

# Real Estate Outlook

Europe – Edition 4, 2019



Fundamentals patchy but  
real estate markets robust





The eurozone is seeing a period of relatively low growth due to ongoing political tensions, slowing global trade and concern about the manufacturing sector. On the positive side, services remain buoyant and occupier demand for the office and logistics sectors is robust. International capital is also still entering the market despite a slowdown. Investors have rotated more into alternative sectors, which we explore in our viewpoint.

## Real estate fundamentals

The eurozone economy stabilized in the third quarter of 2019, but has not shown any sign of picking up after what has been a fairly lackluster year. Growth of 0.2% defied consensus forecast expectations; however, sentiment remains depressed and industrial production is in negative territory.

In fairness, there has been a general slowdown in the global economy which has weighed on the eurozone, particularly the external sector. The added political uncertainty has also been a drag, with the fallout from trade wars hitting manufacturing and the impasse over Brexit weighing on private investment. Germany has been hit particularly hard due to headwinds facing its dominant automotive industry. These will likely gather pace as ESG concerns establish themselves due to the country's reliance on diesel fuel.

Despite softening fundamentals, European office demand has been buoyant since 2014, with leasing volumes showing consistent increases (see Figure 1). Leasing momentum has been strong in cities such as Brussels (+60%), Berlin (+27%) and Liege (+123%), although there are signs of momentum tailing off in other locations. Paris (-14%), Frankfurt (-28%) and Amsterdam (-34%) all saw volumes fall away despite expectations they would benefit from a post-Brexit boom. This is most likely related to the fact that there has been a net job loss in these three cities since 2016, which suggests – in turn – that maybe structural headwinds facing the financial sector are more important drivers than Brexit.

But some of these slightly downbeat city numbers could simply be due to a lack of quality space. Vacancy rates have continued to trend down as completions of new space (particularly in the prime segment) have been limited. According to data from JLL, the vacancy rate for major European cities stood at just 5.5% of units in 3Q19. German cities continue to see exceptionally low availability, with vacancy rates in Berlin, Hamburg and Munich now south of 5%.

Against this backdrop, it is hardly surprising that we are still seeing prime rental increases across most markets. Aggregate prime office rents grew by 2.6% YoY, while most major city centers also saw prime rental growth (see Figure 2).

Liege capitalized on its very strong take-up to move rents on by 14%, while German cities Berlin, Cologne and Hamburg all saw double-digit growth. Rental growth was either positive or stable everywhere else, apart from Marseille in France where there was a slight 6% decline. Going forward we expect to see continued rental growth in the office sector, which will take over from yield compression as the main driver of returns.

The retail sector continues to struggle for reasons that are well documented. The UK is the most affected as capital values have fallen significantly for retail warehouse, shopping center and high street assets. While secondary/tertiary assets have been hit much harder, there is also evidence of stress in the prime segment of the market. Of the 46 prime locations monitored by CBRE, just 4 saw rents increase while 19 saw them decline. The impact varies by country and is closely linked to the level of ecommerce penetration in that location; Italian prime rents for instance have been quite resilient, with values rising by 5% in Milan. Such examples are, however, few and far between, with even successful retailers far more selective about where to open stores as they look to build a more 'asset-light' omnichannel presence.

Supply data is scarcer for the retail sector, but in the UK the high street vacancy rate is now thought to stand at around 13.8% of units, and retail parks have around 12.6% of units vacant. This does, however, mask a high degree of variation. Weak secondary shopping centers now have one in five units empty, while prime retail parks are around 9%. We consider the retail warehouse sector to be more resilient going forward, due its high income returns, good accessibility and larger format units. In light of this, it is hardly surprising we are seeing such high rental decline which we are expecting to continue at least until 2020. We do, however, believe there will be selective buying opportunities once this process is complete.

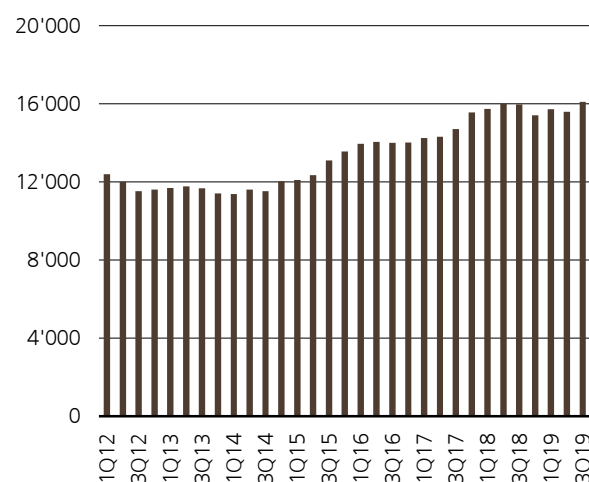
The industrial sector has continued to see strong demand for space with retailer, pureplay operators and 3PLs continuing to acquire warehouse space. Prime industrial rents in the eurozone increased by 3.1% YoY to 3Q19, illustrating high levels of demand (see Figure 2). While occupier demand continues to be robust, there are potential red flags for investors to be aware of. Firstly, the very low margin nature of the distribution business means there may be constraints on future rental growth. A recent UBS investment bank report commented that best-in-class omnichannel retailers were more attractive than pureplay online, due to the latter's lack of progress in growing their cash flows and profit margins. While this is only a single study, this will be of concern to real estate investors as ecommerce operators are currently driving the European logistics market, and a slowdown in that sector could have knock on effects for occupier demand.

On the supply side, there has been increased construction, with completion volumes exceeding take-up last year. However there continues to be a lack of speculative space in the pipeline and very low vacancy rates on a European-wide basis. As a result, we foresee modest rental growth over the next five years for logistics, with greater rates expected in assets located near to cities and large distribution hubs.

Going forward, we expect continued modest rental growth in the office sector, with rents increasing by 1-3% p.a. in the prime segment and 1% p.a. in the average segment. In the retail sector we are expecting some prime rental growth, albeit very selectively while the average retail stock is likely to see rental decline. Industrial is set to still see rental growth continue, but has historically not seen very high rates of expansion. In fact, prime European industrial rents are still only around 8% higher than they were in 2008, while retail rents are 44% above this level and office rents 15% higher. Thus, we are expecting fairly moderate performance, with average growth of around 1% and prime growth of around 2% p.a.

**Figure 1: European office take-up**

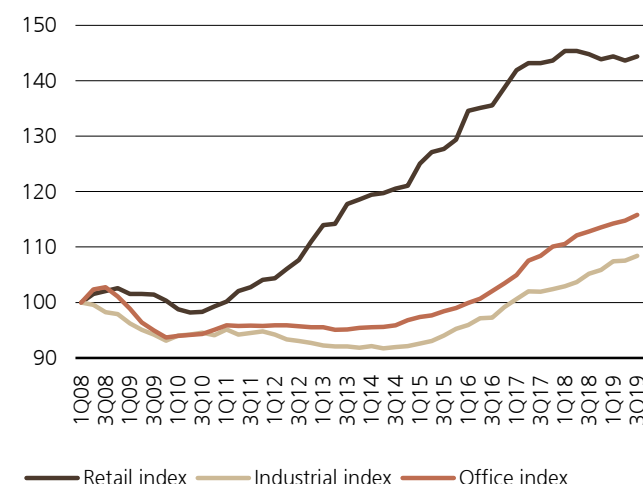
(000s sqm, rolling annual)



Source: JLL, 3Q19

**Figure 2: European rental growth**

(index, 1Q08 = 100)



Source: CBRE, 3Q19



## Capital markets

Year-on-year (YoY) investment volumes have continued to decline for the seventh consecutive quarter, albeit with a degree of stabilization. Volumes were down 5% on the previous year, as weakness in Germany and the UK was offset by France where volumes increased by 16% (see Figure 3). Spain and the Netherlands saw volumes drop off by around 10%, while – surprisingly – Italian volumes jumped 52%, although from quite a low level.

The outperformance of France can largely be explained by Paris overtaking London as the city attracting the most investment in 3Q19. The UK capital has long been the unrivalled location for investment, but political uncertainty in the UK, as well as a strong influx of South Korean money into mostly Parisian offices, has swung the balance the other way. Nonetheless, the UK remains the first port of call for foreign capital entering Europe for the first time, with 70% of first-time buyers making their first acquisition here. Additionally, cross-border investors are still net buyers of the UK, signifying it has perhaps not yet lost its international appeal.

In any case, there is a strange logic to European investment markets at present. While volumes are not growing, they are also not falling substantially either, which with yields at record lows one would expect to happen at some stage. However, with government bond yields now negative in many locations, there is downward pressure on yields as institutional investors are forced to increase allocations to achieve a positive real return. As a result, prime yields continued to compress over 3Q19, with the combined prime yield coming in a further 15 basis points to stand at a record low of 3.6%. This indicates pricing is moving away from any absolute return target, rather relying on the spread over government bonds.

In terms of the individual sectors, industrial (-36 bps) was the best performer followed by offices (-20 bps) but the big surprise was that even retail managed to largely hold the level it was at one year ago. Prime retail deals are very few and far between, but the sale of the Nike store on the Champs Élysées at 2.7% is a reminder that there is still appetite for genuine best-in-class assets. Recent reported declines of 25% on Fifth Avenue in New York should, however, remind investors that no location is immune from the pressures facing the sector.

In fact, all of the traditional sectors have become somewhat unloved of late. As expected, retail investment was at a record low with annual volumes 32% below where they were in 2018.

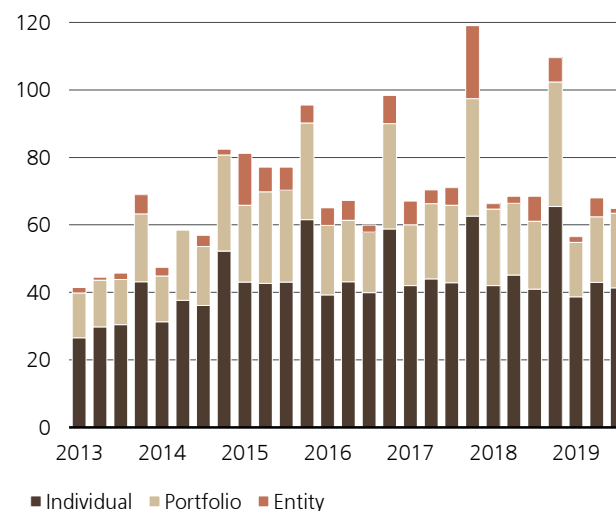
However, industrial and offices volumes were also down by 11% and 4%, respectively. In the office sector, there have been concerns about the increasing market share of serviced office providers, which have really come to the fore following the failed IPO of market leader WeWork. This could lead to an increased risk premium on assets with serviced offices as tenants, especially those that are single-let.

In terms of the industrial sector, while there are still some like-for-like effects of previous large portfolio deals, it is also true to say that investor sentiment has been somewhat varied. We are undoubtedly coming to the end of a long bull run, which has almost entirely been driven by yield impact (with the exception of the UK). As a result, pricing is currently at a level which would require rents to rise to meet return targets. Notwithstanding the structural drivers, many are wondering about the ability of a typically low rental growth sector to generate a strong and sustained increase in NOI.

As a result, investors have turned to alternatives, which have the added benefit of being less cyclical than the core sectors. Investments in senior housing rose 14% on the year, while hotels rose 2%. Apartments remain in vogue and saw YoY investment jump by 7%, while the rate of home ownership continues to decline in most European countries. This particular sector is subject to operating and regulatory risk, however, which we explore further in our viewpoint below.

Overall, our forward-looking expectations for European capital markets are defined by the continued 'lower for longer' interest rate environment. Therefore in spite of high pricing, we do not foresee a significant reversal over the next 12 months.

**Figure 3: Investment volumes**  
(EUR bn)



Source: RCA, 3Q19

## Strategy viewpoint

### Regulatory uncertainties in European residential increasingly on investors' agenda

Since the Global Financial Crisis (GFC) the residential sector has developed from the least favored real estate sector to the second ranked after offices. In 1H19 investments in European residential accounted for more than 22% of total investment volume. Over the last decade institutional and in particular cross-border investors have increased their allocation in to residential.

However, while the downward yield shift in offices and industrial coincided with the cut in central banks' interest rates from 2011, the path of downward yield shift in residential seems to be more timed to the introduction of central banks' unconventional monetary policies in 2015. The yield shift in residential looks drastic but the spread of residential yields to office yields has just returned to its long-term average of 130 bps which was only 80 bps just before the introduction of the ECB's Quantitative Easing program.

The sector's main attractiveness for institutional investors has been the compelling macro story of increasing urbanization, privatization, deregulation and the emergence of an institutional multi-family sector (in Ireland and the UK). Investors have been recognizing residential as a real estate sector offering long-term rental growth prospects at inflation levels (at least). Tight supply in many urban areas has enabled investors to achieve rental growth well above inflation in recent history. After many years of rental growth, affordability of residential rents is now on the political agenda in many European countries. Even though the definition of what constitutes "affordability" is subject to discussion, politicians appear to be focusing on policies limiting rental growth on the landlord side while not tackling the more structural (under) supply side factors.

Economically successful cities are attracting inward migration, but managing residential supply is mainly the responsibility of the local authority regulating the planning and building laws. This can only be managed in the medium-to-long term as highlighted below:

- In 2001 the city of Hamburg introduced an overall regional development initiative. Since then Hamburg has put policies in place supporting growth including how to provide residential supply to support inward migration. The imbalance between supply and demand appears to be less severe in Hamburg as rental growth has been lower compared to other majorly undersupplied but economic successful German cities.

- The city of Helsinki has also followed a long-term supply-led policy approach. Even though there is still a shortage of supply, price increases in the Finnish capital have been less pronounced than for other Nordic peers.

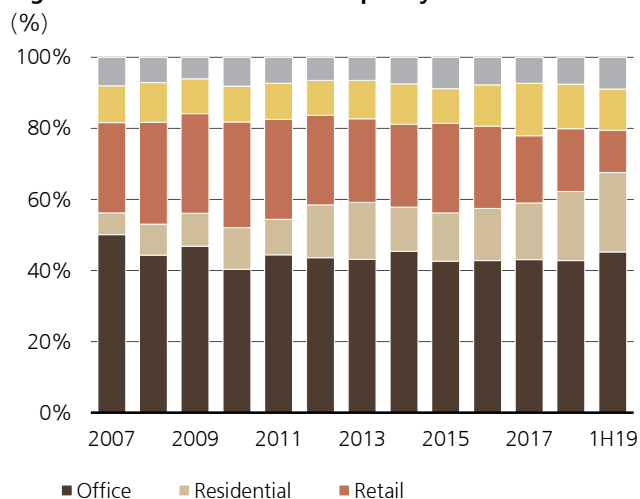
Investors have started to recognize that investing in residential exposes the invested capital increasingly to regulatory risk. While investment volumes in residential are still at very strong levels, cross-border net-acquisitions have slowed. This could be a sign of residential being a more sophisticated real estate sector but also of increasing investor cautiousness. An indication for investors' caution is listed German residential companies which are trading at an 8.7% discount to NAV.

Increasing rent control raises the question on rental and income growth assumptions. Today's yield levels might also be a reflection of the low interest and bond rate environment, which has been supported by a positive rental growth environment.

Increasing regulatory uncertainties on national but also more local levels raise the question of how to factor in a political/regulatory risk premium when acquiring a residential asset. Investors may also reallocate capital to other real estate sectors which are less exposed to regulatory risks. Political risks may not have an immediate impact on the tenants but on invested capex in the future. Considering that the investor's base in residential have been predominantly institutional investors (insurances and pension funds) lower property values tenants might be effected indirectly.

Managing the supply side of a real estate market is a medium to long-term process and requires foresight in policies, while restricting private ownership rights is a short-term (populist) policy but is unlikely to solve market imbalances. Nevertheless, the positive macro story for European residential is unchanged but investors may reconsider (political) risk-adjusted pricing.

**Figure 4: Investment volumes split by sector**



Source: RCA, October 2019

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