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Briefing note
European property: 2015 themes

January 2015

The discrepancy between economy and real estate

■ Property investor sentiment and their consequent market choices will be determined by a variety of economic and geopolitical factors in Europe and their home countries next year. Elections in UK, Spain, Greece, the question of a triple dip recession following the weak performance of the largest European economies of France, Germany and Italy lately, the falling Euro value, the ongoing geopolitical tensions between Ukraine and Russia, the risk of spread of the Ebola virus are only a few to mention. However, there are also some strong themes from 2014 that we expect to carry on in 2015, with European property remaining high on fund managers asset allocation choices.

More money into property

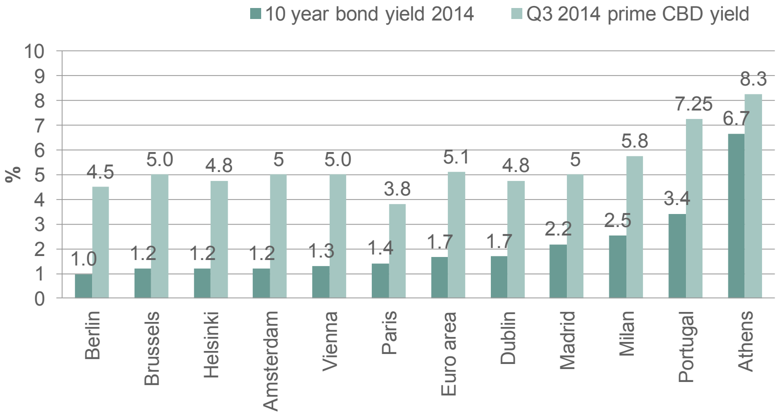
■ 2014 was the year that saw in many markets a full recovery of property investment volumes. The weight of capital going into property was about 30% above the long-term average and close to 80% of the 2007 level. This time investor focus in real estate is not driven by debt, but mostly by equity that simply cannot find a better destination. Bond yields are at record lows and equity markets have been quite turbulent. At the same time property prices in some Asian markets look inflated, while on the contrary some markets in Europe appear to have hit the bottom. Nevertheless prime product values are picking up again quite fast as they monopolise the focus of investor capital. We expect the volume of capital looking for property investment allocation - especially prime- in Europe to remain high and even rise next year, as at the same time financing conditions are becoming more favourable for the right quality asset.

Demand for core vs supply of opportunities

■ There is a plethora of both risk-averse and risk embracing investors looking for different types of opportunities. The majority includes institutional, long-term investors that will be focusing on the safest markets and asset classes, while some opportunistic players will be taking advantage of the expected sales of non-performing assets from the banks, following the completion of the European Banks stress test lately. The transparency that the results of this test is bringing to the sector, should also allow for an improvement in lending conditions to the real economy, amid weak business and consumer confidence.

GRAPH 1

CBD yield premia over 10-year bonds historically low bond yields make property attractive



Graph source: Savills, Oxford Economics

Offices: Gaps in supply and rental growth

■ The improvement in financing conditions could support office development activity next year, particularly in markets with solid demand, such as Dublin and London and refurbishments in markets such as Madrid and Milan. Overall limited new supply the past few years has created undersupplied pockets of good quality office space in the best locations of the office markets in Europe. This is leading to rental increases in these submarkets and we could see that continuing in 2015 in markets such as London, Dublin, Brussels.

Beyond offices

■ Due to relatively weak consumer confidence, we believe that investors will be selective with regards to retail assets, and will continue to chase the best performing retail schemes and high streets, in the catchments where retailers are confident to open new stores. These can include the strong affluent European markets (UK, France, Belgium, Germany) as well as the developing or recovering ones (Poland and Spain). Logistics markets connected to retailer expansion, particularly with regards to their on-line strategies, will also be considered

(Netherlands, Germany, Poland, UK, Spain).

■ In terms of alternative assets, although their share is smaller and requires a degree of specialism, we see further potential as it is demonstrated in the student housing segment and residential segment (Netherlands, Germany) and the hotels segment (London/Paris). Hotels sector in particular, increased its share last year in Europe and we expect to remain under investor's radars, following operator's expansion in the most popular tourist markets/cities in Europe (London, Paris, Amsterdam).

Yield convergence again?

■ The chances of A quality assets in B quality cities and B quality assets in A quality cities (AB/BA) has been rising over the past year. Keen pricing competition in the prime segment and the lack of supply has shifted investor interest in other market segments. In addition to value add and higher yielding assets, there has been a rise in alternative investments (student housing, residential, hotels), in higher yielding sectors (logistics and value add), in recovering markets (Spain, Italy, Ireland). We believe that this trend will continue in 2015 and investors will continue to look to diversify from core.

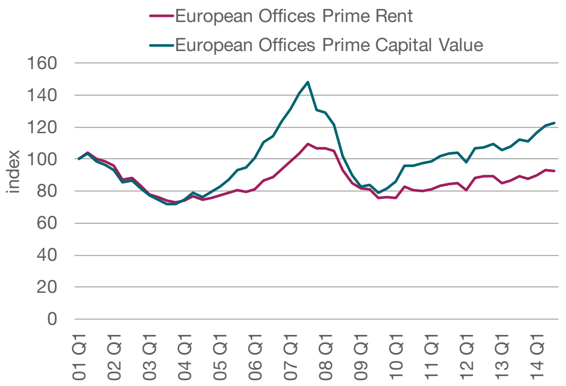
■ This should translate into higher investment in AB/BA assets in core markets (UK, France, Germany, Netherlands) and in increasing share of higher yielding and alternative asset classes. It can also continue to benefit markets that have bottomed out, like Spain, Ireland and Italy. That is likely to lead to further narrowing of the yield gap between prime and secondary yields in the core markets and prime yields between core and peripheral market., Yield convergence is also supported by the historically low interest rate environment and the recovery of bond yields in the troubled economies of Europe (Portugal, Greece), resulting in softening yield premium requirements by investors.

What if we cannot avoid deflation?

■ Although we expect the momentum gained in 2014 to continue in 2015, we are also concerned about the impact of the economic conditions and geopolitical tensions on investor appetite in the short to medium term. If weak economic growth in the largest economies persists and the risk of deflation becomes more real, that could have an adverse impact on investor confidence in real estate. It could redirect once again investors towards safe havens and bond-like assets with secure, long term income, thus interrupting the rising popularity of secondary and value-add investment opportunities. Investors can become once again more selective and risk averse.

GRAPH 2

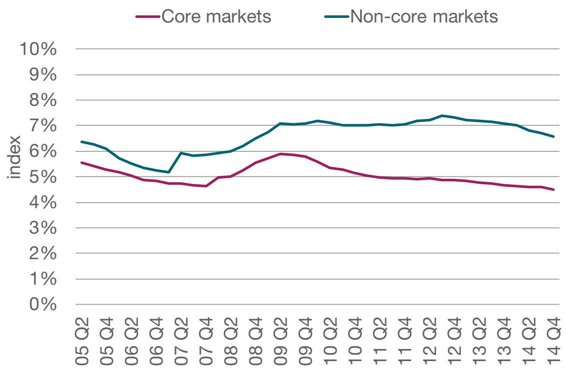
Rents vs Capital values widening gap between occupier and investor markets



Graph source: Savills

GRAPH 3

Core vs non-core CBD yields beginning of a yield convergence again?



Graph source: Savills

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