Did you see this coming?

Are Europe's real estate markets at risk of being undermined by Europe's problems?

by Richard Fleming

This article was meant to be about the outlook for real estate investment markets in Europe in 2016 and beyond. It still is, and the outlook is pretty good — in summary: more of the same, barring unexpected shocks, at least until interest rates start to rise (which could be soon) and maybe even after that — but it quickly became clear that the article cannot be kept within that narrow confine; and nor should it.

Europe cannot control its external borders and it seemingly can do little about the flood of refugees and economic migrants from the Middle East, Africa and Asia that is now pouring illegally across those borders and then any which way through south-eastern and central Europe across the newly-manned and partly-fenced internal borders of the European Union toward their declared destination, Germany. Frankly, remembering how fearsome some of those borders in central, eastern and south-eastern Europe used to be during the Cold War, I am surprised at the restraint that has been shown so far by border guards.

Many of those migrants, of course, are Syrians who are fleeing the civil war in their country and accessing the EU's external border along the Greek coast from Turkey, just a short but dangerous distance away across the Aegean Sea. There is no suggestion that Turkey's attitude in this migratory exodus has anything to do with the EU's repeated refusals over the years to progress Turkey's application to join the European Union. None at all. Turkey is a large country with a very long coastline; it is host to a rising number of refugees from Syria and other troubled countries in the region, there is a high number of rapacious people-smugglers, and emigrants out of Turkey heading for Europe are motivated, obviously able and relatively wealthy. Turkey has its own problems, many self-inflicted.

The numbers add up

In terms of commercial real estate transaction volume for 2015, Europe appears to be heading for a new record, surpassing the previous record set in 2007. Q3 2015 transaction activity numbers from Savills show that a total of €157.5 billion was invested in the first three quarters of the year — a 20 percent increase on the same period last year —

with 2015 as a whole expected to see some €234 billion of turnover, which would be that much-vaunted new record. Another new record that has been set, according to Savills, is that the average prime office yield in Europe's CBDs at the Q3 2015 point was 4.53 percent — 22 basis points below the low recorded eight years ago.

CBRE's latest *EMEA Prime Rents and Yields* survey, for Q3 2015, confirms the reducing yield trend. Richard Holberton, senior director, EMEA research, at CBRE, says that falls in prime yields have been a feature of the market for three years now, and that the last quarter's data gives every indication of the trend continuing, or even accelerating.

"This is linked," Holberton explains, "with strong investment demand for real estate and a supportive capital market environment characterised by low bond yields, low real interest rates and continued quantitative easing. On the rental side, while the pattern is certainly not clear cut, there are indications that some of the early-cycle growth markets such as London and Dublin are heading into a period of slower growth, while some of the later-recovery markets, notably Spain, are beginning to pick up speed."

"It does seem that investment volumes this year are going to beat 2007 levels," says Stefan Wundrak, head of European research at TH Real Estate. "Yields this year have reached a level where it is hard to imagine how real estate could become even pricier. The market looks like it is going to peak next year."

Lydia Brissy, director – European research at Savills, puts it like this: "We anticipate average rental growth in Europe of between 2.5 percent and 3 percent in 2016. Strengthening confidence in the occupier market adds additional appeal to a European market already benefiting from the positive spread between bond and property yields, although growing competition and activity from US and Chinese investors will inevitably put pressure on yields.

"With record high prices," Brissy continues, "we anticipate more assets coming to the market, fuelling further demand and leading to a very strong final quarter. We, therefore, predict that 2015 is on track to see turnover volumes reaching €234 billion by the end of the year."

We all know what happened after 2007. In pure real estate investing terms, though, things are different this time; a cliché, I know, but markets are buoyant and investor sentiment is positive. "When people start saying 'this time it's different,' that's the time to start getting worried!" cautions Kim Politzer, director – European research at Invesco Real Estate. There are a number of clouds on the European horizon, however — not just the migrant crisis — that must give rise to concerns that Europe and its institutions, particularly the European Union, are going to be tested as never before.

In brief, the conflict in eastern Ukraine has gone quiet but remains unresolved, the latest Greek bailout still needs to be signed off, deflation continues to exert worries inside and outside of the euro zone, and the 2017 referendum in the United Kingdom on continued EU membership will generate debate across the continent and polarise opinion; let alone the impact of the IMF's lower growth forecasts, the economic slowdown in China and the emerging markets, and that looming interest rate rise.

Supportive for property markets

The wall of capital — both from within Europe, as investors revise strategies, and from Asia Pacific and North America, with broadly core and opportunistic strategies, respectively — will remain in place but investors will continue to find it difficult to source suitable assets.

"The current environment is ideal for real estate," says Chris Blanchard, portfolio manager, global real estate securities, at Presima. "Its low growth, low inflation, low interest rate, and all those factors tend to be very conducive for real estate as an asset class. The positive thing for 2016 is that we may start to see some growth in the fundamental side of the business.

"2015 has been largely stagnant as far as rental growth goes," Blanchard continues, "but the transaction market has been quite strong. We could expect rents to improve in 2016, and that would support, if not drive, performance in 2016 and beyond."

"Where we are in the cycle now is a different place to where we were in 2007," says Craig Wright, European real estate investment analyst at Standard Life Investments. "We are reaching peak levels in terms of transaction volumes, but 2016 will see a similar level. Given the dry powder that is available and targeting real estate globally next year, if Europe takes the same share of that capital as it did this year and last, then we would expect to see the same level of transactions in 2016. But we will see different strategies next year in terms of where the money is going." Core markets will continue to attract the lion's share of investor interest, Wright believes; "but investors might have to take a broader view on property type and risk strategy."

Cain Hoy and its joint-venture partner Sager Group recently secured a £190 million (€267 million) loan facility from Lloyds Bank Commercial Banking and Investec Structured Property Finance for development of Islington Square in north London.

Skanska Commercial Development Europe recently sold a portfolio of four office buildings in Kraków and Katowice, Poland, to a fund managed by Niam AB. The transaction is the largest this year in the central and eastern European office market.

"The real estate story is relatively straightforward at the moment," maintains Politzer. "We don't believe that there is an awful lot more yield compression to come. But we've said that for the past year or so. And the money keeps rolling in."

The global hunt for yield has had an impact, Politzer says. "If you look at the places that were cheap last year in Europe, they're not cheap any more. The money has found its way into the corners that looked cheap."

Markers for continuing good performance

The real estate party will continue, Politzer believes. "Surveys continue to show a really strong appetite for European real estate. The US market has probably got another couple of years of really good performance, driven by some quite compelling rental growth, but it is getting much closer to the end of its cycle. So you have got capital that is thinking about how it can redeploy or refocus its outlook now to move away from exposure to a potential US cycle 2018-ish. Asian capital is, of course, concerned about the slowdown in its domestic market. Europe continues to be an interesting market just in terms of its stability and the likely longevity of its cycle.

"When US interest rates rise," Politzer explains, "that puts down a marker for capital in the United States to become more expensive and for the spread between property pricing and bond yields to start narrowing. That rate rise is not likely to happen in the euro zone before 2018–2019, so we've probably got a low interest rate environment in mainland Europe until around 2020, supporting current property pricing in a way that we won't have in the United States and won't have in Asia if China starts to re-balance its economy."

"It's very unusual for a market to have no change three years in a row," says Wundrak. But that is what he expects. "We will hit a peak next year, then it looks like it will be flat for a while." There could be a shock; "either a positive surprise that the European economy has done better than expected or an economic shock, for example, from China."

Blanchard does not expect interest rate rises to have the calamitous effect on markets sometimes feared. "It comes down to why rates go up and how fast. If they go up gradually, due to improving economic growth, then that is supportive for real estate going forward."

"If interest rates move up," says Wundrak, "that will only be because the economy is doing better than today, which will mean that the rental side would do better than today." That would cancel out the negative yield shift.

Michael Clarke, head of investor services, EMEA, at CBRE Global Investors, believes that real estate will continue to remain attractive for multi-asset investors. "I don't think things are going to change any time soon. There are quite a lot of big uncertainties out there in the world, so that's going to keep a lid on interest rates probably for longer than most people would anticipate." Low inflation will take the pressure off interest rates.

Low levels of new office supply augur well for rental growth — but not everywhere

The Polish capital, Warsaw, already has an office oversupply situation, following years of construction of new class A space, and the City of London is heading in the same direction. This is vividly illustrated in the "Forecast growth in supply and demand for office space" chart below, taken from the upcoming H2 2015 the *Invesco Real Estate House View*, with both Warsaw and the City of London showing as outliers in the relationship between employment growth and stock growth. This will likely have an impact on rental growth in those locations.

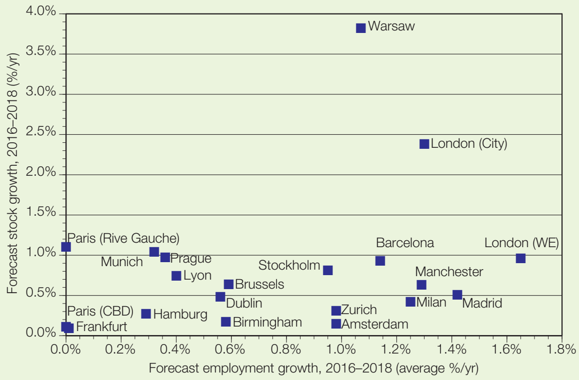
According to Kim Politzer, director – European research at Invesco Real Estate, in the 10 years to 2008 (effectively, pre–global financial crisis) employment growth in the EU–27 averaged 1 percent per year, while from 2008 to 2014 employment fell by 0.2 percent per year. The forecast for employment growth over the next five years is 0.5 percent per year.

"The cities on the left-hand side of the chart are all growing very slowly," Politzer says, "while those on the right-hand side look like the stronger candidates for employment growth and, therefore, office rental growth (and, as a second-round effect, also retail rental growth)." The *IRE House View* forecasts favour markets such as London, Madrid, Manchester, Stockholm and Milan.

"However, the chart also provides a warning — Warsaw, with very strong employment growth, has also seen very strong stock growth, and rents have been falling," Politzer points out. "The City of London is also seeing stock growth accelerate. While at the moment the pipeline looks like it can be absorbed, if there is a further acceleration of development or a shock (eg. Brexit) — and, therefore, uncertainty about the role of London as a financial centre for euro-denominated business — that could trigger another rent cycle."

— Richard Fleming

Forecast growth in supply and demand for office space, 2016–2018



Source: Invesco Real Estate, based on data from CBRE and Oxford Economics, H2 2015

"We think it's going to be potentially quite a long, drawn-out affair and without any real need to push up interest rates. If it does move, we think it will be quite muted.

"It's going to be a low returning environment," says Clarke, "but it's still going to be an attractive returning environment." Clarke thinks that it is feasible to expect some US investors to be looking internationally again as US market returns moderate. "Historically, they look at value-add and opportunistic investing — largely because they want a higher return than they get in their domestic market — and as the core market moderates back at home they may well look at the diversification benefits of core-type investing internationally."

Reasons to invest, part three

Robert Gilchrist, CEO of Rockspring Property Investment Managers, agrees that investment momentum remains strong within Europe. "Each week, each month, one reads about new funds and new allocations to real estate." Gilchrist senses that real estate is winning a number of arguments in the wider sense; "more, perhaps, than it has won in recent history, and so we need to look more at the motives behind the investing."

A number of disparate forces are at play today, Gilchrist suggests. "There is the yield compression brigade," he says, "which only knows how to invest on the back of 'today's yields are going to be lower than yesterday's, so I'm going to carry on investing, that makes me money'. And then there are the asset allocators within Europe, looking for income where income doesn't exist, or is lower, within other asset types; a mere two styles looking at real estate for different reasons.

"On top of that," says Gilchrist, "you throw in sources of capital that want to invest in real estate or real assets for all sorts of other reasons that perhaps didn't exist 15 or 20 years ago — and, indeed, some of these sources of capital themselves didn't even exist back then."

The demand pressures and the demand that are building in the sector "are challenging to fully comprehend. What does it mean for judging correct pricing today?" Gilchrist asks. "The yield compression/decompression brigade is paranoid and fixated by interest rates because all they're interested in is what they see as the correlation between interest rates and initial yield. The asset management brigade is less fixated by that correlation because they are going to argue that rising rents will more than offset the impact of modest rises in interest rates."

Gilchrist suggests that we should remember why people are choosing to invest in real estate. "A large proportion of investors, local and global, invest for the coupon — they are longer-term investors who are actually looking to invest for income into the longer term rather than making capital profits in the short term, which is a very Anglo-Saxon and opportunistic fund viewpoint. It is exactly the attraction of that income from a multi-asset perspective that right now is acting as a catalyst for rising allocations to real estate. Many investors are coming in because they want stable income, not just capital, yield compression–based returns."

Investors still see real estate as an attractive asset compared to where else they can park their capital," adds Peter Hayes, managing director and global head of investment research at Pramerica Real Estate Investors, which operates as Prudential Real Estate Investors in the Americas, South Korea and Japan. "When it comes to Europe, you are talking about a very slow, drawn-out recovery. A lot of markets are still valued below previous peaks, rents are below where they were. And the European Central Bank is talking about extending QE," Hayes points out.

"Capital is continuing to flow into real estate and we expect investment volume to grow over the next 12 months," he says. Hayes agrees with Gilchrist that investors will focus more on income "not just in core real estate, but increasingly also in the traditional areas of non-core real estate in Europe, such as student accommodation and senior housing. It is quite interesting that, historically, real estate cycles — and this is never a perfect science — you would time them at seven to eight years across Europe. If you were thinking that 2009 was the turning point, then that would put you to around 2016–2017," says Hayes.

"But if you look at how property markets recovered relative to previous real estate cycles, then actually the turning point was 2012," Hayes points out. "So if you think about a seven- to eight-year horizon, about 2020 would be the time when pressure of supply will come on line and when interest rates will get to a point of having an impact on demand. We think we have at least two to three years of growth coming through."

Displaced people make for uneasy times

At the end of the Second World War, the movement of people westward in Europe was of displaced Europeans, mainly Christians, fleeing deprivation and Stalin's Red Army and was largely accepted by indigeneous populations as a consequence of war, human upheaval and the need for economic renewal, and the new political reality. And after years

Legal & General and developer Rightacres have embarked on a joint-venture construction of the £400 million (€463 million) Central Square development in Cardiff. The 4.85-hectare mixed-use regeneration scheme, located north of the city's main railway station, will feature 93,000 square metres of city-centre office, retail and residential space.

of family and fabric destruction there was rebuilding work aplenty.

This time, the movement westward of non-Europeans, mainly Muslims, is not largely accepted, work is harder to come by, and indigeneous resentment is higher.

Europe has a rich tradition of helping vulnerable people in a time of need, but this latest situation may be beyond the continent's capabilities — simply too many, too quickly. This is a political issue and is tragic for those concerned, but it is also the socio-economic issue of the day and will, now but also years down the line, have ramifications for real estate across Europe, both markets and properties. How can it not? And who pays for it all, whatever the outcome — the UN, the EU, the countries concerned, the local authorities?

There are, of course, many positive aspects to immigration, if controlled and handled properly. And the boost to a country's demographic and economic development and labour force spending power from young, dynamic new arrivals is undeniable. The four Nordic capital cities have benefited substantially in recent years from population growth brought about by urbanisation and immigration.

As usual with contentious issues, there are multiple facets to consider, no right answers and many wrong answers. For many people, principal among the considerations must be the protection of the weak and defenceless. Against that must be placed the European Union's ability to manage its affairs properly and to guard against existential threats to its borders, long-term security and — bluntly — future as a political force.

We are talking here of illegal immigrant volumes in numbers that real estate investors will be used to — millions. They are literally walking through borders and pushing obstacles aside. Current estimates are that 1 million refugees and would-be migrants will arrive in Germany this year. Many of those will quickly seek, after registration and ahead of consideration of their claim to asylum, to add family members left behind to their cohorts.

Factor in the higher birth rate common in the developing world, even — or especially — where people have emigrated, and you can quickly arrive at an overall 10 million plus increase in the population of Germany within a generation, solving that country's demographic problem — but at what cost, politically, economically and socially? No wonder the indigeneous population, already composed of German and non-German segments, is worried. And that is this year's intake — there is no doubt that, if left unchecked, the flow of refugees and migrants from the Middle East, Africa and Asia will continue. Those millions will add up, and add up big. More record numbers…

The refugees/migrants might not have much money for consumer spending now — one informed view that I heard walking around the halls at Expo Real in Munich in early October is that the main retail beneficiaries in the short term will be Europe's food and clothing discount stores — but over time the expenditure will grow and spread. Many of the new arrivals are highly educated; though whether their qualifications, training and experience will satisfy European employers has yet to be ascertained.

Germany, along with other European countries, has been taking in refugees and migrants for years already, principally from the Balkans. Many have settled in the major cities, where the best work prospects are — but it is in just those cities that Germany's housing supply is most constrained. There is plenty of available housing for refugees and migrants in eastern Germany; and there is a reason for that. Beggars can't be choosers but there is resistance to relocation decisions.

Right questions, wrong answers

Real estate is about residential and commercial buildings but it is also about the people who live and work in them. The outlook for real estate investment markets in Europe in 2016 and beyond was meant to be about the wall of capital that has headed — still heads — for Europe in the global search for yield in this continuing low interest rate environment, and about what will happen to economies and investment markets when interest rates start to rise to trend levels.

The European real estate industry will likely hit new territory between now and the end of the year when the 2007 transaction volume record is broken, but we should use this period of relative calm to reflect on the wider questions that we are being asked. We know the questions and we know some of the answers. Even though that interest rate rise question keeps being ducked by central banks, we know that it is a matter not of "if" but of "when" and we know that market turbulence and volatility is likely.

Where we don't have answers is where we wouldn't expect to have answers. Because they are not our answers to give. Real estate is what makes cities, towns and urban environments tick; together with transport networks, it is the glue that holds modern societies together. Unlike equities and bonds, you can see real estate as an asset class around you; you can touch it and you can feel it. It's part of our fabric.

It is not the real estate industry's fault that its position in society puts it at the heart of the conundrum about what to do with the millions of current and future refugees and economic migrants who have been drawn to Europe: how to receive them, in the widest sense; where to put them; where to house them; how to feed them; where to school their children and their children's children; how to social-service them; how to enable them to become economically active; how to ensure that they become viable members of society and not a festering underclass; how to integrate them; how to ensure that domestic populations do not feel that their current way of life and culture is under threat from the new arrivals; how to deal with the social, economic and political tensions that will arise — and they will. Indeed, they are doing already, both at local and national levels.

Winners and losers

Two things are clear. Firstly, however messily and however easily Europe's borders and structural integrity have been compromised, the migrants who are allowed to stay will be absorbed. Secondly, history will condemn Europe and its leaders not just for allowing this situation to arise, through the combination of ignorance, ineptitude and inaction, but for allowing it to develop into the humanitarian catastrophe that we have now — especially with the onset of harsher winter weather for those making their way through south-eastern Europe — and that was inevitable and foreseeable from the moment the Arab Spring started. That is not said with the easy benefit of hindsight but of foresight — history tells us, for example, that the seeds of the Russian Revolution of 1917 were sown when Tsar Alexander II freed the serfs in 1861 and raised expectations.

The 108,100-square-metre Tours DUO mixed-use project in the Paris Rive Gauche district was recently granted planning permission by the City of Paris. The project, led by Ivanhoé Cambridge, real estate subsidiary of the Caisse de dépôt et placement du Québec, features two office towers — one of 39 storeys, the other with 27 storeys — and ancillary retail, leisure and hotel accommodation.

Things move a lot quicker these days with raised expectations, especially with the speed of communication involving smartphones, their Internet capability and the ready supply of information and people-smuggling hardware. The warning signs were there, the need for decisive action was evident, and that decisive, timely action never happened.

Shame on those leaders; but consider all the multifamily houses, shopping centres and office buildings that may now be subject to heavier consumer demand and greater real estate investor interest than might otherwise have been the case. As an industry, we like demographic growth and heightened demand. We don't like barriers to development, actual or metaphysical. So, who are the winners here in this refugee/migrant crisis and who are the losers? ❖

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