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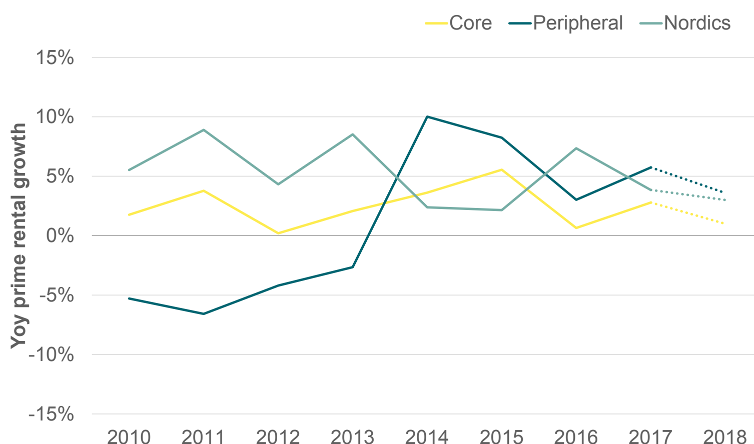
Briefing Note
European property themes 2018

December 2017

GRAPH 1
European economy another year of a healthy growth rate is predicted

Graph source: Oxford Economics

GRAPH 2
Prime CBD office rental growth competition for the best space will push rents up



Graph source: Savills

Summary

Property will remain an asset class of choice

- Positive economic outlook will drive occupier demand for business space in 2018. Shortage of high quality accommodation will force companies to plan ahead their space requirements and wait until new developments complete.
- Landlords will need to adapt to changing occupier needs. New sectors emerge and grow fast as a result of technological disruption and social change.
- Prime real estate will remain an asset class of choice due to attractive yield spreads over long term interest rates and positive rental growth prospects.
- Investors are likely to focus on structural rather than cyclical themes that influence the market fundamentals as we are approaching the end of this cycle. Logistics and alternatives will benefit from this strategy.
- With less opportunities for capital growth, investors are searching for good quality, long-term income streams. This will support further the rising share of the residential sector in property investment.

"In 2018 structural influences will become a core focus for investors"

Eri Mitsostergiou, Savills European Research

Occupier trends

Economy drives demand and disruption drives change

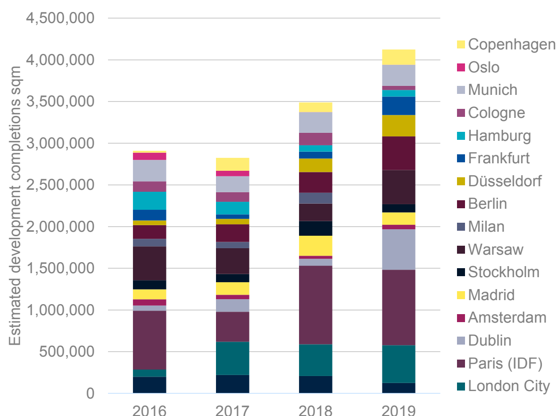
Office occupiers need to plan well in advance their office requirements

Positive economic outlook will drive occupier demand for business space in 2018. Depending on the outcome of the ongoing Brexit negotiations, a number of companies may move some or all of their operations from London to mainland Europe. This could boost demand for office space in some cities such as Paris, Frankfurt, Dublin and Amsterdam.

We expect the scarce availability of efficient space in the most desired locations to remain a hurdle for tenants. Companies are forced to think of their space requirements well in advance as it takes 12-18 months to secure accommodation which often is not in their first choice locations. Next year's occupier activity may also include a significant amount of pre-lets. We expect office completions in our survey area to rise by 17% yoy next year and 18% the year after with about 40% of this space already committed. This will gradually decompress the tension between demand and supply.

GRAPH 3

Office development pipeline about 40% of the space in the pipeline is pre-let



Graph source: Savills

Over 90% of retail sales still takes place in a physical store in Europe

In the retail sector retailers will continue to focus on the best high streets and shopping centres, with some also diversifying between small urban concepts and large cost effective out-of-town formats. Additionally, since over 90% of retail sales still takes place in physical stores in Europe more and more pure online retailers will be expanding into physical space.

Quality of catchment and high footfall remain of paramount importance. Prime locations with high tourist flows in city centres, community centres in dense urban areas and well located regional destinations are all different typologies that can be attractive for different types of retailers and concepts. At the same time we will continue to witness the decline of most secondary and tertiary retail locations, which will need to convert in alternative uses.

We anticipate the best retail locations in Paris, London, Milan, Amsterdam, Munich, Frankfurt, Madrid, Barcelona and Vienna to be amongst the key target markets for international retailer expansion in 2018.

Ecommerce fuels demand for warehouses

At the same time ecommerce in Europe is growing fast, especially in the southern countries. The online retail industry in Europe is expected to be worth around €602bn at the end of this year, 14% up yoy. The online retailer industry is expected to increase by another 14% percent next year. In response to the rising demand for economies of scale we may see more M&A activity in the sector as well as some large regional online retailers expanding cross border in growing markets.

The logistics sector is the main beneficiary of this trend. Demand for warehouses will continue to be strong both in the markets with the highest level of ecommerce penetration such as UK, France, Germany, Netherlands, and Sweden as well as developing markets such as Spain and Italy. Demand will be both for large-scale regional centres as well as small urban last-mile delivery warehouses.

Changing occupier needs

Technological disruption and mass urbanisation are changing fast the way we live, work, shop and socialise. This creates new needs for occupiers and users, who are looking for accessibility, flexibility, versatility, practicality and inspiration in the space they use in their daily lives. As a result of changes in people's needs and habits, new space typologies emerge, which do not fit anymore in the traditional office, retail, industrial split of sectors. Co-working, co-living, micro-living, multifunctional, and shared spaces are some of the growing sub-sectors driven by changing occupier needs. We anticipate the popularity of these emerging sectors to continue next year, forcing the industry to adjust to the new reality of more complex typologies and operational processes. The cities where these trends are more pronounced are the hubs of innovation and brainpower such as London, Paris, Amsterdam, Berlin, Frankfurt, Barcelona, Copenhagen, Stockholm and Dublin.

Investment trends

Another year ahead of strong capital flows in real estate

Rising allocations in real estate

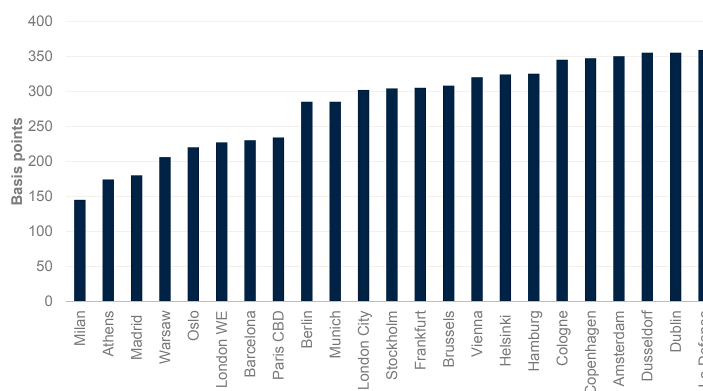
The weight of money in European real estate is nowhere near diminishing, as industry surveys show that several fund managers intend to increase their allocations in real estate further, which still compares favourably to bonds and equities and maintains a good spread over the low interest rates. At the same time despite the prospect of Quantitative Easing tapering, no dramatic interest rate rises are foreseen for the next 2-3 years. In 2018 both investors and lenders are likely to adopt a cautious approach and focus on quality assets across the region, mainly in markets with strong fundamentals in Germany, France, the Netherlands, Spain and the Nordics. However, competition may also push some players beyond the largest and most liquid markets. Non-core markets, which will outperform economically the European average, such as the CEE region, could attract more investors that are prepared to move up the yield curve.

Asian capital inflows to continue

Asian investment into Europe reached €23.2bn by the end of Q3 2017, a 57% increase yoy and with Q4 volumes on course to reach approximately €18bn, we forecast that total annual volumes will reach a record €41.2 bn. Although there has been much talk about a possible slowdown in Chinese investment following restrictions on outbound investment, capital outflows from Hong Kong have been largely unaffected, while mainland investment has also continued, albeit the nature of Chinese investment is likely to shift from trophy assets towards long-term corporate strategic investments such as logistics, student housing and healthcare facilities. In addition, Korean and Singaporean investors, which hold a significant weight of capital, are still looking to Europe for investable grade assets, and so we expect Asian investment into the region to increase further.

GRAPH 4

Yield gap of prime offices over 10 year bonds property will remain attractive due to historic wide spread



Graph source: Savills

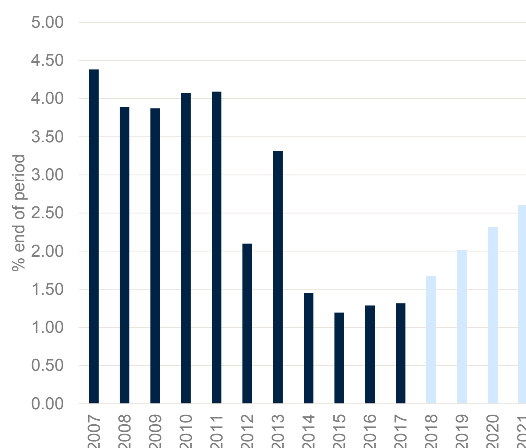
The peak of the cycle?

Yields have compressed to historic lows in all markets in Europe, particularly in the prime segments. At the same time the property risk premium over the long term interest rates is also at a historic high. As the time of almost zero interest rates comes to an end, we can assume that the time of significant capital value gains is also coming to an end.

We believe that real estate yields will stabilise next year and remain at these historic low levels for a while as private and institutional money will continue to compete for good quality assets. Additionally, low prime yields will be justified by another year of positive rental growth prospects in the market segments with healthy occupier fundamentals. Secondary and value add market segments will also be targeted in search for better returns, but this year investors are expected to have a more measured approach to risk, which could restrict volumes and limit yield compression in the non-prime segment. In secondary market segments that are challenged by structural changes such as secondary/tertiary offices and retail may see their pricing moving out.

GRAPH 5

European 10 year bond yields gradual increase expected in the years to come



Graph source: Focus Economics

Traditional vs Alternatives

Focus on structural rather than cyclical themes

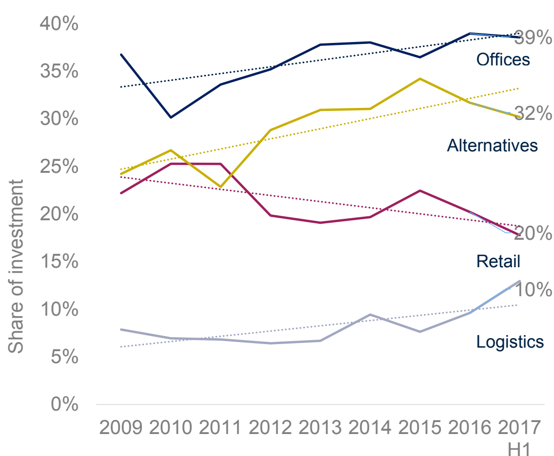
Disruption impacts the sector split

The share of office investments remains robust at almost 40% of the activity. Investors will continue to show confidence in the office sector as the economic fundamentals are pointing to rising demand from occupiers. At the same time, the average vacancy rate in Europe is at a record low of 7.5% with virtually no prime space available in some CBD's (Berlin, London WE, Munich and Stockholm). The positive rental growth prospects act as a counterbalance to record low yields. However, what investors should take into consideration from now on, is that "new ways of working" and technological change will also bring change to offices. Occupiers increasingly require shorter or flexible leases and more versatile space layout, creating the need for a 'smart' approach to asset management.

On the other hand the share of retail is falling, from a long term average of 21% to about 18% this year. This is a trend that may continue this year, as investors are concerned about the impact of e-commerce on the sector.

GRAPH 6

Investment by sector the share of logistics and alternatives above historic trend



Graph source: Savills

At the same time, following the peak of trading activity in 2015, the market has dried out of prime opportunities and there is a reluctance to take higher risks in this segment. In 2018 investors will continue to look for prime opportunities and to focus on the best performing high streets and shopping centres where retailers want to be present. For investors that are prepared to take some redevelopment risk, opportunities will also emerge in secondary urban centres that can be turned around into community retail hubs. Besides, structural change will create some opportunities in out-of-town centres such as retail parks with good catchments that can be redesigned and attract non-traditional retail warehousing retailers, leisure, cinemas, F&B as well as click and collect points. Despite the fact that fundamentals supporting retail sales are robust, with rising consumer spending, falling unemployment and rising tourist numbers, further capital gains are unlikely and rental growth prospects limited. This is also related to tight retailer margins and an ongoing debate on the relevance of turnover rents in an omni-channel world.

Finally, logistics appear to be the winners of the rise of ecommerce, which has intensified demand for regional logistics hubs as well as smaller warehouses close to urban centres for last mile delivery. The share of the sector has increased from a long term average of 8% to about 13% this year and can rise further. Focus on strong fundamentals is essential as opportunities for yield compression are becoming more limited in this sector too.

Alternatives are becoming mainstream

As yields for prime assets are expected to remain low and largely homogeneous across the core sectors in Europe's capital cities, investors have started looking for alternative locations and sectors in order to diversify and achieve better returns.

Overall investors are most likely to focus on structural rather than cyclical themes that influence the market fundamentals as we are approaching the end of this cycle. Mega trends such as urbanisation, innovation and the impact of technology will be closely followed. Most of the alternative sectors, fit well in this strategy, as most have emerged as a response to the structural drivers affecting real estate.

In 2018 we expect to witness further 'leakage' of investment capital form the traditional property sectors (offices, retail, industrial) to alternative sectors such as residential (housing, student housing and senior housing), hospitality, healthcare, data centres, renewables, infrastructure and others. We also expect to experience the rise of emerging sectors, which are a hybrid of the traditional ones. Shared spaces such as co-working, co-living where property is offered as a service as well as a combination of the two with the addition of leisure are concepts that are expanding, particularly in the largest and most innovative cities of Europe. Mixed use has always ensured vibrant, safe and functional communities, where higher returns are generated for individual assets. Investing in these concepts offers an early entry in emerging sectors that are predicted to further grow. It also offers diversification benefits and countercyclical performance.

What may restrict investment in alternatives is, on the one hand, the smaller size of the segment in terms of available institutional quality product, which may require investors to consider committing to development projects.

Certain uncertainties

Strong fundamentals the defence to a late-cycle market

Residential - the fourth sector?

With the income theme consistently strong amongst investors, it is no surprise to witness the rise of the residential sector as an asset class. Residential (PRS/multifamily, student housing, senior housing, co-living), will capture close to one third of all investment activity in Europe this year, and could further accelerate as it offers long term income, rental growth prospects and a hedge against inflation. Places of particular interest are the ones with tight housing market conditions, such as London, the German cities, Nordic cities, Dublin and Amsterdam.

Stable economics, shaky politics

The economic picture looks positive across Europe with the EU economy as a whole set to beat previous forecasts with growth of 2.3%, up from 1.9% forecast in the spring. The EU28 unemployment rate is down to 7.5% from the 2013 high of 11% and office based employment is set to grow by 1.0% annually in 2018 and 2019. In November, the Economic Sentiment Indicator (ESI) for the Euro area improved again, reaching the highest levels since October 2000 (Euro area). Our economists expect the European economy to grow by 1.9% next year supported by a stronger labour market and loose monetary policy.

While the economic fundamentals appear positive, the political scene has become more unstable in recent months, due to risks associated with the Spanish political crisis, the German post election uncertainty and the ongoing Brexit negotiations, just to name a few.

Long term fundamentals against cyclical risks

There are enough signs that we are in a late-cycle market, which creates concern amongst investors. Predicting the turn of this cycle is not just related to trends in the global economy, but also to political events and structural changes.

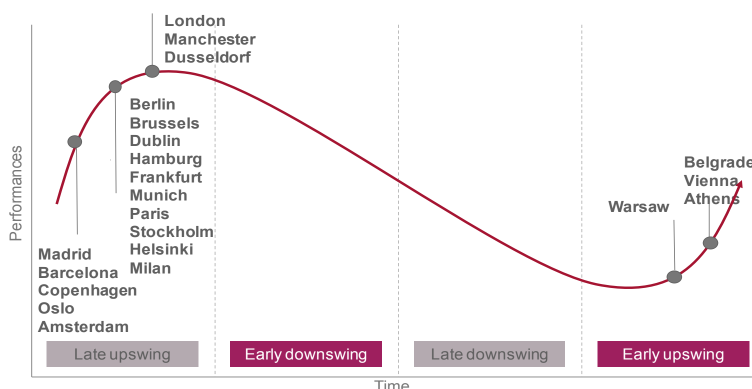
Although economic prospects are positive and occupier fundamentals in the prime segments are strong, geopolitical uncertainty, the prospects of rising interest rates and the disruptive impact of technological and demographic changes cannot be ignored. Cities rather than countries with positive fundamentals in terms of population and economic growth will be the winning destinations as investors are looking into market fundamentals at a more granular level.

Innovation, tourist numbers, student numbers, liveability are all factors to be considered. Looking beyond the traditional sectors into alternative, non-cyclical segments of the markets that are expected to weather better a potential turn of the cycle has become a key strategy.

We believe that in 2018 regional and global political uncertainty will become a new standard for investors, who will need to form their strategies taking this factor of uncertainty as a given, and pricing it in for certain products.

GRAPH 7

Prime office rental cycle rents are already above their last high in most locations, but continue to rise



Graph source: Savills

How strong will 2017 end?

Investment and office take-up trends

■ The total commercial investment volume in the markets we monitor is set to exceed last year's level by 5% to 10% and to be over €230bn in our survey area. Despite the strength of the London market, activity in the UK will be down (-10% yoy) due to the general uncertainty caused by Brexit. However this is counterbalanced by high levels of activity in Germany (approx. €60bn, up 9% yoy) and a strong pick up in the Benelux region (€20bn from €11bn last year) Austria (up 92% yoy). The Southern European markets will also be up by about 10%, continuing the upward trend from last year. In the Nordics, Denmark and Finland will close the year significantly higher than 2016, 10% and 120% respectively. The CEE markets are also performing better (Czech 81% yoy and Romania 109% yoy in Q3 17), while the full year forecast for Poland is for 54% yoy growth. The remaining markets will struggle to reach their 2015 or 2016 peaks, mostly due to high trading and the lack of product.

■ Office take-up this year is expected to fall by around 3% in the markets we monitor, but remain above the five year average. Limited options for occupiers in the face of low development will result in lower volumes in Paris, Brussels and Vienna. The markets that will show the highest increases compared to last year are Amsterdam (above 30% yoy) London WE (26%), Frankfurt (23%) and Madrid (18%).

■ We forecast that prime office rents will grow by 4.7% on average in 2017. Top performers will be Oslo (33.3% yoy) and Berlin (11.3% yoy), followed by Madrid (10.7%), Stockholm (9.2%), Brussels (8.8%) and Amsterdam (8%).

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