

European Investment



A shortage of vendors

Germany drives European investment transactions during 2020 as investors opt for core.

Economic Overview

Europe's second wave of coronavirus continues to dominate the economic headlines and shape the impact of the recovery as the European economy chugs into the final quarter of the year.

Economists are anticipating the European Central Bank will provide more monetary support, lifting the PEPP (Pandemic Emergency Purchase Programme) from €1.35 trillion to €2 trillion in December 2020, providing a further cash injection to stimulate demand and avoid a deflationary spiral. However, less than half of the €1.35 trillion PEPP has been invested thus far, so there is still more unallocated capital from the asset purchase programme to boost the Eurozone economy.

This will aim to maintain business confidence levels and ultimately job stability once furlough schemes are withdrawn over the next two years. Latest evidence indicates that the Eurozone unemployment rate rose to 8.1% in August, up from the pre Covid

low of 7.2%. Focus Economics anticipate that the unemployment rate will peak at 9.5% during Q1 2021, and for Eurozone GDP growth to rebound by 5.3% in 2021, following a 7.9% decline in 2020.

Investment

European commercial and residential investment volumes reached €44.5bn during Q3 2020, marking a 19% increase on Q2 2020, although a 33% decrease on the five year average for the third quarter. Year to date (YTD), investment transactions volumes have reached €164bn, down 15% against the Q1-Q3 five year average of €192bn (Chart 1).

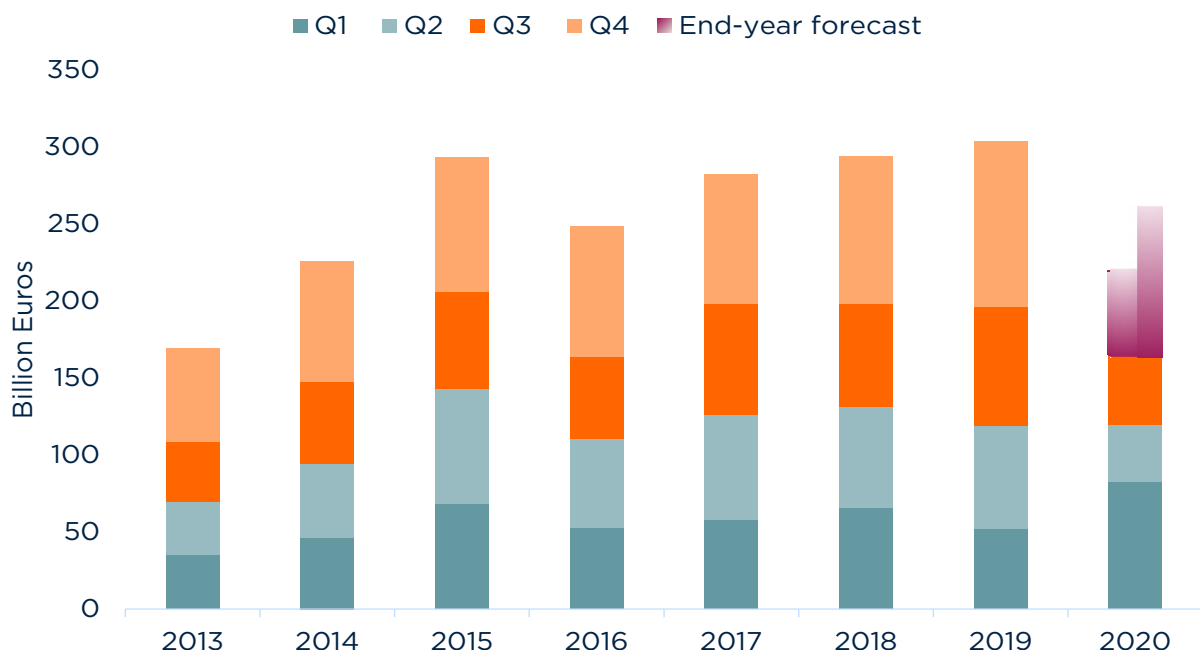
Office investment volumes YTD fell by 26% to €55bn yoy, retail investment fell by 11% yoy to €24bn and logistics investment fell by 8% yoy to €22bn. Multifamily has proven to be the most resilient sector during 2020, representing a 3% fall yoy to €27bn and remains the second most active sector so far this year.

Investor activity across different asset classes has changed tack over the course

of the year. The share of office investment has fallen from 40% in 2019 to 34% YTD during 2020, as we observe proportional increases in retail (from 13% to 15%) and multifamily (12% to 17%). A shortage of prime logistics stock continues to frustrate buyers, as logistics' share rose from 12% to 13% of total transactions.

At country level, investment transaction volumes have varied during Q1-Q3 2020 against five year averages (Chart 2). Germany (+8%) and the Central Eastern European (CEE) countries of Poland (+23%), Romania (+17%) and Czech Republic (+4%) recorded increases during 2020, which can be aligned with a relatively lower infection rate per capita during the first wave of the coronavirus in the CEE. In Portugal, 64% of the €2.1bn investment transactions so far this year has been portfolio deals, including a large retail portfolio during Q1 2020. Brexit negotiations continue to stymie UK investment, although the UK did observe an 85% quarterly rebound in transaction volumes across the three main commercial sectors.

Chart 1: European investment by quarter (€bn)



Source: Savills

- “ The UK market share has fallen from 27% to 20% of Europe’s total activity, as German activity rose from 28% to 34% of total activity. ”

However, delving deeper into the analysis, there are more structural factors at play here. Poland’s €1.9bn of logistics investment has already made it a record year for the sector, accounting for 48% of YTD transactions, as online retail spend was boosted by national lockdowns. In Czech Republic, a €1.3bn of multifamily investment transacted during Q1 2020 boosted total activity, despite more modest Q2 and Q3 volumes. Romania office investment has reached €407m so far this year, marking the strongest year for Romanian office investment since 2007.

Over the last five years, Germany (28%) and the UK (27%) have dominated the market share for investment activity in Europe. However during 2020, the UK market share has fallen from 27% to 20% of Europe’s total activity, as German activity rose from 28% to 34% of total activity. France remains in third place, accounting for 11% of total activity so

far this year, down on last year given the weight of Korean investment targeting the French capital in 2019, although this is still above the five year average of 10%.

Cross border activity

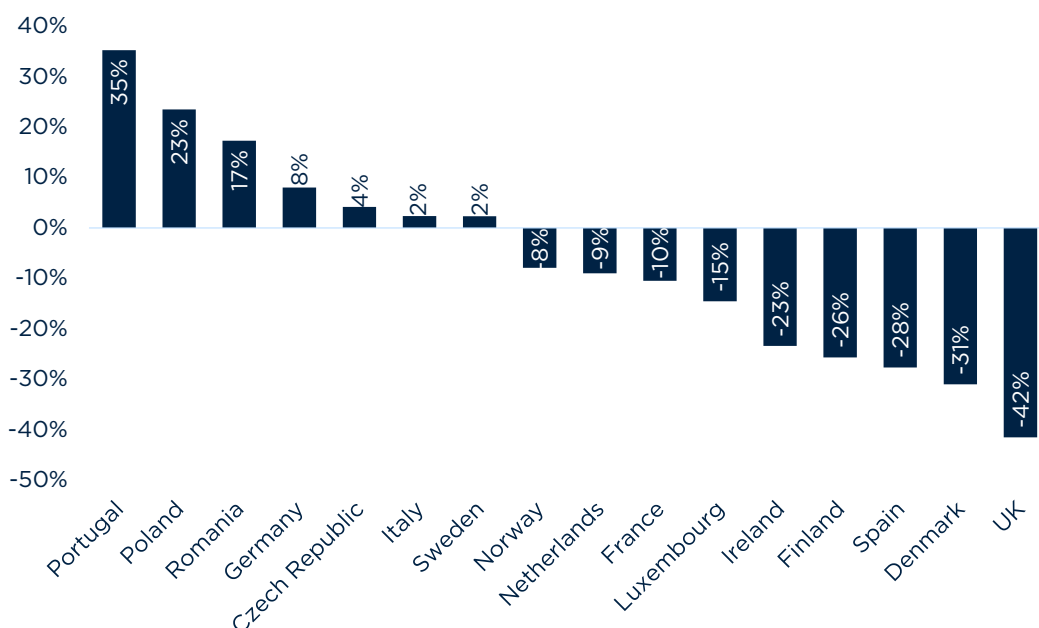
Travel restrictions have limited cross border investment in Europe during 2020, although the reduction has not been as dramatic as some would have anticipated. Cross border transactions fell from 50% to 46% of total activity, according to RCA, accounted for by an increase in private investment activity from 16% to 19%. Another factor at play here is the strength of the Euro which has risen from \$1.12 at end 2019 to \$1.18 in late October 2020, reducing non-European bidders’ competitiveness.

The “flight to familiarity” among cross border investors is reflected in the fact that EME (European and Middle Eastern) investment has risen from 56% to 63% of total cross border activity, as US (30% to 27%)

and Asia Pacific (14% to 11%) both fell proportionally. We are now beginning to see more examples of non-European investors looking for European based equity partners with local expertise in order to deploy capital.

Due to the shortage of openly marketed, single let prime product available in the market, we have observed a rising proportion of portfolio transactions taking place. In France and Germany for example, a combined 44% of transaction volumes were accounted for in portfolio deals, up from 34% in 2019 as investors seek to scale up and deploy dry powder. Due to the extent that investors are looking to increase exposure to the logistics sector, we are observing a premium placed on larger core plus/value add portfolios.

Chart 2: European investment Q1-Q3 2020 vs five year average (% change)



Source: Savills

Yield divergence

Prime CBD office yields remain stable, as logistics pricing intensifies and retail yields move out.

Table 1: Prime Office CBD Yields

City	20 Q1	20 Q3	Yield shift (bps)
Oslo	3.65%	3.25%	-40
Milan	3.25%	3.00%	-25
Paris	2.90%	2.75%	-15
Hamburg	2.90%	2.80%	-10
Stuttgart	2.90%	2.80%	-10
Bucharest	7.00%	7.00%	0
London-City	4.00%	4.00%	0
London-WE	3.75%	3.75%	0
Prague	4.10%	4.10%	0
Cologne	3.00%	3.00%	0
Berlin	2.70%	2.70%	0
Dublin	4.00%	4.00%	0
Dusseldorf	3.00%	3.00%	0
Frankfurt	2.80%	2.80%	0
Stockholm	3.25%	3.25%	0
Munich	2.70%	2.70%	0
Lisbon	4.00%	4.00%	0
Copenhagen	3.50%	3.50%	0
Luxembourg	3.75%	3.75%	0
Madrid	3.25%	3.25%	0
Barcelona	3.75%	3.75%	0
Amsterdam	3.00%	3.05%	5
Helsinki	3.35%	3.45%	10
Manchester	4.75%	5.00%	25
La-Defense	4.00%	4.25%	25
Warsaw	4.35%	4.75%	40
Average	3.60%	3.60%	0

Source: Savills

Offices

European average prime office yields have held stable during the period Q1-Q3 2020 at 3.60%. However, we are beginning to observe a divergence in yield movement between core and non-core markets.

During the Q1-Q3 2020 period, prime office yields have compressed across Oslo (-40 bps), Milan (-25 bps), Paris CBD (-15 bps), Stuttgart (-10 bps) and Hamburg (-10 bps). However, Warsaw (+40 bps), Manchester (+25 bps), La-Defense (+25 bps) and Helsinki (+10 bps) moved outwards. Investors are demonstrating additional caution due to the heightened financing, occupational and liquidity risks across non-core locations.

We have also observed a minor outward movement of 2 bps for average secondary CBD office yields to 4.43% over the last six months- the impact of Covid has not been widely observed thus far. This is perhaps as a result of low vacancy rates across core markets, and asset management upside already being priced in on secondary assets. Manchester (+25 bps), Helsinki (+20 bps) and Amsterdam (+15 bps) secondary offices all moved out, although Oslo (-15 bps) and Munich (-10 bps) compressed, following the trend in prime, and supporting the shift to core cities.

Open ended funds continue to receive net inflows with allocation targets by year-end and many of the German funds are similarly focussed on low risk, core German cities. German banks are willing to lend to core top 7 cities at similar LTVs (loan to value ratios) as during pre-Covid, with similar debt costs.

German banks' willingness to lend on core-plus/value-add German offices, now extends to circa 50-55% LTVs, with higher than pre-Covid debt costs. However, banks are increasingly cautious at lending cross-border and non-core countries' secondary offices with shorter income or rental upside, could observe minor corrections in pricing. Into Q4 2020 and early 2021, we anticipate secondary stock in core CBD markets to remain stable and even potential for prime German stock to harden throughout the year,

due to the shift to a more core strategy.

The main question among core investors remains over the speed of workers' return to offices across Europe and the tweaks to rental growth assumptions over a five to ten year period. We anticipate more visibility over this once a vaccine has been approved and is distributed, although evidence of tenant incentives increasing and tenant controlled office supply returning to the market are being observed.

Logistics

The European logistics sector continues to shine through amid times of adversity, where we have observed average prime yield compression over the last six months of 7 bps to 4.84%. Compression was observed within the Czech Republic (-25 bps to 4.25%), Germany (-20 bps to 3.5%), Norway (-30 bps to 4.25%), the Netherlands (-15 bps to 4.10%) and Spain (-30 bps to 4.85%). Finland prime logistics moved out 10 bps, in line with the trend observed in the offices sector.

Banks' willingness to lend to prime logistics schemes is continuing to support values, and structural changes supported by rising ecommerce penetration during Europe's second wave of coronavirus is supporting capital value growth. Buyers also favour the demographic argument with further urbanisation forecast across Europe's key cities over the next 10 years and rising online sales.

We are seeing more examples of developers building to hold purpose-built assets, which is hampering transactional activity across the major markets. Deals which are re-setting prime yields are generally let to online retailers on single-storey premises, where covenant strength is becoming the main differentiator for pricing.

“ Banks are increasingly cautious at lending cross-border and non-core countries’ secondary offices with shorter income or rental upside could observe minor corrections in pricing.”

Retail

Consumer confidence again dropped in October from -13.9 to -15.5 as a result of reinstated lockdowns and gloomier sentiment over the economic outlook, hindering planned retail expenditure. Despite the extension of a number of Europe’s furlough programmes and increased Eurozone household savings ratios during Q2 2020 to 25% of income, the potential for a consumer bounce-back appears limited. The retail sales rebound has of course been supported to some extent by online activity, as consumer footfall still remains markedly down on pre-Covid levels.

High street retail yields moved out across

a number of markets between Q1-Q3 2020, with average prime yields moving out 15 bps. Amsterdam (+25 bps to 3.75%), Dublin (+50 bps to 4.25%), Helsinki (+50 bps to 5.00%), Lisbon (+25 bps to 4.00%), Milan (+25 bps to 3.25%), Oslo (+15 bps to 4.55%) and Paris (+50 bps to 3.00%) all moved out during this period. German high street yields have remained stable during this period, in line with London Bond Street.

Average European shopping centres prime yields moved out 27 bps between Q1-Q3 2020 as a result of the pandemic and falling shopper footfall. German top 7 markets have moved out by 70 bps over the last six months to 5.00%, comparable with London’s outward

movement to 6.75%. More modest outward movement has been observed in Dublin (+50 bps to 5.5%, Helsinki (+45 bps to 4.8%), Lisbon (+25 bps to 5.00%), Madrid (+25 bps to 5.00%), Milan (+15 bps to 5.4%), Oslo (+15 bps to 5.15%) and Paris (+25 bps to 5.00%). CEE markets, Warsaw and Prague both remained stable, given lower online retail penetration levels and more reliance on shopping centres for retail.

Table 2: Prime Logistics Yields

Country	20 Q1	20 Q3	Yield shift (bps)
Norway	4.55%	4.25%	-30
Spain	5.15%	4.85%	-30
Czech Republic	4.50%	4.25%	-25
Germany	3.70%	3.50%	-20
Netherlands	4.25%	4.10%	-15
Denmark	5.00%	5.00%	0
France	4.25%	4.25%	0
Ireland	4.75%	4.75%	0
Italy	4.75%	4.75%	0
Poland	5.00%	5.00%	0
Portugal	6.25%	6.25%	0
Romania	8.00%	8.00%	0
Sweden	4.50%	4.50%	0
UK	4.00%	4.00%	0
Finland	5.10%	5.20%	10
Average	4.92%	4.84%	-7

Source: Savills

Table 3: Prime Retail Yields

City	SC 20 Q1	SC 20 Q3	Yield Shift (bps)	HS 20 Q1	HS 20 Q3	Yield Shift (bps)
Amsterdam	5.20%	5.20%	0	3.50%	3.75%	25
Berlin				3.00%	3.00%	0
Cologne				3.50%	3.50%	0
Dublin	5.00%	5.50%	50	3.75%	4.25%	50
Dusseldorf				2.80%	2.80%	0
Frankfurt				2.70%	2.70%	0
Hamburg				3.10%	3.10%	0
Helsinki	4.35%	4.80%	45	4.50%	5.00%	50
Lisbon	4.75%	5.00%	25	3.75%	4.00%	25
London	6.00%	6.75%	75	2.75%	2.75%	0
Madrid	4.75%	5.00%	25	3.25%	3.50%	25
Milan	5.25%	5.40%	15	3.00%	3.25%	25
Munich				2.30%	2.30%	0
Oslo	5.00%	5.15%	15	4.40%	4.55%	15
Paris	4.75%	5.00%	25	2.50%	3.00%	50
Prague	5.75%	5.75%	0	4.50%	4.50%	0
Stockholm	4.75%	4.75%	0	3.50%	3.50%	0
Stuttgart				3.10%	3.10%	0
Warsaw	5.00%	5.00%	0			
German top 7	4.30%	5.00%	70			
Average	4.99%	5.25%	27	3.33%	3.48%	15

Outlook

Negative government bond yields will continue to maintain real estate's attraction through 2021.

The macro fundamentals for investing in real estate remains positive. Whilst German 10 year sovereign bond yield -0.6% pa, Berlin prime offices yield 2.7%, with the current yield spread 30 bps above the long term average of 300 bps. With the European Central Bank adopting a dovish policy to stimulate demand and avoid deflation, we anticipate the yield spread to remain attractive across Europe's core office markets.

In many respects, the supply/demand dynamic appears similar to 2019 with rising equity commitments to European real estate, although we are observing a shift back to core strategies. As we move into 2021, we expect to see more price-point clarity emerging for core-plus, given the shortage of vendors for ultra-core/core stock.

Savills latest European Office Value Analysis maintains the view that London City and West End remain under-priced on a pan European basis. As Brexit negotiations are finalised in the closing period of 2020, we anticipate a bounce in transactional

activity. It is the speed of recovery from the coronavirus pandemic, rather than global geopolitical events which will be the main lynchpin for growth over the next 12 months.

There remains an imbalance of willing vendors for core product, although throughout 2021 we do expect lower levels of international capital, reflected in a "flight to familiarity." Asia-Pacific bidding in core markets is less competitive than during 2019 as domestic prices appear cheap, although core European debt is more easily accessible.

Europe's final quarter investment transaction volumes have traditionally marked a 48% increase over the average of Q1-Q3 quarterly investment volumes. This could be of particular relevance to Dutch investors, where the real estate transfer tax on commercial transactions will rise from 6% to 8% and on residential from 2% to 8% from January 2021. For this reason we are maintaining our European investment volumes forecast of between €220bn and €260bn during 2020, down 15-30% yoy.

“Asia-Pacific bidding in core markets is less competitive than during 2019 as domestic prices appear cheap, although core European debt is more easily accessible,” Tris Larder



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Investment

Tris Larder

Joint Head of Regional
Investment Advisory EMEA
+44 (0) 207 409 8014
tjlarder@savills.com

Marcus Lemli

Head of Investment,
Europe
+49 69 273 000 11
mlemli@savills.de

Research

Mike Barnes

European Commercial
Research
+44 (0) 207 075 2864
mike.barnes@savills.com
