February 2018

Real Estate Strategies

Real Estate Trends in Europe

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

Summary

- A robust economic growth environment should further boost European real estate investments in 2018. We expect property rentals to continue rising amid stable to declining vacancies in most office rental markets in Europe.
- Real estate investment must keep abreast of technological developments such as digitalization, which is bringing about significant social changes. We see the following key trends and implications for investors:
  - **Logistics/urban warehouse space** will likely gain increasing importance due to e-commerce trends. We expect that demand for space will continue to rise in the years ahead. The main focus going forward will be on smaller albeit fairly centrally located logistics properties with efficient fiber-optic connections.
  - **The inner-city retail structure** is undergoing a paradigm shift. Whereas older shopping malls and warehouses are facing challenges, opportunities are being offered not only by small, centrally located, and well-positioned spaces but also by state-of-the-art shopping malls additionally offering leisure and entertainment activities, as well as easily accessible specialty shopping centers.
  - **Office properties:** State-of-the-art office properties are not only energy efficient but also flexible and fitted with an open-plan style. The home-office trend is growing increasingly popular, with corresponding savings in terms of space. Similarly, coworking is a new and highly promising trend designed to allow maximum flexibility for users and occupants. Coworking space providers already made up more than 10% of the space rental take-up in London and Amsterdam in 2017. And this trend is on the rise.
- In order to surmount the complex challenges successfully, it is necessary to identify trends at an early stage, using not only technical property construction and asset management capabilities but also competent product management, including research.
- Those investors unable to cover such competencies are advised to implement their real estate allocation through fund solutions. This is no substitute for a manager's experience and track record, which remain decisive.

This edition of "Real Estate Strategies" describes the trends impacting real estate markets in Europe. On the one hand, they include direct trends such as the economic upswing and strong labor market recovery; on the other, technological and social trends stand to affect medium-term investment prospects and should today already be factored into the real estate allocation.

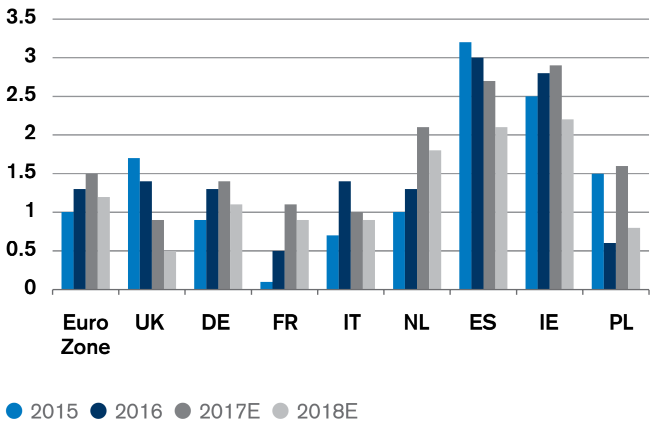
Stronger economic growth in the euro zone

The economic growth situation is directly relevant to the performance of real estate markets. After positive trends were recorded by a number of economic indicators already in mid-2016, gross domestic product growth rates are now also reflecting these increases. The Eurozone is expected to post growth of 2.4% for the calendar year just ended, which would mark the strongest growth in the last 10 years. According to Credit Suisse's economists, we should see an acceleration in economic growth to 2.6% in 2018, driven by the German economic growth engine.
Strong growth is anticipated in just about all EU countries, with Poland and Ireland expected to register the strongest real economic growth – at 4.7% and 3.9%, respectively. Former "economic problem children" France and Italy are also showing encouraging signs of progress.
Nevertheless, the existence of political risks should not be taken lightly – for example, the EU exit negotiations with the United Kingdom (UK) or Italy's parliamentary elections in 2018 have the potential to curb the economic upswing in the Eurozone. At the same time, however, upward forces are still intact and, according to the leading indicators, a continuation of the upswing is foreseeable.

Improved labor market situation

Unemployment in the euro zone continues to decline. According to Eurostat, the unemployment rate was 9.7% at end- 2016 and steadily decreased over the course of 2017 to touch 8.7% in November. Major differences among individual countries still prevail. Whereas the unemployment rate in Germany remains at a historical low of 3.7%, unemployment in various countries such as Italy, Spain, and France exceeds 10%. Unemployment is on the decline in these countries, however, a trend that should continue to accelerate in 2018. In the third quarter of 2017, a total of 236.3 million men and women were gainfully employed in the Eurozone. As reported by Eurostat based on its estimate for December 2017, this is the highest level ever recorded. In the third quarter of 2017, for example, the number of people gainfully employed in the Eurozone and in the EU28 was up 0.4% q/q and 0.3% q/q, respectively, reflecting this economic region's robust growth. As shown in Figure 1, Ireland, the Netherlands, and Spain register the strongest increases in the number of gainfully employed persons. Momentum continues to remain positive overall. Given this favorable environment, we expect to see robust employment growth in 2018 also.

Figure 1: Robust employment growth

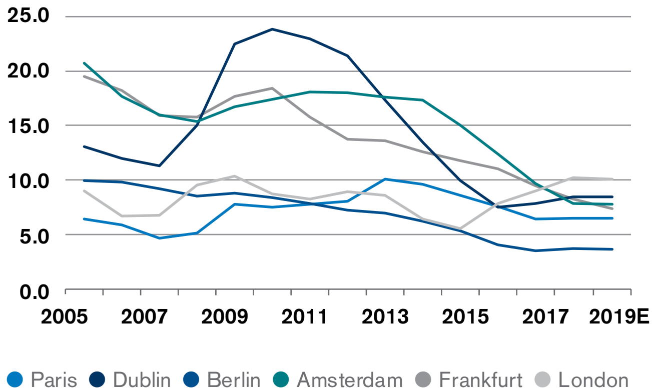


Sources: Credit Suisse, OECD, EU Commission (2017)

Ongoing upswing in real estate markets

The European economic growth recovery is likewise affecting real estate markets in the form of an increase/shift in demand for space. At the same time, the expanded supply is still low so vacancies are down.
Figure 2 depicts the situation across various office markets in Europe. The lowest vacancy rates are found in German cities, as well as in Paris, while vacancies in Amsterdam, Dublin, and Madrid were sharply down. With employment still projected to grow, we continue to expect stable demand. Vacancy rates should either decline further or – as is the case in many German cities – remain at very low levels. This should pave the way for another pick-up in rental prices in 2018 and 2019. One current exception is the office market in London, where demand remains subdued on account of Brexit, with a high volume of new office space also coming to market in 2018.

Figure 2: Office vacancy rates (in %)



Sources: PMA, Credit Suisse

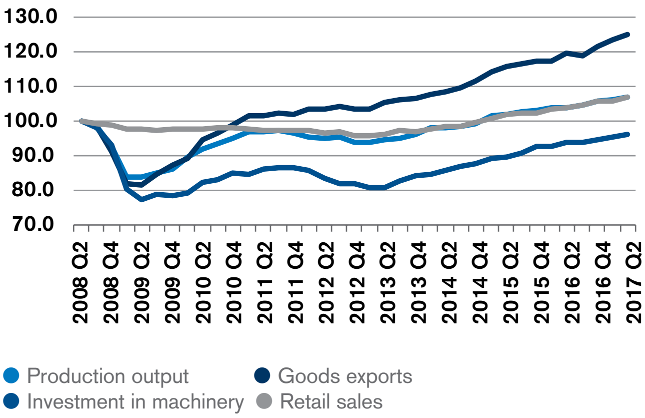
Real estate market undergoing paradigm shift

On top of the economic growth determinants, yet another trend has taken on greater significance in terms of current and future real estate demand: the digitalization trend. To be sure, e-commerce is already here to stay, and its impact on brick-and-mortar retailing is detrimental. What's more, its growth potential has not yet been tapped out. Whereas in the past orders for certain goods were placed at so-called online department stores on a sporadic basis only, today it is already commonplace for users to price shop and order through various online portals. Alongside the restructuring of real estate segments such as the retail and office sectors, the online retail growth segment also has an enormous impact on the logistics sector.

Digitalization – growth driver behind logistics real estate

In addition to the strong economic drivers, digitalization is significantly strengthening demand for logistics real estate while at the same time shifting the demands placed on, and requirements for, these properties.

Figure 3: Logistics growth sector



Sources: Credit Suisse; PMA, Eurostat, EU (28)

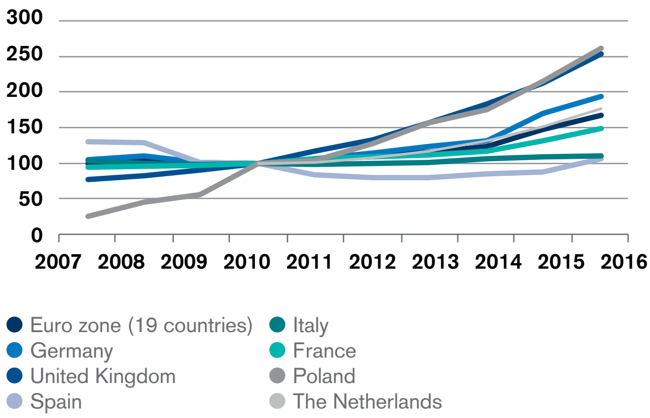
Not only does B2C online retail play a key role on this front but also the fact that companies are placing orders directly with producers (B2B) with increasing frequency is causing demand for logistics real estate to accelerate rapidly. As shown in Figure 3, all logistics demand indicators are pointing north. The corresponding space revenue reached a new all-time high in Europe in 2017.

However, e-commerce requires not only more logistics space but also new types of logistics real estate that caters to the growing demands and requirements of manufacturers, logistics experts, and consumers. The supply chain of the future will need to be substantially more customer-centric if it is to meet customers' growing on-time demands for rapid and flexible availability. In the future, specific products will be systematically demanded by customers – and not simply be made available just by manufacturers and logistics specialists. This means that there will be no need for large volumes of product inventories and long transport routes.

As a result of these demands and requirements, logistics buildings will have to be located more densely in the vicinity of major hubs, as well as close to production facilities. As smaller warehouse spaces will be needed as well, the main focus going forward will be on smaller albeit fairly centrally located logistics properties with efficient fiber-optic connections. Mail order/online retail is experiencing significant growth throughout the euro zone, with sales having doubled since 2010 – notably in the UK and also in Poland.

Various components play a pivotal role here: growth in Poland for instance started from very low levels, i.e., between 2014 and 2017 the proportion of online to total retail sales increased from 2.8% to 4.3%, and this percentage is still one of the lowest by European standards.

Figure 4: Growth in mail order/online retailing



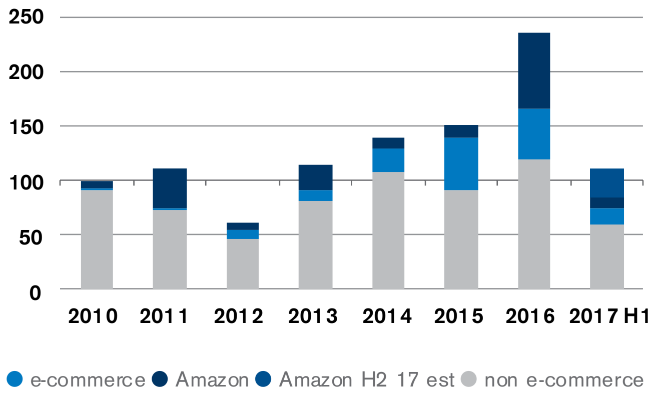
Sources: Credit Suisse; Eurostat

The UK has always been a showcase for e-commerce worldwide and, thanks to the early adjustment made by UK retail, is already far more developed than other European countries. In the UK, nearly 18% of all sales are already conducted online. We expect a further continuation of this trend.

Sea change in retailing offers opportunities

This should lead to lower demand for retail space overall. Particularly warehouses and large, older, and poorly located shopping malls are likely to continue facing major challenges. However, this trend also provides opportunities for retailers and real estate investors. We are seeing a growing convergence between e-commerce and brick-and-mortar retail, creating new trade strategies that are gradually crowding out traditional downtown retail centers. Amazon, one of the most prominent online retailers, is expanding its offering at breakneck speed, for example, and increasingly encroaching on inner cities. With its smaller, branded logistics centers located near inner cities, the Amazon retailer offers downtown delivery within one hour, and delivery to outlying districts inside of two hours. But it is not just the proximity to city centers that is hurting brick-and-mortar retailing: the introduction of "Amazon Locker" – its parcel drop-off and collection station – also goes to expand the online retail specialist's range of offerings. And it is not only Amazon that has adopted this strategy – fashion retailer Zalando is increasingly drawn to the city so it can stay on top of the latest retail trends. Former pure online retailers are currently on the lookout for suitable commercial premises in city centers. Last year, for example, Zalando acquired Munich-based streetwear retailer Kickz, a small but smart, fast-growing chain of retailers. These shops could conceivably speed up delivery processing, as well as accept return goods, including the possibility of personal consultation and the promotion of local events. Zalando is also planning to open smaller beauty shops in city centers while offering its customers personal consultation services. Google and Nespresso are likewise jumping on the brick-and-mortar retail bandwagon. Their shops are designed to draw customers' attention to products and services in a more targeted way: touch, try on, and buy.

Figure 5: E-commerce accounts for one-third of retail letting



Sources: PMA, Credit Suisse

Consumers and investors focus on specialty shopping centers

It is not only downtown retail locations that are undergoing a transformation but also demand for specialty shopping centers is on the rise throughout Europe. Good easy-to-reach locations that allow customers to satisfy their routine shopping needs within an attractive setting to include high-quality culinary offerings meet the needs of customers and investors alike. In this segment, the focus is more on smaller specialty shopping centers covering local needs and housing a growing number of tenants that previously opted for locations in city centers and shopping malls. While these retail formats are appealing not only for their one-stop shopping convenience but often also for their free parking facilities, what draws investors and tenants are relatively low rents, flexible floor space arrangements, and superior logistics structures.

XXL versus mini-format stores

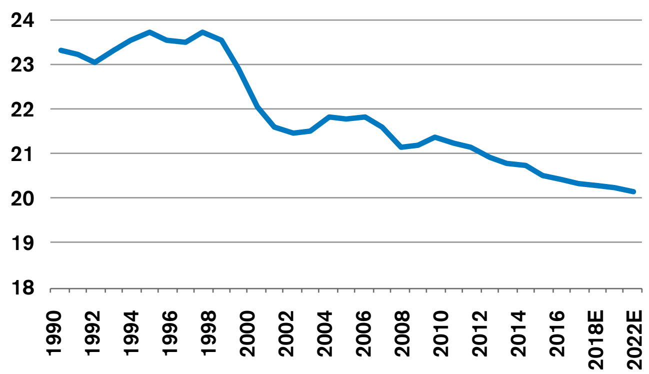
Whereas the preference in the past was for increasingly sprawling retail spaces, currently we are witnessing a counter-trend: companies such as Media Markt, Saturn, and Ikea are offering their customers attractive shopping opportunities in so-called mini-format. A Media Markt outlet that opened in Berlin was only 800 m^2 in size, for example – one-third as large as an average store in the chain. The Saturn chain is even planning to open "Saturn Connect" markets with floor space of only 300-700 m^2. Similarly, Ikea is already experimenting with smaller "Pick-Up Points" that are only around 800 m^2 in size. Their small exhibition area is complemented by consultation services and ordering options while serving as a pick-up point for products ordered online.
There are sound reasons for downsizing the sector: lower approval hurdles for the mini-shops than for large-scale stores on the outskirts. In addition, smaller shops are also a response to the frequently observed decline in space revenues as a result of the online boom.

But this transition is presumably not yet over: One conceivable trend is towards so-called showrooms where products can be merely showcased and tried out. Orders would then be placed online with direct delivery to customers' homes.
For real estate investors specializing in commercial properties, this means that the undifferentiated, "non-research-based" investment of the past will likely be replaced by a focused investment style encompassing a critical analysis of the business plans of individual properties. In this way, asset management and research play a greater role in investment decision-making.

New working styles call for more flexible office solutions

Office properties have not been so obviously impacted by structural transformation as commercial and logistics properties. Yet the office sector is also subject to a variety of far-reaching trends. Figure 6 illustrates that office space per employee in Europe is already down 15% on average since the 1990s. We expect to see a continuation of this trend in the years ahead. Nevertheless, vacancies in the European office markets are low as supply is also shifting.

Figure 6: Office space per employee in the 11 key European locations (m^2/employee)



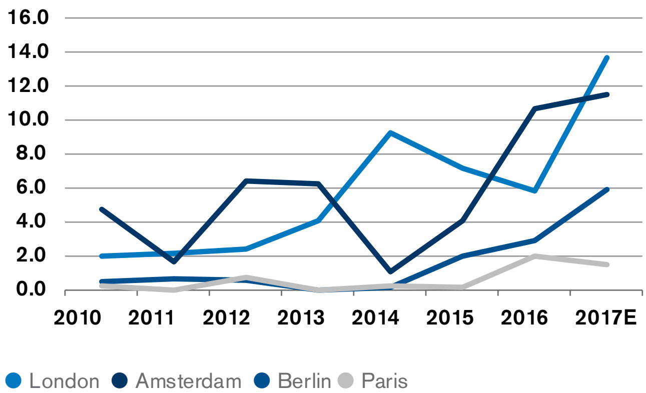
Sources: PMA, Credit Suisse

In order to operate successfully in this environment, office properties must be designed to meet the needs of demand. State-of-the-art office properties are not only energy efficient but also flexible and fitted with an open-plan style. This means that employees no longer have a designated workplace but instead can flexibly choose their work location. As a result, properties with shared workspaces and places for social encounter are becoming increasingly important. Furthermore, the home-office trend is growing increasingly popular, with corresponding space savings here as well. For instance, insurer AXA Versicherung has launched a pilot project at its location in Hamburg: "New Way of Working". All employees have their own laptop and may work from home for up to two days a week on top of their flextime. AXA is following in the footsteps of larger firms such as Google and Microsoft, where this trend is already well established. By the year 2020, the insurance company aims to revamp all of its locations patterned on this model.

Coworking – new tenant segment

Coworking is a key component of this trend towards flexibilization. Providers of coworking spaces rely on demand from young startups, while large companies are also beginning to lease small-sized units in coworking spaces. One of the many providers pursuing this concept is WeWork, which now has 260 locations in nearly 60 cities. Real estate services provider Savills has also jumped on the bandwagon with its Workthere platform founded for the purpose of brokering coworking spaces. They vary in size, some boasting a floor space of 13,000 m^2 while others such as cafés and private offices are smaller. Coworking will also prove to be a viable solution for individual and small enterprises going forward as they can maintain the requisite flexibility while also offering temporary opportunities for SMEs and major companies that might need an additional location for project-related activities, for example.
Unlike in the past, the focus of investors and occupants is on the greatest possible flexibility in terms of space, something older office properties are often no longer able to offer, barring major reconstruction.
Whereas the position of a location or property was defined in the past by the importance of different segments such as banks, other services, or government tenants, today providers of coworking solutions constitute a new demand segment. Consequently, in various central locations such as London, Berlin, and Paris the success of a property also depends on the extent to which it can be used for coworking spaces.
As demonstrated in a market analysis compiled by real estate research consultancy Property Market Analysis (PMA), in 2017 coworking models already made up 10% of the demand for space in London (Figure 7).

Figure 7: Flexible office as % of total take-up



Sources: PMA, Credit Suisse

Implications for real estate investors

How can real estate investors capitalize on these short- and long-term trends?
First and foremost, European real estate investment remains an exciting segment for investors. Robust economic growth and the labor market upswing are further boosting the real estate market. Although property investments have grown more expensive, as a rule they continue to offer a comfortable yield pick-up over bonds; as a result, real estate still looks appealing relative to other asset classes.
In our view, moreover, the real estate allocation should be geared towards the medium-term structural trends outlined above. This comprises the following points:

- Logistics properties are set to play a greater role also in core portfolios going forward.
- Investors should adopt a selective approach to the implementation of retail properties. Small, centrally located, and well-positioned spaces, state-of-the-art shopping malls with leisure experiences on offer, and specialist shopping centers in good urban locations promote opportunities, whereas warehouses and older shopping malls are facing major challenges.
- For office properties, it is important to take note of new design requirements for properties, as well as the new flexible working arrangements. Coworking must also be integrated as a new demand segment into the asset business plans.

Like other sectors, the real estate sector will continue to be affected by technological and social changes. To surmount these challenges successfully, it is necessary to identify trends using not only technical property construction and asset management capabilities but also competent product management, including research.
Those investors unable to cover all the above-mentioned competencies are advised to implement their real estate allocation through fund solutions with the help of specialist property asset managers.

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