SPOTLIGHT
Savills Research

European Investment

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● European investment ● Market fundamentals ● Outlook

> "The overarching theme in investor preferences is flight to quality. Prime, core assets across sectors will continue to attract multiple bids, and competition will lead to some further yield hardening."

Investors focus on quality

Despite the abundance of capital targeting real estate, first quarter activity was restricted by the ongoing COVID-19 measures

The pandemic keeps activity levels low

Investment activity in the first quarter of 2021 has slowed down considerably compared to the same quarter last year. This is not surprising as most countries were still under strict lockdowns, while travel restrictions and requirements for quarantines upon entry have limited mobility and the ability to view assets. The total volume invested in the 19 markets we monitor was over €52.7bn, which is 41% down vs the same quarter last year and 18% below the five-year average. The rolling 4-quarter investment volume was close to €210bn, the lowest since Q3 2014. It is worth noting that Q1 2020 was a record high quarter, and was achieved just before the World Health Organization declared the coronavirus outbreak a pandemic in March 2020.

Germany was still the largest market despite the 47% yoy fall, and captured 30% of the total, followed by the UK (-34% yoy) at 25%. France's share dropped just below 10% and annual volumes dropped by -37% yoy. Sweden (-37% yoy) accounted for 8% of the total and Denmark entered for the first time the top five with a share of 5%.

Smaller markets relying heavily on cross-border capital such as the Czech Republic, Portugal, Belgium and Luxembourg experienced the steepest falls (over 80%). In Ireland (107%) and Denmark (21%), market activity was higher than last year, driven by high activity in the residential market segments.

According to RCA, the volume of cross-border capital invested in Europe dropped by almost 31% yoy in Q1 2021. The UK market attracted over one third of total, followed by Germany at one fifth. France and Denmark accounted for 12% and 11% respectively. The US remained the largest source of capital (40%), despite the fact that it registered a high drop last year (-29% yoy). German and Swedish capital accounted for another 13% each.

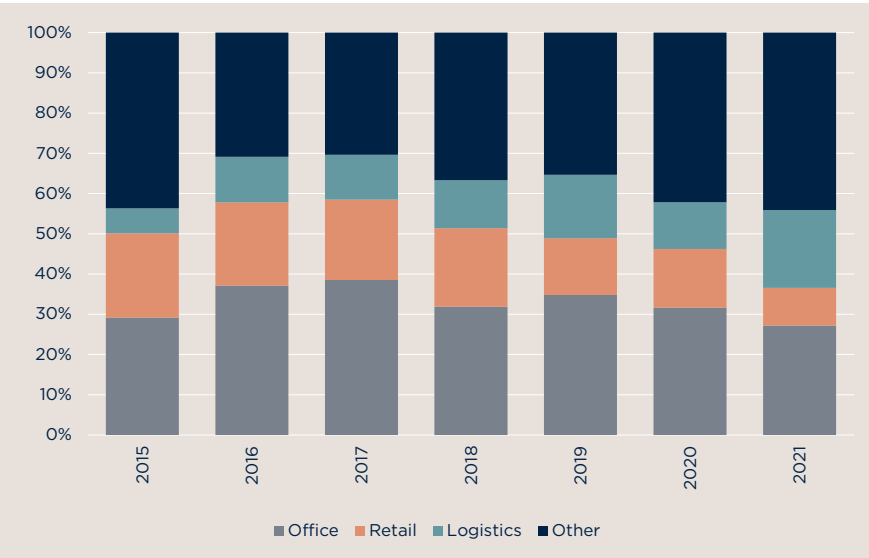
Overall the share of cross border investment declined slightly from 59% to 57% on average yoy, with the highest drops noted in Czech Republic, Sweden and France. Travel restrictions have constrained the activity of overseas investors, especially from Asia, but also the US and even the UK. European capital increased its share of cross border investment from a five-year average of 46% to 52% in Q1 2021.

Alternatives benefit further from investment diversification

A marked shift in sector focus has been recorded over the first quarter of this year. The share of office investment in Q1 dropped for the first time since Q1 2015 to 27% of the total investment activity, compared to its five-year average of 35% (Q1). Similarly, retail share dropped for the first time below 10% to 9%. The share of logistics sector jumped from a five-year average of 12% to 19%, while the alternatives sector (including living and other sectors) saw a further rise to 44% of total. These changes in investor priorities mirror the certainties and uncertainties caused by the pandemic; the steady rise of e-commerce has benefited logistics and harmed retail, changing ways of working have made investors more cautious towards offices and the quality of income streams of the living sectors keeps attracting new players in the sector.

The multifamily segment alone accounted for about one fifth of the total investment volume, up from a five year average of 13%. A number of markets stand out with historic high levels of activity. Multifamily captured a record high of 58% of the total in Ireland, over 50% in Spain, 40% in Finland and 37% in Germany. Numerous new specialty funds have been launched and investments have been targeting the few stabilised assets and mostly new development projects.

European investment Q1 2021 by sector



Source: Savills Research

19%
The share of logistics sector, up from a five-year average of 12%

-32%

Overall Q1 2021 office investment activity was down 32% against the Q1 five-year average, due to a shortage of vendors openly marketing prime assets.

The total investment volume in Q1 was over €52.7bn, which is 18% below the five-year average

The share of office investment in Q1 dropped for the first time since Q1 2015 to 27% of the total investment activity

Germany was still the largest market despite the 47% yoy fall

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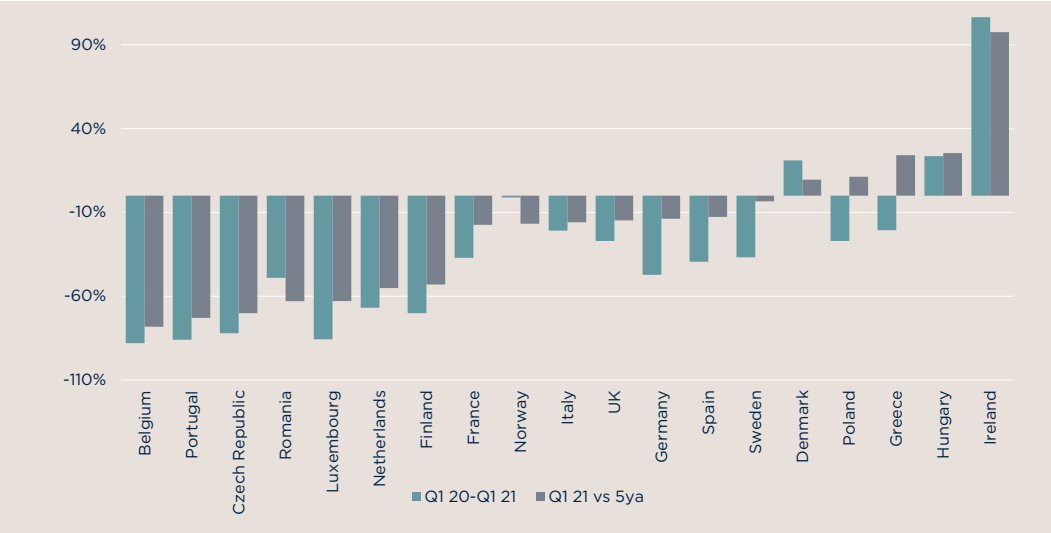
European investment Q1 2021 % change vs Q1 20 and vs 5-year average



Source: Savills Research

Fundamentals determined by structural factors

The future of work, the rise of e-commerce, ageing population and rising demand for rental housing are some of the structural factors affecting real estate fundamentals

Mixed picture in the office segment

Despite the role of the future of the office continuing to divide opinions, investor demand for Europe's prime CBD offices has remained resilient. However, overall Q1 2021 office investment activity was down 32% against the Q1 five-year average, due to a shortage of vendors openly marketing prime assets.

Office occupational market is still slow, but there are signs of a gradual pick-up in tenant demand, as speculation about the future of offices has receded. Companies in their majority are expected to support flexible and agile working, but they still expect the majority of their stuff to be back in office.

The slowdown of leasing activity has translated into a rise of the average vacancy rate to 7.1% from a low of 5.2% in Q4 2019, still below the 9% equilibrium that historically has led to negative prime rental growth.

Prime CBD headline office rents in Q1 remained stable on average, with a divergence of falling rents in 42% of the markets and the remaining registering stable of rising values (annually). Top performers were secondary/non-capital cities such as Lisbon (8.7%), Hamburg (8.3%) and Gothenburg (4.2%) and bottom performers were Dublin (-11.6%), Cologne (-5.1%) and Berlin (-4.3%). The picture is mixed for good quality offices located in secondary areas, which in some cases have achieved higher rents, due to tenant demand for cheaper space for cost efficiency.

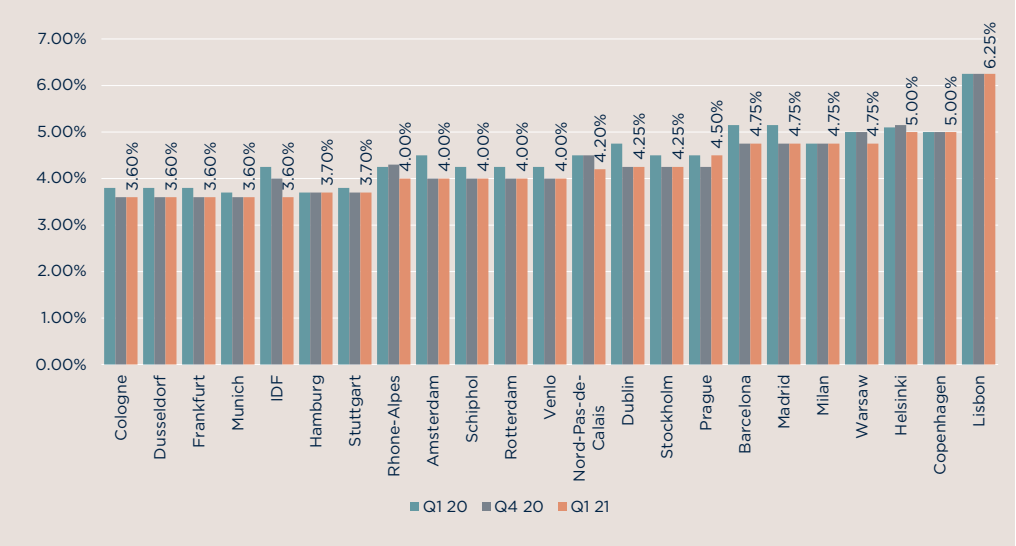
The market segments that are likely to suffer more are low specification offices, which may struggle to find again tenants in the long-term. This should lead to redevelopment/repurposing opportunities, for investors with a more opportunistic risk profile.

Not enough supply of assets to meet demand for logistics

With regards to logistics, a massive shift of investor interest to a market segment that historically has not captured more than 12% of the investment activity, causes a lot of competition. Yields are down to record low levels, with quality of location and strength of covenant driving pricing. Investor confidence is underpinned by the strong fundamentals of the sector.

Vacancy rates are falling across most markets and prime rents are on the rise. Prime logistics rents increased by 1.3% on average last year with strong rises in Hamburg (6.7%), Central Poland (5.3%) and Rotterdam (3.6%). In Q1 the positive trend was led by London SE (9.3%), Dublin and Helsinki (2.3%). The competitive environment has already led to record capital values and shortage of greenfield land around the large cities is expected to be the key factor behind rising rental values.

Prime logistics yields have moved in to record low levels



Source: Savills Research

Acceleration of structural changes in retail

The pandemic has brought forward the expected disruption from the rise of ecommerce to physical shopping and owners of retail premises face the pressure to adapt to consumer's expectations for an omni-channel experience. In some cases, units and assets may lose their lettability for retail uses indefinitely, with the option to welcome complementary uses, which can contribute to customer experience and enhance the sense of placemaking (See Re:Imagining Retail #2). The location of some void retail assets may also become attractive for alternative uses, such as services, medical, storage, dark stores, co-working and others.

On the contrary, assets related to the food sector, such as discounters, supermarket anchored retail schemes and to a less extent hypermarkets attract multiple bids and yields are moving in. The stability and length of income streams is what makes this segment desirable especially for investors with long-term liabilities. The sector was traditionally capturing 5-6% of total retail investment. This jumped to 25% last year, but sourcing product to match demand will be a challenge this year. Supermarkets have become the new retail core.(See Savills_Spotlight_European Food Sector_April 21)

Living sectors are a defensive play

The minimal impact of the health crisis on investor appetite for the living sectors is supported by their strong fundamentals and defensive characteristics. Housing is a basic need and rent collection rates have remained higher compared to other property sectors during the pandemic. Additionally, demand for rental is rising in periods of economic uncertainty, as people feel less secure about their future finances and mortgage lending for house buyers becomes more strict. While PBSA occupancy rates dropped significantly during the pandemic, rising student numbers and low supply ratios in many European university cities, still drive investor demand. Long-term structural changes, such as ageing population, shrinking household sizes and demand for affordable housing in combination with shortage of supply of well-designed product support the investment case of living sectors.

> "Investors show confidence in assets related to the food sector, such as discounters, supermarkets and supermarket anchored retail schemes due to the stability and lenght of their income streams."

Investment volume projection 2021

We anticipate investment activity to normalise in the coming quarters, assuming a successful rollout of the vaccination programme, which should allow return to some degree of normality, allowing travelling and site visits. With no shortage of capital targeting real estate we believe investment turnover could reach last year's levels, which was about 10% below five-year average.

Yield trend projection 2021

With regards to yields, competition for the best assets will continue to put pressure on prime yields. On average we project prime CBD office yields to move in by another -10bps and prime logistics yields by -25bps, hitting another record low level. Although prime shopping centre yields in most markets are likely to further correct by up to 25bps in most markets by the end of the year, we may see some exceptions for best in class assets in affluent cities.

-10%

Total investment turnover this year is expected to be below the five-year average

Renewed yield compression in Q1

Investor competition for the best assets has led to further yield compression and record low levels, particularly in the logistics sector

Prime office yields remain keen

The shock of the pandemic has brought prime yield compression to a halt last year, but despite the slowdown of transaction activity due to practical reasons, investor confidence in the strength of real estate as an asset class has led to renewed yield compression. On average prime CBD office yields moved in slightly by 4 bps yoy to 3.58%. On an annual basis, prime office yields have hardened in Oslo by -40bps, London WE, Brussels and Milan by -30bps and Paris and Hamburg by -20bps. Yields have softened in Paris La Defense, Warsaw and Manchester by 30bps.

Focussing on the core markets, Paris CBD yields remained stable at 2.75% during the first quarter, while Berlin hardened by 10 bps to 2.6% as German investors remain in the market for super-core assets. London still remains at a discount to mainland European core markets, as West End yields remain at 3.50% and City yields at 4.00%. UK debt rates remain more expensive than other core markets, with UK sovereign bonds currently yielding 0.7%, providing a similar yield spread to that of the core German and French markets. London's global liquidity and rental growth expectations will continue to attract cash-rich buyers.

Prime Brussels offices have remained stable at 3.25%, with some resilient demand for ultra-long income outside non-core markets trading around the 3% mark.

Across Southern Europe, prime yields remain unchanged over the course of the pandemic and insurance companies are still bidding aggressively for strong covenants, although product remains hard to find. Non CBD stock is subsequently taking longer to transact.

Investors remain in search for long income within the non-core markets, and are more price sensitive to the tenant covenant strength. Since Q3 2020, Warsaw prime yields have moved out 10 bps to 4.6%, although Prague (4.10%) and Bucharest (7.00%) have held stable.

Rising energy prices are forecast to impact the Nordics markets more heavily, increased the inflation forecast in particular for Oslo, Stockholm office stock has not traded as actively over the last 12 months, with prime yields remaining stable at 3.25%.

Secondary office yields have remained relatively stable on a quarterly basis. The yield gap between prime and secondary yields had reached its lowest point in Q2 last year (68.6 bps) and ever since it has been gradually widening, with the Prime achievable CBD vs Secondary CBD yield gap at 87.5bps.

Logistics yields at record low levels

The strongest yield compression has been observed in the logistics sector, reflecting the impact of large amounts of capital competing for limited assets in the market. Average achievable prime industrial yields were at 4.5% in Q1 2020, moved in to 4.3% by the end of the year and a further 5bps in Q1 2021 to 4.25%. These pricing levels are unprecedented and set new standards for the sector. Prime logistics yields are already below the 4% threshold in the German cities and Ile-de-France, while still at 4% in the Dutch markets. Prime achievable yields are at 5% or above only in Helsinki, Copenhagen, and Lisbon.

Retail yields are softening, but not for supermarkets

The trend has been different for prime shopping centre yields which, continue to soften. Since the end of last year they were 5.17% on average and in Q1 they moved to 5.23%, which is 47bps above Q1 2020. On an annual basis the strongest corrections were observed in London (150 bps) Dublin (75bps) and the German cities (70bps).

Repriced opportunities have started attracting investor attention, such as prime UK retail parks, which have registered for the first time since Q1 2018, an inward yield shift from 6.25% last year to 6.0% in Q1 2021. Overall prime retail warehousing yields have moved out by 18 bps yoy to 5.15%.

Supermarket yields are a noticeable exception to the overall retail trend. Their strong performance during the pandemic has established the sector as a defensive play for investment strategies. Investors are keen to secure these assets which offer stable incomes and long leases to strong covenants. Prime supermarket yields were down by 11% bps on a quarterly basis and 28bps on a yearly basis to 5.4% in Q1 2021.

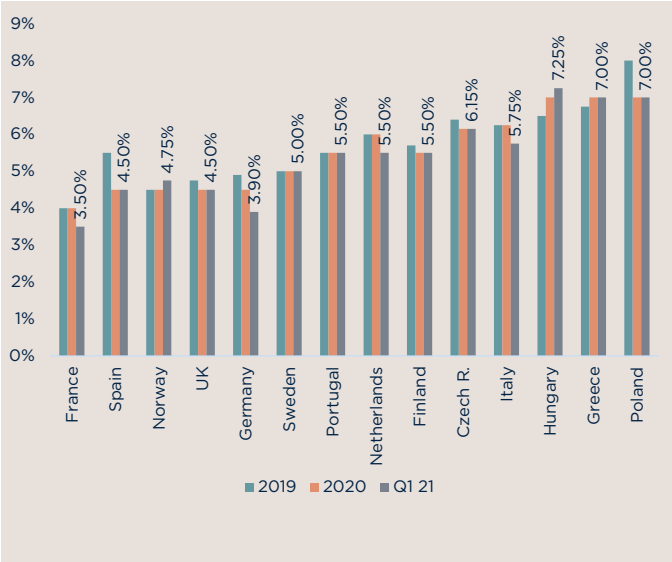
PBSA and Senior housing still offer some yield premium

Intense competition has been pushing yields down over the past few years. The average prime multifamily yield has compressed by 120 basis points (bps) since 2012 to reach a record low of 3.24% in 2020. Prime net multifamily yields range from 2.4% in Berlin to 5.0% in Warsaw, although in the majority of markets command prime net yields of 3.0% to 3.5%.

Prime net student housing yields (PBSA) are at 4.4% on average, stable on a quarterly basis and range between 3.5% (Copenhagen) and over 4.5% (Madrid, Lisbon, Warsaw).

Prime senior housing yields range between 3.3% and 4% and prime care home yields range between 3.5% and 5.75%. This means that senior housing and care homes offer a yield discount of 50 and 90 basis points respectively over multifamily assets.

European supermarket yields Q1 2021 by country



Source: Savills Research

Major investment transactions in Q1 2021

Country/City	Sector	Property	Buyer	Seller	Price
Norway	Industrial (company acquisition)	ABP (106 industrial-led assets)	Balder	Asset Buyout Partners	€900m
France/ Issy-les Moulineaux	Office	Shift	Primonial / La Francaise / EDF Invest	Unibail - Rodamco - Westfield	€627.4m
UK	Retail	Seven retail warehouse parks	Brookfield AM	Hammerson Plc	€382.8m
UK	Logistics	Seven warehouses	BentallGreenOak	BentallGreenOak Morgan Stanley/ Thor	€351.5m
France / Montreuil	Office	Tour Altais	Gulf Islamic Investments	Oaktree / Arpent Capital / Maple Knoll Capital	€250m
Spain / Madrid	Hotels	Plaza Celenque, 2 - The Madrid Edition	Archer Hotel Capital	Perella (KKH Property Investors)	€205m
Portugal / Lisbon	Offices	Portfolio Navigator	Confidential / Singaporean listed fund	Rivercrown	€120m
Italy / Milan, Rome	Logistics	Logistic Portfolio (7 assets)	GLP	Tristan Capital Partners / BNP Paribas REIM SGR	>€100m

Source: Savills Research

4.1% yoy
GDP growth is forecast (Focus Economics) to reach 4.1% in 2021 and 2022 in the Euro Area

Outlook

The overarching theme in investor preferences is flight to quality. Prime, core assets across sectors will continue to attract multiple bids, and competition will lead to some further yield hardening. Supply of assets is restricted, as landlords are cautious about bringing product on the market. Value-add opportunities also attract interest, with the fundamentals of the micro-location playing the most important role.

Office take-up in Q1 was still 25% on average down yoy, which is comparable to the market drop post the Global Financial Crisis (GFC) and in line with 2009 levels. Post GFC, it took the occupier markets about a year to bounce back (30% up in 2010). Are we going to see a similar recovery post-pandemic? Consensus forecasts from Focus Economics point to a robust economic expansion this year. Pent-up spending demand will be supported by expansionary fiscal and monetary policies as well EU recovery funds.

GDP growth is forecast (Focus Economics) to reach 4.1% in 2021 and 2022 in the Euro Area. Unemployment picked up in 2020 to 8.0% and is predicted to rise further to 8.6% this year before start falling again in 2022 to 8.2%. This could mean that we may see a gradual return to normality in office leasing this year and a pick up next year. Already we observed an improvement in occupier sentiment in the first quarter of 2021, and into Q2 2021. We are seeing more examples of occupiers removing grey space from the market, which should stabilise the level of availability. We expect this to gather momentum throughout the rest of H1 2021 as businesses begin to contemplate life beyond the pandemic.

We believe that the winners will be high quality, well located and connected offices with green credentials, while older assets will require substantial investment to upgrade or convert. These assets are already trading at significant discounts. A significant factor to property marketability are the ESG credentials of the asset. This has become a prerequisite for all investors who are looking more closely to the energy certification of the building, waste management, air quality and open, green or public civic spaces – in case of city centre buildings.

Rising e-commerce penetration will continue to drive demand for logistics space in the coming years. Forrester forecasts that the share of online shares in Western Europe will rise from 11.9% in 2019 to 18% in 2021. Most importantly the current supply of space is limited and the supply of land around the major European cities is also restricted or controlled by local planning regulations. This is expected to cause upward pressure on prime rents in the future, as companies compete for the best locations. We expect smaller warehouses within or closer to urban areas to outperform. Forward funding deals and partnerships with developers are often the best route to acquiring assets in this market segment.

Savills Commercial Research
We provide bespoke services for landowners, developers, occupiers and investors across the lifecycle of residential, commercial or mixed-use projects. We add value by providing our clients with research-backed advice and consultancy through our market-leading global research team.

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