Real Estate House View

Europe

First half of 2018

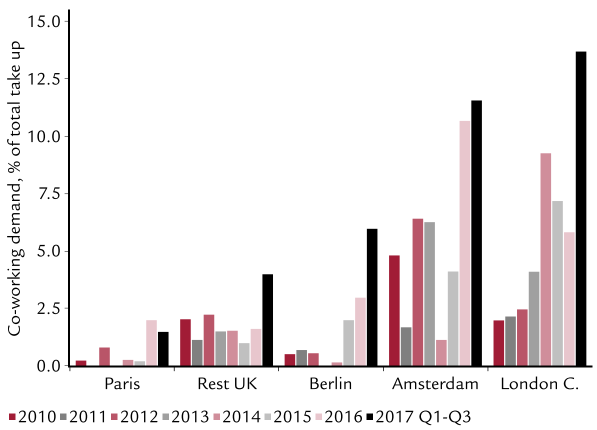
Key takeaways

- Investment markets remain strong in Europe and yields in almost all European capital markets are at historical lows. We expect yields to see only slight compression or to bottom out in 2018.
- Office markets are echoing the economic recovery in Europe. Some laggards such as Spain or the Netherlands are picking up as well and good economic fundamentals are continuing to drive the office sector all over Europe.
- Demand is continuing to outstrip supply, so there is a lack of good quality rental space and assets to buy.
- There is a strong likelihood that the office sector will face challenges in the long term as growth of office employment is set to decrease in Europe and will thus be less of a driver than in previous cycles.
- The retail sector is increasingly lagging behind the other sectors; this is visible in Europe's big centres but also in smaller cities, where closures due to rationalisation within branch networks are most likely.
- The last 12 months exhibited almost no rental growth but only yield compression in the retail sector, underlying the scepticism present in the high street retail markets.

Coworking - here to stay

Coworking is increasingly spreading all over Europe, with the strongest figures being present in the UK. Friendly open spaced and individual designed offices offered by coworking providers attract companies but also shows its impact on owners. Owners are pushed to make their space more flexible and tenant friendly. It also opens opportunities to offer their own coworking spaces instead of letting the unit to providers. All these concepts have yet to prove in different market cycles. But the desire for flexible working is here to stay.

Chart in focus



Source: PMA

Coworking spaces have become a major feature in London's office market. In the year to Q3 2017 flexible work space providers accounted for almost 15% of all take-up compared to less than 1% in 2008. However, it is not only in London but also in other European 'tech' cities such as Berlin and Amsterdam that demand is increasing sharply.

What a difference one year can make: prior to the election of Emmanuel Macron as French president, global investors worried about a potential break-up of the European Monetary Union with severe economic consequences for the regional economies. Twelve months later, France's new president leads the debate on potential reforms and sentiment indicators across the continent have improved significantly during the second half of 2017. While much of the credit for the change in sentiment is given to Monsieur Macron, the more important impulses for continental Europe's current economic revival stem from monetary policies and efforts undertaken by the European Central Bank (ECB) since 2012. A closer look at economic data reveals that real GDP growth in the Eurozone exceeded the region's potential rate in each single quarter since mid-2013. Throughout that time, the ECB's ultra-loose monetary policy ensured a benign interest and exchange rate environment for the corporate sector and for peripheral member states. By now, the economic recovery looks sustainable and increasingly broad-based. Most importantly, capital expenditure spending by the corporate sector should be a significant contributor to growth in the quarters ahead. The synchronous upswing in continental Europe and elsewhere on the planet were clearly beneficial to UK exporters, who enjoyed additional tailwinds in the form of a weak Sterling after the Brexit vote in June 2016. Yet, uncertainty as regards to Britain's future growth perspectives remains exceptionally high at least as long as Brexit negotiations with the EU continue.

Cross border on the rise

Overall real estate transactions remain reasonably strong in Europe, even in the UK. Although Brexit uncertainties are dampening activities a little, especially foreign investors see their opportunities in London or the UK. Cross border investments being a trend generally increasing, especially Asian countries gain importance with investors searching for more opportunities to invest. We expect the interest in UK and continental Europe to uphold as economic drivers are positive and interest rates are expected to remain lower for longer. As a consequence, real estate yields are at historical lows in almost all markets. Therefore, we expect to see investments in 'peripheral' (CEE) and laggards (Spain, the Netherlands) increasing as yields are higher - but also risks remain.

Reaching the peak?

Overall, total returns indicate a slowdown in price development, with capital growth losing momentum and income returns becoming the major performance driver. So while we expect to see good performances, they may peak in 2018. The UK's double-digit performance of 11.2% in 2017 is worth highlighting here. And in terms of risks, we expect political uncertainties to continue in 2018. We are closely watching what impacts Brexit will have on both the UK and on other markets, and are monitoring developments in Spain. So far, Brexit has not had the extreme impact that was originally anticipated and uncertainties in Spain are yet to impact real estate market figures.

Lack of good quality supply

The overall good economic fundamentals are continuing to propel the office sector all over Europe. But at the same time, all major markets seem to be suffering from the same factors: a lack in supply and/or good quality assets. However, construction is starting to pick up in several markets, which will help overcome a lack of supply but dampens the potential for rental growth at the same time. Overall we expect yields to move predominantly sideways in the upcoming years and predict that almost all markets will see some rental growth. Central London offices are suffering from uncertainty relating to Brexit but also from companies reducing costs. The Amsterdam and Madrid office markets are currently recovering after being hit hard by the financial crisis. They are considered to be moderately priced markets, which is why investor demand is compressing yields significantly. Monitoring the European office markets in the long term, we are watching employment trends. Employment growth is expected to decrease in the coming years, and after that even absolute employment figures look set to fall, mainly because of automation. Employment may therefore be less of a driver of the cycle in the future. In the short and medium term, the spread of coworking spaces all over Europe will be closely monitored. WeWork, one of the providers, wants to double its exposure throughout Europe in 2018 – and again the year after. Overall, the strongest growth is expected in cities that have a strong base in the technology and creative sectors along with a good quality of life, such as Amsterdam, Munich, Stockholm and Madrid.

Retail moves sideways

Structural changes due to the rise of e-commerce and changing consumer demand – such as for "experience shopping" – will continue to accompany us in 2018. Overall, brick and mortar retail is not at its last gasp but all stakeholders need to adapt to changes. We believe that we are currently knee-deep in the process of adapting to these changes. As a result, the retail sector is lagging behind office and industrial after years of being a good or even the best performer. A closer look at the retail segments brings out the differences very clearly. Some European markets not only exhibit high street segments but also shopping centres and retail parks or warehouses – the latter being especially attractive in Germany and the UK. But almost all European high street sectors experienced almost no rental growth but only yield compression over the last 12 months: scepticism is rife on the high streets of Europe's capitals and we expect this situation to continue. However, rents will grow in some markets, driven by a relatively good outlook for consumer demand. Capital cities attracting tourism are expected to fare better than regional markets as they profit from high footfall generated by both local and foreign demand.

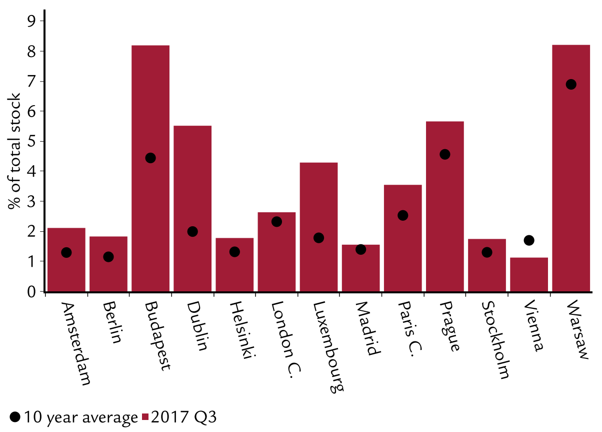
Ongoing residential boom in Germany

The Germans residential market is booming. It is affordable by international standards and is expected to forge ahead. The continuing lack of supply is driving rents and prices. Migration to big cities as well as selected large and medium-sized towns remains the fundamental driver of the local housing markets. New construction (278,000 units in 2016 and approximately 320,000 units in 2017) is far from meeting the requirement of 400,000 units per annum. Switzerland has seen an increase in vacancy rates from 1.3% in 2016 to 1.47% in 2017, which is largely due to high construction with lower demand in peripheral regions/agglomerations. Although 82% of the overall vacancy is in rental apartments, the larger cities still exhibit relatively low vacancy rates. As immigration is expected to produce less high-end demand, the availability of affordable housing in good locations needs to be increased. Not only in Switzerland but in Germany especially, there is an increasing drift towards smaller, economically weaker locations. This increases the likelihood that the (German) markets will reach an end phase or even a turnaround.

Increasing demand for rented apartments

In addition to Germany and Switzerland, the Nordic countries are the only ones in Europe in which a residential market for private rent is properly established. We believe that this will change in the future, as affordability issues and the desire for flexibility increase demand for rented apartments. We expect investors to focus on dynamic cities with an attractive life-work-play environment and an affordable residential market – i.e. less the capital cities but rather the smaller ones.

Chart 1: Office market- building starts



Source: PMA

Chart 2: Office employment growth

Source: PMA

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