Insights
Sector

June 2021

Europe ex UK Real Estate: Capture Recovery as Risks Recede

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- The sector has lagged the broader market since the start of the pandemic. However, as countries across Europe recently accelerated their vaccination programs and began to reopen, real estate has enjoyed strong performance, notably since March 2021.
- As key risks have been largely mitigated and valuation metrics remain undemanding, Europe ex UK real estate appears well positioned to capture the recovery.

Performance and Outlook

Continental European real estate have underperformed broader markets since the beginning of the pandemic. Against a challenging backdrop of lockdowns and elevated uncertainty, Europe ex UK real estate companies sold off heavily, particularly in the shopping mall and office owner categories. Residential landlords bounced back relatively quickly as real estate investors looked for some form of shelter and the importance of having a comfortable home workspace became evident.

Overall, in 2020 and Q1 2021, Europe ex UK real estate has been a complicated sector in a challenged region as European countries introduced multiple lockdowns. The region then lagged the US and the UK in terms of vaccinations, which delayed a return to office and broader economic reopening. Nevertheless, as countries across the continent recently accelerated their vaccination programs and began to reopen, real estate has enjoyed stronger performance, notably since March 2021.

There is still significant room for catch up in European ex-UK real estate compared with the broader market. This catch-up could be even more pronounced if the recovery across European and other major developed markets continues, as expected by State Street Global Advisors (2021 full-year GDP forecase, as of March 2021: +5.3% for the US,+5.5% for the Eurozone, +4.7% for Germany, +5.7% for France, +6.2% for the UK, +3.1% for Japan +3.8% for Australia and +7.7% for China).

Meanwhile, key risks to the Europe Ex-UK real estate sector appear to have been largely paired back. Accommodative monetary conditions and asset purchase programs allow for favourable financing conditions, and the ECB's cautious stance vis à vis potential rate increases reduces the risks of large declines. Moreover, liquidity support from central banks and governments helped both landlords and tenants.

In particular, the largest shopping mall owners across the continent secured financing, either through long-term bond issuance (with low coupons) or via revolving credit facilities. Listed office owners have maintained high occupancy rates in 2020 and long-term leases help provide a protection buffer. Finally, the five-year rent freeze in Berlin, which could lead to a spillover effect on other German cities, has recently been deemed unconstitutional by the German Constitutional Court, which reopens opportunities for companies involved in housing rent.

Figure 1

Total Return Year to Date

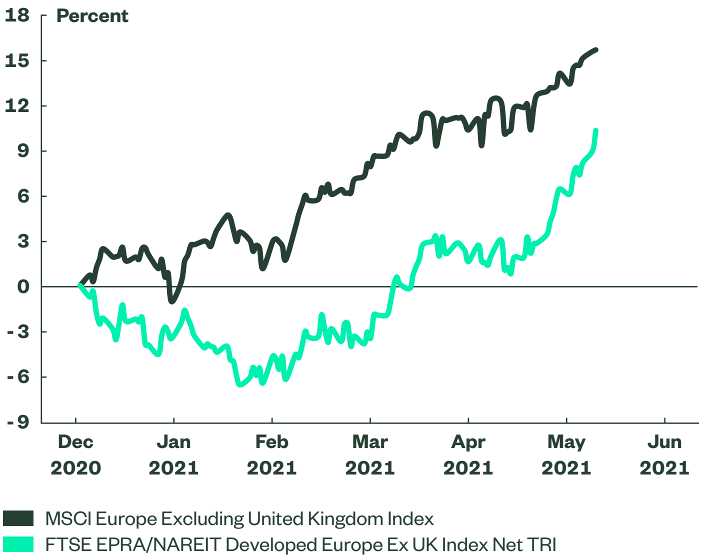
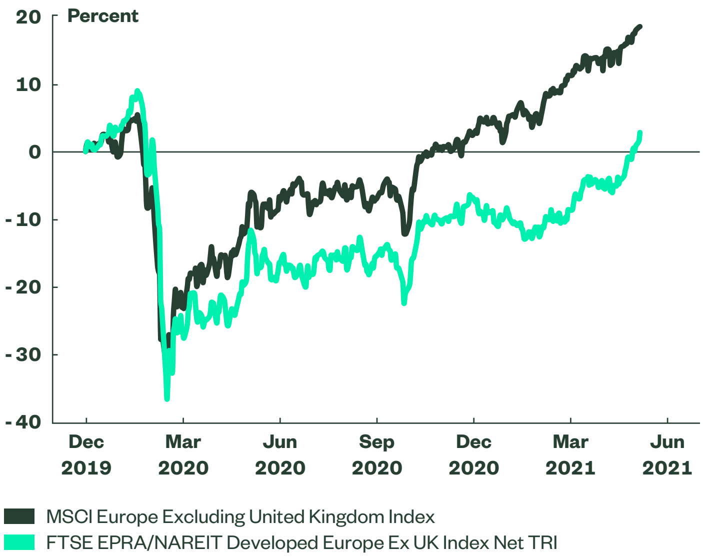


Figure 2

Total Return Since 1 Jan 2020



Source: Bloomberg Finance L.P., as of 8 June 2021. Performance in EUR. Past performance is no guarantee of future results.

Europe ex UK Real Estate Looks Undervalued Relative to Equities

Valuations for continental European real estate remain relatively attractive. Investors in Europe often compare NAVs to look for pockets of value within real estate. In light of the recovery, the sector trades at a 22% discount to one-year forward net asset value (book value). On a relative basis, the Europe ex UK real estate price to book still stands close to historic lows when compared to the broad Europe ex UK equity index.

In addition, the relative one-year forward P/E rebounded recently but remains below its long-term average. As a result, Europe ex UK real estate may not only be viewed as a value opportunity but also as an interesting cash flow proposition. This could be appealing in a persistent low yield environment and potentially bring some protection against an unexpected higher inflation environment.

Figure 3
Price to Book — Europe ex UK Real Estate

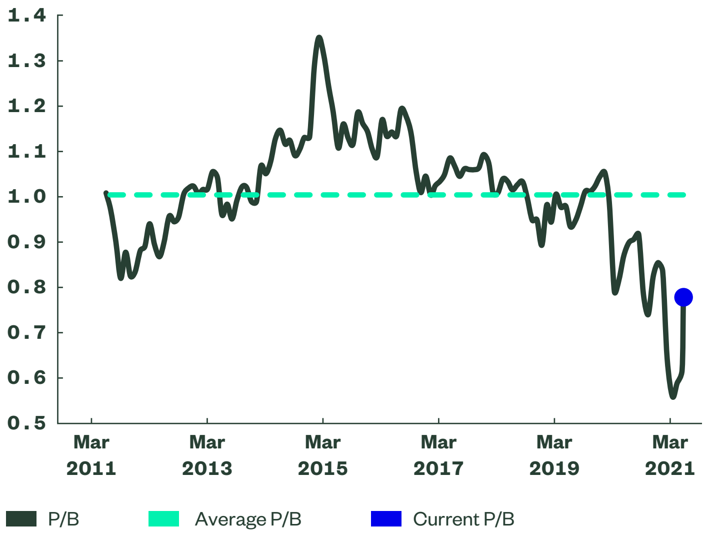


Figure 4
Price to Book — Europe ex UK Real Estate Relative to Europe ex UK Equity

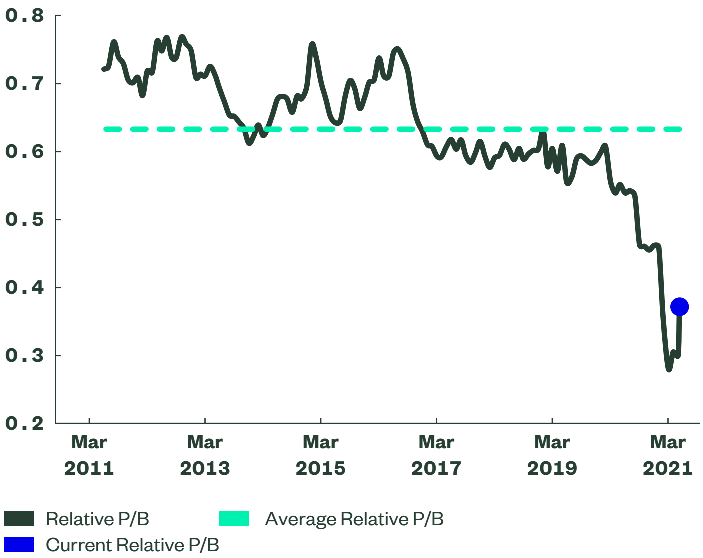
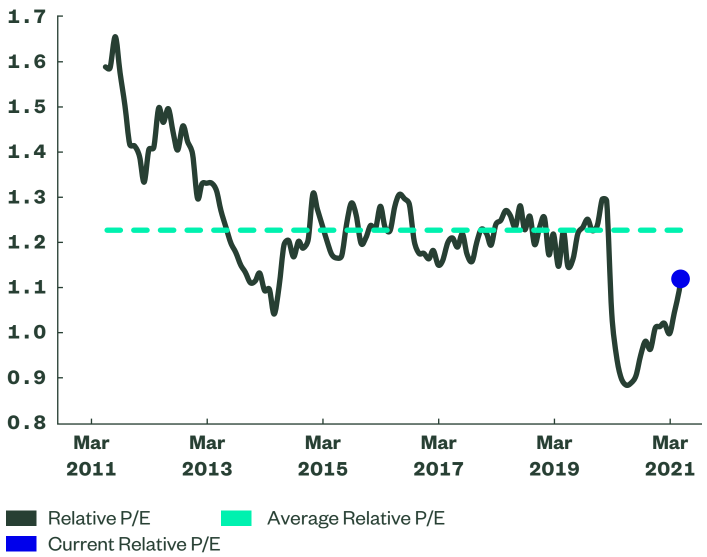


Figure 5
Europe ex UK Real Estate Relative to Europe ex UK Equity



Source: Bloomberg Finance L.P., as of 8 June 2021. P/E is 12m forward BEST_PE_RATIO while P/B is 12m forward BEST_PX_BPS_RATIO. Europe ex UK Real Estate is represented by FTSE EPRA/NAREIT Developed Europe Ex UK Index Net TRI. Europe ex UK Equity is represented by MSCI Europe Excluding United Kingdom Index.

Property Sector Breakdown

Europe ex UK real estate (represented by the FTSE EPRA Nareit Developed Europe ex UK Index) is a diverse sector offering unique exposures through its components. When compared to DJ Global Real Estate Index, it is more oriented towards residential real estate rather than logistics warehouses.

- **Residential Real Estate (35.5%)**[1] — Dominated by German residential real estate (more than 30% of the sector). Three out of five largest companies in the index are German Residential Landlords*: Vonovia (14.8%), Deutsche Wohnen (9.2%) and LEG Immobilien (4.4%). The structural supply-demand imbalance of the German housing market places landlords in a favourable position. This imbalance comes from both the demand and supply side, but the supply side is the key. Demand is growing with urbanisation trends and migration, but this can be viewed across other countries. Supply constraints, however, are unique.

  Rent controls allow rent increases year on year of only by a few percentage points. That, along with a broader increase in construction costs, keeps valuations of existing portfolios well below replacement values, making new builds less profitable for housebuilders and thus keeping the new supply in check. At the same time, the steady rent increase may be achievable as tenants are lining up for vacant apartments due to the supply shortage. These factors place German residential companies among the best positioned real estate businesses not only in Europe but also worldwide. In Berlin, the Constitutional Court deemed a five-year rent freeze unconstitutional, largely reducing the biggest risk for Berlin landlords. Finally, acquisitions within the German residential real estate may allow some cost reduction and hence improve operating margins further.

- **Diversified Real Estate (27.9%)** — Companies investing in various types of real estate, often owning a mix of retail and office space, along with residential and to a lesser extent logistics real estate. Diversified real estate entities tend to be more elastic and can adapt their portfolios faster to changing environments. This diversification allowed certain companies to fare better through the crisis. Diversified portfolios are particularly popular in Switzerland (majority of listed real estate companies in the index by market cap). The largest diversified companies also operate in Germany and Sweden (in that case with a significant residential footprint).

- **Retail Real Estate (10.4%)**[2] — Businesses in this sector have faced challenges around cash flow collection from tenants. However, the scale of listed companies allowed them to navigate through the crisis and they may now be well positioned to benefit from the recovery. As vaccination and reopening progress, particularly in developed countries, retail real estate could benefit from this positive trend, especially as this part of the market has not yet fully rerated to pre-pandemic levels.

  Companies noted strong footfall in shopping malls that have been open this year and, by the end of first half 2021, most shopping malls across the continent should see some level of reopening. The low interest rate environment has been one of the key supportive factors as the largest companies secured financing either through new bond issuance or via revolving credit facilities. Furthermore, leaders in shopping malls are deferring part of their capex, which is a sign of prudence.

* This information should not be treated as an investment recommendation.

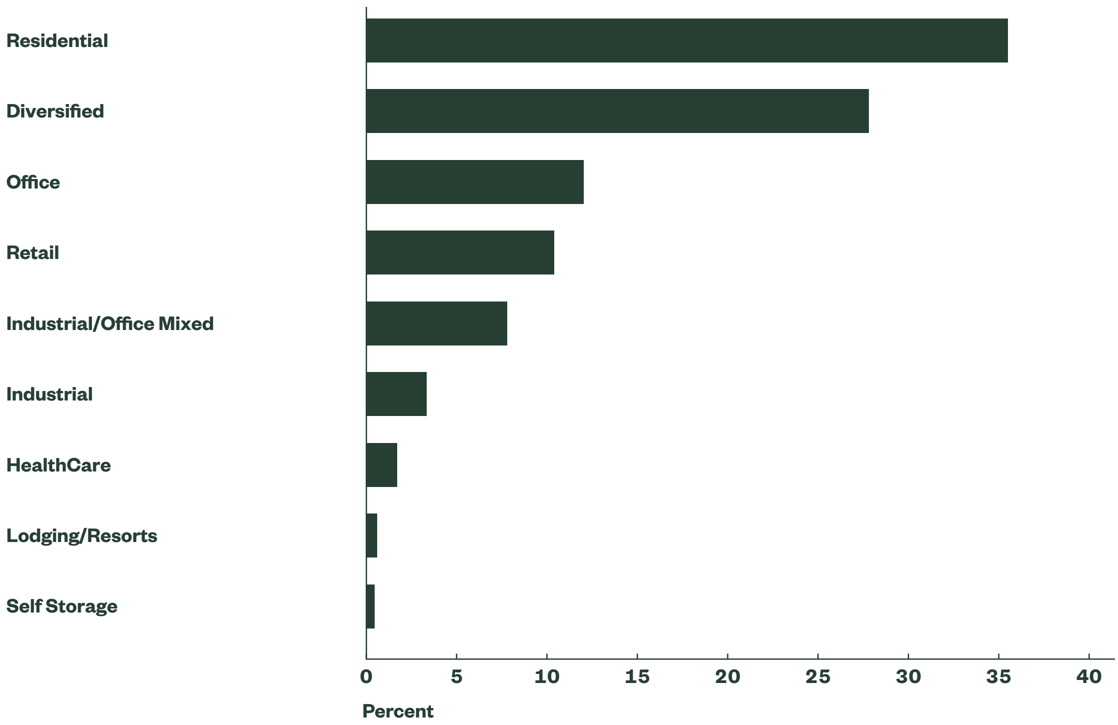
- **Office (12.1%)**[3] — The future of the office remains uncertain. Investors may be reluctant to invest in this segment given the narrative around lower demand for space in the future as employees around the world grow more accustomed to working from home. However, as tenants are reviewing their HR policies, offices are likely to remain an important part of businesses as they enable improved collaboration, relationship management and, importantly, talent retention. Companies often view their offices as a way to attract talent and this may be the key factor for office real estate to rebound and adapt.

  In addition, safety measures ensuring appropriate distance between employees create a natural barrier to cut any real estate footprint too aggressively. Real estate cost reduction is moving gradually lower on the tenants' agenda as the recovery continues. Some key liquidity risks appear to have been pared back as listed office owners from continental Europe in general kept their occupancy rates high. At the same time, rent collection losses were not as severe as investors may have anticipated in 2020. The weighted average unexpired lease terms tend to be longer than four years and liquidity support from the ECB and governments allowed tenants to stay afloat.

- **Industrial Real Estate (3.36%)**[4] — An increasingly important part of the market, boosted in Europe by the e-commerce megatrends. Online penetration has been slower than in the US and the UK but accelerated during lockdowns. Demand for warehouses is structural and is expected to continue beyond the pandemic.

- **Industrial/Office Mixed (7.8%)** — Industrial and office real estate represent a cyclical way to play the recovery. Meanwhile, the logistics real estate component is more structural and is set to benefit in the longer term from accelerated e-commerce penetration.

Figure 6
Europe ex UK Real Estate Property Sector Breakdown

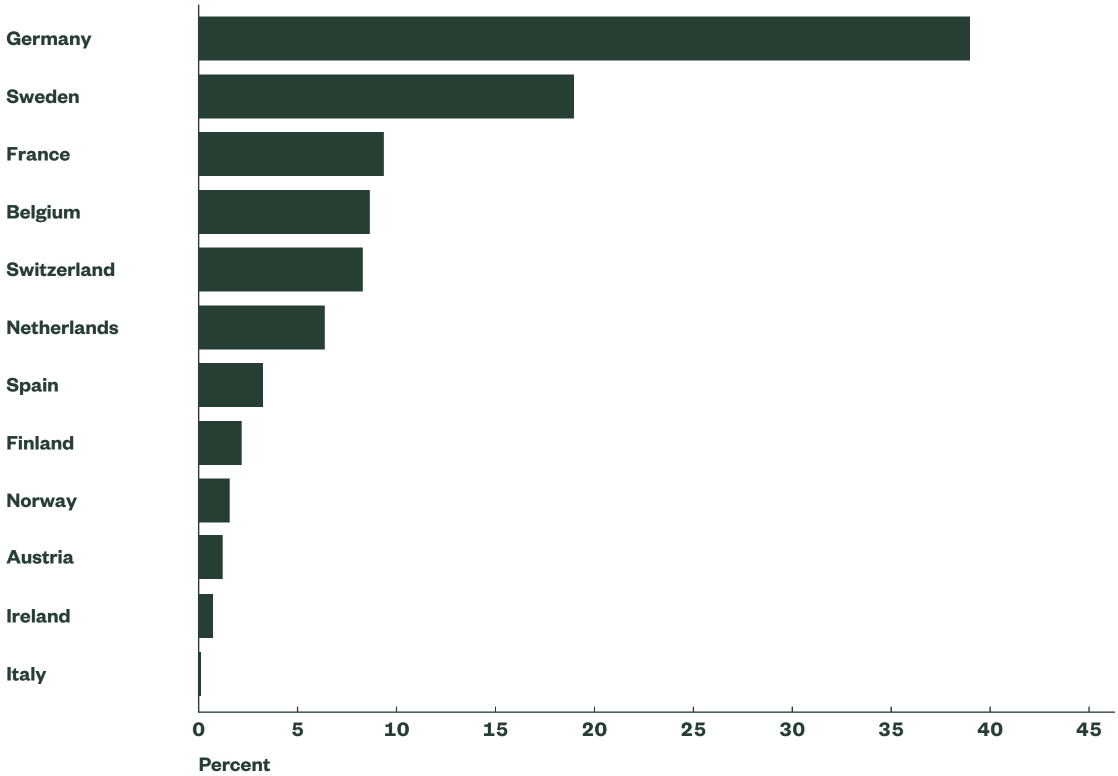


Source: FTSE Russell, State Street Global Advisors, as of 31 May 2021. Breakdowns are as of the date indicated and should not be relied upon as current thereafter.

Country Breakdown

German real estate accounts for 39% of the the FTSE EPRA Nareit Developed Europe ex UK Index. Residential real estate is the main component and is accompanied by office, retail and diversified exposures. Swedish real estate became the second largest weight in the index (19%) as office and residential segments flourished over the past several years. France and Netherlands together account for 15.7% of the index and include the largest pan-European shopping centre owners as well as the French office segment. Belgian real estate is relatively overweight to logistics, health care and student housing real estate and hence complements the more traditional diversified real estate exposures that are particularly present in Switzerland (8.4%).

Figure 7
Europe ex UK Real Estate Property Country Breakdown



Source: FTSE Russell, as of 31 May 2021. Breakdowns are as of the date indicated and should not be relied upon as current thereafter.

Endnotes

1 On an asset by asset basis, retail real estate share is higher as it is also a significant component of diversified real estate.

2 On an asset by asset basis, retail real estate share is higher as it is also a significant component of diversified real estate.

3 On an asset by asset basis, office real estate share is higher as it is also a significant component of diversified real estate and industrial/office mixed real estate.

4 On an asset by asset basis, industrial real estate share is higher as it is also a significant component of industrial/office mixed.

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