UBS

August 2017

Eurozone Real Estate.

Outlook 2H17

Economic growth intensified during 1H17 and perhaps peaked during 2Q. Robust growth was recorded throughout the region with the strongest GDP recorded in seven years. Occupational markets generally strengthened across the region and demand for core investments remained strong. Over the next three years we anticipate All Property total returns will be around 6.3% p.a. The returns are primarily being driven by income with rental growth amidst a strengthening and broadening occupational environment. The industrial sector is expected to remain the strongest performer by some margin, followed by the retail sector and then office.

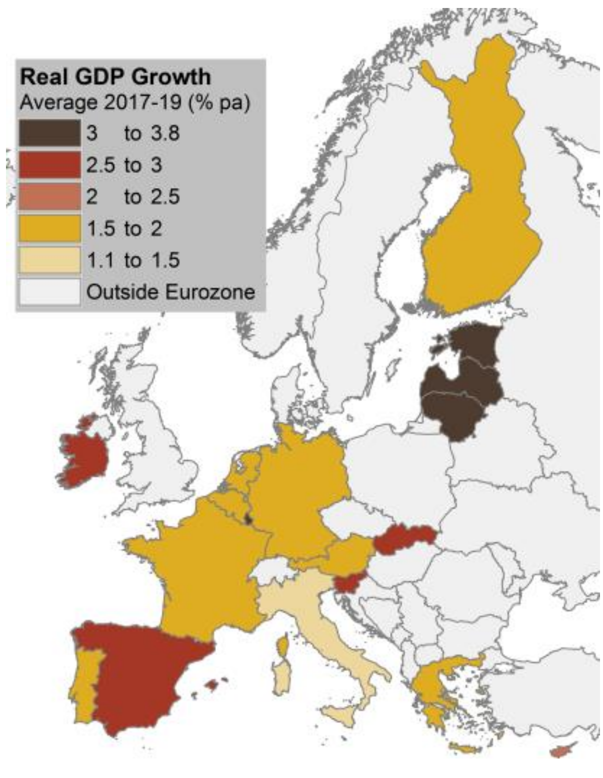
Economic environment & expected occupier demand
Economic growth in the eurozone was strong during the first half of the year, intensifying and perhaps peaking in 2Q17. Robust growth was recorded throughout the region with GDP growth in 2Q17 estimated to be 0.6%, which is the strongest growth recorded in seven years. Particularly strong performance was recorded in the Netherlands which expanded 1.5% during the quarter and contributed strongly to eurozone GDP expansion in 2Q17 despite its relatively small size. Other notable contributions during 2Q17 came from France and Italy which have been trailing behind in the recent past but have now started to make a positive contribution to eurozone growth. The French economy is also in good shape, recording 0.5% growth for the last four quarters. Italy also recorded solid growth of 0.4% for the last three quarters, although risks to future growth remain and are intrinsically linked to the political situation.

The outlook for inflation in the eurozone remains fairly weak despite robust economic growth. The main downward pressure on inflation is a result of the renewed fall in energy prices since 2Q17 and the recent appreciation of the euro. In July, annual HICP (Harmonised index of consumer prices) was stable in France and Spain at 0.8% and 1.5% and German state inflation rose to 1.6% from 1.5%. Although it is expected that wages will eventually increase as the labor market recovery continues but the relative low level of inflation is expected to provide comfort to the ECB to stay cautious about the exit of its quantitative easing program. It is anticipated that the ECB will lower its purchases from early next year.

Looking ahead, it is likely that the eurozone will continue to post above trend growth. Export conditions remain favorable and strong survey data on exports points to sustained activity in the near term. Slowing global growth, coupled with the appreciation of the euro against the dollar is a key risk and is expected to inhibit export volume growth. However, healthy labor markets are expected to aid household spending growth in the region despite weak wage growth. Indeed, we expect household spending growth to ease from 2.0% in 2016 to a still very respectable 1.6% both this year and next. Furthermore, the prospects for investment are good with buoyant business sentiment, healthy export growth, reduced political fears and the continued strength of bank lending pointing to a contribution to economic growth. Business investment is forecast to grow 2.6% in 2017 and 3.1% in 2018.

Overall, we now expect GDP growth in 2017 of 2.1%. In 2018 and 2019, a mild slowdown in growth is expected with 1.9% and 1.6% forecast respectively. The risk to eurozone growth is inflation undermining the recovery as strong labor markets have boosted consumer spending.

Eurozone GDP growth forecasts 2017-19



Source: Oxford economics, Map Info February 2016

Office occupier markets continue to strengthen in-line with the improving economic outlook, with more companies returning to an expansionary agenda and taking on additional space. Take-up for the eurozone reached 4.5 million sq m in 1H17, the highest volume for the first half of the year since 2007 and a 8.5% increase on 1H16. Spain continues to deliver the strongest office-based employment growth in the eurozone, and saw take-up of space in Barcelona and Madrid increase by 47% and 35% respectively off the already strong level of activity recorded in 1H16. The main markets in the Netherlands also now appear to be responding to a recovery in employment levels with Amsterdam, Rotterdam and The Hague all recording sizeable increases in leasing activity in 1H17. The main German markets continued to see a robust level of leasing activity, and the only market to record a slowdown was Berlin. But this was due to the exceptional level of activity recorded in 2016, and the volume in 1H17 actually remained 33% above the long term average for the market, again demonstrating what the structural impact growth in the technology sector is having on levels of demand for office space in the market. Activity in Paris stayed on par with 2016. However, if Macron is able to pass his labor market reforms, the outlook for jobs growth in Paris will improve substantially with positive implications for occupier demand going forward. On the retail side, consumer confidence was robust during 1H17 despite the ongoing political uncertainty within the eurozone. Confidence remains substantially above the long run average and continued to improve during the first half of the year. With the exception of a brief fall in February, consumer confidence has been on a steady upward trajectory since August last year. The outcomes of general elections in the Netherlands and France have generally been well received by consumers and markets and a strong message has been communicated that there will be "no soft Brexit" deal for the UK when it leaves the EU in 2018. As such, consumers are feeling increasing more positive about the outlook for the economy and their own personal financial situation. Looking ahead, households are expected to come under increasing pressure from rising inflation but rising employment and employment intentions for the year are fairly robust and are not expected to dent spending too much.

Supply

As demand has increased, occupier markets are becoming even tighter and eurozone office vacancy sunk to a post-crisis low of 7.6%. Berlin's vacancy rate fell to below 4% driven by strong net absorption and only moderate development, while Dusseldorf (-1.3 p.p YOY) and Frankfurt (-1.2 p.p YOY) also saw office supply become more constricted. The Netherlands continues to see heightened occupier demand as its' recovery gathers steam and secondary office stock is removed from the market, with Amsterdam seeing a 3.5 p.p YOY reduction in its vacancy, albeit from relatively high levels.

Development levels across the eurozone continues to be subdued - total space under construction as a percentage of stock was just 2.8%, meaning tight availability is likely to remain a feature for the foreseeable future. Low levels of development and recovering fundamentals have driven rental growth in most European markets, as annualized prime eurozone office rents rose by 4.5% to 2Q17. The strongest annualized growth was recorded in Amsterdam (12.5%), where occupational demand has been recovering strongly and supply of high quality space is extremely limited as action from the municipality has restricted the development of new office space. Other markets including Berlin, Madrid, Brussels, Dublin, Milan and Helsinki all recorded growth in the 8-9% range as similar dynamics are increasing tenant competition for the best available spaces. This positive trajectory for prime rents is likely to continue until a development response emerges, but there is little indication of this starting in most markets. The outlook for secondary rents is improving. However, in almost all cases, the pace of growth will continue to lag prime as there is still a much greater supply of this space, particularly in some more peripheral locations.

In the retail sector, development activity remains fairly low in a historical context, although there are signs of an increase in development activity. The shopping center pipeline is expanding fairly rapidly and is a potential cause for concern in some more over supplied regional markets should all planned developments go ahead. There are a number of new build proposals but investors are also taking the threat of the impact of online seriously and are looking to extend and refresh their centers to introduce a greater variety of food and beverage outlets and also to expand leisure provision, which is known to increase the attractiveness of centers and extend dwell time and spend. Countries to monitor include; Finland, Ireland and Portugal as these markets have a fairly high shopping center space per capita and pipeline stock as a proportion of existing stock. In addition, proposed retail warehouse development is also very high for 2017 and 2018, although many projects have not yet started. Thus, the eventual increase in supply may actually be much lower. Any substantial amount of development activity in local markets with already high retail space per capita will place downward pressure on rental values of secondary assets.

The outlook for average retail rents is moderate in the eurozone with slightly stronger growth anticipated in prime cities, although a few countries are worth mentioning. We have begun to see an improvement in retailer and consumer sentiment in the Netherlands and believe it is likely that we will start to see this feeding through to positive rental growth for core assets next year after 5 years of rental declines due to downward pressures on household incomes and a weak local economy. We have already seen demand pick up for prime properties in the Netherlands with strong rental growth recorded in The Hague (+7.1%), Maastricht (+6.7%), Rotterdam (+5.9%) and Utrecht (+3%) during 1H17. Other prime high street markets that saw strong rental growth were the southern European markets in Portugal and Spain during 1H17 including; Lisbon (23.8%), Madrid (+10.7%), Barcelona (+9.4%) and Valencia 8.1). More moderate growth was also recorded in the prime shopping center segment in Austria and Italy during the first half of the year; Vienna (+4.3%), Verona (+2.9%), Florence (+1.4%), Milan (+1.1%) although exceptionally strong growth was recorded in the prime market in Utrecht (+23.1%) and Oporto (+15.4%) reflecting the improving sentiment in these markets. We expect this improving sentiment to be reflected in some moderate rental growth for average quality (MSCI) retail property next year.

At a macro-level, the industrial sector has a very positive outlook. Manufacturing PMI's have been at an elevated level since the end of last year, however there continues to be a discrepancy between survey and hard data as actual industrial output has been more inconsistent and tended to lag the rates of expansion suggested by the PMI. Industrial output for June actually declined slightly. However, this was largely due to calendar effects in Germany and the inherent volatility of the French data. The total rate of expansion in 2Q17 was 1.2%, meaning the eurozone q/q growth was one of the strongest since 2010. As a result, demand for industrial and logistics property remains very high, driven by a continued growth in online sales, ongoing consolidation and alignment of distribution processes, as well as the increasing complexity of city logistics and achieving the all-important 'last mile' step in the supply chain. This has translated into high levels of leasing, and take-up in 1Q17 (Q2 figures unavailable) rose by around 5% when compared with the same quarter the previous year. As would be expected retailers, ecommerce and third-party logistics operators form a large component of the market, however manufacturers and other industrial operators have begun to take more space in the last couple of years as there continues to be an improvement in the wider eurozone economy. In terms of format, occupiers remain focused on the large-size modern warehouses with good arterial road connections, as well as smaller distribution centers located in around large urban agglomerations. Specifications are becoming increasingly important to occupiers as the implementation of technological and digital operational models are becoming key to achieving necessary supply chain efficiencies. As a result, there continues to be a preference for design and build solutions, which accounts for nearly 80% of space currently under construction.

While industrial demand has seen a big upswing in recent years, the supply side of the equation remains highly constrained. A key factor here is the fact that the 'one size fits all' model is becoming increasingly difficult to apply, due to the increased levels of specialization within modern supply chains. This has restricted operators to favoring purpose-built solutions, which has in turn, restrained levels of speculative development in the market; according to data from JLL, construction, only around 20% of current space under construction is speculative stock. Added to this is the fact that most major European cities have severe land constraints. While it was previously less important to be located near to major urban centers, ever-increasing consumer demands in terms of delivery speeds have meant modern logistics providers are all trying to add more urban logistics to their networks. This type of asset is in very short supply and development is difficult, due to intense competition from residential development, which tends to be both more lucrative and politically appealing. This trend has pushed vacancy rates to below 6%, and it is estimated that there is currently less than a year's supply in the market. It must be remembered that there are significant national variations, with the UK, Germany and the Nordics seeing the lowest levels of supply, while the CEE countries and Russia are currently seeing very high levels of development.

Capital flows

Political uncertainty in the eurozone spilled over from 2016 and continued to effect some markets in the first half of the year. In 1H17, EUR 64.1 billion transacted, reflecting a 24% increase in investment volumes recorded during the same period in the previous year. The first half of the year has been characterized by political uncertainty as well as a continued low bond yield environment and negative interest rates. However, investor demand has remained strong because real estate remains attractive to investors due to its high yield, although its relative pricing appeal is reducing.

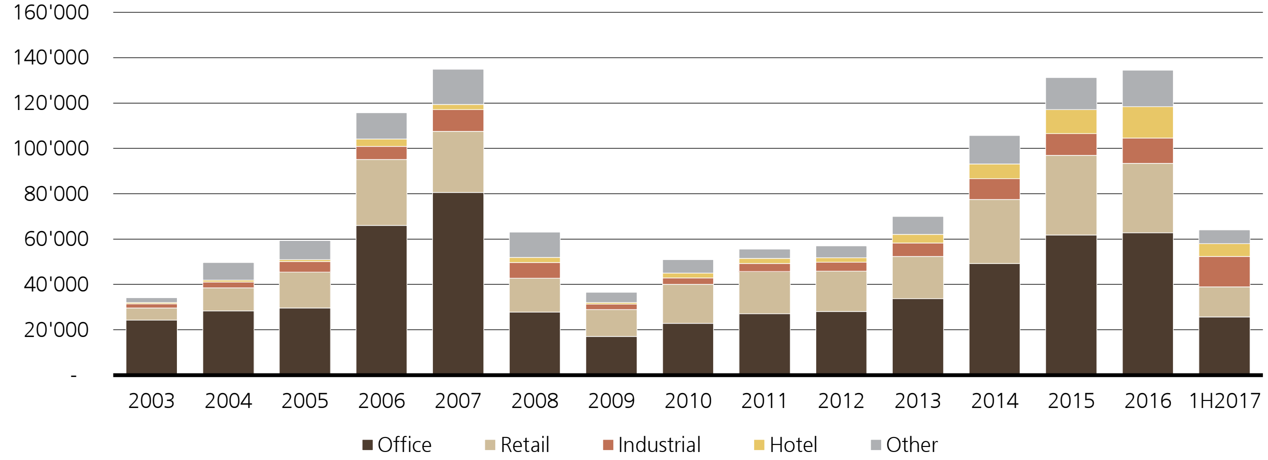
There were some strong performers within the eurozone during the first half as shown in the chart overleaf. Germany benefitted positively from ongoing political uncertainty evident in some other eurozone markets. All commercial property investment volumes increased 46% YOY in 1H17 and totaled EUR 26.1 billion. The greatest increase in investment volumes during the period was in the industrial sector, although transaction volumes were much smaller at EUR 1.8 billion than the office segment (EUR 7.7 billion) due to the total investable market size. Similarly, investment volumes increased substantially (+74%) in Spain and Italy (+58%). Investors were attracted to the recovering occupational market and rental growth potential in Spain, whilst investors started to respond to the improving economic outlook (albeit from a low base) and market sentiment in Italy.

Overall, at a sector level the industrial sector attracted a substantial uplift in attention across the eurozone without exception. Investment volumes in the sector almost tripled YOY in 1H17 with the smaller markets of Portugal and Finland seeing the greatest increase in investment. Demand was also strong in Germany, although the continued shortage of good quality stock and competitive pricing constrained volumes. In contrast to the exceptional performance in the industrial sector, investment volumes remained stable in the retail sector at cEUR 13.2 billion and increased modestly in the office sector (+16%) to EUR 22.2 billion.

In terms of demand, investors continue to be focused on core assets, particularly in major cities reflecting the levels of uncertainty in the eurozone marketplace. Investors remain fairly risk averse and the near term low interest rate environment is likely to push investors towards prime property. However, prime product remains in short supply in major European cities and as such, further inward yield shift may be possible in some markets this year. In most eurozone markets, prime yields have now fallen below, or are very close to, record low levels.

Eurozone investment volumes

(EUR '000)



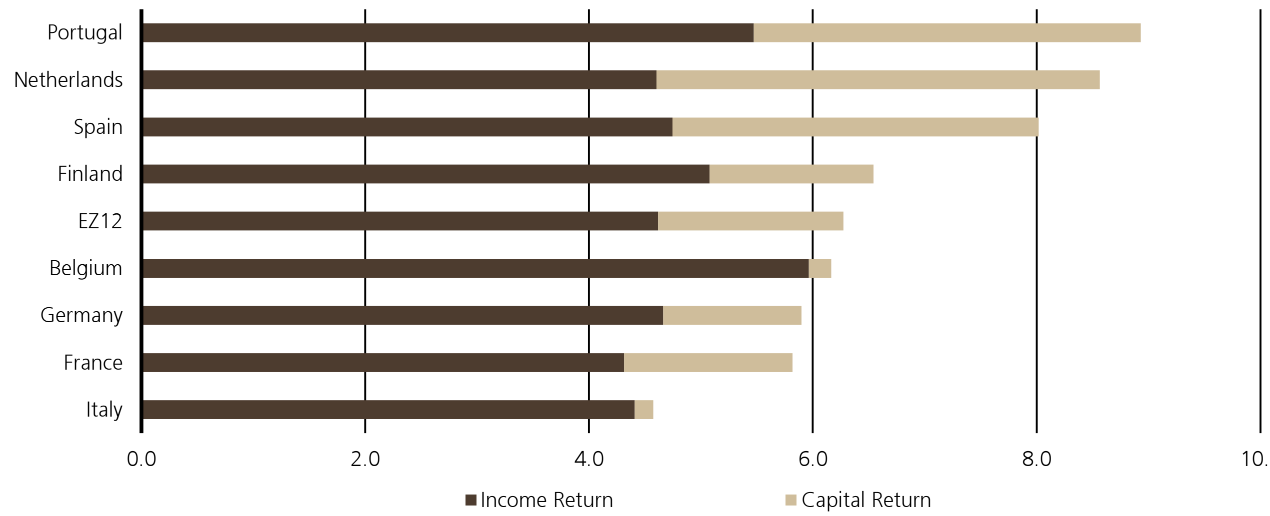
Source: CBRE, 2Q17

Outlook

Over the next three years, we forecast a total return for all property of c.6.3% p.a. This forecast is slightly stronger than our expectations six months ago (6.2%). The stronger return outlook is being driven by a marginally stronger rental growth outlook amidst a strengthening and broadening occupational environment. The industrial sector shall remain the strongest performer by some margin, with a total return of 7.2% and is followed by the retail sector (6.6%) and then office (5.7%). The industrial sector benefits from both higher yields and strong occupier demand as supply chains are upgraded to cater for the evolving impact of e-commerce. Over the next three years, Portugal is expected to be the strongest performer with the Netherlands a close second as shown in the chart below. Both markets are expected to benefit from strong capital growth as a result of strong rental growth while the income return component remains comparatively high. Portugal and the Netherlands are expected to see above average returns supported by front loaded inward yield and strengthening rental growth as a result of improving occupational market conditions.

Total return forecast 2017-19

(% annual average)



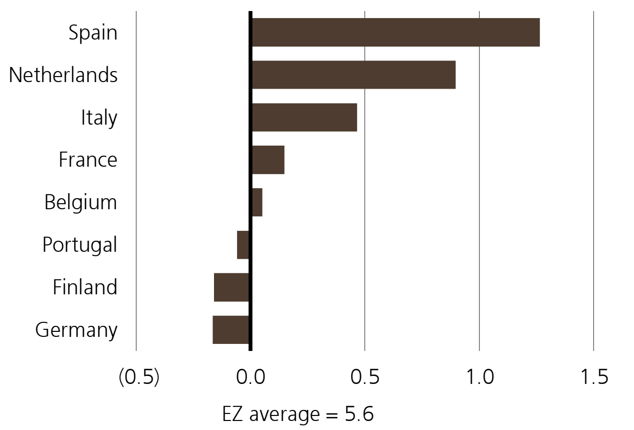
Source: UBS Asset Management, Real Estate & Private Markets (REPM), August 2017

Office

Over the next three years, we expect the strongest performance to come in Spain and the Netherlands as shown in the chart below. The outperformance is driven by a stronger than average outlook for rental growth. Spain continues to have the most positive outlook for economic growth which continues to be supportive of very strong occupational demand in the main cities, whilst the Netherlands is also seeing a strong recovery coming through on the employment side. Supply in both markets has been coming down sharply from high levels fuelled by positive net absorption and both countries have a very limited amount of new supply coming through over the next three years, which will continue to place upward pressure on rental levels.

This supply and demand trend is mirrored, to varying degrees, across other eurozone countries. As a result, we are forecasting all eurozone office markets to have positive rental growth over the three year period with the exception of Italy where growth is dragged down by negative rental growth in 2017 as the country still struggles with political uncertainty, unresolved issues within the banking sector and structurally low economic growth. There is, however, a huge polarization between the Rome and Milan markets where the outlook for prime rents is relatively positive, and the secondary and tertiary markets. This is true to some extent across other markets, with prime still expected to outperform secondary due to the distinct lack of new developments coming through. However, in other markets, we are seeing the strength of employment growth filtering out of the core centers and starting to provide some support for the better quality secondary located assets, for poorly connected buildings the outlook remains challenging across the board.

Relative peformance of office markets against the eurozone average 2017-19



Source: UBS Asset Management, REPM August 2017

Retail

Over the forecast period (2017-19), Portugal and Spain are expected to outperform the eurozone average while the Netherlands, Italy, Finland and Germany are forecast to underperform due to lower capital growth prospects as shown in the chart below. France is also expected to underperform despite reasonably good capital growth due to its lower than average income return. Strong rental growth has been seen in prime markets in the Netherlands and this is expected to filter through to the average (MSCI) retail market as occupier and consumer conditions continued to improve.

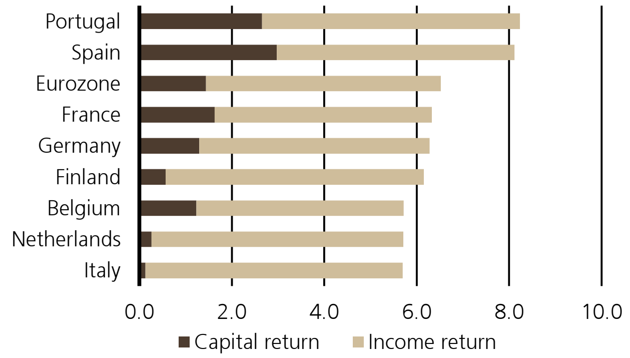
The retail sector is subject to significant structural change although the effects of this are not uniformly distributed. Retailers are still committed to their physical stores and continue to expand, albeit in a more controlled and increasingly forensic manner. Generally speaking, more dominant retail assets and locations receive the most attention from retailers, especially those with international store networks. These retailers tend to be focused on larger, modern stores that enable them to showcase their full product range, providing consumers with choice and customer service. Increasingly, major retailers are more prepared to consider slightly off pitch retail units in the largest, most dominant retail centers than they would be to open a store on prime pitch in a less dominant retail center.

E-commerce remains a significant threat to retailer margins and operations, although 90% of retail sales are still originated in physical stores. Demand is fairly robust in major eurozone high streets, shopping centers and retail parks but decreases as center size and amenity reduces. Progressively, more pure play retailers are starting to open physical retail stores to showcase their brand in the largest European retail center and this occupier group have been a source of demand with both permanent and more temporary "pop-up" concept stores.

The polarization between prime and secondary locations remains a key feature of the eurozone retail market, with diverging prospects. Prime retail attracts greater levels of demand and rental growth than secondary.

Retail total return forecast 2017-19

(% average annual)



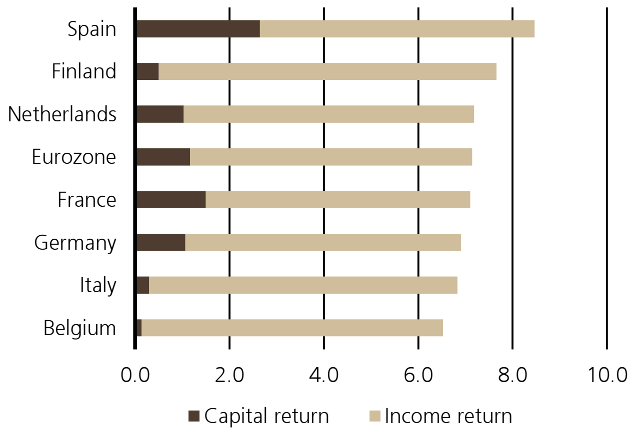
Source: UBS Asset Management, REPM, February 2017

Industrial/Logistics
Over the 2017-19 period, we expect Spain, Finland and the Netherlands to outperform the eurozone average as shown in the chart below. France and Germany are expected to see slightly below average returns, while the weakest performance is expected to come from Italy and Belgium. The Netherlands has seen the biggest improvement to its outlook, having been below the eurozone average at the time of our previous forecasts. It is now in third place. This reflects the improving economic fundamentals there, as the Netherlands appears to be finally recovering from a sustained downturn.

Due to relatively strong yield compression in recent years, it is unlikely there will be high levels of capital appreciation over the forecast period. Spain is likely to see strong growth, however, as it continues to benefit from improving fundamentals as well as pricing which remains significantly below its previous peak. France, having slightly higher yields than Germany and the UK is also expected to experience capital growth levels above the European average. As detailed above, the eurozone as a whole is expected to see relatively low levels of rental growth over the next three years, with most of the major markets mirroring this trend.

Once again, Spain is expected to outperform, with average growth of 1.7% p.a. expected over the next three years.

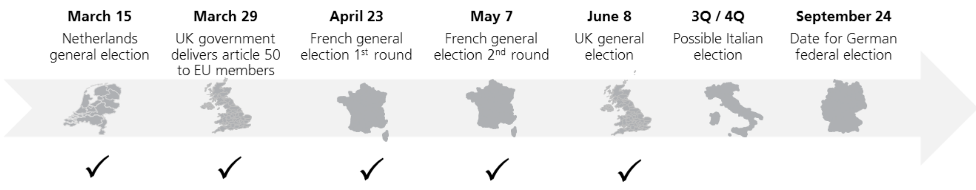
Industrial/logistics total returns forecasts 2017-19
(% average annual)



Source: UBS Asset Management, REPM, August 2017

Viewpoint: Election year 2017: Germany up next
2017 has been characterized by a great deal of political uncertainty in Europe and the penultimate general election of the year is scheduled on 24 September in Germany shown below. The date for the last remaining expected election this year in Italy has not yet been set.

European Elections 2017



Source: UBS Asset Management, Real Estate & Private Markets (REPM), August 2017

At this stage all parties have produced detailed manifestos detailing their policies. The exact nature of the four main party policies varies but all of them have focused on three key areas; further income tax relief initiatives, a common defense policy and a firm stance on Brexit. Income tax relief packages are wide ranging between parties but the impact is likely to translate into a boost in household incomes and spending following the election and into next year. The political message was clear regarding the handling of Brexit, with a hard stance suggested by all, indicating a clear desire to limit the impact of UK exiting the EU. From a labor market perspective, unsurprisingly no major reforms were proposed by any main party due to the continued strength of the German labor market and record low unemployment rates. The only common noteworthy change to policy by all was the proposal to increase retirement age to 67 by 2019.

Currently, the opinion polls are pointing to a victory for Merkel and the conservative CDU/CSU party. The CDU/ CSU party is polling around 40%, whilst the Social Democrats (SPD) have 24% of the vote currently. The other two major parties, the right wing AfD and the liberal FDP are both polling around 8%. From current polls, the results seem fairly clearly cut but approximately two thirds of voters are still undecided about which way they will vote. Potential options for the next government could be a grand coalition (CDU/CSU and SPD) or a collation of CDU/CSU, FDP and the Greens. Also, within the realms of possibility is CDU/CSU and FDP coalition but this is much less likely.

Overall, it seems there will be an end to the uncertainty in Germany. Merkel's CDU/ CSU party is polling to be the favorite to win the election, which would be a positive step and hopefully mean business as usual. As such, the continuation of Merkel as chancellor is expected to provide certainty and policies are likely to provide a short term boost to household consumption and the economy post-election. Therefore, from a real estate perspective, it is likely that demand for German assets would remain in high due to the continued political stability and strong economic outlook.

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