Paradigm shifts in Europe

Why now is the right time to invest

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KEY TAKEAWAYS

- Portfolio allocations to European real estate driven by global relative value
- Growing institutionalization of European ODCE funds offer governance, liquidity & diversification benefits[1]
- Post-pandemic shifts across real estate sectors to offer opportunities to create value through repurposing
- NZC goals: Core & Value-add opportunities to reduce operational and embodied carbon respectively[2]

ECONOMIC BACKDROP

Following the systemic shock of 2020, global economies are reopening doors to schools, workplaces, and easing travel bans. Among G7 countries, Europe is easing restrictions faster according to the Covid-19 Stringency Index[3]. Coupled with a consumer-led recovery, economists now expect economic activity, both in the UK and Eurozone, to return to pre-pandemic levels by no later than Q1 2022[4]. Sentiment has eased from record levels reached this summer however, partly reflecting uncertainties around the Delta variant, inflation, and global supply chain disruptions[5].

Implications for real estate investors

For real estate investors, acceptance of continued uncertainty is necessary to move forward, warranting a diligent approach for low-risk investors. For investors with a higher risk appetite, meeting double-digit return targets requires questioning the role that real estate plays for its 'customers' in response to accelerated structural trends reshaping urban locations. Within this changing landscape, this paper highlights how, in addition to offering global relative value, European real estate markets, offer both risk-off and value creation investment opportunities which have a positive long-term impact on both wellbeing and the environment.

WHAT IS DRIVING REAL ESTATE PORTFOLIO ALLOCATIONS TO EUROPE?

Global relative value

Taking prime office yields as a proxy for All-Property, European markets currently offer a spread of c.350bps above fixed income assets (see figure 1), which compares favorably to the spread offered by North American (up to 260bps) and Asian markets (up to 240bps). The risk of the European spread eroding lies on the upside however, with recent surges in core inflation (up to 1.9% in the Eurozone and 3.2% in the UK), prompting the Bank of England to consider interest rate hikes.

For now, however, we believe inflation at the levels reminiscent of the 1970s seems unlikely. Energy prices should ease after the winter and as economies re-open, consumers are likely to shift expenditure patterns from goods to services, thereby easing global supply chain disruptions. What's more, fiscal stimulus will wind down and the bigger picture is that rates will rise slowly and remain historically low in both real and nominal terms. Finally, since core inflation in the US is far higher, at 4%, European real estate markets are likely to retain their top relative value ranking for the foreseeable future.

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[1] ODCE = European Open-Ended Diversified Core Equity index

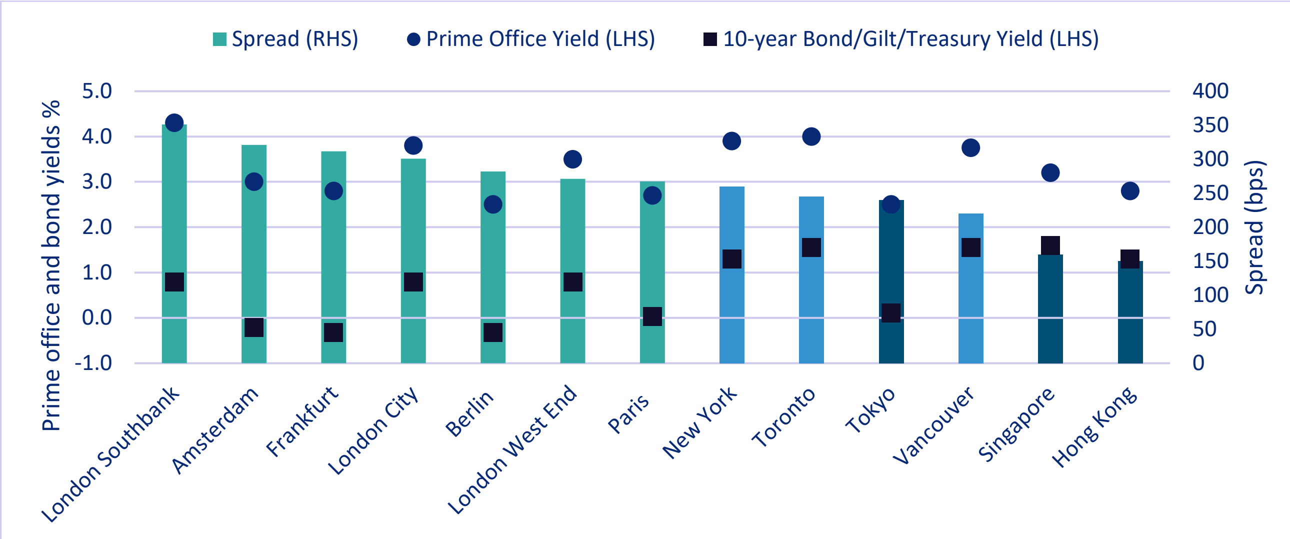
[2] NZC = Net Zero Carbon

[3] A composite measure based on 9 response indicators including school closures, workplace closures, and travel bans (100 = strictest). At 40, Europe compares favorably versus Canada (68) the US (62) and Japan (47). Source: Our World in Data, October 2021

[4] Source: Capital Economics, October 2021

[5] The Composite PMI reached a record 59.2 in the UK and 60.2 in the Eurozone in July 2021. Source: Capital Economics

Figure 1: Prime office yield spread vs 10-year government bonds (bps)



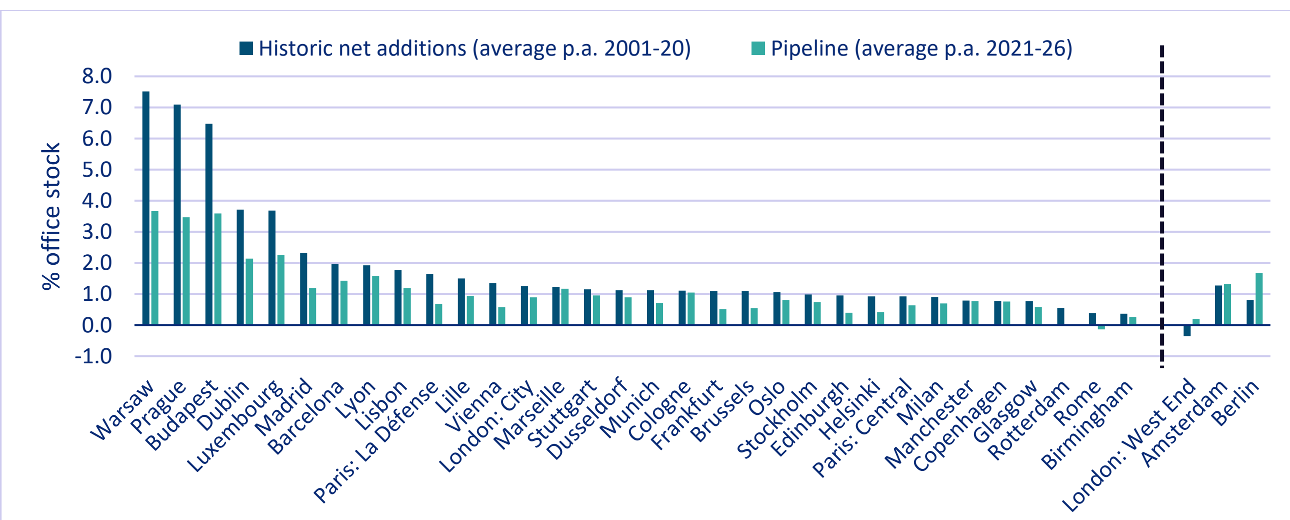
Source : NCREIF Q2 2021, CBRE Erix Q3 2021, JLL Q2 2021, Europa Capital Q2 2021

WHAT IS DRIVING REAL ESTATE PERFORMANCE IN EUROPE?

Offices

The office pipeline across European markets is far lower than historic net additions to stock since 2001, reflecting tight fundamentals (see figure 2). While select markets including Berlin represent an exception to this trend, the capital today boasts among the lowest vacancy rates in Europe at 4.3%, far lower than the European average of 8.1% and the peak seen following the Global Financial Crisis (10.6%). While this is unlikely to prevent short term rental declines, it will at least soften the downside impact.

Figure 2: Office net additions (% stock)



Source : PMA, Autumn2021

Looking ahead, the rebound in employment will support occupier demand, but for the office sector to survive, it will need to adapt to the shift to more remote working as well as changing ‘customer’ workplace expectations, namely improved ventilation, and spaces able to enhance productivity and wellbeing. We identified both Core and Value-add investment opportunities in our recent Reshaping the Workplace study.

Logistics

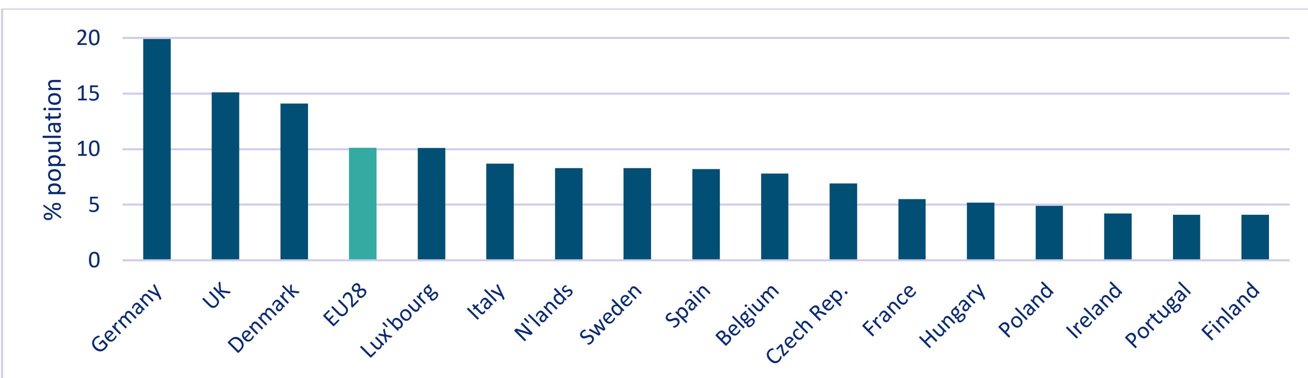
The logistics sector has typically been driven by economic growth albeit in 2020, European take up levels reached record volumes (+11 million sqm), whilst GDP in select economies reached up to double-digit negative figures. Ecommerce occupiers represented 24% of demand, above the 13% ten-year average[6]. And since the shift from in-store to online sales is set to continue we expect structural trends to replace economic drivers.

Moreover, recent headline news regarding goods and labour shortages highlights the importance of supply chain resilience and initiatives to retain talent. In response, market players are already implementing automated warehousing techniques as well as ESG and WELL certifications to improve supply chain resilience, energy efficiencies and the wellbeing of occupiers. We discuss the scope to meet the supply gap of modern logistics stock by investment style (Core and Value-add), in our recent Logistics Leans In study.

Living sectors

The European living sectors are characterized by a combination of rising demand for rental and an undersupply of housing, driving rental prices up. Inevitably, the weight of rental costs has become significant for the average household. In January 2021, the European parliament called for affordable housing to be recognized as a 'fundamental human right' arguing that the 'housing cost overburden' had reached unsustainable levels with Germany, UK, and Denmark topping the ranking (see figure 3).

Figure 3: Housing cost overburden rate, 2020*



* The housing cost overburden is the % of the population living in households that spend +40% of their disposable income on housing

Source : Eurostat 2021

Affordable housing is becoming a priority for investors, partly to meet social impact objectives. Investing in this sector and implementing renewable energy sources, using sustainable construction materials and prioritizing tenant wellness represent select ways to meet these goals. Given the limited supply of income producing assets, a significant share of investments is expected to be in forward funding development projects.

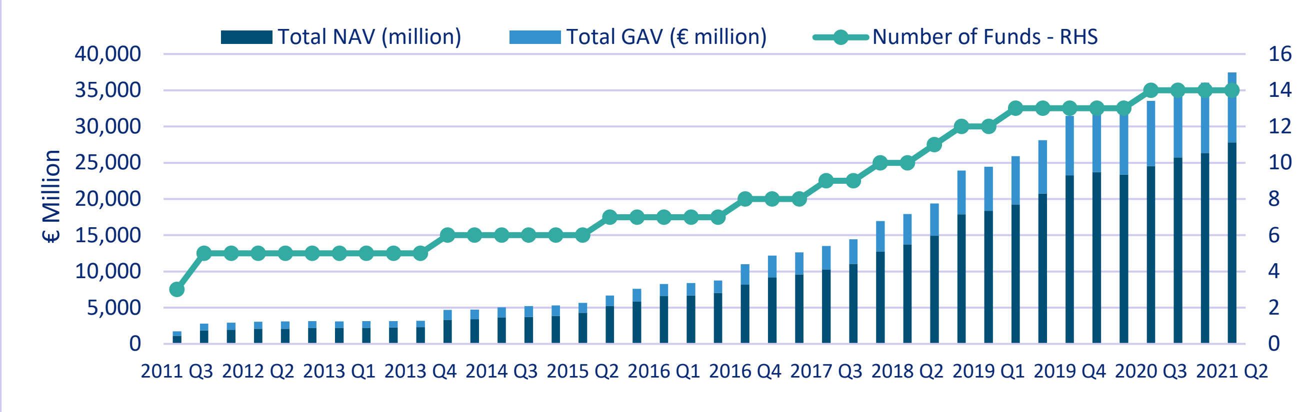
CORE INVESTMENT OPPORTUNITIES

Growing institutionalization of ODCE funds

Pension fund demand for low-risk investments following the GFC fueled the growth of Core strategies with investors now seeking professional, socially conscious, and environmentally competent managers with access to European markets at scale. In response, the INREV ODCE index was launched in 2019 (see figure 4).

[6] Source: PMA Autumn 2021

Figure 4: Evolution of European ODCE funds



Source : INREV Q2 2021

Among its constituent funds, the oldest was first launched exactly 20 years ago. Since then, the average GAV size of an ODCE fund has grown to €2.5 billion which compares favourably to the average size of a non-listed fund in the INREV universe at c. €800 million. This critical mass offers institutions diversification through multi-sector and multi-geography exposures in addition to liquidity benefits. Moreover, institutions can find comfort in the way of the strict criteria that govern ODCE funds in the form of sector/geography exposure limitations as well as limits on debt.

The further institutionalization of the market is likely to create new investment opportunities including meeting the supply gap of logistics and rental accommodation as outlined above. We may also see growing exposures towards 'customer-centric' sectors requiring operational management such as senior living and student housing.

Lastly US ODCE funds were first launched c.40 years ago and while European ODCE funds may not reach GAVs of the order of their US counterparts imminently (average $10.4 billion), the scope of opportunities is such that the direction of travel is decidedly upwards.

VALUE ADD INVESTMENT OPPORTUNITIES

The changing role of real estate

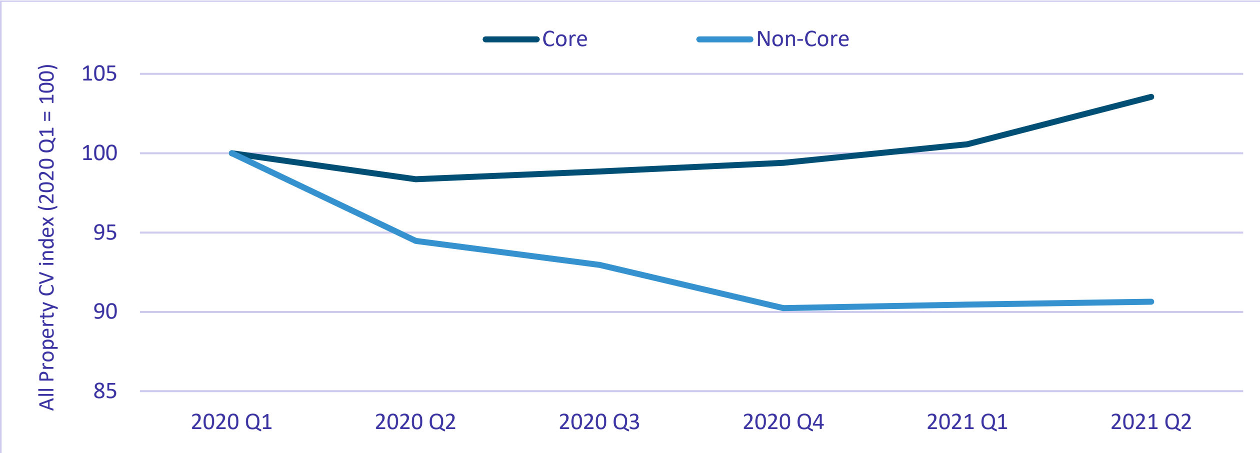
The economic resilience of gateway cities with financial and ICT clusters is likely to endure post pandemic[7]. What will change is the way we use real estate. Underpinned by technology supporting flexible lifestyles, urban landscapes are likely to change significantly over the coming decades.

Among the most important changes will be the shift to more home working with analysts estimating up to a 10% reduction in office demand by 2030 across global markets[8]. There will be some offsets however, as employment recovers and as travel restrictions ease, the exodus of urban residents is likely to slow. Excess retail and office spaces will create opportunities for 'living' uses. This will primarily be apartments but may also involve other types of accommodation such as senior living and student housing. Another urban growth area is likely to be logistics, especially last-mile assets for online delivery to densely packed city populations. Leisure will also play a role in filling the gaps left by exiting retailers on high streets and in shopping centres. In addition, there may also be opportunities for converting excess office space into hotels.

[7] ICT = Information Communication Technology

[8] Source: Capital Economics, Q2 2021

Figure 5: Core vs Non-Core All-Property capital value index (2020 Q1 = 100)



Source : INREV Q2 2021

And with non-core assets falling c.10% since the start of the pandemic, we believe this represents a mis-pricing opportunity to purchase and reposition buildings to accommodate new uses (see figure 5). Undoubtedly individual projects rest heavily on the feasibility (value versus undersupplied uses e.g., residential), political (community opposition), legal (co-tenancy limitations) and physical reconfigurability of existing structures. But evidence of mayors shifting their focus from attracting firms to attracting residents, and thus the property and consumption taxes they bring, by improving quality of life is already evident. For example, the Mayor of Paris' plans to transform the capital into a '15-minute city' free of cars made headlines in 2020[9].

FACTORING IN NET ZERO CARBON GOALS

As the Paris Agreement is being incorporated into national laws across Europe, incentives for property investors to take part in the reduction of carbon emissions are growing. Non-compliance with new regulations represents a risk for investors to see their assets 'stranded' either by law or directly by the market[10].

Tools now exist to help investors anticipate the actions they must implement to comply with regulations and thus limit transition to NZC and reputational risks. The tool developed by the Carbon Risk Real Estate Monitor (CRREM) for example, offers the possibility to calculate for every country-sector combination, the (i) GHG intensity and (ii) energy reduction pathways to given milestones e.g. 2030, 2040, 2050. For example, in figure 6, we highlight the pathways aligned to limiting global warming by 2˚C by 2050 among the top 10 most liquid European office markets by investment style, Core and Value-add.

The pathways to reduce the energy intensity of the office stock are highest in the Netherlands (-76%), Germany (-72%) and Belgium (-70%). The opportunity to achieve this goal is greatest among Core fund managers, owners of stabilized assets able to better manage the 'operational' carbon within their portfolios. Energy reduction strategies include implementing solar PV panels on roofs, improving thermal insulation, switching to LED lighting, and introducing air/water source heat pumps.

[9] The concept of a 15-minute city "is to design the city within a distance of 15 minutes by foot or by bike to the six main urban activities for living: to live, to work, to supply, to education, to health, and to enjoy." Source: Carlos Moreno, Sorbonne university professor and scientific advisor to the Mayor of Paris, November 2020

[10] Stranded assets are properties that will be exposed to the risk of early economic obsolescence due to climate change because they will not meet future regulatory efficiency standards or market expectations. Source: CRREM 2019

The pathways to reduce GHG intensity of the office stock are highest in the Netherlands (-89%), France (-86%) and Spain (-85%). The opportunity to achieve this goal is greatest among Value-add fund managers, willing to take on the risk of owning ‘brown’ assets and retrofitting them. GHG reduction strategies include re-using concrete and steel frames, pre-fabricating construction materials off-site and using timber to sequester carbon.

Figure 6: Office market GHG & energy reductions required for a global warming limit to 2˚C by 2050

		CORE opportunity to reduce OPERATIONAL carbon*			VALUE ADD opportunity to reduce EMBODIED carbon**		
European Office market	Investment volumes 2006-21 (average €bn p.a.)	Whole building **energy** intensity pathway (kWh/m²/yr)		Required **kWh** reduction for 2˚C limit by 2050	Whole building **GHG** intensity pathway (kgCO2e/m²/yr)		Required **GHG** reduction for 2˚C limit by 2050
		2021	**2050**		**2021**	**2050**	
UK	25.4	213.3	90.9	**57%**	55.9	12.2	**78%**
Germany	20.9	198.5	56.2	**72%**	89.4	12.4	**86%**
France	16.1	207.5	88.4	**57%**	21.0	12.7	**40%**
N’lands	4.0	239.2	58.0	**76%**	106.2	11.8	**89%**
Sweden	3.7	243.3	102.8	**58%**	20.9	12.9	**38%**
Spain	3.0	274.6	117.0	**57%**	91.7	13.4	**85%**
Italy	2.6	215.7	87.4	**59%**	62.2	13.2	**79%**
Belgium	1.8	217.2	65.9	**70%**	58.1	13.1	**77%**
Finland	1.5	236.2	100.6	**57%**	41.3	12.4	**70%**
Denmark	1.3	168.2	71.6	**57%**	39.9	13.0	**67%**

*** Operational (or in use) carbon:** The carbon dioxide and equivalent global warming potential of other gases associated with the in-use operation of the building. This usually includes carbon emissions associated with heating, hot water, cooling, ventilation, and lighting systems, as well as those associated with cooking, equipment, and lifts.

**** Embodied carbon:** The carbon emitted up to practical completion of construction. This includes the carbon emissions associated with the extraction and processing of materials, the energy and water consumption used by the factory in producing products, transporting materials to site, and constructing the building.

Source: CRREM 2021, Europa Capital 2021, PMA Autumn 2021

CONCLUSION

Despite near-term inflationary pressures, any interest rate hikes are likely to be gradual and remain low in a historical context. Meanwhile, European real estate markets are likely to retain their relative value versus global markets.

In the context of post-pandemic shifts, this study has identified investment opportunities for both Core and Value-add. Low-risk investors are likely to be drawn to the liquidity and diversification benefits of the growing ODCE fund universe. Among higher-risk investors, the shift to more remote working offers opportunities to create value by repurposing excess shops and offices to undersupplied living and logistics uses. And as demand is redistributed across cities, location will once again prove to be the dominant driver of property performance.

Finally, in the light of reputational, ‘lettability’, financing and liquidity risks posed by ‘brown’ assets, re-positioning portfolios in the short term towards NZC looks attractive for low-risk Core investors with a focus on portfolio resilience. Higher risk Value-add investors are more likely to take the risks of owning ‘brown’ buildings and creating value through repurposing strategies.

CASE STUDY

The Clerys Building, Dublin, Ireland

- 16,857 sqm former department store in Dublin city centre
- Planning consent for a 23,710 sqm mixed use redevelopment
    - 5,572 sqm retail space in two flagship units
    - 8,238 sqm of offices
    - 6,853 sqm hotel, plus gastronomy

Value Creation

- €52 million capex to refurbish and redevelop the office and retail elements
- On track to attain LEED Gold, Wiredscore Platinum, BER B1 accreditation
- Improvement in energy performance; EU EPC G rating (pre refurb), to B rating (post refurb)
- Re-use and Re-Purpose in line with NZC pathways; reuse of existing structure to retain embodied carbon
- Original building structure kept including:
    - original bronze window frames
    - exterior bronze shop canopies
    - ornate stone façade
- Project has used local suppliers for materials e.g. external cladding manufactured in Dublin
- Commitment to prioritise re-employment of staff employed in the former department store

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Vanessa joined Europa Capital as Head of Research & Strategy in September 2020. She is responsible for providing expert guidance to support Europa's tactical and strategic business support needs. Before joining Europa Capital, Vanessa held research roles at M&G Real Estate & LaSalle Investment Management. She received an MSc in Property Development & Planning from University College London and an MEng in European Civil Engineering from the University of Warwick. Vanessa demonstrates commitment to the research community in her roles as Past Chair of the Society of Property Researchers (SPR) and member of the Urban Land Institute (ULI) Smart Urban Growth group, Urban Regeneration Council, Women Leadership Initiative and Europe Awards for Excellence jury.

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