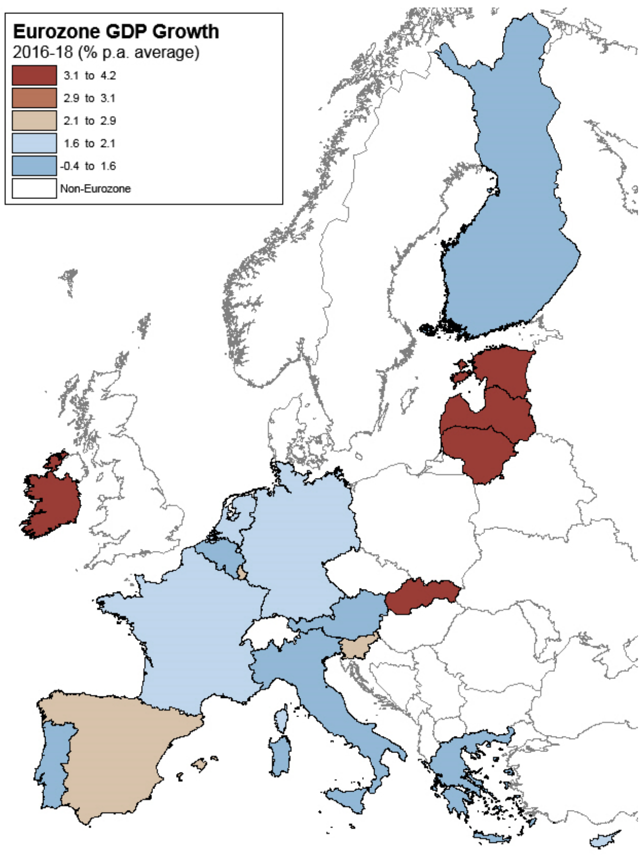
March 2016

Eurozone Real Estate Outlook.

1H16

Economic environment & expected occupier demand
The economic outlook for the eurozone has become increasingly polarized between the relatively positive domestically driven recovery, which drove GDP growth above expectations in 2015, and the decidedly negative global economic headwinds and geopolitical risks that have risen in prominence over the past six months. The slowdown in China and emerging economies, continuing rise of populist parties across continental Europe, the migrant crisis and an EU which is perhaps at its most divided and challenged since its inception, all pose significant threats to the underlying progress of the eurozone economy.

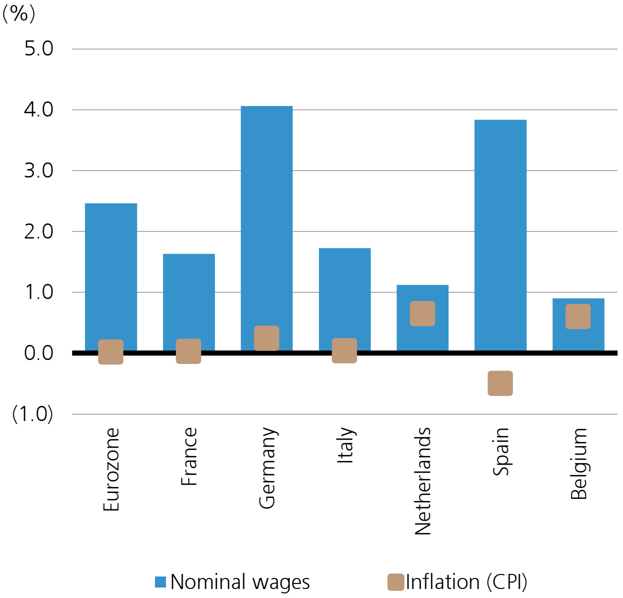
Eurozone GDP growth forecasts 2016-18



Source: Oxford economics, MapInfo February 2016

Underlying all these concerns is a domestic economy which is proving surprisingly resilient, with the labor market in most eurozone markets starting to show signs of recovery. Although employment growth of 1% in 2015 is unexceptional by pre-recession standards, it is nonetheless the fastest pace of growth since the GFC and whilst overall unemployment remains generally high it is now on a downward trend. In undersupplied sectors of the workforce a tightening of the labor market is starting to place upward pressure on wages, which combined with an inflation rate of around 0% is translating directly into rising disposable incomes, which consumers are feeding back into the economy in the form of very strong retail sales. With the price of oil taking a further dip early in 2016, inflation is only expected to rise to 0.5% by the end of the year, providing further capacity for relatively strong real wage growth, which is expected to exceed 3% in 2016 as the labor market continues to strengthen.

Nominal wage growth and inflation



Source: Oxford economics, February 2016

This domestically driven recovery is starting to have positive implications for eurozone occupier markets, and we expect occupier demand to continue to improve across the main European markets. At this stage however, the recovery has been primarily focused in central business and dominant retail locations, and targeted towards better quality commercial real estate. And whilst the pace of growth is encouraging compared to more recent times, it is not forecast to reach a level which can drive positive net absorption in poorer quality space and less established locations.

Reflecting the pick-up in employment growth, take-up levels in the majority of eurozone office markets recorded a marked increase on the previous year, with aggregate take-up in 2015 reaching the highest level since 2007. Some of the sharpest increases were recorded in the Spanish markets of Madrid and Barcelona, where structural reforms in the labor market are now paying dividends in the form of a strong pick-up in company expansion and office-based employment growth, with both markets seeing annual take-up improve by over 50% on the 2014 volume. Similarly, Italy, which introduced reforms slightly later than Spain, has already seen a dramatic increase in take-up in Milan where the 4Q volume reached a new record high. The main German markets continued to perform strongly, increasing take-up levels further above trend, with particularly strong demand coming through in Munich where 4Q take-up reached the highest level since 2011.

With employment growth in the eurozone set to maintain its pace of around 1% in 2016, we would expect another relatively strong year of take-up. Those markets which have implemented labor market reforms should continue to see the strongest recovery in employment growth, with Madrid and Barcelona for example expected to see growth of 2.4% and 2.0%, respectively. Conversely, countries which have failed to adopt meaningful reforms are still expected to see sluggish occupational growth – employment in Paris in 2016 for example is expected to grow by just 0.1%.

The rise in disposable income, triggered by the drop in inflation, has given a substantial boost to consumer confidence in the Eurozone which rose to the highest level since 2007 in 2015. With inflation set to remain low throughout 2016, the macro-economic outlook for the sector continues to be positive and rising real salaries are forecast to translate into robust retail sales growth. However, retailer demand continues to be heavily polarized between the dominant high street locations and shopping centers, and tertiary retail destinations which are suffering disproportionately from the growth in online retailing. Going forward, retailers will typically require fewer stores to achieve nationwide coverage and particularly in countries such as Spain and Italy where online retailing is still in its infancy. This could lead to a sharp reduction in demand for retail units in secondary retail destinations and smaller towns and cities as retailers focus on the highest footfall and turnover shopping destinations.

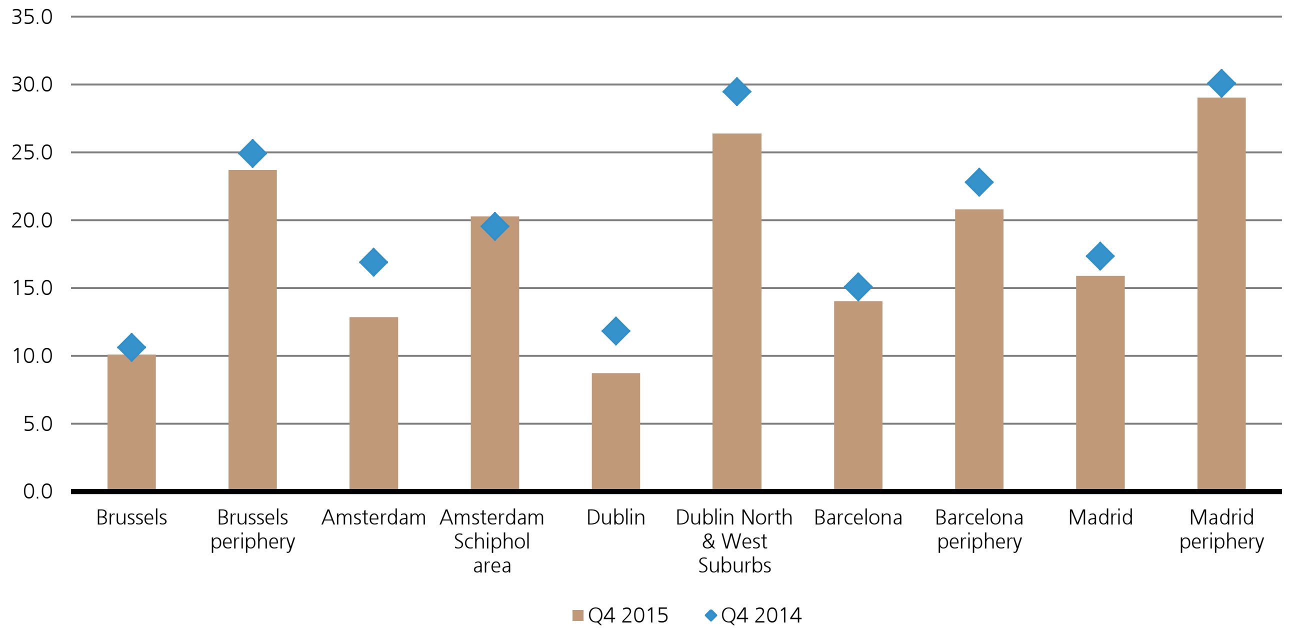
On the other hand, the logistics sector is able to benefit from the growth in consumer spending through both the online and physical retail platforms, and recorded its strongest year of take-up in 2015. Economies of scale and supply chain optimization on the back of strong M&A activity have been a key driver of very large scale logistics take-up, which has boosted the overall figures. On the smaller end of the scale, logistics hubs around big cities are also recording strong demand for units to service the final distribution process, to either the physical store or home delivery address.

Supply

Reflecting the improvement in occupier demand, vacancy levels across Europe are generally on a downward trend. However, there continues to be significant polarization based on quality and location of stock. The aggregate eurozone office vacancy rate fell by 0.7 percentage points over 2015, and at 9.3% is at the lowest level since the GFC. Some of the sharpest declines were recorded in southern European markets including Milan, Madrid and Barcelona.

Whilst absorption of space has started to be positive in most central submarkets, many eurozone office markets continue to suffer from an oversupply of office space in peripheral submarkets, particularly those which have poor public transport connections to the central submarkets and surrounding areas. As a result, overall vacancy rates in these areas remain high, and even markets which have seen a strong recovery in demand in 2015 are still seeing vacancy rates of over 20% in some peripheral submarkets. These include Brussels Periphery (23.7%), Amsterdam Schiphol Area (20.3%), Dublin North & West Suburbs (26.4%), Barcelona Periphery (20.8%) and Madrid Periphery (29.0%).

Submarket vacancy rates
(%)



Source: CBRE 4Q15

By contrast, vacancy in central submarkets has been coming down rapidly, particularly of better quality space, reflecting the preference for occupiers to locate in central submarkets and the absence of significant speculative development across most markets since the GFC. This has driven a strong divergence in performance, demonstrated by prime office rental values increasing by 1.8% in 2015 while the IPD average rental growth for the eurozone office market is estimated to have stayed negative at -0.5% (UBS-AM GRE forecast, February 2016). While we expect the eurozone average rent profile to return positive as the recovery gathers momentum, this will primarily be off the back of well performing good quality space, with the secondary grade space in less established locations continuing to drag down overall performance, and the outperformance of prime (2.2% average growth 2016-20) over average (1.3% average growth 2016-20) is set to continue. 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 between good quality well located stock and secondary is even more accentuated in the retail sector, reflecting the structural changes in retailer demand which have adversely affected non-dominant retail locations. There continues to be strong competition for the very few available units on the prime eurozone high streets, which has driven exceptionally strong prime rental growth with rents now 26% above the pre-downturn peak. But whilst 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. With these changing dynamics, it is likely that a reasonable proportion of retail space across Europe will be deemed surplus to requirements in its current form.

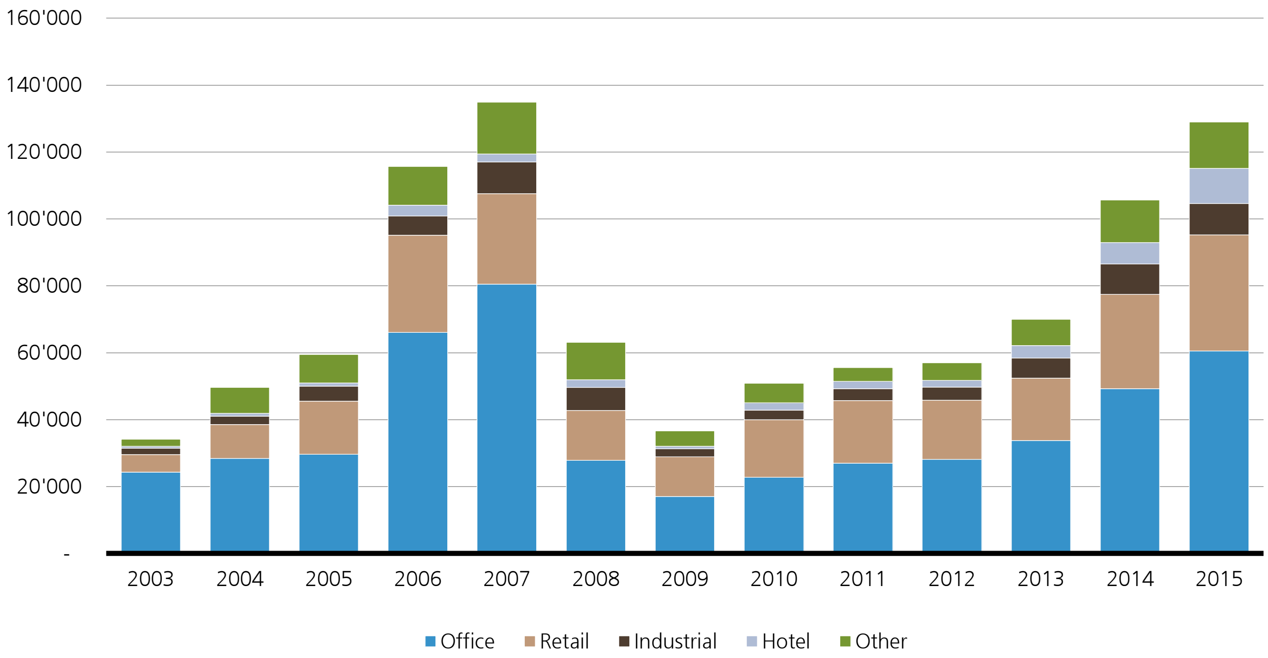
Reflecting the positive occupier demand dynamics driving the sector, and an absence of speculative logistics development since the GFC, vacancy rates for industrial property have maintained a downward trend. The development pipeline expanded during 2015 but this was largely fuelled by build-to-suit projects, which are popular amongst logistics operators who continue to seek supply chain optimization through reconfiguring and upgrading their network capacity to accommodate the growth in cargo volumes and remain competitive on cost in a very low margin industry. However, this low margin nature means there is a limit to the potential for rental growth, despite the positive supply-demand dynamics. This is forecast to restrict average ERV growth over the next five years to an average of 0.8% p.a. However, as with the retail and office sectors, prime industrial space are expected to see much stronger than average growth, particularly in locations surrounding key urban conurbations.

Capital flows
The pace of recovery in the investment market in the eurozone has outpaced that of the occupier market, with commercial real estate investment reaching EUR 127 billion, just 5.7% below the peak level of 2007. Monetary policy by the European Central Bank (ECB) has not only been supporting the Eurozone's economic recovery but is encouraging eurozone investors to look for alternative investments to government bonds. The introduction of negative deposit rates increased the pressure on investors but also on banks. As a consequence, there has been an increase in lending activity to real estate. An influx of capital from outside of Europe has been an additional driver of this record level of investment turnover, with foreign investors seeking diversification outside of their domestic market. With the comparatively stable political and economic platform in Europe and attractive returns when compared to fixed income investments and domestic property yields in some parts of the world, much of this capital has focused on core eurozone real estate assets.

Changing regulation in recent years has enabled a significant inflow of capital from Asia and the Middle East, which has typically targeted the core markets in Germany and France. Despite some concerns that investment demand from some oil dependent sovereign wealth funds would dip away, overall investor demand in these markets was actually particularly strong in 4Q, with both countries recording their strongest quarter of investment activity since the financial crisis. Investor demand has also been extremely strong for peripheral markets including Spain, Italy and Portugal. This capital tends to be more opportunistic and is driven by domestic, cross-border European and US investors.

Reflecting the weight of capital targeting European assets, prime yields have continued to contract across Eurozone markets. In most eurozone markets prime yields have now fallen below, or are very close to, record low levels. In some markets 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 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 twelve months.

Eurozone investment volumes
(EUR '000)

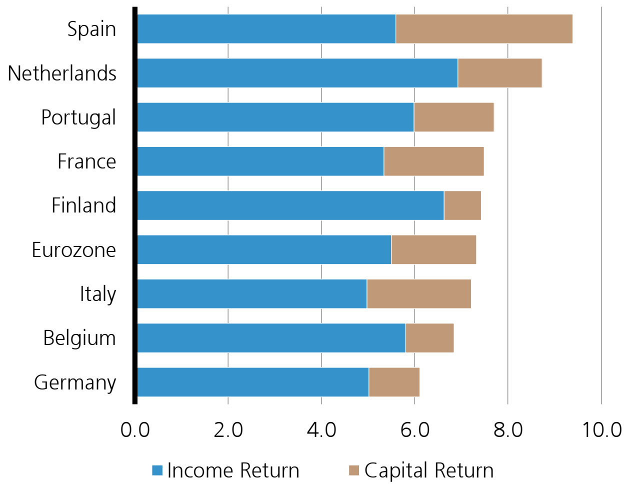


Source: CBRE Quarterly Investment Volumes 4Q15

Outlook
Over the next three years we expect a total return of all commercial real estate of ca. 7% p.a.. The industrial sector is likely to outperform, followed by the retail and office sector. Capital growth and total returns are likely to peak in 2016 before gradually softening during the following years. Over the last few years capital growth was mainly driven by inward yield shift; however, we expect that from 2017 onwards capital growth is likely to be driven more by income growth while yields are expected to stabilize. As a consequence total returns in all countries are likely to be front loaded.

In 2016 we are expecting a wide range of returns, with southern European markets seeing strongest performance. Over the next three years France, Netherlands, Portugal and Spain are likely to outperform due to their strong income return and stabilized capital return, while Austria, Germany and Ireland are likely to underperform towards the end of the three-year forecast horizon as yields may become exposed to a slightly increasing bond rate environment.

Total return forecast 2016-18
(% annual average)

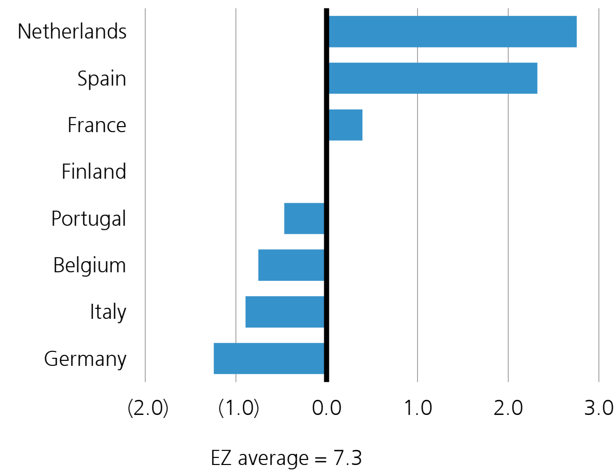


Source: UBS Asset Management, Global Real Estate Research; August 2015

Office
Over the next three years the Dutch, French 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 and Italian office markets are not likely to see a correction, but are prone to underperform the eurozone office market and capital returns should be more supported by income growth than in many other eurozone markets.

The improving occupier market outlook is likely to support rental and income growth in the office sector. However, economic growth may not support strong rental growth on a national level but might be focused in the prime and core segment in the major office cities. A supply shortage of good quality space in city centers and well connected emerging technology locations also support value–add and opportunistic strategies. While value-add strategies in Paris and the major German office centers are almost fully priced, we could still see attractive opportunities in Belgian, Dutch, Italian and Spanish markets. Prime office yields are likely to reach a floor in 2016 and may become exposed to changing monetary policies in the medium term but which is unlikely to happen this year.

Relative performance of office markets against Eurozone average 2016-18
(%)



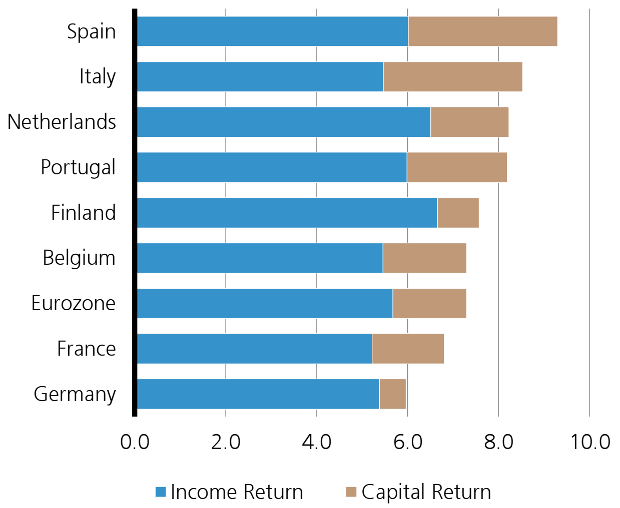
Source: UBS Asset Management, Global Real Estate, February 2016

Retail
Over the 2016-18 periods we expect Dutch, Italian and Spanish retail to outperform the eurozone average while France, Germany and Ireland are forecasted to underperform due to lower capital growth prospects.

Eurozone retail is going through a major structural change which is likely to continue for the next few years. The emergence of online retailing also has significant consequences for physical retail and, as such, retail real estate assets. The traditional link between retail sales growth and rental growth on a national level is broken. While retail sales in physical retail are still growing, the bigger growth rates are forecasted to be in the online sector. Furthermore, a growing number of retail product categories are becoming exposed to online competition and, therefore, the polarization of retail real estate will continue. Dominance in the catchment area is likely to be key to outperformance. This does not mean that new assets may automatically perform well but the changing macro environment may also provide opportunities in repositioning older, well located assets. Historic city centers, in particular in southern European cities, are touristic and retail hotspots but are often characterized by outdated (listed) office buildings. Office occupiers have been consolidating their premises in more efficient assets outside the historic city centers which create repositioning opportunities for retail or hospitality. Expanding the high street in supply constrained historic centers provides the opportunity to capture the strong rental growth prospect for high street retail while secondary locations may get affected strongly by online retailing. Dominance could also mean convenience for the customer. Consequently, retail locations close to transport connections and urban centers may capture growth in physical retail sales.

Total return forecast 2016-18

(% average annual)



Source: UBS Asset Management, Global Real Estate, February 2016

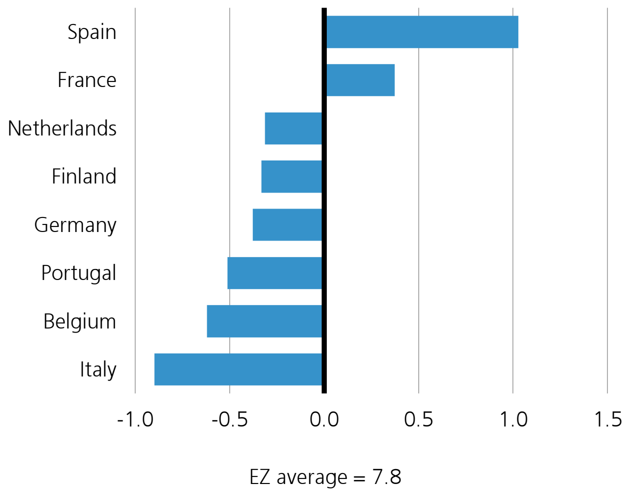
Industrial / Logistics

Over the 2016-18 period we expect Ireland, Spain and France to outperform the Eurozone average with the weakest relative performance expected to come in Austria and Italy. Returns in Ireland will continue to be supported by very strong rental growth, whilst capital appreciation is the main driver of the outperformance in Spain and Italy.

One of the key drivers of the strong demand and rental growth for industrial space in Ireland has been the rapid growth in e-retailing which, similar to the UK, has outpaced that of continental Europe. In the UK and Ireland the growth of online retailing has made industrial investment a very attractive proposition, driving both strong rental growth from the occupier side and heavy capital appreciation as investors buy into the strong underlying fundamentals supporting the sector. In these more mature markets, logistics operators are investing heavily in their distribution networks to absorb the growing demand in volume and cost efficiency which is key within an industry which has notoriously low profit margins. In continental Europe online retailing is already well established in Germany, and to a slightly lesser extent, France and the Netherlands. However e-retailing market share in Spain (3.5%) and Italy (2.5%) remain well below the European average of 8.4%. It may take some time before consumer attitudes in these countries fully embrace the concept of online retailing, but if it does begin to catch on in the same way as other European countries there is clearly huge potential for the expansion of the logistics networks to support the growing industries. Following the example of more evolved markets, we would expect the best located industrial parks around key urban centers and sites with large scale potential for warehouse development on key infrastructure hubs to see the most benefit from a rise in e-commerce in these relatively immature markets.

Relative performance of logistics markets against Eurozone average 2016-18

(%)



Source: UBS Asset Management, Global Real Estate, February 2016

Viewpoint

The forecasts are based on the underlying economic data for the eurozone, which has actually improved over the past six months as the recovery in domestic demand has strengthened. But whilst the economy has improved, geopolitical risks which are notoriously hard to quantify have undoubtedly risen in prominence and need to be taken into account when considering the outlook for eurozone real estate.

A number of the key geopolitical risks have evolved from a breakdown of unity between European countries, which has placed significant pressure on a European Union which is facing its most challenging period since inception. The increasing focus on protecting one's own interests is perhaps best demonstrated through the absence of any co-ordination or collective responsibility to address the migrant crisis. The reluctance of many EU countries aside from Germany to accept anything close to a proportional number of refuges will eventually reach a breaking point. Unless an agreement of fairer distribution is reached Germany may at some point close its borders, and the end of Schengen would be a significant step backwards for the EU. A potential change in German government could lead to a potential power vacuum in the largest and most influential economy at the point of the EU being at its most strained.

In terms of physical membership, there will be a referendum in the UK on their future membership of the EU on 23rd June, 2016. David Cameron was successful in obtaining some concessions from the EU for Britain's continued membership; however several leading figures of the Conservative party, including London Mayor Boris Johnson, have announced they will be campaigning to leave the EU. Whilst we believe that the most likely outcome will be a vote to remain in the EU, polls are indicating it is likely to be close and the EU is a notoriously emotive topic amongst the UK public which can be swayed by negatively perceived events. Aside from the immediate consequences of the UK leaving the EU, this may have more significant ramifications for the longer term sustainability of the EU and give rise to sections of other member states where negative feelings towards Brussels have been evolving.

In this environment of self-interest and preservation it is perhaps unsurprising there has been a significant increase in support for independence movements in Scotland and Catalonia. Against a backdrop of disillusionment with the established political system amongst the younger eurozone population, particularly in southern regions, there has been a sharp rise in populist political parties in Greece, Spain and Portugal. In economies where youth unemployment remains above 50%, this is not surprising, and has the potential to lead to a situation where a whole generation feel they have very little to lose from leaving the status quo, with inherent consequences for the existing establishment. Additional support from monetary policy could only be temporary and must be used by governments for much needed structural reforms.

At the moment the direct impact on the real estate market of these uncertainties has been fairly minimal, and it is still more likely than not that the EU will work through the upcoming challenges in one way or another. However, there should be an awareness that the relative political stability within which the European real estate market operates and strongly benefits from should no longer be taken as a given going forward and investments made today may find that the political landscape could change significantly over the life cycle of the investment. With the risks of this change skewed to the downside, they should to be taken into account when assessing the relative value of any opportunity. In addition, diverting bond yields within the eurozone in the early part of 2016 might be an "early" warning that investors may also require greater yield differences between real estate markets.

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