UBS

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European Real Estate Summary.

Edition 2, 2016

Strong demand for German offices while political uncertainties weight on France and the UK

Low construction activity restricts availability of prime space

Lower investment volumes reflect shortage of core investment products

Outlook for 2016 remains positive but UK referendum creates uncertainties

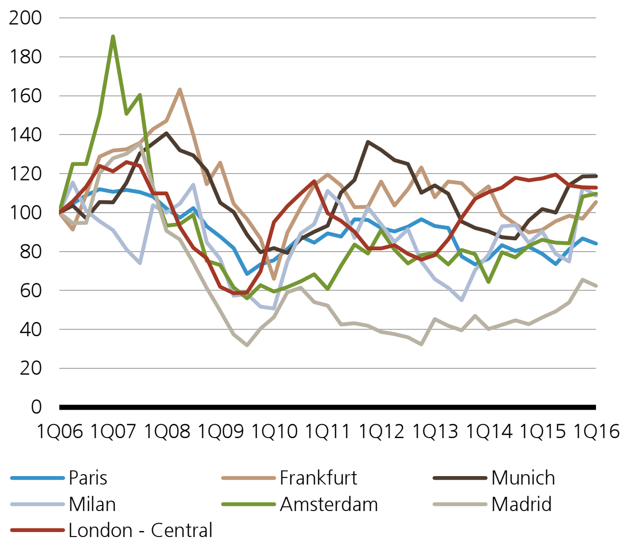
Demand

Since the beginning of 2016 global capital and financial markets have been on a roller coaster. On the back of slowing economic growth in Emerging Markets (EM) many European sentiment surveys moved southward, suggesting a slowdown in European economic activity as well. However, by the end of the first quarter, sentiment data stabilized and preliminary data shows that many European economies experienced resilient and or even strengthening domestic demand. Encouragingly, the labor market in most European markets is starting to show signs of recovery, with annual full time EU employment expected to rise by 0.8% in 2016. Although overall unemployment generally remains quite high, in undersupplied sectors of the workforce (i.e. technology sector) a tightening of the labor market is starting to place upward pressure on wages. Disposable income is supported further by almost zero inflation, which consumers are feeding back into the economy in the form of very strong retail sales. The domestically driven recovery is having positive implications for European occupier markets, and we expect occupier demand to continue to improve across the main European markets. However, political uncertainties may cast a shadow over the recovery in occupier markets. The UK's referendum on EU membership creates uncertainties for occupiers, but office take-up numbers have not been affected yet. So far, occupiers have focused their leasing activity primarily on good quality assets in central business and dominant retail locations.

Traditionally, the first quarter is the quietest and it is difficult to make projections for the whole year. On a rolling annual basis, office take-up in most European office markets was flat in 1Q16. However, some German markets reported the strongest 1Q leasing data since 2009, reflecting the pick-up in employment growth. Despite the political uncertainties in the UK, Central London office take-up achieved almost identical results compared to 1Q15. On the other hand, Paris the lowest 1Q take-up level since 2004, giving concerns that the economic recovery may not lead to increasing office space demand.

Even though European consumers are supported by low inflation and in some countries (e.g. Germany, UK and Sweden) increasing wages, retailers remain cautious in their expansionary policies. Retailer demand has focused on dominant high street locations and shopping centers, while tertiary retail destinations are neglected. International retailers from outside Europe are still looking to enter the market, but are likely to prefer the most sought-after locations as well.

European office take-up volumes
(indexed rolling annual 1Q06=100)



Source:CBRE 1Q16

Supply

There continues to be significant polarization in the availability of commercial real estate space based on the quality and location of the assets. In the office markets, the aggregate European markets vacancy was largely stable in 1Q16 reflecting the steady level of occupational demand, with the overall level falling by 0.1 percentage points (pp). The sharpest declines in 1Q16 were in the smaller markets including Dublin (2.5 p.p), Birmingham (-2.3 p.p) and the Schiphol Area in Amsterdam (-1.9). The key office markets generally recorded marginal declines in vacancy, continuing the trend from the previous year. One exception was Central London where availability increased slightly (0.1 pp) reflecting the mild slowdown in occupier demand in the run up to the referendum and continuing new supply coming through to the market. CEE Warsaw recorded a substantial 1.9 pp increase in the vacancy rate as the volume of new supply continues to outweigh demand in the market, a trend which is set to continue.

London and Warsaw are very much exceptions within the European office market; however, most locations continue to see very limited development activity. This is contributing to a continuing polarization of available space in CBD and CBD fringe submarkets, which are now in many cases under-supplied, and the peripheral submarkets which are still suffering from very high vacancy rates from the overhang on development during the previous cycle, combined with a weakness in occupier demand for this type of office space.

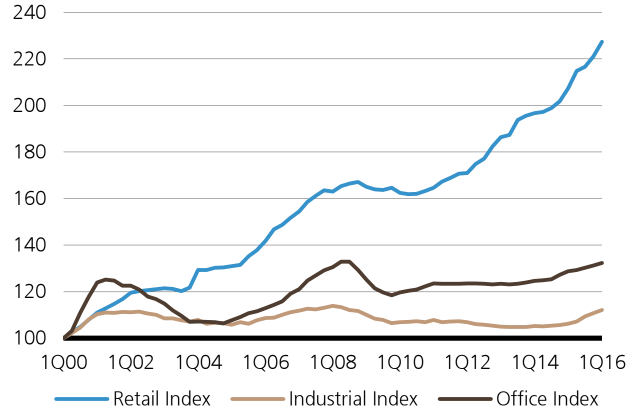
Structural oversupply in these areas is maintaining overall vacancy rates at a high level, and even markets which have seen a strong recovery in demand in 2015 are still seeing vacancy rates in some peripheral sub-markets at above 20%. These include Brussels Periphery (23.0%), Barcelona Periphery (20.2%) and Madrid Periphery (29.4%).

On the other hand, due to the lack of new supply in central locations, we are seeing some positive rental growth coming through in the prime segment of the market. The Weighted Average EU-15 Office Market Rent Index rose by 0.8% in 1Q, taking annual growth to 2.8%. Whilst unexceptional growth compared to previous recovery periods, it is nonetheless encouraging that rents are moving in an upward trajectory after several years of stagnation and decline. With limited signs of a speculative supply response starting across Europe (with a few exceptions) the supply and demand imbalance in this segment of the market is expected to continue to drive positive rental growth over the coming years. The outlook for secondary locations and poorer quality buildings is much weaker, however, and with the pace of economic growth not forecast to drive a recovery in demand in some areas, a significant amount of current vacant space may become redundant in its current form.

This polarization in supply and demand is mirrored by the retail, and to a lesser extent, industrial sector. There continues to be strong competition for the very few available units on prime European high streets, and this has continued to drive strong rental growth for the prime end of the sector

Prime rents index

(2000 = 100)



Source: CBRE 1Q16

Prime rents increased by 2.8% in 1Q, and rose by 10% on an annual basis. But while the prime retail segment has seen the strongest rental growth of all property sectors, secondary and tertiary retail locations continue to suffer from much higher vacancy, which is subduing any capacity for rental growth. These are the locations which are the most affected by the growth in e-commerce, as retailers are typically streamlining their store portfolios, focusing on dominant locations and coming out of secondary areas where they can now rely on their online platform to achieve coverage. With these changing dynamics, it is likely that a reasonable proportion of retailing space across Europe will, over time, be deemed surplus to requirements in its current form.

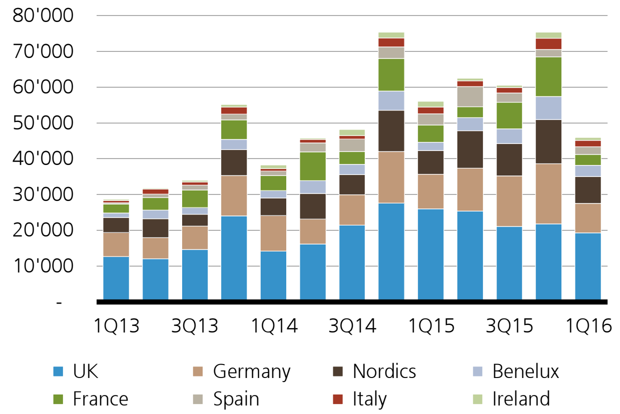
Capital Markets

The first quarter of 2016 has seen a sharp deceleration in activity from the exceptionally high levels reached in 2015. Whilst the first three months of the year are traditionally quieter, the EUR 50 billion invested represents an 18% decrease. Nonetheless, the start to 2016 was bound to lie in the shadow of such a busy year and according to CBRE data it was actually the third best Q1 on record, bettered only by 2015 itself and 2007. Sentiment is also still broadly positive, with the majority of respondents to PMA and CBRE's surveys of investor intentions saying they plan to invest more in the next 12 months. Nonetheless, it is highly likely that concerns about the world economy, geopolitical challenges and falling commodity prices have brought about a degree of caution. Tellingly, investment from Asia and the Middle East declined in both capital invested and market share.

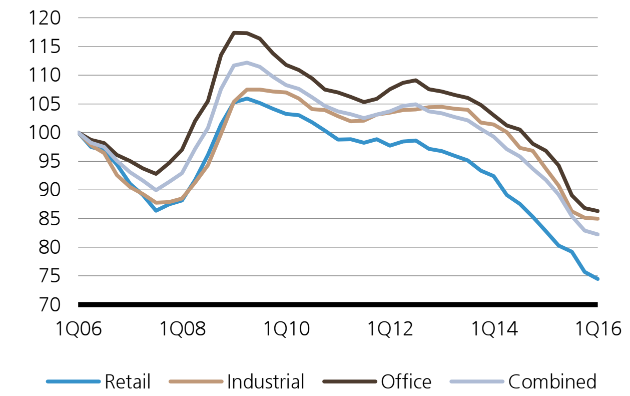
Investment across core markets decreased markedly as Germany (-14%), France (-37%) and the UK (-25%) all fell back with concerns about pricing and limited availability of core products likely restricting activity. This seemed to benefit the Nordics and Benelux countries, which saw respective increases of 14% and 37%. Portugal also catapulted itself back onto the investment radar seeing an increase in excess of 150% year on year, although this is coming from a very low base. Indeed, the total invested for Q1 2016 came to just EUR 569 million. The hot spots of yesteryear (Ireland and Spain) seem to be cooling off, with investment declining by 51% and 33% respectively. Investment capital targeting more peripheral markets tends to be opportunistic, leading to regular fluctuations in volumes. Of the main asset classes, investment in retail tailed off the most, declining by 32% when compared with the same time last year, while industrial continued its impressive rise in popularity, showing an increase of 57%. The amount of capital targeting logistics assets is unsurprising as it still offers a near 200 bps premium to offices.

Reflecting the weight of capital targeting European property, average yields moved in for the fourteenth consecutive quarter across all the major asset classes. Investors seem to have an increasing willingness to look up the risk curve for returns and this is reflected in yield movements outside of the core European markets. The biggest shift was seen in high street retail in Sofia which contracted by 200 basis points to hit a record low of 5.5%. Reflecting the increased popularity of Portugal, office yields in Lisbon (-25 bps) and Porto (-75 bps) both contracted. In Lisbon, some secondary areas outperformed the CBD; for example the Western Corridor (-75 bps) and Parque des Nacoes (-50 bps). Spanish regional cities have attracted a fair amount of interest too, as the recovery spreads out from Madrid. Valencia was particularly in demand and saw yields harden in industrial (-125 bps), offices (-75 bps) and retail (-50 bps). Poland also fared reasonably well, with Lublin, Krakow, Poznan and Warsaw hardening by 25 bps. London, Paris and Munich saw no change and indeed the vast majority of core markets remained flat, while a small outward shift of 10 bps occurred in Oslo most likely due to oil price volatility. In most European markets, prime yields have now fallen to below, or are very close to record low levels. In some markets, particularly in the UK, we believe we are reaching the peak of pricing in this cycle, although there may be a bit more inward yield shift to come in a few of the peripheral European markets, particularly as the "lower for longer" outlook for central bank interest rates means the attractive spread between European government bonds and real estate will be maintained for at least the next 12 months. Accordingly, Europe's safe haven status will likely continue to attract overseas investors, particularly in the context of low yields in many domestic property markets worldwide.

European Investment volumes
(EUR million)



European Yield Index
(1Q06 = 100)



Source: CBRE 4Q15

Viewpoint

Cooling London? Not yet says the data, but…

Given the headwinds of market uncertainties due to the UK referendum on EU membership, data from 1Q16 suggests the market has actually been holding up surprisingly well. Take-up for Central London came in at 3.1 million sq ft, which was on a par with 1Q levels recorded in 2014 and 2015. Similarly, provisional investment volumes indicate that, despite the uncertainty, levels will remain similar in 1Q16 to 1Q levels in 2014 and 2015 (1Q is historically the weakest quarter of investment volumes by some margin). It appears that the investment demand which is coming to the market has become more focused towards core property in central submarkets, which would be expected during a period of heightened uncertainty. Indeed, in the West End even with the provisional number of GBP 0.7 billion this was larger than the 1Q levels in 2014 and 2015. Some of this may have been driven by the completion of deals which were initiated last year, and as the referendum was not officially announced until half way through the quarter it is possible that the full impact of the uncertainty will not be reflected in the volume numbers until 2Q.

Prime yields have been stable in the West End at 3.5% since 2Q15, reflecting a cooling off of investor demand given the various headwinds and the fact that both prime and average yields in the market are at record lows. For March 2016, MSCI IPD reported negative total returns for the first time since June 2009. Valuers have become more cautious again, in particular outside the core segment. As we head closer to the referendum date, we would expect to see the market slow further. Given the timescales involved, few investors would be able to complete transactions before the referendum result so "wait-and-see" is the most likely outcome. The following months will tell us if volatility is only the result of short term uncertainties or if the UK real estate market has already peaked.

Source: (Data) Property Data April 2016; UBS Asset Management, Global Real Estate, Research & Strategy April 2016

Real Estate Research & Strategy – Europe

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