February 2016

# European Real Estate Summary.

Edition 1, 2016

European office demand reaches highest level since GFC

Shortage of good quality CRE for occupation is driving prime rental growth

European investment volumes reach new peak level in 2015

Generally positive outlook for 2016 but geopolitical risks persist

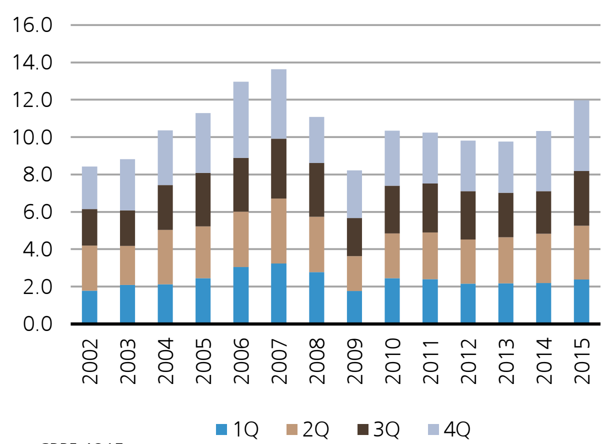
# Demand

Although the European economy continues to face significant headwinds, these are predominantly from external forces and a tentative recovery in the domestic economy actually drove economic growth above people's expectations in 2015. 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 1.1% in 2015. Although overall unemployment generally remains quite high, in undersupplied sectors of the workforce a tightening of the labor market is starting to place upward pressure on wages. Combined with an inflation rate of around 0%, this is translating directly into rising disposable incomes, which consumers are feeding back into the economy in the form of very strong retail sales. This domestically driven recovery is starting to have positive implications for European 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 the central business and dominant retail locations and targeted towards better quality commercial real estate. The steady pace of recovery is not expected to reach a level which would drive positive net absorption in poor quality space and less established locations.

Reflecting the pick-up in employment growth, take-up levels in the majority of European markets recorded a marked increase on the previous year, with a strong 4Q bringing aggregate take-up for European office markets in 2015 to the highest level since the financial crisis. Some of the sharpest increases were recorded in the Spanish markets of Madrid and Barcelona. Structural reforms in those labor markets 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 2014. 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 its highest level since 2011. And despite continuing economic challenges, the Paris market surprised on the upside with a strong 4Q of take-up which reached its highest level since 2012. One of the few core markets to see demand levels fall back slightly was Central London – this is attributable to its very advanced position in the cycle compared to the rest of Europe and the exceptionally high levels of demand which had been recorded previously. Despite the slight dip, take-up remained 18% above the 10-year average in 2015.

Retailer demand remains heavily polarized between the dominant high street locations and shopping centres, 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.

**European take-up volumes (million sqm)**




Source: CBRE 4Q15

# Supply

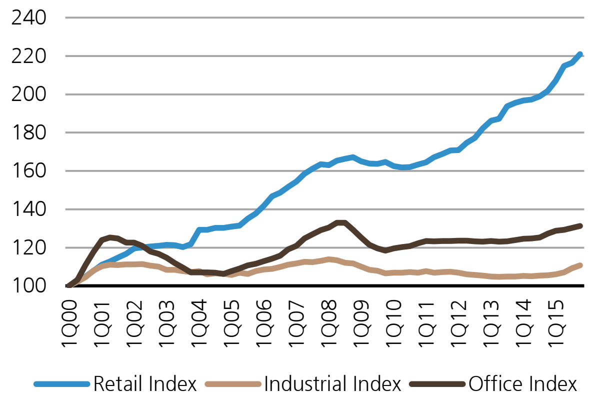
Reflecting the improvement in occupier demand, vacancy levels across Europe are generally on a downward trend, however, there continues to be significant polarization based on quality and location of stock. In the office markets, the aggregate European markets vacancy continued on downward trend and fell by 0.3 percentage points (pp) () in 4Q15, and is now at its lowest level since the Global Financial Crisis (GFC). The sharpest decline in vacancy in 4Q was recorded in Milan, where the vacancy rate fell by 1.6 pp to 11.9%, while other recovering markets, including Dublin, Madrid, Amsterdam and Barcelona, also continued to see a steady erosion of the overall vacancy rate declining by between 0.4-0.9 pp over 4Q.

Whilst absorption of space has started to be positive in most central sub-markets, many markets across Europe continue to suffer from an oversupply of office space in peripheral locations, particularly those with poor public transport connections to the central sub-markets and surrounding areas. 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 (23.7%), Amsterdam Schiphol Area (20.3%), Dublin North & West Suburbs (26.4%), Barcelona Periphery (20.8%) and Madrid Periphery (29.0%).

On the flip side, vacancy, particularly of better quality space, in central sub-markets has been coming down rapidly, reflective of the preference for occupiers to locate in central sub-markets and also the absence of significant speculative development across most markets since the GFC. This growing supply-demand imbalance has been placing upward pressure on prime rental values, with the Weighted Average EU-15 Office Market Rent Index rising by 0.7% in 4Q, taking the total annual growth for 2015 to 3.1%. With limited signs of a speculative supply response starting across Europe (with a few exceptions) this supply 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 the 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 4Q15

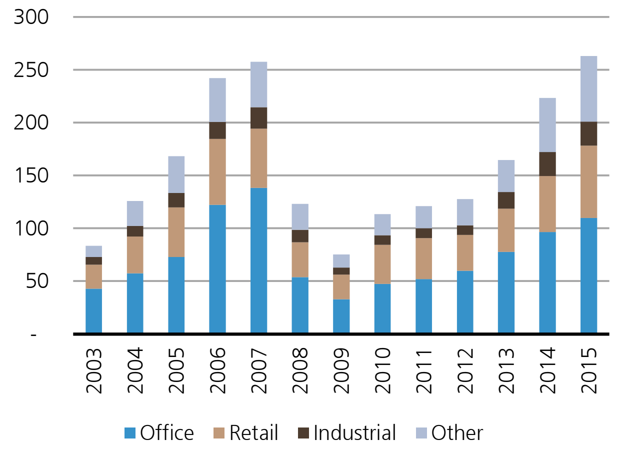
Prime rents increased by 2.1% in 4Q, and are now 32% above the pre-downturn peak – prime office rents incidentally are still marginally below their previous peak level. But while the prime retail segment has seen the strongest rental growth of all property sectors, secondary and tertiary retail locations 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 pace of recovery in the investment market in Europe has outpaced that of the occupier market, with commercial real estate investment in Europe reaching a new record peak in 2015 at EUR 263 billion. An influx of capital from outside of Europe has been one of the key drivers of this record level of investment turnover, with foreign investors seeking diversification outside of their domestic market. With the relative political and economic stability 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 European real estate assets. Changing regulation in recent years has enabled a significant inflow of capital from Asia and the Middle East, and capital from these regions has typically targeted the core markets in the UK, 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 Germany and France recording their strongest quarter of investment activity since the financial crisis. The UK saw a slight slowdown in 4Q compared to the previous year's final quarter, but at EUR 21.6 billion this still took the annual investment volume to another record level for the market. 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 continued to move in 4Q across a number of markets. Some of the sharpest inward yield movements in the office markets were in second-tier cities with Lyon (-50 basis points (bps)), Rotterdam (-30 bps), The Hague (-25 bps) and Utrecht (-20 bps). Southern European markets also continued to see yields contract with Milan, Madrid and Rome all moving in by 25 bps. Further smaller contractions were also recorded in Paris, Hamburg, Munich and Vienna. In these markets yields are already well below previous records. The sharpest contractions in High Street retail yields were recorded in southern Europe – namely Milan, Rome and Malaga which all declined by 50 bps in 4Q. In addition, Dublin, Amsterdam, Barcelona and Madrid all recorded a 25 bps decline. In the UK, prime yields were flat in all the major office and retail markets, reflective of a slight easing of investor demand and the current level of pricing in the market, which is in a more advanced position within the cycle than the rest of continental Europe. 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 maintain for at least the next 12 months.

**European investment volumes (EUR billion)**




Source: CBRE 4Q15

# Viewpoint

While the economic outlook for 2016 points towards a steady, if somewhat unspectacular, continuing recovery in Europe, there are a number of headwinds facing the region both domestically and globally. The primary challenges on the domestic front come from geopolitical uncertainties, with a UK referendum, the continuing migration crisis and the inconclusive outcomes of the recent general elections in Spain and Portugal all contributing a significant degree of uncertainty to what the political landscape of Europe and the EU will be in 12 months' time.

Externally Europe will continue to be affected by the slowdown in China and emerging markets. However, we would highlight that while this has undoubtedly shaken global financial markets and contributes to a heightened air of uncertainty, Europe – as a net consumer of goods and commodities from emerging markets the region – should still be able to benefit from the falling prices, which should outweigh any loss of exports back to the region. With inflation set to stay well below its target of 2% again this year after further decline in oil prices in January, the consumer sector again appears set to drive positive growth with rising disposable incomes which should continue to support retail sales. For European property, one of the key questions now is how this lower for longer environment of inflation and interest rates may disrupt the pattern of the cycle. Property in many markets already looks expensive compared to historic property values, but continues to look attractive against fixed income returns which is unlikely to change over the course of the year. And with QE continuing until at least March 2017, an environment of inflated asset values putting further upward pressure on property pricing cannot be ruled out.

Source: (Commentary) Oxford economics February 2016; UBS Asset Management, Global Real Estate, Research & Strategy February 2016

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