Real Estate Investments in Europe – Monetary Turnaround on the Move?

Between theory, risks and irrationality

While the focus in the real estate context is essentially on returns, risks are mostly neglected. Hiding risks is a practicable, but not an efficient risk avoidance strategy. People ignore hazards that are completely obvious because they are used to them until the hazards get out of control. In the real estate fund industry, the traditional maxim is "we don't put all our eggs in one basket". In last year's two studies on the subject of "yield and risk analysis", we were already concerned to increase sensitivity to unlikely events and have increasingly dealt with the subject of "distribution analyses of total return yields". On the one hand it was worked out in particular that the classical normal distribution assumption adequately describes the empirical distribution of returns in the rarest cases for real estate investments (Market Tracker – November 2016: "Risk analysis of European commercial real estate investments up to 2020 – the occurrence of highly unlikely events"). On the other hand, model-theoretical returns were calculated and derived risk premiums were checked for plausibility (Market Tracker – November 2017: "Commercial real estate investments in Europe – risk evaluation in times of boom and uncertainty"). In the context of this year's analysis, we would like to contribute to an analysis of the effects that property market values experience when monetary policy returns to normal. In addition, strategic premises for real estate investment are derived from the analytical interrelationships.

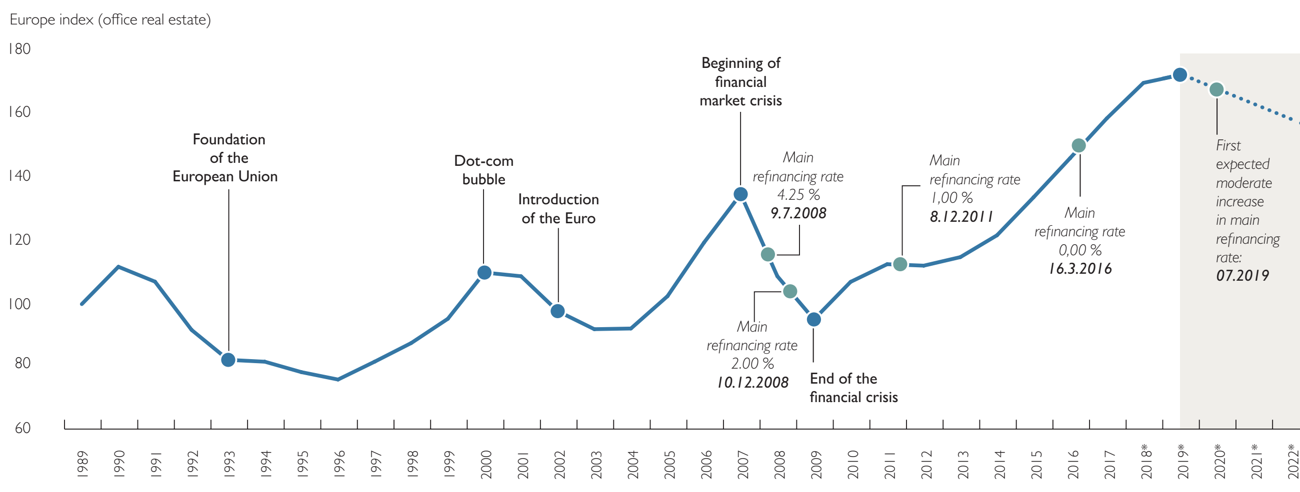
The economic environment in Europe at the turn of the year 2018/2019

Before we deal with real estate market risk and capital market risk, we must first consider the economic environment and thus the country risk. Despite the non-homogeneous economic development of the national economies in Europe, it can be seen that the interdependence of the economic activities of the various countries of the old continent is becoming ever greater. Discrepancies are often more political than economic. Some countries have been back on a long-term growth path for years, and many economically weaker nations are also developing very positive in recent years.

Real estate market developments and monetary policy conditions

The European commercial real estate market is subject to a very cyclical development. In the past, both clear upward and downward movements were discernible. Market developments are the result of fundamental supply and demand factors and speculative behavior. Another important factor is the level of interest rates. In recent years, the European Central Bank (ECB) has used both conventional and unconventional monetary policies. As part of its conventional monetary policy measures, the ECB abruptly reduced the main refinancing rate ("main refinancing rate") from 4.25 % to 2.0 % to 1.0 % following the flare-up of the US subprime crisis. Although a slight interest rate hike was implemented at the end of 2011, the ECB gradually reduced the interest rate to zero. As a result, various "quantitative easing; QE" programs were adopted as part of the unconventional measures. At the same time – from the end of 2009 until today – prices for commercial real estate in Europe have risen. In the current "super-cycle" alone, prices have risen by 54 %. The general influence of monetary policies on prices is undisputed. The monetary policy measures implemented in recent years have led to a massive inflow of liquidity into the European real estate markets and to a compression of the initial yields of real estate for all types of use.

FIG. 1: CYCLICS OF THE EUROPEAN COMMERCIAL PROPERTY MARKET

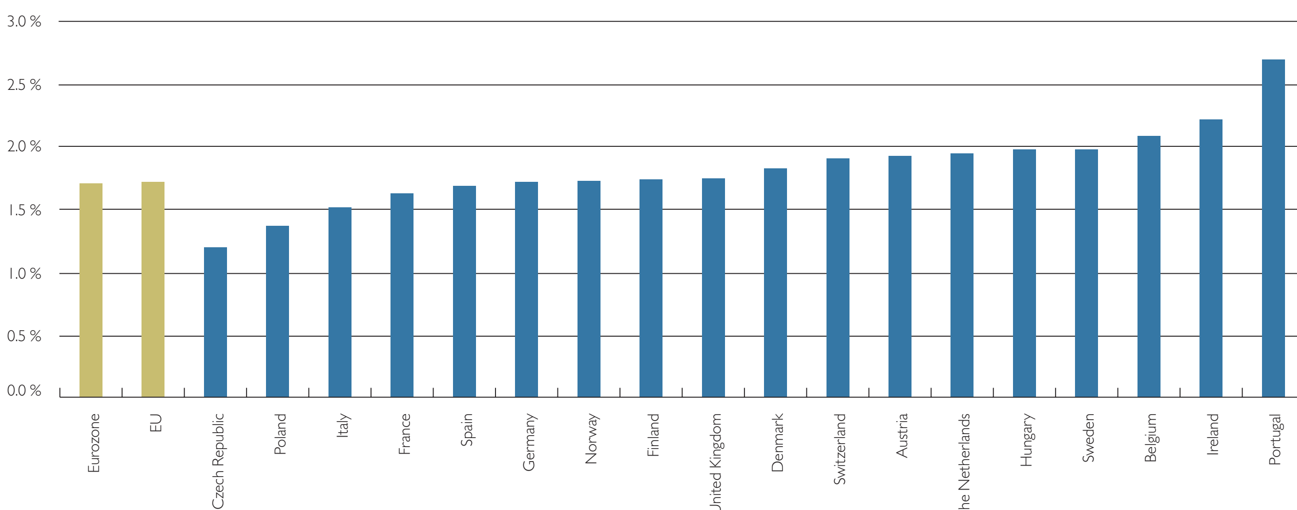


* Forecast
Source: Property Market Analysis (PMA) / Calculation & visualization: Catella Research 2019

A monetary policy scenario until 2022

The future course of the ECB is being discussed controversially. While opponents of the policy demand an end to what they consider to be a misguided strategy, supporters demand an unconditional continuation of the measures. The current environment of stable economic growth with moderate inflation will probably bear fruit even without additional monetary policy impulses. The national debt in most Eurozone countries would still be sustainable with higher interest rates, as maturing high-yield bonds from times before the financial crisis are still being extended at comparatively moderate conditions. The banks are also better capitalized today and are financing themselves more long-term. A normalization of monetary policy is therefore expected in the medium term. If the ECB orients itself on the interest rate cycle of the Federal Reserve Bank (FeD), three interest rate steps per year can be expected. Due to the potentially more restrictive monetary policy, it is expected that the yield on government bonds will rise significantly in all European countries. We expect that a change in monetary policy could raise national government bond yields by up to 270 basis points by 2022. On average, the yield on a fictitious European government bond (Eurozone) could rise by 171 basis points to 2.75 % by 2022. Due to allocation effects, such a development must also be considered for real estate investments. Against this background, a real estate investment should react to this development with limited elasticity.

FIG 2: EXPECTED RISE IN GOVERNMENT BOND YIELDS UNTIL 2022



Source: Oxford Economics
Calculation & visualization: Catella Research 2019

The development of rents until 2022

Catella Research expects that rents for office investments will rise significantly until 2022 due to the positive economic development in numerous European cities. In a European comparison, Berlin is clearly leading the rental growth list with +20.0 %. Basically, it can be assumed that the largest growth rates will be achieved in the major metropolises. Medium-sized cities and small towns have positive growth rates below 10 %. The higher expected rental dynamics in the larger metropolises – in addition to increased liquidity – mean that numerous fund concepts only include the large cities in their geographical allocation. However, this does not go far enough, as the primary focus is on the real estate market. The capital market and possible allocation effects on this market – triggered by a different interest rate level – are largely ignored.

Development of net initial yields until 2022

In an upturn in the market, rising rents and rising factors - and thus declining initial yields - are generally associated with the upturn. An economic depressive phase is analogous to this characterized in that rents and factors decrease over time. For the upcoming years, however, it can be assumed that on the one hand rents in cities will continue to rise due to the favourable economic development. On the other hand, however, it cannot be assumed that the factors will continue to rise due to the expected more restrictive monetary policy. If the European interest rate level rises again, alternative investments will be partially substituted by fixed-income investments. Rather, it is to be expected that the market will experience a decompression of returns. Initial yields in Berlin are currently below 3.0 %. Munich, Frankfurt and Hamburg have yields around or slightly above the 3 percent mark. In medium-sized German cities such as Munster, Leipzig and Hanover, initial yields are just under 4.5 %. This corresponds to a premium of almost 50 %. In the rest of Europe, cities such as Aarhus (4.5 %), Lille (4.75 %), Rotterdam (5.05 %) and Utrecht (5.75 %) also generate significantly higher initial yields than the corresponding metropolises. In the event of a change in interest rates, real estate investments in medium-sized cities will therefore face less competition from fixed-income investments with higher interest rates than low-interest real estate investments in large cities.

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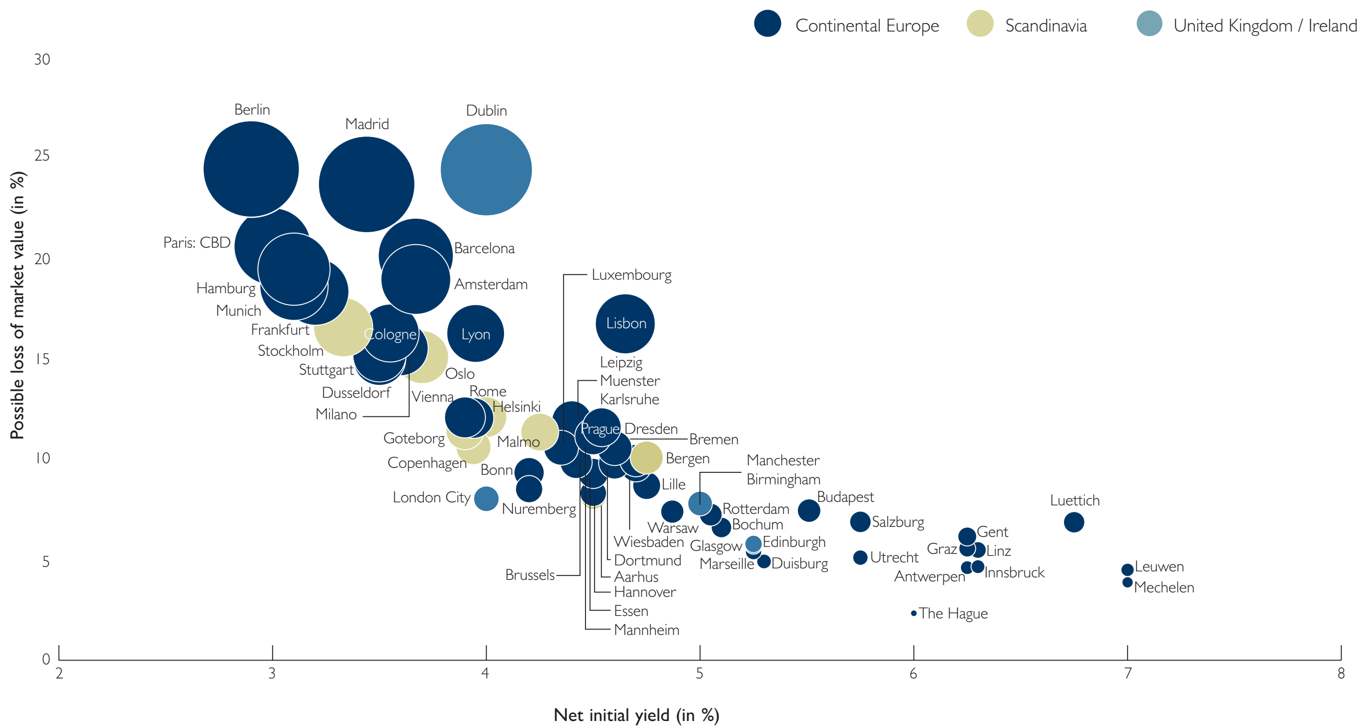
Summary and strategic implications for the Real estate investment 2019

"Rent" and "return / factors" are two sides of the same coin and should not be considered in isolation. The analysis assumed that government bond yields would rise by an average of 140 basis points by 2022. By combining interest rate expectations with the elasticity analysis, an expected loss in market value can be modelled before possible rent compensation. It can be seen that numerous large cities will have to accept losses in market value of more than 15 % by 2022. This effect is much smaller for medium-sized European cities. Obviously, there is a falling convex correlation between market value losses and the level of the net initial yield. The analysis primarily reflects the effects of the capital market. Consequently, the real estate markets and thus the rental growth potential must be included again in the analysis in order to be able to evaluate an overall model. Due to robust economic development and moderate construction activity, it can be seen that a loss in market value resulting from the capital market can be compensated by rental price developments. This would require, for example, a rental growth of 32.3 % for a real estate investment in Berlin. The forecast analysis also assigns a high growth potential of 20.0 % to Berlin. Nevertheless, the growth potential must also be realised. This can only take place if the properties have a very short remaining lease term (WAULT; Weighted Average Unexpired Lease Term), so that the rent increases can also be implemented contractually and de facto by re-letting. If this is the case, however, it is difficult to claim that the property is still a core investment. Rather, the asset must then be classified in the "Core Plus" or the "Value Add" segment. In the case of real estate investments in smaller cities, real estate managers can already compensate for the price effect by achieving low rental growth rates. It is therefore currently a good idea to make real estate investments in medium-sized cities, especially within the framework of core strategies.

FIG. 3: ADAPTIVE EXPECTATIONS AND MARKET VALUE ANALYSIS 2019



Note: The size of each bubble symbolizes the necessary rental growth for compensating fully the interest rate effect.

Source: Catella Real Estate AG
Calculation & visualization: Catella Research 2019

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