For Investment Professionals only

M&G REAL ESTATE

Investment case

Continental European real estate

January 2020

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is shown, please note that this is not a guide to future performance.

Continental Europe's real estate market offers investors the scope to tap into a wide opportunity set, capitalise on the region's economic recovery and reap the benefits of diversification, while keeping risk down to levels consistent with core, income-driven investments.

The case for investing in continental Europe is backed by:

- **Economic pick up and improving market fundamentals**
- **Attractive relative pricing creating a healthy risk premium over bonds**
- **Some of the highest total return prospects globally**
- **Market liquidity and transparency offering safe haven benefits**
- **Diversification and risk-adjusted performance**

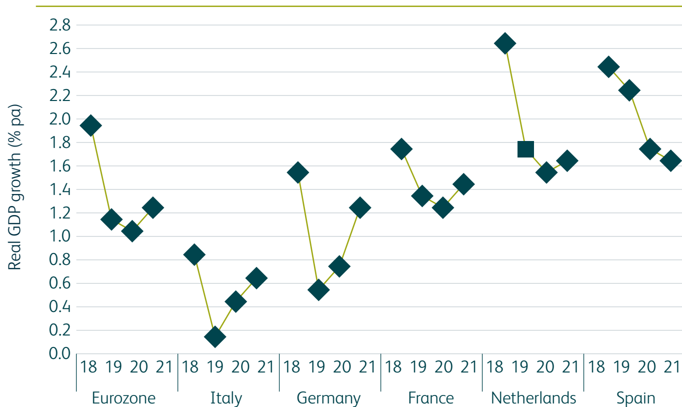
Softer economy shows sign of pick up

The outlook for the Eurozone has softened compared to the last few years but continues to show signs that a pick up is in sight. The European Central Bank has reiterated its accommodative stance, cutting its deposit rate to the lowest level on record (-0.5%) and restarting its quantitative easing programme. The new president, Christine Lagarde, is expected to push for greater fiscal stimulus at a national level, particularly given the improved health of government budgets.

Gross domestic product (GDP) is expected to bottom out in 2020 at around 1% per annum, before rising to 1.3% over 2021. This recovery is likely to be underpinned by a shift towards a more amicable trading relationship between the US and China.

The labour market remains in good health, with unemployment falling to a ten-year low of 7.5%. Wage growth is also trending well above inflation at 2.7%: the fastest in ten years. This should bolster household incomes in the medium term.

Figure 1: Eurozone economic forecasts



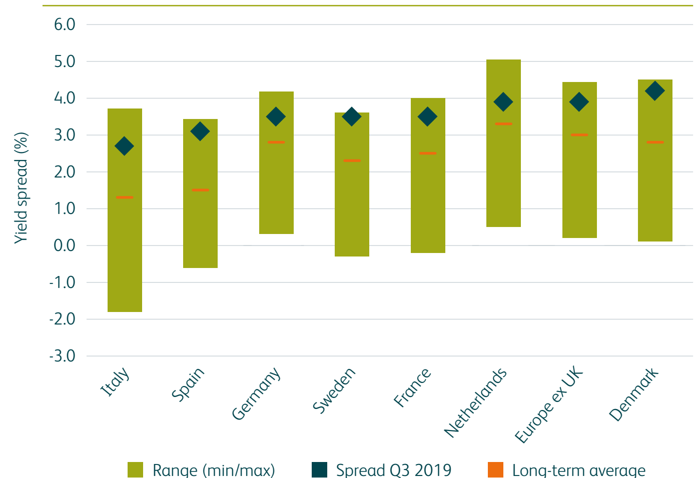
Source: Bloomberg Consensus Forecast, October 2019.

Attractive value in real estate

In a global context, the European real estate cycle remains in growth phase. Having lagged the more rapid recovery of the US and UK markets following the Global Financial Crisis, Europe's wide ranging group of countries now offer a balance between more advanced economies and later-cycle economies. On a pan-European basis, this means the Continent now benefits from a diverse blend of attractive risk-adjusted returns.

European property also offers a healthy value spread over government bonds. This attractive risk premium should support its appeal to income-seeking investors such as pension funds, while offering additional scope for yield compression. These spreads should also protect property from significant upward pressure on yields should interest rates start to rise, though we expect the 'lower for longer' era to continue in the medium term.

Figure 2: Prime office yield spread over 10-year government bonds



Source: PMA; Bloomberg data, October 2019.

Solid return prospects

The current relative value found in Europe is all the more attractive when considering the region's prospects for strong returns, backed by recovering economies and falling unemployment.

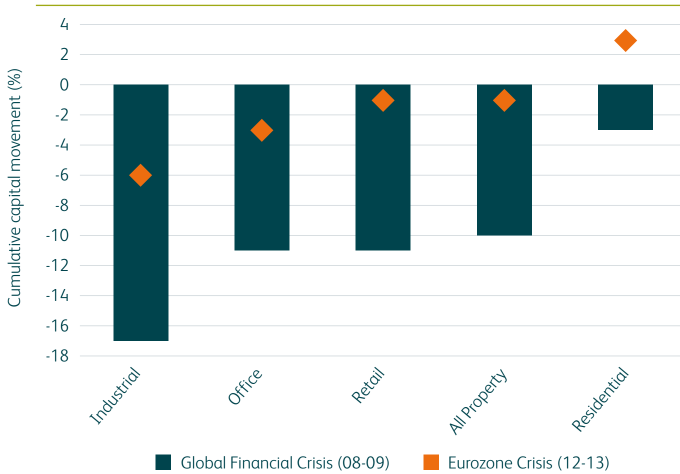
Over the next three years, we forecast that the Europe ex UK All Property total returns will average 5.8% per annum, with the private residential and industrial sectors outperforming. At this stage of the cycle, residential also offers strong diversification benefits to an all commercial property portfolio.

Pressure on yields continues to build as Europe attracts investment from lower risk pension funds and insurance companies looking to reallocate capital from bonds to other income-generating asset classes. As a result, property yields in core markets such as Germany and France now sit at record lows. However, there is scope for further yield compression in some markets, namely the Nordics, Benelux and Southern Europe.

Low yields in Central Business Districts (CBD) are likely to encourage investors to look further afield to find value. Edge-of-CBD submarkets, for example, continue to offer more attractive pricing, while benefiting from limited supply and strong prospects for rental growth. Improving connectivity across European cities through greater infrastructure investment is opening up new submarkets that offer a balance of both yield and growth potential. Combining the two can provide opportunities to secure higher risk-adjusted returns.

The return prospects for the alternative sectors, such as private rented residential, student housing and senior living, also continue to attract new investment. The potential to enhance portfolio returns through their defensive characteristics, while delivering a healthy income return, offers a key benefit to investors.

Figure 3: Cumulative capital movement



Source: M&G Real Estate; MSCI Annual Property Index, 2020 (Europe ex UK).

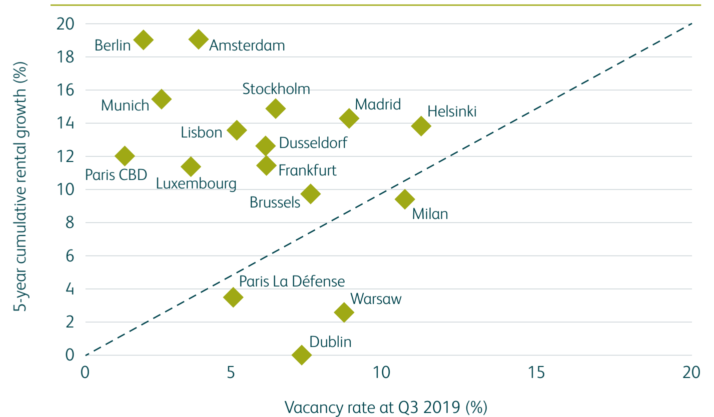
Long-term shift towards income growth

Going forward, an increasing part of overall returns in Europe will come from rental growth. Given the positive dynamics of the office sector, European cities are now some of the best placed globally to maintain and grow rents. Labour markets are improving, while restricted pipelines have pushed vacancy rates to record lows, helping to drive healthy rental uplifts.

In the logistics sector, there is still latent growth potential to come. Rising online sales, physical infrastructure improvements and a lack of modern facilities should support this shift. The retail market is more challenging, with performance polarised between best-in-class defensive retail and the weaker secondary market. We expect quality assets in affluent destinations to prove more stable. Due to the structural undersupply of housing across Europe, and a clear shift towards urbanisation, residential rents in the unregulated private sectors are likely to outperform the commercial sectors.

All Property prime rental growth is expected to rise by 2.2% per annum across Europe over the next three years. This should create opportunities for investors to tap into a strong and growing income stream over the medium term.

Figure 4: Office rental growth and vacancy



Source: M&G Real Estate rental growth forecasts; JLL vacancy data, Q3 2019.

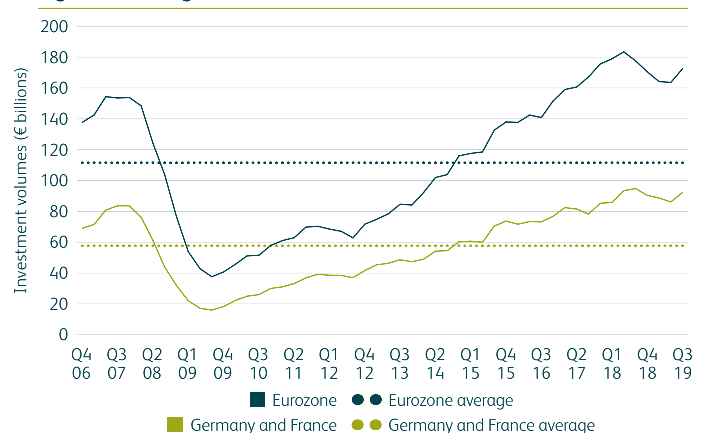
Liquid and transparent markets

Transparency, whether in terms of investment performance, market fundamentals or regulation and process, is a vital measure of investability for investors looking for core returns outside of their domestic market. This is a particularly important consideration for investors that are used to highly transparent domestic markets, such as the UK, US or Australia.

Continental Europe scores strongly in this respect. Six of the ten 'highly transparent' global markets identified in the JLL Global Real Estate Transparency Index are located in this region, with all major European markets ranked as 'transparent' or above.

The European property market is also highly liquid. Transaction volumes reached €172 billion in the four quarters to Q3 2019, according to JLL – 12% higher than the levels seen in 2007. Just over 50% of transactions continue to be recorded in the core markets of Germany and France, but demand for pan-European real estate continues to grow.

Figure 5: Rolling annual investment volumes



Source: JLL data, Q3 2019.

A growing proportion of investment now comes from cross-border activity. Global real estate investors have increasingly turned to European real estate, identifying attractive investment opportunities across a broad range of sectors. According to INREV's survey of investor intentions, Europe remains the top destination for global real estate capital to be invested in the medium term.

More broadly, and regardless of the domicile of the investor, the best risk-adjusted returns can be achieved with a global portfolio diversified across geographies and sectors.

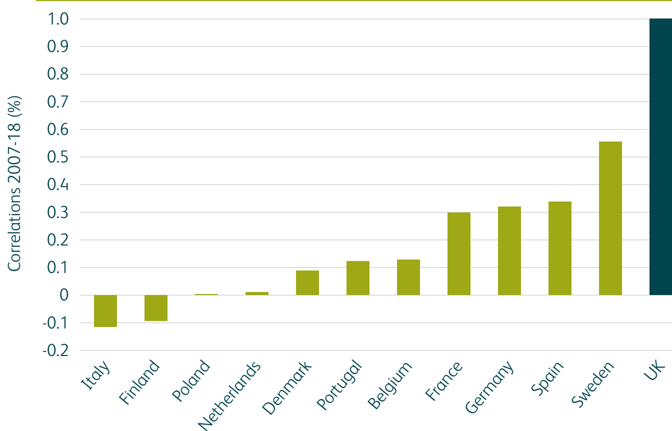
Diversification benefits

For international investors, Europe also offers substantial diversification benefits. According to modern portfolio theory, which forms the backbone of asset allocation across most types of investment, investors can maximise the expected risk-adjusted return by diversifying across a basket of assets.

By allocating capital beyond its domestic borders, an investor can exploit differentials between the economic and market cycles and consequently lower the overall level of risk to which the portfolio is exposed.

Key components of successful diversification include negative or low positive correlations between a potential new investment and the rest of the portfolio, as well as scope for that investment to improve the overall risk-adjusted return. All major European real estate markets have correlations with the UK that are below the 0.7 'strong relationship' level, as defined by widely held consensus.

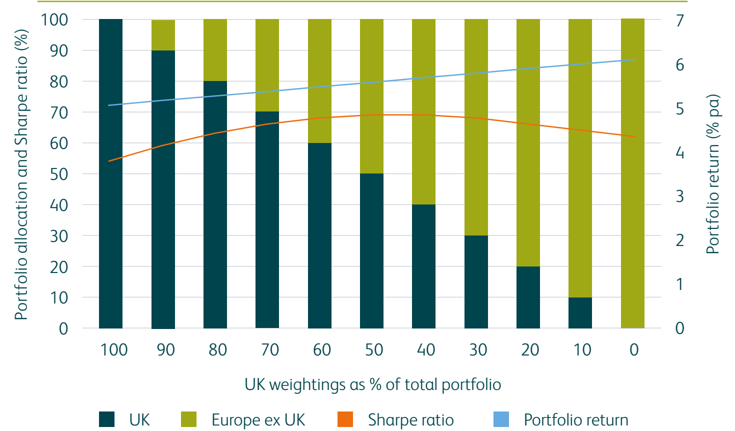
Figure 6: Total return correlations



Source: MSCI Annual Property Index, 2018 (local currency); M&G Real Estate.

Our portfolio optimisation analysis shows that adding Europe to a domestic portfolio leads to higher risk-adjusted returns (measured by the Sharpe ratio, as represented in the chart below). Taking the UK as an example, investors can achieve higher returns – both total and risk-adjusted – by including just 10% of continental Europe in an otherwise domestic portfolio. Risk-adjusted returns increase steadily as the allocation to Europe is increased towards the 50% mark.

Figure 7: Optimal portfolio, maximised Sharpe ratio



Note: The Sharpe ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk. The proxy for the risk-free rate is the average of weighted 10-year Eurozone bond yields over 2007-18.

Source: M&G Real Estate. Analysis is based on IPD All Property total returns 2007-18 in local currency.

Conclusion

Backed by a recovering economy, monetary and fiscal stimulus, continental Europe offers investors strong return prospects in a global real estate context and value can still be uncovered in many parts of the market.

The potential for rental growth across the major sectors should further boost the appeal for income-seeking investors such as pension funds. Europe's transparency and liquidity credentials mean it is well suited to core investors.

For non-domestic investors, Europe's attractions are accentuated by its diversification benefits. By adding continental Europe to a UK or other domestic portfolio, they can expect to enhance risk-adjusted returns.

The historically high transaction volumes are testament to investors' confidence in the region – and to the strength of the opportunity.

Contact

Lucy Williams
Head of Business Development and
Investor Relations, Real Estate
+44 (0) 20 3977 1035
lucy.williams@mandg.com

Alex Lund
Senior Associate
European Property Research
+44 (0) 20 3977 0691
alex.lund@mandg.com

www.mandgrealestate.com

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