

Research Blast

European Real Estate Market, March 2017

Changing monetary policy environment – challenges and opportunities in eurozone real estate

As at the end of February 2017, the European Central Bank (ECB) had purchased monetary assets of ca. EUR1.7 trillion under its extended asset purchase programme (APP). Translating this amount into concrete terms this equals roughly to 120 Channel Tunnels or 1,100 Burj Dubai Towers. ECB's monthly asset purchase volume of ca. EUR 60 billion represents almost twice the budget of "Grand Paris", Europe's current biggest infrastructure program. Negative interest rate policies and tightening regulation complicate investor's life. In the search for yield and return, asset prices, including real estate, have increased since the introduction of unconventional monetary policies across the world. Nevertheless, even though commercial real estate prime yields in Europe are at all-time lows, ultra-low government bond rates still make commercial real estate attractive for income-orientated investors. According to CBRE, compared to 2015 investment volumes in eurozone commercial real estate have plateaued; however, with a total volume of ca. EUR 132 billion, the 2016 result was only slightly shy of the 2007 figure (ca. EUR 135 billion).

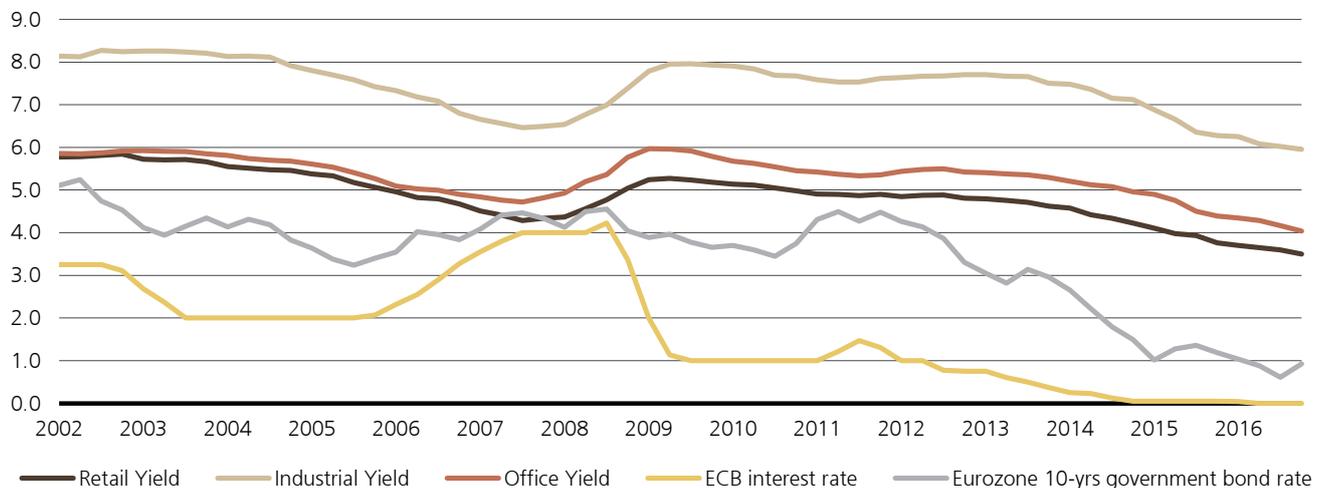
The current form of ECB's APP program is scheduled to last at least until the end of 2017. Improving economic data in the eurozone, including on the labor market and on core inflation, but also a diverging monetary policy to the US Federal Reserve, is raising the question on when the ECB might start tightening its monetary policies and what implications this may have on commercial real estate. There is no definite answer to this question as the world has never experienced such a period of loose monetary policy.



Active income management is likely to be the core strategy in a tightening monetary but improving economic environment

EU-15 ex-UK prime real estate yields and interest rates

(in %)



Source: CBRE EU-15 ex-UK Prime Yield Index Q4 2016, Oxford Economics March 20, 2017

Bond markets might be at a turning point from ultra-low levels; however, the long-term macro trends in the eurozone are challenging and are likely to limit bond rates returning to pre-GFC (Global Financial Crisis) levels. The demographic outlook for most eurozone countries is negative and the reluctance of many governments to commit to structural reforms is likely to limit economic growth in the long term. Therefore the outlook for core inflation in the eurozone looks muted. The ECB may keep the official interest rate low for longer, but less accommodative monetary policies may place upward pressure on bond rates. However, in a low growth environment investment return results are also likely to be modest and investors may have to reassess their return expectations.

Monetary policy gave investors a strong tailwind

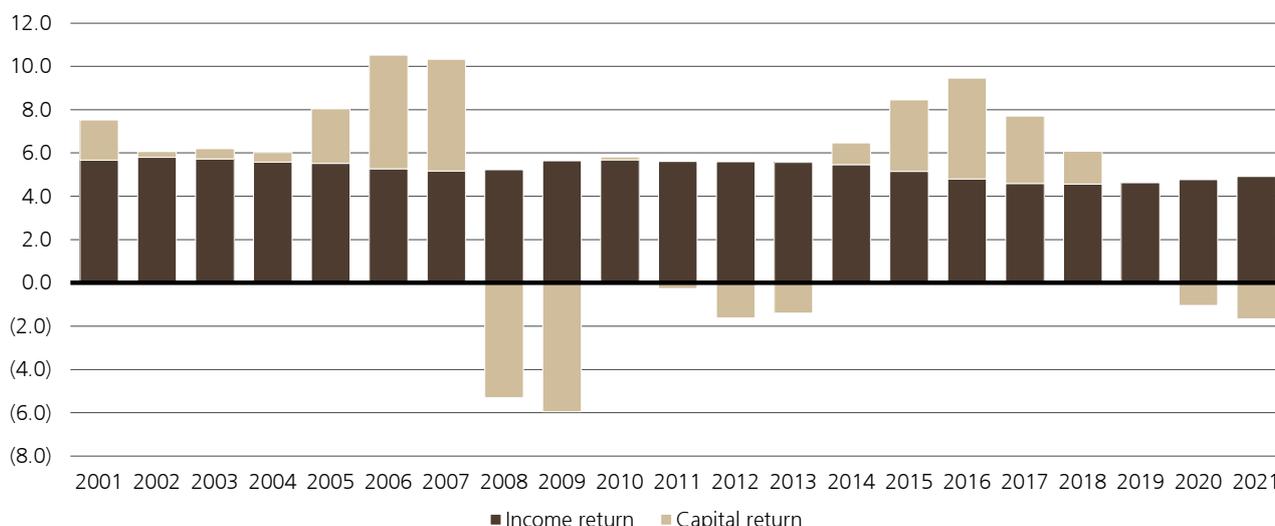
Eurozone commercial real estate markets entered the GFC almost at the peak of a real estate development cycle and highly levered. In 2008 the GFC caused a collapse in occupier demand across the eurozone, with rising vacancy rates, weak

occupier demand and a severely damaged banking/lending industry pushing commercial real estate yields out. Unconventional monetary policy and low interest rates channeled more capital in to the prime real estate segment in particular, even though occupier markets were still weak or even weakening. Over the last few years not only global but also eurozone real estate have enjoyed a period of significant capital growth by an inward yield shift which has not been fully based on real estate market fundamentals but supported by monetary policy.

In some eurozone markets, particularly in so-called safe haven markets such as Germany but also in the southern eurozone's prime/core segment, investors have virtually enjoyed a "free lunch" (or Beta in financial terms) of capital growth by inward yield shift while prime rents were still falling or flat. Going forward, capital markets and monetary policy are likely to give real estate much more of a headwind. Rising bond yields are expected to put pressure on eurozone's real estate yields by 2019/20 and there is the risk of capital value decline.

Eurozone all real estate total return forecasts

(in %)



Source: MSCI historic data 2001-2016; UBS Asset Management, Real Estate & Private Markets, Research & Strategy, February 2017

Real estate market fundamentals are shifting

While the German economy weathered the storms of the GFC, many eurozone economies either faced a prolonged period of GDP decline (e.g. Spain), a shallow recovery (e.g. Austria and France) or even double-dip recessions (e.g. Belgium, Finland, Italy, the Netherlands and Portugal). Only over the last two years has the eurozone economy experienced sufficient economic growth to support a rise in employment. Despite all the political uncertainties the economic outlook for the eurozone economy is positive, in particular in eurozone's second largest economy, France.¹ UBS Equities research also suggests that earnings of European

listed companies are likely to increase which would support real estate occupier markets as well.²

A positive byproduct of the GFC for eurozone's commercial real estate sector is eurozone's weak banking sector. The Loan-to-Value (LTV) ratio for European commercial real estate is estimated to be at ca. 44%, well below pre-GFC level (close to 70%).³ Tightening regulations also limit banks' abilities to lend against riskier real estate strategies, in particular developments. Consequently, despite positive signs in the occupier market, eurozone commercial real estate markets

¹ Source: Oxford Economics, March 20, 2017

² Source: UBS Asset Management, Real Estate & Private Markets (REPM) European Equity Strategy – Thematic March 20, 2017

³ Cushman & Wakefield: Global Wall of Money 2017

have not experienced a supply/development cycle. Net absorption in the European office sector has been positive since 2011 but the overhang of pre-GFC development activity has kept vacancy rates high. However, since 2015 the aggregated office vacancy rate in central locations dropped from ca. 8.5% to 6%, which is the lowest level since the GFC. Due to the lack of office development activity vacancy rates in safe haven central sub-markets are often below 2%, placing pressure on prime rents. Due the scarcity of available office space rental growth has started moving towards city-edge locations which are also often the preferred location for newly emerging occupiers from the technology sector.

Late-yield-cycle: yield expansion is inevitable but rental growth ahead

In the absence of an external shock, a yield expansion for eurozone commercial real estate is not likely to happen in the short term. Nevertheless, an improving economic and inflationary outlook supports higher bond rates and may place upward pressure on real estate yields by 2019/20. However, this scenario is not automatically negative for core real estate. Real estate's performance attribution is moving towards its core elements – income return and rental growth. The music

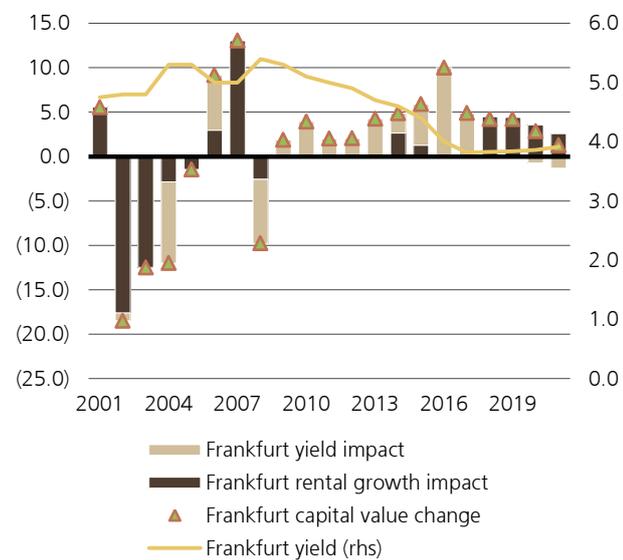
may stop for those investors who played just the yield-cycle but those investors who are able to manage assets actively are more likely to mitigate the risk of future rising yields.

Risk-takers: stay prudent on location but take risks on an asset level

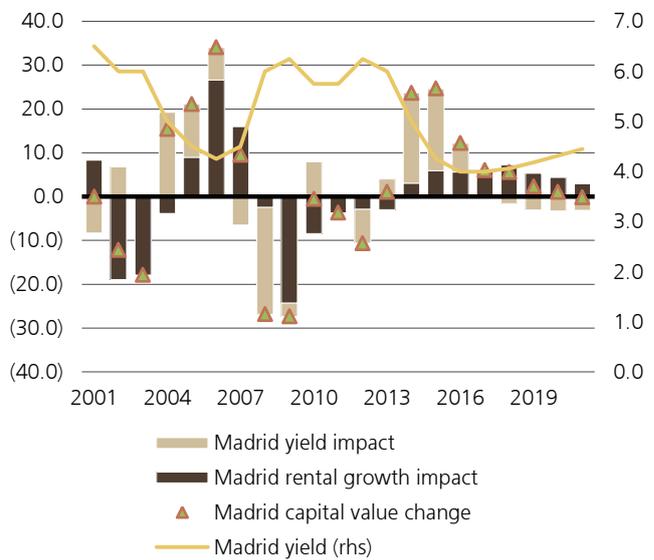
Real estate supply is quite inelastic in nature and even if demand turns out to be slightly lower than predicted, supply in central and dominant locations is likely to remain constrained. Due to the lack of development activity in all real estate sectors real estate supply has been aging since the GFC. However, tenant requirement for modern space is strong and offers opportunities for investors who are prepared to take risks on an asset level. Taking active risk positions on short leases or repositioning inefficient assets while remaining staying prudent on location could justify today's prices. These type of assets offer rental and income growth opportunities and could mitigate the risk of falling capital values by rising real estate yields due to increasing bond rates. Active asset and income management are likely to be the core strategy in a market environment, which faces headwinds from tightening monetary policies but improving economic conditions and real estate market fundamentals.

Prime office capital growth likely to be driven by rental growth but outward yield movement expected
(in %)

Frankfurt prime offices



Madrid prime offices



Source: UBS Asset Management, Real Estate & Private Markets, Research & Strategy calculated on the basis of CBRE prime office forecasts, February 2017

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