Global real estate

Five themes for 2015

by Richard Gwilliam, head of research, M&G Real Estate

Global real estate looks to be on track for another strong year, building on 2014's performance. We expect the U.S. market to continue to perform well, but there are also attractive opportunities further afield — which come with the additional benefit of diversification. Here, we would like to highlight five key themes for global real estate investment over the short to medium term.

Value in Europe

Continental Europe has lagged the global economic recovery — and the consequent rises in property prices. As a result, Europe now appears to be offering some of the best value across the globe, and we believe that this will continue to attract investors into the region.

We expect secondary yields across Europe to compress further during this year, driven by the improving investor risk appetite and brightening occupier fundamentals. Vacancy rates are gradually falling in the prime markets, reflecting the limited supply of top-quality space due to the constrained level of construction seen in recent years. It will take time for this to filter down to secondary properties, but the overall trend is definitely encouraging.

Of the three main sectors, we expect offices to see the strongest prime rental growth over the next five years. Here, Germany looks well-positioned in terms of fundamentals, with Munich in particular forecast to experience rapid growth in prime rents.

Looking at the investment market, industrials continue to show the best relative value in Europe, with prime capital values on average still about 25 percent below their 2007 peaks. The continued interest from investors is expected to provide the sector with the best relative performance prospects in the short to medium term, thanks to the potential to benefit from structural changes such as the rise of e-tailing. The traditionally high yield, high income return nature of the sector should also help.

Secondary assets in U.K.

The U.K. real estate market enjoyed one of its highest returns in a quarter of a century in 2014. While we do not rule out that returns may moderate somewhat this year, we expect performance to remain very strong.

However, with much capital targeting real estate, we expect 2015's biggest challenge for investors to be finding the best opportunities in such a competitive marketplace. Investors already appear to be reducing their required returns, and there is increased risk that some may be pushed into overpaying for assets, or driven towards riskier property or markets where occupational fundamentals are less likely to justify sharply rising pricing.

The key in the U.K. is to focus on good secondary assets. We believe that "location, location, location" is an important mantra for investors, with lesser-quality assets in good locations likely to offer better longer-term opportunities from an income

M&G Real Estate portfolio spotlight: Crossrail opportunities

Officials estimate that Crossrail will generate at least 75,000 business opportunities and support the equivalent of 55,000 full time jobs around the U.K., as well as significantly improving transport links into and around London and Heathrow airport. A number of our current investments are on track to benefit from the scheme.

Victoria Square, Acton, London

The forward-funded scheme is set to provide 152 private rental homes in Acton, West London. We see strong opportunities in the UK multifamily sector (known locally as the private rented sector, or PRS) against a backdrop of a rapidly growing population, a socio-economic shift from buying to renting and cross-party political support. The location already enjoys good transport links and will further benefit from the arrival of Crossrail (which will halve train journey times into central London to 9 minutes) and the broad regeneration which that is expected to bring.

1 Forbury Place, Reading

The 185,000 sq ft state-of-the art office development is located in the town centre of Reading, which is due to be linked both to Heathrow Airport and to central London by the high-speed Crossrail by 2019. The scheme, which is already in development, is targeting top environmental credentials to meet a growing demand for sustainable, energy efficient buildings from UK occupiers.

R+, Reading

Also in Reading, this 'Grade A', 100,000 sq ft office development is due to be completed by the end of this year. It will provide six floors of prime office accommodation behind a copper clad façade, located immediately opposite the train station. We expect occupier demand to be supported by limited pipeline of new, top-quality offices, along with strong rental growth prospects in the area.

Quantum Business Park, Maidenhead

We acquired the business park in 2014 for an initial yield of 6.7%. The scheme features two 'Grade A' office buildings totalling 123,217 sq ft, multi-let to six tenants. Maidenhead is one of the prime office locations in the South East of England, with its credentials set to be further boosted by the arrival of Crossrail in the next three to four years.

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perspective than better-quality assets in weaker locations.

In particular we see attractive opportunities in the office sector outside London — in well-linked locations in the southeast and in some of the top regional cities such as Manchester, Edinburgh and Leeds — as well as in the industrial sector. In retail, assets which have "destination appeal" — prime pitches in larger towns and well-serviced shopping centers — are likely to outperform.

Growing core markets in Asia

The Asia Pacific real estate market has grown into the largest in the world, accounting for some $4.6 trillion of invested stock — or 36 percent of the global total[1]. Fortunately for investors, the growth has come alongside increasingly high levels of maturity, transparency and liquidity.

The region remains dominated by opportunistic investors, but alongside that there is a rapidly growing pool of opportunities in core real estate — offering strong locations, highly creditworthy tenants, long leases and international-standard covenants. That means institutions can tap into the Asia Pacific growth story and diversification benefits without having to move higher up the risk curve.

That pool of opportunities is continuing to broaden as maturity and transparency spreads through the region. For example, we believe that South Korea's logistics sector is the latest market worthy of the attention of core investors.

Strong economic growth, a stable employment market, high household income and an expanding tourism industry are fueling consumer spending. In response, demand for modern logistics and distribution warehouses is rising steadily, with the development of the industry supported by the advancement of Korea's transportation network and infrastructure. Leasing practices in logistics have also improved markedly, and the sector now offers good leasing covenants and predictable cash flows, thus meeting institutional investors' demand for stable income-driven returns.

The increased institutional capital flows into Korean real estate, coupled with strong demand from tenants for quality and well-managed commercial space, provide ample room for significant growth in the logistics sector this year and beyond.

Developing opportunities

The recovery of real estate markets in the United States and the United Kingdom, as well as parts of Asia and Europe, means that pricing for some of the very prime assets is not as attractive as it was one or two years ago. In such an environment, it is important that investors do not overpay for assets which may not be able to deliver the desired levels of long term, sustainable returns, but also avoid the trap of taking on too much risk in pursuit of value.

We believe this the time to focus on assets where property managers can add value — be it through redevelopment of existing buildings or the funding of new ones. Local knowledge and location selection are key to the success of such initiatives, with the focus on regional economic health, supply pipeline and occupier fundamentals. Infrastructure and transport are also important with new projects such as the U.K.'s Crossrail creating new opportunities.

Crossrail will weave its way through London and beyond, and we expect that areas along the route will see a strong uplift in demand for residential accommodation as well as becoming more appealing locations for offices.

Brave new world of retail technology

An increasing proportion of global consumers are doing at least some of their shopping online — be it browsing, buying or both — and they increasingly use portable or handheld devices to do so. Technology is already changing retail and will continue to do so. The key is for investors to adapt to those changes themselves and to choose the assets and occupiers which are also able to change with the times.

On the occupier side, we believe that investors should focus more on adaptive retailers that do not just perceive online as an additional revenue stream, but embrace it as a way to provide a complete offer to their customers. In addition, we suggest focusing on occupiers that value the leisure and experiential side of retail, including investing in R&D and experimenting with 3D printing.

Investors, for their part, can play a significant role as well, by collaborating with their occupiers in order to enhance the multichannel offer of the assets. Space configuration to suit "showrooming," mobile applications, free WiFi service or even the use of more advanced technologies such as iBeacons and geocoding can help assets fit better in the modern retail landscape.

For assets which are not expected to benefit from the retail landscape as it evolves, investors should consider alternative uses. These range from change of use to other property types, to exploring the potential of converting the asset to a collection hub for Click & Collect purposes. ■

[1] DTZ, "Money into property 2014"

COMPANY OVERVIEW

M&G Real Estate is the real estate fund management arm of M&G, and one of the top 25 real estate fund managers in the world by assets under management. It has over £20 billion ($33 billion) invested in a broad spread of properties across Europe, North America and the Asia Pacific region (as of September 30, 2014). M&G Real Estate offers institutional investors a range of commingled strategies, as well as segregated mandate and joint venture opportunities with a focus on generating long-term income driven returns through prudent asset selection and active management.

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