Research Blast

European Real Estate Market, July 2015 Update

Beginning of a recovery?!

Eurozone economy

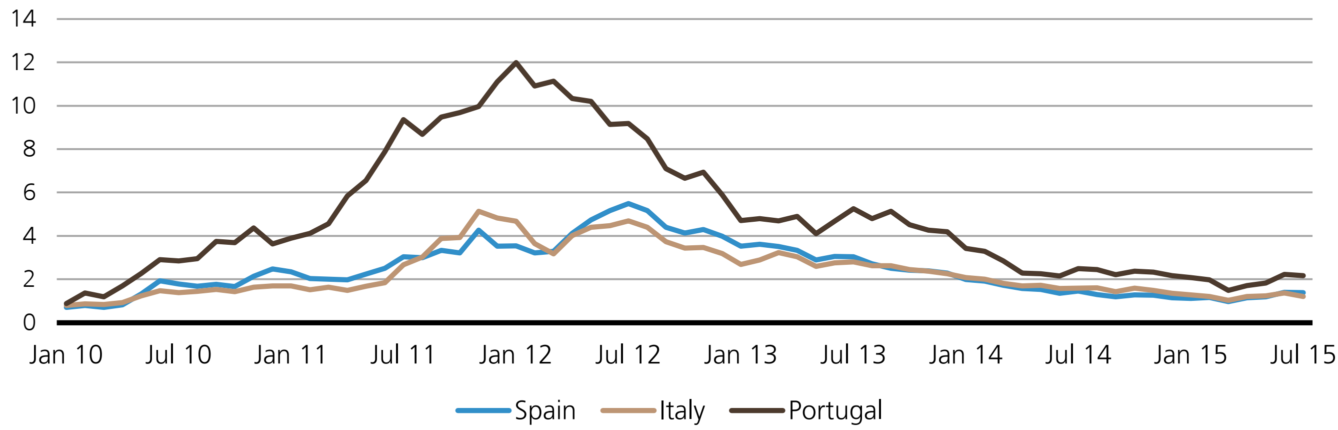
Behind the headlines of the crisis in Greece, the eurozone economy has produced some encouraging indicators in 2Q15, which suggests that it is moving into a phase of sustainable economic growth. GDP is forecast to grow by 0.5% quarter-on quarter (QOQ), and by 1.5% year-on-year (YOY) in 2015, which would 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 strength 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.

Improving labor markets support commercial real estate

Data source: CBRE, Oxford Economics, Thomson Reuters Datastream

10-year Government Bond Yields, limited contagion (in %)



Source: Thomson Reuters Datastream

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.

On 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 quarterly GDP growth in recent years in 2Q, at 0.8% and 1.1% QOQ, with annual growth forecast to come in at 1.9% and 3.2% YOY, respectively. The French economy appears to have turned a corner and after growing by just 0.2% in 2014 is expected to have a strong rebound in growth in 2015 to 1.3% YOY. And while Italy still lags behind the eurozone, it has nonetheless left recession and is expected to record quarterly growth of 0.2%-0.3% QOQ throughout 2015.

Real estate market

Prime office rents were flat in the majority of eurozone markets in 2Q; however, two of the recovery markets, Barcelona and Dublin, recorded strong quarterly growth of 5.6% and 5.2%, respectively. Elsewhere the only notable rental movement was in Berlin, where rents increased by 2.2% QOQ. Availability of prime space is relatively thin across most eurozone office markets, and a sustained improvement in occupier demand is likely to result in more widespread prime rental growth over the coming quarters. Prospects for secondary grade space and peripheral locations, which generally have a much higher vacancy level, remain challenging in most markets. Prime high street retail rents were largely flat during the quarter, the main exceptions coming in southern Europe with Milan (4.2%), Rome (12.5%), Madrid (5.6%) and Barcelona (8%) all recording robust growth. The retail markets in these countries are benefitting from an improving domestic economy, in addition to tourist spending, which is creating strong competition amongst retailers for the few prime pitches which become available.

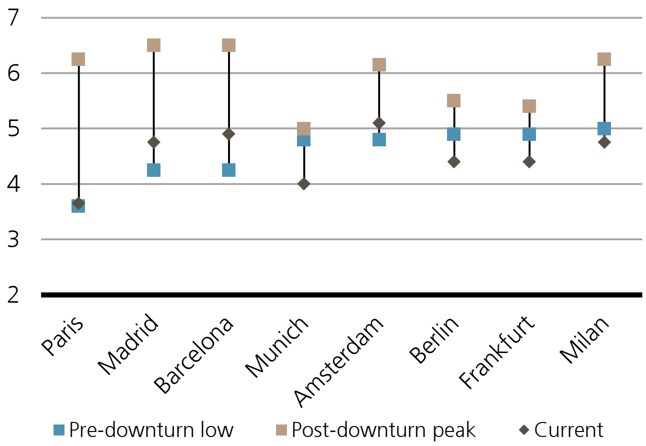
Investment activity in Europe kept pace with the strong volumes recorded in recent quarters, totalling EUR 55.9 billion, which was marginally below the volume recorded in 1Q. The figure is likely to be revised up when more transactional information is released over the coming weeks. Even at this level, it was 15% above the level recorded in 2Q14, and it is likely the annual investment volume in 2015 will far exceed the 2014 level. Investors have continued to seek out opportunities in peripheral markets, with transaction volumes in Spain and Portugal reaching their highest ever quarterly level. In recent quarters investors have also turned their attention to Italy, which recorded another very strong quarter of activity.

In the core markets, investors were particularly active in Germany which recorded EUR 12 billion of transactions, the highest 2Q since 2007 and nearly double the level of 2Q14. Activity in France by contrast was somewhat subdued, at just EUR 3 billion, 40% below 1Q15 and 63% below the 2Q14 volume.

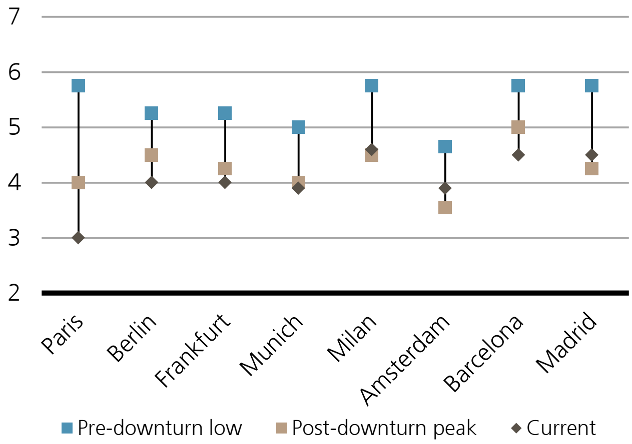
Data source: CBRE, Oxford Economics, Thomson Reuters Datastream

Prime yields are now below, at or very close to pre-recession lows

Offices (in %)



Retail (in %)



Source: CBRE 2Q15

Prime yields have continued to contract across many markets in the eurozone in both the retail and office sectors. The sharpest yield contractions were generally felt in Southern Europe with Milan and Rome seeing yields move in by 25 basis points (bps) in both sectors while office and retail yields in Lisbon moved in by 25 bps and 50 bps, respectively. Prime yields in the main German markets continued to edge down, with Munich retail recording the sharpest inward movement of 30 bps while office yields came in by 20 bps. Berlin, Frankfurt and Dusseldorf all saw both retail and office yields move in by 10 bps over the quarter. In Paris prime office yields contracted by 10 bps, and at 3.65% is just 5 bps above the record low level recorded in 2007, while retail yields were flat at 3%, although at this level they are already 100 bps below the 2007 record.

UK update

Broadly speaking, the UK economy has continued in a positive trajectory in 1H15, with expectations for annual growth unchanged from the start of the year at 2.6%. The services sector, and in particular the consumer sector, continues to surge ahead; however, the manufacturing sector, especially those reliant on exports, have had a much tougher time partly due to sterling's appreciation against the euro. Strong volumes of both domestic and international capital continue to target UK real estate assets, reflecting the comparative strength of the economy, low government bond yields and improving occupier fundamentals. There has been an increase in investor appetite for higher yielding regional property, with volumes increasing by 25% in 1H15 on the first half of 2014. Central London also continues to attract strong investor demand; however, there are some downside concerns in the medium term. The weight of capital targeting Central London real estate has pushed yields down to the record lows recorded in 2007. Investors have been benefitting from strong rental growth in recent years; however, with rents now approaching new peaks occupier affordability may start to become an issue. With a large development pipeline coming through from 2016 onwards this may moderate the potential for further rental growth, and when interest rates start to move up properties being purchased at record low returns could look overpriced by comparison. But the biggest risk to the outlook for UK property is the looming EU referendum. The uncertainty in the run up to the vote is likely to slow both the investment markets and the occupier markets, and in the event of a Brexit, the impact for UK real estate, and in particular Central London offices, is likely to be overwhelmingly negative.

Data source: CBRE, Oxford Economics, Thomson Reuters Datastream

Real Estate Research & Strategy – Europe

Gunnar Herm
Melanie Brown
Zachary Gauges

For more information please contact

UBS Global Asset Management
Global Real Estate Research
Gunnar Herm
Tel. +49-69-1369 5317
gunnar.herm@ubs.com

www.ubs.com/realestate

UBS