SPOTLIGHT
Savills Research

European Investment

Preliminary H1 figures

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H1 first estimations • 5%+ opportunities • Outlook

Inflation, inflation, inflation

With inflation on everyday headline news, consumer confidence is currently even lower than it was in the early days of the Covid-19 pandemic. In May, retail sales increased slightly after a sharp fall recorded in April. That said, consumer spending has performed reasonably well so far this year, supported by a strong labour market and a still sizeable pool of consumer savings. However, consumption will likely slow down during the second half of the year. Rising consumer prices will squeeze real income and eventually alter discretionary spending and cause precautionary savings behaviour.

The euro area manufacturing output declined in June for the first time in two years (to 52.1 from 54.6 in May), based on the flash PMI data. The main risk hanging over the industry is energy supply cuts when winter chills will require heating as rationing of supply will prioritise households over the industry.

Intending to bring inflation down, global central banks, led by the US Federal Reserve (Fed), are raising interest rates. During its May meeting, the Fed increased US interest rates by 75 percentage points to 1%, the largest hike in decades. Following its latest monetary policy meeting in June, the ECB announced it intends to raise its key interest rates by 25 basis points at its July meeting, with a further 50 bps expected later this year.

Every real-time indicator is now pointing to a marked economic slowdown in Q2. Pricing is expected to drag down GDP by 0.3% during the second quarter of the year. For the full year, the eurozone economic growth is now expected to rise by 2.6%, down from 5.3% in 2021.

Rising construction cost is a buffer for occupational markets

On the bright side, rising construction costs are supporting rental levels. Prices for building materials such as steel, concrete or timber have had significant highs and lows over the past 24 months, making new construction projects financially challenging to anticipate and to bear for developers and investors.

Following the sharp decline in construction in 2020 and a strong rebound the following year, building production (residential and commercial) is forecast to rise only slowly during the next three years, by 2.3% this year and next and 1.4% in 2024, lower than pre-pandemic levels according to Euroconstruct.

The shortage of new deliveries of space and the limited amount of new construction in the pipeline has kept the level of vacancy low, notably in the office and the logistics sectors.

In Q1 2022, the European office vacancy rates stood at 7.2% with the Western European markets ranging between 2% and 5%. In turn, the shortage of prime stock has put upward pressure on prime rents which rose by 2.2% on average across Europe between Q1 2021 and 2022, with some double-digit rental growth recorded in Munich (+18.4%), Oslo (+12.2%) and Amsterdam (+11.1%). On average across Europe, prime CBD rents are expected to increase by 2.3% this year and then slow down to 1.8% YoY growth next year, according to Capital Economics.

Within the logistics segment, the availability of space reached an all-time low in Q1 2022. The European logistics vacancy rate was at 3.3% on average, with Dublin (1.1%), Denmark (1.5%) and Barcelona (1.7%) even below the 2% threshold. Hence, prime rents increased by 5.9% annually, most notably led by London (20%) and Warsaw (15%). Prime rental growth is expected to remain positive this year but to slow down sharply to 2.6% and 2.0% in 2023, according to Capital Economics.

However, we anticipate prime and secondary rental levels to take a divergent pace toward the end of the year, which will further accentuate in 2023.

Annual construction growth

Source: Euroconstruct June 2022 * residential and commercial output growth

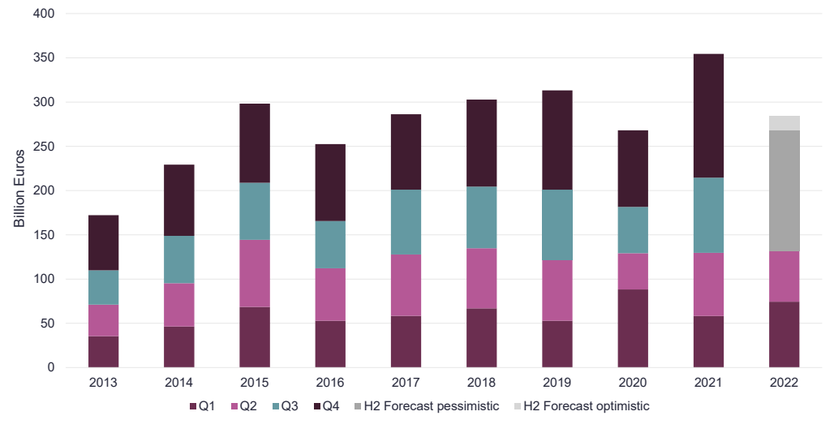
The investment market ...on the lookout

Preliminary results suggest that the total investment volume for the second quarter of the year will reach slightly less than €60bn. This would mark a 20.2% drop from the same period last year, which was a particularly strong quarter and a 10.5% decline compared to the previous 5-year average. Although we do not have all the country details yet, it seems that the slowdown in investment activity is not evenly spread across Europe. It looks like it has been mostly dragged down by a sharp drop in investment volumes in Germany and the UK, the two largest recipient countries. At the opposite end of the spectrum, in France, the investment volume is likely to be 50% above Q2 2021. Investment activity was notably fuelled by a few trophy office assets that were put on the market as well as revival in retail activity. In Denmark, we also anticipated the Q2 transaction volume to have nearly doubled compared to the same period last year. In Italy, activity increased by 51% compared to Q2 2021 bringing the volume for the first half of the year to a record high.

Hence, the investment turnover for the first half of the year should be approximately €131bn, 1% up on last year and 2% above the previous five-semester, thanks to the strong start of the year. But clearly, the investment landscape has changed over the past two months. Paradoxically, the dry powder to be invested is still there and there are currently many assets coming onto the market as some investors are looking to sell, but the number of bidders per offer, which used to approximate 15-20 one year ago, is now reduced to a handful. As always in times of uncertainty, the bid-ask spread is the main stumbling block threatening to bring certain negotiations to a standstill. The bulk of investors are shifting their attention back to quality assets and we see the weight of capital increasingly focused on assets with good fundamentals. That said, the pricing of the super prime assets in the very core western European markets is coming under pressure in light of the current inflationary environment. The cost of debt is also reducing the range of active market players to cash-rich investors, with the like of Blackstone or other private equity investors, slowly retrenching. Additionally, the fast-rising construction costs and most importantly the high volatility in raw materials pricing, seem to have started impacting the volume of forward funding purchases, as both investors and developers are unwilling to bear the inflation risk. Preliminary data from RCA points toward an inflexion trend although volumes remain still high by historical standards.

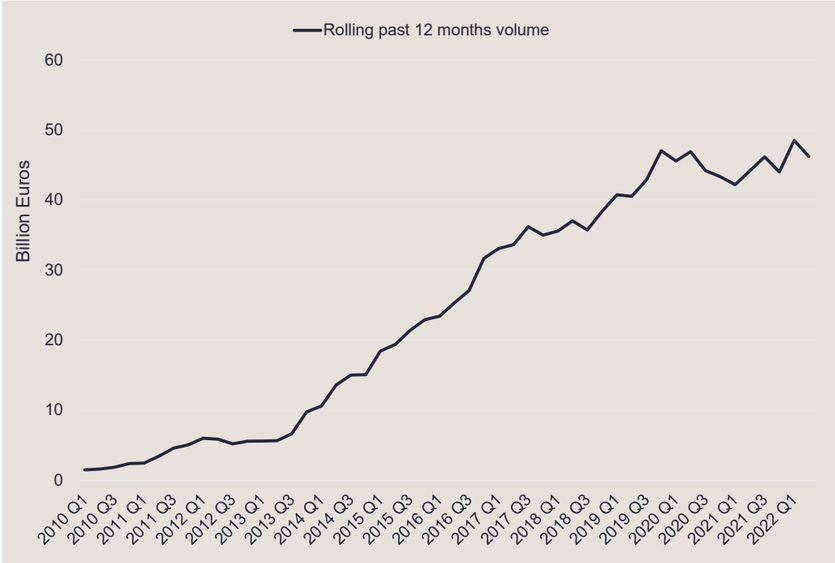
Based on the growing economic headwinds and the recent shift in the investment market, we revised our outlook downwards. We now anticipate the end-year volume to range between €267bn and €284bn (from €300bn last quarter). The delta will depend on the length of the wait-and-see attitude from investors. On top of quality, investors will be seeking value, regardless of asset type. That said, we expect the overall retail and leisure investment volumes to be negatively impacted by slowing down consumer spending. The Nordic region and southern European countries will likely benefit from their competitive pricing advantage.

European investment volume



Source: Savills / * preliminary results

European forward sales



Source: RCA

There is still a large range of 5% plus opportunities

In the current context, the likelihood of further yield compression is limited, yet competition for prime products remains high as investors' demand is focused on quality assets providing secured long income streams. Finding assets with strong fundamentals and acceptable returns has been very challenging in recent years, but we believe that the recent repricing in many markets around Europe offers attractive investment opportunities, especially in the Core+/ Value add segment of the market.

Over the past five years, prime shopping centre yields moved out by 85 bps on average in Europe and became the two most competitive commercial asset types. That said, the most defensive types of retail assets are supermarkets/ hypermarkets and retail warehouses/parks in dominant locations, anchored with large DIY retail brands.

Despite the weaker momentum of the office market during and following the Covid-19, the tight labour market and the very low vacancy rate have continued to put pressure on prime office CBD yields. Core+/Value add investors seeking opportunities within the office segment will have to look into well-connected peripheral markets.

There is an increasing demand for purpose-built student housing accommodation (PBSA) across the major European university hubs. In nearly all the large capitals prime yields are already below 5%. However, we believe that there are still Core+/Value add opportunities attractively priced in tier 2 and tier 3 markets cities.

Over the past five years, demand for logistics space surged across Europe, alongside the growth of online sales. Hence during that period, prime logistic yields compressed significantly (162 bps) and income returns are now below 5% in most European markets except for some of the CEE countries and in secondary locations in some western and southern European locations.

5% plus investment opportunities in Europe

Country	Sector and location	Asset type	Yield range
Belgium	Offices in secondary locations	Core+	5.00 - 8.00%
Belgium	Retail and retail parks	Core+	6.00 - 8.00%
Czech Republic	Offices in CBD and peripheral markets	Core+	5.25 – 6.75%
Czech Republic	Regional retail parks (outside of Prague and Brno)	Core+	6.50 - 8.00%
Czech Republic	Industrial/ B grade	Core+/Value add	> 6.50%
Denmark	Multi-tenant offices in greater Copenhagen	Core+/Value add	5.00 - 6.00%
France	Prime offices in inner suburbs	Core+/Value add	5.00 - 6.00%
France	Prime shopping centres in regional cities	Core+/Value add	5.25 - 8.50%
France	Prime retail parks in France	Core+/Value add	5.25 - 6.75%
France	Logistics in northern and southern parts of the country	Value Add	5.00 - 5.25%
Germany	Prime offices in small regional markets (typically <150,000 inhabitants)	Core+	5.00-7.00%
Germany	Commercial parks in major conurbations	Core+	5.00%
Germany	Prime and secondary shopping centres across the country	Core+/Value add	> 5.00%
Ireland	Student housing located in Ireland's large cities	Core +	5.00%
Ireland	Suburban offices	Core +/ Value Add	5.00 - 6.00%
Ireland	Prime retail warehousing	Core+	5.00 - 6.00%
Italy	Prime retail park and retail warehouses across the country	Core/core+	6.50 - 7.25%
Italy	Prime shopping centres across the country	Core+/value add	5.90 - 6.25%
Italy	Offices in Milan's periphery and emerging cities (Torino)	Core+/Value add	5.25%
Netherlands	Hotels in secondary locations	Core+/Value add	5.00 - 7.50%
Netherlands	Offices in secondary locations	Core+/Value add	5.00 - 8.00%
Netherlands	Industrial	Core+/Value add	5.00 - 8.00%
Norway	Big boxes in central locations	Core	5.25 - 5.50%
Norway	Offices in Oslo fringe	Core+	5.00 - 5.25%
Poland	Warsaw non-central offices and rerionalal	Core	5.00 - 6.50%
Poland	Industrial nationwide (incl. portfolios)	Core+	5.00 - 6.00%
Poland	Retail	Value Add	8.00 - 10.00%
Portugal	Retail parks near Lisbon and in secondary cities	Core+/Value add	6.50 - 7.00%
Portugal	Offices and mixed-use in Porto	Core+	5.50 - 6.00%
Portugal	Supermarket Gaia	Core+	5.50 - 6.00%
Romania	Prime office buildings in Bucharest and regional cities	Core	6.75 - 8.50%
Romania	Prime industrial nationwide	Core	7.75 - 8.25%
Romania	Secondary office buildings in central Bucharest	Value Add	7.25 - 8.00%
Spain	Prime shopping centres and retail parks across the country	Core	> 5.00%
Spain	Hypermarkets	Core	> 5.50%
Spain	Secondary retail parks and retail warehouse units	Core+	6.00 - 7.50%
Spain	Offices in secondary Non-CBD locations of Madrid and Barcelona	Core+/Value add	6.25 - 6.50%
Spain	PBSA schemes in tier 2 and tier 3 cities and care home developments	Core+/Value add	5.25 - 6.25%
Spain	Logistics in secondary cities (>200,000 inhab.), light industrial in prime markets	Core+/Value add	5.00 - 6.50%
Sweden	Shopping centres in B-locations	Core+/Value add	5.25 - 6.50%
Sweden	Retail warehouses in regional cities	Core+/Value add	5.25 - 6.25%
Sweden	Suburban secondary offices in Stockholm, Gothenburg and Malmö	Value Add	5.00 - 6.50%
UK	Prime shopping centres, high street retail and leisure in regional cities	Core+/Value add	6.25 - 7.50%
UK	Prime regional student accommodation	Core+/Value Add	> 5.00%
UK	South East offices	Core+/Value Add	5.25%
UK	Care homes	Core+/Value Add	5.00 - 6.00%

Real estate pricing ... likely to move out in the next six months

Preliminary figures suggest that overall prime office CBD yields remained stable this quarter at around 3.40% on average across Europe, with the first indication of yield softening recorded in the German cities (approx. +30 bps), Oslo (+20 bps) and London City in June (+15 bps). Due to the shift in the investment landscape towards more opportunities and less competition, we estimate the average prime office CBD yields will move out by 25 bps in the final quarter of the year. Early indications of outward yield movements in secondary offices are multiplying, confirming our view of a distinct prime-secondary yield divergence during the second half of the year.

The fundamentals of the logistics market will lose momentum, with the declining purchasing power affecting sales - including online sales - and ultimately distribution. Rising base rates have also posed a mathematical dilemma to many investors in the market, which has seen a surge from overseas leveraged investors who, generally, are paying the keenest yields. We have continued to see record levels of take-up across Europe and most markets have vacancy rates at record low levels, which in turn is continuing to push rental growth. Whilst we expect certain markets to continue to see yields harden, the impact of rising debt costs should ultimately mean, that at a blended continental average, yields should move back from their record low levels. Our preliminary Q2 2022 data indicate that prime logistics yields moved out in Oslo and Stockholm (+20 bps) and the German cities (+10 bps).

The living sectors seem to have kept attracting an increasing share of the total European investment volume during the first half of the year. Given the current economic context, we expect the sectors to fare better than the others. With homeownership unlikely to increase and affordability issues likely to deteriorate in the near future, private rented sectors have a bright future ahead. Early indications suggest that the average prime multifamily yield in Europe compressed further (by 5-10 bps YoY in Q2). Competition within the sector is expected to remain high as the sector will increasingly polarise investors' demand. The challenge will come with rising service charge costs and rents stabilising.

The retail sector is about to face another storm, with the European purchasing power about to decline. Despite the price competitiveness of the sector, we expect prime retail yields to soften by 15-20 bps on average in Europe, with further yield compressions expected within the prime segment, notably for prime supermarkets and prime retail warehouses.

Savills Commercial Research
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