European Commercial - December 2019

SPOTLIGHT
Savills Research

European Property Themes 2020+

savills

2019 review ● Investment tips ● 2020 predictions

> “Rental growth prospects remain positive for most property types, however we believe that they will be more restrained (2% for prime CBD offices) due to the slower economic activity”

2019 IS COMING TO AN END

Another year of (un)predictable political events, of an (un)anticipated economic slowdown, of (un)expected extreme weather conditions and for European real estate another year closer to the hard-to-predict peak of the investment cycle. 2019 was once again characterised by high competition for prime assets, ever so low(er) yields and high flows of capital in real estate.

According to Oxford Economics the global economy will continue to slow in 2020 with a 30% probability of a global recession. Uncertainty, particularly over tariffs and Brexit will continue to be a drag on business investment in Europe. While ECB monetary policy has helped financial conditions, expansionary fiscal policy is now required from governments to boost demand. GDP growth in the Eurozone is forecast to reach 1.2% pa this year and slow down to 1.0% in 2020.

In this context of low interest rates and low cost of debt, property will continue to offer better returns compared to other assets, despite the fact that prime yields are at record lows and have fallen even below 3% in some core markets. In this publication we look back at our 2019 hypotheses and we provide our predictions for the European property themes of 2020.

Our hypotheses for 2019

Were our predictions for 2019 correct?

DEFENSIVE OFFICES
Offices indeed remained the top investor pick in 2019. In Q3 19 offices accounted for 42% of the total activity compared to 38% last year and the average prime CBD rental growth reached 6.3%, above the 3.4% that we predicted last year.

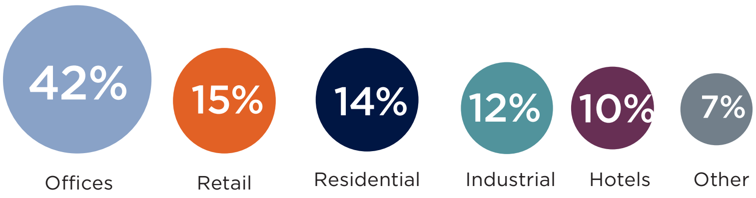
RESIDENTIAL FOR INCOME
Residential has become the fourth largest investment sector and is growing. Multifamily investment up to Q3 was over 20% of total compared to 16% in 2018.

LACK OF PRIME ASSETS
Lack of prime assets has restrained investment activity in 2019 and we expect that full year investment volumes will miss last year’s total by 18%. Although we expected prime yields to remain stable, they compressed further and in Q3 19 were 12 bps lower yoy on average across sectors.

THE RISE OF LOGISTICS
Occupier demand for logistics was strong in 2019 and prime rents increased by 3.9% yoy on average across Europe (Q3 19). Prime yields moved in by 17bps yoy to 4.49%. Despite rising investor demand the share of logistics investment has not increased. The lack of prime product has become an issue in this market segment too.

SPACE AS A SERVICE
“Space as a service” has captured headlines during the year in many ways. 2019 has been another boom year for flexible office take-up which accounted for 12% (Q1-Q3) of the total compared to 10.5% in 2018, driven by niche operators and landlords who entered the market.

SMART MIXED USE
There are several (re) development urban projects across Europe, which focus on creating dense, mixed use communities (eg Paris, Madrid, Hamburg, Barcelona, Helsinki, Athens, Oslo). In Germany investment in mixed-use assets this year was up 22% yoy (Q3 2019) 46% of which was in new developments.



Investment shares by sector in 2019 (Q1-Q3)

Our predictions for 2020

Infrastructure, Affordability, Sustainability, Repurposing and Space as a Service will be key themes

Investment strategies

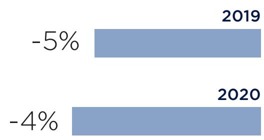
- Investors will continue to search for yield next year and the comparatively attractive returns real estate can offer will keep demand high. With fewer opportunities for organic rental growth and yield compression the search for income-producing assets will be a key driver of the market and investors will be typically buying to hold, which will be limiting stock levels.
- The question "are we close to the peak of the cycle?" will be lingering for another year and as a result we expect flight to quality to prevail. There will be constant competition for prime stock and we expect top grade assets in the best locations to continue to attract multiple bids from investors with core/core plus strategies that are looking for safety. Core markets such as Germany, UK and France as well as the Netherlands, Spain and the Nordics will attract most interest.
- Investors will also seek diversification across sectors and geographies, as long as the assets are best-in-class. A rising number of players are expanding in the market segments that are positively affected by structural changes (technology and demographics) such as logistics, data centres, healthcare and living sectors. Local and intra-regional players who are already familiar with their markets, will be more competitive. Others will be following GDP growth and will be choosing markets which are later in the economic cycle and still growing (such as Portugal, Greece, Romania).
- Some less risk-averse players and developers will be looking for value add opportunities through new construction, refurbishment and re-purposing. Development activity in under supplied areas and around new transport hubs may rise. The repricing in the retail sector will bring more opportunities to the fore, especially in the countries with higher consumer spending such as the UK, Germany and France.
- Regarding source of capital, we anticipate European investors will account for the largest cross-border investment flow. US capital will remain active, while it is likely to see some slowdown of capital inflows from Asia as pricing becomes even more competitive.
- Looking forward, Savills Research forecast that the majority of core markets expect stable yields during the forecast period, while there is the most room for prime office yield compression in the Athens and Bucharest markets over the next 12 months. Warsaw, Lisbon, Budapest and Milan offices could also see some additional yield hardening. Further industrial yield compression is expected across Germany, France, Portugal, Spain, Greece, Sweden, Czech Republic and Romania. In the retail sector, yield softening is expected in the sector notably in the UK, France, Norway, Sweden, Spain and Portugal, whilst it should remain stable in Germany, Netherlands, Italy and Poland.

Landlords as operators

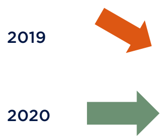
- Landlord-tenant relationship is changing, as small and large tenants across sectors are expecting a higher degree of service, convenience and flexibility from property owners. Commercial investors are not rent-collectors any more but operators of space. Despite the fact that this makes asset management more intensive and costly, it also offers a competitive advantage: adaptability in a fast changing world. Space can adapt to technological change, to dynamic business environments, to economic uncertainty, by offering to tenants what they need and maximising occupancy.
- The case of WeWork is a good example of the opportunities and risks involved in this model, but despite negative publicity and criticism the trend is irreversible and spreading across sectors.
- In retail there is demand for this type of space offer from both emerging and established brands. For landlords this may mean 'white-boxing' space with additional services, including customer data analytics, design, performance measurement, last mile logistics and marketing, on an all-in cost basis similar to the co-working model. Some landlords are already testing this approach as part of their overall offer. Macerich, a mall REIT in the US, launched 'Brandbox' in 2018, a turnkey concept largely aimed at digitally native brands who want to make the leap to physical stores. The offer is a complete package of flexible real estate and services.
- In the residential sector co-living, a shared urban living concept which focuses on communal living could cause disruption in the multi-let residential sector as well, offering short leases, furnished apartments and a range of all-inclusive services. This type of space meets the needs of students and young professionals who are struggling to find good quality living space at affordable prices in dense urban centres. Additionally the concept is appealing to urban migrants who are looking to integrate and connect with other people. Companies like The Collective and Quarters who are strong in the US are also testing the European market starting from London and Berlin, while plenty of other operators have also defined themselves as offering "co-living" or "shared-living" accommodation.
- The concept of space as a service is disrupting other property sectors too. Dark kitchens, food markets, pop-up stores are all concepts promoting flexibility and sharing and they support young businesses and start-ups. Flexspace in the UK for example is a provider of flexible office, workshop, industrial and self storage space for small to medium enterprises.

Projected key figures & trends

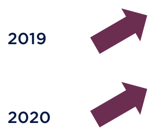
Investment activity (yoy)



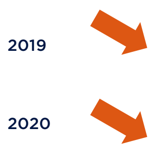
Prime office yield trends



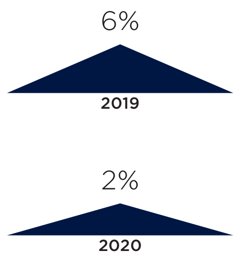
Prime retail yield trends



Prime industrial yield trends



Prime office rental growth



Source Savills

> "Prime offices, logistics and multifamily assets in well connected locations will suit core (+) strategies due to demand and supply imbalances"

2020 EUROPEAN HOT SPOTS

TOP PICKS FOR CORE / CORE+

1. Prime CBD and well connected non-CBD offices in cities with solid occupier demand and low vacancy such as Berlin, Paris, Munich, Dublin and London, Good rental growth prospects in Madrid, Barcelona, Stockholm, Amsterdam, Oslo, Luxembourg and some further yield compression in Milan and Warsaw.
2. Logistics assets in strategically located areas with demand and supply imbalances and rising e-commerce penetration in Germany, Netherlands, Poland and Czech Republic.
3. Residential for rent (multifamily) in countries with strong urbanisation trends and housing shortages such as Stockholm, Helsinki, Copenhagen and in the top four Dutch cities, for secure long term income streams.

TOP PICKS FOR VALUE-ADD

1. Office development and refurbishments in CBD and non-CBD locations in cities with strong fundamentals such as Stockholm and Paris and smaller markets such as Luxembourg, Lisbon.
2. Retail repositioning of good quality schemes in mature retail markets such as the UK and Germany.
3. Hospitality in tourist destinations with rising visitor numbers such as Italy, Portugal, Greece.

TOP PICKS FOR OPPORTUNISTIC

1. Repriced secondary retail schemes for redevelopment/repurposing in countries where e-commerce has impacted retailer demand.
2. Office development in non-core, higher yielding cities such as Athens and Bucharest.

Re-purposing

- Disruption across all property sectors has forced landlords to ensure their space works harder for the end user. The growth of online retail has pushed landlords to increase the provision of experience-led retail and is forecast to account for 15% of total retail sales in Western Europe by 2023. Landlords with a high retail exposure are investigating opportunities to adapt their space in order to maintain attractiveness and increase dwell time and ultimately revenue. Food halls, as witnessed at Platea, Madrid (a former cinema); experience centres such as Samsung at Kings Cross, London and even Emporio Armani's Caffè, Munich are good examples of re-purposed schemes where retailers are becoming more innovative with their space to engage with their customers.
- E-commerce has created further demand for last mile logistics space in Europe's most digital cities. Parts of retail parks in well-connected locations can be converted to urban logistics hubs to enhance their performance. SEGRO's development of a multi-storey industrial warehousing in the Paris outskirts reflects the competition for land in the last mile.
- A shortage of new homes has increased demand for rented accommodation across Europe. Residential has become not only a viable but also profitable alternative for obsolete or under-performing assets, as part of re-purposing or mixed use strategies. Offices in the Avenida da Liberdade, Lisbon, for example, have been converted into hotel and apartment use, which have achieved higher rental levels as new office sub-markets ooze out of the traditional CBDs. Similarly in the centre of Athens some old office buildings have been converted into boutique hotels often combined with retail and F&B.
- Flexible offices, leisure, food-halls and health and fitness are all uses that enhance the vitality of mixed use environments and improve the user's experience.

Affordability

- Urbanisation across Europe has increased competition for space within key gateway cities. Office occupiers have seen prime rents increase between 4-6% per annum on average since 2014, tightening their operating profit margins. However, Savills What Workers Want survey indicates that the majority of Europe's workers want to work in a city centre, which reflects the majority of a business' costs. In an increasingly cost conscious environment, office occupiers will seek to increase desk utilisation rates from what is currently around 66% across European cities. Occupiers are now increasingly looking towards the flexible office sector as a solution to optimise their workplace usage. Flexibility of lease comes at a premium however- those businesses able to forward-plan their real estate decisions will stick to longer, more institutional-friendly leases.
- With a shortage of new residential developments across Europe's cities, more young people are turning to the co-living sector as buying a home fast becomes a pipe-dream. Berlin's government has agreed to a five year freeze on rents to counter rising housing costs in the German capital in an attempt to tackle this. Despite this, investors have perceived this as an opportunity, particularly in the Netherlands, Germany and Nordics, where multifamily investment volumes have been comparable with offices in recent years.
- Declining footfall across some of Europe's mass market high streets has meant that we have seen a slight softening of rents in Oxford Street, London and Kalverstraat, Amsterdam. However, there are a number of factors in play including high business rates for existing retailers and a shortage of smaller unit sizes available for retailers.
- The structural growth of online retail has heaped upward rental pressure on last mile logistics tenants. Although this is a smaller proportion of total operating costs for tenants, logistics operators are investigating automating roles through robotics in warehouses.

Infrastructure & mobility

- Strong urbanisation and surging density across European capital cities had a severe knock-on effect on urban sprawling over the past decade. In order to attract a growing number of students, talents and tourists, local authorities are moving towards planned poly-centric urban development to unclog city centres by creating new satellite peripheral hubs. Yet, city centres remain the place to be for youth, talents and tourists. Savills What Workers Want survey indicates that nearly half of Europe's workers want to work in a city centre and 47% use public transport to go to work.
- Poly-centric development can only be successful with strong connectivity to both city centres and other secondary areas. Over the past few years, a growing number of urban public transport infrastructure projects has seen the light or has been planned for the coming 10-20 years. This is notably the case in London (Elizabeth line), Paris (Grand Paris Express), Berlin (Extension of U-Bahn and tram), Munich (Extension of U-Bahn and tram), and Helsinki (Jokeri Intercity tram line) to name a few.
- Grand Paris Express, is probably the most striking example of the catalyst effect on property development activity trigged by new transport network. This vast project includes four new fully automatic metro lines totalling 205 kms, two extended lines and 68 new stations due to be delivered within the 2020-2030 horizon. Some 2.6m sqm of real estate are already planned over time including 815,000 sqm of residential development and 650,000 sqm of commercial property. All schemes are located within easy reach of the new Grand Paris Express stations, with some clear new tertiary hubs already taking shape such as Saint-Denis Pleyel, accelerating development of recent areas such as Clichy/Batignolles and some expansion of existing businesses districts such as La Defense.
- Development activity in these new or expanding tertiary hot spots provides the market with great and competitive opportunities for investors, especially in markets where prime assets are scarce and highly-priced (Top German cities and French capital). Good transport connectivity has recently become a key decision-making factor for investors. According to the Emerging Trends Europe 2020 survey, transport connectivity is currently the top consideration in selecting a city for investment or development, before forecasted returns.

Environmental, Social and Governance policies (ESG)

- Whilst real concerns over Environmental, Social and Governance policies (ESG) hardly took off over the course of the past century, 2019 will certainly act as a wake-up call. Loud public outcry and multiplying voices clamouring over the effects of climate change have made the headline news. At the same time, Europe and the rest of the world were hit by several episodes of extreme weather conditions.
- Additionally, in March this year, the EU has taken an important step forward on advancing sustainable finance as the EU Parliament and Council achieved political agreement on requiring ESG integration. By the end of 2020, asset managers, investment funds, insurance companies, pension funds and intermediaries will have to publish their policies on the integration of sustainability risks in their investment decision-making process.
- Of the three pillars that commonly define ESG policies, environmental factors tend to be the easiest to assess and measure. As a matter of fact, buildings account for more than one third of global energy consumption and 40% of total CO_2 emissions. Whilst the social and governance dimensions, which implies less tangible ethical and moral criteria, are more complex to embed. In the dawn of this very broad concept, ESG rating agencies and services providers using different approaches and methodologies are multiplying, creating further confusion amongst investors.
- Overall, the rise in environmentally conscious initiatives are clearly indicative of a gradual systemic shift from local authorities and populations. Still, according to the Emerging Trends Europe 2020, 26% of the surveyed investors do not see any material impact from climate change on their portfolio for now. However around a fifth believe it is already leading to greater capital expenditure, higher operational costs and faster obsolescence. The reality is that establishing the direct correlation between low ESG risk and better returns remains a challenge.
- There is a large breadth in ESG credentials across property types, with some practical limits applying to certain sectors and some natural leverage benefiting to other sectors. We believe that in the long run, some asset classes are likely to profit from ESG policies as their intrinsic nature appear to be more "ESG–proof" than others, such as social housing, healthcare, education, urban farming and to a lesser extend mixed-use properties. Within the traditional sectors, office appears to be the easiest property type to implement ESG policies. Firstly because office tenants are increasingly concerned about their employees' experience and sustainability matters. Secondly because investors are more likely to have an operational control over their assets, which is crucial to make sure the building is managed in a sustainable ways.

HALF
Of European employees want to work in city centres.

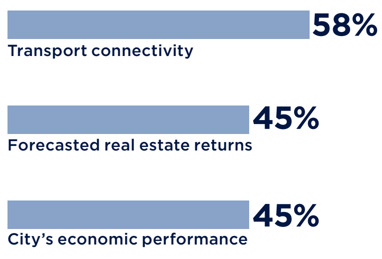
47%
Of European employees use public transport.

44%
Of European employees spend more than 30 minutes to commute, of which 10% spend more than one hour.

74%
Of European employees find that transport connectivity is an important factor for their ideal workplace.

Source: Savills What Workers Want survey 2019

Transport connectivity is currently the top consideration in selecting a city for investment or development, before forecasted returns



Source: Emerging trends Europe Survey 2020 / Question: Importance when selecting a city for investment or devlopement

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