

Real Estate House View

Europe

Second half-year 2019

Key takeaways

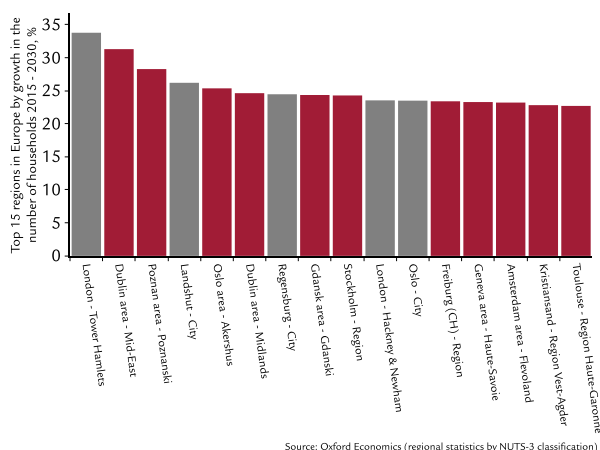
- **Decreasing transaction volumes in the first half of 2019:** slowing economy, high prices and most of all a shortage of good quality assets are key drivers
- **Altered investment sentiment due to structural changes in all sectors (online shopping, wellness in office etc.):** blurring sector lines where “story” of asset and tenant generating income is crucial
- **Residential investment is the “new” darling:** this sector is expected to be attractive, while retail investments are decreasing, nevertheless there may be selected opportunities
- **Moderate positive overall outlook on further performance of European real estate:** need to closely monitor countries and sectors against the backdrop of low interest rates, a slowing economy and insufficient supply

Hospitality – emergence of the one new sector?

“Hospitality” often is associated with hotels. An operator sub-lets on a short-term basis parts of the property to guests whilst leasing/owning the entire property in the long term. This sector model has been adopted by other real estate sectors over the past few years, with the emergence of co-working, co-living, pop-up stores, student housing, etc. Traditional real estate – such as

office, residential and retail – thus is being transformed broadly into a hospitality-like model where landlords lease to operators instead of the final tenant. New implications for landlords are a deeper analysis of the covenant and its business model in order to evaluate the sustainability of the rent – like analysing a hotel property.

Chart in focus



Urbanisation is one of the main trends in European real estate markets. The aspiration to live in the city increases demand for living space with the result of rising rents. This is where politics comes into play with enhanced discussions about affordability in the rental sector. As a result, the local government in Berlin decided to cap rents for the next five years. The affordability issue, which is affecting rentals as well as owner housing, needs to be closely monitored to allow evaluation of future sustainability of the city. With increasing rents and prices, more people – especially young ones, are forced to move further out of the city. The outcome of the combination of these effects – urbanisation and urban outmigration – need close monitoring to determine its potential implications.

Economic dynamics continued to slow down in the first half of 2019. Combined with the absence of a meaningful acceleration of inflation, this resulted in a substantial drop in long-term interest rates. Consensus is that monetary policy rates will remain low for longer. Thus, financial repression remains a major driving force for real estate markets across Europe. A noteworthy fiscal impulse should ensure that gross domestic product (GDP) growth remains near or slightly below long-term potential in most European countries until year-end. Yet, the mid-term risk of a shallow, temporary recession has risen in economies which are particularly dependent on global trade. Not surprisingly, manufacturing sentiment in Germany, Austria, the Czech Republic and Switzerland has deteriorated during the first half of 2019: Manufacturing Purchasing Managers' Indices in these countries are currently well below the 50-points expansion mark. In Western Europe, countries such as Ireland, Belgium, the Netherlands, Sweden and France seem less affected by global headwinds. France is riding on its very own economic cycle – dynamics seem to have gathered momentum in the second quarter of 2019 with the move of Europe's Banking Authority (EBA) from London to Paris, triggering some relocation in financial sectors. Furthermore, infrastructure spending ahead of the Olympic Games in 2024 will also contribute to growth in the medium-term. Meanwhile, apart from the ongoing tension from the US trade policy, home-grown political obstacles have still not been removed and weigh on investors' and consumers' sentiments: in the UK, the tail risk of a hard Brexit has gained in importance over the past six months. While Rome's anti-establishment coalition continues its confrontative budget policy course with Brussels and Italy's economy remains stuck in stagnation.

Are the good years over?

Looking at the numbers, it seems like the economic slowdown has immediately impacted investors' appetite and therefore the transaction volumes during the beginning of 2019. According to Real Capital Analytics (RCA), the commercial transaction volume was EUR 44.5 bn in Europe in Q1, quite below the recent average of EUR 71 bn and the number of completed deals was at a six-year low. Yet, it is not only the slowing economic growth, but the combination with high prices, challenges sourcing suitable stock and the ongoing political uncertainty that keeps levels at bay. As we still

speak of "low for longer", the investor sentiment is nevertheless rather bullish – the relative attractiveness for real estate investments remains, supporting the cycle, while yields show signs of levelling out. Polarisation across and within countries increases, forcing investors to look closely at changes in individual markets.

Mixed performance in Europe

In the UK, the annual total return had fallen to 4.4% at the end of March 2019 compared with 6.0% in 2018. This slowdown is driven by price softening across most segments resulting in an absence of capital growth in large parts of the market. Nevertheless, the UK transaction volume has held up better than in France and Germany, despite the ongoing Brexit negotiations. Performance remained strong in Germany with a 10.2% total return in 2018, reflecting an expected decrease compared to the record year of 2017 (10.9%). France too has seen a decrease from 8.4% to 7.1% in 2018. From our core markets, only Switzerland has seen an increase in total return from 5.8% to 6.1% – which can only be explained by the strong investor demand. Additionally, residential construction activity in Switzerland, and partly in Germany, is still at a very high level, making the polarisation between urban and peripheral areas even more distinct. The resulting essential need for investors to carefully select assets based on local market dynamics and occupational need holds true for all countries.

Lack of supply in top locations

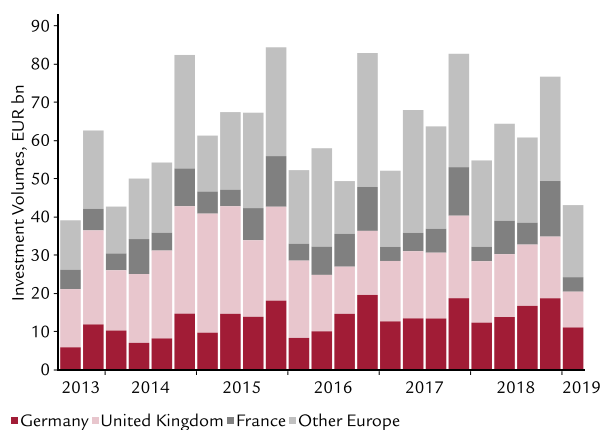
The selection of assets is complicated by a shortage of quality assets across Europe, especially in the office sector. Although construction is increasing, we see demand to exceed supply also in the future, further driving rental growth. With the economy slowing, the shortage of supply is the main driver, leaving yields stable. Investors that are looking for good quality assets in a lot size between EUR 20 and EUR 50 mn will find it difficult to secure a suitable opportunity. Stagnant supply causes a huge competition in bid for properties coming to the market. This influences prices, quite often irrationally. As the cycle has been going on for a while, most objects were transferred and normally optimized by the seller or re-seller in that cycle already. It is proving a challenge to acquire assets with improvement potential. Mostly, upsides are already priced in

with rents. In order to actually be able to buy assets, some market participants in their analyses indicate positive growth of rentals in the last couple of years and thus increase expectations. This scenario is reminiscent of 2006/2007 – and it is questionable, if this approach is healthy for the market and the individual investor. Institutional investors are often unwilling to sell quality assets due to the lack of alternative assets. Liquidity is thus decreasing. One option to access stock is to source good quality product via development – but this alone is not sufficient to increase supply. As land is rare in inner city locations, projects need to be planned as refurbishment or demolition and new construction. Otherwise, developers and investors must buy land in the suburbs, where availability is high but so is the risk concerning the location and the asset. Nevertheless, the importance of forward funding deals increases in the current market environment. Savills reports a share of 22% of project developments in single residential transactions in Germany in the first half of 2019 – yet the share might be even higher.

Online retailers looking for new concepts

Over the past decade, online sales have constantly enjoyed double-digit annual growth. This has started to decrease, yet it still compares to only 1% of growth for total retail turnover in Europe overall (JLL). Furthermore, e-commerce in Europe is forecasted to be worth EUR 621 bn by the end of 2019, corresponding to an increase of 13.6% compared to the previous year. This continues to have an impact on retail and logistics.

Chart 1: Commercial transaction volume

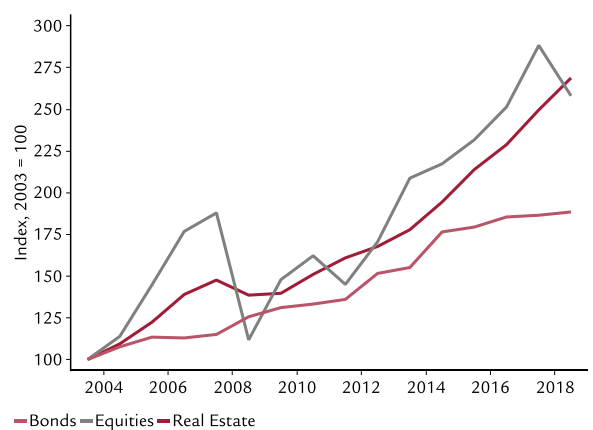


With consumers expecting ever faster delivery times and the impact of high traffic volumes on city roads, new solutions are needed. As a consequence, online retailers such as Zalando are not only opening physical stores but are also exploring the use of other stores to have smaller and centrally located distribution hubs.

“New” darling: residential

With the real estate market getting more crowded, investors are seeking to widen their investment scope. In the case of the residential sector, higher demand is driven by fundamental trends. Demographic change, decreasing household size, urbanization and increased flexibility support this sector. According to RCA, apartments now constitute the second biggest sector after offices in Europe. In Ireland, Norway, Portugal and Belgium, investment volumes reached record level over the last 12 months. At the same time, residential investments are well known in markets like Germany, Switzerland, the Netherlands and the Nordics, where it is well established and highly demanded. As fundamental drivers have continued momentum, developments in this sector should also be ongoing and investor interest remains high. Politics will continue to play an important part in well-developed residential investment markets, such as Germany, the Nordics and Switzerland, as regulations might impact further developments.

Chart 2: Total return index by asset class, Europe



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