The persistently low-interest-rate environment is continuing to support demand for core real estate investments in Europe. Risk premiums are above their historic averages despite the low level of initial yields, as there are only a few alternative sources of yield.

The economic weakness in Europe is likely to persist in 2019 and demand for real estate space will cool somewhat. Supply and vacancies also remain low. We therefore anticipate a further rise in market rents at selected investment locations for logistics and office real estate in 2019 and 2020.

However, market and investment management expertise is needed to access the potential of real estate investments in an investment portfolio. In particular, we feel that the following structural trends already need to be taken into account when investing today:

- **Co-working/flexible working solutions** and structurally low construction activity are supporting the persistently low vacancies in office markets. We continue to expect solid growth in rental prices and net income. The trend to co-working and business centers should be reflected in a focused portfolio strategy that takes account of the change in rental models and the increased credit risks of start-ups.

- **Retail properties** look set to remain challenged by the move to **online sales**. Retail in the UK is already in crisis, and we expect little growth in bricks-and-mortar retailing in continental Europe. However, we continue to see focused investment opportunities in segments less affected by online retailing that are still seeing growth, such as local store concepts or retail parks that can be combined with other types of use, especially residential.

- **Logistics properties** are still seeing **dynamic demand**. The overheated transaction market requires selectivity when picking assets and tenants. In view of the social trends, we continue to expect strong rental growth for urban light industrial compared to prime logistics. Strategic locations remain key to investing.

- **The trend to ESG/sustainability is accelerating** among both tenants and investors. We are seeing a shift from strategies based purely on a label to holistic implementation of ESG in investment management. The Global Real Estate Sustainability Benchmark (GRESB) is gaining in importance.
This issue of Real Estate Strategies gives an overview of the European real estate markets. The sustained period of low interest rates is leading to high demand for real estate investments. Because of the solid yield differential compared to the alternatives, this asset class remains a focus for both private and institutional investors. In our view, the impact of technological developments on the real estate markets should not be underestimated, and we will be pointing out the many effects on the markets for office, retail and logistics properties. The influence of ecological sustainability on real estate investing is also likely to rise, and including ESG/sustainability criteria is an essential part of any institutional real estate asset management approach.

Real estate investments in a low-interest-rate environment
The European economy slowed in 2018. The growth rate in real GDP in the Eurozone fell from 2.5% in 2017 to 1.8% in 2018. The trend continues to weaken. Credit Suisse economists are forecasting only 1% growth for the Eurozone in 2019. The UK, too, is seeing slower GDP growth. Real growth in 2018 was 1.4%, compared to 1.8% in 2017. 2019 is likely to see growth in line with last year. The lower prospects for the economy and inflation are also affecting monetary policy and the level of interest rates. The ECB has made clear in its reaction to the weaker economy that it is unlikely to hike rates this year. The yield on ten-year German Bunds, the Eurozone benchmark, is back in negative territory, posing a challenge for investors.

Direct property investments posted a good performance in 2018. Figure 1 shows the trend in total returns at asset level by type of use for the three largest markets in Europe, based on data from institutional portfolios.

Industrial properties have been the strongest segment in the last two years. The total return on retail properties in France and the UK fell noticeably year-on-year in 2018. Germany too saw a weakening. This reflects the rising significance of online shopping and the investor preference for logistics assets rather than shops. Offices put in an outstanding performance again despite the slower economy, driven by further rent rises.

![Figure 1: Total return on real estate investments (in %)](image)

Sources: Credit Suisse, MSCI Last data point: December 2018

Transaction prices for European properties have already gone up substantially in recent years. Even so, real estate investments have a positive yield differential over government bonds (see Figure 2). With the exception of Italy, the spread is in line with last year and above the historic average. We expect the situation to remain positive, as no major changes are likely in the current interest rate environment.

![Figure 2: Yield differentials between office properties and government bonds (in %)](image)

Sources: Credit Suisse, PMA Last data point: Q1 2019

Demand for office space should weaken slightly in 2019 because of the economy. The for the office market relevant labor market reacts to economic trends with a lag and remains solid. The number of office employees went up by 1–3% in 2018 in some locations despite the growth slowdown. In most cases, growth is comparable to last year.

At the moment, the financial markets are full of uncertainty. Factors contributing to this include a delayed Brexit, the re-emergence of populism and trade disputes between the US and its trading partners. Against this backdrop, real estate investments look set to remain attractive for investors, as the asset class offers stable running yields and limited volatility.

Office markets marked by low vacancies and co-working
Office real estate markets continue to put in a positive performance despite the economic uncertainties. Demand remained intact in the first quarter of 2019, rising around 7% year on year, after a record year for rental transactions in 2018 (source: JLL). With completions still low in most European cities, vacancies continued to decline.
Figure 3 shows that in some markets, there is a shortage of high-quality office space. Vacancy rates in Munich, central Paris and Berlin are now below 2%. We expect a higher level of completions in Berlin and Paris, but in Munich the situation has become more pronounced. Those markets where vacancies were well into double digits in 2013, such as Amsterdam, Madrid, Dublin and Warsaw, have seen a very strong recovery over the last three years. Warsaw in particular is performing as we anticipated and the market has posted a decline in vacancies from over 15% to below 10% since the end of 2017. Investors are feeling the benefits of this reduction in vacant space. Rents in the first quarter of 2019 rose 5.1% year-on-year, aggregated across the European markets. The strong recovery in the office market is not just due to economic factors, it is also a consequence of the trend towards co-working/more flexible tenant structures and new working models.

Co-working providers have existed since the 1980s. It was only the appearance of technological innovations like mobile apps and changing working models and preferences that made it possible for specialized providers of flexible office space such as WeWork, IWG (Regus, Spaces) and other small firms to establish themselves as a considerable sector of demand. Providers like these accounted for 14.7% of rental take-up in the UK over the past 12 months, and 12% in European markets outside the UK. Figure 4 compares the percentage accounted for these providers by city over the periods 2011–2015 and 2016–2018.

In the last three years we have seen a higher share in almost all cities for these models. The significance can vary strongly by market, however. Flexible office providers play an intermediary role, like banks in the circulation of money. They tend to take space long-term and hire it out very short-term (by the hour, day, month or year). The higher percentage in the UK markets is surely a consequence of Brexit, as many tenants are unwilling to enter into long-term commitments. These flexible options for renting space meet the needs of international service providers in the UK. Another segment is the strong growth of tech firms/start-ups in London’s Shoreditch and Birmingham. In our view, some cities in continental Europe are still lagging behind this trend and we expect to see such providers remain a major presence in the rental market in 2019/2020.

Real estate investors have to take account of the positioning of the properties in the market and the credit quality of these providers in their portfolio strategy. We feel that such tenants are likely to successfully position a property in the market. The share they occupy in a building should be limited to no more than 25–30%. Many providers still have profitability problems and their resilience to a crisis has yet to be tested in a recession, even if these risks are unlikely to materialize in the short term. At present, the positive impact from improved efficiency and lower vacancies is predominating on the rental markets. With demand in the segment expected to remain strong, we see office rents rising in continental Europe in 2019 and 2020. As stated, net initial yields on offices have fallen, and the above-average risk premiums should give further support to current valuations. Our view on European office real estate therefore remains positive.
Digitalization and changed consumer behavior
The value chains for retail and logistics properties are undergoing major changes. These are the result of technological progress, as mobile communications become increasingly embedded in all aspects of our daily lives. Consumer habits and demands are changing as a consequence. Figures on the use of iPhones show that the average global user spends more than three hours 15 minutes on their device every day. Even if they spend only a fraction of this time shopping, the trend in the segment is irreversible – if anything, it is accelerating (Source: https://blog.rescuetime.com/screen-time-stats-2018/).

Online sales continue to soar. Sector leader Amazon saw its revenues in Germany rise from EUR 8.9 bn to EUR 16.8 bn between 2014 and 2018. The company’s worldwide revenues in 2018 were USD 277 bn. Chinese providers like Alibaba and JD are now moving into the European market. Global sales of goods at Alibaba were USD 768 bn in 2018. JD and Walmart, which have a cooperation, had combined revenues of USD 758 bn. Online retail experts are also seeing a shift in the business model of online retailers towards specialization in individual goods segments. Zalando is aiming to position itself as the number one online in 2018. In Italy, Portugal and Spain, by contrast, the fraction of online sales was less than 4%. We expect the move towards higher percentages online to continue across Europe. This brings with it the sustained high growth rates of online retailing. On the other hand, traditional retailers will likely see only modest growth in Europe, apart from a few countries in Eastern Europe.

The impact of this trend is different for the different segments of retailing. While non-food posted a nominal decline in revenue of 1.6% in Germany in 2018, traditional food retailers enjoyed 3% revenue growth (Source: Destatis.de). Local store chains like REWE, Aldi Nord, Aldi Süd, Lidl, Norma, Edeka and Netto reported revenue growth of over 5% p.a. in the last three years. Fashion, sports and electronics, on the other hand, continue to suffer and many retailers are closing outlets. We see this trend continuing for these segments. Some 15–20% of sales in these segments now take place online, a figure we expect to rise to 30–40% in the next five years (Source: Credit Suisse).

Trend in retail property markets in Europe
Figure 6 shows the trend in rents for different countries and segments in Europe.

Most types of retail property in the UK are in crisis. Rents are under downward pressure outside London for shopping centers, prime locations and retail parks, as many retailers are restructuring their liabilities using company voluntary agreements (CVAs), a precursor to insolvency. At the same time, investor interest in the segment has fallen sharply. We have seen net yields climb between 100 and 200 basis points in 2018 and the first half of 2019 (Source: Costar). We recommend waiting for the uncertainty to end, but we are monitoring the situation actively as valuations in the segment are now very low. The situation is more nuanced in continental Europe and the Eurozone. Traditionally, prime retail sites in the Eurozone, i.e. those with high footfall, saw rents moving up over the long term. Even during economic downturns the segment saw low volatility in the past. As Figure 6 shows, this has changed in the past few years.

Across Europe last year, a rise in prime retail rents was seen only in Paris, Dublin, southern Europe (Barcelona, Madrid, Milan and Lisbon) and central and eastern Europe (Prague, Budapest and Warsaw). Apart from Berlin and Munich, there was not even a rise in the rents for prime sites in city centers in Germany and the Netherlands. In smaller cities in Germany, city centers saw rents fall sharply. Secondary locations in city centers and retail concepts that have been overtaken by social change like large department stores or older shopping centers with nothing to distinguish them are struggling across Europe with lower rents and higher vacancies.
Investors are cautious about retail as an asset class. As on the rental markets, capital markets also saw considerable differences. Prime sites continue to trade on very low net yields, often around 2.5-3%. German retail parks and local store concepts such as supermarkets remain sought after Investments and saw net yields decline. These typically trade on net initial yields of 4–4.5% (Source: PMA). By contrast, we have seen a move toward higher capitalization rates over the last 12 months for shopping centers, prime assets in smaller cities and secondary locations. The level of yield varies by location, quality and the market position of the properties.

Which retail concepts work?
Looking at the sector as a whole, we are still cautious on retail assets, since the process of change looks set to carry on apace. For investors able to read the current social trends correctly and focus concepts on current consumer needs, the segment still has potential. This is because various investors not specializing in retail have pulled out of the sector.

We think the following concepts could be successful:

- **Prominent smaller stores on high streets**: High footfall and visibility are key, as stores are contributing ever more to brand presence. Trend toward showrooms and stores for online platforms in inner cities. Focus on prominent ground-floor locations, upper stories being converted to apartments/hotels. Focus on large and mid-sized cities, eastern and southern Europe tourist destinations. Avoid smaller cities with no particular attractions.

- **Innovative local store concepts/retail parks**: Focus on convenience food segment, meeting daily needs. Can also be implanted in new modern residential developments. Demographically favored sites with prospects of population growth. We still see high potential for bricks-and-mortar food retailing in Germany and the rest of Europe. We also feel there is still potential in specialist retailers and retail parks. The key criteria for success are the tenant mix and the catchment area.

- **Modern shopping centers with distinctive features**: Focus on shopping centers that can serve as an attraction and help to form modern communities. Ideally, shopping centers should be number one in the catchment area and offer entertainment, a cinema, the right mix of tenants and a trendy food and beverage offering. This requires great selectivity. Only get on board if net initial yields are correspondingly higher (over 5% net), as the segment is currently experiencing a repricing.

**Logistics real estate: demand for warehouses continues to rise**
The trend toward multi-channel distribution in retail is also driving a considerably higher need for logistics assets. Aggregate annual demand in Europe in the last two years was about 60% higher than the average between 2010 and 2014. Vacancies continue to fall, despite relatively strong construction activity. Aggregate vacancies across Europe have almost halved since 2013 and were 3.1% in the first quarter of 2019. Most of the demand continues to come from third-party logistics providers, who took 42% of total space in 2018. Traditional retailers were still the second most active segment at roughly 25% of space taken, with e-commerce providers accounting for roughly 20% of demand. Amazon dominates the latter segment with a share of 75%, 65% and 45% in the UK, southern Europe and Germany respectively. Remarkably, discounters also have a strong presence in the logistics market. After Amazon, Lidl was the second largest renter of logistics assets in Europe (Sources: PMA, JLL). As described above, we expect new Asian competitors to enter the market in the next few years and see the prospect of sustained high demand for space, even if Amazon is already growing less strongly than it was a few years ago and hence is likely to be less significant when it comes to renting space.

**Urban light industrial versus prime logistics**
There is also a difference in logistics properties between the traditional large-scale buildings along major roads but often in urban regions with lower population density, and urban light industrial buildings.
The latter are located in the agglomerations of major cities and are often smaller assets. Figure 7 shows the trend in rental prices for these two segments in continental Europe and the UK based on a new set of data from the researchers PMA. Firstly, it is obvious that the UK has seen rents in both segments rise faster than the rest of the continent. This can be put down to the fact that online sales are already greater than on the continent, and to the greater shortage of supply and the planning regime. In our view, logistics rents will continue to rise despite the uncertainties of Brexit since the trend towards online sales is continuing.

**Figure 7: Trend in rental prices for logistics properties**

![Figure 7: Trend in rental prices for logistics properties](chart)

Sources: Credit Suisse, PMA

On the European mainland there are fairly clear differences between the urban light industrial and prime logistics segments. Rents in the latter are still below the level of 2007 and only started moving up in 2015. The lower increase in rents is due to the greater availability of land for such projects and the lower percentage of retail sales online in many countries. The market also had to wrestle with a major supply overhang during the global financial crisis and the euro crisis which has only been unwound in the last few years.

While urban light industrial has grown more strongly, we anticipate that demand will be stronger in future for urban logistics assets, while supply is limited. Both traditional and online retailers need warehouses close to consumers, as the expectations of their consumers are rising.

We remain optimistic on the rental market for both sub-segments of logistics assets over the coming years. However, net yields have already fallen considerably due to investors’ large appetite. In the UK, net yields are already lower than for similar office assets, which suggests the market is overheating. Net yields in the segment are also down sharply in continental Europe. Investors must look carefully at locations, pricing and asset quality.
before investing. We prefer strategic logistics locations in Europe such as the Rhein-Ruhr, southern Germany, northern Italy, the “Golden Triangle” plus western Poland and Slovakia, or urban sites such as Paris, Berlin, Hamburg, Madrid and Barcelona.

**Trend to ESG/sustainability: GRESB increasingly significant**

Sustainability is an important trend that is changing the real estate markets. It is having an impact on users and investors. For many users, renting sustainable assets is an important selection criterion. Large international companies in particular have corporate policies specifically focused on sustainability. They consider holistic ESG criteria that cover environmental, social and governance aspects.

From the investor perspective, sustainability certification and building labels are no longer sufficient to demonstrate a portfolio is sustainable. Investment managers must be able to document improvements in energy, CO₂ and water consumption and a reduction in waste at portfolio and individual property level. This means the data has to be recorded, internal processes and the achievement of energy targets monitored and necessary actions taken.

GRESB has now established itself as the leading initiative in ESG assessment. The GRESB calculates the sustainability performance of real estate and real estate portfolio globally using consistent ESG criteria.

In 2018 over 900 leading real estate companies and funds in 64 countries were systematically analyzed for their ESG and sustainability performance. This means the GRESB looks at total assets of over CHF 3.5 tn, or around 79,000 properties. The peer groups are evaluated and compared with each other by size of portfolio, type of use and country allocation. GRESB uses a holistic evaluation to review participating listed and unlisted real estate companies based on management, transparency, opportunities/risks, performance indicators, monitoring and environmental management system, stakeholder involvement, new building/refurbishment and building certificates. A total of some 50 indicators are checked across the main categories mentioned. The GRESB allows investors to measure and compare sustainability in the real estate sector. This is the only way that ESG performance can be systematically optimized and that compliance with sustainability is possible in the first place.

The number of participants in Europe has risen from about 100 in 2010 to almost 450, so a critical mass has now been reached. We expect the number of participants to continue growing in the coming years.

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1 For a more detailed examination of GRESB benchmarking, please see the Credit Suisse real estate study published in March 2019.

The disclaimer at the end of this document also applies to this page. Forecasts are not reliable indicators of future performance.