EUROPEAN FORECAST & FAIR VALUE REPORT

Q1 2019

CUSHMAN & WAKEFIELD

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ECONOMIC OVERVIEW

Economic activity in the Eurozone accelerated by more than expected in the first quarter of the year, after suffering a sharp slowdown in the second half of 2018 on the back of a struggling manufacturing sector and a less supportive global trade environment.

According to preliminary estimates, Eurozone GDP increased by 0.4% q/q in Q1, doubling the 0.2% expansion in H2 2018. While a detailed breakdown is not yet available, consumer spending supported by low unemployment and rising wages likely drove the result.

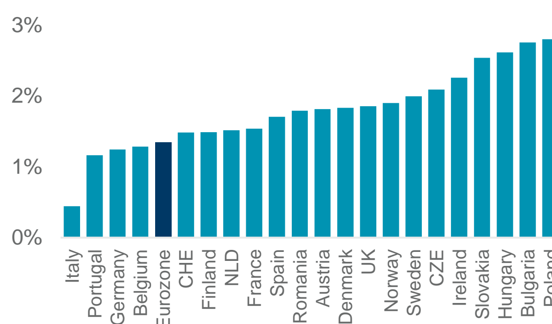
According to Oxford Economics, over the next five years all European economies are expected to grow at a slower pace, and in many cases significantly below 2%, with the best being CEE countries, Ireland and Sweden (Figure 1).

The recovery in the Eurozone labour market continues, but the pace of job creation is now slowing as the unemployment rate is down to a decade low of 7.8% (Figure 2). There are still considerable differences in labour markets among countries, with Germany, the Netherlands, the UK and most of the CEE having less than 5% unemployment rate, while it remains in double digits Italy and Spain. On the positive side, tighter labour markets are supporting a rise in wages, which in turn should support household spending. Inflation should continue to decline in 2019, reflecting negative oil base effects, before picking up in 2020.

Slowing economic growth and a relatively weak inflation outlook mean that the ECB will remain very cautious about withdrawing monetary support. In March, the ECB provided forward guidance that interest rates would remain on hold for 2019. Moreover, it announced a third round of TLTRO's which will support the Eurozone's most exposed banks, particularly in Italy and Spain.

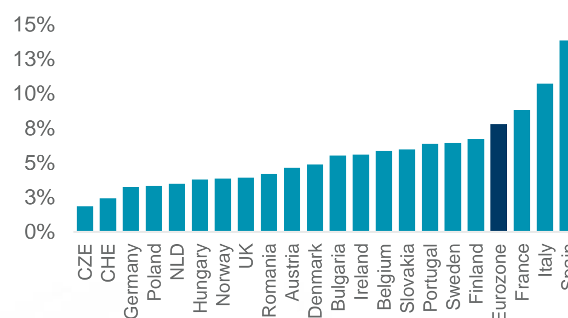
The Bank of England began rate tightening in late 2017, moving interest rates from the low of 0.25% up to 0.5%, then a further rise to 0.75% in Q3 2018. Oxford Economics expects just one rate rise in 2019 and two in 2020 taking rates to 1.25% by end-2020. However, the monetary tightening path is still highly sensitive to economic/Brexit related developments (Figure 3).

FIGURE 1: GDP GROWTH, AVG 2019 – 2023 %P.A.



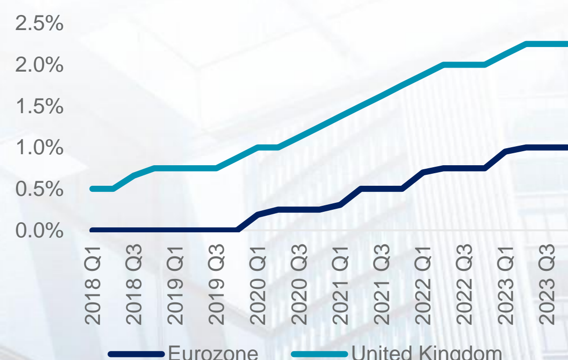
Source: *Oxford Economics*

FIGURE 2: UNEMPLOYMENT RATE %, 2019



Source: *Oxford Economics*

FIGURE 3: CENTRAL BANK INTEREST RATE



Source: *Oxford Economics*

OCCUPIER OVERVIEW

With only modest economic growth forecast and positive but slower growth in employment, limited rises are forecast for commercial property rents across much of Europe.

As such, European all sector* prime rents are forecast to increase by around 1.1% p.a. over the next five years, with logistics showing faster growth than office with retail underperforming (Figure 4). However, although the vast majority of markets are clustered around sector averages, there are significant outliers.

In the office sector, positive but slower growth in office-based employment will be reflected by more moderate leasing activity in 2019 than 2018 (Figure 5).

Demand from the technology sector remains dominant in cities such as London, Madrid, Berlin and Dublin among others. Falling vacancy rates continue to limit the availability of grade A stock in many of Europe's major office markets which has increased the willingness of occupiers to pre-let space. As such, development activity has picked up in the last two years and is expected to remain elevated in 2019-20.

The retail sector across Europe continues to be negatively impacted by changing consumer habits. In the UK, for example, online sales now account for around 20% of total sales, which are growing at 10% per annum, four times faster than total sales (Figure 6). As such, we have downgraded our retail rental growth outlook across Europe and the UK.

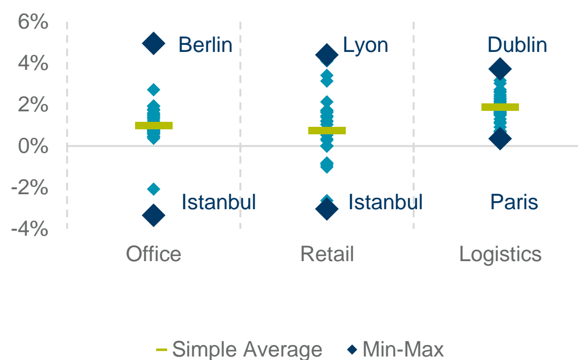
However, we expect rental growth in relatively cheaper markets, where retailer expansions have not been as pervasive, and where the macroeconomic environment remains positive for the sector, such as Budapest, Dublin, Prague, Stockholm and Madrid.

The logistics sector is expected to continue showing a high level of activity in 2019 and over the next five years, supported by a combination of economic growth and the expansion of online sales.

The best rental growth are expected to be concentrated in supply constrained locations, such as Dublin, Barcelona and Lisbon.

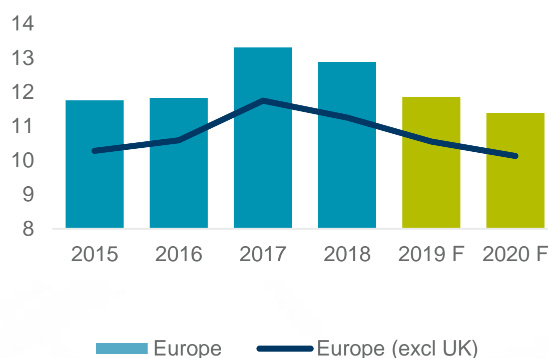
*123 European markets: 49 office, 41 high street retail and 33 logistics

FIGURE 4: RENTAL GROWTH, AVG 2019 – 2023 % P.A.



Source: Cushman & Wakefield

FIGURE 5: OFFICE TAKE UP, MILLION SQ.M.



Source: Cushman & Wakefield

FIGURE 6: UK INTERNET SALES AS A % OF TOTAL RETAIL SALES

Source: *Cushman & Wakefield, ONS*

CAPITAL MARKET OVERVIEW

2018 was another good year for commercial property, with more than €300bn invested, but 9% down on 2017. The first quarter of 2019 was also slow, reflecting the advanced stage of the property cycle with prime yields at their historical lows across all sectors, a lack of suitable investable stock and slowing economic growth.

However, the structural case for real estate investment remains. Despite the end of the ECB QE programme at the end of last year, bond yields ended lower during the first quarter, remaining at ultra low levels and making real estate attractive in comparison (Figure 7).

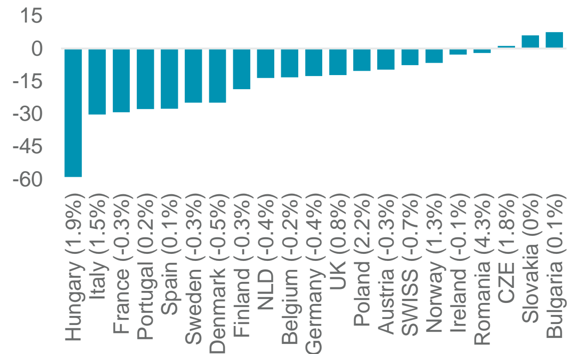
Bond yield compression reflected a dovish shift from central banks, increased risk aversion and volatility amid continued macro uncertainty relating to trade tensions, Brexit and politics in Italy. German government bond yields were more than 12bps lower and were at their lowest level since 2016 Q4 as investors fled to the perceived safe haven asset.

During the first quarter, the European investment market was the lowest since 2013 with €43bn, as activity shrank across the largest markets (Figure 8). The biggest challenge is finding quality assets at the right price with the opportunity to generate future income growth. As a result only 11% of the markets have experienced yield compression, with an average shift inwards by 22bps (Figure 9).

The UK, Germany, France, Sweden and the Netherlands were the top five most active markets in Q1. Investment activity in the UK held up better than expected despite the ongoing saga surrounding Brexit, supported particularly by strong demand for alternative assets.

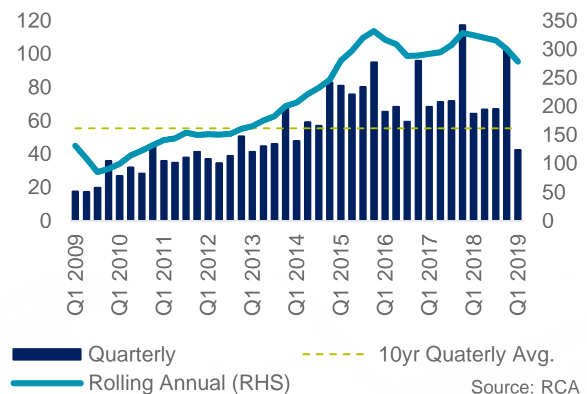
On the other hand, both Germany and France recorded a slowdown, reflecting GDP downgrades and high prices. Across the sectors, retail registered the steepest decline in activity, particularly in the UK, where it was the slowest quarter on record.

FIGURE 7: 5-YEAR BOND YIELDS BPS CHANGE, Q1 2019 VS Q4 2018



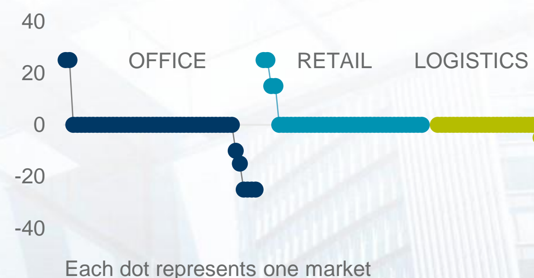
Source: Bloomberg

FIGURE 8: EUROPEAN INVESTMENT ACTIVITY, € BN



Source: RCA

FIGURE 9: PRIME YIELD MOVEMENTS BPS, Q1 2019 VS Q4 2018



Source: Cushman & Wakefield

FAIR VALUE INDEX RESULTS

The all-sector European Fair Value Index score was 24 in Q1, up from the Q4 figure of 16, reflecting an improvement in the attractiveness of prime opportunities across Europe.

As such, a modest number of markets were upgraded this quarter (21 in total), with the largest component moving from fully priced to fairly priced (14 markets). The sector upgraded the most was the logistics, reflecting the improvement in our logistics rental growth outlook.

In many of the Eurozone markets, we delayed our first property yield increase from 2020 to 2021 to reflect the more dovish monetary policy environment. As such, our capital growth expectations have improved. In addition, the combination of bond yield compression and a lower illiquidity and risk premium component has increased the spread between the fair and forecast return, improving property attractiveness, and causing the index to increase.

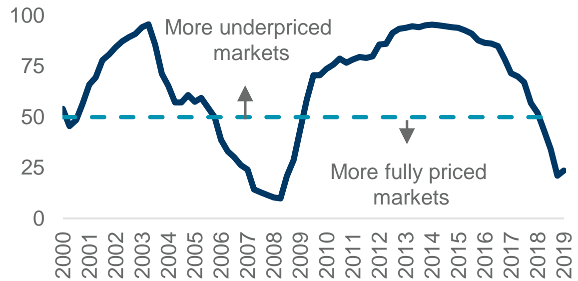
Nevertheless, the majority of our 123 markets covered in the analysis are classified as fully-priced. The most opportunities can still be found in the logistics sector rather than retail and offices which have more fully priced markets than fairly or under-priced.

Geographically, the CEE, Germany and semi-core have the most under-priced markets while core markets such as the UK and France have more fully priced markets.

The most underpriced European markets in Q1 are the logistics markets of Bratislava, Copenhagen, Dublin, Barcelona and Lisbon, experiencing the highest medium term rental growth forecast and yield compression in 2019.

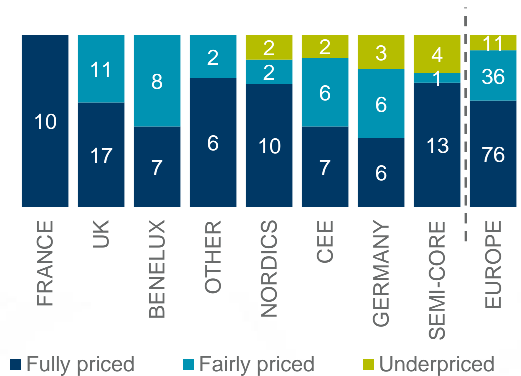
Conversely, the top five most fully priced markets in Europe are Milan, Paris, Rome (retail) and Istanbul (offices and retail). A very high bond yield in Turkey has pushed fair returns for property to more than double our forecast returns. While prime retail in Milan, Rome and Paris have reached their lowest historical yield with no expectation of further yield compression and modest rental growth expectations making them look unattractive on a relative pricing basis.

FIGURE 10: EUROPEAN FAIR VALUE INDEX ALL PROPERTY, Q1 2019



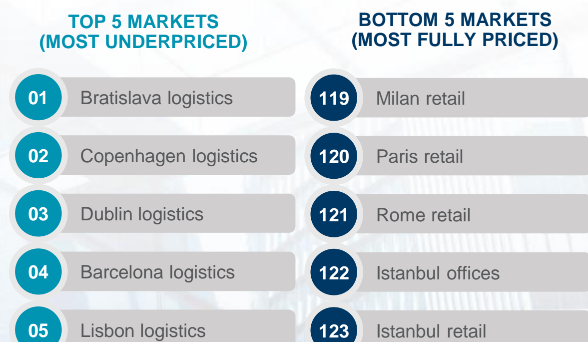
Source: Cushman & Wakefield

FIGURE 11: NUMBER OF MARKETS IN EACH FAIR VALUE CATEGORY BY REGION, Q1 2019



Source: Cushman & Wakefield

FIGURE 12: FIVE MOST UNDER/FULLY PRICED MARKETS IN EUROPE, Q1 2019



TOP 5 MARKETS (MOST UNDERPRICED)		BOTTOM 5 MARKETS (MOST FULLY PRICED)	
01	Bratislava logistics	119	Milan retail
02	Copenhagen logistics	120	Paris retail
03	Dublin logistics	121	Rome retail
04	Barcelona logistics	122	Istanbul offices
05	Lisbon logistics	123	Istanbul retail

Source: Cushman & Wakefield

MARKET IN FOCUS

Ranked 11th overall in our Fair Value Index in Q1, Berlin Offices is underpriced by 5.5% according to our Fair Value analysis.

Germany's economic fundamentals remain robust, albeit at a lower level, continuing to positively impact the office letting market in 2019.

Oxford Economics expects the German economy to grow by 1.1% in 2019, supported by recovery in the car sector and buoyant domestic demand and strong labour market. However, risk factors exist, particularly at a global level – a slowdown in China's economic growth, a further escalation in international trading policies, a potential no-deal Brexit, as well as new majorities following the EU parliamentary elections.

Berlin is an attractive place to live, highlighted by the relative strength of recent population growth in the city. With 3.6 million residents, Berlin is Germany's biggest city by both population and GDP.

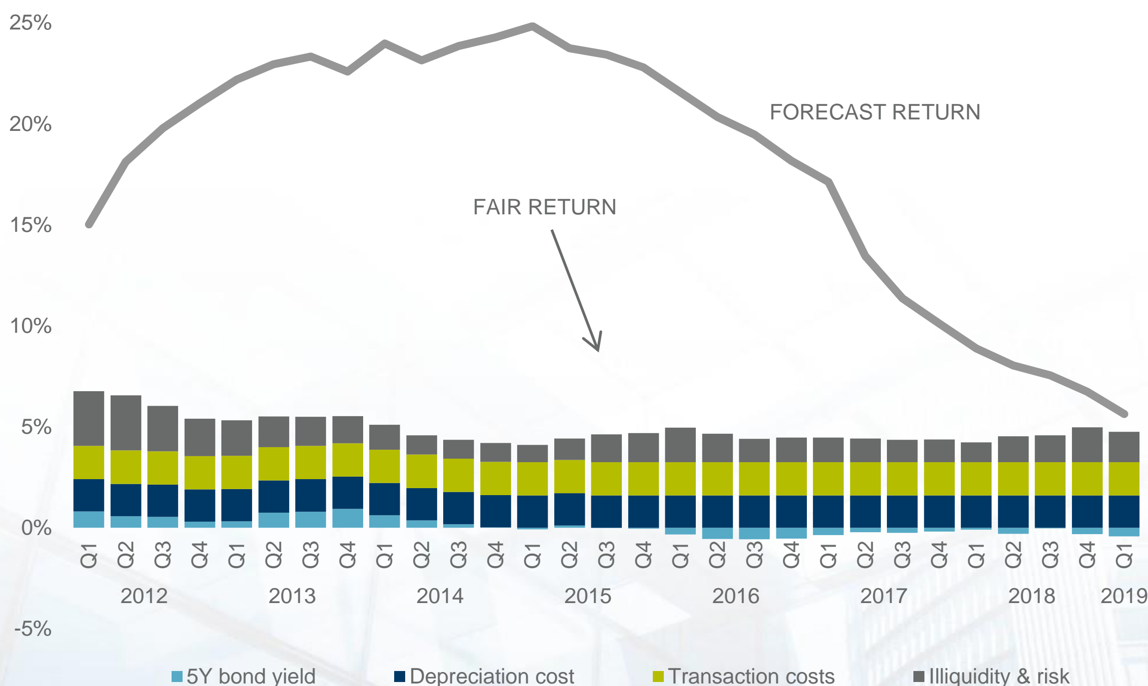
Berlin offices recent success has been underpinned by its strength in business services and established reputation as a digital and creative hub.

In 2019, strong demand for space will be met by an increasing supply shortage. Potential take-up is limited due to the low vacancy, currently at 1.3%, and moderate level of new construction.

In 2018 Berlin prime rents rose by as much as 13.8%, and it is expected to follow a similar pattern in 2019, with rents expected to increase by 12.1%.

The low (negative) bond yield and positive office return outlook maintained the degree of underpricing for Berlin in Q1. Our expectation is for yields to compress in 2019 by 10bps to 3.00%, supported by healthy investment volume and continued rental growth, aided by strong occupier demand. This leads us to forecast prime total returns of c. 4.9% p.a. over the next five years (Figure 13).

FIGURE 13: BERLIN OFFICE FAIR AND FORECAST RETURNS, 2019 Q1

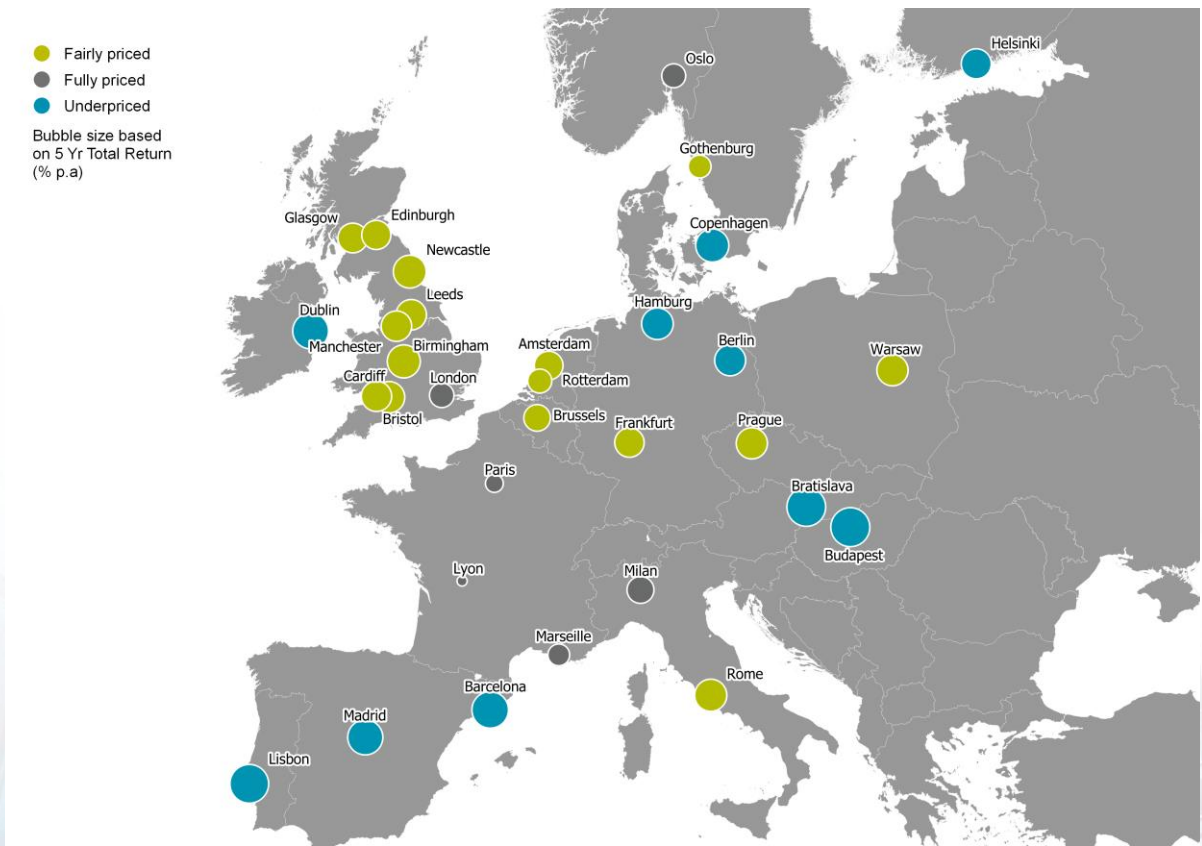


Source: Cushman & Wakefield

SUMMARY

- The big challenge for investors is finding attractively priced core assets, without making elevated future income growth assumptions. However, there are still opportunities around Europe in select locations.
- Logistics remains the sector with the highest number of underpriced markets while geographically, the CEE and Semi-Core regions offer the most interesting opportunities.
- Despite the end of the ECB QE programme at the end of last year, bond yields ended lower during the first quarter, remaining at ultra low levels and making real estate attractive in comparison
- Nonetheless, the current forecast is for bond yields to rise which implies that investors should expect a higher required return on real estate. Therefore, if government bond yields rise and the risk premium remains broadly at today's level, then investors will need to have higher long-term income growth expectations to justify real estate pricing at today's levels.

EUROPEAN LOGISTICS MARKET FAIR VALUE CLASSIFICATIONS, Q1 2019



Source: Cushman & Wakefield

About the Report

This report was written by Riccardo Pizzuti in the EMEA Research Insight team.

The report has been prepared using Cushman & Wakefield historical and forecasting data, Oxford Economics, Bloomberg and Real Capital Analytics (RCA) as at Q1 2019.

The report includes the latest Cushman & Wakefield forecast outlook & fair value index results.

Fair value is the value at which an investor is indifferent between a risk free return and the forecast return from holding property, taking into account the extra risk of investing in the property asset class.

Our forecast and fair value analysis focuses on prime assets and a five-year investment horizon.

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