EUROPEAN FORECAST & FAIR VALUE REPORT

Q3 2019

CUSHMAN & WAKEFIELD

CONTENTS

ECONOMIC OVERVIEW

Following a 0.2% expansion in Q2, it looks as though the Eurozone economy remained very weak in Q3 (EZ flash estimate was 0.2%).

The weakness in the industrial sector and persistent external threats continue to cloud the outlook for the Eurozone. The 2019 GDP growth forecast has been cut to 1.1% as at October 2019, and 1.1% for 2020 (from 1.4% in July).

Over the next five years (2019-2023), the Eurozone economy is expected to grow on average by 1.2% p.a., below the UK (1.6% p.a. under an orderly Brexit scenario). Growth in the region is fragmented with CEE economies expecting growth of 2% p.a. or more, while countries such as France, Germany, Belgium, Netherlands and Italy are likely to record growth below 1.5% p.a. (Figure 1).

The recovery in Eurozone labour markets continues, but the pace of job creation has now plateaued as the unemployment rate has fallen to a decade-low of 7.4% (Figure 2). On the positive side, tighter labour markets are driving a pick-up in wages, which are rising at their strongest pace in a decade.

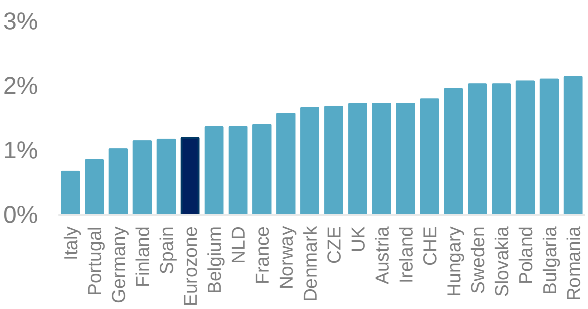
According to Oxford Economics, Eurozone wages are expected to rise by a solid 3.4% this year, which combined with lower inflation should provide a boost to real incomes and support household spending. Private consumption is forecast to grow by 1.2% in 2019 and 1.3% in 2020.

The ECB launched a large stimulus package in September 2019 to combat the deteriorating growth and inflation outlook. The ECB cut the deposit rate by 10bp to -0.50% in September and reactivated its asset purchase programme, at €20bn a month, announcing it would be open-ended. The extension of lower for longer now means that interest rates are not expected to rise until 2022 at the earliest.

Forward guidance for monetary policy by the Bank of England continues to be highly dependent on Brexit related developments but has become more dovish over recent months. In the minutes of the MPC's September meeting they referenced "political events" as risking a further period of uncertainty and so depressing demand and inflationary pressures.

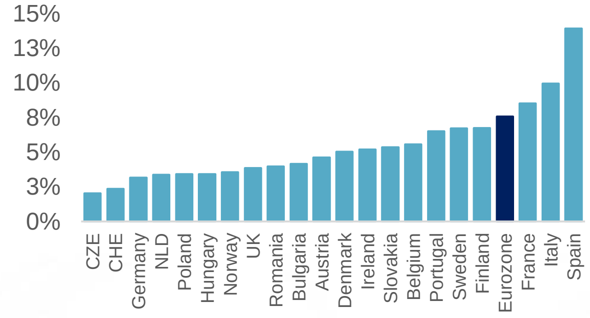
Thus, the next interest rate movement may shift downwards, not up, even if a no-deal Brexit is avoided. However, for the time being, assuming Brexit is orderly, the base rate is expected to remain at 0.75% until Q4 2020, with increases of 25bp a year thereafter (Figure 3). In the event of a no-deal Brexit, the MPC is expected to quickly cut base rate to 0.25%.

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



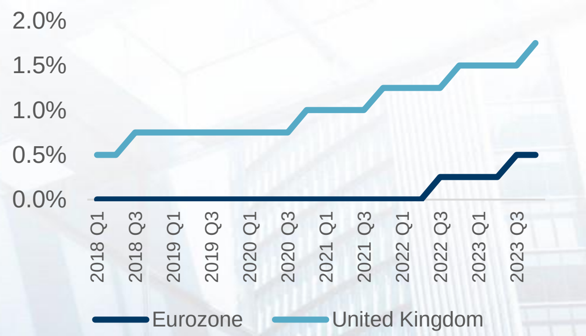
Source: *Oxford Economics*

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 0.9% p.a. over the next five years with logistics showing faster growth than office and retail underperforming (Figure 4).

In the office sector, we continue to be of the view that leasing activity will ease over the next two years, as a subdued economic environment holds back firms' expansion plans and office-based employment growth fades (Figure 5). As such, office rents are projected to grow by an average of 1.4% p.a. over the next five years.

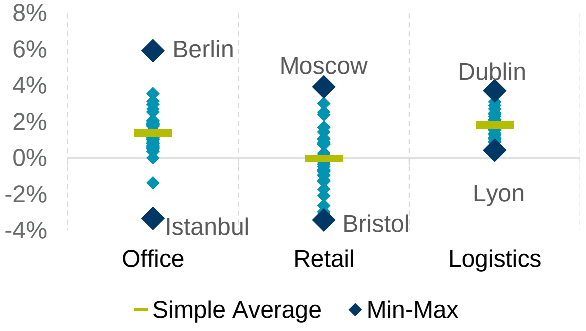
However, there are geographical differences in performance with Benelux, CEE and the Semi-core experiencing higher levels of take-up relative to recent years, while France, Germany, the Nordics and the UK all have moderating take-up. In many cases this is due to exceptionally low vacancy rates. Many businesses are now being forced to look at pre-leasing to satisfy requirements, particularly for larger amounts of space. In cities such as London, Paris and Berlin pre-leasing now account for 30-50% of space under-construction.

The retail sector across Europe continues to be negatively impacted by changing consumer habits. In addition, with employment growth losing momentum and wage growth peaked, retail sales growth over the coming years are set to slow (Figure 6).

At a regional level, the more mature markets have slowed, with prime rents recently being marked down in a number of areas. Those markets that have slowed are seeing the impact of online, with many retailers adopting a 'wait and see' position to see how the sector evolves. Relatively speaking, leasing markets in Southern, Central & Eastern Europe have remained more robust. Online penetration in these regions is much lower, as are levels of modern retail provision – so the effects of structural change in retail will likely be delayed.

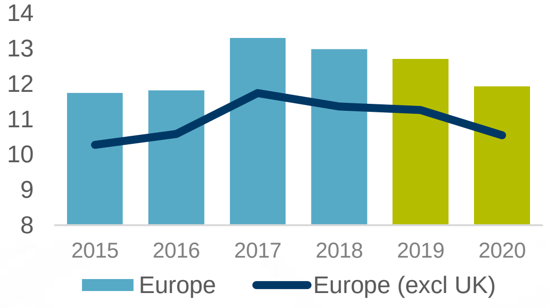
The logistics sector is expected to continue showing a high level of activity in 2019 and over the next five years, supported by a combination of economic growth and the expansion of online sales. As such, logistics rents are projected to grow by an average of 1.8% p.a. over the next five years. The best rental growth is expected to be concentrated in supply constrained locations, such as Dublin, Barcelona and Lisbon.

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: EUROPE TOTAL RETAIL SALES, %

Source: Oxford Economics

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

CAPITAL MARKET OVERVIEW

European commercial property investment regained some of the momentum lost in the first half of the year. Europe's low rate environment offset the weakness caused by external headwinds and pulling more capital into the market. Moreover, a renewal of the ECB's QE programme is likely to amplify this trend.

Government bond yields fell sharply over the quarter due to heightened risk aversion in August when US-China trade tensions escalated, with 13 out of 21 countries in negative territory (Figure 7). The 5-year Bund yield fell 12bps to finish even deeper in negative territory at -0.8%. The Italian 5-year yield saw a substantial move, falling 118bps to 0.2% due to anticipation, and ultimately announcement of new stimulus measures and a calmer political backdrop. Continued QE and a new Italian government with a less confrontational approach to the EU should also keep a lid on the spread between Italian yields and those in the core countries. The UK saw further escalation in Brexit uncertainty. The 5-year UK yield fell 31bps over the quarter, with most of this occurring in July.

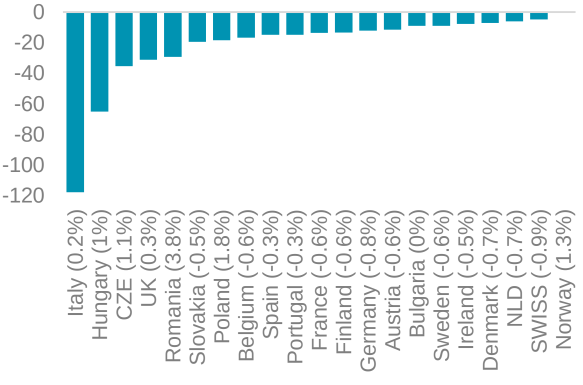
During the third quarter, the European investment market fell by 5% y-o-y in Q3 (RCA), with €64.8bn transacted during the quarter (Figure 8).

The biggest challenge is finding quality assets that generate sufficient risk adjusted returns in a mature phase of the cycle. As a result, only 18% of the markets have experienced yield compression, with an average shift inwards by 18bps (Figure 9).

Germany, the UK, France, Spain and the Netherlands remained the top five most active markets in Q3. However, UK property investment volume continued to slow, compounding the negative outturn already recorded in the first half. Germany, Spain and the Netherlands also slipped, though to a smaller degree than the UK. The outlier among the top five markets is France, where volume is up substantially on the quarter and higher for the year. France is less exposed to the slowdown in global trade than more trade dependent nations such as Germany, and this is providing some reassurance to investors to keep placing capital in what is already an expensive market.

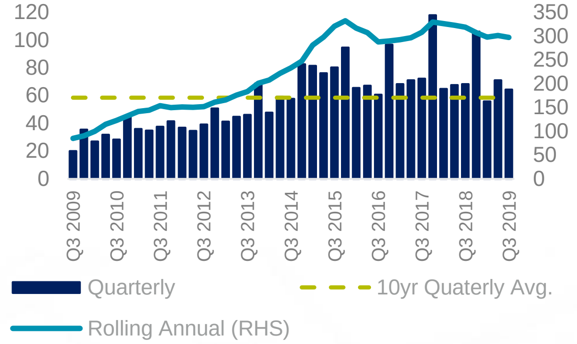
Across the sectors, European retail continued to register a decline in activity, falling by more than 30% y-o-y. Investors have been shifting their focus from the core commercial sectors to alternative, such as apartments, hotels and senior housing since 2014. With prime yields at historical lows, investors are focusing on income to drive returns.

FIGURE 7: 5-YEAR BOND YIELDS BPS CHANGE, Q3 2019 VS Q2 2019



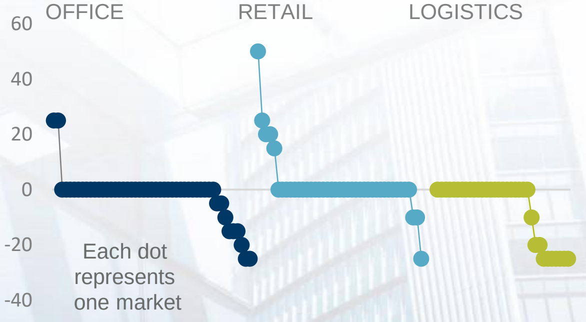
Source: Bloomberg

FIGURE 8: EUROPEAN INVESTMENT ACTIVITY, € BN



Source: RCA

FIGURE 9: PRIME YIELD MOVEMENTS BPS, Q3 2019 VS Q2 2019



Source: Cushman & Wakefield

FAIR VALUE INDEX RESULTS

The all-sector European Fair Value Index score was 45 in Q3, up from the Q2 figure of 31, reflecting an improved relative valuation of prime commercial property opportunities across Europe (Figure 10).

As such, a number of markets were upgraded this quarter (39 in total), with the largest component moving from fully priced to fairly priced (29 markets). The sector upgraded the most was the office, as the number of fairly priced markets rose to 32, from 12 (out of 49).

In many of the Eurozone office and logistics markets we continued to see an improvement in capital growth expectations, reflecting the more dovish monetary policy environment. In addition, the combination of bond yield compression and 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.

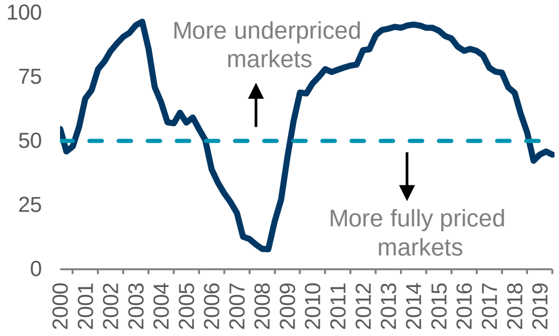
Nevertheless, the majority of our 123 markets covered in the analysis are classified as fairly priced. The most opportunities can still be found in the logistics sector rather than offices and retail, with the latter showing more fully priced markets than fairly or underpriced.

Geographically, Benelux and the Nordics have the highest percentage of underpriced markets while Germany, Other and Semi-Core have the highest percentage of fully priced markets (Figure 11).

The most underpriced European markets in Q3 are the logistics markets of Madrid, Copenhagen, Dublin, Bratislava and Amsterdam (Figure 12), experiencing the highest medium-term rental growth forecast and yield compression.

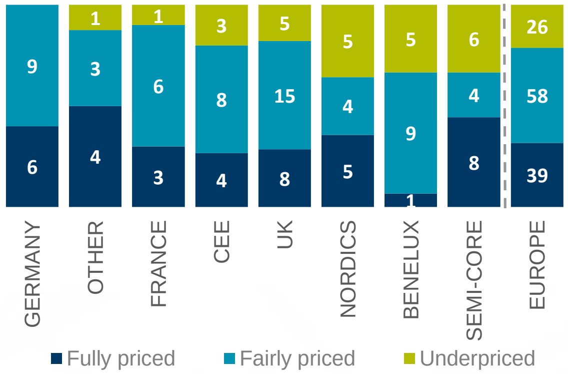
Conversely, the top five most fully priced markets in Europe are Stockholm, Glasgow, London (retail) and Istanbul (offices and retail). A very high bond yield in Turkey has pushed fair returns for property to more than four times our forecast returns. While prime retail in Stockholm, Glasgow and London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

FIGURE 10: EUROPEAN FAIR VALUE INDEX ALL PROPERTY, Q3 2019



Source: Cushman & Wakefield

FIGURE 11: NUMBER OF MARKETS IN EACH FAIR VALUE CATEGORY BY REGION, Q3 2019



Source: Cushman & Wakefield

FIGURE 12: FIVE MOST UNDER/FULLY PRICED MARKETS IN EUROPE, Q3 2019

TOP 5 MARKETS (MOST UNDERPRICED)		BOTTOM 5 MARKETS (MOST FULLY PRICED)	
01	Madrid logistics	119	Stockholm retail
02	Copenhagen logistics	120	Glasgow retail
03	Dublin logistics	121	London (WE) retail
04	Bratislava logistics	122	Istanbul retail
05	Amsterdam logistics	123	Istanbul offices

Source: Cushman & Wakefield

MARKET IN FOCUS

Ranked 1st overall in our Fair Value in Q3, Madrid Logistics is underpriced by 15.9% according to our Fair Value analysis.

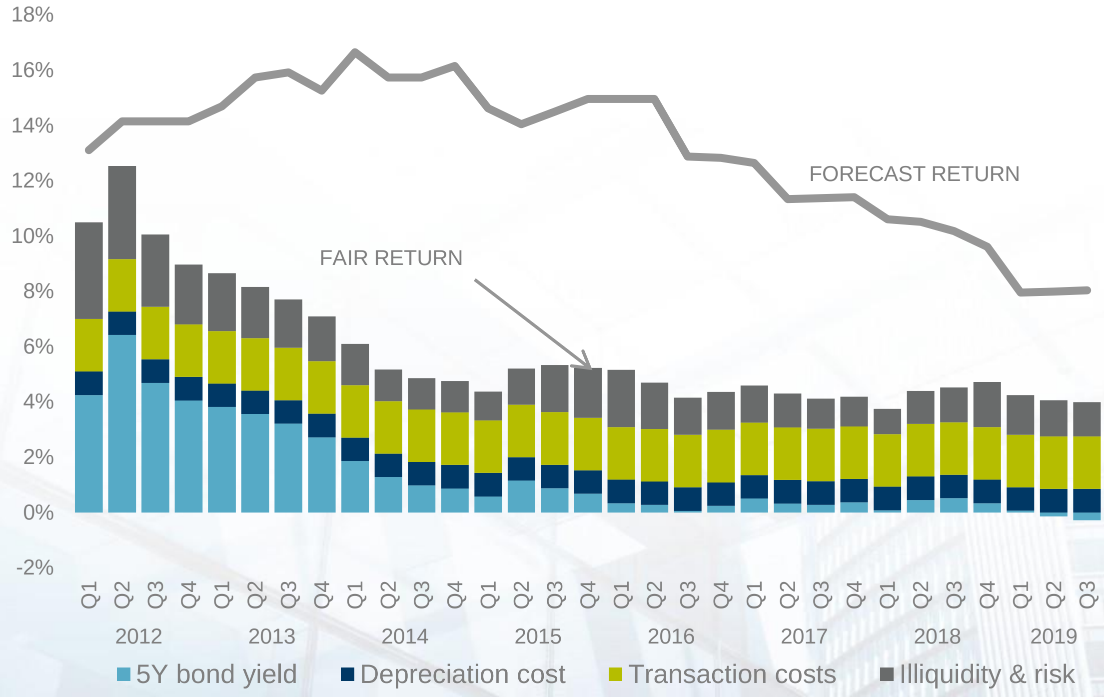
Oxford Economics expects the Spanish economy to grow by 1.8% in 2020. While the Spanish economy continues to grow above the Eurozone average, signs of slowdown are becoming more prevalent. Cooling domestic demand and a negative external environment mean that growth is unlikely to pick up from current levels.

Madrid's pace of economic growth has significantly exceeded the Spanish average over the past decade, reflecting strength across a range of indicators, including its more favourable demographics, highly skilled workforce and industrial composition. Its economy is predominantly service-based, with a large presence of business services, consumer-focused activity and, as the capital of Spain, a sizeable public sector.

Warehousing and storage space continue to be critical for the configuration of the supply chain in Spain. Operators and developers are betting boldly on new logistics premises adapted to the new era of e-commerce, multi-channel retail and super-fast last mile distribution. In this context, the market has developed well between January and September 2019 in terms of space take-up, and new deliveries. Investor intentions are also strong, and 2019 will sustain historically high investment volumes. In Madrid, new supply will deliver in 2019 about 467,000 sqm of new sheds that will cope the 600,000 sqm of take-up expected for the same period. As such rents are expected to grow by 5% in 2019, and by an average of 2.5% p.a. over the next five years.

The low (negative) bond yield and positive logistics return outlook maintained the degree of underpricing for Madrid in Q3. Our expectation is for yields to compress to 5.00% by 2020, supported by healthy investment demand for high quality income producing assets, and continued rental growth, aided by healthy occupier demand. This leads us to forecast prime total returns of c. 8.0% p.a. over the next five years (Figure 13).

FIGURE 13: MADRID LOGISTICS FAIR AND FORECAST RETURNS, 2019 Q3

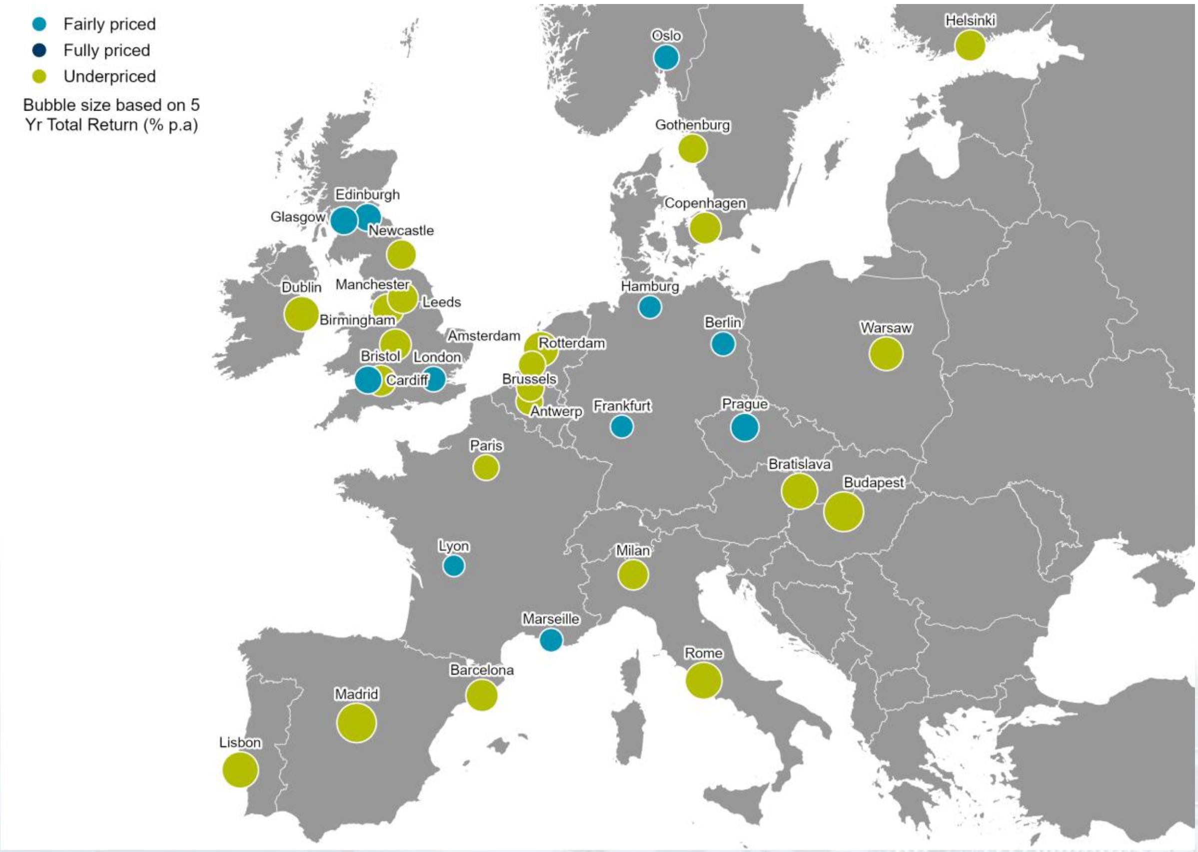


Source: Cushman & Wakefield

SUMMARY

- The big challenge for investors is finding quality assets that generate sufficient risk adjusted returns in a mature phase of the cycle. However, there are still opportunities around Europe in select locations.
- Logistics remains the sector with the highest number of underpriced markets while geographically, Benelux and the Nordics regions offer the most interesting opportunities.
- The combination of government bond yields compression, which fell substantially in Q3, and lower illiquidity and risk premium component improved the relative valuation of prime European property markets.
- 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, Q3 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 Q3 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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