UBS

August 2015

Eurozone commercial real estate market

Improving occupier market fundamentals – in a tightening real estate pricing environment

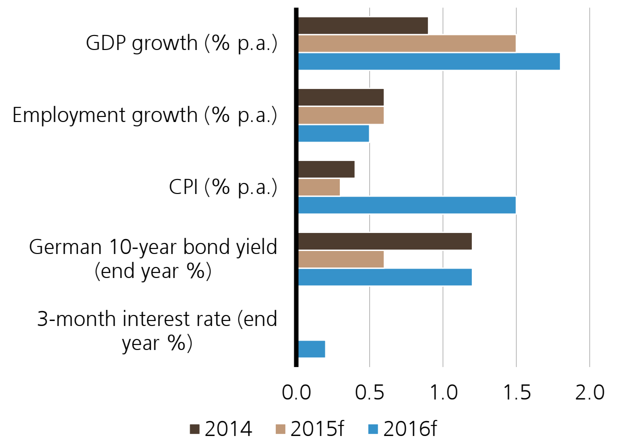
The economic environment

Behind the headlines of the crisis in Greece, the eurozone's economy has produced some encouraging indicators in 2Q15, suggesting that it is moving into a phase of sustainable economic growth. GDP is forecast to grow by 0.5% quarter-on quarter (QOQ), and by 1.5% year-on-year (YOY) in 2015, which would be better than the 1.3% growth forecast at the start of the year. Encouragingly, the consumer sector remained buoyant in 2Q despite a rise in inflation, suggesting the recent growth is sustainable and not purely driven by the fall in energy prices. Monthly export data has also been strong despite the slowdown in emerging markets, as the weak euro has improved the competitiveness of eurozone goods. There are also tentative signs of strengthening in the labor market, with the number of people in full-time employment growing again and expected to increase by 0.8% YOY in 2Q15. As a result unemployment has been edging down, falling from 11.5% at the end of 2014 to 11.1% at the end of the quarter; however, in Southern Europe the rate remains much higher.

The challenges posed by the situation in Greece will inevitably cloud over the eurozone's progress in the coming weeks and months. The eurozone is in a much stronger position to resist contagion than in 2010, partly due to the tools available to the ECB to limit contagion risk through Quantitative Easing (QE) bond purchases and the Outright Monetary Transaction (OMT), as well as through the scaling back of foreign direct exposure to the Greek economy, which has been taking place since the previous crisis. As a result the market reaction to the escalation of the crisis has so far been relatively subdued; bond yields in peripheral markets have moved out marginally but remain well within normal territory and substantially below the levels seen at the height of the previous crisis.

The situation within Greece itself however is bleak. The enforcement of capital controls will have already done severe damage to an already weak economy. For capital controls to be completely removed, a massive increase in emergency liquidity assistance would be required to meet the demand for deposit withdrawals. The scale of demand means it is implausible that the eurozone and ECB will sanction this until Greece is firmly on a credible path towards economic and financial stability and its future in the eurozone is no longer in doubt. Needless to say if this does happen, it will be months if not years, and whatever the outcome the reputation of the eurozone as a single currency will have been damaged by this episode.

Eurozone key economic indicators



Source: Oxford Economics, 28.July 2015

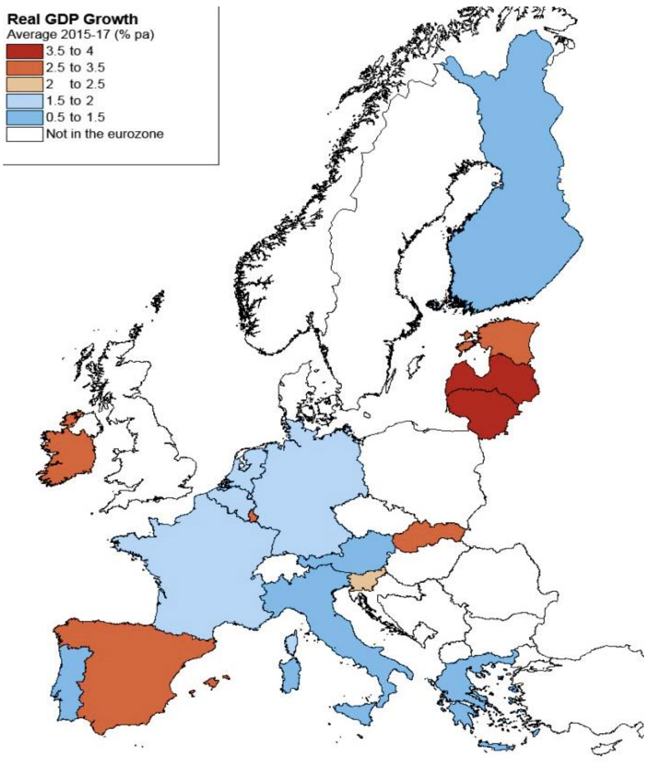
At a country level, the main eurozone economies are starting to return to levels of relatively health GDP growth. Germany and Spain are forecast to record the strongest annual GDP growth in recent years, at 1.9% and 3.2% in 2015, respectively. The German economy is still heavily dependent on exports and is thus exposed to the recent slowdown affecting the Chinese economy. Conversely, Germany also benefits from a depreciated currency and healthy outlook of the US economy. Economic growth in Germany, however, has swung more towards domestic demand this year and may lead to a more sustainable growth path for eurozone's biggest economy. The French economy appears to have turned a corner, and after growing by just 0.2% in 2014 is expected to rebound strongly in 2015 with growth of 1.3% YOY. While Italy still lags behind the eurozone, it has nonetheless left recession and is expected to record annual growth of 0.5% in 2015.

Despite the tense situation in Greece there has been a notable positive shift in sentiment in 2015, which has significantly improved the outlook for the eurozone. The fall in oil prices appears to be having a positive influence on eurozone growth even though the depreciated euro is softening the effect. Consumer spending, however, has picked-up in significantly. Eurozone retail sales rose by 1.3% in 2014, the fastest rate since 2007. In 2015, retail sales in the eurozone are forecast to reach 2.2%, mainly supported by the strong expected growth in

Germany (3.2%) and Spain (3.8%).
While by the end of 2014 many commentators were flagging a deflationary scenario, this seems to be much less likely anymore. There is no evidence to suggest a deflationary environment; indeed the opposite appears to be true and consumers are recycling their additional disposable income created by low inflation back into the economy. Furthermore, the European Central Bank (ECB) has taken drastic action to stave of the threat of deflation and stimulate growth. In January 2015, the ECB announced a larger than expected injection of EUR 1 trillion into the ailing eurozone economy through quantitative easing (QE). ECB's QE action will last at least until September 2016 which should keep bond rates at very low levels for some time. Over the last 12 months the euro has depreciated by around 20% against the dollar. A hike in US interest rates by the US Federal Reserve may put additional pressure on the euro later in the year.

With further depreciation expected against sterling and the dollar, forecasts for eurozone exports have been revised up to 3.6% for 2015. Unlike the examples of large-scale bond purchases by other central banks earlier in the crisis, the ECB's injection comes when the eurozone economy had already shown signs of improvement, and could provide a significant impetus to growth.

Real GDP growth 2015–2017 (% p.a.)



Source: Oxford Economics, July 2015; MapInfo

The greatest threats to the outlook for the eurozone economy are still likely to arise from geopolitical events. Even though Greece has been on the front pages since the beginning of 2015, general elections later this year in Spain and Portugal may also see the rise of anti-austerity parties. Political discussions on a strengthening eurozone have just begun and need to be taken seriously by eurozone governments as political reform in the eurozone has so far been lacking. Other geopolitical events which may have a negative impact are the ongoing situation in Ukraine, the slowdown of the Chinese economy and increasing political tensions with its neighbors.

With interest rates remaining at low levels over the course of 1H15, there has been strong investor interest in eurozone commercial real estate (CRE), with the total volume of circa EUR 53 billion invested , a 20% increase on 1H14 and the strongest half yearly results since 2007. As investors have moved up the risk curve in search of higher yields, recovery markets such as Spain and Italy have seen record levels of CRE investment in 1H15. The weight of capital chasing European real estate assets is showing no signs of abating. Global capital is increasingly chasing eurozone real estate and recent regulatory changes in China might be the start for a significant source of capital, in particular for core assets.

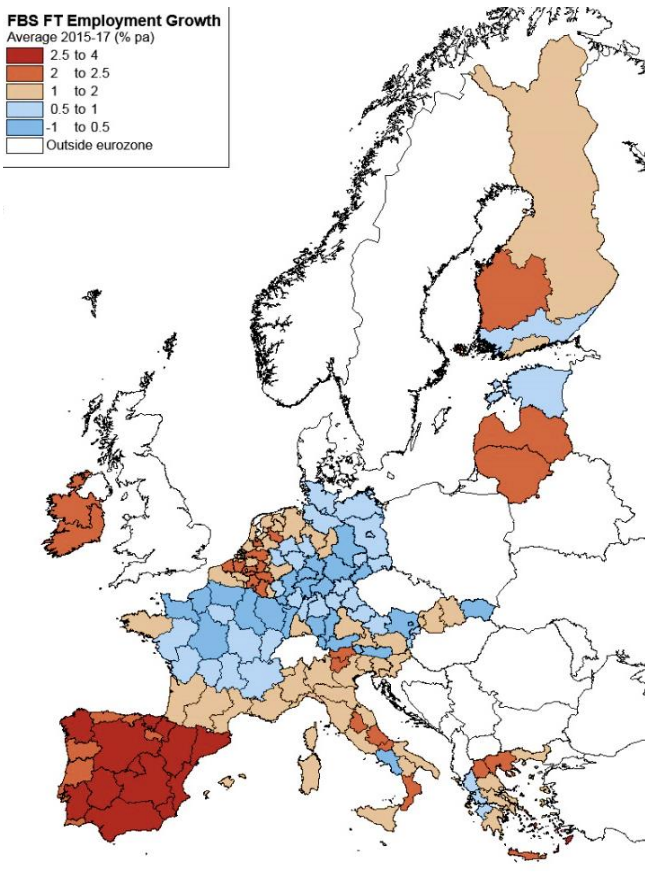
Office sector outlook

While investment volumes in much of the eurozone are returning to, if not exceeding, pre-recession levels, occupier fundamentals lag well behind. The eurozone office occupier market reported mixed results in 1H15. Demand in Germany remained healthy. In Hamburg take-up increase by +70%, while Frankfurt and Munich experienced increases of 14% and 9%, respectively. Berlin has experienced a disappointing start in to 2015 with a circa 47% drop in leasing activity. Also in In Paris and Milan office too, leasing activity decreased by 25% and 12%, respectively when compared to the first six months of 2014. In contrast, the Spanish office occupier market is experiencing a significant positive turnaround. In 1H15 office take-up in Barcelona increased by 62% and in Madrid by 31%. After six years of declining office demand, the Dutch office market appears to have stabilized, with Amsterdam reporting take-up of circa 5% in 1H15.

Net absorption of office space has improved but cost-cutting and efficiency gains continue to be the main drivers of leasing activity. Even though development activity has increased slightly, the lack of finance keeps development activities low. Occupiers are still taking advantage of relatively low rental levels in established locations, which encourage occupiers to either relocate to more central locations or to better quality space. Consequently, vacancy levels in the prime and core have been stable or even falling. Due to a shortage of high-quality supply in city center locations, prime rental levels have been increasing during the last two years. During the course of 1H15, however, prime rents have remained more or less flat. Dublin reported the strongest rental growth (11.2%) in the prime segment this year. Since the beginning of the global financial crisis the Finance and Business Service (FBS) sector remains a major driver in job growth while the Technology, Media and Telecommunication (TMT) sector has become a significant driver for the office market.

Over the next two years, we are expecting the stabilization or an increase in office leasing activities in most eurozone markets while the development pipelines in most eurozone markets are likely to remain subdued. Dublin is the only office market in the eurozone which might be at an early stage of a significant development pipeline. In most other markets we are expecting an intensification of the under-supply situation in the prime and core office segment, which could push rents upwards. We remain skeptical, however, that the rental growth recovery will reach beyond the core segment.

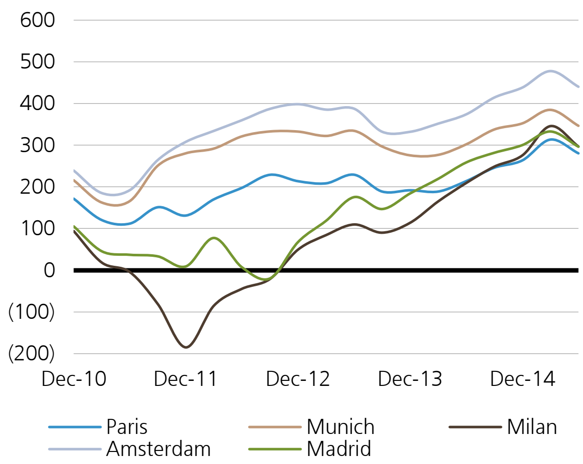
FBS employment growth 2015–2017 (% p.a.)



Source: Oxford Economics, July 2015; MapInfo
Note: FT FBS = Full Time Finance and Business Services

On the back of low government bond yields and an almost zero interest rate policy by the ECB, investors are continuously looking for alternative investment opportunities. Geopolitical uncertainties but also new regulations outside the eurozone – such as the possibility of Chinese insurance companies investing in non-domestic real estate – have been directing capital towards the eurozone, which seems to be at an early stage of an economic recovery. Over the last 6 months the risk premium – measured as the difference between the national government bond yield and the prime office yield – has decreased. The declining risk premium is a combination of slightly increasing bond rates because of marginal increasing inflation expectations but also due to declining prime office yields.

Difference between prime office yield and national 10-year government bond yields (bps)



Source: UBS Global Asset Management, Global Real Estate Research, Oxford Economics, July 2015, CBRE 2Q 2015

Risk premia for prime offices in Madrid and Milan have even surpassed Paris, and consequently international capital has increasingly started to target southern eurozone markets. The Spanish real estate market has been attracting a lot of investor attention since the latter part of 2013 and reported record investment volumes in 2014. Prime yields in Madrid have come under downward pressure and dropped below the 5%-mark in 2Q15 (4.75%). While pricing in the Madrid prime office segment seems to be already tight, we believe that investors may find better value in taking leasing and refurbishing risks in central locations. A similar development for the Milan office market can be anticipated for 2015 and even the Dutch office markets are likely to start their occupier market recovery this year.

Germany is still eurozone's most popular office investment destination and attracting almost 50% of total office investment volume in the region. Domestic and non-domestic investors are competing for core and increasingly non-core assets. As a consequence, prime office yields in Germany are heading for new all-time lows (below 4.5%) and also a convergence of yields between prime and secondary office is noticeable. We recommend remaining in central locations but moving up the risk curve on an asset level-basis as yield levels for German secondary offices would require a steeper rental recovery; something which we are skeptical about due to the structural over-supply in non-central locations.

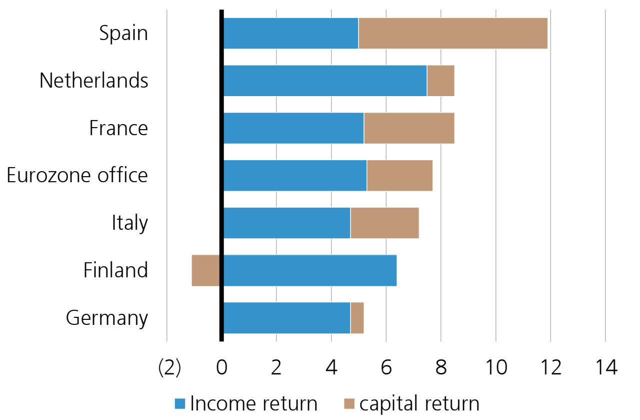
Paris, eurozone's biggest office market, enjoys strong demand from domestic and foreign investors alike despite disappointing occupier demand in 1H15 (-20% on average between 2005 and 2014). Quality office supply is quite subdued, however. Improving availability of finance supports return prospects of core and value-add assets in central locations while returns in peripheral sub-markets are likely to remain under pressure.

The ECB's QE program will be executed until September 2016; as such the low interest rate environment may be here to stay for a protracted period of time. Higher inflation expectations and increasing interest rates by the US Federal Reserve may also result in slightly higher eurozone bond rates. In the case of rising government bond rates we consider an income return of 250-300 basis points (bps) above the national 10-year government bond rate for a core property in a core eurozone market as good value. Current yield gaps to government bond rates provide some cushion in a rising bond rate environment. Prime yields are likely to converge across the eurozone; however, we are becoming concerned with converging yields between core and non-core assets as the occupier market recovery may be less pronounced than some investors assume. Therefore, we remain cautious by recommending investments in non-core assets in many markets because in most cases the economic fundamentals do not support rental growth.

Over the next three years the Dutch, French, Irish and Spanish office markets are expected to outperform the eurozone average. Slightly converging yields are expected to support capital returns (valuation-based) at an IPD level despite a

low rental growth environment but income return is likely to be the main driver of total returns. The German office market is not likely to see a correction but is prone to underperform the eurozone office market and capital returns should be more supported by income growth than in many other eurozone markets.

Forecast three-year office returns 2015–2017 (% p.a.)



Source: UBS Global Asset Management, Global Real Estate Research; August 2015
Note: Returns based on an IPD portfolio (valuation based); selected markets only

Retail sector outlook

Despite the political uncertainties the consumer and retail sector started their recovery in the eurozone during 2014. Regardless of the political noise between the Greek government and its creditors, consumer confidence in the major eurozone economies has improved significantly during the first half of 2015. In all major economies consumer confidence is well above the long-term averages and in the case of Spain actually at the highest level since 2002 (and in the Netherlands since 2007). In Italy, consumer confidence has improved over the last 12 months, reflecting a more optimistic outlook following recent reforms. The lower oil price may not have a significant impact on the eurozone households because most of the decline is counterweighted by the depreciated euro and increasing energy taxes.

After three years of contracting retail sales 2014 was a turning point. In the eurozone retail sales increased by 1.3% in 2014. With the exception of Finland, Greece and Slovenia, all eurozone countries reported positive retail sales growth numbers. There was a reasonably wide spread of retail sales growth on a country-by-country in 2014, however, ranging from +8.5% to -1.1%. The strongest rates of growth were recorded in Luxembourg (+8.5%), Estonia (+7.0%) and Lithuania (+5.0) while the weakest levels of growth were recorded in Greece (-0.4%) and Finland (+1.1%). By national standards Germany recorded a strong result of +1.8% in 2014 and also the Spanish retail sector may have turned the corner (+0.9%). Going forward the outlook for retail sales growth is improving. For 2015 retail sales in the eurozone are projected to grow by 2.2%, the strongest growth rate since 2001. In particular Germans appear to be on a spending spree. Retail sales are forecast to grow by 3.5% in 2015, the strongest growth rate since 1991. Albeit coming from a low basis, retail sales growth in Spain may reach 3.8% in 2015 and also the French consumer may return with a projected retail sales growth of 2.2%. Countries which are likely to lag behind are Finland, Greece and Italy.

Demand for retail real estate is improving slowly across the eurozone although it is highly uneven and focused. Retailer, both international and strong domestic players, remain very cautious and highly targeted in terms of new store expansion. Prime and increasingly "off prime" units adjacent to prime pitch locations in major European cities continue to be the most popular acquisition targets for retailers with weak demand for more secondary pitches and cities. Similarly, space in larger more dominant shopping centers remain the most attractive propositions in the shopping center segment for retailers due to their critical mass, low(er) vacancy rates and higher associated footfall. The impact of ecommerce on retail is increasing steadily. Mid to long term, the demand for retail space will fall but there will be different impacts by retail good types, location and store format. Omni-channel retailing is likely to accelerate the process of store concentration and new "types" of distribution channels like "click & collect" or "24 hours package boxes" could be alternatives in the future. As a consequence of retail's business changes traditional leases have come under pressure and landlords have to adjust how to participate in retailer's performance and landlords have to embrace digital technologies in their asset management strategies.

The country that is attracting the strongest levels of retailer's demand is Germany due to its sound fundamentals, which feature low unemployment and debt as well as rising disposable incomes and house prices. In contrast, demand is still patchy in recovering country economies such as Spain, Portugal, Italy and Netherlands. Network consolidation is also still commonplace across the eurozone, particularly in Spain and Italy. Retail warehouses remain popular with expanding value retailers across the eurozone, albeit on a selective basis.

Development activity is still very subdued in most eurozone countries with the exception of Italy, which will help to support the sector over the next few years coupled with the improving demand outlook. Shopping center development activity, however, is expected to increase in Germany and in particular in Italy over the next few years. While in Germany shopping centers are moving more inside town centers and may compete with the traditional high street, the Italian shopping center market is facing more refurbishment/redevelopment of some older schemes. Looking ahead to 2015 the outlook is one of further strengthening in consumer confidence and retail sales, particularly in those economies that have undertaken structural reforms such as Ireland and Spain and less so in the less reform minded countries, such as France and Italy. Germany is expected to perform very well (almost at record high level since unification) with further increases in retail spending anticipated.

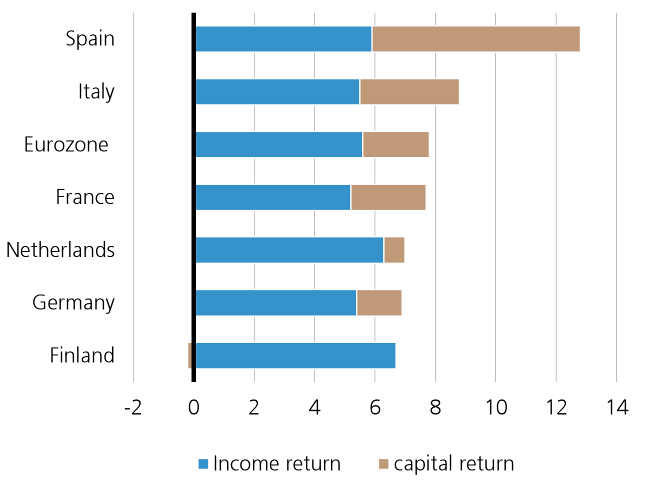
In line with robust demand levels, we expect prime rental levels will again see relatively strong growth this year, and that IPD rental levels will just stabilize, albeit improving retail sales environment anticipated in 2015, with negative growth in France, Finland, Italy and the Netherlands. Beyond 2015, we see a gradually improving IPD retail rental growth outlook and this is feeding into stronger rental growth expectations for 2016–2019.

The strengthening retail and consumer outlook continues to drive retail investment sentiment and transaction activity. During 2014 retail investment in the eurozone volumes amounted to circa. EUR 29 billion, a 45% increase on 2013 levels and the highest annual total since 2006. During 1H15 more than EUR 15 billion was invested in retail in the eurozone which may result in a record investment volume year. Retail investment was particularly strong across the recovering eurozone markets including Ireland, Spain, Portugal and Netherlands. Strong activity was also evident in Italy due to a high degree of large prime shopping centers. Investment volumes in Germany showed a phenomenal start in to 2015. Investment volumes have almost reached total 2014 results until end of June 2015. Investment demand is still polarized with strong demand for more secondary product in core countries as investors search for yield. While demand is highest for core products in the recovering eurozone countries of Spain, Portugal and Italy, there is strong evidence of investors starting to move up the risk curve in markets where the recovery is a little more established, such as Spain. Consequently, we saw prime high street and shopping center yields move in by up to 25 bps and 50 bps, respectively in key eurozone markets during 1H15. We expect interest in secondary retail to continue to increase, albeit selectively, and for the sector to see inward further yield shift in 2015.

In 2H15, we are more optimistic about prime retail returns than IPD retail due to the comparative strength of the prime occupational markets versus IPD. Further inward yield shift in the prime sector is also likely to support capital growth. Beyond 2015, however, IPD retail returns are likely to outperform prime, particularly in countries that have undertaken reforms and where recovery is already underway. Even though Germany has already enjoyed some years of growth in the retail sector, we still see some selective quality hybrid retail warehouse park opportunities in Germany. We believe the recovering eurozone markets of Spain, Italy and possibly France and the Netherlands will also create opportunities during 2015 and beyond.

Over the next three years, we expect to see a return to capital growth towards for most markets from 2016 onwards of the three-year forecast period, on an IPD-portfolio level basis. Capital returns will be supported by inward yield shift but also a return to rental growth in many markets from 2015, with stabilization occurring in peripheral markets the following year. Ireland, Italy and Spain are expected to outperform on a total return basis, while France, Germany and the Netherlands are likely to underperform.

Forecast three-year retail returns 2015–2017 (% p.a.)



Source: UBS Global Asset Management, Global Real Estate Research; August 2015
Note: Returns based on an IPD portfolio (valuation based); selected markets only

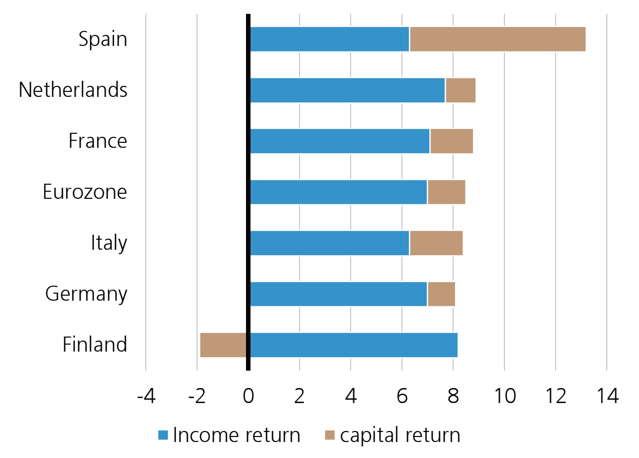
Logistics sector outlook

During the first half of 2015 manufacturing and business sentiment in the eurozone improved slightly, a remarkable occurrence considering the political noise about Greece and the eurozone. Demand in the logistics sector was sustained in 1H15. Eurozone manufacturing output showed growth in January, with a PMI of 52.5 continuing the expansionary activity seen during 2H14. Most recently business improvements have been seen in Spain and Netherlands and Italy, while growth in the manufacturing sector has been moderated in Germany, mainly due to a slowing Asian economy. It might be a bit early to tell but the introduction of QE by the ECB may have start helping the eurozone via improved business confidence, while the weakening of the euro will improve business competitiveness. In addition, lower energy costs are also expected to reduce manufacturing costs and boost margins/profitability.

Demand in the eurozone logistics sector continued on a steady upward path during 1H15. Due to the lack of quality modern stock in many sought after markets, construction activity continued to increase although, activity remained firmly focused on non-speculative and to suit developments. As a consequence the availability of modern stock in key distribution hubs remains extremely limited, and this is a trend that we expect will persist over the next few years. Finance conditions remain challenging for speculative logistics development despite the obvious undersupply in key markets and will continue to impact modern supply levels.
Even though investors' interest in the logistics sector is still strong, investment volumes declined in 1H15. Investment volumes in 1H15 reached circa EUR 3.3 billion, circa 23% down on 1H14. Substantial increases in half annual investment volumes were recorded in the recovery countries of Spain (+241%) and Portugal (+371%) while investment volumes reduced in France (-62%) and in Germany (-23%). The main reason for the decline is that the first half year saw less portfolio transactions than a year ago. Overall, we anticipate that investor interest will persist during 2015 and apply downward pressure on yields for product in the most sought after markets. Due to constrained supply and the lack of any meaningful speculative development activity prime rents in most major markets across the eurozone are likely to grow. The most popular assets are modern flexible property in key distribution hubs but investors have started increasingly spreading their net wider to incorporate core property and moving away from prime in search of yield during 2015. Increased investor activity for quality assets in the logistics sector in core Europe led to further inward yield shift during 1H15. We anticipate total returns of 8.9% for the Eurozone in 2015, representing a slight increase on 2014.

Logistics real estate remains attractive to investors due to the high, relatively stable income return in a low interest rate environment. We are getting concerned that pricing may get too tight because the sector is highly exposed to obsolescence which many investors do not seem to factor in their calculation. In 2015 we are expecting a wide range of returns, with core markets seeing strongest performance. Over the next three years Ireland, France, Netherlands and Spain are likely to outperform due to their strong income return and stabilized capital return, while Germany is likely to underperform towards the end of the three-year forecast horizon as yields move in-line with reducing investor appetite in preference for higher yielding assets.

Forecast three-year logistics returns 2015–2017 (% p.a.)



Source: UBS Global Asset Management, Global Real Estate Research; August 2015
Note: Returns based on an IPD portfolio (valuation based); selected markets only

Strategy

During 1H15 the eurozone's stability has been challenged once again. While the ECB has been supporting the monetary politicians have been challenging stability of the region. While countries such as Ireland, Portugal and Spain implemented structural reforms early, some countries and governments are stretching other's solidarity to the outmost. Despite political uncertainties, the eurozone's economy seems to have bottomed and economic growth could be anticipated. The region's main risk is not economical but political, which could derail the eurozone's economic recovery.

ECB's QE program may to lead to a prolonged period of low interest rates and is likely to directed more capital into the region's real estate markets. Compared to other asset classes, real estate still offers higher income yields in all eurozone countries. Even though a gradual increase in bond rates may lead to some outward yield shift over a five-year forecast period it can be anticipated that the implications on real estate may likely be partly offset by income growth in an improving economic environment.

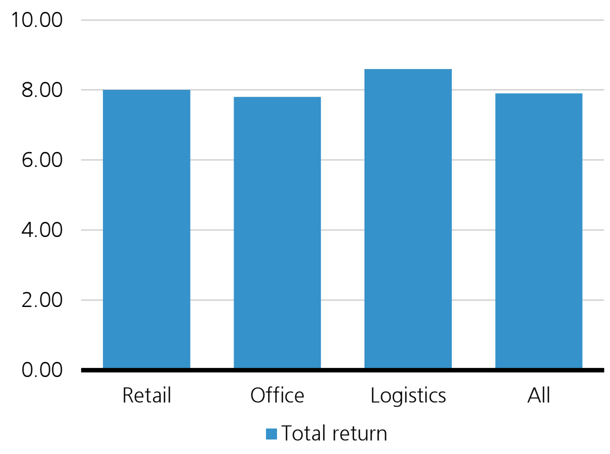
We do see a risk that investors are moving up the risk curve due to the search for yield and absolute return but neglecting the associated risk. Lower return expectations in a (still) historic low bond rate environment might be more appropriate for investors.

Moving to higher yielding markets has been the preferred routed of investors over the last few years. While Spain was investors' favorite new market in 2014, Italy seems to be investor's 2015 target. However, the counter-cyclical market route is likely to come to an end this year. In a counter-cyclical asset move, investors may consider high-risk refurbishment strategies where a lack of high quality assets in central locations is foreseeable. But this is more a bottom-up than a country/market story. We could identify local pockets for value-add strategies in the office sector in the big German office centers, in Paris as well as in the major Spanish and Italian office markets. Repositioning dominant retail warehouses across the large eurozone countries (France, Germany, Italy and Netherlands) and on the Iberian Peninsula also offers potential for asset management intensive strategies.

In 2015, Belgium, France, Ireland and Spain are forecast to outperform the eurozone average total return (based on valuations). The Dutch, German and Italian markets are expected to perform slightly below the eurozone average in 2015. The weakest performers are expected to be Austria and Finland (excluding Greece from our forecasts). Over a five-year period total returns are likely to be front loaded with expected negative capital returns at the back end of the forecasts.

Based on current prices, investors should consider the core segment in Italy, Spain, France and the Netherlands; however, they should increasingly look at the edges of core, in supply-constrained local markets. For new investments in a core portfolio, we expect logistics to outperform retail and offices over the next three years.

Eurozone forecast three-year total return 2Q15 – 2Q17 (% p.a. – price based, unleveraged)



Source: UBS Global Asset Management, Global Real Estate Research; August 2015
Note: Returns based on an IPD portfolio (price based)

In 2015, political uncertainties are likely to persist and have the potential to derail the economic recovery, even though this is not our main scenario. Real estate investors are operating in an improving but still low growth economic environment. Supply constraints offer value-add opportunities in many eurozone markets but should be carefully assessed by bottom-up fundamentals.

The very low interest/bond rate environment has led to a growing disconnect between investment volumes and occupier fundamentals. Improving financing conditions and growing demand for real estate assets has been pushing property values in markets some way above their historical trend. As and when interest rates do start to rise, there will be an increasing reliance on rental growth to compensate for any consequential outward movement in yields.

Sources: Oxford Economics, CBRE Erix

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