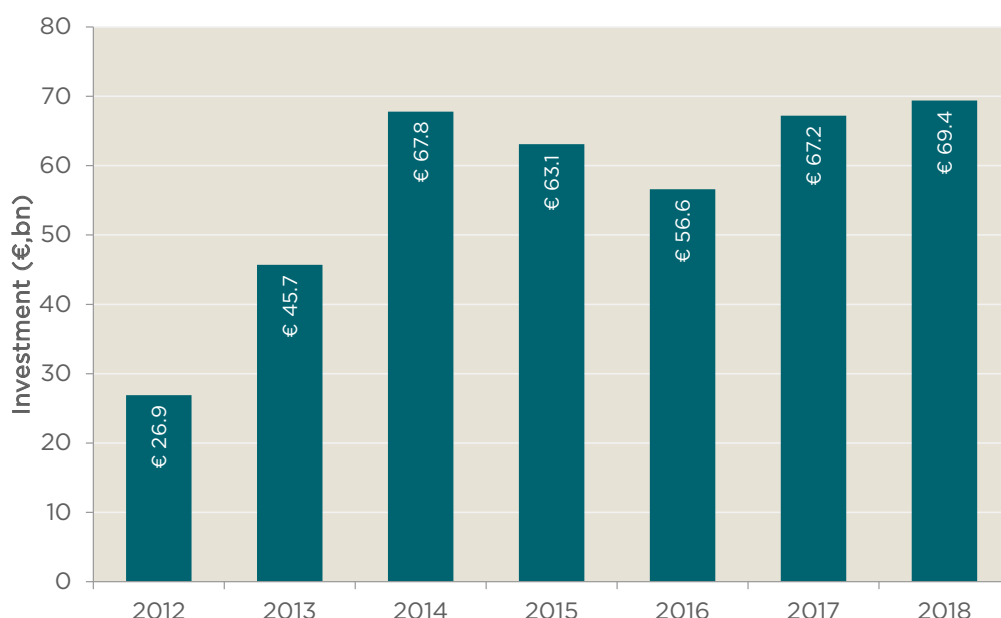


# The impact of a low rate environment



**Chart 1:** Equity raised for European non-listed real estate (€,bn)



Source: INREV

## A sustained low interest rate environment: the impact on European real estate

### What's happened?

The European Central Bank (ECB) has cut the deposit rate by 10 basis points to -0.5% in its September meeting. The ECB subsequently announced that in order to stimulate growth in the Eurozone area, it would acquire €20bn per month of government bond purchases for “as long as necessary” to accommodate the impact of the policy rates so that the inflation outlook increases to close to 2% pa.

Euro Area GDP growth is forecast to slow sharply this year to 1.1% due to lingering weakness in the manufacturing sector, a less favourable global backdrop and geopolitical concerns hampering investment and exports. Risks to the outlook remain elevated and include rising global protectionism, slower-than-

expected growth in China, a no-deal Brexit and sluggish domestic growth.

### What does this mean for real estate investment?

Lower risk-free rates have been the influential driver of office yield compression across Europe's markets, which has had a huge impact on the lending community across Europe. Lending rates to CBD offices have dipped below 1.5% per annum on most of Europe's core cities, with c. 60% loan-to-value (LTV) ratios on offer for investors.

As a result, €69bn of global equity was raised in 2018 for non-listed European real estate (Chart 1), according to INREV. Rather than institutions continuing to pay to deposit funds in Europe's banks, lenders are increasingly

looking to deploy their capital into income-producing opportunities across Europe.

Likewise, global real estate investors are aware of the relatively attractive income on offer in Europe compared to domestic markets. As capital controls loosen in Asia, funds are more willing to increase exposure across Europe in multi-country funds.

Back in 2013, 10-year German bonds were yielding 1.6% and we have since witnessed a steady decline in bond yields to 0.4% at end 2018 which are lodged into negative territory in H2 2019. During this time, annual European real estate investment rose from €173bn to €297bn (Chart 2), as multi-asset class investors shift their focus from fixed income to real estate. Prime European office

📉 Euro Area GDP growth is forecast to slow sharply to 1.1% in 2019 and 2020. 📉

yields have compressed 12bps YOY to a record low of 3.7% during Q2 2019, and as investors increasingly scrutinise the fundamentals backing each investment opportunity, we expect end year investment volumes to reach €241bn, 18% below the level in 2018.

#### So which sectors have benefitted most from the fall in bond yields?

Chart 3 shows the investment volume increase for the last five years (2014-18) vs the previous five years (2009-13) across each sector. The sectors which have seen the strongest increase in investment on the previous five years are those where long-term 'bond-type' income is generally more common, including within the hotel sector (+132% on previous five years), the industrial sector (+142%) and the alternative sector (+143%). For example, sale and leaseback agreements in the hypermarket sector and transactions involving long-term leases to hotel operators have been more sought after, as investors are becoming more sector agnostic. Investors have also tapped into the demographic changes, with ageing populations bringing more income opportunities including care homes, senior living and multifamily. However, we should also be aware of some of the more cyclical investment factors, including a shift to alternatives late in the cycle.

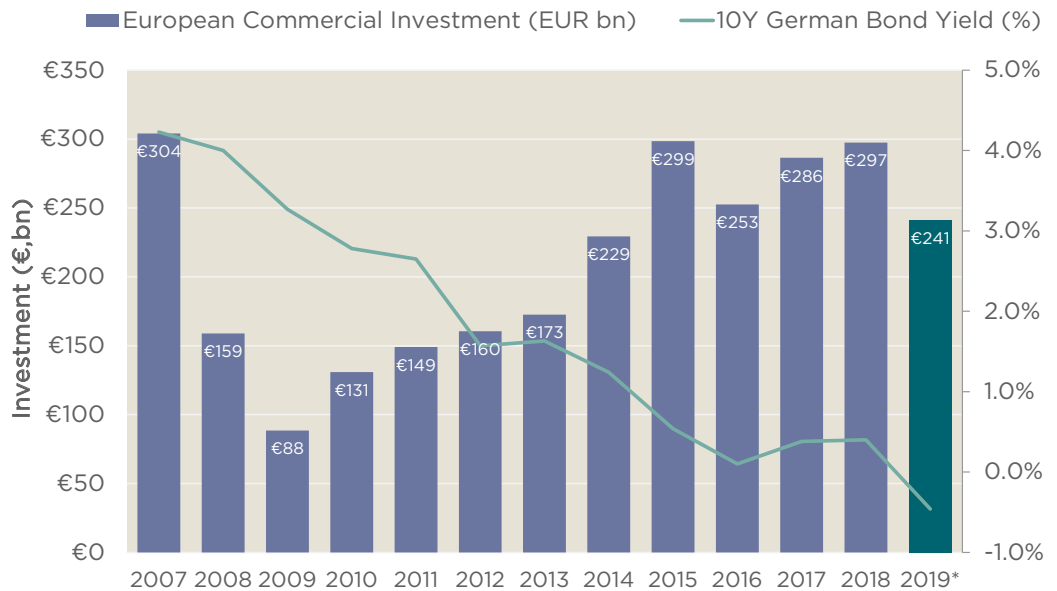
Given modest economic growth prospects, investor interest has grown for long income funds across Europe with 20 years+ unexpired income. After all, the round trip costs associated with acquiring real estate has encouraged investors to take a longer-term view, as this could equate to over two years' worth of income from CBD offices at current price levels.

## €241bn

Forecast for 2019 full year European investment transactions volume.

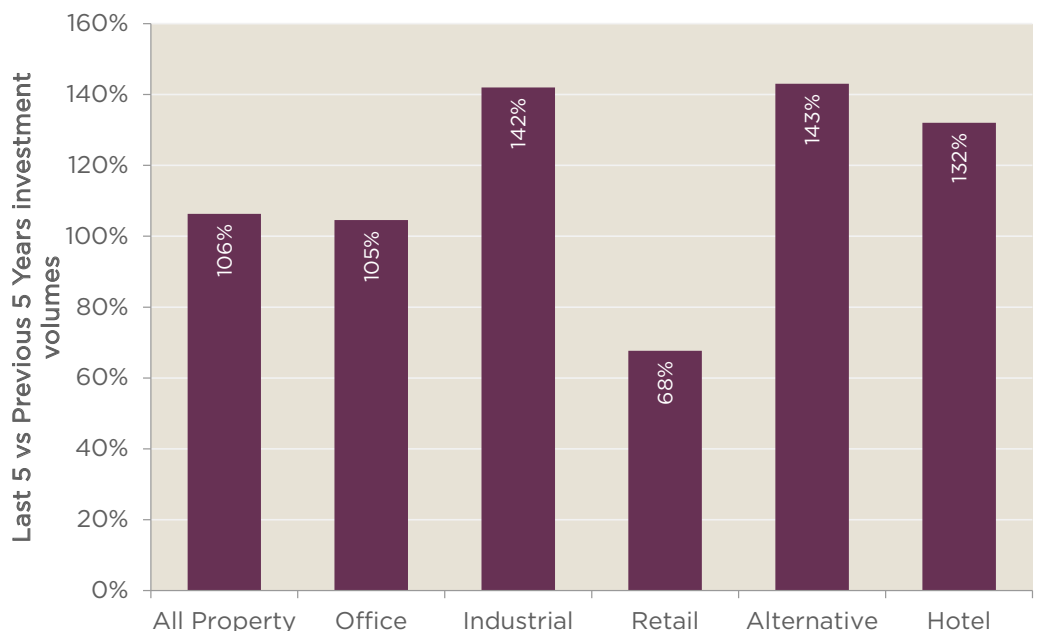


**Chart 2:** European Commercial Investment (EUR bn) and 10Y German Bond Yield (%)



Source RCA, Savills Research (2019 full-year forecast)

**Chart 3:** What is the most bond-like sector? Investment volumes increase - last five years (2014-18) vs previous five years (2009-13)

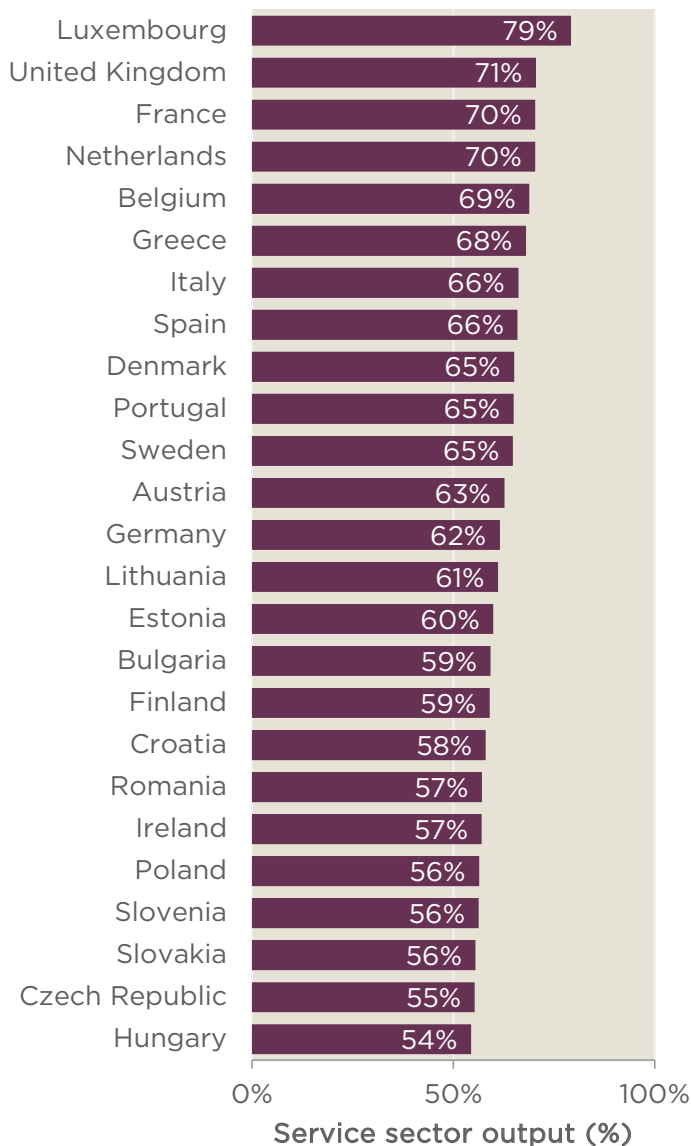


Source RCA, Savills Research



## What macro drivers will impact the office sector?

**Chart 4:** Service sector output as a % of total GDP



Source Statista

“ The services sector currently accounts for 66% of the total GDP in the EU. Countries with more dominant services sectors are forecast to see the strongest economic growth over the next five years. ”

### What macro factors will impact the office sector?

A low interest rate environment attracts more business investment and provides a boost to the services sector, which currently acts as the main thrust behind Europe's economic growth. The services sector currently accounts for 66% of the total GDP in the EU according to the World Bank, and countries with more dominant services sectors are forecast to see the strongest economic growth over the next five years, including Luxembourg (79% of total GDP), UK (71%), Netherlands (70%) and France (70%) (Chart 4).

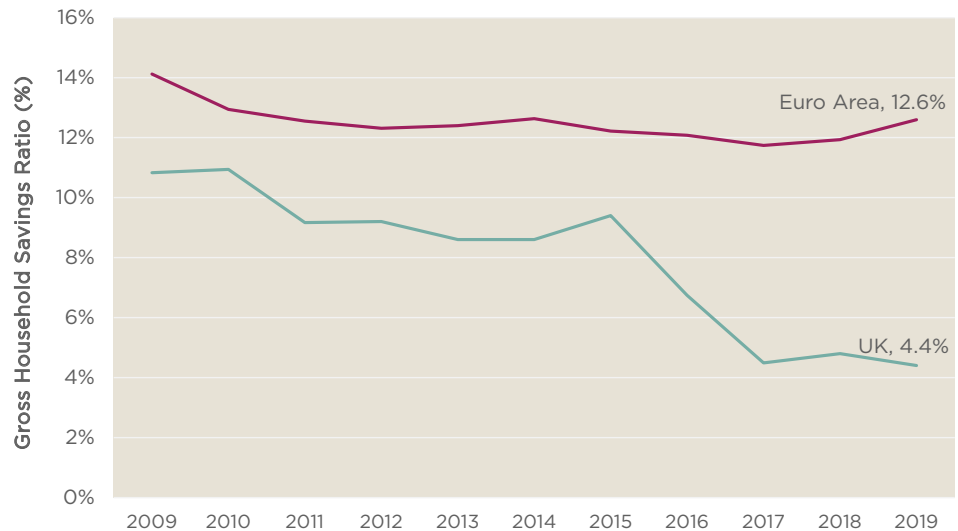
Positive services sector growth will create office-based employment growth and new demand for office space. Oxford Economics forecast that 3.1 million additional office-based jobs will be created over the next five years across Europe, representing 4.9% growth during this period. London (+182,000 office-based jobs), Madrid (125,000) and Paris (90,000) will see among the largest increases over the next five years.

Assuming a ratio of 10 sq m of office space for each employee, this indicates a need for an additional 31 million sq m of space. Professional, science and tech will contribute 1.1 million additional jobs, representing 7.4% growth in this sector, more than any other sector.

**66% of EU GDP is accounted for from the service sector.**

**Savills forecast a need for an additional 31 million sq m of office space in Europe over the next five years.**

**Chart 5: Gross household savings ratio**



Source: INREV

## What macro drivers will impact the omnichannel retail sector?

A low interest rate environment will continue to boost retail sales. Investors in search of attractive retail locations will be paying close attention to consumption growth. According to Focus Economics, Spain and Portugal are forecast to witness consumption growth of 1.6% pa over the next five years, above the Euro Area average of 1.3% pa.

One of the challenges of a low interest rate environment for retailers is that rather than increasing consumption, households have endeavoured to pay off their existing debt levels. Since 2010, Euro Area household debt has fallen from 64% to 58% of GDP, as households have generally kept their consumption levels stable, with only a recent uptick in the household savings ratio to 12.6% of gross income (Chart 5). Although this has not played into the hands of retailers, this has provided insulation to future downturns, so on balance can be considered a positive.

Since Brexit, however, UK households have more than halved the proportion of gross income saved from 9.4% to only 4.4%, suggesting that UK households are more exposed to downside economic risks (Chart 5). It is estimated that for every €1 billion

of online retail sales, this results in an increase in demand for 75,000 sq m of warehouse space. Using Forrester's forecasts, this indicates a need for a net additional 15m sq m of warehouse space over the next five years to meet the rising demand for online retail alone.

A weaker Euro Area interest rate will, of course depreciate the euro, making exports more attractive in a global context, in a time when the Eurozone manufacturing sector continues to drag on overall economic growth. Since February 2018, the euro/dollar has fallen from \$1.25 to \$1.11 in September 2019, according to Morningstar. Cheaper European exports could thus, generate new demand for logistics space in proximity to Europe's busiest cargo ports and arterial routes. This will act as a welcome boost for Europe's manufacturing sectors as Euro Area exports are expected to grow by 2.5% pa over the next five years, down from 4.6% pa over the previous five years.

However, the lingering prospect of a trade war between China and the US continues to hamper growth in the manufacturing sector. Eurozone Manufacturing PMIs have been below 50 (signalling a contraction in output

growth) ever since February 2019, which could reduce demand for logistics space in Europe. There is, however, a range in the latest manufacturing outputs - between December and July, industrial output in Germany declined by over 4% whereas in France it rose slightly. This has been partly due to the automotive (more cyclical) output in Germany, compared with the pharmaceutical and energy sectors (less cyclical) in France.

One of the biggest concerns for European logistics operators is the shortage of available, affordable labour to develop their supply chains. The EU unemployment rate currently stands at 6.3% in the EU, the lowest level since records began, which has increased wages by 3.1% for the year to Q2 2019. With over half of warehousing costs accounted for by wages, wage growth will continue to reduce logistics operators' profit margins. We expect further westwards migration across Europe to take advantage of tighter labour markets and higher wages, however, we expect this to struggle to keep up with the pace of online retail sales growth, as retailers will be less sensitive to rental increases.

# Outlook

**A low growth environment presents challenges and opportunities for European real estate investors.** We expect traditionally “alternative” sectors to come to the mainstream as investors increasingly search for long, secure income. The weight of money targeting European real estate will keep yields low for the foreseeable future and we feel that the underlying risk of holding property ahead of bonds has not materially changed, which will continue to keep the yield spread with bonds stable. Rental growth, rather than capital growth will be the main driver of returns in 2020.

However, with negative government bond yields, multi-asset managers will increasingly consider the property risk premium against holding cash, rather than government bonds in 2019. With debt so comparatively cheap across Europe and office occupational markets

remaining tight, we believe there is an opportunity for property companies willing to take on development risk to secure long income and sell on to institutional landlords.

Geopolitics will also be an influential factor in investment decision-making, as European economies become more exposed to exogenous global shocks. The more risk-loving investors will be paying close attention to the impact trade wars have on exchange rates and will time their real estate acquisitions accordingly.

Savills analysts forecast office yields to move in over the next 12 months in Belgium, Czech Republic, France, Greece, Italy, Romania and Sweden supported by resilient investor interest. This has been supported by strong rental growth forecasts of 3.8% for the full year across Europe’s CBD

offices, although some softening of yields is expected in the UK and Portugal office markets.

Looking forward over the next 12 months, further industrial yield compression is expected across the Czech Republic, France, Germany, Greece, Italy, Portugal, Romania, Spain and Sweden. All other markets industrial are forecast to remain stable.

Conversely, some softening of yields in the retail sector is forecast in Belgium, Czech Republic, Ireland, Norway, Portugal, Spain and UK markets. Romania is the only market forecasting any inward movement of yields in the retail sector in the next 12 months as a mismatch between buyers and sellers expectations continues.

	Office-12-month yield outlook	Retail-12-month yield outlook	Industrial-12-month yield outlook
Belgium	harden ↓	soften ↑	stable →
Czech Republic	harden ↓	soften ↑	harden ↓
Denmark	stable →	stable →	stable →
Finland	stable →	stable →	stable →
France	harden ↓	stable →	harden ↓
Germany	stable →	stable →	harden ↓
Greece	harden ↓	stable →	harden ↓
Ireland	stable →	soften ↑	stable →
Italy	harden ↓	stable →	harden ↓
Netherlands	stable →	stable →	stable →
Norway	stable →	soften ↑	stable →
Portugal	soften ↑	soften ↑	harden ↓
Romania	harden ↓	harden ↓	harden ↓
Spain	stable →	soften ↑	harden ↓
Sweden	harden ↓	stable →	harden ↓
UK	soften ↑	soften ↑	stable →



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### **Savills Commercial Research**

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