ALTERNATIVES

# European Real Estate Equity: Uncovering Value City by City

BARINGS CONVERSATIONS

This piece was adapted from an interview with Charles Weeks.
The full audio podcast can be found ***here.****

In this Q&A, Charles Weeks, Barings' Head of Real Estate Equity for Europe and Asia Pacific, discusses the backdrop for European real estate markets, where the team is seeing the most value by sector and geography, and why, in all cases, they take an active approach across strategies and investment styles.

*Full podcast URL: https://www.barings.com/us/institutional/viewpoints/european-real-estate-late-cycle-value-from-manchester-to-munich

*Having a presence in one market, like Berlin, doesn't necessarily equate to being able to execute deals in Frankfurt. It's important to be local to those markets—which is the reason we have such a significant presence in Germany, with five offices and about 50 people."*

## As investors hear rumblings of a coming recession, and wonder how to navigate markets at this point in the credit cycle, what is your view on the overall backdrop for European real estate?

I would certainly say that we are in the latter stages of an extended real estate cycle, which has now been going on for over 10 years—due in part to the quantitative easing and low interest rates of the previous decade. But despite the headwinds we're facing—ranging from global trade and political uncertainty to weakening economic sentiment—the markets are still fairly well supported from a fundamental perspective, bolstered by an increasingly dovish ECB and Bank of England. Generally speaking, we've seen resilience in labor markets—particularly in the service sector—and real wages are rising for the first time in a decade, which bodes well in terms of sustaining domestic consumption. Additionally, leverage remains in reasonable territory. While Eurozone growth has been fairly modest, around 1.2%, property prices offer significant relative value to other assets—and we are seeing strong inflows of capital to European real estate, which should support markets going forward across multiple sectors and styles.[1]

## Within European real estate, can you explain the various attachment points across the risk-return spectrum? At what stage does Barings invest?

The most stable assets—or bond-like assets, from an income perspective—are **core** and **core-plus** investments. These generally have strong covenants with long leases, and they tend to be located in the largest, most liquid markets—which means the yields are typically modest, but so are the risks. The target returns are often in the 6–7% range—about two-thirds current income and one-third capital appreciation—and have relatively low leverage, maxing out at about 30% loan-to-value (LTV).

**Value-add** investments often involve acquiring well located but capital starved, under-managed assets—often with impending heavy vacancies—with the intention of fixing them and selling them to core investors. They could also include a forward funding—where you're essentially buying an asset that's still under construction, with strong conviction that the completed building will be leased up quickly—while the developer retains the development risk in terms of timing and cost overruns. Target returns for value-add are higher, in the 10–12% range—with a significant portion coming from capital growth, rather than current income—and they tend to have a LTV up to about 60%. In that respect, it's more of a capital value play than an income play.

Then there are **opportunistic** investments—which are perhaps best encapsulated by ground-up, 100% speculative types of developments, usually located in fast-growing markets. The risks are highest for these assets, but so are the target returns—around 15% or greater—with LTV typically starting around 70%.

Barings' real estate team invests across the entire risk spectrum—from core and core plus, to value-add and opportunistic. We believe this is a meaningful advantage, as we understand the nuances of the markets that we buy and sell into. If we buy a value-add asset, or execute a ground-up development, we frequently sell it to a core buyer. We understand what those investors expect, because we are also one of them. From that standpoint, as a core investor, we can confidently underwrite long-term holds, because we understand the evolution of a core asset as it ages and/or experiences tenant turnover. This insight benefits the investment throughout its life. Also, regardless of style, we believe in implementing an active management approach. We always look to buy assets that have bandwidth for value creation—where we can improve the Net Operating Income (NOI). This is even true for the most stable core assets; there really is no such thing as a 100% passive property investment.

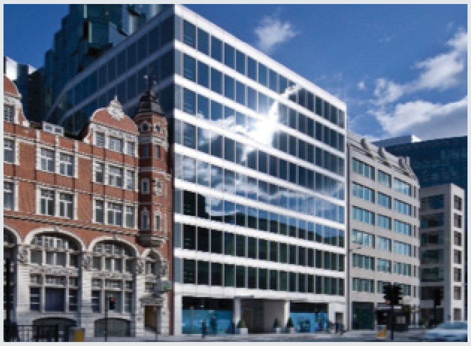
## As you step back and look across a very diverse region, what geographies within Europe present the most compelling opportunities today?

In the current environment, we're seeing valuable investment opportunities in many of the major gateway cities across Europe—particularly those with favorable structural and cyclical drivers, in addition to strong fundamentals. Specifically, where there's a shortage on the supply side, we're seeing some good traction. Right now the standout markets for us include Stockholm, Madrid, Manchester, Amsterdam, and a number of German cities—particularly Berlin and Munich. Germany is the largest market in Europe, but it's also one of the most complex and opaque—largely because of its polycentric nature. So, having a presence in one market, like Berlin, doesn't necessarily equate to being able to execute deals in Frankfurt. It's important to be local to those markets—which is the reason we have such a significant presence in Germany, with five offices and about 50 people.

1. Source: European Commission. As of September 2019.

# CASE STUDIES

## CASE STUDY: Enhancing Core in London



| | |
|---|---|
| LOCATION | London, U.K. |
| SECTOR | Office |
| STYLE AT AQUISITION | Core |
| SIZE | 14,670 SQM |
| ACQUISITION DATE | October 2013 |
| SOURCE | Competitive |

**Nexus Place** is a 14,670 square meter office building in London, located in close proximity to Crossrail—a brand new high frequency, high capacity railway that will cross the city from east to west. Barings purchased the building fully leased in October 2013. The team then began speaking to tenants and conducting rent reviews, ultimately reworking the rental profile of the building. This increased the rental rate from £35 per square foot to £66 per square foot, on average.

## CASE STUDY: Adding Value in Milan

| | |
|---|---|
| LOCATION | Milan, Italy |
| SECTOR | Office |
| STYLE AT AQUISITION | Value-Add |
| SIZE | 12,043 SQM |
| ACQUISITION DATE | December 2016 |
| SOURCE | Off-Market |

**Via Pola** is a 12,043 square meter office building in Porta Nuova, the rapidly emerging new business district of Milan. Built in the 1970s, the building was in need of significant structural and cosmetic improvements. While the average rental rate at the time of purchase was €260 per square meter (PSM) for the market overall—it was only €159 PSM for this building. In December 2016, Barings acquired the building vacant, and did a comprehensive repositioning—which included a new façade, reconfiguration of the ground floor to incorporate a new reception area, and replacement of the retail tenants. The locally-based team then re-leased the majority of the units. Although the estimated rental value (ERV) for the refurbished building was €360 PSM at the time of completion, the current rental rate is over €400 PSM—significantly higher than the investment team's expectations.

## CASE STUDY: Creating Opportunity in Berlin

| | |
|---|---|
| LOCATION | Berlin, Germany |
| SECTOR | Office |
| STYLE AT AQUISITION | Opportunistic |
| SIZE | 19,600 SQM |
| ACQUISITION DATE | August 2016 |
| SOURCE | Off-Market |

In August 2016, Barings invested in a ground-up office development in the heart of Berlin—one of the most competitive markets in Europe—located in close proximity to the city zoo. The original building was demolished, and the investment team developed plans to replace it with **Budapester Strasse 35**, a brand new state-of-the-art building with 19,600 square meters of space and multiple terraces. The building was already 35% pre-let before construction began—and once complete in mid-2020, the team will likely look at potential exit options.

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## Shifting gears to sectors, we've seen a real sea change in technology with the rise of e-commerce. From your perspective, how is that affecting the retail and logistics sectors?

**Retail** is undeniably one of the most challenged sectors in the market, as a consequence of the "e-tailing" trend. That said, shopping patterns vary across the landscape. They're far more distinct in the core Northern European markets—with the U.K. seeing retail internet penetration levels above most other European markets, followed by Germany and the Nordics. But in Southern Europe, internet penetration rates hover at just 3–5%.[2] There is an expectation that these markets will eventually succumb to the change in shopping patterns as well—but the impact is not solely as a result of e-tailing. Floor space is also an important factor—specifically the amount per capita in each individual market. For example, the U.K. has relatively high floor space per capita, compared with other European markets. What we're seeing is a crunch on anything that is secondary, generally speaking, and certainly anything that is tertiary in the retail sector. Additionally, in light of the capital erosion that we've witnessed in the space, retail assets that are dominant in their specific territory—particularly those with a monopoly position—will likely be best suited to weather any threats posed by similar new developments coming online.

On the flipside, one sector that's benefitting from the challenges facing retail—specifically the supply chain disruption—is **logistics**, where vacancies have been falling for the last decade. In 2009, the vacancy rate was about 15%, whereas it's closer to about 4% today—which proves supportive for rental growth and suggests that the sector is well-positioned for the foreseeable future.[3] In fact, Barings has looked for opportunities to capitalize on this trend, and we've acquired over $800 million in logistics assets across Germany, France, Spain and the U.K. in recent years.[4]

## What types of opportunities are you seeing in other sectors?

We tend to think of the **office** sector as being more cyclical, with higher rents and occupancy during times of economic strength, and vice versa. However, there's much less fluctuation in the major gateway cities of Europe, which tend to have relatively low vacancy rates that, in many markets, are continuing to fall. Typically the inflection point for rental growth, especially in the U.K., is anything sub-8%—and across Europe, the vacancy rate is currently around 6% overall.[3] While there's undoubtedly a pinch in certain markets, in others—Munich, central Paris and Berlin, for example—the vacancy rates are currently 2–3%, thereby still supporting strong rental growth prospects.[3]

We also have a space in Europe that we refer to as **alternatives**. This primarily comprises apartments, student and senior housing, and hotels—and is still less developed in some areas within Europe, relative to its more mature, established presence across the U.S. Considering some of the constraints we're seeing in other markets, coupled with the amount of capital available for real estate investment in Europe, this sector looks particularly attractive—and continues to generate interest among investors for its potential to provide strong, stable cash flows, attractive yields and capital returns. As evidence of this, 30% of all assets acquired in the U.K. so far this year have been in alternatives.[5] In fact, in some markets, we've seen record levels of investment in this sector.

2. Source: Centre for Retail Research. As of 2018.
3. Source: Cushman & Wakefield. As of September 2019.
4. Source: Barings. As of June 30, 2019.
5. Source: RCA. As of September 2019.

## All things considered, what manager attributes should investors consider when investing in the space?

Despite being late in the cycle, plenty of attractive opportunities remain across European real estate markets. But careful manager selection is a critical component—and there are a series of manager attributes to consider before making an investment. First, and perhaps most importantly: Is the manager **local to the market** in terms of origination? In other words, do they have a presence with respect to deal flow and sourcing transactions, understanding the nuances and cultures of the market, and executing both in-market and off-market transactions? Second, when it comes to carrying out business plans: Do they keep all of their **key skill sets in-house**, or do they outsource to third parties? Having those internal resources—to execute the investment management, asset management, project management, and even development services in some markets—can create a strong competitive advantage by effectively retaining the value enhancement aspects of real estate, without losing control or oversight of the investments. Third, regarding their management style: Do they employ a truly **flexible approach**? Because investors have unique objectives and requirements, being able to access and invest across regions, countries and sectors by employing different strategies—whether core, core-plus, value-add or opportunistic—is a meaningful differentiator of a consistently successful property investment manager.


### Charles Weeks

Head of Real Estate Equity—Europe & Asia Pacific


*Charles Weeks is a member of Barings Alternative Investments, a global real estate, private equity and real assets platform. Charles is a Managing Director and Head of Real Estate Equity—Europe & Asia Pacific, overseeing the European and Asia Pacific real estate platform. He leads the development of the European and Asia Pacific real estate business strategy and oversees key aspects of its implementation to further the group's reputation and ensure its success. In addition, he serves on the European/Asia Pacific and Equity Securities Investment Committees. Charles has worked in the industry since 1992. Prior to joining the firm, Charles was responsible for business development and investor relations activities at Protego Real Estate Investors LLP, which he founded in 2004 and the firm acquired in January 2010. Charles was also responsible for corporate marketing and sales at Aberdeen Property Investors International. His experience has encompassed devising, arranging, structuring, marketing, and closing a number of collective investment schemes, targeting U.K. and European institutional investors and clients, as well as property derivatives and synthetics. Charles holds an estate management degree from the University of Central England. He is a Member of the Royal Institution of Chartered Surveyors and a member of the Investment Property Forum.*

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