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July 2017

# Real Estate Strategies

## European Real Estate Markets at Mid-Year 2017

**Welcome to the latest edition of "Real Estate Strategies":**




**Summary**

- The macroeconomic environment for European real estate investments remains favorable. The economic recovery has strengthened, while the political risks in the euro zone have faded into the background for now
- We believe that the recovery of the real estate markets in the euro zone is likely to continue. Since completion levels of new space are likely to stay low in the next two years, the continuing economic recovery is projected to lead to excess demand on the rental markets
- Yields for core investments in the euro zone have already fallen. Currently we see the greatest potential in Value-Added and Core+ investment strategies, because investors can best benefit from positive rental or project development potential in these segments. Deal selectivity and proven asset management competencies are a "must"
- Brexit remains in the spotlight for the UK. Even if political uncertainty is still high, we see a greater probability of a "soft Brexit" vs. a “hard Brexit” since the parliamentary elections in June 2017
- Investments in the London real estate market are very popular with large-scale Asian investors. For the short term, London's high prices do pose higher rental market risks and uncertainties. However, for the long term we are optimistic about London as a global hub for the financial and service sectors
- We feel that investments in regional British markets are an integral part of broad diversified European Core and Value-Added investment strategies. Investments into office buildings in Bristol, Cardiff, Leeds, Glasgow, and Edinburgh show higher yields compared with similar assets around the world. We feel that low construction activity in these cities is likely to support rental markets, in spite of some temporary uncertainty relating to Brexit


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Source: Credit Suisse Asset Management Global Real Estate

This edition of Real Estate Strategies will look at developments on the European real estate markets – including various political events in the first half of 2017 – and discuss the current outlook for real estate investments in Europe.

## Euro zone: Decrease in political risks

The outlook for the European commercial real estate markets was cautiously optimistic at the beginning of 2017. Most market participants expected that the situation on the real estate markets would continue to be positive. However, pivotal elections in the Netherlands, France, and Germany, along with the pending negotiations on Brexit, left room for doubt.

**Table 1: Political events in Europe in the first half of 2017**

| Political events | Comments |
|---|---|
| Presidential and parliamentary elections in France | Reformer and newcomer Emmanuel Macron and his "en marche" movement was the clear winner with an absolute majority in parliament<br>• Potential positive effects on economic growth and collaboration between FR-DE, which will strengthen the EU |
| Elections in the Netherlands | Conservative government confirmed, right-wing populist Gerd Wilders lagged behind expectations<br>• No negative impact on economic growth from politics |
| Brexit/elections in the UK | Prime Minister Theresa May invoked Article 50 of the EU Treaty at the end of March, ordered new elections, and lost the absolute majority, but is governing with the support of Unionists from Northern Ireland<br>• Higher probability of a soft Brexit but general uncertainties remain; risk of new elections<br>Scottish SNP with large losses<br>• Scottish move toward independence is on ice for now |

Source: Credit Suisse

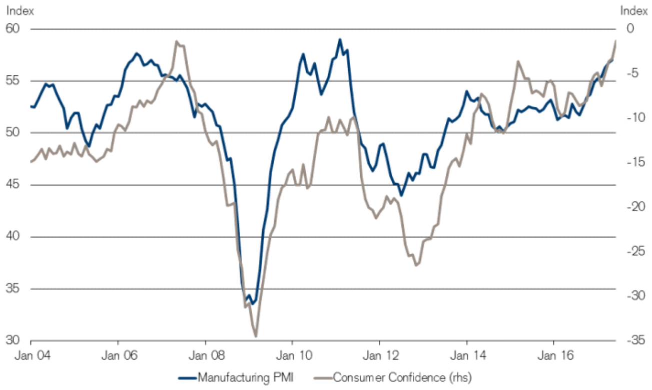
As summarized in Table 1, the centrist parties in the Netherlands and France came out ahead in the elections. In France, the elections may even result in a surprising boost to reforms, with positive effects on economic development if the new leader's reform plans become reality.
All in all, in terms of EU institutions and the euro, the first half of the year was a successful one. This is also reflected in surveys from such organizations as the Bertelsmann Foundation, which show that the population is now more in favor of the EU institutions and the euro.
The next important elections will be held for Germany's Bundestag on September 24, 2017. We feel that these elections pose little risk to developments on the real estate markets, because the two major parties have a large majority and the more extreme parties only have marginal support.

We expect political risks to decline in the euro zone as the discussion about a potential breakdown of the euro subsides for now.

## Greater likelihood of a "soft Brexit"

Brexit remains an unknown quantity. When the UK invoked Article 50 of the EU Treaty at the end of March 2017, it launched the formal exit process from the EU. However, contrary to the initial expectations, the parliamentary snap elections held on short notice in June did not give Prime Minister Theresa May the solid majority, and she now depends on the help of the Northern Ireland Unionists to govern. The government majority remains very narrow.
This continued political uncertainty has been received with great negativity on the financial markets, and the pound sterling took a dive following the elections.
As far as the mid-term outlook on London's real estate markets, we are now more optimistic than we were prior to the elections. This is because we feel there is now a greater chance of a "soft Brexit." Given the outcome of the election and the ailing majority for a Brexit, we even think there is a slight chance that the Brexit decision will be reversed entirely, even though it is indeed slight.
We also take it as a positive sign that following the Scottish Nationalists' loss, Scotland has set aside its independence plans for now. This will reduce uncertainty for investments in the Scottish real estate market, which we find appealing in terms of valuation.

**Figure 1: Consumer confidence and Purchasing Managers Index for the euro zone**




Source: Credit Suisse IDC. Last data point: July 2017

## Euro zone: Higher economic growth, lower vacancy rates, and rising office rents

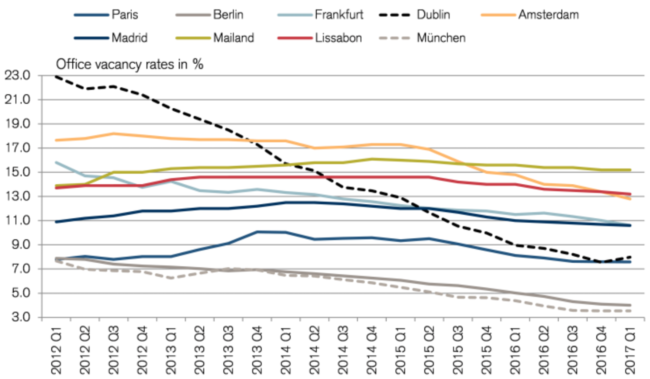
The political risks in the first half of the year had no real impact on economic developments in the euro zone. The labor markets continued to improve and the leading economic indicators, the Purchasing Managers Index and consumer confidence, revealed greater economic momentum (see Figure 1).

Thus, Credit Suisse Research predicts that real economic growth in the euro zone will rise to 2,0% this year, following on from 1,8% last year. Moreover, Spain, Ireland, and now the Netherlands will generate more than 2%, while Germany will remain robust at 1,8%. While Italy, Portugal, and France are still lagging behind, for these countries we also see real GDP growth between 1,0 and 1,6%.

This positive economic environment has already led to declining vacancy rates for office real estate, as shown in Figure 2.

The German real estate markets continued their strong recovery; In Munich and Berlin vacancy declined to around 4% and available space is becoming scarcer and scarcer in these two markets. Vacancies are down in Frankfurt as well, and have dropped from 16% to below 11% since 2012.

**Figure 2: Trend towards lower office vacancy rates**

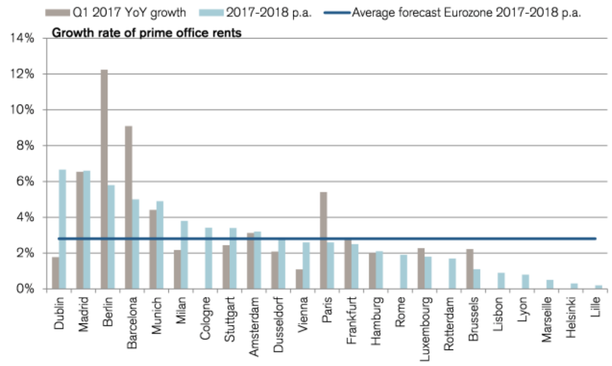



Source: PMA, Credit Suisse
Last data point: March 2017

Office real estate is on the upswing in the Euro zone, and not just in Germany. Vacancies are down in most of the other countries too. This implies higher market rents, because as the supply decreases, landlords can negotiate higher rents with tenants. Figure 3 compares the current momentum of rental prices (Q1 2017) with our forecasts for 2017 and 2018. In Berlin, Munich, Barcelona, Madrid, and Paris, prime office rents recorded impressive growth already in Q1 2017.

We can already anticipate that in 2017 and 2018, most key office markets in the euro zone will continue to see historically low volumes of newly constructed space (less than 1% of the entire inventory on average), because few major construction projects have been initiated in recent years. Because we also expect demand for space to be supported by an ongoing recovery of labor markets, we anticipate further rental growth. On average, we project market rents in the euro zone to increase by 2,8% p.a. until the end of 2018 with office markets in Germany, the Netherlands, Spain, and Ireland to have higher growth rates than the Eurozone average.

**Figure 3: Rising office rents in the euro zone**




Source: PMA, Credit Suisse
Last data point: July 2017

## Structural and economic factors influence retail and logistics properties

The positive economic environment is also benefiting the markets for retail and logistics properties. As distribution channels move toward multi-channel distribution, there is high demand for logistics space. The rental prices have remained fairly stable in the euro zone, so we see further potential. Retail property is suffering on the one hand from this structural trend, because the need for space is expected to drop in structural terms by 10%–20% due to online retail. In particular, older premises in unappealing locations are facing some serious challenges. On the other hand, the impact on retail real estate is complex. Successful internet retailers are combining bricks and mortar sales with online shopping, and many centrally located properties in good locations are still seeing a positive trend. As consumer demand recovers in Europe, logistics and retail properties should benefit economically as well. However, the condition and location of the space remains essential for determining whether investors can profit from this general market upturn.

## Further decline in net initial yields for transactions

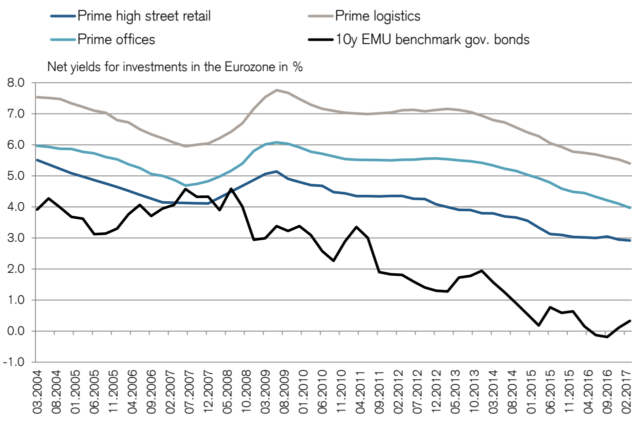
Given the improvements in the rental market and continued low interest rates, real estate investments in the euro zone continue to enjoy high demand from institutional and private investors.

Excess demand on the investment market caused net yields to drop in the first quarter, as shown in Figure 4 for the three real estate segments. Net initial yields for retail property in Grade A locations were at 3,5%, and nearly 4,0% for office space, while investments in top logistics hubs saw net yields of 5,5%. Especially for the top seven cities in Germany, we saw a further sharp decline in net yields in Q1. Our preliminary indicators show that this pressure on yields will continue in Q2. Because the ECB is continuing with its monetary easing, core real estate investments will continue to earn healthy premiums of 300 bps versus the 10-year EUR benchmark bond, even if risk premiums have dropped in the last year.

## Core+ and value-added strategies have the most potential

Because the ECB is likely to initiate a gradual exit from quantitative easing in the second half of 2017 and in 2018, net returns will bottom out in most markets. However, we still assume that net yields will largely remain stable at this low level over the next two years. Historically, net yields tend not to rise until the middle of the interest rate increase cycle. Thus, we remain constructive in our investment perspectives. However, we anticipate lower total returns for pure core strategies, because we will not anticipate additional positive valuation effect that results from a further decline in net yields. Rental market developments should play a greater role now.

**Figure 4: Decrease in net initial yields in the euro zone**




Source: PMA, Eikon, Credit Suisse
Last data point: March 2017

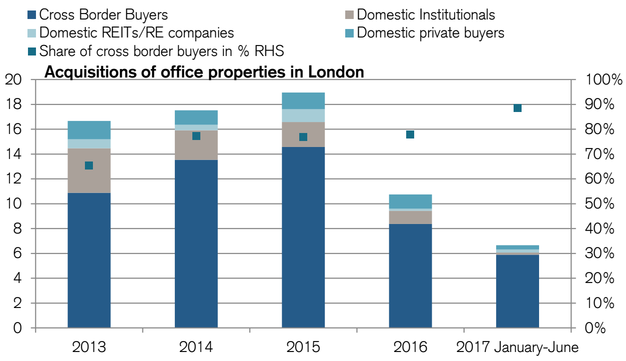
The question for real estate investors is how to position themselves in the current environment. We are of the opinion that currently in the euro zone, the Core+, Value-Added investment strategies promise the best risk-return prospects. In the current market recovery period, investors can enhance their potential returns on real estate by taking some rental and project development risks. Depending on the investors' risk budget, it is also worth pursuing a "value-added strategy," because the positive outlook for the rental markets and continued low construction volume mean potential.
As we discussed in our "Real Estate Strategies" paper on Value-Added back in February, deal selection and asset management are absolute prerequisites. We favor selective, well-researched investments in value-added investment strategies in Germany, Spain, the Netherlands, and Ireland. By mixing value-added funds with core real estate portfolios, investors who previously invested only in core funds can move the return and risk profile of their investments toward a Core+ risk profile. By doing so, they can generate returns in addition to the lower-yielding core investments. While risks will increase as well, we feel that this is justified by the market perspectives.

## Brisk demand for office investments in London despite Brexit

Although more than a year has passed since the Brexit referendum, there are still political uncertainties that could affect real estate market development.
The commercial real estate markets in the United Kingdom have shown different responses to Brexit. In the first few months after the June 2016 referendum, investment transaction and rental market deals came to a virtual standstill. Valuations for real estate came down by 5%-10% on average, because independent real estate appraisers used higher discount rates in their models and market prices came back to a certain extent.
Around year-end, the situation stabilized for the commercial real estate investment market in London. Rental markets in London and the regional markets picked up again, because economic developments in the UK also remained positive in spite of expectations to the contrary. So valuation have also somewhat rebounded since then.
However, in 2016 Brexit had a negative impact on the performance of real estate investments, and the MSCI IPD Index showed a total return of just 3.9%. This was the lowest annual performance since 2012 and a massive drop from the 13.1% total return in the previous year. In a global comparison of industrialized countries, UK was the second-weakest country. Only Italy performed worse for real estate investments.
2017 has been different so far. The liquidity for real estate investments in London improved significantly again in the first half of 2017. Notably, big deals and even mega deals have been closed, such as the "Leadenhall" building.
Transaction activity in London had been dominated even in years past by foreign investors. This dominance increased further in 2017 with a share of some 90% versus the three-year average of 75%. Two-thirds of foreign investors in 2017 were from Hong Kong and China (see Figure 5).

These investors often have a longer-term view, and they see the significant depreciation of the British pound as an attractive gateway to Europe's most liquid office market. We think the situation could be volatile in London for the short term, but over time we believe that London – regardless of Brexit – will remain a global leader and competitor as a financial and service hub.
The short-term market outlook however is modest for London and we expect a further increase in vacancies and about 10–15% lower rents until the end of 2018.

**Figure 5: Office transactions in London**

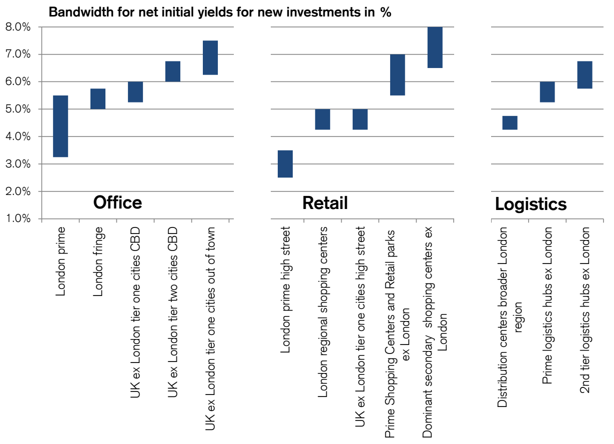



Source: RCA, Credit Suisse
Last data point: July 2017

## Interesting valuation levels on the UK regional markets

The level of investments outside the UK capital was still rather weak, since many participants are still sidelined. Figure 6 shows the largest variation in yields that are currently affecting the British transaction market. Even in the British capital, the level of net yields varies depending on asset characteristic, sub-market, term of outstanding leases, and tenant structure. Compared with other global cities, we note that real estate investments in British cities outside London are trading with substantially higher yields than similar properties in core cities in Europe, the US, and Asia. We feel investments have appealing value particularly in English or Scottish regional cities such as Bristol, Cardiff, Edinburgh, Glasgow, and Leeds because yields are 1,5% to 2,5% higher than in London. At the same time, we expect that due to the lower construction volume here, supply risks will be limited, while vacancy rates have already begun to rise in London. While we do not expect rental prices to increase much in the regional cities as they will in the euro zone, the rental market should remain stable. Thus, investments in the British regional markets remain a core theme of our Core and Value-Added strategies. The combination of such investments with investment portfolios in the euro zone means that in sum, European portfolios will become more diversified and these portfolios will be more resistant to shocks, such as rising interest rates in the euro zone, and the higher yield levels support offer higher cash on cash yields.

**Figure 6: Wide differences in yield levels**




Source: Cushman and Wakefield, Savills, Credit Suisse
Last data point: March 2017

## Publishing Information



Publication Date
July 2017

Published by:
Asset Management Global Real Estate

**Author:**
Zoltan Szelyes, CAIA, CFA
Head Global Market Research
Asset Management Global Real Estate
Email: zoltan.szelyes@credit-suisse.com

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