

# Finding RE Growth in Europe

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# Finding Europe's RE GROWTH

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**The path to growth in Europe is looking increasingly uncertain in 2016**, yet for commercial real estate investors, the region has never been more in demand in the wake of the financial crisis.

Despite headline GDP growth at a lackluster 0.4 percent, unemployment north of 10 percent, and the unpredictability of Britain's referendum on European Union membership, LP deal activity in Europe rose dramatically last year.

Indeed, according to data provider RCA, transaction volume among global and continental European investors in 2015 increased 33 and 45 percent, respectively, while Europe is expected to surpass the U.S. as the preferred investment region by institutional investors in 2016, says Preqin.

Europe's headline growth may therefore look sluggish, but for LPs the 28-nation bloc presents some of the most compelling real estate investment opportunities in the world.

That's certainly the view of Raimondo Amabile, head of Europe at PGIM Real Estate (formerly Prudential/Pramerica Real Estate Investors\*) and Doug Crawshaw, head of EMEA real estate manager research at consultant Willis Towers Watson.

While the region-wide figures may look worrying to investors on a macro-level, both men agree that key countries in the European Union have strong property fundamentals in place, with supply still trailing historical and cyclical averages and debt financing, not least for new development, very much constrained.

"Continental Europe will be a low growth environment," says Amabile, "but it's a growing environment and the real leg of its net operating income [NOI] growth comes from the fact that the supply side is missing." Even in London, where oversupply concerns are most prevalent owing to the construction of more than 11M square foot of office space in the second half of 2015, Amabile says there is a "solid growth story."

For Crawshaw, it's about understanding where you are in the cycle. "Property is cyclical," he says. "It always has been and always will be and as soon as one understands where they are in the cycle and works within the context of that cycle then you can, to a certain extent, protect yourself from some of its ravages, especially if you focus on income that is not only defensive but also the most stable element of total returns."

The question, of course, is where in the European Union's 28-nation bloc are the best opportunities?

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London: a solid story even with price rises

## United Kingdom

Many property investors would argue that some of the U.K.'s property markets have already reached, or are nearing, their peak, with 2015 investment volume hitting £65.8B—a 12 percent increase over 2014 levels and 10 percent above the peak of 2007. Indeed, in central London, where four-fifths of investment has been targeted, pricing for office increased 30 percent alone last year.

However, Amabile says there is a growth story to be told in the U.K. It's one, though, that needs careful monitoring.

"It's definitely the most mature market within the E.U. and it really is following what's happening in the U.S. in terms of where pricing, rents and cap rates are going," he says. "But on the other side there is an NOI growth story.

"There is a GDP growth story, which we believe is a solid one and while there will be some ups and downs, the trajectory of growth is there. You just have to monitor supply and debt financing indicators very carefully," says Amabile.

For PGIM Real Estate, which manages more than \$7.5B of assets across Europe, part of that answer is to become much more active in U.K. mezzanine and preferred equity investing in 2016, while taking on some value-add risk in equity deals, including considering new senior housing development opportunities in London and the southeast.

"We like building in some [downside] protection on day one in the capital structure by being on the lending side. And that's pretty much what we're doing with the majority of our U.K. strategy," says Amabile.

Crawshaw echoes that focus on defensive strategies saying that the U.K. property cycle, viewed at a macro level,

is likely in the "fourth quarter of a four-quarter cycle," predicting around one year to 18 months before the market may peak.

Yet the advanced state of the U.K. cycle isn't all bad news, says Crawshaw. Supply, not least of office construction in London, is currently being absorbed by demand and the lack of historic development in other sectors and in the regions is helping to support rental growth.

"There's pent-up demand, which is also generating rental growth, so that's fine at the moment. It's what happens next is the question," he says.

## Continental Europe

When it comes to targeting continental Europe, investors are typically focusing on Germany and France, the EU's second- and third-largest property markets, respectively, and the number one and number two preferred locations for investment in 2016, according to the European real estate association, INREV.

For Amabile, the focus on these two markets is "simple." The introduction of quantitative easing by the European Central Bank in March 2015 to help stimulate economic growth, coupled with a lack of new inventory and rising demand from tenants for new locations and properties, including to better recruit and retain talent, means there are value-add opportunities for LPs and GPs.

"There is potential for cap-rate compression in Continental Europe," Amabile says, explaining that it's driven, in part, by economic growth, but predominantly by the lack of supply. "If you track how much cap ex has been invested in the existing stock of buildings across Continental Europe it's very limited.

"If you can get your hands on a building that has the ability to become core, you can transition it to something that is going to look very different after a refurbishment and that becomes a strong NOI growth story."

Competition for deals is rising, though, making it increasingly hard to concentrate on the key markets of Berlin, Frankfurt, Munich, Hamburg, and Dusseldorf in Germany, and Paris in France.

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“What a good investor needs to do is to invest in a good building, in a good location where there will always be good demand prospects irrespective of what happens in the wider economy,” says Crawshaw. “What one has to be careful of is chasing yield and compromising on location and going too far down the road of extending investment criteria to include the next tier of locations or poorer quality of buildings, unless you’re in it for the very long term or have a clear rationale.”

That is starting to happen in Germany and France, adds Crawshaw. “It’s nothing to be too concerned about at this moment in time because it’s been very hard to get debt.

“But as people are able to apply higher loan-to-value financing, as you become a little bit more relaxed in your deal criteria, that’s when it starts to get more dangerous for the rest of the industry,” he says. “Good investors are only using leverage on income-producing assets—and at modest loan to value levels.”

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## Spain and Italy

Considered Europe’s peripheral markets, Spain and Italy are emerging on the radar of many global investors and managers as the country’s economies begin the road to recovery.

Indeed, over the past three years more than \$32B of cross-border capital has flowed into the two markets, the majority from U.S. private equity real estate funds including Blackstone, Cerberus, Colony Capital, and Goldman Sachs.

For Crawshaw such capital inflows have pushed pricing towards post-crisis highs. “There has been a lot of activity in Spain and things are starting to happen in Italy as well. And I have to question whether the fundamentals and the strength of the economies are there to support the rationale [of such investments] in general terms,” he says.

Amabile argues that much of the activity in Spain and Italy has been fueled by opportunistic funds taking “macro bets” on the countries, and while PGIM Real Estate sees some value-add opportunity in each market “they are still not liquid enough.

**“It’s a cliché, but in real estate it is about location, location, location—always has been and always will be.”**

Doug Crawshaw, Willis Towers Watson

“They continue to lack domestic capital on both the equity and debt sides—Italy more so than Spain—which means they are still not functioning the way they had in the past and so we need to be very, very selective,” Amabile says. “We are currently underwriting deals, but we’re not in a rush to buy in either country.”

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## Deal Discipline

Ultimately the skill—and challenge—of investing in Europe today is to be disciplined about where you invest, says Crawshaw.

“The real key is to be disciplined and to accept we are in a different world [of slower growth] and not to chase yield. It’s a cliché, but in real estate it is about location, location, location—always has been and always will be.”

Amabile emphasizes that need for discipline, saying there are two trends investors always have to monitor in any real estate market: oversupply and excess capital.

While most European markets were in check in relation to supply and a lack of debt financing was preventing excess leverage being applied to deals, Amabile says investors should be mindful of new capital sources entering the market.

“It can surprise you the way some new investors are pricing assets because they’re coming from a different experience, a different mindset,” he says, highlighting the growing number of fixed-income players looking to Europe’s real estate markets.

“When you start to feel a market is unbalanced in terms of being oversupplied, that’s the time to get out. If the market is inflated by excess capital chasing deals, then you end up in a market which becomes too expensive,” Amabile says. “When you see these two things out of balance, that’s the time to get out.” ■

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\* PGIM Real Estate changed its name in May 2016 to support its global diversified investment platform and client base. It previously operated globally under two names for more than a decade—Prudential Real Estate Investors in the Americas, Japan and Korea, and Pramerica Real Estate Investors in all other markets.

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