

# Operating expertise essential for delivering core-plus returns in European real estate market

**Chase McWhorter**, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with **Jorge Duarte**, fund manager of Hines European Property Partners, a diversified, open-end core-plus real estate fund focused on quality, stabilized assets in European markets with embedded growth potential. Following is an excerpt of that conversation.

*Can you tell us about the European real estate market and what dynamics are currently at play?*

We've had significantly higher inflation and interest rates during the past two years, which has resulted in a big correction, on par with the three prior resets. Property values have been down by approximately 20 percent or more, since early 2022. What's interesting this time around is that real estate supply/demand fundamentals have been much stronger than we'd normally expect at this point in the cycle. Employment in Europe is high. Compared with previous resets, this is the opposite. There was plenty of excess capacity to burn through in the market before improving demand fundamentals, and that is really not the case at the moment. Also on the supply side, previous cycles coincided with a large run-up in development activity, so supply growth was quite substantial. But this time, it has been pretty subdued. And it has been subdued for the past 12 years, due to the post-GFC reduction in appetite from banks for speculative development. That has kept supply in Europe very tight, in contrast with the United States. Europe also has quite a restrictive planning environment, particularly in the city centers, which means we've never had a huge amount of new supply.

The strong demand, combined with limited supply, has resulted in sustained rental growth pressures throughout this downturn. To a certain extent, the pricing corrections in the market during the past couple of years have been compensated slightly with the rental growth, which is in sharp contrast to previous resets, where we had price correction but also had rental-growth correction.

Previous resets have resulted in both capital markets and occupier market recessions because of increase in supply. This time around, the driver of the correction is the increase in inflation and, therefore, the increase in interest rates and financing costs. But we still have a robust occupying market compared with previous cycles.

*What property sectors are looking most attractive to you given the current dynamics?*

Hines takes more of an asset-by-asset approach. There are interesting opportunities across all sectors and risk profiles today. We believe the living and logistics sectors, though, have much stronger tailwinds than the other sectors, so we've been a lot more focused on these two, particularly for the core-plus fund I run.

We do a lot of work with our research team to determine where we expect to see stronger rental growth during the next five years. It's certainly in the living and logistics sectors, but we are also feeling a bit more positive now about retail than we were maybe 12 or 24 months ago. According to Hines Research, the retail sector is forecast to be one of the best-performing sectors during

the next five years. I think there are still some downside risks, particularly when you look at forecasts for ecommerce growth and online spending, but it's certainly the sector where we've seen the biggest correction, both in terms of capital markets and rental correction.

The office sector has been impacted by structural changes as a result of working from home. The right types of offices, in the right locations, with the right characteristics – particularly in terms of ESG credentials – should continue to have strong rental growth, but there is quite a big disparity between the better-quality and the lower-quality offices in terms of rental growth.

In the CBD of Paris, where beautiful, historic buildings have been converted to offices and where it's very difficult to build, the office market is still performing extremely well. Compare that with downtown Seattle, Manhattan or San Francisco. There you have big towers that are less appropriate for current tenant demand. That's where we're seeing the problems. The United States has a laxer planning system compared with most of the European countries, which applies to logistics, as well, with about three times more stock per capita of logistics space than in Europe.

*How is this different from this time last year?*

The biggest change I see is a certain degree of certainty around inflation and interest rates. Everyone will have a different view on whether interest rates have reached a peak, or whether inflation will remain elevated for longer, but in Europe, most will agree interest rates will start to trend down again sometime this year. Inflation already has been trending down for quite some time. The European economies continue to perform relatively well. We expect an increase in activity in the market later this year, with more deal volume and liquidity, as investors start to feel more confident about their ability to underwrite new deals, underwrite where the cap rates are going to be in five years and where the rental growth is going to come from, and to know the cost of debt. That was one of the biggest impediments to deals 12 months ago because the cost of debt was incredibly elevated, and cap rates were still relatively low in most places. This meant most deals would have to be done with negative leverage – meaning the cost of debt being higher than the cap rate. That has corrected to a certain extent, and more deals are in positive leverage territory.

*How are you finding value right now?*

It's not easy to find in a market with limited liquidity. We benefit from having 17 offices in Europe with professionals deeply rooted in those markets. They know their markets very well, and consequently, we continue to find interesting opportunities with sellers that are generally motivated, but not necessarily distressed, who want to deal with a counterparty that will give them greater transaction security. With our core-plus fund, we are looking for income-producing assets to which we can add value by growing the income over time. What's interesting now is that we are finding deals where income is mispriced, and we are able to achieve core-plus or even value-added returns, while

taking significantly less risk than we would expect at this point in the cycle. We're able to find this value because there is limited liquidity, and the core buyers are just not there right now.

***Are there specific markets where the opportunities look particularly strong or numerous?***

The European market doesn't move in tandem. Certain countries and sectors have corrected faster and early on, and that's where we have focused in the past two years. For example, U.K. logistics yields corrected about 200 basis points in the first quarter of 2022, and they've been stable ever since. There are some other countries or sectors that have been slower to reprice, but they are moving in the right direction. The United Kingdom and the Netherlands repriced more quickly than other markets, but markets such as France and southern Europe are now following the same path.

In terms of sectors, logistics was the fastest to reprice. Cap rates for prime logistics were in the low-to-mid threes throughout Europe. They corrected to high fours, and even fives, in certain markets, in the first 12 months. We have been very active in that sector. We also like the student accommodation sector, and the living sector, generally. Tailwinds are pretty strong for living, but particularly for student accommodation, where we've seen a sharper correction in cap rates compared with multifamily. And we are still seeing strong rental growth as a result of significant supply/demand imbalance, particularly in terms of good-quality stock that can house students today. Students nowadays want something different from the days when I was at university. Today, some of the student assets we developed and now own are more akin to a hotel, with swimming pools, gyms, social areas with cinemas, and so on. And these types of assets operate extremely well at very high occupancy and with significant demand that outstrips supply at the moment.

***How are you thinking about constructing your portfolio, given where certain property sectors sit?***

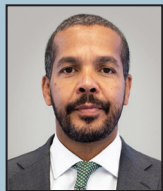
Ours is an evergreen fund, and we truly believe in the benefits of having a diversified fund, both in terms of geography, and also in terms of sector. We also recognize there are stronger tailwinds in certain sectors, such as living and logistics, where we expect to see stronger rental growth for the next five years.

Consequently, nearly 90 percent of the fund is invested in these two sectors. We have been adding diversification by investing in the living sector in multifamily as well as student accommodation, for example. In logistics, we have been investing in last-mile logistics as well as big-box logistics. I think there will be some interesting opportunities in the retail and office sectors, and we are looking into underwriting some deals that might make sense in the portfolio.

From a risk profile point of view, we focus on core-plus, but we're also exploring forward-funding opportunities where we do not take planning or construction risk – just leasing risk – and are able to price these at a significant spread to stabilized assets, which we think will result in attractive risk-adjusted returns. These opportunities were not available two years ago because a number of core investors were willing to take that leasing risk, but still buying it as a core asset. So, we are able to do a small amount of development within the core-plus fund, by doing these forward-funding deals, limiting the planning or permitting risk, and just taking leasing risk.

***There is a lot of talk about active asset management, the importance of generating alpha and passive investors struggling. What does that mean, in practice, for Hines?***

Financial engineering today will probably not produce outsized returns because the cost of capital remains quite high. That is part of the reason there is low liquidity in the market, as much of the value-added and opportunistic money sitting on the sidelines requires leverage to be able to deliver the returns they promise, and it's difficult for them to deliver them solely through pure real estate skills. Our objective is to outperform the market, and to do that, you need to be an active manager. It's that simple. Otherwise, you're just going to perform like the rest of the market. We focus on key macro drivers of demand, such as demographics, technology and climate change, to inform our investment decisions. But from there, our strategy is focused on adding value by growing NOI beyond market growth. We do that through traditional renovation, repositioning, densifying and improving ESG credentials, which is incredibly important today. You can't rely on market growth to generate NOI growth. You really have to work with your assets and your tenants and have operational expertise to be able to justify growing rents and, therefore, growing value.



**CONTRIBUTOR**

**Jorge Duarte**  
Fund Manager  
Hines European Property Partners

Jorge Duarte joined Hines in January 2022 to lead Hines European Property Partners. In his capacity as fund manager, he is responsible for strategy, investment selection, portfolio finance, reporting, fundraising and overall team contributing to this flagship strategy. Duarte brings more than 20 years of investment experience across multiple jurisdictions and core property sectors, having been directly involved in the acquisition, sale, financing and management of assets in 14 European countries. Prior to joining Hines, Duarte was managing director – head of core investing Europe at Barings Real Estate, where he had overall responsibility for the firm's flagship European fund. Prior to that, he was a fund manager at AXA Real Estate, where he was responsible for several Pan-European vehicles.

**COMPANY OVERVIEW**

**Hines** is a privately owned global real estate investment, development and management firm, founded in 1957, with a presence in 384 cities in 30 countries and \$93.2<sup>1</sup> billion of assets under management and more than 109 million square feet of assets, for which Hines provides third-party, property-level services. The firm's current property and asset management portfolio includes 857 properties, representing more than 270 million square feet. With extensive experience in investments across the risk spectrum and all property types, and a foundational commitment to ESG, Hines is one of the largest and most respected real estate organizations in the world.

<sup>1</sup> Includes both the global Hines organization and RIAAUM as of March 31, 2024

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