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FOR THE WORLD'S PRIVATE REAL ESTATE MARKETS

"THIS IS EUROPE'S TIME IN THE SUN"

PERE's roundtable explains why the region is investors' top pick

Europe's sunny afternoon

The continent's appeal to real estate investors has rarely been greater, but investors face challenges in deploying their capital in a crowded market, writes Stuart Watson

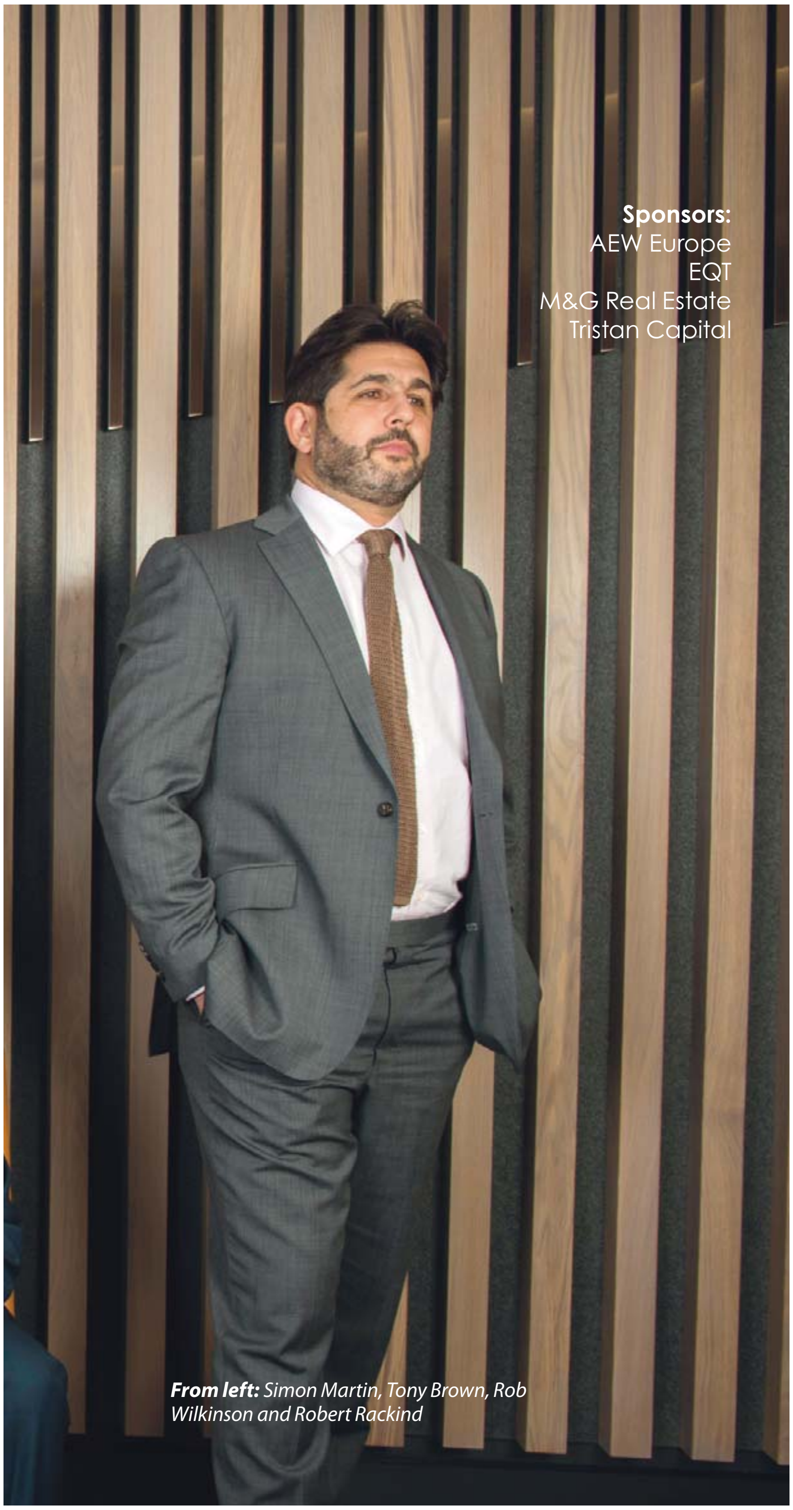
Photography by Marcus Rose

Few times and places are so perfectly suited to talking about the weather as England on a chilly February afternoon. Although it was a weak and watery light that shone on the participants as they strolled through Soho toward the London offices of investment manager EQT for *PERE*'s European roundtable, the subsequent discussion illuminated a real estate investment market that is currently basking in much warmer conditions.

"This is Europe's time in the sun," says Tony Brown, chief investment officer at UK-based fund manager M&G Real Estate, a verdict with which the other three investment managers present, Robert Rackind, head of real estate at host EQT, Simon Martin, senior partner at Tristan Capital Partners, and Rob Wilkinson, CEO of AEW Europe, readily concur.

The 2018 global investment intentions survey compiled by the European Association for Investors in Non-Listed Real Estate Vehicles predicts that over €51 billion is expected to be invested into global real estate this year, and a big chunk of that capital, 41 percent, would like to find a home in Europe.

"In the six years to 2013, Europe has probably been the



From left: *Simon Martin, Tony Brown, Rob Wilkinson and Robert Rackind*

"We have learned to keep away from secondary cities and stick to gateway cities because even if the market turns against you will still be able to trade your asset and get your capital back"
Robert Rackind

most difficult regional market," continues Brown. "There was the global financial crash then the sovereign debt crisis and nothing moved for a while, but now our prediction is that continental Europe will do better than any other market in terms of total returns in the next 12-18 months. There is more cap rate compression to come, but also pretty good rental growth."

Martin, who oversees research and investment strategy for London-based boutique value-added manager Tristan Capital Partners believes the fears about political instability of the eurozone appear to have subsided. In that context, European property investments represent a comparatively attractive option for global capital.

"Investors are weighing up the allocation options they have," he says. "Equity volatility is coming back and they don't want to buy bonds at very low yields so real estate comes to the fore. Then they think there is uncertainty and volatility in Asia and they see that the US cycle is at least two years more advanced than that in Europe. And then they look at Europe, which has been beaten up for most of the last decade, but which now looks relatively cheap and stable."

European investors are buying aggressively in their own patches, says EQT's Rackind: "While cross border investment is significant, domestic capital is strongest in its own markets. In Paris you get a few headlines about the Koreans coming in, but typically there is a far greater depth of domestic institutional capital for core. The Nordics are reasonably closed. In Germany there is huge amounts of domestic money. The UK stands out as a recipient of overseas capital."

Capital controls imposed by the Chinese government have somewhat abated the flow of money from that source, but a further wave of overseas investment could yet add to the activity in an already busy marketplace, says AEW's Wilkinson: "Not much Japanese capital has entered the market yet and that could be a really big number. Volumes have come off a little in the US, but that hasn't happened in Europe. But buying stock at the returns you think you should get has become more challenging. That said, we have well over €1 billion of disposals underway in the core space and those buyers seem to feel they are getting enough of a return at the moment."

Risk spectrum

Demand for core remains robust despite falling returns, says Martin. "Like the bond and stock markets, the real estate market is adjusting to a lower forward-looking return assumption."

Meanwhile, US investors which were focused on opportunistic returns, but now find them difficult to secure, are becoming more comfortable with a core-plus risk profile. "A lot of investors are saying that in the second half of the cycle the right thing to do is to manage your risk effectively, so we

Tony Brown

Chief investment officer
M&G Real Estate

In April, Brown will move from his current role to become M&G's head of global real estate. He will lead a team of 300 people managing around £29 billion of real estate in 27 countries. M&G Real Estate manages investments on behalf of its parent company, UK financial services group Prudential, as well as serving a range of institutional clients and managing funds for retail investors. The firm's biggest third-party funds are in the core space, but it runs strategies across the risk spectrum and recently held a first close of £125 million for a UK value-added fund.

Robert Rackind

Partner and head of real estate
EQT

Based in London, Rackind leads EQT's 18-strong real estate team. He joined the Swedish based global multi-strategy investment manager in January 2015 from private real estate investor-developer Wainbridge where he was co-founder and managing director. EQT closed its first real estate fund in June last year. For the €420 million EQT Real Estate I, the firm pursues a value-added office recovery strategy in Europe and has so far committed 56 percent of its capital.

are seeing a lot of our US clients saying that they like the idea of core-plus."

While some investors are looking to de-risk their portfolios at this point in the property cycle, others are looking to boost the comparatively low returns available for core investments by taking on some higher-risk assets. Rackind warns: "Core is very much a macro play, while value-add opportunistic investing is about creating the value even if the macro goes against you. I am not convinced going down from value-add to core is a good thing and likewise the core investors that move up to value-add and opportunistic are not necessarily the best at doing it either."

Nonetheless, larger institutions still want to invest across a broad risk spectrum, says Wilkinson. "In the core space, where they feel they know what they are doing, they will be more comfortable with direct investment, whereas if they are going up the curve to secure higher returns, then they will tend to invest with discretionary funds. That can work but I agree that when you see people start to move away from their natural hunting ground you need to be a bit careful."

"Continental Europe will do better than any other market in terms of total returns in the next 12 to 18 months"
Tony Brown

Style drift

The participants agree that as long as managers communicate clearly the risks involved in their strategies then investors can make informed decisions. However, Brown raises a point that is to become one of the main themes of the conversation: "Style drift is the danger when you get to this point in the cycle. There is so much competition for assets that you have to be a bit more creative about what you will accept. It's important that fund managers don't stray into risks they shouldn't be taking. It is definitely an issue in a highly competitive market where you have to look hard to find value."

Some of the pent-up capital may never reach the market because it lies within private debt funds that will never succeed

Simon Martin

Senior partner, research and investment strategy
Tristan Capital Partners

Martin helped found boutique value-added real estate investment house Tristan Capital Partners in 1999. The firm manages just over €9 billion of assets across Europe for a mix of institutional investors, sovereign wealth funds and high-net-worth individuals. About two thirds of that capital is managed in its opportunity fund series with core-plus strategies accounting for the balance. Tristan is currently raising its fifth core-plus fund, which is expected to be oversubscribed against a fundraising target of €1 billion. Candriam Investors Group, an affiliate of US insurer New York Life, bought a 40 percent stake in the company last month.

Rob Wilkinson

Chief executive
AEW Europe

Wilkinson joined AEW Europe in 2009, where he is CEO and chairman of the investment committee. The real estate asset manager oversees $60 billion of property worldwide, with Europe accounting for around €28 billion, as well as half of its global headcount of 600 people. Core assets make up 80 percent of total AUM, although AEW manages capital for a broad investor base in strategies ranging from core to opportunistic.

in deploying their capital, and if managers stick to their disciplines then that capital will simply be re-allocated elsewhere, says Martin. "However, the risk is if those funds start to get towards the end of their lives and they want to deploy, are they going to go for broke by doing development to get the money out and end up financing development in the wrong places?"

For better or for worse investors are exploring corners of the European market that they have been reluctant to enter since the financial crisis. Martin observes that in Germany the big four cities – Berlin, Hamburg, Munich and Frankfurt – have lost some of their exclusive cachet: "Those cities used to have a premium to them. Now you are starting to see a lot of institutional investors out buying in all of the other top 10 German cities without really discriminating between them. They are trading off liquidity against being able to deploy capital in a reasonably diversified fashion. Otherwise they are simply buying London, Paris and Berlin, which is not diversification because they are highly correlated and owned by the same people."

"The type of capital that is investing in core assets can look through a soft-to-middling Brexit and a hard Brexit isn't on their radar"
Simon Martin

Rackind is unconvinced of the wisdom of that approach. "Having experienced a number of downturns we have learned to keep away from secondary cities and stick to gateway cities because even if the market turns against you will still be able to trade your asset and get your capital back; we prioritize liquidity over returns," he says. "If you are buying evolving sub-districts like Croydon in London or Courbevoie in Paris, analyzing occupational trends, employment growth and infrastructure investment, you can find opportunity in the big liquid cities. You just have to be much more laser-focused on the real estate fundamentals to identify those growth sub-markets that have been overlooked."

Wilkinson acknowledges that there is a danger that investors taking on greater risk will increase the danger of another crash, but adds that there are few signs of imminent danger. "At the moment there isn't high leverage or supply in the system. Are we then in the ongoing low growth, low interest rate environment that everybody talks about?" he asks.

Long lines

With interest rates and bond returns at such low levels investors are keen to put their capital to work quickly in more lucrative real estate investments, but they are finding it increasingly difficult to do so. "Most open-ended funds have long queues to get in," says Brown. "Potential investors ask how long it will take to get money invested and a lot of funds can be self-selected out because of that."

Nonetheless positions in open-ended vehicles are in high demand: "They are taking in lots of money across all product types. Across Europe and Asia €2 billion-€3 billion is still quite big, but we expect to see the development of something like the US model where you have huge open-ended core funds of $20 billion-plus, which are a one stop shop for exposure to the sector."

Closed-ended funds are also facing increased pressure to deploy capital in a timely manner, says Martin: "A lot of them are 80 percent committed, but are only 20 percent drawn because they have developments or complex assets within the portfolio where they can't deploy capital immediately. There is a lot of investor scrutiny on whether capital is being used."

Brown argues that the unprecedented amount of money queuing to get into real estate funds explains the popularity of alternative asset types: "We saw it in the UK with student housing becoming mainstream 10 years ago and now we are seeing it with the UK residential rented sector, which is hugely popular. We will probably follow the lead of the US in sectors like healthcare, self-storage and datacenters."

European investors have shown an increased appetite for logistics and residential, giving rise to the oft-coined phrase 'sheds and beds' in recent years. "Those two sectors have drivers that transcend the weakish economy that we have been through in Europe," says Wilkinson. However, he is unwilling to write off the other main asset classes: "Offices are always going to be more cyclical, but if you play them right you can make a lot of money, and quality high street retail has double digit rental growth in the last three years."

"Offices are always going to be more cyclical, but if you play them right you can make a lot of money and quality high street retail has double digit rental growth in the last three years"
Rob Wilkinson

Seeing through Brexit

The continued and deepening uncertainty surrounding Brexit negotiations remains a significant issue for the UK. "Although volumes looked quite healthy last year, if you take away the Chinese capital there is definitely a bit of weakness in the real estate capital markets in the UK that doesn't exist in, say, Germany," says Brown. "In most European countries there is a lot of demand for assets almost irrespective of quality. In the UK the definition of a prime asset has narrowed. It is seen as riskier and pricing is getting weaker although there is no evidence of an impact on prime asset valuations yet."

Rackind takes a more optimistic view: "Anything that is non-core generally speaking isn't trading, but it is not enough to kill the market. Long term core investors are seeing through Brexit and are understanding that London will continue to be a global financial city. Apart from Paris there is nowhere else in Europe that has the scale of London."

Investors are confident there will be no cliff-edge departure from the EU, says Martin. "The type of capital that is investing in core assets can look through a soft-to-middling Brexit and a hard Brexit isn't on their radar because they don't believe it will happen. If people believed hard Brexit was certain we would be seeing a very different market environment."

The outlook for the UK may be cloudy, but the participants in this year's roundtable forecast a benign climate for the rest of Europe. For investors the challenge will be finding a place in the sun that is not already occupied. □

Rising star, dark horse, falling knife

The participants' top sector picks in the European real estate market, interesting niches and pitfalls to avoid

	Rising star	Dark horse	Falling knife
Tony Brown	Stockholm CBD offices	UK retail warehousing	UK secondary shopping centers
Simon Martin	Dublin residential	UK retail warehousing	London south bank residential
Robert Rackind	Stockholm CBD offices (and some sub-markets)	Offices in German second-tier cities	UK secondary retail
Rob Wilkinson	Frankfurt offices	Offices in Dutch second-tier locations	Polish secondary retail

Signs of the times

The roundtablers discuss recent landmark deals in the European market

1 Sale of Logicor

US private equity giant Blackstone sells its European logistics business, Logicor, to Chinese sovereign wealth fund China Investment Corporation for €12.25 billion and subsequently announces that its European core-plus fund will buy back a 10 percent stake in the company.

SM: That is incredible sleight of hand. There aren't many people who would be able to put that together without creating ripples within the business. It gives you a sense of how closed the ecosystem of the very large closed-ended funds is, and also of the demand there is for core.

RR: We have had a number of LPs saying: "It is such a shame you are going to be selling these assets when they are finished because they are just the type of asset we want to own as core."

TB: We would find it very difficult to transfer assets internally.

2 WeWork's City HQ purchase

US-based co-working group WeWork buys the 13-property Devonshire Square estate from Blackstone for £600 million ($842 million; €676 million). The price paid for the 626,000 square feet of office space in the City of London was £50 million higher than that at which the asset was being marketed in 2016.

RR: I would love to understand the rationale behind it. You have the WeWork phenomenon combined with a price well in excess of previous bids. Is that the top of the cycle? Is that a bubble? I imagine we don't understand the real strategy behind the deal.

SM: WeWork's ability to do this is based on investors' continued willingness to support an extremely high stock valuation with multiples that make what real estate companies trade for look ridiculously small.

TB: They make it stack up by selling add-on services. WeWork represents a shift away from the traditional landlord model because of the data they have on occupiers and the services they can sell them.

3 Amundi, Primonial Paris complex buy

Paris-based asset manager Amundi Real Estate, insurer Crédit Agricole Assurances and fund manager Primonial REIM acquire the 1.7 million-square-foot Coeur Défense office complex in Paris from Lone Star for €1.8 billion, one the largest single-asset deals ever in Europe.

RW: That the retail money behind Amundi was able to access a deal of that size is pretty extraordinary. It was a club with two other investors mixing retail with institutional money. They have had a few questions posed of them recently because of the extent of their buying.

RR: There was a period in 2017 when Amundi and Primonial were buying almost every Parisian building that came to the market. From what I understand the regulator has requested to know: "Why are you outbidding everybody else? Please can you justify your risk management?"

4 Spelthorne Council's sale and leaseback

UK local authority Spelthorne Borough Council buys BP's Sunbury on Thames campus in Surrey in a £340 million sale and leaseback transaction, representing a yield of around 4.5 percent, as it attempts to find alternative sources of funding to offset central government cuts.

TB: Over the past 12 to 18 months UK local authorities have been buying long-let buildings to provide an income stream by taking advantage of the arbitrage between the yield and low-cost borrowing from the public works loan board. On the plus side we have sold buildings to some of these buyers, but it has also been negative where we have tried to purchase because we can be outbid by them. Some of those deals are quite big, and some councils are buying outside their own areas. What happens if those buildings become vacant? The risks may be greater than they realize.

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