SPOTLIGHT
Savills Research

European Investment

Preliminary Q1 figures

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Strong first quarter • Solid end-year results expected • Prime yields

Europe at the epicentre of the Russia/Ukraine conflict

The Russian invasion of Ukraine and the following sanctions have brought significant European social, political, and economical uncertainties. As events evolve on a daily basis, it is difficult to firmly measure the full extent of the impact of this unprecedented crisis. At the time of writing, the direct and most obvious effect is on commodity prices and inflation. Indeed, Russia supplied about 40% of Europe's gas imports during 2020, and around 30% of its oil imports. Hence, the eurozone inflation increased to a record high of 5.8% in February. Capital Economics expects headline inflation to breach 6% in the coming months and ease later in 2022, averaging 5.5% for the year and easing to 2.5% in 2023.

Other economic impacts will be determined by the longevity of the crisis, sanctions and retaliation, with a possible risk of stagflation in the worst-case scenario. However, for now, most economists have only adjusted their growth forecast slightly downward. According to Focus Economics, the eurozone is expected to expand 3.9% in 2022, and 2.5% in 2023. The economic expansion will be still backed by the unleashing pent-up consumer spending that will drive positive domestic demand, although the impact of falling consumer confidence on retail spending will be observed more closely in the coming months. Growth will also stand to benefit from private businesses. The eurozone composite purchasing managers' index (PMI), rose to 55.8 in February from 52.3 in January; the highest reading in five months. Hence, the index moved further above the 50-threshold suggesting the business conditions are improving.

Finally, the disbursement of EU funds and expansionary fiscal and monetary policies will also boost the European economy. Following the Bank of England's base rate increase, Capital Economics now forecasts the ECB to raise interest rates by 25 bps this year and 50 bps in 2023. Since the ECB's February press conference, Italian bond yields have risen by 20 bps, whilst German bond yields have risen back into positive territory, to their highest level since the end of 2018.

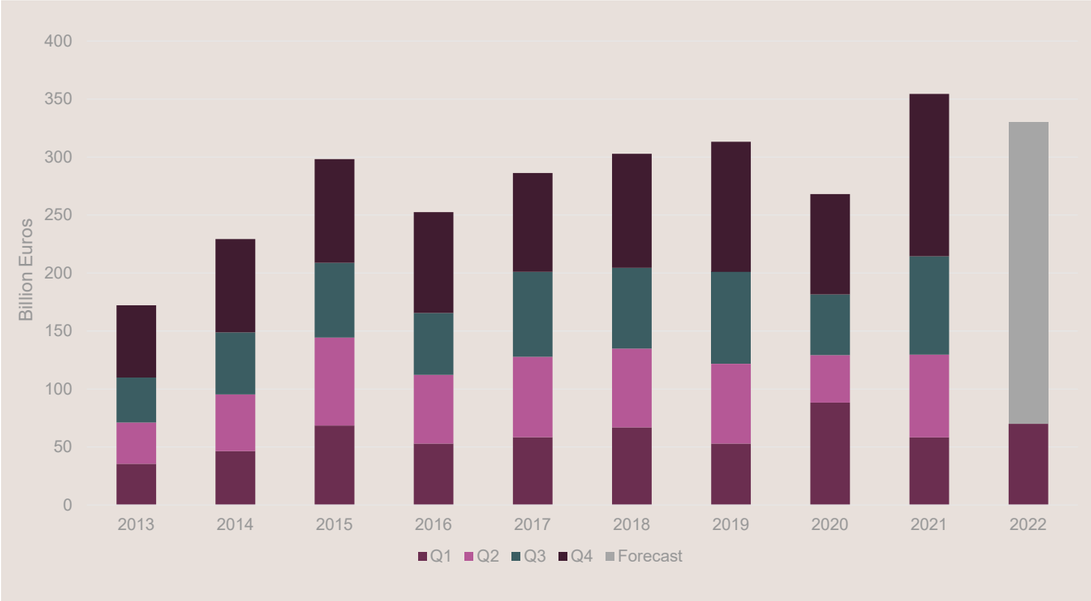
Strong Q1 investment volume – still solid prospects for the remainder of the year

Preliminary results suggest that the total investment volume for the first quarter of the year will reach approximately €70bn, which is 19.5% above the level achieved during the same period last year and in line with the fast-growing investment activity recorded over the past 12 months. European investment volumes rocketed to an apex during the final quarter of 2021, with €140bn transacted. This brought the annual volume to €355bn, marking a 25% jump on the past 5-year average. Investment activity was notably fueled by a large number of entity acquisitions mainly targeting the living sectors. RCA data suggest that M&A deals accounted for 13% of the total European investment last year compared to 8% on average during the past five years.

Although the Russian invasion of Ukraine brought significant uncertainties amongst investors, we expect the direct impact on the European investment market will be limited, notably to the CEE region. As some risk aversion rises, we believe most of the activity will shift back to the prime and core segments of the market. Hence, this will be restraining the resurgence of value-add deals as we initially anticipated. We also believe there is likely to be an investors' enthusiasm for index-linked assets countries to hedge against inflation.

Yet, at the time of writing, we still expect solid European investment activity for the remainder of the year, notably fuelled by large portfolio and entity deals to be transacted. We anticipate the annual European investment volume will be slightly below the record high achieved last year, between €300bn and €330bn.

European investment



Source: Savills Research

Shift back to core countries

The CEE region will likely pay the highest price, which remains difficult to quantify as it depends on the longevity of the crisis. First, the proximity of the region with the epicentre of the crisis is undermining investors' confidence which may see a quarter point impact on prices in the short term before recovering later in the year with transactions taking longer to complete. Second, investment activity in CEE countries generally relies a lot on cross-border capital, although these are usually transacted in euros, which should reduce any major impact.

Given the current context, we expect most of the investment activity will concentrate in western Europe and particularly, the core countries. Our preliminary Q1 figure suggests that UK, Germany and France have contracted 66.6% of the total European investment volume this quarter. Last year, core countries accounted for 61.4% of the total volume, and the Nordics' share reached a high of 21.8%, notably thanks to very strong activity in Sweden and Denmark. We still expected strong investment activity in the Nordics region for this year, yet we believe it will slow down compared to the record high level of activity recorded last year.

Investment allocation per assets – towards a more even breakdown

Fast-growing multifamily and logistics investment activity continued this quarter and is expected to continue until the end of 2022 and beyond. Last year, European multifamily investment volumes reached approximately €92.3bn in 2021, marking a steep 79% increase YoY and a 120% increase on the past five-year average. At the same time, logistics investment (€64.7bn) increased by 58% YoY and by 85% compared to the past five-year average.

Office investment activity has been growing slowly throughout last year. European office transactions reached a total of €99bn during 2021, 8% down on the previous five-year average. However, in the final quarter alone, €38bn of transactions took place, in line with the final quarter average over the same period. As most European countries have passed the last Omicron wave, the new work from the office/home balance is likely to reassure both landlords and investors about the future of the office. We believe office investment activity will resume and slowly set its new norm. Although this year, most activity will remain concentrated in the prime segment of the market. The office sector also appears relatively sheltered to higher inflation due to the indexation of rents across core European cities.

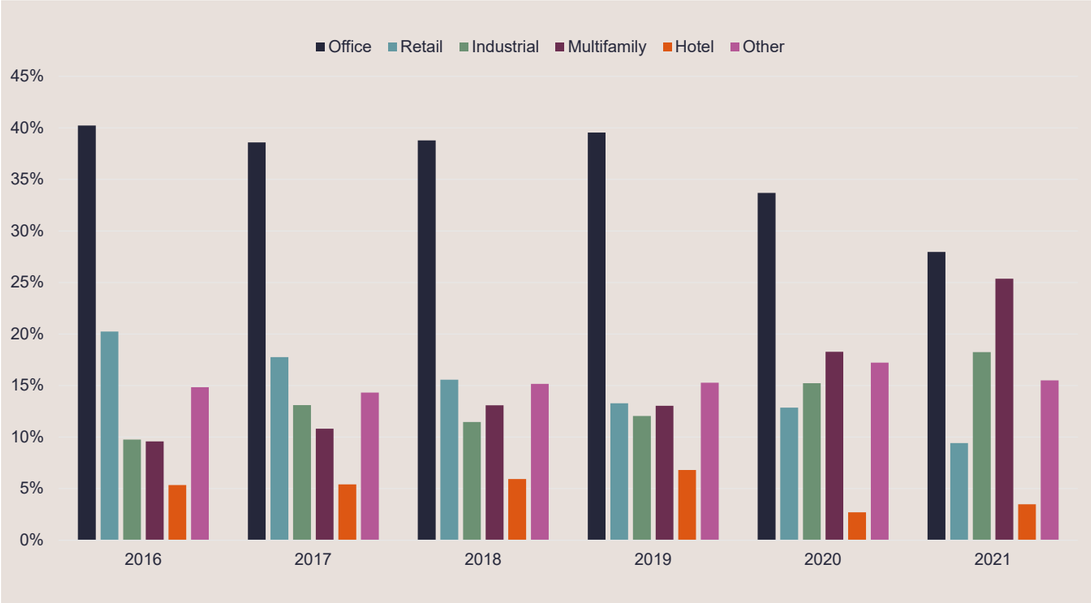
Some €33.4bn were invested in retail assets last year, 3% down on the previous year and 26% down the past 5-year average. Nevertheless, starting from the 2nd quarter of 2021, volumes started to slowly pick up and continued until the first quarter of 2022. As we predicted at the end of last year, retail owners have now acknowledged the price deprecation (+80 bps over the past four years on average across Europe), hence negotiations are unlocked. Some investors, which are heavily exposed to the sector, are disinvesting, , while others seek yield and greater portfolio diversifications.

Cross-border activity – should remain solid

In the context of economic recovery and improved travelling conditions, the amount of cross-border capital invested in Europe totalled approximately €135bn last year, which is 27% up on 2020. Hence, we estimate that approximately half of the total investment originated from cross-border capital last year, which is in line with the long-term average. Gradually over the past year, long-haul cross-border investment activity picked up, notably led by US investors and, to a lesser extent, by Canadian and Singaporean funds. According to RCA, in 2021, overseas capital invested in European real estate reached €76bn, which is an annual increase of 36%. Yet, this remains 6% below the last five-year average, with the amount of capital coming from North America 11% up compared to its long-term average (AsiaPac -30% and the Middle East and Africa -36%). On the other end, intra-European cross-border volume totalled €81bn last year, which is 8% up on 2020 and 1% above the past five-year average. European investors remain the dominant source of cross-border capital in Europe.

As of today, we believe the Ukrainian crisis will have a modest impact on cross-border investment in western countries. Indeed, Russian investment outflows in Europe averaged only €252million over the past five years, according to RCA. However, as risk aversion rises, it may have a more significant knock-on effect within the CEE region, most notably Poland. The preliminary Q1 figure indicates that the share of cross-border investment remains unchanged compared to last year. We expect cross-border investment volumes to remain solid over the course of the year and will be led by both overseas and intra-regional capital. US investors will remain the predominant cross-border market player in Europe, followed by German funds and Swedish real estate companies, mainly listed ones. The weaker euro in early 2022 will help to support non-European investor demand.

investment per asset class



Source: Savills Research

Prime yields – still expected to compress for multifamily and logistics properties

For now, the war in Ukraine does not change our view that prime European property yields will continue to support valuations across many asset types and countries, although yield compressions will be less than initially predicted.

Based on our preliminary figures, prime office yields compressed further by an average of 17 bps YoY to 3.40% in Q1 2022. Office yield spreads to risk-free rates continue to illustrate the sector's attraction despite some more recent increases in bond yields. Given this, we believe the potential for further yield compression is less likely, and we forecast a stable outlook on pricing throughout 2022.

Resilient logistics demand for core product observed downwards pressure on prime, compressing by an average of 51 bps YoY to 4.5% in Q1 2022. Given the allocation of real estate capital targeting the logistics sector, we anticipate further yield compression as buyers are increasingly willing to take on more vacancy risk.

Intense competition for multifamily properties is putting further downward pressure on yields. The average prime multifamily yield in Europe compressed by 10 bps YoY in Q1 2022 to reach a record low of 3.50%. Competition for income-producing assets is expected to be stronger than ever, and prices may rise further, especially in markets where rental housing supply lags demand.

Prime shopping centre yields reached a high of 5.47% in Q4 2021, versus the last cyclical peak of prices at 4.5%. This is 12 bps above the previous year's. As we anticipate retail investment to resume this year, we expected yields to slowly stabilize toward the end of the year.

Savills Commercial Research

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