

Real Estate Outlook

Europe – Edition 1, 2020



Markets holding firm.



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We are in a market of contradictions:
weak economic fundamentals but
robust property market performance.



In 2019, the European market continued to see positive performance in occupier markets following a late fourth quarter surge in the investment markets. We expect the softening economic fundamentals to continue to weigh on demand. As interest rates are unlikely to rise this year, we do not anticipate a price correction in 2020 despite yields in most cities reaching record lows.

Real estate fundamentals

Sustained high demand continues to drive prime rents

2019 was a challenging year for the eurozone as international geopolitics, domestic political uncertainty and slowing fundamentals weighed on economic performance.

Initial figures show that GDP growth was 1.2% for the year.

The main story has been the slowdown in the German economy, which has struggled with weakness in the manufacturing sector. Part of the weakness is external: car exports have fallen to China and other high-spending emerging economies; however, there are also structural issues such as the falling demand for diesel engines accounting for a large share of production.

A bright spot has been the labor market as unemployment continued to trend down and deliver wage growth ahead of inflation. Thus, in line with global trends the European consumer was very resilient throughout 2019. Employment growth, however, is now beginning to tail off as labor markets tighten.

Despite weakened fundamentals, European occupier markets have remained stable, with aggregate take-up in line with the previous year, and despite a slight dip in the first quarter (see Figure 1). Prime rental growth in 2019 was positive or stable in practically all major European cities, with the exceptions of Vienna and Marseille. German cities continued to see strong growth, but for the first time Berlin was not leading the pack. The capital still saw growth of around 12% YoY, but was bettered by Cologne which saw values increase by 13%. Hamburg and Frankfurt were also top performers, with rents increasing respectively by 11% and 7%, while in Southern Europe, Lisbon (+14%) and Barcelona (+10%) also saw very strong demand.

This continued prime rental growth is to a large extent being driven by under-supply of grade A office space and prime eurozone rents increased by 3.1% over 2019. Building remains relatively depressed in most major cities with the historical nature of the CBD often preventing wholesale development.

As a result the majority of European centers have less than 5% of their total stock currently under construction, despite high levels of demand. The exceptions to this are Paris, Luxembourg and Dublin – where developers are possibly betting on a Brexit boost – as well as CEE markets, in particular Hungary and Budapest. In general though, supply remains very tight with very few cities having more than 10% of space available.

The lack of demand in the retail sector due to the growth of ecommerce has been well documented. As a result, average rents have fallen in most European locations, while more recently prime rents in many cities have also started to decline. This has come about as a result of both corporate administrations and failures, as well as successful retailers looking to close excess stores or rebase rents significantly. The UK is the most advanced in this process; however, Germany, Belgium and the Netherlands have already seen prime rents start to fall, while analysis from UBS Investment Bank suggests France is likely to follow suit. Rents declined by 3% in Berlin and 4% in Cologne while Ghent in Belgium saw values fall by 9%.

It is not all doom and gloom, however. There is still some positivity to be taken from the fact that retail sales are growing on the back of a relatively moneyed labor force. As a result aggregate retail rents actually saw a surprise rise in the fourth quarter by 2.9% YoY (see Figure 2). This was driven by southern European cities as rents continue to rise in Milan (6%), Porto (8%) and Lisbon (4%). However, this could be more due to the fact that valuations have not quite caught up on the downside. UK cities have not reported at the time of writing, and a correction is expected there as average rents continue to fall.

On the supply side, there remains relatively little under construction due to low levels of demand. There is actually likely to be a net loss of retail space in many European locations, as conversion to residential is becoming increasingly popular. This is particularly pertinent for in-town shopping centers which still have high land values and would be well-located for apartments. Another possible use of out of date retail warehouse stock is to convert them into last mile logistics hubs, another thoroughly under-supplied segment of the market. This particular strategy has been held back by retail land values remaining ahead of industrial; however, we have heard of several such schemes now being brought forward in the UK.

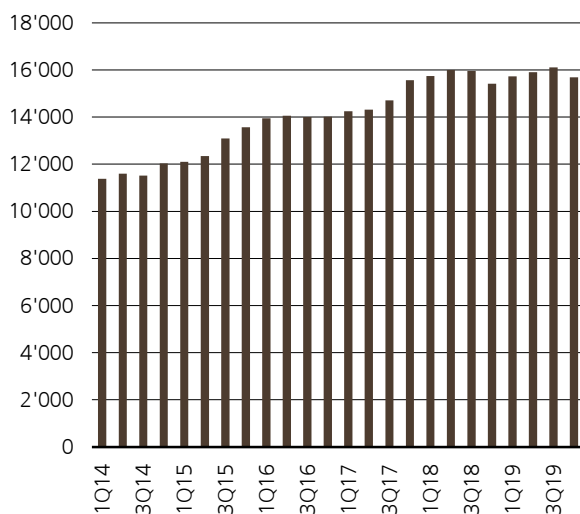
The logistics sector has been the sector of choice over the past few years, with a variety of different operators seeking new space. Rental growth has historically been limited in this area, but by 4Q19 rents had expanded by 4.4% YoY, making industrial the best performing European sector. Prime rents were either growing or stable in all European cities, with the key Dutch distribution hub Venlo-Venray seeing values increase by 11%. Lyon and Liege also saw growth of 10% while German cities Hamburg (7%), Berlin (5%) and Düsseldorf (5%) also saw values increase.

This comes despite a year of underperformance in the German manufacturing sector, further underlining the current disconnect between real estate market and economic performance. Rental growth has also been more pronounced for smaller last mile warehouses located near major cities.

Following the Global Financial Crisis (GFC), there was a significant overhang of supply in the logistics sector which suppressed development across Europe. While there is a scarce supply of data, there are indications that development is beginning to increase, particularly in the UK where a significant amount of speculative space is now under construction. As a result availability has increased over the past year, although supply does remain fairly constrained around the major hubs. Nonetheless, this is something investors will need to be increasingly aware of as the logistics sector is one which typically has very high elasticity.

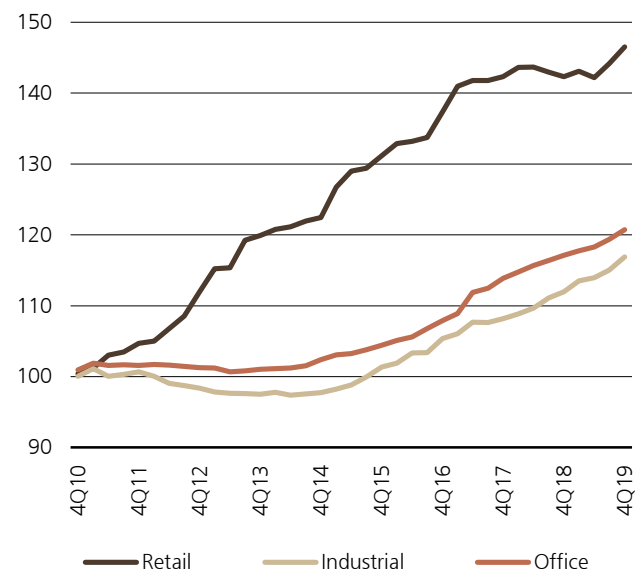
Overall, we are expecting more modest performance over the next three years, as economic fundamentals remain subdued and retail continues to see structural adjustments. We are expecting rental growth of 0.3% for average office stock and 1-3% for prime stock, depending on location. In the retail sector, we are expecting prime and average rents to decline by an average of -0.6%, while logistics will see average growth of around 1% and prime growth of 1.5-2.5%.

Figure 1: European office take-up
(000s sqm)



Source: JLL, 4Q19

Figure 2: Rental growth
(Index, 100=1Q10)



Source: CBRE, 4Q19

Capital markets

Lower for longer boosts investment

European investment markets have been sluggish. Prior to the fourth quarter, there had been seven consecutive quarters of decline in investment volumes. The fourth quarter of 2019 bucked this trend, however. A little over EUR 110 billion was invested, which was consistent with 4Q18 levels and meaning only a very small (-2%) year-on-year decline (see Figure 3).

This recovery was driven by several factors. The first half of the year was marred by uncertainty and a widespread expectation that banks would soon raise interest rates. In the second half of the year, this expectation was dashed and investors became more comfortable with exceptionally low yields. Germany is a good case in point. Despite being one of the worst performing economies globally and having prices at their highest level, an exceptionally strong fourth quarter saw EUR 30 billion invested, making 2019 Germany's best year ever in terms of spending¹.

Similarly, the UK had a very busy December, with around GBP 8 billion spent following the conclusion of the general election, which both averted the risk of a left-wing Labour government and provided more certainty on Brexit. While France has seen a year of intense civic unrest with the "Gilets Jaunes" protest followed by recent strikes over pension reforms, it has also recorded its strongest year ever. These three cases are highly illustrative of quite how disconnected economic and property markets have become in this lower for longer environment.

In terms of cities, Paris overtook London as the capital of European investment with an annual inflow of EUR 28 billion compared with London's EUR 26 billion. This was driven by a large influx of South Korean capital, which appears to have actively targeted the French capital and spending EUR 4 billion alone on offices in 2019. More broadly, the appeal of Paris is likely rising due to the anticipated completion of the First "Grand Paris" stations in 2024. Berlin took third place for the year with a 23% increase in investment. Offices remain the most popular asset class following a year of double digit increases, and surprisingly residential saw EUR 1 billion invested despite the recent introduction of rent controls.

The sectors broadly expressed investor sentiment with senior housing and care seeing a whopping 18% increase in volumes while hotels (+5%) and residential (+2%) saw volumes increase as well. Industrial surprisingly saw a -2% decline on the previous year but this appears to be more due to a lack of appropriate products as the RCA hedonic pricing index showed a year-on-year price increase of 10% per square meter. Offices saw a 2% increase in volumes with EUR 128 billion invested, while retail had a very poor year with investment volumes down by 21%.

Pricing remains very high, with most centers seeing their prime yields either remain stable or fall further over the course of the year. Offices have come back into fashion in most jurisdictions as they offer the highest liquidity and largest lot sizes.

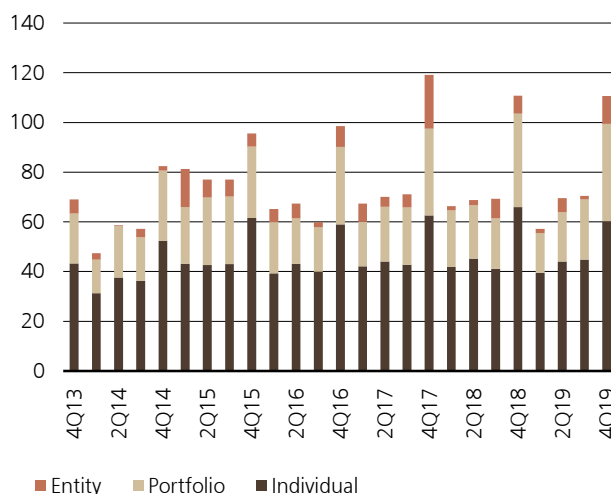
Yields compressed in Madrid, (-50bps), Lisbon (-50 bps) and Rotterdam (-70bps) while German cities Munich (-30 bps) and Hamburg (-30bps) compressed further below the 3% mark. Munich is now the most keenly priced center (outside of Switzerland) with yields standing at 2.6%.

Industrial yields in Germany and the UK have in recent years remained at a similar level; however, the UK saw prime yields stabilize in 2019 to 4-4.5% while German yields dropped to an unprecedented 3.6%, reflecting high capital inflows. France has also seen significant compression in yields, as prime assets in the major conurbations dropped a further 50 bps to stand at 4% for the first time. Retail has followed an opposite trajectory, with yields largely moving out, particularly in the shopping center segment. Yields moved out in most centers, although there were one or two bright spots to be found. Lisbon, which has a less developed ecommerce market, saw prime high street yields compress by 50 bps, while Stockholm saw yields come in by 35 bps.

While we have been arguing that levels of pricing are unsustainable, it seems likely that structurally low interest rates will continue to provide support for record-high capital values. Nonetheless, we do believe that we must be approaching a floor as investors will surely begin at some point to demand a discount for the transaction costs and depreciation charges in real estate, as opposed to intangible government bonds. Overall, we think prime office yields will remain stable over the year, while prime retail will move out by 20bps on average, and industrial will move in by 20bps. The same results should be observable in average office and industrial stock, although average retail will likely see a slightly higher correction of 30 bps.

Figure 3: Investment volumes

(EUR billions)



¹ According to data from Real Capital Analytics
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Strategy viewpoint

ESG is the new buzzword in town – but is it just marketing gloss or does it have substance? We take a look at the evolving theme of sustainability...

According to the World Green Building Council, global building stock is currently responsible for over one third of all CO2 emissions worldwide. Properties also provide the spaces where people live, work, shop and meet, giving them great social importance as well. Sustainability as a concept is therefore growing in importance to extend well beyond just the environment, with ESG (environment, social, governance) one of the keys to this holistic approach for investors.

In order to meet the targets of the 2015 Paris Climate Agreement, environmental regulation is set to get stricter in the property sector. CO2 taxes on building emissions as well as energy consumption thresholds are potential tools of this approach. Sustainability regulations are, however, also reaching out beyond just energy efficiency. For instance, some local regulations might require buildings to comply with social standards, with a main focus on comfort and safety in and around the property. As the urban environment densifies, architectural quality, the organization of communal areas and recreation areas will become more important.

Investors (institutional in particular) are also increasingly embracing ESG when deciding upon real estate investments and external fund managers. In 2019 PERE ran a global survey of institutional investors in the real estate sector. 43% said that they would not invest with a fund manager who did not have an ESG policy. Negative screening to ensure minimum sustainability requirements are met is becoming ever more popular when selecting real estate products and managers. One third of all EMEA respondents have already built this filter into their investment processes (see Figure 4). Primary beneficiaries of institutional real estate investments are also at the forefront of this evolution; eg. pension fund members are increasingly vocal in demanding greater ESG transparency.

New ESG preferences of property users are also changing real estate. This is especially true with the commercial sector, with lessees disclosing more about their corporate responsibility and the environmental impact of their businesses. Sustainability indicators such as these for the property being leased can be a factor in assessments, thus automatically placing new demands on commercial leases.

Real estate asset managers are reacting

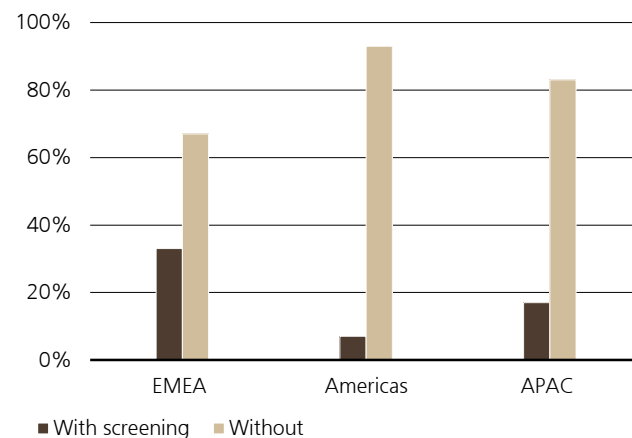
The Global ESG Real Estate Investment Survey by Bentall Kennedy, Realpac and UNEP Finance Initiative (2019) shows that most managers around the world have already built ESG into their decision making. 90% of the investment platforms analyzed, which manage around USD 1,100 billion worldwide, include ESG reporting in their processes. The survey also reveals that asset managers are placing greater emphasis on social responsibility, sustainable corporate management and the circular economy, in addition to just energy-related matters. The integration of ESG factors by the real estate industry is leading to new measurement, reporting and comparability requirements. Comprehensive sustainability strategies require analysis of data on real estate portfolios and lessees, in turn demanding the production and management of significant quantities of data. The use of new technology is essential if a range of sustainability KPIs is to be efficiently and economically reported on.

Latecomers risk loss of value

Developing an integrated approach to sustainability within the real estate investment world is a long and complex process. The physical nature of real estate, its legal aspects and major social and environmental consequences mean that a wide range of data from different sources must be obtained and analyzed. This in turn means that investment in digital infrastructure, such as IoT sensors and data management systems, is essential. Hence, real estate investment managers should adopt a proactive approach in this field. Not doing so could cost them dear as increasing regulatory pressure and the swing in the preferences of investors and lessees carry the risk of leading to the gradual obsolescence of their real estate investments and to value loss in the long run.

Figure 4: Poor ESG indicators leading to exclusion

(% of institutional real estate investors applying a negative ESG-screening when selecting fund managers)



Source: PERE ESG Investor Survey 2019, July/August 2019; UBS Asset Management, Real Estate & Private Markets, Research & Strategy.

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