PGIM REAL ESTATE

3Q21

QUARTERLY INSIGHTS | INVESTMENT RESEARCH

EUROPE

Key Themes

- Momentum Turns Positive
- Yield Shift Driving Value Growth, But Risk Premium Being Eroded
- How Does Real Estate Fare Against Inflation?

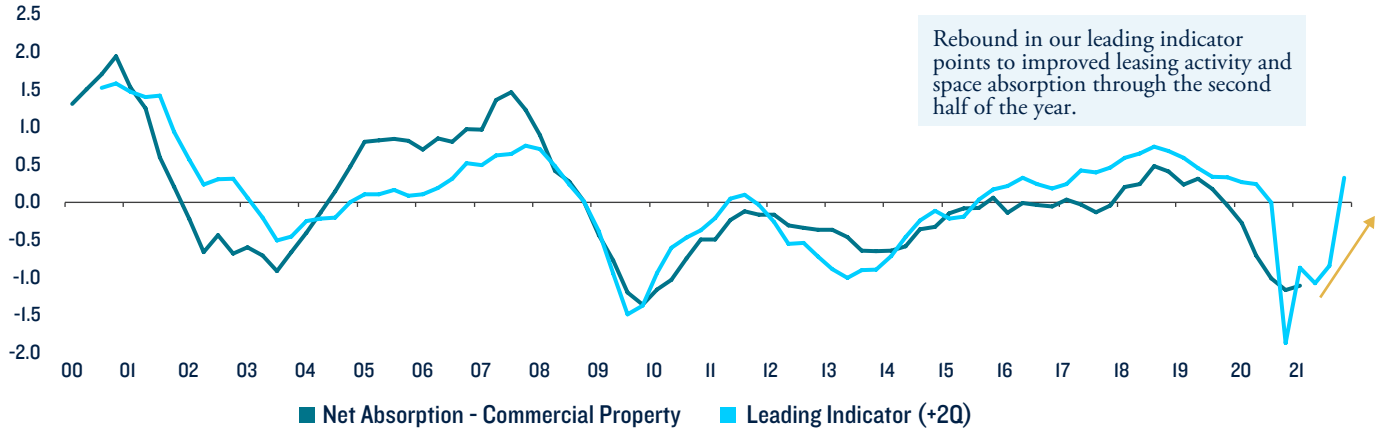
Momentum Turns Positive

The past few months have been notable for a significant pickup in sentiment. Key forward-looking measures of real estate demand—which include hiring intentions, business sentiment and consumer confidence—have improved dramatically, linked to successful vaccine rollouts across Europe and significant reductions in restrictions that have permitted widespread reopenings in service industries.

Based on our leading indicator, real estate space demand is set to follow suit (exhibit 1). We expect to see a pickup in net absorption through the remainder of the year as corporate demand gets boosted by a more optimistic outlook, expansion plans to capitalize on the growth environment and, for many tenants, the necessity of finally dealing with long-delayed location decisions.

Exhibit 1: Space Demand and Leading Indicator

Normalized European Commercial Property Absorption and Leading Indicator



Sources: Cushman & Wakefield, Eurostat, PMA, PGIM Real Estate. As of September 2021.

Yield Shift Driving Value Growth, But Risk Premium Being Eroded

As we would expect, investors are picking up on the same positive sentiment signals. COVID-19-related restrictions are easing, and investment volume is rising, now close to regaining its pre-pandemic levels. Capital raising has been patchy this year, but investors still have a lot of dry powder left over from several strong years leading up to the pandemic. With occupier performance improving, a lot of capital is ready to be deployed, and deal volume is set to increase further as the year goes on.

Competition for deals is heating up, and the share of markets reporting yield compression—which represents an excess of investment demand for assets in a given sector or market over available supply at a given price—has picked up (exhibit 2). When pricing improvements are put alongside strengthening occupier markets, capital value growth is set to return to positive territory this year.

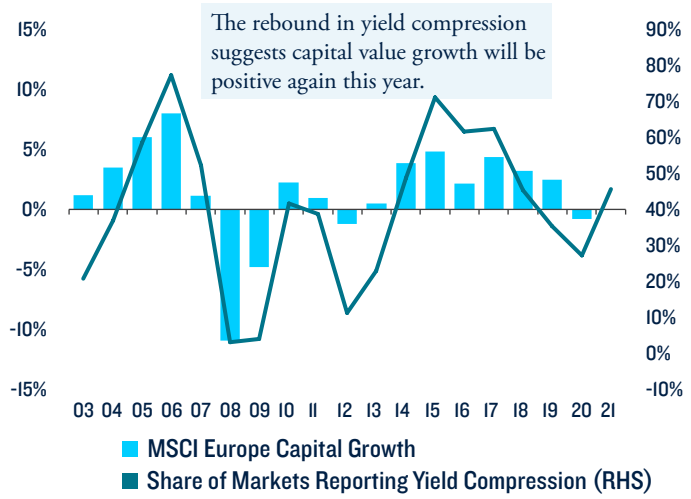
However, there is another side to the story. By definition, yield compression implies erosion of risk premium—other things being equal; and they are equal because there has been no major shift in either long-term growth potential or interest rates. In turn, this makes property relatively less attractive, and once it goes past its equilibrium level, it starts to look expensive, thereby raising the prospect of a future value correction.

Risk premium erosion is most notable in the logistics sector, in which more than 90% of major European markets have recorded inward yield shifts since the start of the year as investors look to increase historically low portfolio weightings to what is still the best-performing sector.

In our view, logistics clearly has a strong near-term outlook and is still supported by structural trends that point to lower risk premiums than observed in the past. However, capital is flowing in at pace, yields look likely to compress further and the risk is that the sector starts to look expensive. And then we're in line for a correction if, for example, supply starts to adjust.

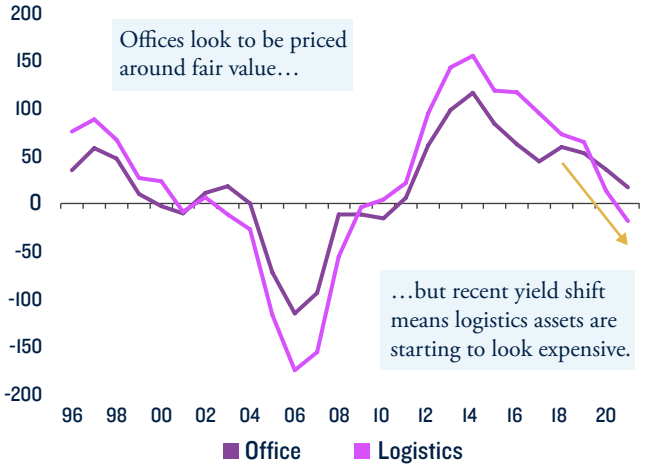
Exhibit 2: Yield Compression and Relative Pricing

Share of Markets Reporting Yield Compression (%) and MSCI Europe Capital Growth (% p.a.)



Sources: Cushman & Wakefield, MSCI, PGIM Real Estate. As of September 2021.

Risk Premium Relative to Estimated Long-Term Equilibrium (Basis Points)



How Does Real Estate Fare Against Inflation?

A look beyond the near-term momentum story shows it is certainly worth revisiting the question of property as an inflation hedge, given that a substantial—though likely transient—increase in inflation is acting as a backdrop to the current global economic recovery.

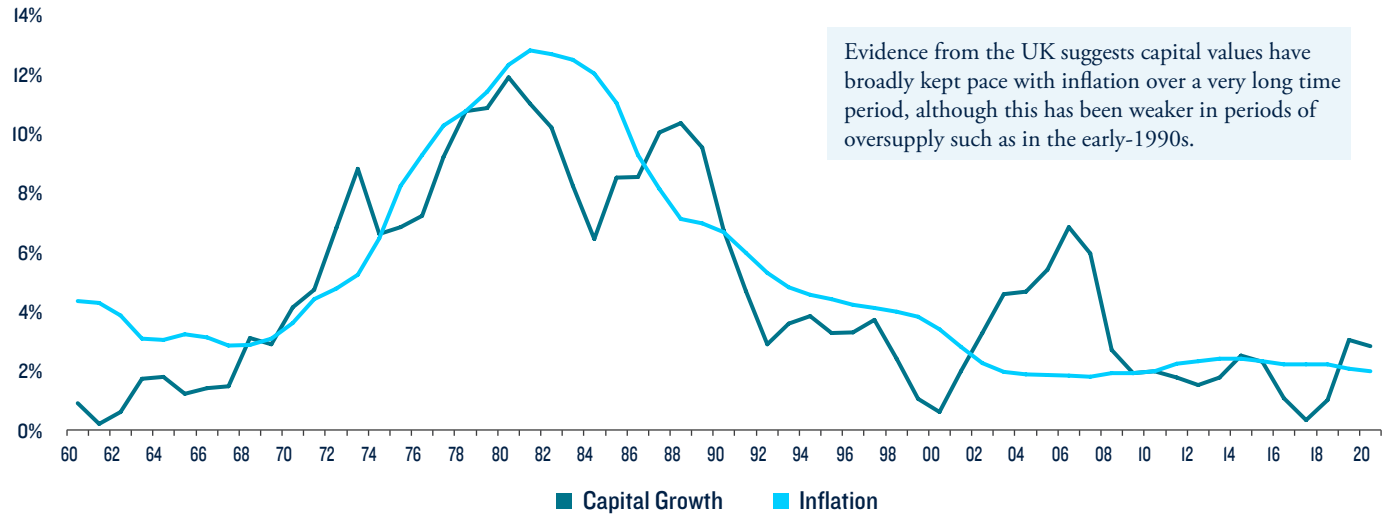
Clearly, compared with nominal fixed-interest assets, real estate is relatively well positioned to capture inflation through several channels, including contractual lease uplifts, renewals and the reletting of empty space.

In the UK, we can look at how property has fared over a long time period. Exhibit 3 makes clear that property values have broadly kept up with inflation over a sustained period—and importantly during times of much higher inflation, including in the 1970s and 1980s.

Since 1980, UK real estate values have broadly kept pace with inflation, and although that suggests a strong inflation hedge, the relationship varies significantly over time based on such factors as supply; and we also must consider that property has gone through a long period of structural yield compression in the past few decades. We think property yields can't move much lower on a sustainable basis, and therefore this boost is unlikely to be repeated; so we also must look at how the income side fares.

Exhibit 3: UK Long Run Performance

UK All Property Capital Growth and CPI Inflation – 10-Year Rolling Average (% p.a.)

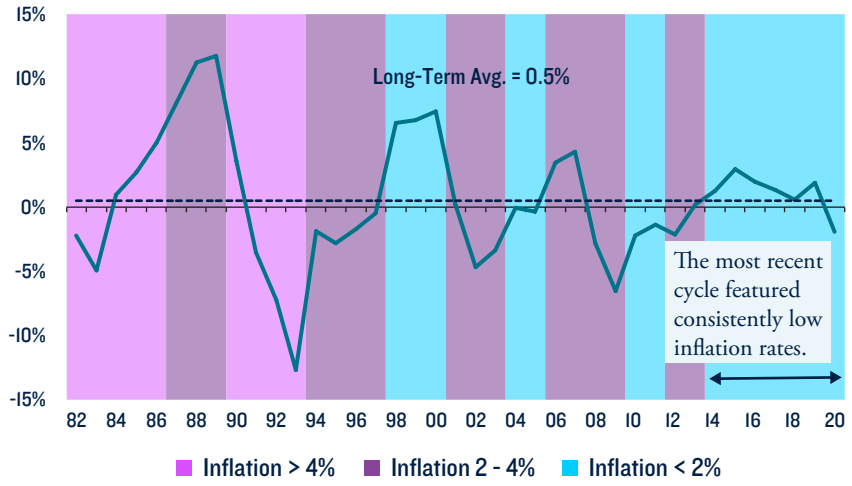


Evidence from the UK suggests capital values have broadly kept pace with inflation over a very long time period, although this has been weaker in periods of oversupply such as in the early-1990s.

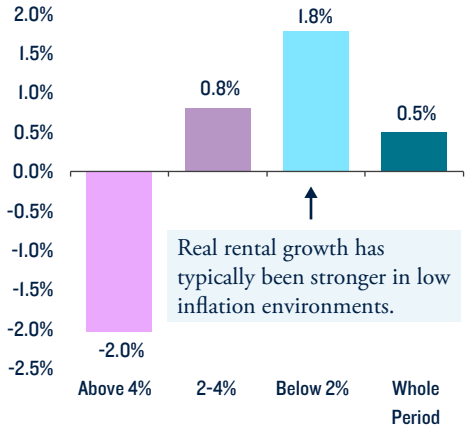
Sources: Cushman & Wakefield, Eurostat, PMA, PGIM Real Estate. As of September 2021.

Exhibit 4: European Real Rental Growth

European All Property Prime Real Rental Growth (% p.a.)



Long-Term Average Prime Real Rental Growth by Sector (% p.a.)



Sources: Cushman & Wakefield, PMA, Oxford Economics, PGIM Real Estate. As of September 2021.

Exhibit 4 looks at all property rental growth in real terms across Europe. Similarly, over a long time period, that growth has been positive—by way of an average of 0.5% per annum since 1982—although it is also highly cyclical. As before, much of the cyclicity can be explained by supply: most notably, in the early 1990s, when vacancy was persistently high and rents declined for several years.

But we can also see that real rental growth has typically been stronger during periods of lower inflation, when only modest nominal rent adjustments are required to generate positive growth numbers. In contrast, during periods in which inflation has been above 4%, rents have struggled to keep up. That's partly because landlords struggled to capture the full extent of the higher inflation in lease negotiations at those times, but history also shows that the likelihood of a supply response that dampens rental growth rises when inflation is high.

So, although there are a lot of factors to consider, we can say confidently that real estate is a better hedge against inflation than nominal assets are, and it offers good protection over long-enough time horizons. Real estate's ability to protect against inflation will be boosted by a low-supply environment that is currently a feature of the market, and ultimately, inflation should remain below that worrisome 4% mark—even if it is higher than usual for a while.

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