For Investment Professionals Only

Investment case:
Continental Europe

The value of an investment and the income from it can fall as well as rise and you may not get back the amount you originally invested.

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:

- **Sound and improving fundamentals –** economic growth expected to reach 1.8% over 2018 in the eurozone, following healthy expansion in the previous two years
- **Attractive pricing –** Europe currently offers some of the best value among the world's developed real estate markets, according to M&G Real Estate's valuation models
- **Strong return prospects –** total returns forecast to average 5.2% per annum over three years
- **High transparency level –** all major European markets are ranked 'highly transparent' or 'transparent'[1]
- **Diversification benefits –** due to low correlations with other regions

Strong economic recovery

The eurozone has experienced a steady economic recovery as political risks have receded. Having suffered greatly as a result of the financial crisis, the region has recovered strongly to see highs in output, demand, employment and inflation, supported by the European Central Bank's €1.1 trillion quantitative easing (QE) stimulus programme.

2018 gross domestic product (GDP) growth is forecast to reach 1.8%, with the solid pace of expansion continuing over the medium term.[2]

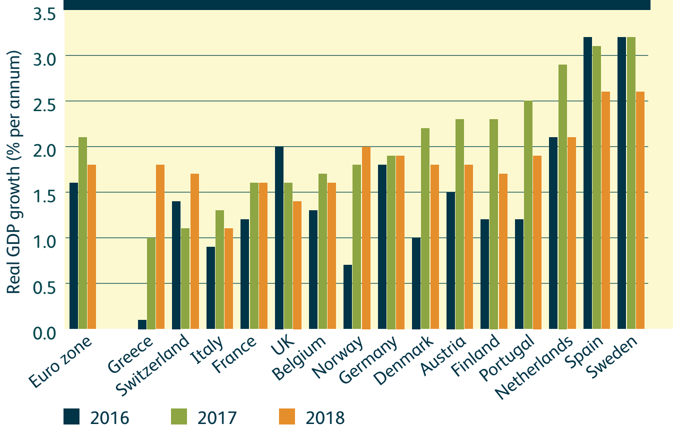
Unemployment rates are falling across the region, including in peripheral countries. Loose monetary policy and low debt costs have seen asset values rise, with investors now taking on some additional but measured risk.

Attractive value in real estate

The economic recovery in continental Europe follows the strength already seen in the UK and the United States. The same holds true for the real estate market, where Europe in a global context is at an earlier stage of the cycle and has been catching up in delivering attractive returns. According to our models, individual markets in Europe still have the best long-term value compared to other developed real estate markets based on current pricing.

European property also looks very attractive compared to bonds, which supports its appeal to income-seeking investors such as pension funds. Indeed, all of the major markets in continental Europe are currently offering attractive yield premiums versus government bonds. A healthy spread protects property from significant upwards pressure on yields.

Fig 1: Strong economic recovery seen across Europe



Source: Consensus Economics, September 2017. Countries sorted by growth projection for 2017.

Fig 2: Yield spread versus bonds: 2007-17

Source: M&G Real Estate, Bloomberg, CBRE Q3 2017.

[1] JLL Global Real Estate Transparency Index 2016.
[2] Consensus Forecasts, September 2017.

Solid return prospects

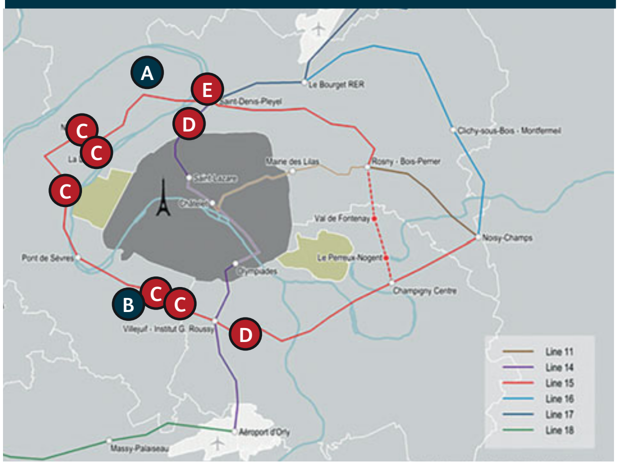
The current value that can be found in Europe is all the more attractive when you consider the region's prospects for strong returns, backed by growing economies and falling unemployment.

Over the next three years, we forecast that Europe ex-UK All Property total return will average 5.2% per annum, with industrials performing the strongest.

In part, this will come through some yield compression, such as in the Nordics, Benelux and Southern Europe, as Europe attracts investment from risk-averse pension funds and insurance companies who are looking to reallocate capital from bonds to other income-generating asset classes. Already a result of this, property yields in core markets such as Germany and France have compressed to new record low levels.

Low yields in CBDs are likely to persuade investors to look further afield to find value. Edge of CBD submarkets, for example, continue to offer more attractive pricing, and also benefit from limited supply and strong prospects for rental growth. With transport links improving across European cities, as governments invest more into both digital and physical infrastructure, submarkets deemed to be core are expanding. Given the discounts on offer, non-CBD submarkets with strong occupier fundamentals and greater urban connectivity can provide opportunities to secure higher returns.

Fig. 3: Paris submarket returns relative to CBD



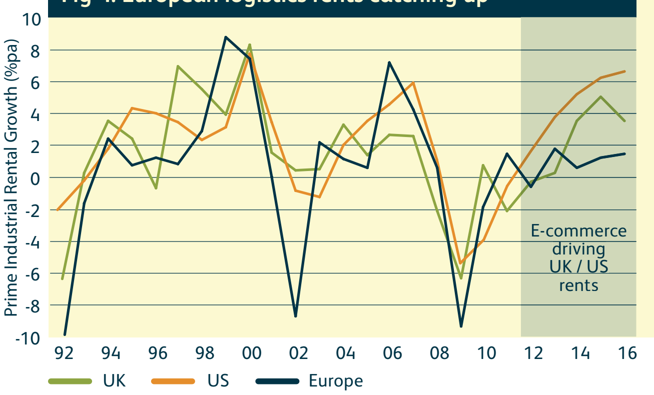
Band	5-year average total return premium relative to CBD (bps)	
A	Gennevilliers	150 to 249
B	Malakoff	250 to 399
C	Nanterre, Montrouge, Suresnes, La Défense Bagneux	400 to 499
D	Saint-Ouen, Villejuif	500 to 599
E	Saint-Denis	600 to 750

Source: JLL, M&G Real Estate, December 2017.

Going forward an increasing part of overall returns in Europe will come from rental growth. This has already come through in high street retail shops on supply-constrained prime pitches particularly in French, German and Benelux markets. As labour markets have improved, rental growth has spread to offices and now industrials. Logistics rents are showing the strongest growth, driven by rising online sales, stronger consumer and manufacturing confidence and digital and physical infrastructure improvements on a pan-European level.

We see All Property prime rental growth rising to 2.5% across Europe in 2018. This creates the opportunity for investors to tap into a strong income stream over the coming years.

Fig 4: European logistics rents catching up



Source: M&G Real Estate, Q3 17, JLL, PPR, Transwestern.

Liquid and transparent market

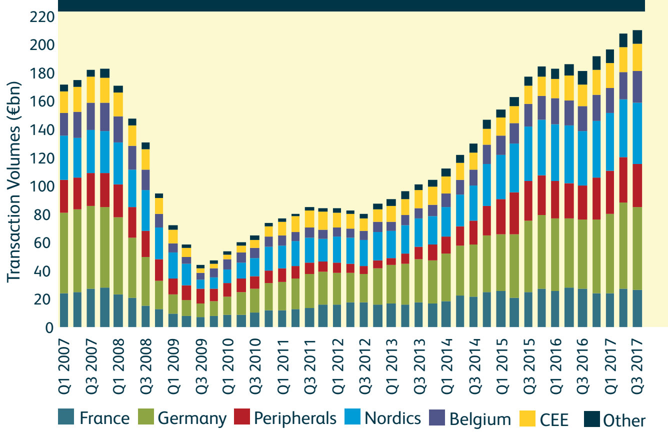
Transparency, whether in terms of investment performance, market fundamentals or regulation and process, is a vital measure of investability for anyone looking for core returns outside of their domestic market. This is likely to be a particularly important consideration for investors who are used to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

Continental Europe scores strongly in this respect, with all of major markets ranked 'highly transparent' or 'transparent' in the JLL Global Real Estate Transparency Index.

The European property market is also highly liquid. Transaction volumes reached €191 billion in 2016 – higher than the levels seen in 2007. With €210 billion transacted in the four quarters to Q3 2017, demand from investors for European real estate is clear.

A growing proportion of investment comes from outside of the region, underscoring that global real estate investors are increasingly identifying the attractions of Europe and are more comfortable about deploying their money there.

Fig 5: €210bn transacted over the four quarters to Q3 2017



Source: Bloomberg, CBRE Q3 2017.

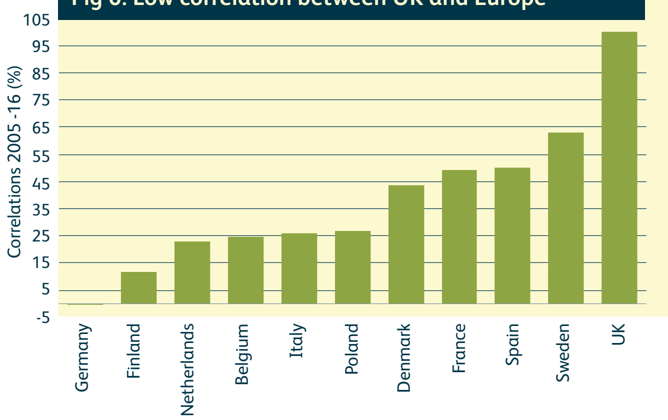
Diversification benefits

For foreign investors, Europe's attractions are boosted by diversification benefits. According to modern portfolio theory (MPT), which forms the backbone to 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 the 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 ingredients for successful diversification are negative or low positive correlations between a potential new investment and the rest of the portfolio, as well as the scope for that investment to improve the overall risk-adjusted return. The majority of European real estate sectors have correlations with the UK market that are below the 70% "strong relationship" level.

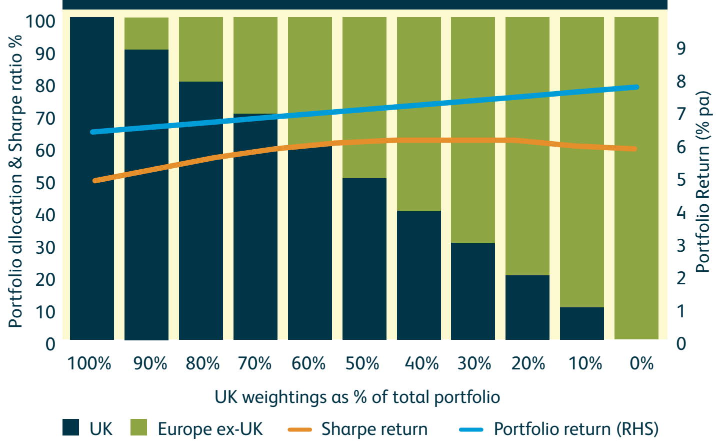
Fig 6: Low correlation between UK and Europe



Source: MSCI Local currency, M&G Real Estate. Market correlations 2005-16.

Our portfolio optimisation analysis shows that adding Europe to a domestic portfolio leads to higher risk-adjusted returns (measured by the Sharpe ratio). 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 60% mark.

Fig 7: Investing in Europe boosts returns vs UK-only portfolio



Note: The **Sharpe ratio** is the average return earned in excess of the risk-free rate per unit of volatility or total risk. Proxy for the **risk-free rate** is averaged over the past 10 years' yield on 10 year UK bond.

Source: M&G Real Estate. Analysis based on IPD All Property total returns 2007-16 in local currency.

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.

Conclusion

Backed by a recovering economy and central bank stimulus, continental Europe today, offers investors strong returns prospects in a global real estate context and value can be uncovered in parts of the market.

As the cycle in Europe catches up with the US and UK, the potential for rental growth across the major sectors further boost the appeal for income-seeking investors such as pension funds. Europe's transparency and liquidity credentials make it well-suited for core investors.

For non-domestic investors, Europe's attractions are accentuated by the diversification benefits. By adding continental Europe to a UK (or US, or Japanese, or any other domestic) portfolio, they can expect to improve risk-adjusted returns.

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

For more information

Vanessa Muscarà
Associate Director- Property Research

+44 (0) 20 7548 6714

vanessa.muscara@mandg.com

Alex Lund
Associate: Property Research

+44 (0) 20 7548 6555

alex.lund@mandg.com

Richard Gwilliam
Head of Property Research

+44 (0) 20 7548 6863

richard.gwilliam@mandg.com

www.mandgrealestate.com

Lucy Williams
Director, Institutional Business UK and Europe, Real Estate

+44 (0) 20 7548 6585

lucy.williams@mandg.com

Christopher Andrews, CFA
Head of Client Relationships and Marketing, Real Estate

+65 6436 5331

chris.j.andrews@mandg.com

Stefan Cornelissen
Director, Institutional Business – Benelux, Nordics and Switzerland

+31 (0) 20 799 7680

stefan.cornelissen@mandg.co.uk

M&G REAL ESTATE