Real Estate House View

Europe

First half-year 2019

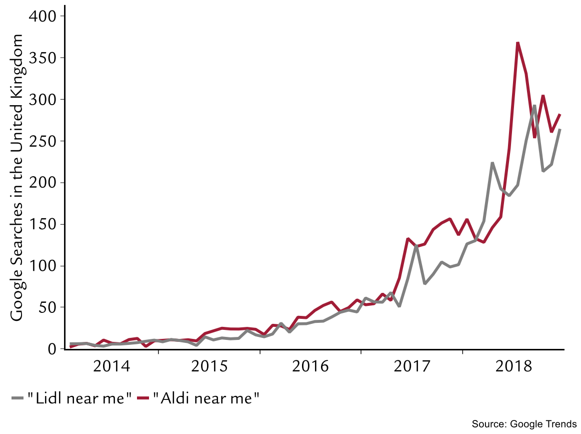
Key takeaways

- Investors are relatively unimpressed by the slowing in economic dynamics. Attractive risk spreads compared to other asset classes are keeping up the interest in European real estate and hence also the volume of transactions.
- While the real estate cycle is still on an upward trend, uncertainty about the momentum persists.
- Solid economic fundamentals have driven office markets all over Europe. With growth slowing, the still relatively high lack of supply will continue to support rental growth in the years to come.
- The performance of the retail sector continues to deteriorate all over Europe as retailers try to find a balance between offline and online.
- With increasing urbanisation and affordability issues, the rental residential market is increasingly interesting, not only in well-established residential markets but all over Europe.

Pop-up stores as a permanent solution?

Pop-up stores are fast becoming the new retail standard. It is not only the start-ups but also the well-established brands that use vacant space to promote their products. Whether in whole stores or just as a "space in space" within an established retail environment, pop-up solutions resolve a lot of challenges: the desired tenant flexibility, brand visibility to keep customers remembering their products but also customer demand for changing shopping experiences and novelty. At the same time, in-store market research can facilitate the transition between offline and online sales.

Chart in focus



Speculation on the future of retail has been ongoing for some time and now there is a clear divergence among different retail formats. In addition to the established distinction between high street, shopping centre and retail warehouse, the differences between discount, mid-priced and luxury shops are increasingly important. Mid-priced brands are suffering most but luxury brands and discount products seem to better meet customer needs. Whereas the shopping experience in the luxury segment seems obvious, the expansion of discount supermarkets such as Aldi and Lidl is a new trend.

During the third quarter of 2018, economic dynamics slowed from Sicily to Kiruna. Gross domestic product contracted in Italy, Switzerland, Germany and Sweden. Negative growth came as a surprise and triggered concern about the end of a benign economic period. While the political situation in Italy has led to higher financing costs for the private sector there, we view the dip elsewhere as temporary. In Germany, industrial production and exports suffered from problems in the car manufacturing sector, which should have been overcome by now. A payback in coming quarters is plausible. Data for Switzerland were distorted by a slump in energy and pharmaceutical exports, which was reversed in the final quarter of 2018. Although one should not read too much weakness into the third-quarter data, the cyclical peak has been left behind. Purchasing managers' indices (PMI) across Europe consistently point to moderating activity in the manufacturing sectors. Only in Italy do the PMI readings hint at a continued contraction. Labour markets are increasingly tight. Wage growth, the missing element in the inflation puzzle, is likely to accelerate in 2019. This in turn should lift core inflation and help to anchor inflation expectations. Central banks across Europe thus envisage a normalisation of monetary policy. In the Eurozone, the end of the asset purchase programme poses an upside risk for sovereign bond yields in peripheral member states. In our view, the ECB will continue to reinvest maturing bonds over a prolonged period of time in an attempt to cap nominal bond yields. Thus, financial repression remains a major driving force for markets across Europe.

Another year into the cycle…

So far, real estate markets in Europe have been relatively immune from slowing economic dynamics: sentiment is strong and investors are keen to invest their money in property. This is mainly driven by the still very attractive risk spread and hence the relative appeal compared with other asset classes. In the meantime, the cycle has become one year older and the end is still uncertain. This uncertainty is impacting investors, yet we expect transaction volumes to be in line with previous years and not to overshoot. At the same time, performance in 2019 will be comparable with previous years. In the medium term, this could change. Yields are at historical lows with little further to go, thus limiting or even resulting in negative capital growth. We therefore expect total returns to be driven by income, limiting the strength of capital growth. In the medium term, as we expect the ECB to increase interest rates, impacts on the real estate markets need to be watched. We do not expect harsh reactions, as there is room for an interest rate increase. If the hikes are gradual, the impacts on real estate markets will also be gradual.

…and the end is still unclear

Speaking of the ongoing real estate cycle: apart from Sweden, Germany is probably the market considered the furthest along the cycle but is also the one that poses the most questions about its length. So far, the economy has helped and low construction activity in the office sector has lowered vacancy rates and increased rents. German real estate is sought after, with increasing transaction volumes in the year up to the third quarter of 2018. Meanwhile, the UK real estate market is being impacted by the ongoing political uncertainty. While aggregate investment volumes have held up, the market is increasingly being supported by large transactions. On the other hand, political uncertainty does not seem to be impacting investors in Spain and Italy: the retail sector especially is still seeing relatively good performance.

Retail still in transition

The retail sector seems to be still attracting investors in southern Europe as well as France, but investors are more cautious in other countries. This is especially true in the UK, which perhaps because of being the European leader of e-commerce and new shop formats, is seeing retail suffering quite heavily. Retail returned just 0.1% in Q3 2018 with capital declines of 1.3%. Over the year to date, November 2018 has returned 1.8%. There are pockets of resilience within the sector but the pervasive negative sentiment means that we expect the downward trajectory to carry on. The picture is similar in other countries, although less pronounced. According to MSCI, retail returned 1.3% in Q3 2018 in the Netherlands, far less than offices (2.7%) or residential (4.0%). The stock markets also indicate negative retail sentiment. Shopping centre operators such as Deutsche Euroshop and Klepierre have lost more than 40% in value since their highs in the middle of the decade. While we do not expect bricks and mortar retail to die, the transition phase in which retailers are trying to find the right balance between online and offline is challenging. This lowers expectations for rental growth and increases the probability of rising yields.

Office markets performing well

With economic growth peaking, European office markets also performed relatively well in 2018. Vacancy rates are decreasing as employment rises and due to the ongoing lack of supply. The latter is also driven by subdued construction activity in many European markets, though activity is slowly picking up in some regions. Ongoing relatively good economic fundamentals and a limited supply of new stock should underpin rental growth in the medium term. With the economic cycle turning, impacts on the office markets need to be watched. We expect the highest rental growth in cities that have a strong base in technology and the creative sector along with a good quality of life, such as Amsterdam or Edinburgh, or extremely short office supply, as in Berlin and Munich.

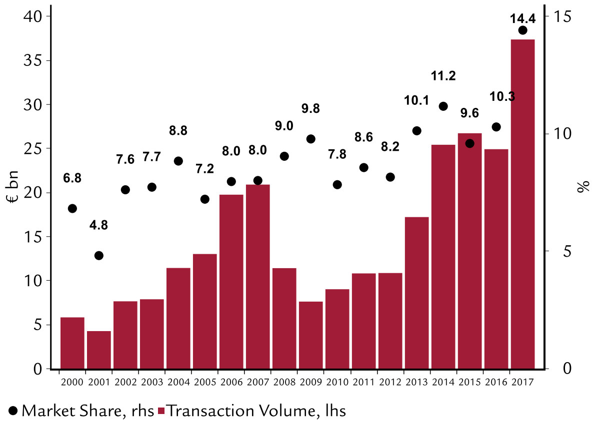
Interest in logistics holds up

The logistics investment market has become increasingly well established over the past few years. During the first half of 2018, transaction volumes decreased by 21% compared to the year before, according to BNP. This is still the second highest mid-year volume of investment; investor interest is not fading. We expect future performance to stem from rental growth rather than further yield compression, which also raises the question of where rental growth comes from and how much is possible. Rental growth has been limited in the past but accelerated in recent years, especially in major logistics hubs. The upward trend is likely to continue in the core markets due to low availability of land and high construction costs. In general, rental growth in the logistics sector is limited, especially as logistics depends to a large extent on economic cycles and companies are subject to price pressure from their customers.

Residential – a no brainer?

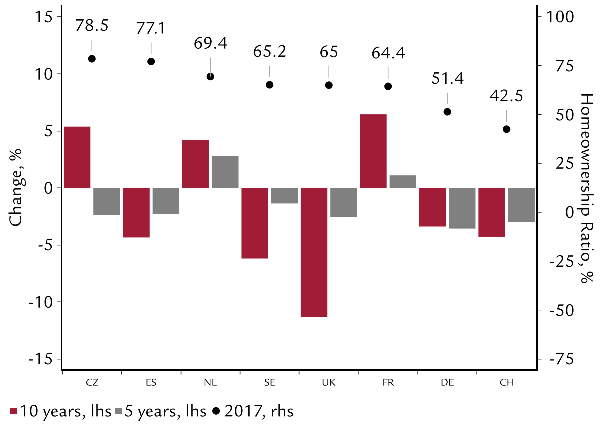
With urbanisation and affordability issues growing, the rental residential market is increasingly interesting, not only in well-established residential markets such as Germany, Switzerland and the Nordics, but also in France and Southern Europe. Overall, we expect rental growth to be positive. Young people are driving high rental demand, as they are increasingly renting rather than owning – rented apartments are flexible, practical and in many cases more affordable. This leads to changes in the design: smaller apartments, which are not measured in square metres but units. Furthermore, many European cities have only a limited supply of modern, well-appointed apartments in urban areas. Construction is still moderate in most cities, and with ongoing urbanisation, demand is continuing to outstrip supply. Given the fundamentals, the sector is increasingly interesting for institutional investors.

Chart 1: Logistics transaction volume



Source: PMA

Chart 2: Homeownership in Europe



Source: Eurostat

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