

Market in Minutes

Yield gap narrowing between prime asset classes and prime locations

June 2018

Economy decelerated due to temporary factors

The Eurozone economy decelerated in Q1 2018 from 0.7% in Q4 2017 to 0.4%, caused by slower export growth due to a strong Euro, easing household spending likely resulting from adverse weather and other temporary factors such as industrial action. Nevertheless, EU growth is set to remain stable overall thanks to the falling unemployment rate which at 8.7% is the lowest since 2009. In May, European consumer confidence rose by 0.4 points to -0.1.

On the political agenda, risks come from ongoing Brexit negotiations which continue to dominate news headlines. Until there is more clarity regarding how the UK will exit the EU, it is difficult to accurately predict how businesses and the property market will react.

On the Italian front, bond yields increased sharply on 28 May and weighed on the euro due to the political standoff. Political instability could cause further turbulences in European financial markets.

Last but not least, frictions are rising between the EU and the US, notably due to new import tariffs on European steel and aluminum imposed by the US government, likely to bring retaliatory action from European Union trade regulators. Additionally, the US President Donald Trump's decision to withdraw from the Iran nuclear agreement jeopardizes the landmark arms control agreement and further fueled tensions between the two continents.

Investment activity subdued following the Q4 2017 boom

Following the strongest investment quarters on record in Q4 2017, the European investment market seems to have marked a pause during the beginning of 2018. The total commercial investment volume totalled €46bn across our survey area, 8% down compared to the same period last year. Yet the first quarter is traditionally highly volatile and Q1 18 is more or less (-3%) in line with the long-term average Q1 volume.

The biggest drops were recorded in Romania (-81%), the Czech R. (-77%) and the Netherlands (-53%). It should be noted that the Czech R. and the Netherlands experienced investment activity well above their long-term average in 2017 and the fall in volumes may be a sign of market correction or investors taking a breath in Q1 before searching for more property later in the year.

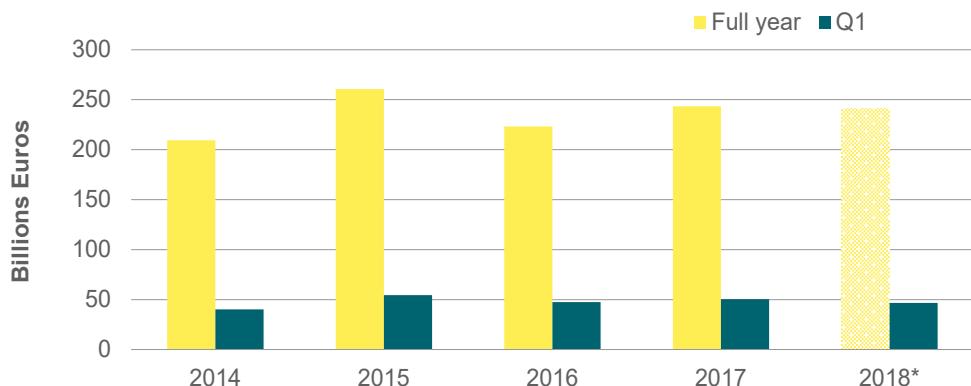
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 “In spite of soft investment activity during the first quarter, we expect the full-year turnover to be in line with last year's volume: circa €242 billion.” Lydia Brissy, Savills European Research

The exceptions to the fall in volumes were Poland (+329%), Belgium (+248%) and Luxembourg (+144%). In the case of Poland, the sale of the €1bn retail portfolio gave the Q1 volume a boost and in Belgium, a number of large deals carried over from Q4 2017 to Q1 2018. It should be noted that the deal count is down in Belgium but the volume is boosted by big ticket deals.

In the three core markets, the UK, Germany and France, the decrease in the investment volume is exactly in line with the pan European volume

FIGURE 1

Investment volume set to reach 2017's level by the end of the year



Source: Savills/*Forecast

(-7%). Their market share out of the European total volume remains unchanged (63%). In the UK, the trade flow is similar to that of the post Brexit referendum level whereas investment activity shifted from London to regional markets. In France and Germany, investment activity is restrained by the lack of available product at "suitable" price.

Breakdown per asset classes and origin of buyers remains relatively unchanged

All asset classes were affected by the drop in the investment volume but the office sector remains the favourite accounting for 42% of all commercial investments. Additionally, both domestic capital and cross-border capital are down and it should be noted it is not one particular destination or buyer that has caused the investment volumes to fall.

The amount of overseas money invested in the old continent also remained unchanged, accounting for slightly more than 30% of all cross-border investments, whilst the allocation per asset classes and geographical destinations become even more pronounced depending on the origin of investors.

Yield gap closing between asset classes and locations

Strong demand for offices is continuing to put pressure on yields, whether prime, secondary, in CBD or non-CBD locations. Overall office yields are at historic lows. Prime CBD office yields moved in by -22bps on average yoy and have now passed down the 4% threshold (3.86%). The highest differences compared to Q1 17 were noted in Frankfurt (-70), Amsterdam (-60), Lisbon (-50), Helsinki (-50) and Berlin (-50), whilst in 1/3rd of the European cities surveyed, prime office CBD yields stabilised.

Due to the lack of prime office space available in CBD locations, secondary CBD office yields and most remarkably prime non-CBD office yields are also under strong downward pressure. On average across Europe, they moved in by 32bps and 37bps respectively. The average prime non-CBD office yield currently stands at 4.91% below the average secondary CBD office yields which is at 4.93%. This also reflects the strong office rental growth in non-CBDs.

Prime retail warehouses experienced the highest yield compression of all sectors at -39bps on average. The sharpest inward shifts were noted in the German cities: Stuttgart (100bps), Berlin, Cologne, Dusseldorf, Frankfurt

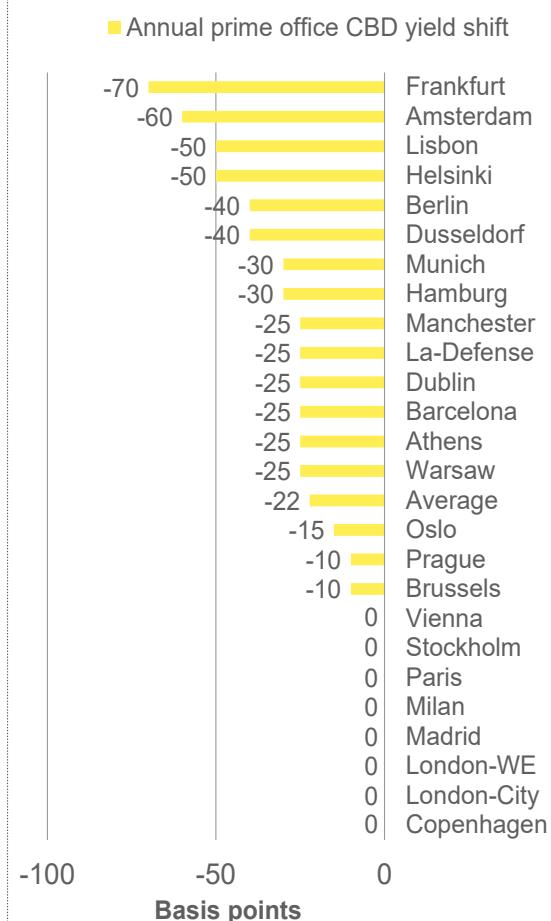
FIGURE 2 Destinations of global money invested in Europe over the past 2 years

Origin of buyers	Major sectors of destination	Main countries of destination
Australia	Offices	Core countries
Canada	Offices, retail and Logistics	Netherlands, Germany, UK
China	Logistics	Germany, France, the Netherlands
Hong Kong	Offices	UK
Korean	Offices	Germany, France and Belgium
Latin America	Offices	Spain
Singapore	Logistics mainly, retail, hotel	Netherlands, Germany and the UK
South Africa	Retail	CEE
Thailand	Hotel	CEE, UK
US	Across sectors	Across Europe

Source: Savills / RCA

FIGURE 3 Prime CBD office yield Q1 2018

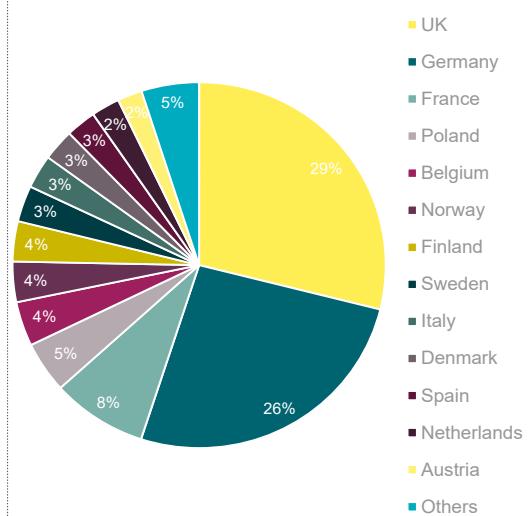
hardened by 22bps yoy on average



Source: Savills

FIGURE 4 Volume breakdown per country

Core countries still account for 64% of all investments



Source: Savills

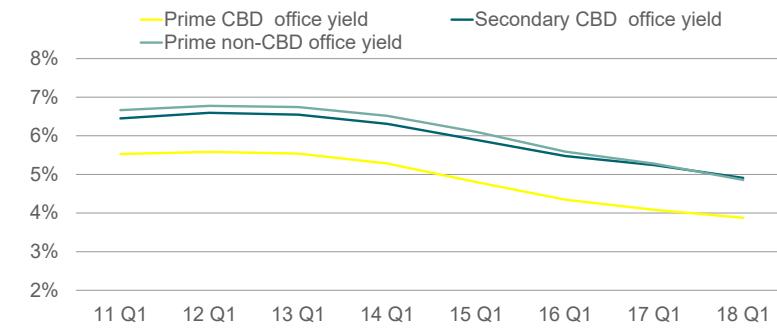
→ and Munich (-90bps). Logistics yields are also under strong downward pressure -38bps yoy on average. The average prime yield is at a historic low at 5.2% compared to 6.28% five-year average.

On the other side of the spectrum, prime shopping centre yields have

stabilised across the European markets and they stood at 4.46% on average in Q1 2018, compared to 4.48% at the same period last year. The lowest yields were recorded in Munich at 3.5% and Hamburg at 3.8%. Hence the gap between shopping centre yields, retail warehouse and logistics yields is closing. ■

FIGURE 5

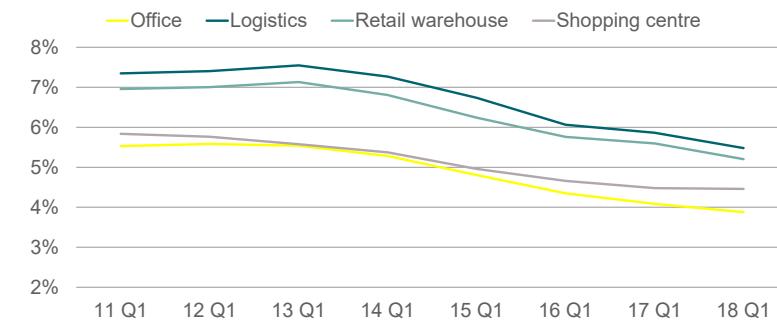
Prime non-CBD office yield hardened by 37bps due to strong occupier activity in peripheral markets



Source: Savills

FIGURE 6

Prime property yields The gap between prime SC, RW and logistics yields is closing



Source: Savills

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Savills plc

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OUTLOOK

Few clouds in a still clear sky

■ In spite of a slow start of the year, the outlook for the European and the world economies is positive for 2018. Growth dynamics are expected to be underpinned by accommodative monetary policy, improving labour market and positive sentiment, although a weak external sector will likely drag growth down 2017's level. | The Focus Economics Consensus Forecast for 2018 GDP is at 2.1% pa and 1.5% pa on average for the following four years. This should continue to support business expansion.

■ The political landscape, however, has recently darkened, with the ongoing Brexit negotiations, the political standoff in Italy and tensions with the US all hanging over the future economic activity.

■ Yet, prime real estate will remain an asset class of choice due to still attractive yield spreads over long-term interest rates and positive rental growth prospects. We expect the annual commercial investment volume for 2018 to be in line with last year. Offices will continue to be the preferred asset type although investors' appetite for alternative assets will continue to rise.

■ The ongoing development of the One Belt, One Road (OBOR) initiative could also spur further demand for logistics investments. Notably thanks to increasing rail services between China and various Europe cities such as Poland, Germany, the Netherlands, Belgium, France and Spain and due to some investment projects in European container terminals in Belgium, the Netherlands, Italy, Portugal, Spain, Croatia, Slovenia, Latvia and Lithuania.

■ Prime office yields will remain stable in core countries and will continue hardening in other parts of Europe, notably CEE and southern European countries. Yields will continue to converge across asset types and locations but prime product will remain the key target for investors.