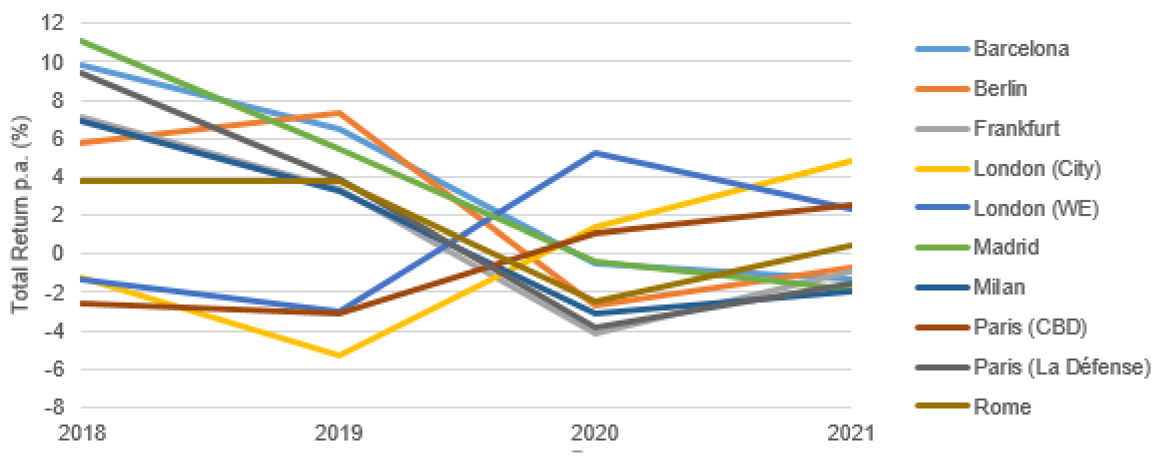
The Pull Factors: A Resurgent Europe with Complementary Sectors

While the full economic implications of Brexit are not yet clear, slower growth is the expected outcome over the medium term. In contrast, much like in the US, Continental European economies have been booming. While latest survey indicators suggest that GDP growth may have peaked, the economic recovery looks set to continue at a healthy pace over the next few years. Against such strong market fundamentals, we expect Europe to maintain its current momentum for rental growth in the real estate markets with the next stage of the cycle to be focused on driving returns through such growth. While yield compression is unlikely to be such a significant driver of returns in the foreseeable future, the yield gap between property and long-term government bonds remains and, overall, the yield differential for European property still looks relatively attractive compared to the historical average.

"Germany remains at the forefront, benefiting from a favourable global economy and improving trade"

Given the slowing UK economy, the outlook for UK office markets in particular in 2018 is understandably challenging. Meanwhile, the Continental European prime office market has seen a positive recovery over the past couple of years and looks set to continue as labour market conditions have gradually strengthened. Germany remains at the forefront, benefiting from a favourable global economy and improving trade. Indeed, while the Frankfurt office market has not been substantially affected by the UK's EU referendum result to date, we understand that Brexit related take-up activity did increase through 2017 as companies continue to make their staffing plans. Paris is similarly well placed to take advantage of this climate of UK economic uncertainty and period of adjustment and improve its own business environment, economic power and European ranking over the coming years. However, as Figure 1 shows, the returns advantage may only be in the near/short term, indeed the Paris CBD office outlook may not be too dissimilar to that of London. The focus should be on complementary investment sectors.

Fig 1. Office Sector Total Returns Forecast 2018 - 2021 (Source: C&W Research)



The Push Factors: Brexit & Political Uncertainty

With many uncertainties remaining around what impact the UK leaving the EU will have on the economic relationship between us, investment markets have barely been influenced by June 2016's vote to date. Likewise, real estate occupiers seemingly moved on with business as usual from the end of 2016 and throughout 2017. Some businesses are preparing to move some staff to elsewhere in the EU but the extent of such moves is probably overstated, with most threatened moves not yet implemented.

"the impact of a change in government on the UK real estate market would surely be more fundamental than the impact of Brexit"

While it remains likely that the UK real estate market will be able to absorb the changing demand that Brexit may bring, extensive media speculation about possible moves will doubtless continue throughout 2018. Similarly, the possibility of a change in government continues to occupy column inches, and the impact this would have on the UK real estate market would surely be more fundamental. It is therefore not surprising that we are helping an increasing number of our UK investors to formulate strategies to extend their investment in real estate beyond the UK. With many clients already holding investments overseas across their other asset classes, making commitments to ex-UK real estate is a logical step.

A Question of Logistics

Retailers, e-tailers and third party logistics providers targeting distribution spaces close to the major cities they are servicing has resulted in strong activity in the European industrial sector, with a surge in demand for logistics and warehousing space. The UK logistics market is distinct from Continental Europe and performed incredibly strongly in 2017, underpinned by very strong demand and extensive supply constraints. The sector saw only a marginal fall in values following 2016's referendum, a loss that was recovered almost immediately. Demand for modern space continues to outstrip supply in many regions, keeping prime headline rents under upward pressure. Nonetheless, at this advanced stage of the cycle, investors are starting to reappraise their assumptions, particularly the risk premium for secondary properties as pricing in the sector approaches somewhere close to boiling point.

Logistics remains an essential component of a well-diversified portfolio and expanding the investment remit outside of the UK offers a way of releasing the pressure valve.

"Conditions in the logistics market have now improved on the continent to a point where future growth should outperform the UK"

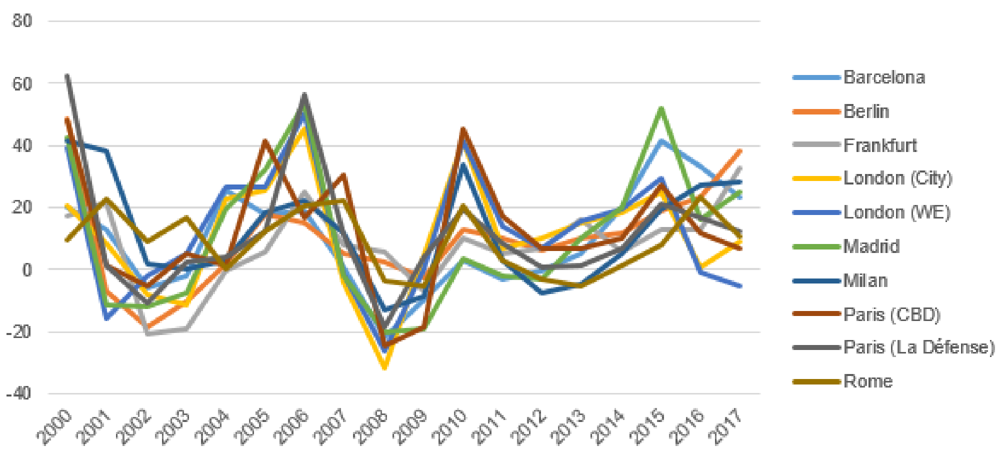
Northern Europe has a high consumer density and well-developed transport networks and Germany is the largest and most important logistics market in Continental Europe. Access to the gateways of global trade, economic networks and workforce availability are the most important location criteria for logistics operators and, alongside Benelux, the logistics corridors and metropolitan areas in Western Germany best exemplify these characteristics. According to Cushman & Wakefield's Q4 2017 Fair Value Index, the Logistics sector offers the best value across Europe. 94% of markets monitored were classified as "fairly priced" or "underpriced" - meaning they are expected to deliver or beat what we would consider to be a fair return given the associated market specific risks.

We believe we are at a point of inflection in the logistics sector. The UK has benefited from years of accelerated growth but conditions have now improved on the continent to a point where future growth should outperform the UK. Replacement costs have risen due to constrained supply in the most desirable locations and average vacancy rates were at a cyclical low in 2017.

A Real (Estate) Diversifier?

Real estate supply and demand is heavily influenced by local regulatory, tax and planning frameworks and regional socio-economic and political environments. Thanks to cultural differences and variations in political beliefs and strategy, international real estate markets are likely to continue to move asymmetrically, just as they have done in the past. Europe should therefore offer greater choice and potential for a better sector diversification in key investment markets. However, investment markets across Europe are relatively well correlated, as demonstrated by the office sector returns profile in Figure 2. While there is scope for this correlation to change as the UK leaves the EU, to achieve a diversified overall portfolio, we advocate targeting markets and strategies that are not readily replicable in the UK.

Fig 2. Office Sector Total Returns 2000 – 2017 (Source: C&W Research)



“What is clear regarding the UK is that its real estate cycle is more mature than other European markets in terms of rental recovery”

Not all markets in Europe have recovered from the GFC to the same extent. Some market rents such as those in Ireland and Spain are still at large discounts to where they were before the crash. Other markets on the other hand have already surpassed their previous rental peaks and in some instances by significant margins. What is clear regarding the UK is that its real estate cycle is more mature than other European markets in terms of rental recovery. This suggests that from this point in the cycle investors could benefit from stronger rental growth outside of the UK real estate market by selecting those economies further behind the UK in terms of economic and real estate recovery.

In addition to the pure diversification benefits, European real estate remains attractive for international investors, due to favourable financing terms, supported by the Eurozone’s low interest rate environment and expectations the first base rate hike will not be until 2020. Different lease structure is another key difference between the UK and Continental Europe. In Continental Europe, most leases are, for example, linked to inflation, rather than following the UK rent review mechanism, providing support to the income return.

Taking the Indirect Route

Depending on the size of allocation available, direct investment in property outside the UK is unlikely to achieve the diversification needed. We have generally found investment in indirect funds to be the most suitable investment category to reflect our clients’ need to achieve a diversified exposure and to avoid overlapping with other investment exposures in their equities and fixed-income mandates. Although indirect investing is very popular, historically it is more so with international investors who have an international investment outlook. One attraction for them over direct investment is the liquidity advantage provided by an ever-growing secondary market for indirect funds. Well established in the UK, secondary trades in European vehicles are on the rise and often in significant volumes. This is particularly beneficial given we would recommend a tactical and changing split of allocation between UK and Europe, given Brexit uncertainties and current market outlooks. Switching focus back to the UK may prove accretive in the medium term.

“Within the UK Government’s LGPS pooling initiative, indirect property investments are expected to be used to invest in overseas real estate”

UK investors can be put off by the loss of management control and ‘fees on fees’ issues that come with such an investment route. Indeed, within the UK Government’s pooling of Local Government Pension Scheme (“LGPS”) assets initiative, most cost savings from the property asset class are expected to come from the removal of fund of fund fees and the migration of indirect to direct real estate investment. However, the initiative continues to see a place for indirect investment in Local Authority real estate allocations. Alongside accessing specialist sectors, indirect investments are expected to be used to invest in overseas real estate. Therefore, the indirect focus for Local Authorities may increasingly shift overseas, with Europe a feasible first post.

DTZ Investors is a specialist European Real Estate Fund Manager, part of the Cushman & Wakefield Group. The business was established in 1968 in the UK and expanded into Continental Europe in 1999. At DTZ Investors, our indirect investment team has a range of complementary skills and a wealth of experience in managing successful indirect investment mandates. Our strategies are supported by our in-house strategy team and Cushman & Wakefield’s global research capability, C&W Research (which covers over 220 international markets). We are a full indirect fund management service which can be tailored to meet client needs. Portfolios are managed separately, not collectively, with each portfolio structured according to clients’ objectives, as these increasingly extend to investment into Continental Europe and beyond.

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