

August 2018

Real Estate Strategies

Focus on the European Real Estate Cycle

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Summary

- European real estate markets continued their positive performance in H1 2018 and are now in their fifth year of upswing.
- Real estate cycles could last long longer than expected. Our review of the past 40 years in the US shows that uninterrupted periods of positive quarterly returns of core real estate funds can last up to 15 years.
- For office and logistics real estate in Europe, we anticipate a further solid rise in market rents over the next three years. Both sectors are also supported by structural factors, such as coworking and e-commerce.
- By contrast, the situation has deteriorated for retail properties. The news from the UK became increasingly negative and we expect a difficult market environment in the Eurozone going forward. We anticipate vacancies to continue rising throughout Europe and recommend selectivity.
- We are optimistic that the current cycle will prevail for office and logistics real estate. Although net initial yields for investments have fallen in the last few years, the yield differential compared to bonds is still high and the positive rental market prospects are persuasive. For investors with a higher risk appetite, focused value-add strategies that exploit the low construction volume in Europe and/or the positive rental potential offer opportunities.
- Brexit will probably continue to be a drag on rental prospects for property in the UK in the short term, but we expect it to outperform the Eurozone again from 2020 onward. Once again, a diversified approach for risk-oriented investors that spreads the investments over a number of countries is invaluable.
- The greatest risk to this positive outlook would be a sudden economic downturn that could be triggered by intensification of the trade dispute between the US and its trading partners or by political events in Europe. Credit Suisse still believes that this type of scenario is unlikely.
- However, investors who think otherwise and believe such a scenario more likely will continue to be well served with European core real estate portfolios that typically are low-risk, income-oriented strategies.

Introduction

This edition of *Real Estate Strategies* gives you an update on developments on real estate markets in Europe. Commercial real estate markets in Europe are still in excellent shape. The economic drivers are intact, rental price growth is positive in most locations while supply risks are limited. In addition to economic factors, the trend toward coworking is a further boost for the office real estate market. Office vacancy rates are also declining at the moment due to the demand from flexible office providers, such as WeWork and Spaces. Logistics real estate is also being supported by structural factors while the situation for retail properties has continued to deteriorate. Investor interest in real estate continues to be steady. The interest rate reversal, forecasted several times in the current cycle in Europe, has yet to materialize, as the European Central Bank (ECB) is gearing its monetary policy toward the needs of weaker countries in the Eurozone. This means that the requirements remain intact for the upswing to continue.

Real estate cycles could last longer than expected

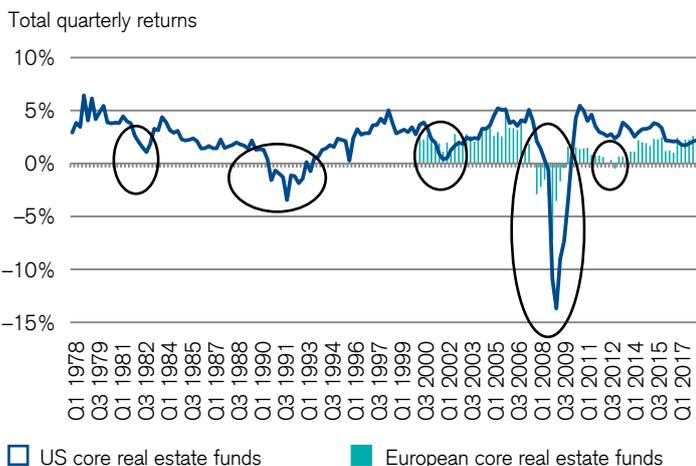
Due to the fact that the financial market and euro crises occurred ten and six years ago respectively, some market participants wonder how long the upswing in real estate prices in Europe can continue.

If we look at the history of real estate cycles over the past 40 years, we see that there is no typical duration for a real estate cycle. They last for different periods and sometimes for somewhat longer than originally expected. Figure 1 shows the performance of quarterly overall total returns of European and US real estate funds with a core investment strategy based on the main NCREIF and INREV indices.

As the European data only go back to 2001, we have also included the US data in our analysis.

Since the beginning of the 1980s, real estate markets overall had downturns in the US and Europe that began in 1982, 1990, 2002, 2008 and 2012 and ended the previous upswings. The chart also clearly shows that some downturns simply go into a phase of nominal weakness of total returns and do not necessarily result in absolutely negative total returns.

Figure 1: Real estate cycles in Europe and the US



Sources: Credit Suisse, INREV, NCREIF
Last data point: Q1 2018

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If the absolute definition is taken as a benchmark, the upswings in the US sometimes lasted between 12 and 15 years, despite occasionally shorter phases. It is also the case that the strongly negative total returns during the financial crisis were more of an exception than the rule.

In light of these considerations, the current cycle in Europe that in many countries only began after the euro crisis in 2013 does not yet indicate a long upswing phase. How long it will last depends on the performance of rental and capital markets for real estate and on economic and financial conditions.

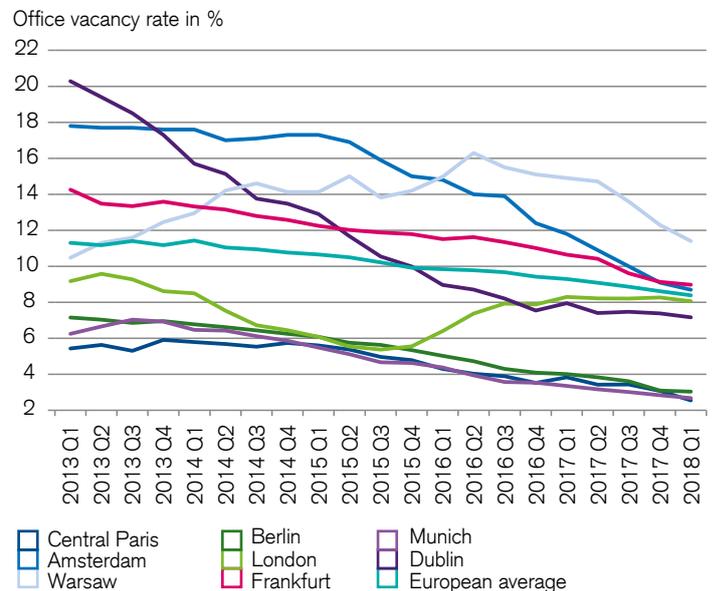
European office real estate markets with strong fundamental data in H1 2018

Office real estate markets in Europe continued their upswing in the first half of the year. Demand for office real estate is the consequence of solid economic growth and the recovery in European labor markets.

However, while economic developments in Europe have slowed down somewhat compared to the dynamic movements of last year, corporate demand for space has intensified. On a gross basis, in Q2 2018, around 3.5 million square meters (source: JLL) of office space were leased out in Europe; this is a new quarterly record figure and around 5% higher than in Q2 2017.

It also reflects the trend toward coworking as well as economic factors. Depending on the city, 7% to 15% of the space take-up was accounted for by coworking providers. In London, WeWork has now become the second-largest tenant after the UK government. In most cities in Europe, the supply of new office space cannot keep up with the high demand. The consequence was another fall in vacancy rates.

Figure 2: Falling office vacancy rates in Europe



Sources: PMA, Credit Suisse
Last data point: Q1 2018

The chart illustrates trends since 2013 using important large cities as examples; vacancy rates are in the 2% to 3% range in Munich, central Paris, Berlin and Stuttgart (not shown in the figure). Large companies are finding it difficult to find additional space to suit their requirements, but even markets such as Amsterdam,

Frankfurt, Dublin and Warsaw, which reported double-digit vacancies over the past few years, are seeing a significant decline in vacancies. Aggregated over the 40 most important markets in Europe, vacancy rates over the past four years have fallen from 11.4% to 8.4%, which also means upward pressure on market rentals. JLL reports that in Q2 2018, rents in Europe rose by around 4.1% on average compared to the previous year. German and Dutch cities currently show the highest rates in rental price growth. In London however, vacancies are roughly stable and rents continue to be under pressure as tenants are still cautious. In 2018, the City of London submarket expects completions to be at a level of roughly 5.5% of overall supply of office space.

Continued solid rise in office rental prices in the Eurozone expected

Overall, the expected supply and demand situation indicates robust growth in rents and stable vacancy rates for the period 2018 to 2020.

Table 1 summarizes our rental price forecasts and expectations. Although the volume of construction projects in progress has on average increased slightly, we expect that on an aggregated basis, over 40 markets in Europe, only around 1.4% net of new space, will come onto the market in this period, compared to 0.9% over the past three years (as a percentage of total space). Credit Suisse expects the economic environment to remain robust in the Eurozone in 2018 and 2019, with economic growth forecast to be 2.2% and 2.0% respectively. We therefore expect demand for office rental space to stay intact too, as we assume that office employment will continue to grow at 1.6% p.a. Vacancies that have already fallen are thus likely to consolidate at their current levels. As landlords continue to have the negotiating power, we expect some markets to experience strong growth in market rents.

Table 1: Outlook for prime office market rentals and vacancies

Office markets	Expected rental price growth 2018–2020 p.a.	Projected vacancy rates 2018–2020
Central Paris	2.5%–3.0%	Stable vacancies at 3%
Munich	4.5%–5.0%	Stable vacancies at 3%
Berlin	5.0%–5.5%	Stable vacancies at 3%
Frankfurt	3.0%–3.5%	Falling vacancies by more than 2% from current 9.0%
Dublin	4.5%–5.0%	Stable vacancies at 7%
Warsaw	0.5%–1.0%	Stable vacancies at 12%
Amsterdam	4.0%–4.5%	Slightly falling vacancies from current 8%
Madrid	2.5%–3.0%	Stable vacancies at 9%
London	–2.5%–2.0%	Rising vacancies from 8% to 9%, stabilization in 2020
Regional office centers UK	–0.5%–0.0%	Slightly rising vacancies of around 11% on average
European average	2.0%–2.5%	Stable vacancies at average 8%

Forecasts are in line with the expectations of Credit Suisse Asset Management (Switzerland).
Source: Credit Suisse
Time of forecast: August 2018

The real estate markets in the UK are an exception, as they are in a different cycle. Demand for office space in London fell back slightly after the UK announced it would be leaving the EU, as there was still strong demand for space from coworking providers and technology companies, while major multinational companies in the service and finance sectors were cautious. In 2018 and 2019, we expect that cumulatively, around 4% of newly built space (as a percentage of overall space) will come onto the market, resulting in further downward pressure on rents. (As highlighted above, the City of London submarket will see a higher increase in percentage terms). However, in the UK's regional markets such as Manchester, Bristol and Edinburgh, there is very little construction activity in progress. Supply is also expected to ease toward the end of 2019, which means that we can expect another upswing in 2020.

However, we expect the Eurozone to demonstrate the strongest rental price trends in 2018 and 2019, weakening in 2020. Once again, investors would therefore be well advised to invest in diversified portfolios covering various countries in Europe.

Online retailing, a disruptor of retailers' value chains

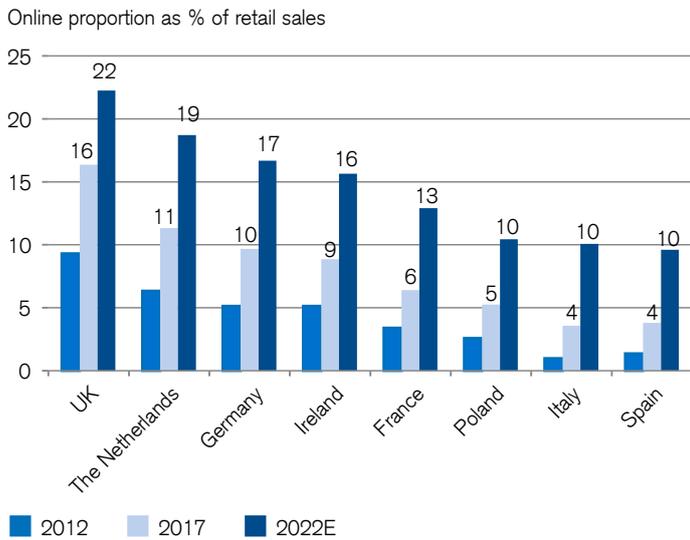
Unfortunately, the situation for the European retail real estate markets is more challenging. Changing consumer habits are reflected in an increased trend toward online shopping, a topic we dealt with extensively in our last issue in February 2018.

The situation has intensified even further since then in the UK. At least ten large retailers, such as House of Fraser and Mothercare, were granted company voluntary agreements (the legal step prior to an insolvency regime) in order to close some of their struggling branches or reduce their rental payment obligations. For real estate investors, this means downward pressure on rents, lower income and higher vacancies in portfolios. Although secondary assets with vacancy rates of already more than 20% are affected the most, assets in good locations are also faced with challenges. By contrast, high street rents in London are continuing to rise, as they benefit from high footfall, and the weaker pound sterling encourages shopping tourism in the capital.

The rental market situation for retail real estate remained stable on the European continent, as countries in the Eurozone and eastern Europe lag behind the UK in terms of e-commerce, and retailers operate in a good economic environment. But on the European continent too, the proportion of online retailing is rising rapidly and is expected to continue to do so according to the forecasts of GlobalData, an independent research provider (Figure 3). By 2022, the proportion of online shopping is likely to rise in Germany, the Netherlands and Ireland to levels seen in the UK last year. We assume that for the next few years, store-based retail sales will only see very weak growth of 0.5% p.a., with two-thirds of sales growth being transacted online. This is of course a simplistic view, as physical and online sales are now interwoven. Successful retailers must also be able to count on powerful online platforms.

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Figure 3: Increased trend toward online retailing

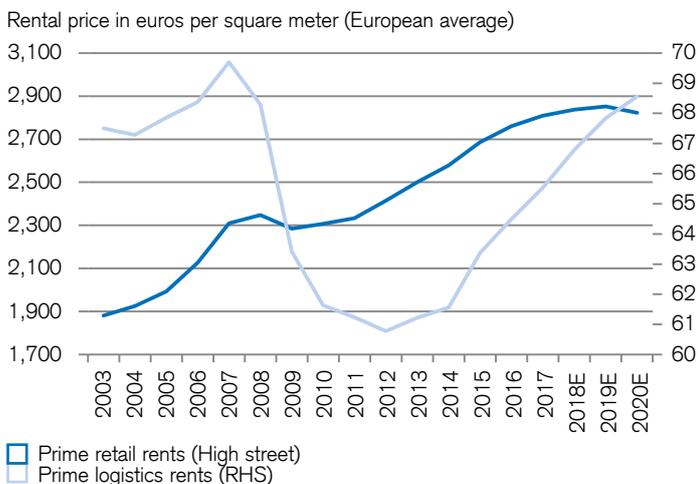


Forecasts are in line with the expectations of GlobalData.
 Source: GlobalData
 Time of forecast: Q1 2018

On the European continent, there was already a clear trend toward a greater differentiation in performance; high street retail and modern and well-positioned shopping centers as well as retail parks with good local anchor work well, whereas department stores, secondary inner-city locations and older shopping centers are already struggling with major turnover problems. We believe this trend is set to continue, but even retail real estate, which is faring well today, will become more management intensive.

Apart from highly sought-after high street locations or distinguished shopping centers, rents in many European locations are likely to fall in the coming years. We are therefore not predicting any further rent increases for the European average. These forecasts place us substantially below consensus expectations, as it is generally anticipated that there will be continued solid growth in retail rentals, particularly on high streets. However, we believe that the market is facing fundamental challenges.

Figure 4: Rental price performance of retail and logistics real estate



Forecasts are in line with the expectations of Credit Suisse Asset Management (Switzerland).
 Source: Credit Suisse
 Time of forecast: August 2018

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Logistics real estate as a beneficiary

The beneficiary of the weaker trends in physical retailing is logistics real estate, as the multi-channel distribution approaches in retailing are increasing the need for storage capacity.

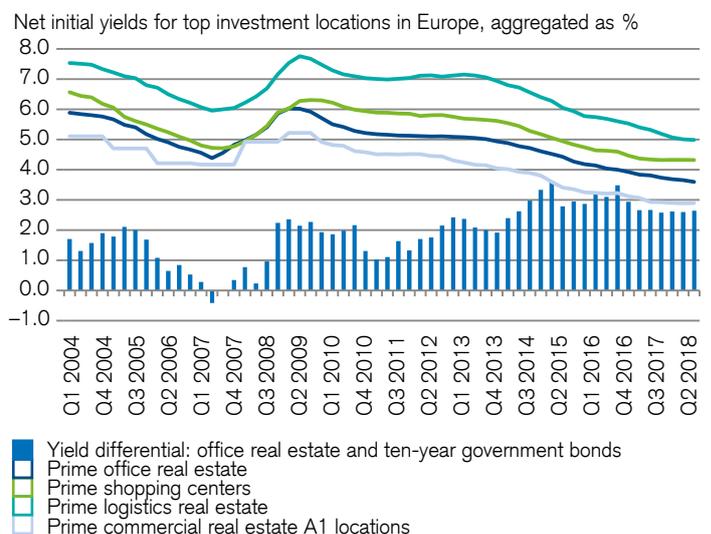
In the UK, logistics real estate has been the sector with the strongest performance since the UK's referendum on its membership of the EU in June 2016, with the segment there recording a rise in rental prices of 6.7% p.a. on average between 2015 and 2017. In continental Europe, the rise in rents was less pronounced at 2.1% p.a. in the same period.

However, the indicators of market demand are all positive and the volume of logistics space take-up is seeing an uptrend in many European logistics hubs. In Germany, the volume of logistics space take-up since 2012 has more than doubled according to our data, but construction activity in this sector was also strong throughout Europe as a whole. There are various reasons for this. The availability of development land in semi-urban locations and the preference of online platforms such as Amazon for new build, modern logistics real estate were factors that favor this type of performance. Older and over-sized warehouse space is not a top priority for tenants. We also believe that the trend toward small urban logistics space that is close to consumers is likely to intensify due to consumers' requirements for quick delivery of online orders. We continue to be optimistic about the logistics real estate market and anticipate rents rising between 2018 and 2020 by around 2% for logistics real estate in the Eurozone and 3% in the UK.

Yield advantages support investor demand

Investor demand for commercial real estate in Europe continued to be strong in H1 2018. European real estate is still favored by European, Asian and US investors. Despite the uncertainties about the implementation of Brexit, office market transactions of GBP 5.3 bn were concluded in London in Q2 2018, meaning investment volume in the first six months for the capital was 22% above the ten-year average (source: CoStar). There is still a demand overhang on the investment market in the Eurozone and Eastern Europe too. Retail real estate is an exception, as transaction volume there is falling and investors are somewhat wary.

Figure 5: Net yields and risk premiums for real estate investments in Europe



Sources: PMA, Credit Suisse
 Last data point: Q2 2018

As Figure 5 illustrates, net initial yields continue to be under downward pressure and have fallen back significantly in the last few years in all core real estate segments, as prices have increased. Even retail property yields hover around these lows. However, the generally low yields must be seen in the overall financial market context. As yields on bonds have continued to decline, risk premiums for real estate assets remain high. Compared to before the financial crisis, the yield differentials are at significantly higher levels, and the fall in yields for ten-year government bonds in H1 2018 means that the yield differentials for real estate have actually risen. For prime office real estate in Europe, they are still at a comfortable 260 basis points on average, which is above the long-term average. For investors looking for healthy income yields, the focus is therefore still on real estate as an asset class.

Risk assessment and investment strategy

The situation in European commercial real estate markets remains comfortable. The current economic upswing is likely to provide a further boost to market rents in the office and logistics real estate sectors, despite their market situations differing. In addition to cyclical drivers, both segments are also being supported by structural factors such as the trends toward coworking and e-commerce.

Although property transaction prices have already risen significantly in the past few years, the high yield differentials suggest sound valuation levels. The ECB's wait-and-see approach, which seems to rule out any interest rate hikes until at least the middle of 2019, will probably contribute little to changing this situation for the time being.

However, we would be more cautious toward investments in retail real estate, as rents are only expected to increase in a limited number of cities, but on average, we predict a further rise in vacancies in Europe. Smaller-scale prime high street space is expected to continue to benefit from the integration of logistics and retail value chains. Modern shopping centers with entertainment facilities and retail with successful retailers can be interesting if they generate a high enough yield, but investors must take a close and critical look at the mix of tenants and business plans. As such, we continue to view the performance of diversified core/core+ portfolios in Europe (with a strong underweight stance in retail property) in a positive light and believe that they belong in every investment portfolio due to the robust levels of distribution yields. For investors with a higher risk appetite, focused value-add strategies that exploit the low construction volume in Europe and/or the positive rental potential offer opportunities.

We see two risks to this positive scenario. One is that a rapid rise in interest rates would negatively impact real estate valuations unless it were accompanied by stronger economic growth. The structurally low wage inflation due to technological developments and the demand for income-producing assets that exists through the aging of society means that such a risk is unlikely to materialize in the near future.

The second is that an abrupt slump in global economic growth could negatively impact rental market trends and therefore price trends. We believe this is more of a realistic risk in the current environment. A trigger for this type of development could be further intensification of the trade dispute between the US and its trading partners or political risks, such as Brexit or the

populist government in Italy. But even in a scenario of slower growth, we see factors such as low construction activity and the still modest use of debt capital limiting downward risk.

However, this is not our main scenario, as we anticipate further solid global economic growth overall.

Investors who believe such scenarios are more likely to occur typically have a sensible investment alternative with lower-risk core strategies where around 70% of the overall returns is derived from income yields. We would recommend avoiding investments in Italy. We recommend investing in the UK within diversified European and global strategies.

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