The Growing Opportunity in European Real Estate

Rogier Quirijns, Senior Vice President and Portfolio Manager
Edited by Gregory Dorsey

With Europe in its best shape since 2008, we expect a strengthening economy to boost already attractive real estate fundamentals. Adding to the total-return potential of European REITs are a reduced cost of capital resulting from governance reforms, and compelling relative and absolute valuations.

A Broad-Based Expansion

European real estate is finally getting what it has lacked for years—a tailwind of accelerating economic activity following a prolonged period of anemic growth. Second-quarter 2017 EU-wide gross domestic product (GDP) growth reached its highest level in more than six years. Pointing to continued strong growth, the European Commission’s economic sentiment indicator for the 19 countries that make up the Eurozone stands at a post-crisis high amid rising optimism across all sectors of the economy. This optimism flows from several key factors:

Improving jobs market. The Eurozone’s recovery has broadened out from a credit-led rebound of the last several years. Consider job growth trends, often the best indicator of future demand for the real estate market. Exhibit 1 shows how after years of trailing the U.S., Europe now leads in job creation. EU unemployment has dropped nearly a full point in the past year to 9.1%, down from 12% four years ago. More people at work fosters greater household formation and consumer spending. Yet there is still considerable room for improvement in the employment situation.

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<tr>
<th>Exhibit 1: Eurozone Job Growth Is Accelerating</th>
<th>Quarterly Employment Change, Millions</th>
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<tbody>
<tr>
<td>Quarter</td>
<td>Eurozone</td>
</tr>
<tr>
<td>2010</td>
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<td>2011</td>
<td>0.2</td>
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<td>2012</td>
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At September 30, 2017. Source: Morningstar, Cohen & Steers. Europe employment data generally reported about one quarter behind the U.S.

Data quoted represents past performance, which is no guarantee of future results. See back page for additional disclosures.

Highlights

- A broad-based expansion: After years of sluggish growth, Europe’s prospects have brightened considerably amid rising consumer and business confidence, a healthy job market, continued low inflation and a marked improvement in the region’s political climate.
- Capital views: We highlight attractive opportunities across Europe, particularly in Germany, Spain and defensive sectors in the U.K.
- Improved business models: We believe European real estate companies have improved their longer-term risk-return profile via improved business models and governance standards.
- Compelling valuations: Real estate valuations in Europe and globally are particularly appealing, in our opinion. They are trading at the low end of their five-year valuation range, while global equities are near the top of their five-year range.
Favorable monetary conditions. Monetary policy should also continue to stimulate growth. Bond yields remain near historic lows, and inflationary pressures are still largely absent in Europe. Although the European Central Bank (ECB) has acknowledged that the risk of deflation has disappeared, it has signaled its intention to maintain accommodative policies until growth and inflation appear sustainable. With the recent strength in the euro, we believe the ECB is under less pressure to remove stimulus or reverse its low-interest-rate policy.

Reduced political risks. Fading political risks on the continent could further boost the European economy. While Brexit negotiations have formally begun and the U.K. is expected to leave the EU in 2019, the rejection of populist, euro-skeptical political parties in France, the Netherlands and elsewhere earlier this year reaffirms the EU's resilience, which may additionally buoy consumer spending.

Together, these factors could bolster what was already a favorable outlook for European real estate securities.

Capital Views

Attractive real estate opportunities can be found today across Europe among companies operating in a variety of sectors.

Berlin ist der Ort (Berlin Is the Place). Germany, the economic gravitational center of the EU, is enjoying strong economic, population and job growth thanks to a vibrant exports sector and attractive migration policies. German household formations are running at the highest levels since the boom years in the early 1990s following reunification. Nowhere is this more evident than in Berlin, which has attracted both German nationals and immigrants with its low costs of living and doing business.

While the public sector and tourism are playing central roles in Berlin's revitalization, the city is quickly becoming the Silicon Valley of Europe, where software developers and venture capitalists, lured by generous incentives, are converging to launch startups. Berlin's thriving arts, entertainment and cultural scenes are also acting as a magnet for businesses and new residents.

Although residential supply is increasing in Germany, it has not been nearly enough to meet demand, especially in Berlin. It is estimated that 20,000 new housing units are needed each year to meet new and pent-up demand in the city. Yet the market has supplied only half that amount annually in recent years (Exhibit 2), which is helping to drive rents higher. Quality office space in Berlin is also scarce, with strong job growth driving low vacancy rates and rising rents amid the creation of limited new supply. Berlin office take-up has set records in each of the last several years, but supply has met only a quarter of that demand.

Company example: Deutsche Wohnen—owns 160,000 residential and commercial units in Germany, mainly in Berlin and other major metropolitan regions.

Spain is Heating Up. Spain was among the countries hardest hit following the 2007–08 financial crisis and subsequent sovereign debt crisis. Its housing market collapsed, triggering a deep recession and essentially bankrupting the country's banking sector. But unlike Italy or Greece, which experienced similar issues, Spain tackled its problems early on and is now seeing advantageous results. Structural labor reforms, surging exports, a revitalized service sector and a tourism boom have put the country on pace for its third consecutive year of economic growth of more than 3%—the fastest of any large economy in the euro area (Exhibit 3).
An improving job market and the steady rise in business confidence are spurring strong demand for office space. With a limited new supply of quality office space available, landlords are enjoying rising rents for prime properties. Although vacancy rates are still relatively high, they are expected to decline sharply in the next few years. We also see opportunities in the hotel and resorts market—particularly since other large tourist destinations, such as Turkey and Egypt, are facing geopolitical difficulties. Regarding the Catalonian secession movement, we believe the region will remain a part of Spain. From our observations, most Catalans will not risk economic growth and chaos for the sake of complete autonomy—particularly since the EU does not support an independent Catalonia.

**Company example: Merlin Properties**—Spain's #1 office, high street retail and logistics warehouse landlord and second-largest shopping center owner.

**Post-Brexit Britain.** Since voting to leave the EU in May 2016, the U.K. economy has been slowing. Office and retail REITs have underperformed amid a rising cost of imports, the prospect of businesses departing for other parts of the EU, and general uncertainty around Brexit negotiations. We believe these sectors remain particularly vulnerable due to the limited scope for U.K. wage growth, anticipated job losses in London and new supply from projects that were under development before the Brexit vote.

On the other hand, we believe U.K. sectors with more defensive/higher income and external growth characteristics—where fundamentals have been strong and there is likely to be little to no impact from Brexit—are likely to remain relatively insulated from a possible economic downturn. These include industrial, self storage, student housing and health care landlords.

Industrial sector landlords are seeing significant e-commerce tailwinds as logistics services tenants strive to improve product delivery times to customers in the critical “last mile” of the e-commerce value chain and the land available for such warehouses located in urban areas is limited.

**Company example: SEGRO**—owns urban and big-box warehouses, as well as warehouses used as data centers, with assets concentrated in the U.K. and continental Europe.

**Improved Business Models**

For most European countries, REITs are still relatively new. The REIT structure has only been available in the U.K. and Germany for about 10 years, and in Ireland and Spain for about five years. Like we have seen in the U.S., which has had the REIT structure for more than 50 years, European and U.K. REITs have increasingly adopted significant reforms that have improved environmental, social and governance (ESG) standards and increased shareholder returns.

These include:

- Simplified strategies involving less leverage, less development and greater emphasis on cash flow
- Increased specialization on specific sectors or regions
- More efficient capital raising
- Leverage-neutral share buybacks
- Increased insider ownership and improved compensation structures, better aligning the interests of managements and shareholders
- Greater accountability by boards of directors for management decisions and performance

Based on our observations, companies that have been successful in these efforts have often seen an improved cost of capital, giving them a competitive advantage versus the private market. Some “new kids on the block” have used these principles from the start and have seen solid total returns, with what we believe is still a bright long-term outlook.

**Compelling Valuations**

European REITs have experienced strong year-to-date gains through September 30, 2017. Yet valuations in general remain attractive both on an absolute basis and relative to global equities. Exhibit 4 displays real estate securities’ price-to-funds from operations (P/FFO), the real estate equivalent of price-to-earnings (P/E).

![Exhibit 4: Real Estate Securities Valuations](image-url)

**At September 30, 2017. Source: Morningstar, Cohen & Steers estimates based on proprietary qualitative and quantitative metrics.**

Data quoted represents past performance, which is no guarantee of future results. The information presented above does not reflect the performance of any fund or account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above. Real estate multiples measured by average price to funds from operations (P/FFO); equity multiples measured by average price to earnings (P/E). FFO is the REIT industry's key earnings metric, calculated as GAAP net income, plus real estate gains (or losses), GAAP real estate depreciation and amortization. See below for index definitions and additional disclosures.
We believe real estate securities represent attractive values relative to the broader global equity universe today.

Measured by P/FFO, the REIT markets in most countries are trading at the lower end of their five-year range. This is due largely to the fact that cash flow growth in most regions has exceeded the expansion in multiples. We believe valuations are low due partly to concerns over policy tightening by central banks. However, we expect the process of rate hikes and shrinking central bank balance sheets to be gradual. Provided the global economy continues to grow, we believe the uptick in yields should not have an adverse impact on real estate.

It’s also worth noting the relative attractiveness of global real estate securities. At 18.0x P/FFO, they are at the low end of their five-year range. This compares favorably to global equities, which, at a 19.3x P/E, are near the top end of their five-year P/E range. In other words, we believe real estate securities today are among the more attractive values in the broader global equity universe.

Closing Thoughts

Healthy economies throughout Europe are driving demand for commercial real estate at a time when supply is generally limited and credit conditions remain supportive. In addition, we believe valuations for real estate securities are attractive on an absolute basis and relative to global equities. Real estate also offers high income compared to most fixed income categories—income that may rise over time, potentially protecting against rising interest rates.

Differences in sectors and geographies underscore the importance of fundamental analysis, which is at the core of active management. By investing in an actively managed portfolio of real estate securities, investors may benefit from the insights of professional asset managers, who can adjust a portfolio’s allocation based on their view of the risks and opportunities offered by various securities and market segments.

A pioneer in the REIT investment market, Cohen & Steers has consistently delivered superior results for our clients for more than 30 years. Our competitive advantage in this unique asset class is underpinned by the world’s largest team of portfolio managers, analysts and traders, dedicated to identifying trends and opportunities in real estate securities around the globe.

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Index Definitions. All returns and investment characteristics discussed in this report are based on the indexes below. An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes. Global real estate/REITs: FTSE EPRA/NAREIT Developed Real Estate Index (net) is an unmanaged market-capitalization-weighted total-return index, which consists of publicly traded equity REITs and listed property companies from developed markets. Global stocks: MSCI World Index consists of a wide selection of stocks traded in 24 developed countries. It is weighted for market capitalization and is considered an important benchmark of the state of global stock markets.

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