European diversified real estate strategies: right time, right place

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European diversified real estate strategies: right time, right place

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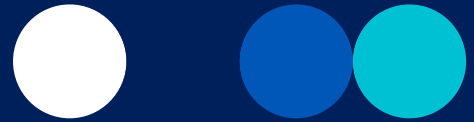
Executive summary

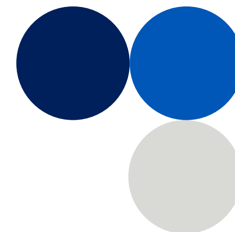


- **European real estate funds are ready to deliver again** European diversified real estate strategies are at a pivotal moment following a large correction in values. Tectonic shifts in demand drivers mean they need to be adapted to maintain their role in delivering investors' returns. Future-ready strategies offer investors a route into the best of what the asset class offers.
- **Historical performance and diversification benefits** European real estate has delivered higher total returns with lower volatility, compared with other asset classes over the last 20 years. This offers significant diversification benefits for multi-asset investors – a characteristic that has strengthened significantly over the last decade as bond and equity correlations have increased.
- **Strategic shifts and adaptations** The strategic evolution of European real estate funds includes changing approaches to diversification across countries and sectors, and adjusting risk strategies across the cycle. European strategies have gone from investing in just a handful of countries and sectors, to much broader strategies to capture growing opportunities in a maturing market. Managers need to further adapt their strategies to be future-ready, and to increase their conviction in tactical allocations and their timing.
- **Importance of thematic change and sustainability** Strategies that align with regulatory requirements and that emphasise sustainability are increasingly linked to better performance and limited risk exposure. But while retrofitting and decarbonisation costs are important considerations, they can result in strong and resilient investments too.
- **Current market opportunity** The major benefit from instant access to cross-border, fully diversified real estate portfolios is the efficiency for investors to gain access to such a strategy. But timing is key. Today, the European market presents opportunities – especially in core real estate, given capital value resets, relative value attractiveness, and real rental growth. Our forecasts and risk measures can help strategic decisions.
- **Conclusion: adapting strategies for future success** European diversified real estate strategies must adapt to thematic changes and sustainability to deliver the best of what the asset class has to offer. Not all strategies are the same, so investors should carefully consider the ability for managers to adapt and create future-ready solutions.

Craig Wright

Head of European Real Estate Investment Research

European diversified real estate strategies: right time, right place



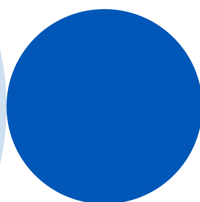
1. Introduction

After a brutal slump, the worst since the Global Financial Crisis, real estate prospects are on the rise. Interest rates soared, rattling financial markets and hurting returns on income-generating assets like bonds and real estate. But real estate is bouncing back from its sharp correction, showing signs of resilience and early signs of recovery. This presents a once-in-a-cycle opportunity for investors.

As we look ahead, we face a world of change and disruption, driven by technology, demographics and geopolitics. These forces will shape markets and real estate's role in investors' returns. European real estate strategies need to adapt and innovate, as they have done before, to overcome these challenges.

In this paper, we explore how core European real estate funds can meet investors' needs, how they have delivered returns, how their strategies have evolved, and why now is an attractive time to invest in these strategies. We believe diversified strategies will offer investors access to the best of what the asset class has to offer, with the expertise required to navigate the market recovery successfully.

"Real estate is bouncing back from its sharp correction, showing early signs of recovery."



2. What have diversified European real estate strategies delivered for investors?

2.a. The growth of the fund peer group

Real estate has been a key asset class for institutional investors, with a historical preference for domestic markets. The transition to non-domestic, particularly European real estate, offers benefits like increased diversification and potentially higher long-term returns. Pooled real estate funds (existing since the 1970s) have evolved, with the Association of Property Unit Trusts (now AREF) playing a significant role in the UK. These funds have offered investors an efficient route to access returns from an asset class that requires significant expertise to manage. The key outputs are stable cashflows, capital growth and partial inflation hedging. The introduction of the AREF index in 1989 showcased significant growth, reaching £42 billion in assets by March 2024.

Expanding these fund models into European markets have helped investors to mitigate some volatility, enabled by the financial integration and currency harmonisation of the EU and the Euro. European diversified real estate funds in MSCI's pan-European Pooled Fund Index have seen substantial growth since the early 2000s, reaching €62 billion in assets by March 2024. Targeting Europe offers two main opportunities for investors. Firstly, they have provided the opportunity for investors to capture higher risk-adjusted returns through core and core-plus strategies. Secondly, they have given investors greater potential to source higher absolute return strategies in Europe. This is summarised in chart 1. This paper is focused on the risk-adjusted return aspect – an area we believe is due to make a significant comeback. The barriers to entry for other routes have become more costly and challenging, while existing European pooled vehicles -with the platform and expertise to efficiently deliver real estate returns for investors- are ready to do just that.

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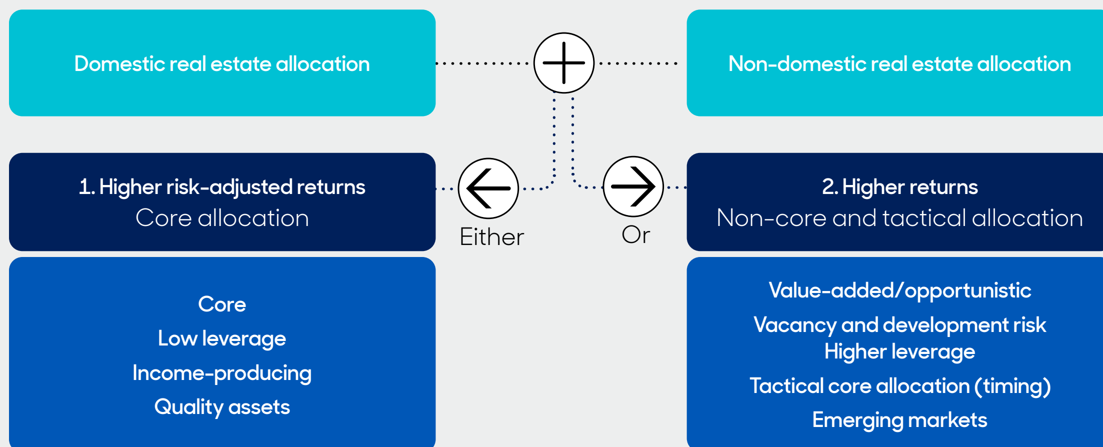
"Existing European pooled vehicles -with the platform and expertise to efficiently deliver real estate returns for investors- are ready to do just that."

Chart 1: Adding non-domestic real estate allocations provides multiple benefits for investors

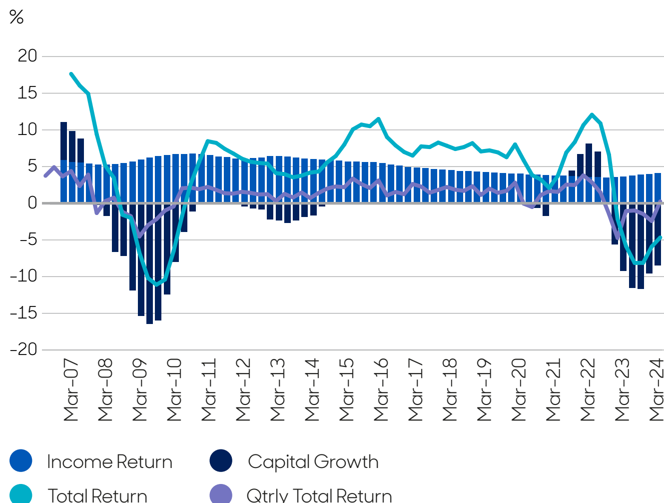


Source: abrdn August 2024.

2.b. Performance characteristics

While the asset class has taken a bruising during the recent downturn (so much so that some analysts called it the "end of the real estate super-cycle"), we believe it serves a purpose for investors. Absolute returns, real returns, risk-adjusted returns, stable income, lower volatility, and diversification are the main attractions of the asset class. The performance is shown in chart 2.

Chart 2: MSCI Pan European Pooled Fund Index (PEPFI) asset-level total returns for Balanced Funds (% p.a.)



Source: MSCI PEPFI asset level total returns, abrdn August 2024.

Over the last 20 years to March 2024, European direct real estate has delivered higher total returns with less risk (volatility on a quarterly basis) than bonds, and delivered lower returns with less risk compared with equities. This is shown in chart 3. Performance is clearly differentiated from other asset classes, sitting well above the efficient frontier. However, some of this performance needs to be rationalised against the illiquidity of direct real estate. The illiquidity premium can be measured in several different ways and there is debate as to whether the additional returns generated by the asset class are sufficient to mitigate this risk. However, the asset class clearly brings differentiated performance characteristics to portfolios.

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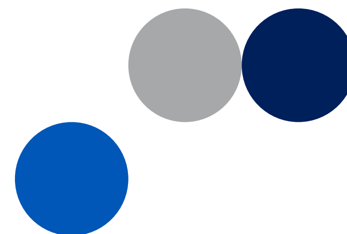
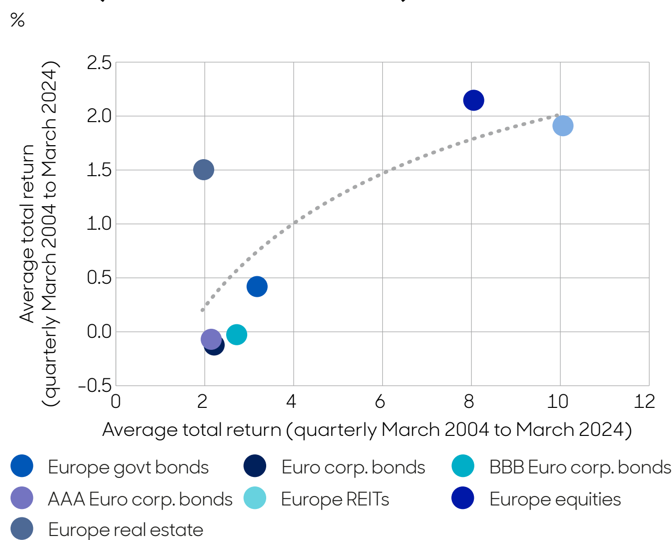


Chart 3: Quarterly total returns and volatility across asset classes (March 2004 to March 2024)

%



Source: LSEG, MSCI asset level PEPFI total returns, IBOXX, FTSE EPRA NAREIT, abrdn August 2024.

Presenting this in a slightly more useful way, we have calculated returns per unit of risk, as seen in chart 4. This shows that real estate has delivered more return per unit of risk. Real estate comes out on top in this measure, despite underperforming real estate investment trusts (REITs) and equities in terms of absolute returns. Much lower volatility gives European funds their edge in this measure, although we acknowledge valuation smoothing and the additional illiquidity premium necessary to justify an allocation.

Chart 4: Return per unit of risk (March 2004 to March 2024)

	Return per unit of risk (%)
Europe real estate	0.8
Europe equities	0.3
Europe REITs	0.2
Europe govt. bonds	0.1
BBB Euro corp. bonds	0.0
AAA Euro corp. bonds	0.0
Euro corp. bonds	-0.1

Source: LSEG, MSCI asset level PEPFI total returns, IBOXX, FTSE EPRA NAREIT, abrdn August 2024.

The quarter-on-quarter timing of returns also matters when considering the impact of an allocation to diversified European real estate. European direct real estate has a low level of quarterly correlations with other asset classes over the last 20 years to March 2024. Its highest correlations are with European REITs, which is understandable given the direct relationship with the underlying performance of the asset class. Against the other asset classes, there is very little relationship in performance trends, as shown in the correlation table.

> **"Much lower volatility gives European funds their edge."**

Chart 5: Quarterly asset class correlations chart (March 2004 to March 2024)

	Europe Govt. bonds	Euro corp. bonds	BBB Euro corp. bonds	AAA Euro corp. bonds	Europe equities	Europe REITs	Europe real estate
Europe Govt. bonds	1.00						
Euro corp. bonds	0.46	1.00					
BBB Euro corp. bonds	0.28	0.96	1.00				
AAA Euro corp. bonds	0.85	0.75	0.62	1.00			
Europe equities	-0.29	0.51	0.57	-0.02	1.00		
Europe REITs	-0.02	0.64	0.64	0.26	0.79	1.00	
Europe real estate	-0.04	0.01	-0.03	-0.04	0.25	0.40	1.00

Source: LSEG, MSCI, IBOXX, FTSE EPRA NAREIT, abrdn August 2024.

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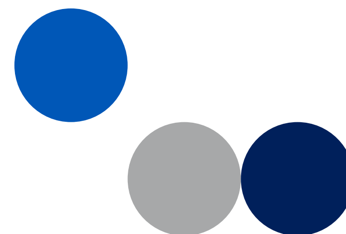
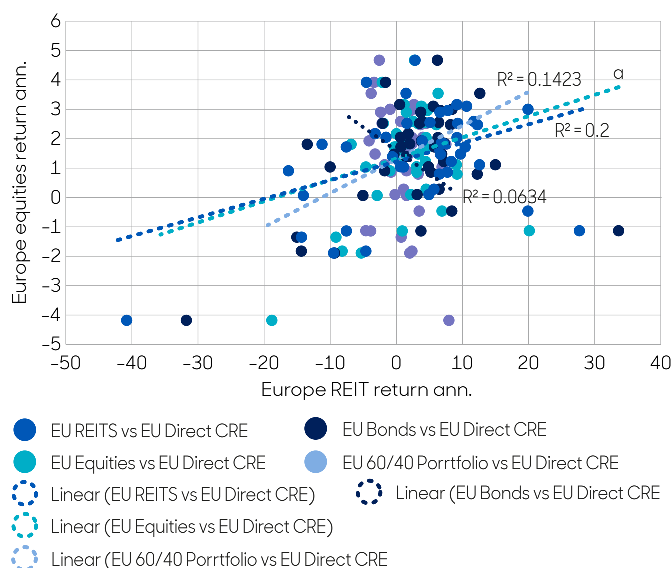


Chart 6 illustrates the quarterly returns of European real estate and their relationship with European equities, bonds, REITs, and a 60/40 equity-bond portfolio. Each dot is one quarterly return point for each asset class (x axis) and the corresponding return from real estate that quarter (y axis). As you can see, there is very little correlation between real estate and other asset classes on a quarterly basis. Linear regression shows the lack of strength of these relationships. R-squared values indicate how much of the dependent variable's return is explained by the independent variable. The R-squared results are low. The strongest link is between REITs and European real estate returns, and the weakest is between bonds and the 60/40 portfolio. This suggests the diversification advantage of including European real estate in multi-asset portfolios has increased.

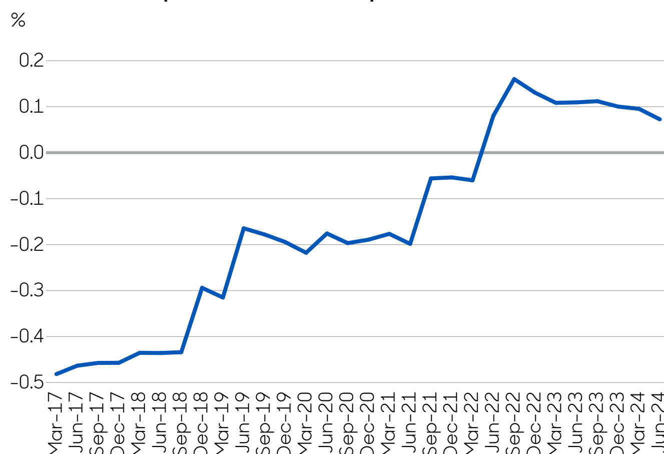
Chart 6: Correlations between asset classes versus European real estate (March 2004 to March 2024)



Source: LSEG, MSCI, IBOXX, FTSE EPRA NAREIT, abrdn August 2024.

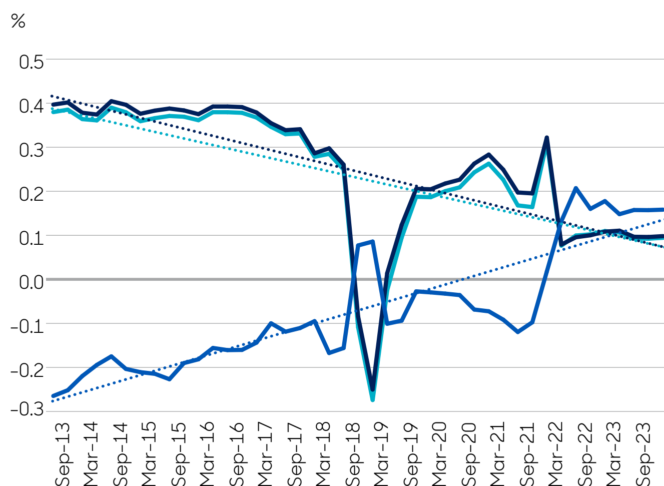
Relationships in the financial markets are dynamic. They can shift during times of significant market volatility or through protracted periods of time. Chart 7 illustrates the growing correlation between equities and bonds over the past decade. While there may be some decoupling now that bond yields are generating positive cashflows and providing an alternative to growth assets like equities, the traditional balancing impact of a 60/40 portfolio has notably decreased since the early 2010s.

Chart 7: Rolling 10-year quarterly total return correlations between European bonds and equities



Source: Source: LSEG, MSCI, IBOXX, FTSE EPRA NAREIT, abrdn August 2024.

Chart 8: Rolling 10-year quarterly total return correlations between asset classes and real estate



Source: LSEG, MSCI, IBOXX, FTSE EPRA NAREIT, abrdn August 2024.

"The diversification advantage of including European real estate in multi-asset portfolios has increased."

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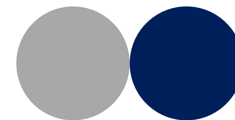
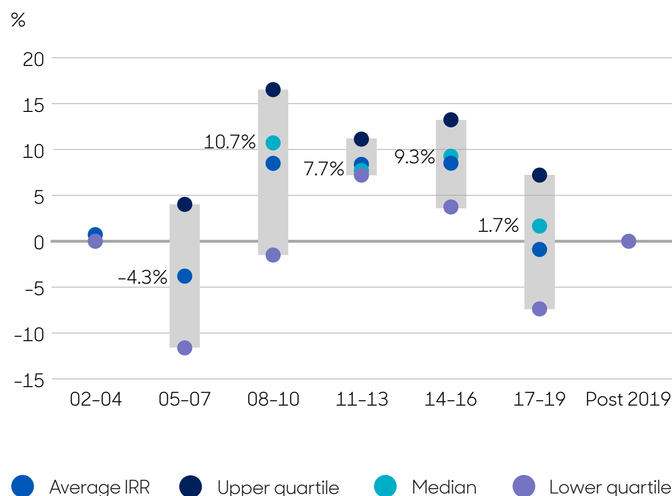


Against a traditional 60% equities and 40% bond allocation (20% corporate bonds and 20% government bonds in this analysis), real estate has also demonstrated a lower correlation over time. At the most recent 10-year rolling correlation of 0.1, an allocation to direct European real estate has offered the strongest diversification benefit for multi-asset investors on record. Because equity and bond correlations have increased over the last two decades and equity and real estate correlations have fallen, real estate could potentially play a more valuable role in improving risk-adjusted returns in a multi-asset portfolio.

2.c. Impact of investment timing on European real estate returns

Over extended periods, real estate exhibits cyclical behaviour. Recent technological advances and demographic changes have mitigated some cyclical pressures, which enhance diversification benefits. However, macroeconomic factors, relative pricing, debt markets, and development cycles continue to influence this asset class. INREV's internal rate of return (IRR) data (as shown in chart 9) reveals how multi-country European funds performed in different cycle phases. Funds that raised capital between 2005 and 2007 (peaking) have exhibited median IRRs of -4.2% since inception. Conversely, those with their initial closing between 2008 and 2016, following the Global Financial Crisis, generally achieved continuing IRRs of 8.5%. Similar to pre-Global Financial Crisis, capital raised before the pandemic produced a median IRR of -0.9% annually up to the first quarter of 2024. The market remained relatively stable during the pandemic. But recent downturns, driven by high interest rates and significant liquidity reductions, have hindered performance. While average index performance provides insight, individual investor experiences vary based on fund choice. Performance disparities among funds increased after the Global Financial Crisis because of market dislocations and country-specific variations. Investors with substantial exposure to Southern and Central Europe faced greater losses, whereas those invested in Western Europe generally outperformed for nearly a decade amid the Eurozone crisis. The gap between the top and bottom decile funds narrowed sharply as recovery spread throughout the region. Funds initiated immediately after the Global Financial Crisis benefited from advantageous entry pricing and low interest rates over the past decade. This led to significant outperformance.

Chart 9: INREV multi-country fund IRR analysis by vintage Q1 2024



Source: INREV, abrdn June 2024.

In summary, European diversified real estate funds have delivered differentiated risk and returns for investors over their 20-year lifespan. On a shorter interval basis, they have delivered low correlations with other asset classes and attractive absolute returns over the long term. The inter-relationships between asset classes have changed over time, but lower volatility and decorrelated returns from European real estate have held up through some significant market distortions. However, timing is critical in an asset class that has cyclicality, and those investors entering at the most opportune time stand a much greater probability of achieving better returns over the investment period.

"Because equity and bond correlations have increased over the last two decades, and equity and real estate correlations have fallen, real estate could potentially play a more valuable role in improving risk-adjusted returns in a multi-asset portfolio."

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"Investors entering at the most opportune time stand a much greater probability of achieving better returns over the investment period."

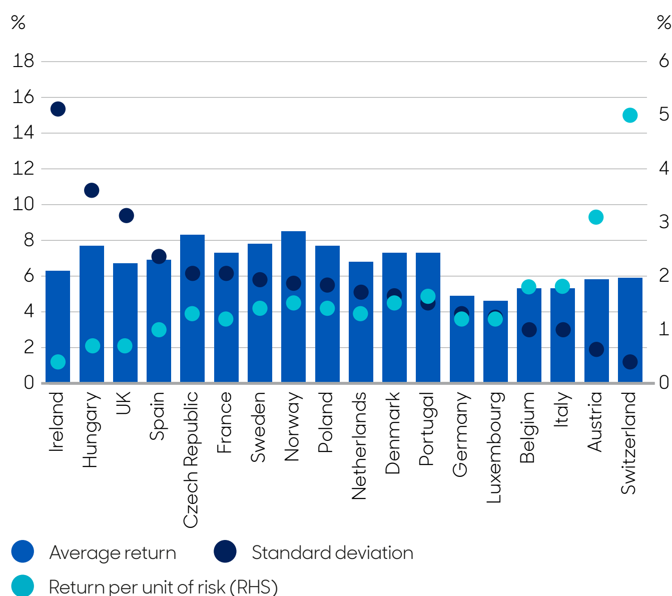
3. How have European real estate funds delivered this type of performance?

European diversified funds have taken a different approach to their investment strategy over time. This has involved both structural and cyclical adaptations by managers. However, there are only three significant levers to pull. These include country and sector allocations and the risk strategy. We explore these factors in turn.

3.a. Countries

European funds initially derived most of their performance from a few key countries. Data from the MSCI's European Property Fund Index (PEPFI) indicates that between 2004 and 2014, allocations within the multi-country fund sample were dominated by the UK, Germany, and France, which together represented between 60% and 70% of all allocations. By 2024, the number of countries in the sample expanded from nine to 16. Despite the increase in the number of countries included, more than 50% of the assets remain concentrated in the UK, Germany, and France. When adding the Netherlands and Spain, the top-five countries account for over 70% of the total assets in the index. The smallest six countries collectively represent less than 10% of the sample. Most investments are concentrated in Eurozone countries, with the UK being the only significant non-Eurozone allocation. For many managers, the UK's market size makes it indispensable; especially if they cater to a global investor base, where the UK is seen as an integral part of the European investment landscape. However, some managers avoid allocating to the UK if their investor base is predominantly from the UK, as investing domestically can reduce the diversification benefits of international investments. According to the MSCI European Index, the average annual total return on property investments was 6.3% between 2001 and 2023. The range of returns across countries during this period was relatively narrow, but the risk measured by volatility varied significantly. Therefore, long-term country selection has had a greater impact on portfolio volatility than on overall long-term returns. Also, currency exchange risks and the need to manage them (which varies at the investor level), have led fund managers to invest in the eurozone only.

Chart 10: Country-level total returns and volatility ranked by returns per unit of risk



Source: MSCI European index, abrdn August 2024.

Comparing individual country returns with the European Pooled Fund Index demonstrates the benefits of diversification with notably lower volatility. This shows how spreading risk across markets reduces instability. However, data suggests this relationship has weakened over time because of rising market transparency and the globalisation of financial markets. Brokerage firms like CBRE, Colliers, Cushman & Wakefield, JLL, Knight Frank and Savills now standardise real estate services across major European economies. Over the last 23 years, total return spreads decreased, with five-year rolling average returns falling from 17% in 2005 to 14% in 2023. Despite being a slight drop, it signifies a decline even as the sample sizes grew. After a significant correction in 2022, downside return ranges were narrower than during the Global Financial Crisis, which affected the UK and Ireland more severely. While diversification benefits from country allocations have diminished, they remain meaningful, as shown in chart 11.

"While diversification benefits from country allocations have diminished, they remain meaningful."

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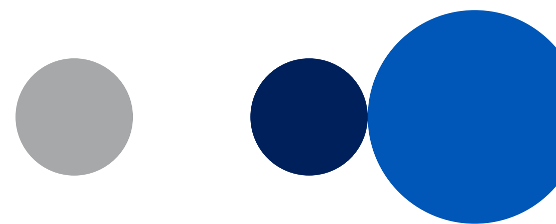
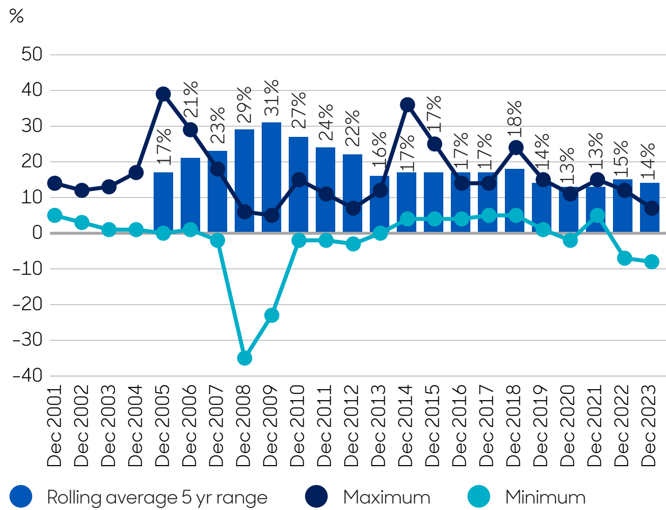


Chart 11: Country-level total returns and five-year rolling range of returns

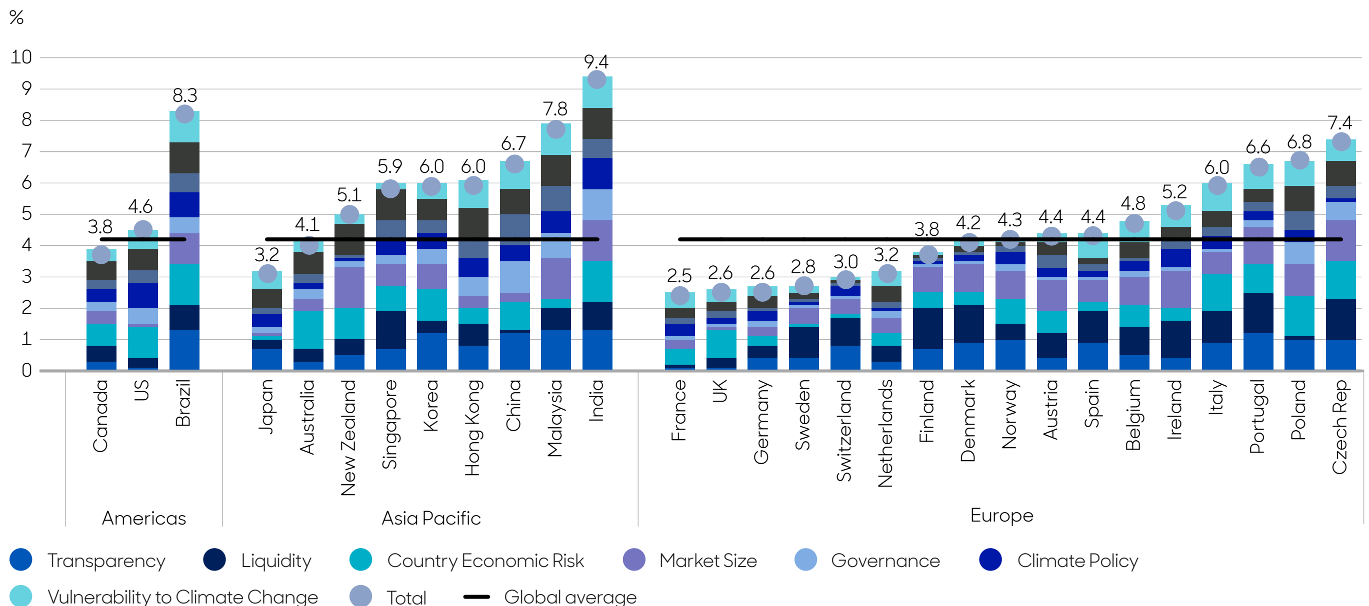


Source: MSCI European annual index, abrdn August 2024.

Volatility is not the only measure of risk at the country level. We use our Global Risk Navigator (found **here**) to explore the level of implementation risk inherent in each country. Our measure includes nine factors that affect the likelihood of delivering desired returns for investors within a reasonable range of performance expectation. The highest-scoring markets are expected to have the greatest likelihood of an expected outcome, while the lowest-scoring markets should provide the lowest deviation in the outcome. This is shown in chart 12.

This method isn't about excluding high-risk markets, but assigning a relative risk score to compare different opportunities. We know an 8% return in France isn't the same as in Poland, so adjustments are necessary for investment decisions. Although creating a return-based risk metric is tough, this approach offers a clearer, risk-aware alternative to standard volatility metrics.

Chart 12: Global Risk Navigator 2024



Source: abrdn, LSEG Workspace, JLL, NDGAIN, abrdn August 2024.

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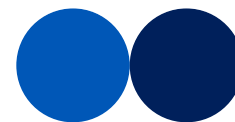
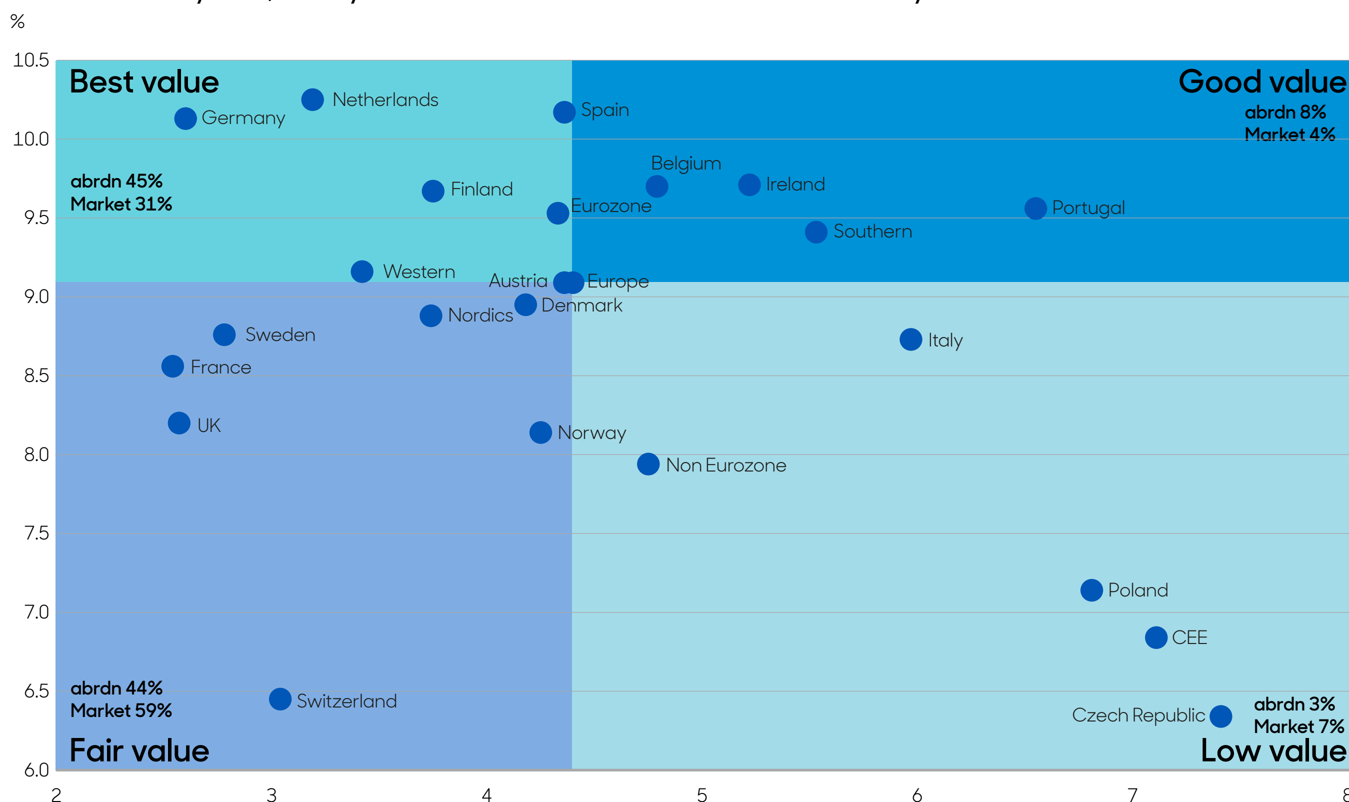


By cross-referencing country-risk scores with return projections, we can see if strategies meet their objectives while minimising risk. Chart 13 shows the link between our expected returns and country risk over three years. Core markets are set to offer the best risk-adjusted returns as they recover, while Southern Europe, like Spain and Portugal, also looks strong. Conversely, Central and Eastern European markets might underperform and carry extra risks, suggesting they may not offer favourable risk-adjusted returns now.

We mapped abrdn's allocations against MSCI market size estimates to see if our resources are efficiently allocated from a risk viewpoint. Currently, our strategies focus on 'best-value' and 'fair-value' markets, as we are generally invested across the most transparent markets in Europe with the lowest Global Risk Navigator scores. Since forecasts are updated quarterly and risk scores annually, this tool helps fine-tune geographic allocations. While some analysis seems intuitive, our method ensures a consistent framework for managing country risk.

Chart 13: Country-level, three-year annualised forecast total returns versus country-risk scores



Source: abrdn, LSEG Workspace, JLL, NDGAIN, abrdn August 2024.

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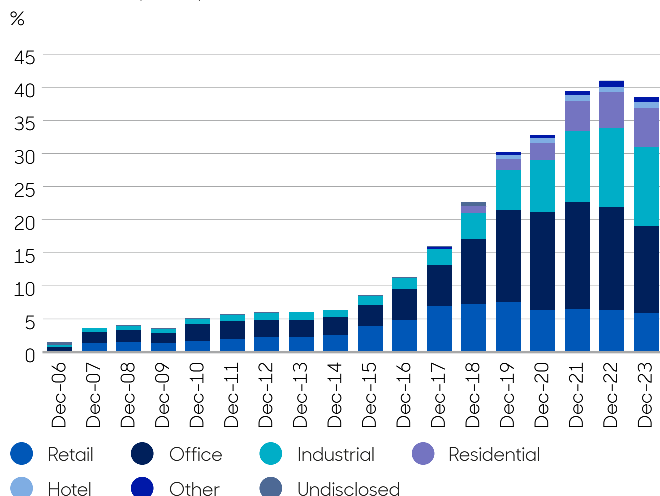
3.b. Sectors

Throughout the life of European funds, sectors have played their role in determining performance too. To begin with, these funds were solely invested in offices and retail assets, with a small allocation to industrials by 2007. Allocations remained focused on these sectors for a further 10 years, until allocations to 'other' and residential appeared in the index in 2017 and 2018, respectively. Since then, non-commercial real estate sectors have grown to account for over 20% of the European balanced fund sample, as shown in chart 15.

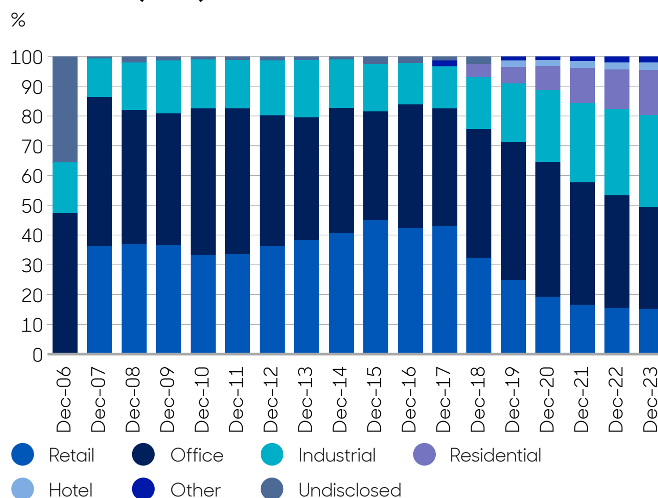
Chart 14: European Balanced Pooled Funds Index sector allocations (€bns)



Source: MSCI PEPFI, abrdn August 2024.

"Non-commercial real estate sectors have grown to account for over 20% of the European balanced fund sample."

Chart 15: European Balanced Pooled Funds Index sector allocations (€bns)



Source: MSCI PEPFI, abrdn August 2024.

The three main commercial sectors have experienced phases of growth and contraction as market conditions have fluctuated. Allocations to retail peaked at 45% in the 2015 sample, but have since fallen to just 15% of assets in the funds. A similar picture exists for offices, which generally carried a long-term stable allocation of between 45% to 50%. However, the pandemic and the explosion of working from home have thrown the future of the sector into doubt. Allocations have fallen to 34% in just two years because of a mixture of disposals and asset devaluations. Logistics on the other hand has grown to 31% of the sample, and is now challenging offices for top spot.

Looking at the same analysis of the range of returns across sectors, we can see the opposite trend in performance variation to the country trend. As shown in chart 16, sector performance has generally become more dispersed over time, with the rolling five-year range increasing from 7% in 2001 to 13% in 2023.

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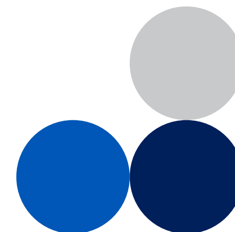
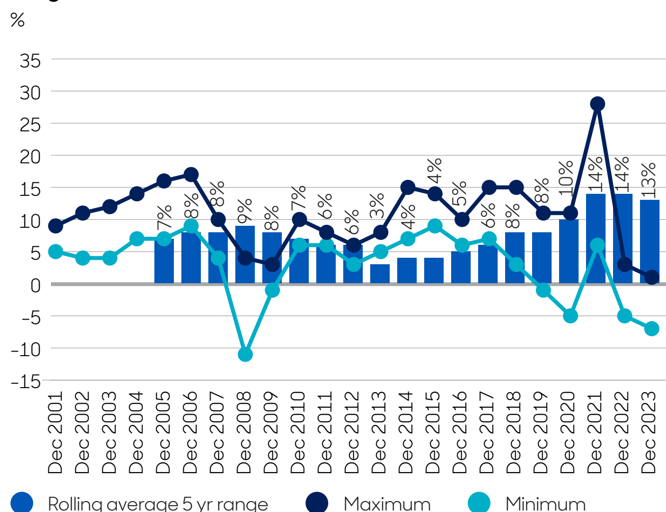


While some of this can be explained by the inclusion of more sectors in the sample of the PEPFI, the residential and hotel sectors have generally performed fairly closely to the all-property level and have not added to the spread. The underperformance of retail after 2015 and the outperformance of industrial in recent years are the main drivers of the dispersion. While this is across just two sectors, they make up a large share of the overall sample. We believe offices will continue to lag the performance of the other sectors in the coming years and that they will continue to drive greater sector performance dispersion.

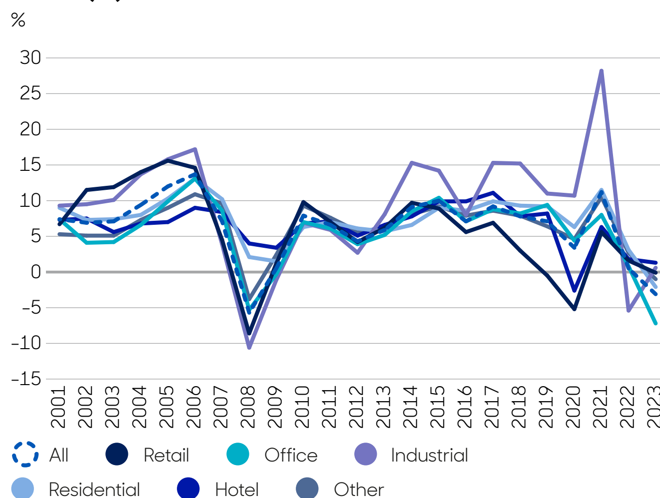
Chart 16: Sector-level total returns and five-year rolling range of returns



Source: MSCI European annual index, abrdn August 2024.

Charts 17 and 18 highlight the performance of sectors across the wider sample of property covered by MSCI in Europe. Emerging sectors, like residential and hotels, have delivered strong risk-adjusted returns, which provide some insight into why balanced funds have branched out into these alternative sectors of the market.

Chart 17: MSCI European Index annual total returns by sector (%) 2001-2023



Source: MSCI, abrdn, August 2024.

Chart 18: MSCI European Index annual total returns and risk by sector (%)

	Average total return 2001 to 2023 (%)	Standard deviation 2001 to 2023	Return per unit of risk (%)
Industrial	8.9	8.1	1.1
Residential	7.2	3.4	2.1
Hotel	6.4	3.0	2.1
All	6.3	4.5	1.4
Other	6.3	3.5	1.8
Retail	5.8	5.9	1.0
Office	5.6	4.7	1.2

Source: MSCI, abrdn, August 2024.

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"The market will be significantly disrupted by advanced technology, demographic shifts and climate change."

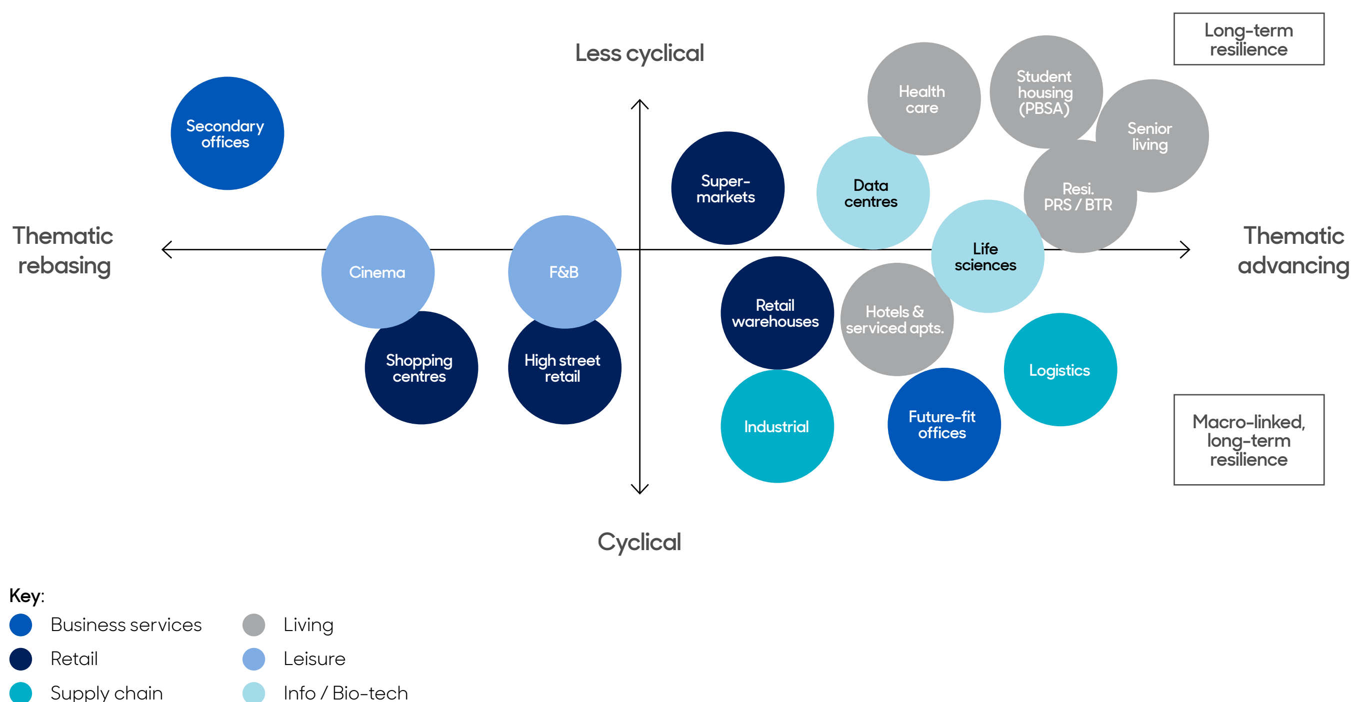
Looking ahead, the market will be significantly disrupted by advanced technology, demographic shifts and climate change. These elements have already affected retail demand because of ecommerce and office trends from remote working. Technological advances facilitated these changes, with climate change likely affecting asset performance.

We've categorised major real estate segments by their exposure to cyclical and thematic pressures to gauge their structural growth or decline and economic influence.

Positioning well for both cyclicality and structural change is key for building future-ready portfolios. Chart 19 reflects our perspective on segment drivers. We've weighted abrdn's diversified strategies by segment exposure against the MSCI investible universe. Currently, abrdn's allocations align with market segments that could benefit from a cyclical recovery and with thematic demand drivers. Despite being underweight in some sectors for strategic reasons, abrdn avoids structurally impaired market areas that could hamper performance without significant investment.

Chart 19: Adapting portfolios to capture thematic trends and to prepare for the cycle

Long-term thematic pressures and cyclical timing



Key:
- Business services
- Retail
- Supply chain
- Living
- Leisure
- Info / Bio-tech

Source: abrdn, January 2024.
This visual is not based on specific data and only represents our views on sector trends from a thematic perspective. It should not constitute specific allocation advice in isolation.

European diversified real estate strategies: right time, right place

"The US REIT index now contains a vast number of subsectors that come under the umbrella of real estate, including cell phone towers and data centres."

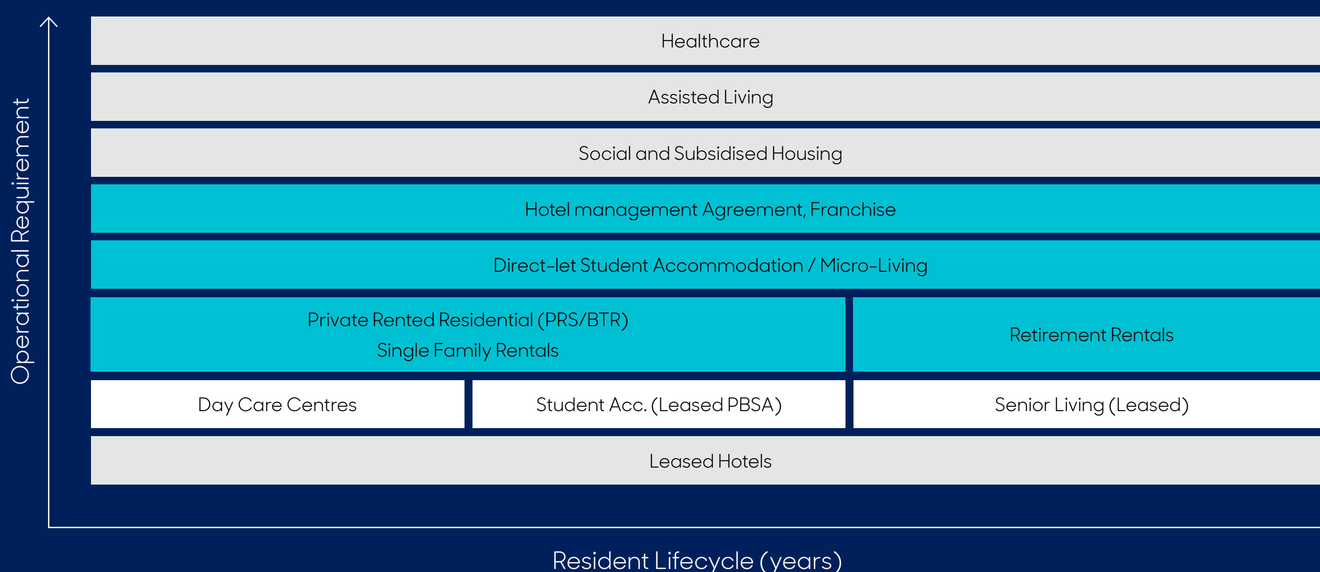
Introducing alternatives and living sectors to diversified funds

As shown earlier, the investment universe has expanded rapidly in the last decade to include more than just offices, retail and industrial real estate. The US REIT index now contains a vast number of subsectors that come under the umbrella of real estate, including cell phone towers and data centres. The European REIT market is evolving similarly and we think it will converge with the US model. Residential has been the first new sector to become firmly established in diversified European funds, but we believe it will be followed by hotels, data centres, healthcare, leisure, and other subsectors of living – such as purpose-built student accommodation (PBSA) and senior living.

Many of these emerging segments have operational characteristics, where the 'building is the business' and the landlord carries more exposure to underlying performance. However, there is a sliding scale of operational exposure, where the landlord can opt to target assets with a headlease in place or full exposure to underlying net revenues. In the leased model, the landlord benefits from the certainty of income and the operator is motivated to achieve operational efficiency to grow profits or EBITDA. The landlord needs to understand the implications of tenant failure in operational assets and have a plan for replacing operators if insolvency occurs. Furthermore, operational assets that provide a roof over someone's head, a service, or care also need to be managed with a view to accountability. Hands-off management and oversight will not pass the reputational risk test. While diversified funds offer investors a one-stop shop for European real estate exposure, they can lean on expertise that the manager has in other strategies. For instance, abrdn manages a large book of residential assets across Europe, providing strong management expertise for residential assets, regardless of which fund or strategy they belong to.

Chart 20 shows the residential investible universe and highlights where investors can source long-term cashflows from the sector.

Chart 20: Living lifecycle and operational risk in cashflows



Source: abrdn, 2024.
PBSA = Purpose Built Student Accommodation.

European diversified real estate strategies: right time, right place

“Residential demand and supply drivers are sufficiently different to commercial property to bring strong diversification benefits too.”

While private-rented sector (PRS) or build-to-rent (BTR) schemes are leased unit-by-unit and landlords are exposed to operational performance, this sector can provide strong, long-term cashflows that are linked to inflation. That said, sufficient scale is required to eliminate the idiosyncratic risk within individual assets. Occupancy rates are high in most cities in Europe and required development levels are expected to fall short in most areas. Residential demand and supply drivers are sufficiently different to commercial property to bring strong diversification benefits too. Strong fundamentals and indexation in rents helped residential outperform during the recent correction.

We therefore believe the residential sector will continue to offer interesting opportunities that match the risk-and-reward profile for most diversified European funds and that allocations will rise from the levels we see today towards as much as 25% in some vehicles.

3.c. Risk strategy

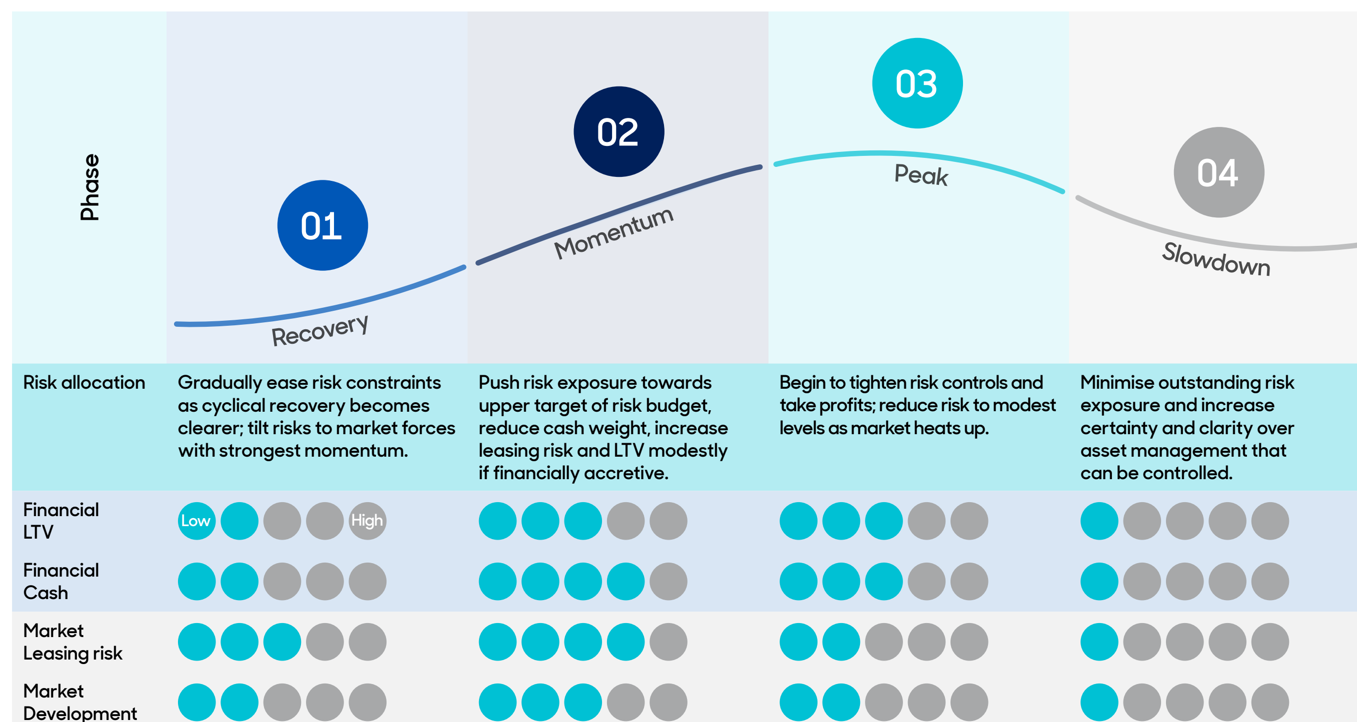
Alongside country and sector allocations, risk strategy is another critical determinant of performance. The risk tools available to funds can be broadly placed into four buckets: financial leverage (debt), liquidity management (cash), leasing risk, and development exposure. The taps can be tightened and loosened during the cycle, in line with fund guidelines and market conditions.

Risk exposure targets are set, but then flexed throughout the cycle. It’s not easy to add or remove risk in response to sharp changes in market conditions, so it’s vital for managers to operate within the confines of their overall risk parameters. That said, investors expect their managers to deploy predetermined risk measures to achieve the target risk-adjusted returns over the long term. Chart 21 illustrates the four main phases of a real estate cycle and the risk management in each phase. It is not prescriptive, as each cycle is different and managers should deploy risk where conviction is greatest in the outlook for each variable.

Chart 21: Illustrative real estate cycle and risk strategy

Real estate fund cycle and risk appetite

Risk exposure through the cycle – core funds



Source: abrdn August 2024

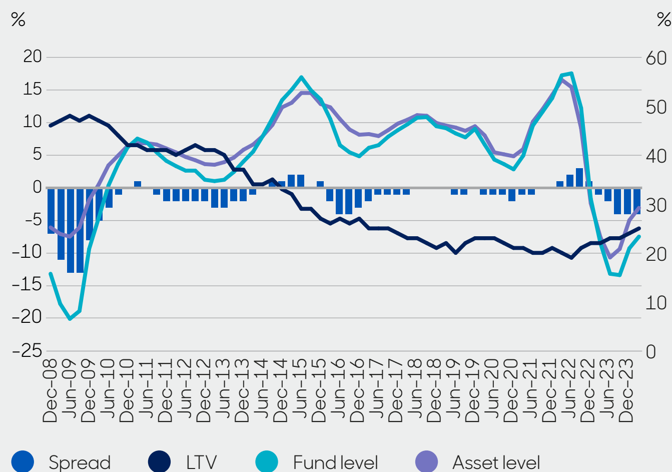
For illustrative purposes only and not meant to constitute advice. Actual outcomes may differ.

European diversified real estate strategies: right time, right place

Financial leverage

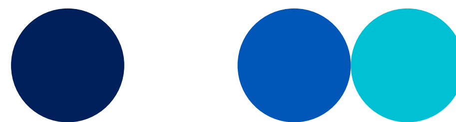
Debt has been integral to many European strategies, using financial leverage to expand mandates and diversify investments, especially in cross-border ventures where a larger footprint is necessary. When the cost of debt is below real estate net yields, leverage boosts net cashflows, distributable proceeds, and overall returns. However, debt increases risk; falling values affect equity more significantly than unleveraged strategies. Breaching loan covenants can have severe financial consequences. Thus, while leveraging has benefits, it carries risks. For core and core-plus strategies, which dominate diversified fund styles, a long-term maximum loan-to-value (LTV) ratio below 40% is suggested. Since the Global Financial Crisis, target LTVs have decreased. Post-crisis, Continental European asset-level returns dropped by 7.5% over the year to June 2009, with fund-level returns at -20.1%, largely due to leverage. Now, LTV ratios are lower. Chart 22 illustrates changing debt usage in the PEPFI over time. While market movements cause short-term fluctuations, funds have generally reduced their debt exposure. Recently, European funds saw asset-level returns of -10.7% and fund-level returns of -13.4% over the year to June 2023. The smaller spread was partly due to lower LTV ratios and lower-cost debt.

Chart 22: Performance at asset level and fund level across continental European property funds and LTV % GAV



Source: MSCI, abrdn August 2024.

Our fund modelling experience suggests that with an LTV of 30% and long-term average debt costs, leverage can add between 150 basis points (bps) and 200 bps per annum (pa) to core portfolio returns over the long term. Rather than providing significant performance upside, one way to consider the use of modest leverage is as an offsetting mechanism against the impact of tax, fund costs and fees. Without leverage, there is nothing to help absorb the costs incurred in managing a multi-country real estate fund. We therefore expect to see the continued modest deployment of leverage in funds in the future.



4. Approach to sustainability

A recent survey by JLL found that 78% of tenants and 83% of investors expected climate risk to pose a financial threat to their business, yet only 23% had made any provisions to mitigate it. Indeed, S&P Global found that only 26.5% of companies had a plan for how to cope with the physical risks of climate change. Regulation is beginning to encourage landlords and tenants to think about their decarbonisation responsibilities in a more proactive way. This is no different to the managers and clients investing in diversified European real estate strategies.

For real estate investors, it can be hard to know where to start. At the highest level, the European Green Deal is a comprehensive plan aimed at making the EU's economy sustainable by turning climate and environmental challenges into opportunities across all policy areas. Within the Green Deal, there are several major pieces of legislation that investors need to be aware of.

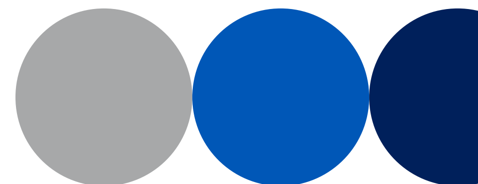
1. **The EU Taxonomy** is a classification system established to provide companies, investors, and policymakers with appropriate definitions for which economic activities can be considered environmentally sustainable. It is a key component of the Green Deal, helping to direct investments towards sustainable projects and activities.
2. **Sustainable Finance Disclosure Regulation (SFDR)** requires financial market participants to disclose how they integrate sustainability risks and consider adverse sustainability impacts in their processes. It works in conjunction with the EU Taxonomy to ensure transparency and prevent greenwashing.
3. **Energy Performance of Buildings Directive (EPBD)** sets out requirements for the energy performance of buildings, including targets for renovations and the phase-out of fossil fuel-based heating systems. The 16% least-efficient commercial properties must be renovated by 2030 and the bottom 26% by 2033. All new buildings will be required to have zero on-site greenhouse gas (GHG) emissions beginning in 2028 for public buildings and 2030 for others. This, in effect, eliminates gas furnaces in new construction by the end of the decade. This is one of the most immediate areas of focus for European real estate investors.
4. **Energy Efficiency Directive (EED)** establishes measures to promote energy efficiency across the EU, including binding targets for energy savings.
5. **Renewable Energy Directive (RED)** sets targets for the share of renewable energy in the EU's energy mix and promotes the use of renewable energy sources.

These pieces of legislation are supported by various other regulations and directives that address specific aspects of environmental protection, such as waste management, water quality, and biodiversity conservation. Together, they form a comprehensive and integrated approach to achieving the EU's sustainability goals. Other specific legislation will have an impact on real estate performance. The cost of transitioning assets to meet minimum standards or the 'brown discounts' applied by investors are already affecting performance. Investors need to meet new regulatory requirements to remain compliant and to ensure decarbonisation costs are minimised.

At abrdn, we take our sustainability obligations seriously, and our approach is embedded throughout the investment process. While the regulatory obligation is increasing, we also believe that it's an important asset management consideration and part of good investment management practices. Diversified European real estate strategies are in the crosshairs of this regulation and need to comply with the EU Sustainable Finance Disclosure Regulation (SFDR). Valuers are increasingly assessing sustainability characteristics in their valuations. So, having a well-established sustainability process is critical for the success of European real estate strategies in the future.

"We take our sustainability obligations seriously and our approach is embedded throughout the investment process."

European diversified real estate strategies: right time, right place



4.a. abrdn's approach to sustainable investment

abrdn's approach to ESG in direct real estate investment

At abrdn, we are committed to integrating environmental, social and governance (ESG) factors into every stage of our direct real estate investment process. We believe that this leads to better outcomes for our clients, tenants, communities, and the environment. In this paper, we will outline how we apply our ESG principles and practices across the following areas: fund-level planning, asset-level planning, asset and property management, refurbishment and development, and transactions.

Fund-level planning

At the fund level, we set our ESG ambition and goals for the year ahead, based on our ESG real estate approach. This approach groups 21 material sustainability indicators into four themes: environment and climate; demographics; governance and engagement; and technology and infrastructure. These themes guide the prioritisation and integration of ESG factors at the fund and asset level. They also provide a structure for engagement and reporting. We use an ESG risk and performance dashboard to flag ESG risks and opportunities for each asset in the fund, and to track progress against our goals. Our goals are aligned with voluntary and regulatory ESG frameworks, such as the Global Real Estate Sustainability Benchmark (GRESB), the Sustainable Finance Disclosures Regulation (SFDR) and the EU Taxonomy.

Asset-level planning

At the asset level, we integrate ESG considerations into our asset management plans. These plans are designed to enable the assets to contribute to the fund-level ESG goals and to enhance the ESG credentials of the assets. We identify and implement ESG actions, such as installing solar panels, improving water efficiency, engaging with occupiers, and enhancing biodiversity. We update and monitor these actions quarterly, using our ESG database. We also include decarbonisation capital expenditure into our 10-year IRR calculations, to ensure that we account for the costs and benefits of reducing our carbon footprint.

Asset and property management

We work closely with our property managers to ensure that ESG factors are integrated into the day-to-day management of our assets. We select preferred property managers who share our ESG vision and values, and we include ESG services and key performance indicators in our property management contracts. We also provide ESG training and engagement to our property managers, to build their capacity and collaboration. We collect and analyse ESG data from our assets, such as energy consumption, carbon emissions, waste generation, and occupier satisfaction. We use this data to inform our ESG actions and reporting, and to benchmark our performance against industry standards.

Refurbishment and development

We have established ESG guidelines and standards that apply to all our new construction, major renovations, and forward-funded developments. These guidelines and standards set out the ESG criteria that we use to appraise and design our development schemes, such as building certification, energy and carbon performance, biodiversity, and physical climate resilience. We seek approval for major development through our Investment Committee, which considers ESG factors alongside other material issues. For smaller refurbishment projects, we use an ESG checklist to identify and include ESG opportunities that support our fund goals.

Transactions

We have recently launched a standardised approach to ESG due diligence across the UK and Europe, which covers both acquisitions and disposals. This approach involves two key steps: a pre-bid ESG screen and a post-bid detailed ESG assessment. The pre-bid screen is done internally to support our investment decisions and to inform our assumptions and costs. The post-bid assessment is done by external consultants to assess ESG risks and opportunities in more detail, such as contaminated land, physical climate risk, decarbonisation risk, and alignment with SFDR and EU Taxonomy criteria. Our approach to ESG due diligence ensures that we minimise our exposure to ESG risks and maximise our potential for ESG value creation.

You can find out more about abrdn's approach to addressing climate change **here**.

European diversified real estate strategies: right time, right place

4.b. Article 8 under the EU Sustainable Finance Disclosure Regulation (SFDR)

Many European real estate funds are now targeting Article 8 classification to ensure they are aligned to the EU's sustainability targets. Direct real estate funds with an Article 8 classification, under the EU Sustainable Finance Disclosure Regulation (SFDR), signify a proactive approach towards promoting environmental and/or social characteristics into their investment strategies. This classification not only highlights the fund's commitment to sustainability, but also offers a range of advantages that align with the growing demand for responsible investing.

Firstly, Article 8 funds are designed to promote environmental and social characteristics, ensuring that the investments made are in properties that adhere to high environmental standards. Besides promoting sustainability, Article 8 funds can also opt for adopting a minimum percentage of sustainable investments in the portfolio; either EU Taxonomy or a credible, proprietary methodology can be applied to define a sustainable investment.

This includes energy-efficient buildings, properties with lower carbon emissions, or those using sustainable materials. For investors, this means participating in efforts that support the transition to a low-carbon, sustainable economy – a crucial factor for those looking to make a positive impact through their investment choices.

Secondly, the focus on social aspects within the ESG framework ensures that investments are made in properties that consider the wellbeing of their communities and residents. This can include affordable housing projects, developments that contribute to local employment, or those that offer essential amenities to underserved areas. Such initiatives not only foster community development, but can also enhance the long-term value of the investments by creating more vibrant, sustainable communities.

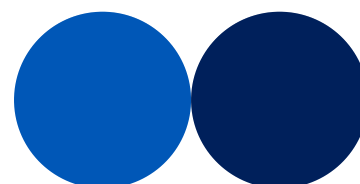
Lastly, governance factors play a critical role in the management of Article 8 funds. Strong governance practices aim to ensure transparency, accountability, and ethical business conduct. For investors, this means greater confidence in the management of their investments. They know that there is a commitment to maintaining high standards of corporate governance, which is essential for sustainable, long-term value protection and creation.

4.c. Impact of sustainability credentials and transitioning on total returns

While investors have no choice but to tighten their approach to sustainability, understanding how this will affect returns is important. So, does taking a proactive approach to sustainability influence returns? While there is no perfect data that shows a consistently measurable relationship between sustainability and performance, there's some compelling evidence that performance is increasingly linked to sustainability factors. A recent study by INREV and GRESB shows that by simply participating in GRESB, funds had a stronger chance of outperforming those that didn't. We believe that at the highest level, this demonstrates that sustainability considerations, and the desire to measure them, are part of modern asset management strategies. Those taking a proactive approach are benefiting from better performance.

There are higher correlations between total return performance and environmental scores in GRESB, suggesting that the material improvement to a building's environmental impact has a positive impact on performance. This is good news for assets that beat minimum efficiency standards – the sort of assets held by core European real estate funds. However, there is evidence from the study that governance, social and management scores had a negative correlation with performance. Essentially, these aspects of sustainability are a cost for managers that they are not directly compensated for in terms of performance.

"There's some compelling evidence that performance is increasingly linked to sustainability factors."

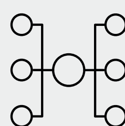


European diversified real estate strategies: right time, right place

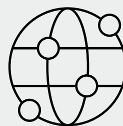
Where risk tolerance allows, some managers might find that creating future-ready assets for their portfolios can be a good way to bring the right quality of assets into their portfolios. Forward purchases of pre-let logistics warehouses, offices or other assets can ensure strategies are exposed to future-ready stock from the outset, while minimising the need for costly decarbonisation works. One of challenge for managers looking to reduce emissions is gas heating. Removing gas heating and replacing this with air-sourced heat pumps is expensive and not always possible. This can leave lasting effects on energy efficiency ratings and sustainability assessments.

What steps can managers take to capture 'green premiums' and avoid 'brown discounts'? Firstly, they should ensure that both current assets and future acquisitions are on a decarbonisation path to prevent them from turning into 'stranded assets'. Additionally, it's crucial to identify the clear costs of decarbonisation for any assets that require it. Managers also need to understand that their sector and country allocations will influence their sustainability obligations.

"We believe that countries that already have advanced sustainability criteria, minimum efficiency requirements and building quality controls will offer more resilient options for investors in the future."



Sectors Some asset types are more energy-efficient or have lower emission intensities than others. Those with a focus on hotels or life sciences will face higher energy and emissions intensity compared with those investing in residential properties, student accommodation, or self-storage. The overall emissions from a property also depend on the division between operational carbon (landlord) and occupational carbon and behaviour (tenant).



Countries Country allocation also matters, and not only due to the range in climate change impacts and transition risks between hot and cold countries or the pace of decarbonisation of the national grid. The EU is permitting some autonomy in setting domestic legislation when it comes to factors such as setting deadlines for Energy Performance Certification (EPCs) scores. We believe countries that already have advanced sustainability criteria, minimum efficiency requirements, and building quality controls will offer more resilient options for investors in the future. If regulation tightens at the EU level in the next decade, managers with exposure to the most stringent markets today will have less to do to harmonise their approach to sustainable investing or to the physical condition of their assets Green Street has a useful country ranking designed to help managers to ascertain how severe sustainability regulations are in each jurisdiction. While low-ranking markets such as Warsaw, Rome and Milan might have fewer regulations and costs for investors to deal with today, future regulatory expansion would leave investors requiring significantly more work to meet harmonised requirements. Amsterdam, Helsinki, Lisbon, Lyon, Paris and Stockholm are some of the most stringent markets in Europe today, but should require less costly adaptation in the future. Understanding the forward path for decarbonisation and how much of that lies with the landlord is critical to understand.

European diversified real estate strategies: right time, right place

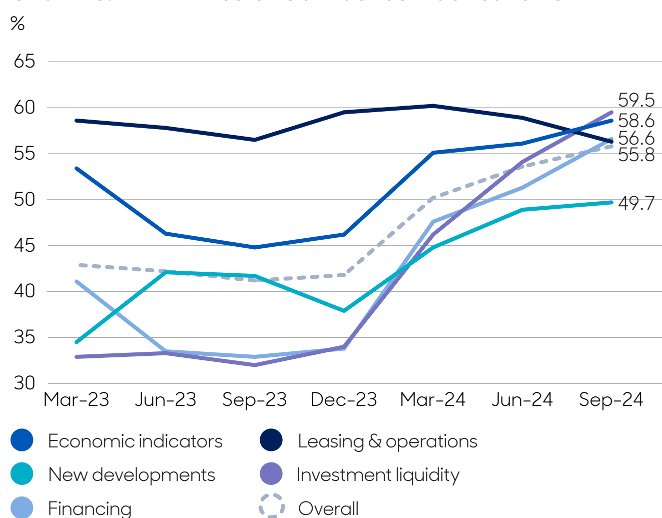
5. Why now for European diversified real estate funds and what strategies should they employ?

5.a. Indicators support growing momentum in recovery

We are now seeing signs of stability emerging. For example, in the first quarter of 2024, INREV reported the first positive quarterly total return from European and UK real estate in seven quarters. In the second quarter, the MSCI Pan-European Pooled Fund Index delivered its first positive return since the downturn. In addition, over 80% of CBRE's monthly market yield estimates for over 300 segments of the European market were reported as stable over the quarter to August 2024. You can read more about our outlook for European real estate **here**.

What differentiates this cycle is that rental growth has continued during the downturn and looks set to beat inflation over the next few years as supply remains low. However, in addition to resilient cashflows, financing and liquidity conditions are improving, and now most of the key variables are pulling in the same direction. Chart 23 shows INREV's latest confidence indicators across key drivers, all of which are now in growth territory except for development fundamentals. Subdued development is one reason why we expect rental growth momentum to persist.

Chart 23: INREV Investor Confidence Index June 2024



Source: INREV, abrdn September 2024.

5.b. Key supporting factors behind the opportunity

We think the best opportunities from a risk-adjusted return basis are to be found in core European real estate. With stronger foundations supporting the market, expected core returns have risen sharply in recent quarters. We now forecast core European real estate to deliver total returns of 9% pa over the next three years. The latest INREV confidence indicator to June 2024 also shows a notable rise in sentiment behind core strategies.

We believe now is an opportune moment for investors to consider allocating to core European diversified funds. Here are the five main reasons for our view.

1. Core capital value reset. The European and UK markets have seen values decline by 19% and 22%, respectively, from their June 2022 peak, according to data from MSCI. This puts a significant amount of repricing risk behind us and provides space for a recovery. Some segments, such as UK logistics and European residential, have already seen values begin to rise once more. The vintage analysis by INREV referenced earlier in this paper highlighted the importance of allocation timing in the delivery of returns to investors.

2. Relative value flashing green. Real estate yields have risen to levels not seen for more than a decade in some sectors. The average prime yield in the UK and Europe is now at 5.7%, up from 4.2% at the peak of the cycle. This represents an appealing cashflow for investors, compared with interest rates on cash. It also compares favourably with yields on Eurozone and UK government bonds, which are currently at 3.1% and 4%, respectively. As shown in chart 24, a spread of roughly 280 bps represents a healthy illiquidity premium for core assets, especially when considering the outlook for income growth over the next few years. With the Riksbank, European Central Bank and others across Europe now easing policy and cutting rates (albeit gradually), the momentum is certainly in favour of real estate relative pricing and lower debt costs.

> "What differentiates this cycle is that rental growth has continued."

European diversified real estate strategies: right time, right place

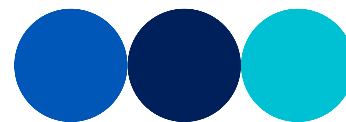
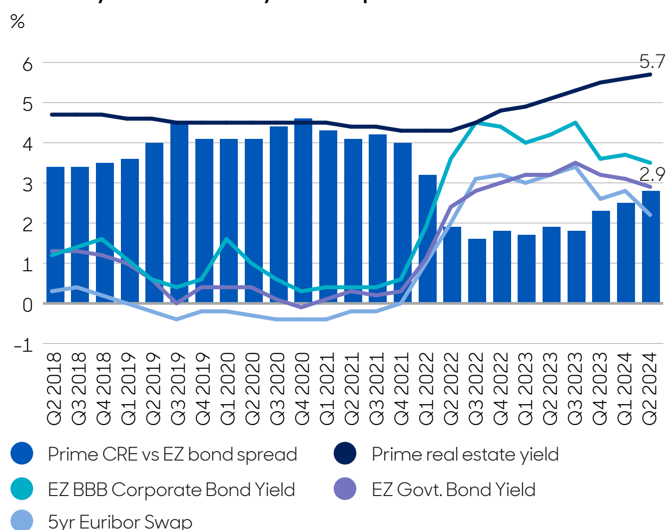
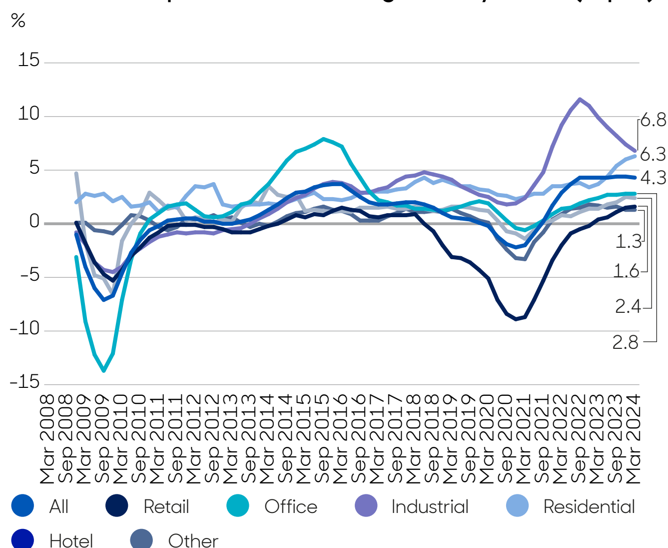


Chart 24: Spread between real estate yields and fixed income yields and five-year swaps



Source: LSEG, abrdn Houseview yields June 2024.

Chart 25: European market rental growth by sector (% p.a.)



Source: MSCI European Quarterly Index, abrdn June 2024.

Investors have options across asset classes. But the higher yields now prevalent in core real estate assets, compared with three years ago, offer stronger potential returns at this point in the cycle. Core assets also face fewer headwinds from decarbonisation costs and expensive financing for capital expenditure projects associated with higher-risk strategies. INREV's latest investor confidence survey shows a sharp increase in appetite for core real estate strategies in June 2024, at the expense of more opportunistic strategies as investors switch focus.

3. Cycle-defining income growth. After the 2008/2009 Global Financial Crisis, rental growth across sectors turned negative and took the best part of three years to recover. In the latest downturn (which was almost entirely fuelled by sharp interest-rate hikes, as opposed to economic recession), rents in all sectors have risen in both nominal and real terms. All property rents have risen some 8.5% over the two years since the downturn began in June 2022.

Average rents across all sectors rose by 4.3% in the year to March 2024. European and UK logistics rents increased by an average of 7% and residential rents by 6% over the same period. Even office rents beat inflation with 2.8% growth. Prime office rents in Munich increased by a staggering 17%. So, not only are investors able to source attractive yields in core real estate again, but those cashflows are growing year on year too.

Looking ahead, a reduced development pipeline is likely to mean this cycle is characterised by above-average rental growth for some time. Structurally, we will be creating fewer new properties, as materials become harder and more expensive to source, and as policy adjusts to promote the improvement of existing buildings rather than the addition of new ones.

Cyclical pressures are also weighing on construction. European construction order books contracted by 18% in the year to May 2024. And residential development is set to fall to just three housing units per 1,000 people next year – the lowest level in over a decade. This is in response to high financing and construction costs, developer insolvencies, and a lack of appetite for development strategies.

4. Sustainability divides the best from the rest. The definition of core real estate is changing. Tighter sustainability regulations (such as those established in the EU's Energy Performance of Buildings Directive), and more discerning tenants and investors when it comes to environmental standards, mean strong sustainability criteria are now essential if assets are to be considered core. As discussed earlier, there is a growing amount of research that shows a positive correlation between sustainability scores and total return performance. And with the EU introducing new target dates for minimum energy performance certificate ratings, as part of the Energy Efficiency Directive, asset sustainability criteria will have a greater impact on performance.

European diversified real estate strategies: right time, right place

There is growing evidence of the costs required for assets to meet decarbonisation targets. Core assets that beat minimum efficiency standards will be confronted with fewer decarbonisation costs, which should act to further differentiate performance compared with less-efficient assets.

5. Debt accretive for core assets again. The days of ultra-cheap debt are over, yet we should consider that decade-long period an anomaly as opposed to the norm. Today, debt is readily available for core European real estate and debt pricing is improving. Clearing banks have been profitable during the higher interest-rate period and they have cash to lend. This has created competition for assets among lenders, driving margins lower. With the five-year Euribor swap rate currently trending stable at around 2.2% (down from 3.5% in October 2023), the all-in cost of fixed loans is below current prime yields. With values showing tentative signs of improvement, leverage should gradually begin to add to the performance of core real estate.

Chart 26: Debt costs, real estate yields and debt spreads – selected markets (%)

Country	Sector	5yr Euribor Swap	Bank margin	All-in debt cost	Net Initial Yield	Debt yield spread
Germany	logistics	2.2	1.2	3.4	5.3	1.9
Germany	office	2.2	1.2	3.4	5.2	1.8
Belgium	logistics	2.2	1.4	3.6	5.3	1.7
Netherlands	logistics	2.2	1.4	3.6	5.2	1.6
France	office	2.2	1.7	3.9	4.7	0.8
Spain	residential	2.2	1.7	3.9	4.5	0.6

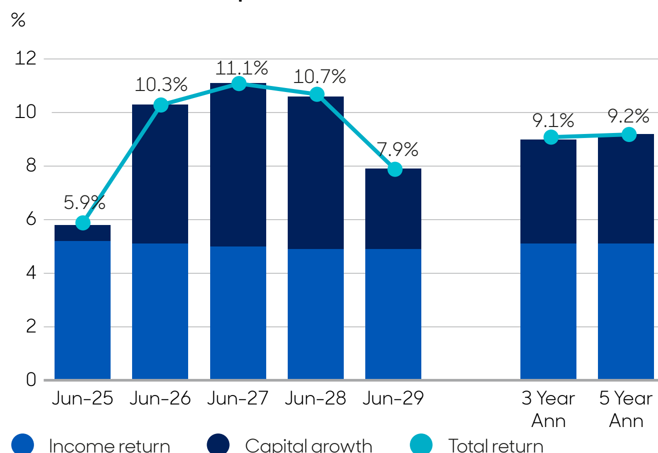
Source: Green Street yields, abrdn treasury survey, LSEG, abrdn August 2024.

5.c. Forecasts and strategy

With the market hitting the bottom and the fundamentals holding up well, expected returns have increased steadily. With valuations now stabilising and rents rising, we're forecasting European real estate to return 9.1% pa over the next three years. This will be led by the residential and logistics sectors at 10.8% a year each, student accommodation at 10% pa and hotels at 9.4% pa. These are the strongest forecasts we have published since before the pandemic–with double digit returns from core assets in mature real estate markets typically only achievable in the wake of large corrections – which is where we stand today.

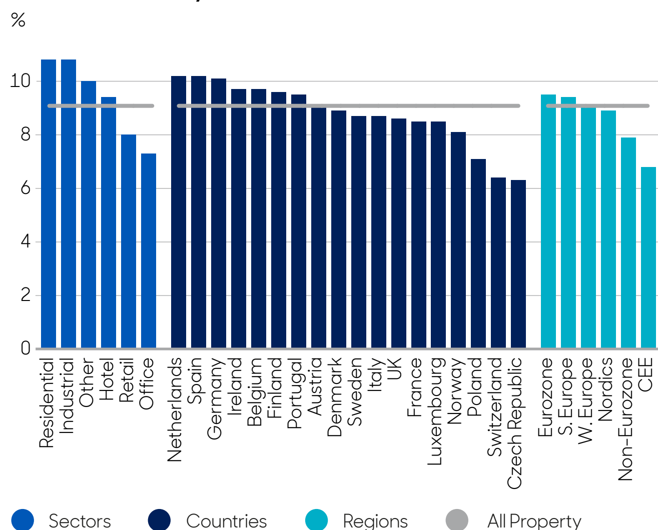
Offices remain under pressure from the increased prevalence of working from home and we forecast a 7.3% annualised return from the sector in Europe. Some higher-quality central business district offices will perform well, given consolidation into core areas, but this is only a small proportion of the investible office market. Many of those will still face higher tenant churn, shorter income and higher capital expenditure to meet minimum efficiency standards. Chart 27 shows our forecasts for European real estate as of June 2024, and chart 28 splits the forecasts out by sector, country and region for three-year annualised total returns.

Chart 27: abrdn European real estate forecasts



Source: abrdn June 2024.

Chart 28: Three-year annualised total return forecasts



Source: abrdn June 2024.

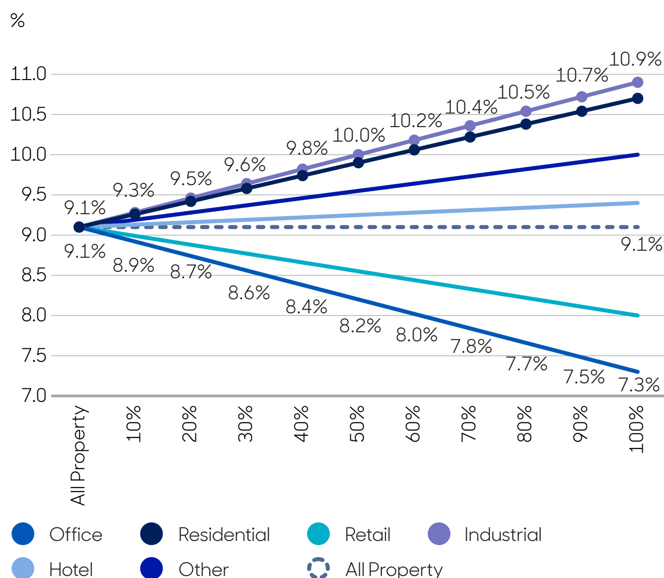
European diversified real estate strategies: right time, right place

"Stock selection is as important as sector selection in driving good performance for investors."

5.d. Allocations designed to get the best out of the market

Diversified funds are often referred to as 'balanced funds' but to be future-fit and to get the best out of the asset class they need to be more targeted than the title suggests. Chart 29 shows the current all-property forecast return (9.1% pa) and then the expected asset-level portfolio return based on incremental increases in allocation to each sector from the weighted all-property return. A 50% allocation to logistics within a diversified fund would give a 100-bp outperformance pa over a five-year period. A 50% weight to offices on the other hand would take 100 bps per annum off returns. Being in the right parts of the market should support the probability of better performance.

Chart 29: Forecast five-year annualised returns with incremental allocations to individual sectors



Source: MSCI, abrdn August 2024.

This is a fairly arbitrary way of considering the impact of sector allocation. The following chart shows the impact on returns and portfolio volatility from an increasing allocation from all property to specific sectors. Increasing allocations to residential, hotels and alternatives (other) would all improve the risk-adjusted returns of the portfolio. Increasing the allocation to logistics adds to total return performance expectations but also adds volatility.

It's fair to say that some of the logistics volatility has been skewed to the upside in recent years, so it might be overly penalising a strong sector. However, it still means the allocation would increase tracking error against a market-weighed portfolio.

It is also important to note that not all offices are bad and not all logistics warehouses are good ones. That is where manager expertise comes in. Stock selection is as important as sector selection in driving good performance for investors. We see a clear consolidation trend into the best offices in the best locations in Europe, and investors need to be on the right side of this polarisation.

Chart 30: Forecast five-year returns and volatility with allocations to sectors

Source: MSCI, abrdn August 2024.

A similar exercise can be carried out with country-risk exposure, using our proprietary Global Risk Navigator model. It doesn't just look at volatility, but measures implementation risk within each country. We can also use it to see how increasing or decreasing allocations to each country would affect return and country-risk exposure in the future. Based on our current forecasts and risk scores, allocations to Germany, the Netherlands, Finland, Spain and Sweden would increase return potential and reduce overall weighted country risk. Allocations to Ireland, Belgium and Portugal would increase total return potential but increase weighted-average country risk. This is shown in chart 31.

European diversified real estate strategies: right time, right place

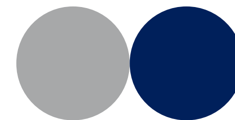
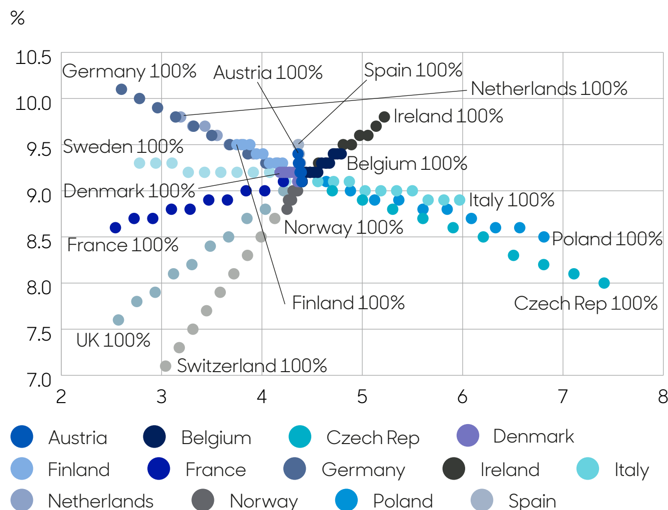


Chart 31: Five-year annualised country-level total return forecasts and risk scores by allocation



Source: abrdn Houseview and Global Risk Navigator August 2024.

This data could be used to run portfolio optimisation. But to gain sensible answers, many adjustments and constraints need to be put in place. The quality of the data used to reach the results is also imperfect. Our approach allows managers to understand how portfolio decisions impact risk-and-return potential. A quarterly review of the forecasts and risk measures means we can stay on top of market trends and what they mean for current allocations.

There are many other considerations that go into strategic decisions. Currency exposure is an important one as it can bring additional volatility or costs to a strategy if the currency is to be hedged. In many respects, a Eurozone-only strategy can provide enough geographic diversification without additional currency risk and this can be more appealing to a wider pool of investors too.

6. Final thoughts – adapting strategies for future success

In this paper, we have demonstrated that European real estate delivers attractive risk-adjusted returns for investors. European diversified strategies bring additional returns and less volatility. But they can also act as a strong diversifier to bond and equity holdings, which have become more correlated over the last 10 years. Real estate could potentially act as a stronger diversifier if we see interest rates continue to drift lower. So, whether an investor is looking to diversify domestic real estate strategies or to balance risk and reward from multi-asset portfolios, this type of vehicle can provide attractive supplementary risk-adjusted returns. Liquidity is a barrier for many pools of capital, but as long as investors have a medium- to long-term investment horizon, the liquidity challenge should not be a significant barrier to investing.

However, we also acknowledge that the asset class must continue to adapt to technological disruption, demographic shifts and climate change to meet investor expectations. These factors are a significant barrier to new entrants into the market due to their cost and complexity, so this further enhances the value of strategies already adapting and delivering against this backdrop of structural change.

Managers already on the pathway to creating future-ready portfolios are stealing a march on the competition.

We believe sectors, quality and sustainability will be the predominant drivers of relative returns between assets and portfolios, while country allocations will influence risk exposure. Sustainability will play an ever-greater role in defining asset quality through tightening regulation, decarbonisation costs to meet net-zero deadlines, and investor and tenant requirements. Managers must adapt their risk strategies, sector allocations and sharpen their assessment of quality to build future-ready portfolios. However, while the ingredients need to change, the essence of what diversified real estate funds offer investors should prove valuable. It's simply a case of ensuring portfolios are positioned well for the future, so that they deliver more than the sum of their parts.

"Managers already on the pathway to creating future-ready portfolios are stealing a march on the competition."

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