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INVESTING FOR THE NEXT STAGE OF EUROPE'S PROPERTY CYCLE – IS IT TIME TO TAKE RISK?

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A communication to investors

Property cycles are inescapable. Closely linked to the economy, real estate markets will inevitably rise and fall. The key to investing in them is to identify where we are in the cycle and to position portfolios accordingly.

Two key questions:

So where is Europe in the cycle?

What are the prevailing risks and how can they be addressed?

Savills Investment Management identifies four stages of the cycle:

Phase one
There is a sharp sell-off in the market: rents decline and yields rise as investors demand higher risk premiums. This phase can be aligned with the period around the global financial crisis (GFC).

Phase two
Rents continue falling, but yields stabilise. Generally speaking, this is where we were two to three years post the beginning of the GFC.

Phase three
Also known as the 'Goldilocks' phase, this is the best period for investment returns. Yields compress while rents start to rise. Clearly, this represents the tailwinds of the last three to five years.

Phase four
Yields stabilise but rents continue to rise because there is enough economic momentum in the market – a phase we seem to be in or approaching.

Where are we in Europe now?

Examining prime rents and yields in more than 100 markets, we can see that Europe has completed or is close to completing phase three and now entering phase four.

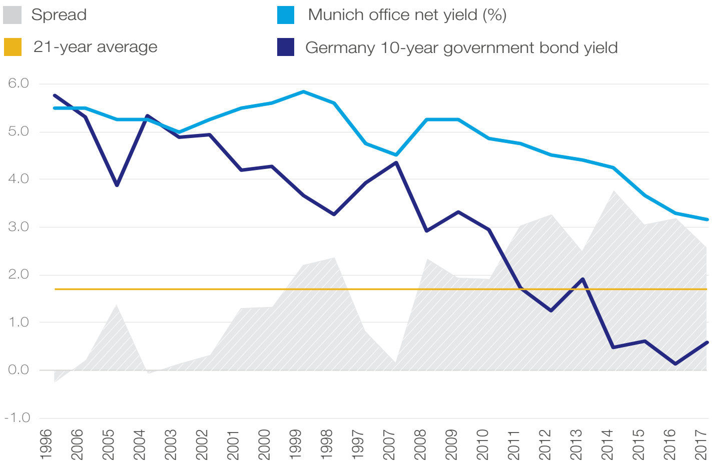
This is a general observation, however, because some locations such as London and Warsaw are already advanced into phase four. Others such as Paris and parts of Munich are just closing out of phase three and entering the final phase of the cycle.

We are seeing early signs that yield compression is slowing down. Interest rates are expected to continue rising, led by the Federal Reserve and followed by the Bank of England. According to the European Public Real Estate Association, REITs are generally trading at discounts of 21% for major players in the UK and 6% for those elsewhere in Europe. This collectively highlights that we are approaching phase four of the cycle.

Although real estate assets could be seen as fairly valued, they are still highly attractive, especially compared to fixed-income assets, which are set to see their capital values come under pressure as interest rates rise. Notable is the fact that the yield gap between prime offices and 10-year government bonds is approximately 250-350 basis points, which sufficiently compensates for the higher risk of investing in real estate.

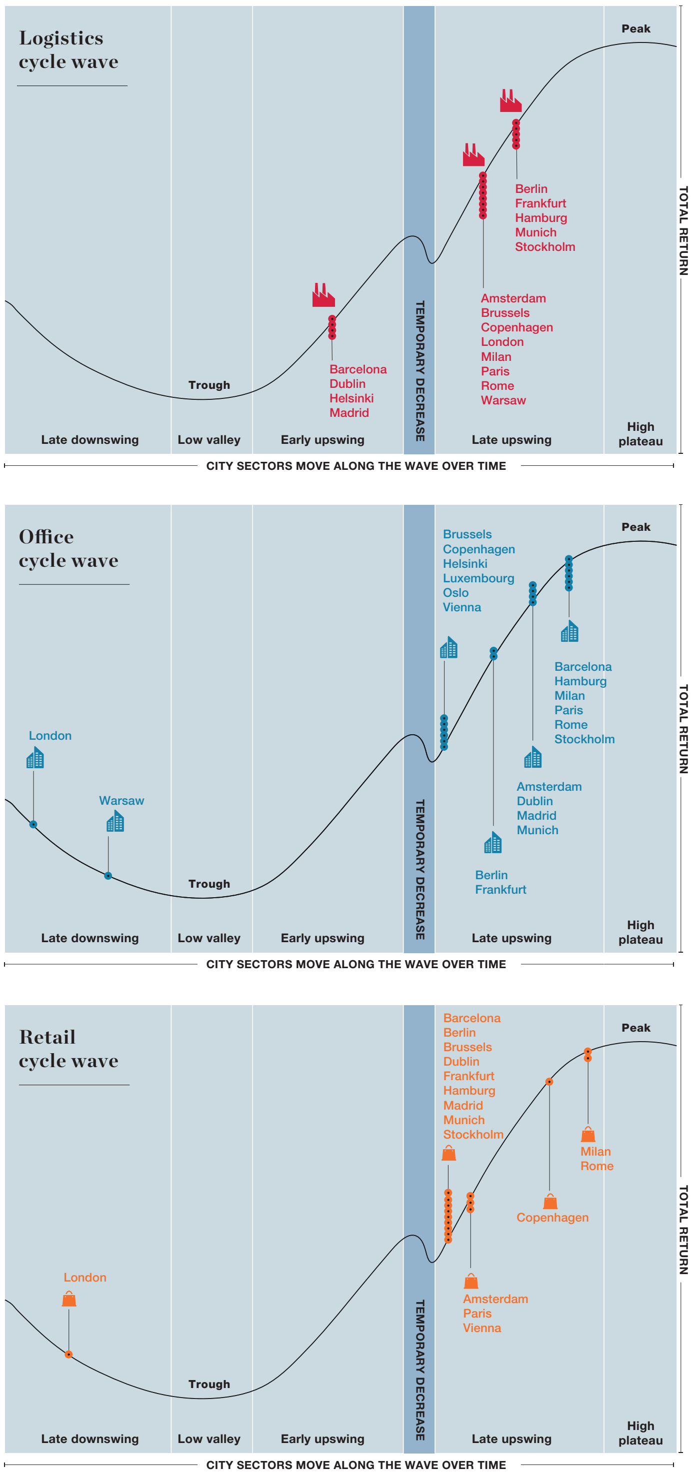
The fourth phase is marked by very strong optimism in the investment market. Banks typically lend aggressively, although they are lending less today because of the more stringent regulations introduced after the GFC. As such, the rise in property values has not been as sharp as in previous cycles. See the chart where the 2007-17 cycle is compared to that of the late 1980s to early 1990s.

FIG. 1:
Germany government bond and munich office yield



Sources: MSCI, Savills Investment Management

FIG. 2:
European Total Return Cycle



Sources: PMA, Savills Investment Management

Therefore, could future paradigms be somewhat different?

Are cycles becoming more elongated?

We have modelled three likely scenarios in the coming fourth phase. The first is our own base case, in which there is limited yield compression, but rental growth continues to support investment returns. This scenario is explored in further detail in our Outlook 2018 report.

In the second scenario (an upside case), monetary policy and a growing economy prove supportive, and real estate returns increase. Although the likelihood of this scenario is low, we could envisage banks and debt funds entering the market aggressively, providing very low all-in borrowing costs. This would result in rental growth and possibly further yield compression, prolonging the existing property cycle, which is now extending to nearly a decade. All types of property risk-takers would be rewarded, including core/core plus investors as well as those willing to take on illiquidity risk, weaker covenant risk and being in secondary/tertiary locations.

However, what goes up must come down. The fallout when the cycle comes to an end would be a sharper property market correction, one possibly no different to that of a major correction like we saw in the last GFC. A flight to core will prevail, implying that the riskiest investments are likely to fall the most.

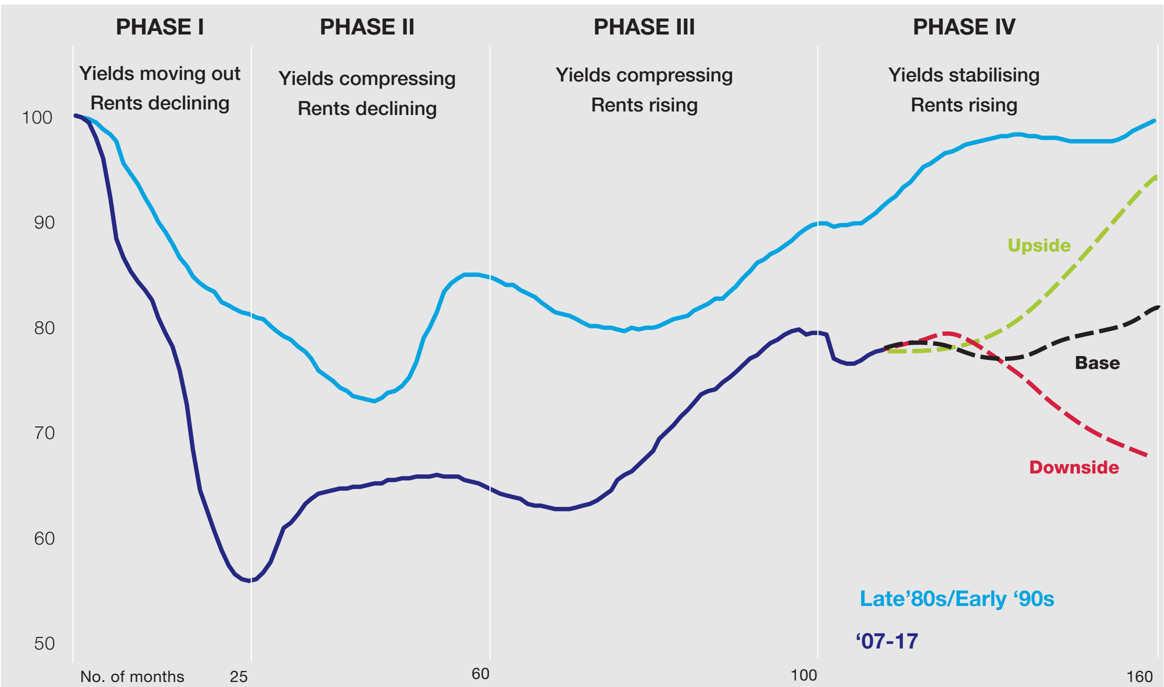
The third potential scenario is bearish compared to our base case. For example, investment uncertainty could rise because of geopolitical developments such as growing populism, Brexit, a trade war with the US or crises in the Middle East and Korean Peninsula. Investors must not underestimate any one of these risks. The income gap between millennials and - the baby boomers has widened and is showing no signs of narrowing. This cannot go on forever. Political parties need to be conscious of the policies they adopt if they want to stay in power.

Brexit is the unknown. Only time will tell if a smooth transition can happen or if there will be considerable volatility on the way. Challenges still lie ahead in areas of customs union, trade, security, the Northern Ireland border, etc. Many things to resolve with many countries in an environment where UK politics itself can bring twists and turns. Italy is also a concern given the hung parliament and where a far right party won the majority of votes. Not sure if an Italian exit of the Euro is on the cards? Italy has to do something to get its economic growth rate up. A weaker currency is strong tool but that is difficult under a Euro regime. Is an Italian lira a better option - "Italexit"?

US President Trump's blocking of the Broadcom-Qualcomm deal and his trade tariffs on steel and aluminium could undermine investment markets. The Trump administration trade sanctions announced thus far this year – on solar panels, washing machines, steel and aluminium – have been inconsequential from China's perspective: the US last year imported only around USD 6 billion worth of these products from China. Media reports, however, suggest that much more extensive tariffs are now being considered as a response to China's theft of intellectual property from US firms. These could cover US imports from China worth up to USD 60 billion. That would still be only 12% of China's total goods exports to the US, but enough, we suspect, to draw a response from Beijing and start a global trade war.

These factors could put a damper on the strengthening global economy, possibly leading to an earlier-than-expected market correction. In such an environment, it is best to be invested in core/core-plus property with strong, income-durable characteristics. Going up the risk curve today would not make sense if one expected a market correction to be around the corner – i.e., something akin to phase one of a new cycle.

Markets are approaching the final phase of the cycle - Scenarios



Sources: MSCI, Savills Investment Management

A strategy for 2018

If you accept our base scenario, what should investors be doing now.

Under this scenario, investors need an evolving strategy of two parts: secure income investing with some dry powder, and then switching to take advantage of the distress in the market as you start to see the rise in yields beginning to level off.

In our view, given the current backdrop, investors should focus on income protection and income enhancement. They should avoid taking unnecessary risks and look to reduce the 'satellite' exposure in their portfolios. Now is not the time for duration investors to be too adventurous.

As Europe enters the late-cycle (fourth) phase in 2018, investors are likely to benefit from buying defensive assets and creating and selling secure income. Accept the lower returns on offer – don't chase the higher returns as there is a higher probability of them not materialising.

Investors should be rotating out of cyclicals and shorter leases/older stock, instead choosing opportunities that are defensive against structural urban or demographic change. Examples of these include core city centre offices with strong rental prospects, urban logistics and retail warehouses, especially those designed to serve the growing 'click and collect' market.

We recommend seeking high alternative-use value in sectors with low obsolescence and under-priced 'teenage leases.'

The 'dynamic cities' that we identified in our special report last year, which benefit from a supportive backdrop in the wider European city context, should also be a focus.

Many investors may think core markets look expensive, leading them to go up the risk curve to find better value. We see this as a mistake given the possibility of a correction in a few years time, given all the potential downside risk and volatility that entails. Instead, we firmly advocate core to core-plus strategies.

The key to success

Whatever the market conditions, stock selection and understanding market dynamics is key. Investors will benefit from partnering with managers that can draw from the benefits of a broad network of offices and local market understanding to source and add value to assets.