SPOTLIGHT
Savills Research

European Investment

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• Capital and rental values • Inflation and bond yields • Top investment picks

Strategic and tactical shifts

Recent market activity reflects a shift in investor behaviour, in terms of sectors and attitude to risk, compared to pre-Covid19 times.

Occupier demand drives sector allocations

Offices remain the largest sector in terms of investment turnover, but it has lost part of its share to logistics and living sectors, which currently benefit from demographic and technological changes, caused or accelerated by the pandemic. Office investments are expected to reach about €60bn in Q1-Q3 this year (based on Q3 closed and pending deals according to RCA data), accounting for 32% of transactions, below the long term average of 35%.

Living and Care sectors are likely to capture 29% of total investment by the end of Q3 and logistics 20% of total, continuing a busy start to the year, boosted by a number of large portfolio deals. Both living sectors and logistics markets accounted for a significantly higher proportion of total investment than their historic averages.

Retailers and logistics operators have been driving occupier demand for warehousing space and shortage of buildable land has been driving vacancy rates down and rents up. Overall, European logistics vacancy rates have fallen by an average of 80 bps yoy to 4.6% (Q2 21). As a result, prime rents have risen by an average of 3.2% yoy.

The residential sectors in major urban centres are characterised by structural undersupply of housing, which has led rental growth over the past few years. The average multifamily rent is 26% higher compared to five years ago (on average) across the cities we monitor. Currently affordability has become a critical issue in many markets and rent controls are tightening. Nevertheless, the stable, indexed-linked income streams that the sector offers remain the key point of attraction.

Although retail is the sector that investors are mostly avoiding, due to changing consumer habits and risks around occupier covenant strength, there is a sub-segment that shines; Food-anchored assets / supermarkets and strong performing retail parks/warehouses are in high demand. Competition has pushed prices at historic low levels and they are converging with shopping centres, which are experiencing corrections across markets. With the average prime European retail warehousing yield at 5.41%, the yield gap with shopping centres is at 10bps in Q3 21 vs. a five year average of 75 bps. European average prime supermarket yields are at 5.38% and edging downwards.

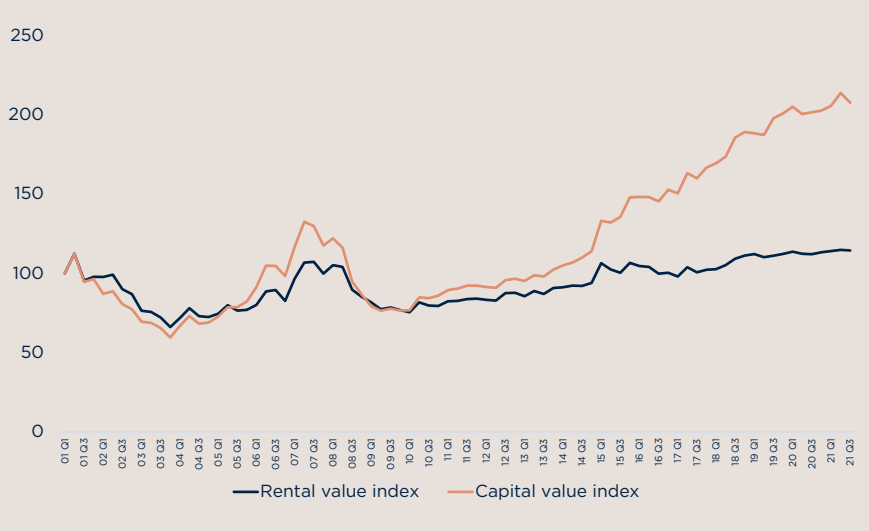
Capital values are growing faster than rental values

While the share of office investment has dropped, pricing of core office product remains keen. Prime CBD office capital values continue to rise faster than their respective rental values in most capital cities. In Q3 21 the average rent index (2001=100, eight cities) is at 114 points, while the average capital value index has increased to 208 points, reflecting investor competition for prime assets in core markets. Similar discrepancy between the two cycles had also been observed during the previous peak of the market. In Q3 2007 the rental index was at 100 points and capital value index at 121 points, showing that during the current market cycle, capital value growth has reached new record high levels. From the eight cities we analysed (London, Paris, Berlin, Munich, Madrid, Amsterdam, Warsaw and Stockholm) the capital value index is still lower than the past peak in London (-2%) and Warsaw (-26%). In the remaining cities the widest gap between capital values in the current and the previous market peaks are observed in the German cities (Berlin capital values are 225% higher in Q3 21 compared to Q3 07).

Wall of capital is driving yield compression

We believe that the widening gap between rental and capital value growth is driven by the weight of capital targeting the limited product available that meets investor criteria; buildings with the best specifications and highest ESG credentials in core European markets. A symptom of this competitive

European rental and capital value index the gap is at a historic high



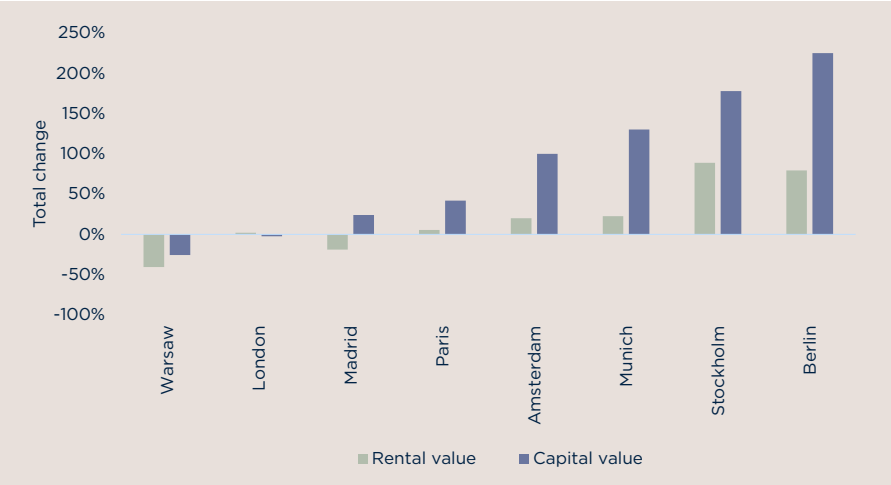
Source: Savills Research

208 vs 114

The gap between the capital value index and the rental value index in Q3 2021 (100=2000) reflects the competitive investment environment.

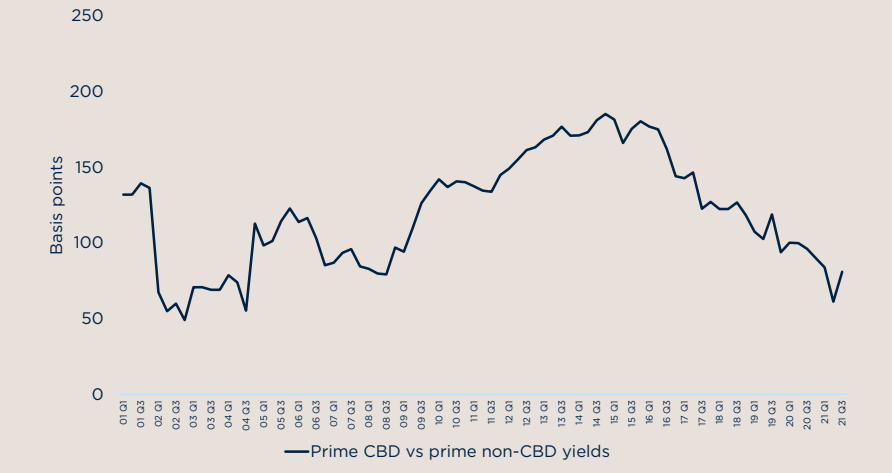
> "We believe that the widening gap between rental and capital value growth is driven by the weight of capital targeting the limited product available that meets investor criteria"

2021 rental and capital values vs 2007/08 peak



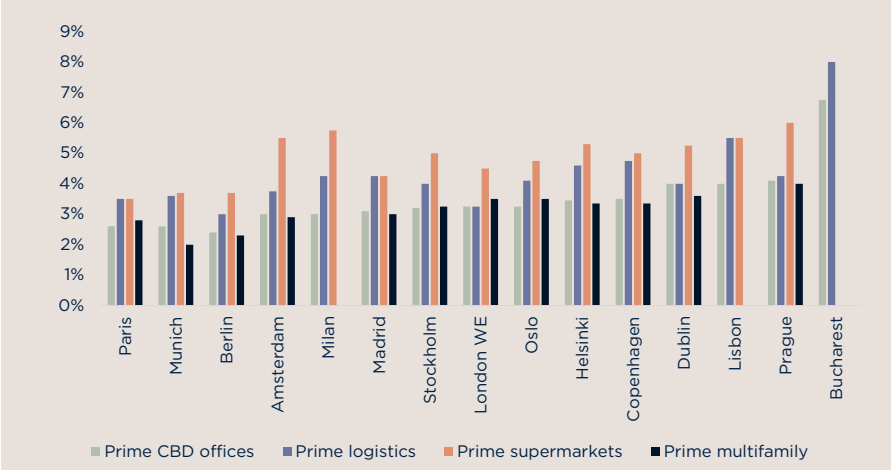
Source: Savills Research

Prime office yields: CBD vs non-CBD the gap is similar to past peak



Source: Savills Research

Prime achievable yields by sector



Source: Savills Research

environment is the convergence of prime yields in CBD and non-CBD locations. For the eight cities analysed, above the gap between prime CBD and prime non-CBD office yields is at 81bps in Q3 21, up from 61bps in Q2 but still lower than the long-term average (10 years) of 120bps. The previous low was noted in Q3 2008 at 79 bps.

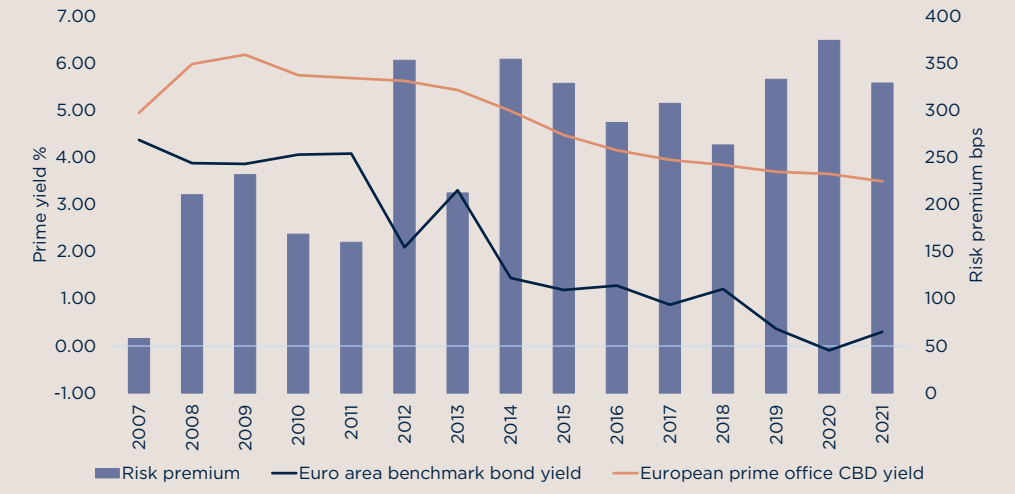
On the other hand, we observe that investors continue to avoid secondary offices, which either require significant refurbishment or they may need to be repurposed. The uncertainty around the impact of hybrid working patterns on office demand is an additional caution factor. This probably explains why the yield gap between prime and secondary offices is widening. In Q3 21 it was at 139bps (on average in the eight CBD locations), vs a 10-year average of 114 bps.

No major rent corrections so far in this cycle

During periods of economic slowdown, property rents are expected to drop, as weaker demand for commercial space leads to higher voids. During this unique downturn, despite that fact that take-up dropped by 24% over the five year average (H1 21), prime CBD rents did not experience a significant fall so far, as in several markets supply of prime space is still tight. In H1 21 headline rents were on average just 1% yoy lower, while incentives had increased. Overall, office vacancy rates continue to creep upwards, rising by an average of 150 bps to 7.2% over the past 12 months (Q2). In some cases the amount of grey space has also increased. Among the fastest risers in terms of space availability were La Défense, Warsaw and London City. Markets with a higher exposure to financial services were already observing a tapering of demand prior to the pandemic.

Although we expect by the end of the year prime CBD rents to remain stable in the majority of markets, Q3 evidence indicates that we will witness modest prime rent corrections (-1% up to -5%) in some cities, compared to last year (Berlin, Munich, Madrid, Barcelona, Dublin, Warsaw, Prague).

Risk premium for prime European offices remains high despite record low yields



Source: Savills Research, ECB

Inflation and real estate

How is rising inflation going to impact the real estate investment market?

Rising inflation is a threat to muted rental growth

According to Capital Economics forecasts, the average European All property rents are projected to grow by 1.2% pa by 2025. These rental growth expectations imply that property rents will be vulnerable to higher inflationary pressures. Although most lease structures in Europe provide for index-linked rents, which offer a hedge against inflation, the question remains if by the end of the lease, market rents will have adjusted in real terms. Economists reassure us that inflationary pressures are a short-term symptom of supply-side shortages and they do not expect this trend to last.

According to Capital Economics the effects of re-opening and supply problems could intensify in the next few months. After rising to a near-10-year high of 3.0% in August, they expect that eurozone inflation will rise even further in the short term, a result of the increase in gas prices. But this is due to temporary forces that should fade next year, as global consumption and trade patterns return to something like their pre-pandemic norms, and producers are able to increase their output. They project that the headline rate will average 2% in 2022.

Is there a risk from rising bond yields?

Prime real estate yields have reached unprecedented low levels during this market cycle. However, real estate still appears good value compared to other asset classes, driving strategic allocations in the sector, which exacerbates competition. Ultra-low risk-free rates across the European economies have also dragged property yields to ultra-low levels. These levels have become more acceptable by investors in recent years, as higher market liquidity and positive market fundamentals have supported investor confidence in property.

Rising inflation puts increasing pressure on the European Central Bank to abandon its expansionary monetary policy. In the financial markets, this potential shift can lead to higher bond yields. This would have a negative impact on the real estate markets, as it would lead to higher financing costs. It would also reduce the property risk premium, which currently sits comfortably at 348bps (Q2 21), and potentially shift investor interest in other asset classes.

During 2021 European bond yields rose slightly in anticipation of a potential policy shift from the ECB. In September the Bank confirmed that it will reduce the pace of its asset purchases slightly, but this is a long way from being a "full taper". According to Capital Economics, what does seem likely for the coming months is that the Bank will maintain its focus on "favourable financing conditions", allowing bond yields to rise only very gradually as the economy recovers. According to their forecasts the ECB is likely to leave its deposit rate unchanged until beyond 2025.

Since the majority of eurozone government bonds are still showing negative or around zero yields, more capital is likely to flow into the real estate markets. Additionally property still offers a good hedge against inflation. This could mean further yield compression in the core property segment.

Economic sentiment is improving

Risk aversion is a typical post downturn investor behaviour, so the focus on core assets is not surprising. As vaccinations are progressing and restrictions are lifted, economies are bouncing back and business and consumer confidence is recovering. The Economic Sentiment Indicator reached an all-time high in July and eased slightly in August, but remains at a high level of 116.5 points in the EU. The Employment Expectations Indicator (EEI) increased further in August reaching its highest level since November 2018 (112.6). According to Focus Economics the eurozone economy rebounded strongly in Q2 with the lifting of lockdown measures in the region and further afield, also supported by expansionary fiscal and monetary policy stances. The services sector and household spending likely benefitted the most from the easing of restrictions. The recovery has seemingly carried over into the third quarter amid further progress on the vaccination front. The economy is forecasted to bounce back this year amid the gradual lifting of restrictions, unleashed pent-up spending, the disbursement of EU recovery funds and loose fiscal and monetary policies. The economy is seen expanding 4.6% in 2021, by Focus Economics panellists, while in 2022, GDP is seen increasing 4.4%.

4% Eurozone inflation is likely to hit this level soon. Economists expect it to fall in 2022.

Living and logistics sectors account for a significantly higher proportion of total investment than their historic averages.

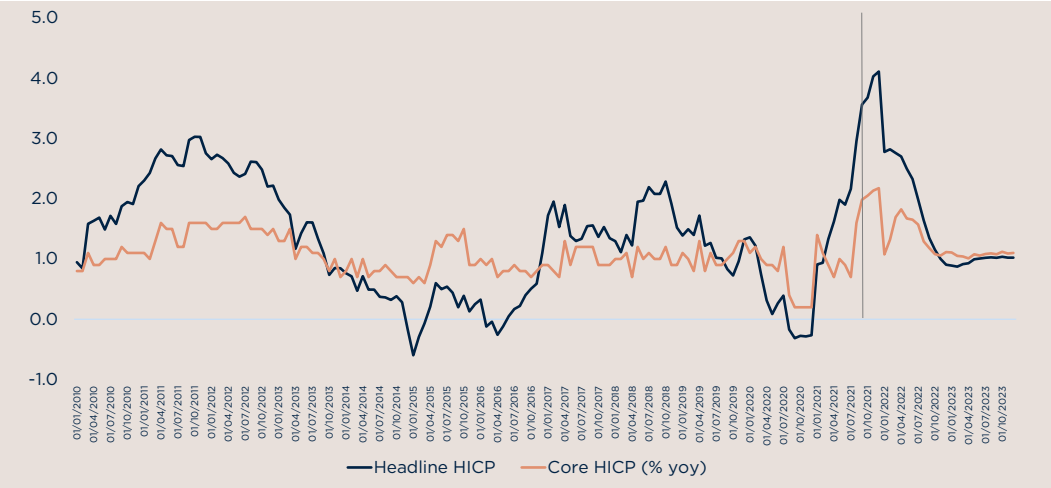
Although overall retail yields are softening, prime supermarket and retail park yields are edging downwards.

Prime CBD office capital values are rising faster than their respective rental values.

The gap between prime CBD and non-CBD office yields is narrowing. It is at 81 bps compared to a historic average of 120 bps.

As inflation rises temporarily, the ECB may slowdown its asset purchases but is unlikely to raise its deposit rate until 2025 (Capital Economics).

Eurozone HICP (% y/y) Economists project that it will trend down next year



Source: Capital Economics

Outlook

Investor interest in real estate will remain strong

We believe that investor interest in real estate will remain solid in 2021 and 2022. As governments gradually lift Covid-19 related restrictions and cross-border mobility improves across the globe, we expect pent-up cross border investor demand for European property to translate into transaction activity and boost investment volumes. This year we expect the total to be close to €270bn, at least 15% above last year's levels. This will be driven by dynamic activity in the Nordics and expectations for higher turnover levels in most other markets.

We expect pricing for core to remain keen . Capital values may rise further for the best-in-class assets in key markets. This will be supported by economic recovery and improvement of fundamentals. As investors realise that the prospects of higher returns in the prime market segments become more and more limited, interest in tactical allocations into the value-add segment will rise. This is a trend that we already observe through investor requirements, but has not materialised yet due to the pricing gap in buyer and seller expectations. However, the liquidity gap between prime and secondary assets is pointing to potential price effects in the short term for this market segment. This may unlock opportunities for redevelopment, refurbishment and repurposing of assets, which need to be upgraded in order to meet occupier and investor criteria.

Early signs from the office leasing markets are indicating that activity is picking up. There are more enquiries for space and the size of the requirements is also larger. Companies see their employees gradually returning to the office and based on a new hybrid working model they reassess their property requirements. This is expected, on the one hand to intensify demand for the best-in-class office space in good locations, and on the other hand to put more pressure on secondary stock for upgrading. We expect prime CBD rents to remain quite stable over the coming quarters. In the medium to long term, we believe that the increased capex required to upgrade prime office space to meet environmental criteria will begin to push up asking rents.

In the logistics sector we anticipate rental growth to accelerate over the next 12-18 months, particularly in core markets, driven by undersupply of existing and future stock. Retail rents on the other hand will continue to experience downward pressure, with the exception of locations with high footfall, which are likely to show more resilience, as mobility and tourist flows recover.

Investment into income producing living sectors will remain high, supported by rising demand for rental across all demographic groups. Demand exceeds supply of operational assets, therefore we expect to see more investments into development projects.

Top picks for European investment

Our top tips for the next 12 months are based on the current market conditions but also on the medium-term socioeconomic trends that will impact demand and supply of real estate in the coming months and years.

Positive rental growth prospects

One of the key considerations for sector and geographical investment allocations is rental growth and its future outlook. This has become even more important in an environment of rising inflation.
The sector that is expected to demonstrate an above inflation rental growth trend (>3% yoy) in 2021 and 2022 is logistics. We believe that we are going to witness this in markets where ecommerce penetration rate has exceeded the inflection point of 10.7%, where we observe rapid occupier demand for logistics space. These markets include the Nordics, Netherlands and France. Shortage of development land will contribute to this trend, through rising land values.

Despite the drop in office take-up (-24% vs 5-year average in H121), we believe that prime CBD rents in markets with tight demand and supply conditions could also experience positive rental growth again in the medium term. Higher asking rents may also be linked to a premium for best in class buildings, that meet the required ESG credentials. In most European cities, office vacancy rates remain below 9%, which is the level that triggers rental falls historically. In a number of cities it is still below 5%, including Berlin (2.3%), Cologne (2.9%), Paris CBD (4.4%), Hamburg (4.0%), Munich (4.0%) and Stockholm CBD (5.0%).

Stable income streams and capital preservation

Capital preservation and stable, long-term income streams also fit some investment strategies. In a low yield, low rental growth environment, this option may become unavoidable. The sectors that offer this type of returns are multifamily, senior housing and care homes. Already they are expected to capture 29% of the activity by the end of Q3 (according to RCA data). Structural undersupply of housing in major European capitals and ageing population provide the strong fundamentals behind these market segments. Regarding the growth of elderly populations, cities where increases above 20% are forecast between 2020 and 2025 include Amsterdam, Madrid, London, The Hague and Utrecht.

In terms of overall household creation growth over the same period, the cities that are expected to experience strong increases by 2025 include German, French Dutch and Nordic cities.

Value-add opportunities and yield compression prospects

In this competitive investment environment, several investors are looking for value-add opportunities, that can offer higher returns, through cyclical plays or active asset management.

One of the sectors that offers yield compression prospects is the Food sector. Supermarkets and discounters show rising liquidity and yields are moving in (European average is at 5.4% vs 5.7% two years ago). Although in some markets they are already at sub 5% levels (France, Spain, UK, Germany), higher yielding opportunities may be found in Southern and Eastern Europe (eg Poland 7%, Greece 7%, Italy 5.75%, Czechia 6.15%, Portugal 5.5%).

Conversely, other retail formats are experiencing significant yield corrections. The average prime shopping centre (SC) yield in Europe stands at 5.31% (Q3 21), the highest it has been since 2014. UK, Germany, France, Spain and Ireland have experienced the strongest price corrections (prime SC yield has moved out by 25% or more compared to its last peak). Certain retail assets in these markets can attract opportunistic interest, especially as economic activity bounces back. Given the market context, understanding and selecting the 'right' retail stock is fundamental. While some assets may lose their lettability for retail uses indefinitely, others can benefit from the recovery of consumer spending and changing shopping patterns. For example, the convenience sector and retail parks in particular, have proven resilient against a backdrop of subdued footfall for retail as a whole, compared to pre-Covid 19 levels.

In terms of active asset management opportunities, these could include: repurposing of repriced retail assets on the back of improving consumer spending, conversion of retail to high turnover storage to support the growth of ecommerce, conversion of secondary offices to residential, refurbishment of obsolete offices to high standard space with strong ESG credentials.

Major investment transactions in Q3 2021

Country/City	Sector	Property	Buyer	Seller	Price (Euro million)
Germany/Frankfurt	Office	T1	Allianz, BVK	Groß & Partner	1,400
Netherlands/Eindhoven	Office (science park)	High Tech Campus Eindhoven	Oaktree Capital	Ramphastos Investements	1,044
Finland	Office	Portfolio of 22 props	Castellum AB	Brunswick RE/ Blackstone	640
Germany/Frankfurt	Office	Skyper	Ampega Real Estate	Allianz	550
France/Paris La Défense	Office	50% Tour Saint-Gobain	Antirion SGR	Generali France	300
Spain/Barcelona	Offices	Portfolio Pentagon (5 buildings leased to regional government)	KanAm Grund Group	AXA	280.5
UK/London WE	Offices	New Bond Street 47-45	Private Middle Eastern	Oxford Properties & Richemont	263
Italy	Logistics	Century portfolio 2021	GLP	Logicor	260
Spain	Logistics	Portfolio Centrum (5 platforms)	P3 Logistics	Pulsar Iberia Logistics	175
UK/London City	Offices	Capital House	Barings	DWS	151
France	Retail	4 Galeries Lafayette	Societe des Grands Magasins	Groupe Galeries Lafayette	150
Portugal/Lisbon	Office	17 Buildings in Quinta da Fonte	Sixth Street	Signal Capital	150
Romania/Bucharest	Office	Campus 6.2&6.3	S Immo	Skanska	97

Source: Savills Research

€270bn
We project that total investment volume will reach this level across the markets we analyse by end of 2021.

ESG update

Understanding the performance of your asset will protect you from being left with a 'stranded asset'

With ESG and net zero at the top of the business agenda, the environmental impact of the built environment has, rightly so, been a key focus. However, as part of this transition the value of real estate is likely to be impacted due to the growing potential for 'stranded assets' – the term used to describe a property which will not meet future energy efficiency standards or market expectations, and as a result will be increasingly exposed to the risk of early obsolescence. Increasingly investors are relying on technical due diligence (TDD), with an evolving 'ESG Due Diligence' element, to inform them about how an asset actually performs and identify potential risks.

A future shift away from modelled energy use (such as EPCs) towards metered actual energy consumption and carbon emissions must also be factored in on investments. If not, many investors will have portfolios of properties that will not meet forthcoming energy performance legislation. Understanding the current energy intensity and carbon performance of a building, relative to carbon budgets, is a key area of risk for investors. It is likely that in the future those assets with a high carbon intensity, which are exceeding their carbon budgets, may be unlettable and subject to financial penalties under future legislation. During a TDD exercise, the carbon emissions of an asset can be benchmarked against known industry carbon budgets and a client's carbon reduction ambitions, just one ESG factor that is increasingly impacting on asset value and investment decisions.

An asset may be performing badly now, but there are opportunities to make improvements and ultimately add value. The leasing structure of a building can drive the ability to influence this process. It can relate to both lease events and the type of occupier, which may make it easier, or possibly harder, to improve the ESG performance of a property. Understanding this 'potential to improve' and the long-term performance is critical during an investment process, to avoid assets being discounted due to current poor performance and to ensure ESG enhancements are factored into capex plans and investment financial figures.

As always, to be forewarned is to be forearmed and this knowledge will enable an investor to influence their asset value in line with changing legislation, ensuring they do not become stranded when it comes to ESG.

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Savills Commercial Research
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