In This Report

Europe’s real estate investment markets continue to benefit from positive momentum. Deal volume is rising again, although returns are starting to ease as yield impact fades. Occupier momentum is positive, especially in office markets, supported by low supply, and pointing toward an attractive environment for value-add equity and debt strategies. Logistics and the accommodation sector are benefiting from favorable trends.

In terms of opportunities we highlight the following investment strategies:

- **Value-Add Equity and Debt**
  Given a lack of grade A space in the office pipeline, strategies that seek to “create core” remain attractive, along with selected developments.

- **Logistics**
  Rental growth is starting to come through on the back of rising demand for logistics space, while the yield spread versus offices remains high.

- **Accommodation and Living**
  Supportive structural trends point towards ongoing opportunities in accommodation and living, including in hotels where occupancy is rising.
Positive Economic Momentum

The economic and political backdrop for European real estate markets is the strongest it has been for some time. European GDP growth is running above trend, central bank monetary policy remains supportive and, despite some indicators falling back in the early part of 2018, forward-looking sentiment measures are at cyclical – and, in some cases historic – highs.

Some risks are lingering but, so far, a recent flare up of political uncertainty – extending beyond Brexit to issues such as a renewed push by the Catalan independence movement and populist gains in the Italian general election in March – is not having a material impact on the growth outlook.

The combination of broad-based economic growth, which is supporting sentiment among real estate occupiers, and, compared to recent years, relatively limited political disruption, implies favorable conditions for investors. For now, real estate returns are elevated and capital continues to target European markets, although slowing yield compression hints at a more challenging investment environment to come.

Deals Are Still Getting Done

Europe’s real estate investment markets continue to benefit from positive momentum, despite concerns about pricing. Deal volume rose 12% in 2017, supported by an increase in large portfolio transactions and a partial recovery in the UK – Europe’s largest investment market – as Brexit uncertainty started to ease (Exhibit 1). In a historical context, the average annual deal volume of €279 billion recorded across Europe since 2015, is higher than the investment pace recorded at the top of the last cycle in 2007, prior to the financial crisis.

Behind the headline numbers, activity is varied by sector and geography. Office, which is by far the largest segment of the market, recorded a moderate uptick in demand, boosted by an acceleration in deal volume in the second half of the year in Amsterdam and – most strikingly – Paris, where occupier conditions and investor sentiment improved significantly following the general election.

Despite an improving outlook for wage growth and consumer spending, retail assets remain largely out of favor as the trend towards a rising share of online spending – previously confined to the UK – spreads across Europe. Instead, investors are tapping into favorable consumer trends by increasing exposure to logistics, where demand is being driven by growth in supply chains, and accommodation and living sectors, such as residential and hotels.
The composition of Europe’s real estate capital markets is changing too. While activity among domestic investors has eased off slightly over the past two years, activity among overseas investors is increasing, encouraged by the improving economic outlook. Global investors recorded the most significant increase in volume in 2017 – focused heavily on key eurozone markets, rather than the historically popular UK – while the share of activity among domestic investors dropped to 46%, some way below its 10-year average.

The last time the share of domestic activity was at today’s level was in 2007, when excessive liquidity and leverage prompted investors to expand their horizons significantly. The question today is whether the increased share of global capital reflects – as it did back then – overstretched investors searching for yield, or whether Europe simply offers an attractive opportunity set and diversification potential on which an increasingly global investor base is seeking to capitalize.

Yield Impact Widespread…But Can’t Go on Forever

For domestic investors – although perhaps not global players that can have different objectives, such as long-term capital preservation – pricing is a concern. Prime yields continue to compress, reaching new historic lows and driving double-digit prime returns across much of Europe over the past year – raising questions about their sustainability as the current cycle progresses.

According to a RICS sentiment survey, about three quarters of real estate investors now view pricing in the key core eurozone markets of France and Germany as “expensive” – although some parts of Europe are still viewed as “fairly valued,” including later recovery markets, such as the Netherlands, along with the UK, where values have fallen since Brexit.

Sources: Real Capital Analytics, PGIM Real Estate. As of May 2018.
Over the past three years, confidence about the outlook has improved and a legacy of caution among investors – that stemmed from the global financial crisis as well as the ensuing period of eurozone turbulence – is abating. Feeling more confident about the outlook, investors have been bidding up pricing, and yield compression has been driving value growth across almost all parts of the market.

In the earlier part of the cycle, pricing recovered most quickly in the top quartile of markets by yield level, a segment that mainly comprises the most sought-after assets in major core European cities – such as Paris, Munich and, prior to Brexit, London (Exhibit 2). However, with yields now some way below levels recorded prior to the global financial crisis, investors – under pressure to meet target returns – are turning their attention to previously less favored sectors and locations.

As risk appetite improves, markets in the bottom quartile are reporting further compression, taking yields to historic lows. Over the past year, yields in the bottom quartile have compressed by 25 basis points, compared to just 10 basis points across top quartile markets. By sector, an increasing number of non-CBD office and logistics markets are reporting yield compression, reflecting their relative rental growth performance, while pricing momentum in more expensive CBD office and high street retail markets is fading.

**EXHIBIT 2: EUROPEAN PRIME YIELD ANALYSIS**

![Graph showing European prime yields by quartile](image)

Sources: Cushman & Wakefield, PGIM Real Estate. As of May 2018.

The question is: what comes next? Inflation remains contained, but the monetary policy environment is, very gradually, tightening. The ECB have started to taper asset purchases under their QE program, while the next move in eurozone interest rates is set to be upwards, following the pattern at the Bank of England, which recently hiked rates. Across Europe, 10-year government bond yields are gradually climbing higher in anticipation.

History suggests that yields can overshoot in an upswing, so further yield compression cannot be ruled out in this cycle. However, as risk-free rates rise, the scope for a sustainable further decrease in yields – in absence of a more significant acceleration in growth potential – appears minimal.
Returns Starting to Ease

Yield impact is starting to come out of returns, implying a period of weaker performance to come. Even though yields are still falling in many markets, the pace of compression is slowing and prime returns are slowing (Exhibit 3). In contrast to the prime segment, average returns, which reflect a broader composition of property by quality, are yet to see a significant effect from declining yield impact: performance picked up in 2017, partly due to a rebound in UK values. However, the correlation with prime is high and it is only a matter of time before the same trends show up in the numbers.

EXHIBIT 3: REAL ESTATE RETURNS BREAKDOWN

Yield impact typically has less influence over longer time periods.

Sources: Cushman & Wakefield, MSCI, PGIM Real Estate. As of May 2018.

Over longer periods of time, the significance of yield impact diminishes. Since 2010, yield impact has accounted for 40% of total returns recorded. Yet, going back further to 1980 – covering a long period during which property values benefitted from a secular decline in interest rates – yield impact only accounts for about 15% of performance. For long-term investors, income and income growth remain key.

The extent to which returns drop further from current elevated levels – unadjusted prime returns are running at 13%, with average MSCI All Property Returns at 9.2% – depends on how much occupier performance improves. However, rent impact is still quite low compared to the last upswing, contributing 3% to prime returns in 2017, compared to an average of 6.5% per year in 2006 and 2007.

Supply Growth Remains Limited

Productivity growth – which supports rental growth potential as it allows occupiers to absorb higher costs – is still relatively low across Europe, but there are other factors supporting the rental growth outlook, including a favorable combination of rising employment and low supply growth.

Across Europe’s office markets, net additions to stock remain low, reflecting a subdued pace of building completions along with withdrawals of older buildings and conversions to other uses such as hotels and residential (Exhibit 4). At the
same time, wary of repeating the mistakes of past cycles, lenders and developers remain cautious. Yet tenant demand is rising and – even once efficiencies from new trends such as flexible working are factored in – vacancy is coming down quickly, meaning the supply of grade A space is becoming limited.

EXHIBIT 4: OFFICE SUPPLY ANALYSIS

Supply growth is set to pick up a little, rising back towards 1.3% of existing stock over the next two years – although that pace is still well below historical norms for an expansion phase of the cycle. Forecasts have repeatedly been too strong in recent years, suggesting supply may remain even more constrained than expected – not because of construction projects being delayed or halted, but related to ongoing stock withdrawals.

On the face of it, rents are now at or above a level estimated to support development activity in many markets, suggesting more speculative construction should be taking place. However, almost all major cities are reporting a slower pace of supply additions than during previous cycles.

In markets such as Amsterdam and Frankfurt, a legacy of oversupply from the early-2000s has discouraged new construction for many years. While vacancy is coming down now, developers remain cautious. Elsewhere, the case for a faster pace of development activity looks stronger, not least in markets like Paris and Munich where available space in central areas is very low, and rents are rising sharply.

Looking more broadly, there are differences across commercial sectors. In contrast to offices, most retail formats are struggling to attract and retain tenants. Vacancy rates are creeping upwards, even on previously fast-growing high streets, despite almost non-existent development activity. In logistics markets, tenant demand has been more closely matched by growing investor interest, resulting in better availability of finance for built-to-suit projects to meet expanding demand.
Where is the Rental Growth?

Faced with low initial yields and the prospects of declining – albeit still positive – returns, investors are looking for ways to generate income growth, supported by a decent economic outlook, improving occupier demand and, in many parts of the market, low supply growth.

Focusing on the market level route to generating income growth – as opposed to strategies to secure asset-level revenue increases, for example via re-leasing, repositioning, or refurbishment of an existing building – recent data point to considerable momentum, particularly in office markets.

Hiring intentions among major services employers have been elevated for some time, and take-up has picked up sharply (Exhibit 5). Demand is strong across many markets, though the main driver has been the large Paris market, where a quick dissipation of the electoral uncertainty last May fueled an uptick in corporate sentiment and a rapid acceleration in leasing activity through the second half of 2017.

**EXHIBIT 5: OCCUPIER MARKET PERFORMANCE**

Over the past year, half of all office markets have recorded rental growth in excess of 5%, with non-CBD markets continuing to out-perform CBDs, reflecting a range of factors including a lack of space in central areas as well as preferences among occupiers in certain sectors, such as technology firms or flexible office providers, for cost-effective space in fringe submarket locations.

Away from offices, rental growth momentum is mainly either decelerating, as in the case of high street retail, or remains moderate.

Rental growth across all retail formats was just 1.3% over the past year, with even previously resilient high streets coming under pressure as retailers close premises and put store expansion plans on hold. Vacancy rates are edging upwards, even
on prime pitches, limiting scope for rental growth in all but a handful of locations including Milan and Rome, reflecting a low online spending penetration rate in Italy.

Logistics markets are reporting slightly faster rental growth than in recent years, not least in the major distribution corridors of the United Kingdom. However, in Continental Europe, factors such as supply chain restructuring and consolidation – along with built-to-suit supply additions, in the Netherlands for example – mean that overall vacancy remains fairly high, despite rising demand.

Like logistics, accommodation and living sectors are gaining attention owing to favorable structural trends, such as rising city center populations, growing student numbers and increased flows of tourists. In the stable apartment sector, where in-town demand is rising, rents face pressure from factors such as regulatory constraints, for example in Germany, and increased supply owing to office conversions.

In contrast, the hotel sector is benefiting from a pro-cyclical pick-up in demand, which is translating into rising occupancy rates, while supply growth remains subdued. Hotel operators are finding themselves able to translate rising demand into higher room rates, and RevPAR continues to grow at 4% per year, a rate which looks attractive compared to mainstream commercial sectors, although new formats, such as Airbnb, pose a threat to traditional operators.
Investment Opportunities

Returns are slowing as yield compression fades, but investment conditions remain favorable in the near-term. With a lot of capital still targeting the sector, the opportunity set remains substantial, despite concerns about how long the current cycle can go on. Looking ahead, opportunities are focused on how to generate rental income growth to boost near-term performance as yield impact fades, and provide some defense against any adverse cyclical value movements to come.

1. Value-Add Equity and Debt

Given a lack of grade A space in the office pipeline, strategies that seek to “create core” remain attractive, along with selected developments.

Europe’s cycle has been going on for some time now and returns are starting to slow. But despite the risk of a value correction over the next few years, value-add deals continue to benefit from positive market momentum and a sizeable opportunity set. Continental Europe remains the focus of attention in the near-term although opportunities are likely to emerge in the UK once Brexit uncertainty has diminished or been more clearly priced in.

Much of the value-add opportunity set is in offices – a sector that accounts for about half of all investment activity in Europe and is currently benefiting from positive rental growth momentum. In many of Europe’s major CBDs, factors such as rising demand, low supply growth and falling vacancy – along with an aging profile of existing stock – point to the ongoing attractiveness of strategies that seek to “create core,” given little grade A space is in the pipeline to meet tenant requirements.

Cities with low vacancy rates are the most obvious target for refurbishment or repositioning strategies. Markets such as Berlin, Munich, Paris, Stockholm and Vienna all have vacancy rates below an estimated “natural rate,” pointing towards ongoing competition for space and prospects for further rental growth in the near term, while allowing investors a degree of confidence about taking on leasing risk. Development strategies look increasingly attractive too (Exhibit 6).
In other markets the opportunity varies. Cities like Brussels and Frankfurt still have relatively high vacancy rates and require a more selective approach for now, targeting low vacancy submarkets, for example. Amsterdam and several peripheral markets – notably Madrid, Milan and Rome – have a legacy of oversupply that is yet to be fully worked off, limiting opportunities.

Given that many investors are concerned about where Europe is in the cycle, investing via a debt structure – as opposed to an equity stake in a first-loss position – may represent an attractive entry point, trading off a portion of return for an additional degree of capital protection. Given that traditional lenders remain cautious and restricted by regulation, demand for loans made by non-traditional capital providers – in senior or subordinate positions – is expected to remain high, especially for higher-risk deals.

2. Logistics

Rental growth is starting to come through on the back of rising demand for logistics space, while the yield spread versus offices remains high.

Since the 1980s and 1990s – a period in which factors such as transport liberalization and rapid consumer expansion drove, at times, rapid rental growth on distribution facilities – returns on industrial and logistics assets have been driven by income receipts, rather than rental growth. Until recently, efficiency gains among logistics operators and relatively responsive supply conditions have limited rental growth, despite improving demand linked to e-commerce.
Rental growth is coming through in some markets, and upside to the outlook stems from factors such as an acceleration in the shift of consumer spending to online retail along with technological innovations in the logistics space that have the potential to increase the value of space usage (Exhibit 7). At the same time, yields remain elevated, at least compared to office markets.

**EXHIBIT 7: SHARE OF ONLINE RETAIL AND LOGISTICS RENTAL GROWTH AND YIELD SPREADS**

Sources: PMA, Cushman & Wakefield, PGIM Real Estate. As of May 2018.

Looking ahead, conditions look set to become more favorable, implying an ongoing opportunity for investors, notably for built-to-suit projects that can meet and adapt to changing tenant needs, albeit limited by the size of the sector. Even large sites have low land values, so deploying large amounts of capital remains challenging.

### 3. Accommodation and Living

Supportive structural trends point towards ongoing opportunities in accommodation and living, including in hotels where occupancy is rising.

As the opportunity set in commercial sectors has become more crowded, not least owing to retail’s loss of popularity, investors are looking more broadly at other sectors to deploy capital. Supportive structural trends – such as rising city center populations, an increasing elderly population, and growing tourism demand – point towards ongoing opportunities in accommodation and living real estate.

The amount of capital being deployed in accommodation and living sectors across Europe has grown sharply, rising threefold from an annual average of €25 billion between 2010 and 2011, to €75 billion a year since 2015 (Exhibit 8).
The relatively defensive apartment sector accounts for about half of the accommodation and living investment market, although the hotel sector is gaining in popularity owing to attractive RevPAR growth of 4% per year over the past five years, which has been supported by favorable supply-demand dynamics.

In recent years, demand has grown among tourist and business occupants, while supply – as in many other sectors – has failed to keep pace. Occupancy rates have risen significantly, allowing operators greater pricing power to drive revenue growth.

In terms of characteristics, tourism-driven markets – as determined by analysis of overnight stays and the share of tourism in city GDP – tend to have higher occupancy rates, which enable stronger revenue growth. Unless building rates pick up, demand forecasts remain ahead of the current pace of room additions, suggesting occupancy is set to rise further in this cycle.

For the time being, hotel returns are broadly in line with those recorded on commercial real estate. However, with higher initial yields than office and retail, and conditions that point towards further RevPAR growth, relative performance is set to be attractive in a slowing returns environment in the years to come.
Global Map of Investment Opportunities

**Niche Sectors**
Increased investor interest in non-traditional property types goes beyond a search for higher yields as many also offer stable and growing income streams.

**Suburban Apartments**
The opportunity in the apartment sector is evolving towards better performing class B, suburban assets with walkable amenities and good transit access.

**Accommodation and Living**
Supportive structural trends point towards ongoing opportunities in accommodation and living, including in hotels where occupancy is rising.

**Value-Add Equity and Debt**
Given a lack of grade A space in the office pipeline, strategies that seek to “create core” remain attractive, along with selected developments.

**Seeking Growth in Office**
Strong employment growth continues to support robust demand for office across major developed and emerging markets.

**Logistics**
Consumer demand is evolving rapidly and logistics rents are rising, pointing to investment opportunities across the Americas and Europe.

**Looking Beyond Established Markets**
Finding values and secular growth in new markets and sectors that offer structural demand for real estate beyond the short term leasing cycle.

**Active Asset Management**
Active asset management is becoming a more critical driver of growth as occupier markets are evolving rapidly.

**Debt Strategies**
Depending on risk preferences, debt instruments offer an attractive risk-return trade-off in weaker market conditions.
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