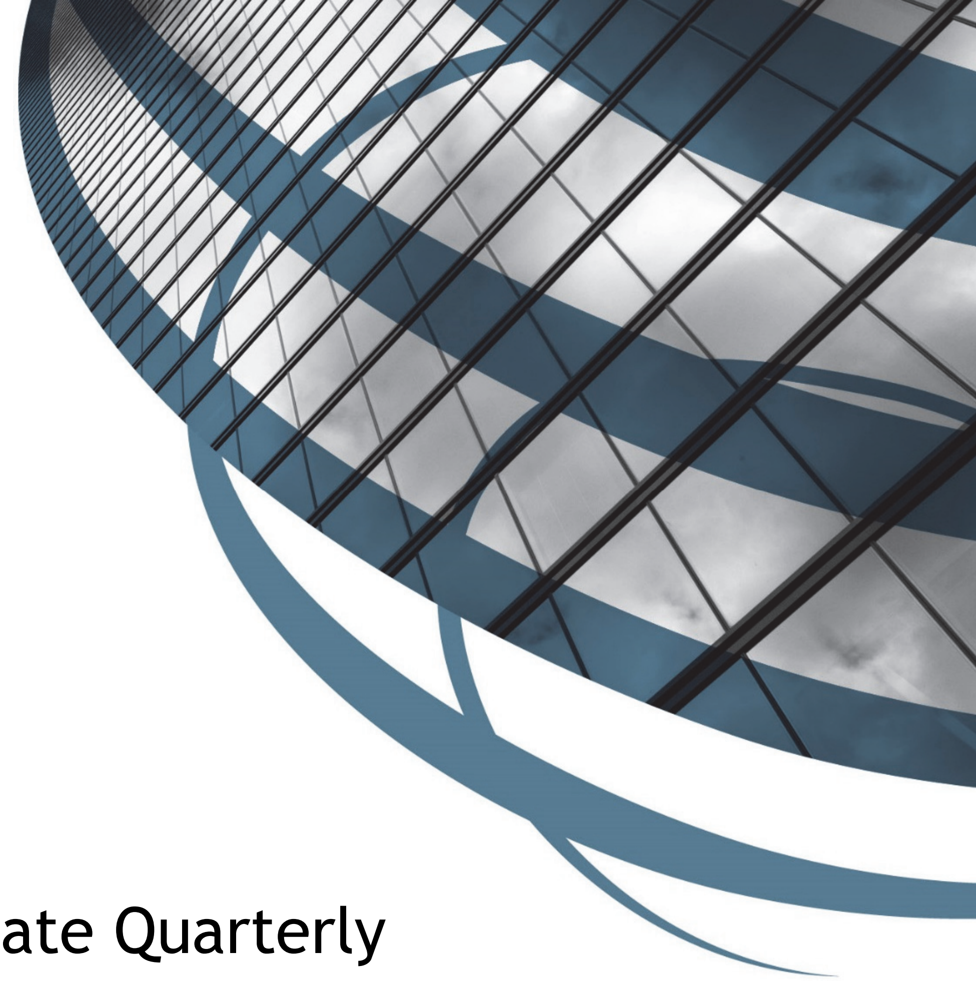


European Real Estate Quarterly

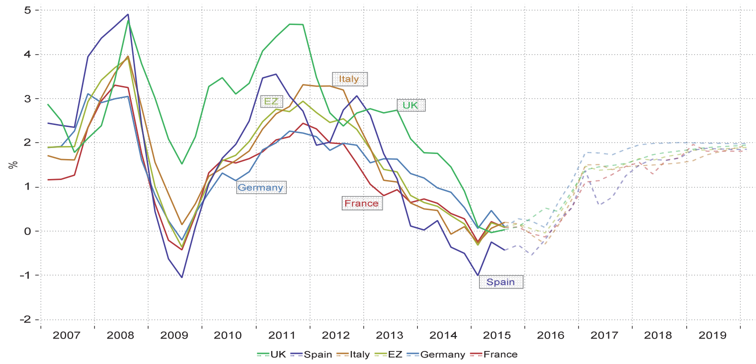
Q1 2016

AEW EUROPE

Economy and Capital Markets

- Towards the end of 2015 and into Q1 2016 there have been an increasing number of commentators speculating that the world economy is on the cusp of a new recession, triggered by slowing emerging market economies. The IMF has stated that such a downturn is a material risk and financial markets' sentiment has continued to deteriorate into 2016, with some equities markets becoming more volatile;
- **Despite this negative sentiment and leading indicators moving lower in recent months, growth is likely to remain resilient in the US and Europe, and most developed economies are likely to register positive growth throughout 2016;**
- China, which has been the epicentre of recent investor concern, has seen its leading indicators stabilise over recent months after the dramatic weakening early this year. Similarly, world trade appears to be stabilising, after a short period of deterioration during mid-2015;

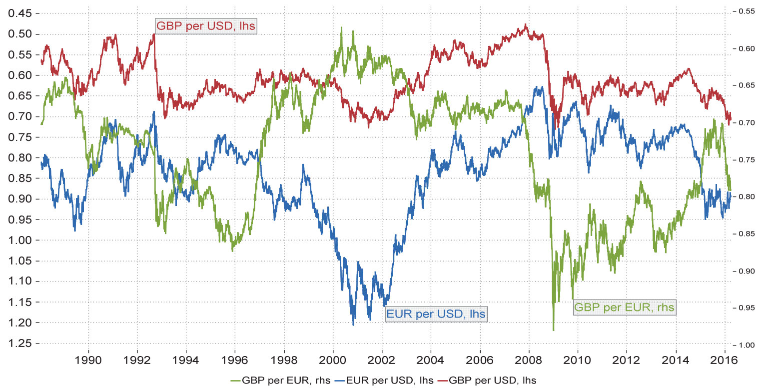
Figure 1. Selected countries' headline consumer price inflation



Source: Macrobond, Oxford Economics

- Despite there being differing conjecture on the likely path of global demand over the short-term, there is consensus on the likely path of inflation over the next five quarters as Figure 1. shows. **A continuation of the current 'lowflation' environment (and possibly further disinflation) is quite likely;**
- **While the ECB further loosened monetary policy in early December, it was more restrained than the market was expecting.** The ECB cut the deposit rate by 10bps to -0.3%, extended the current QE program by six months to March 2017 and expanded it to include local and regional authority debt;
- **However, at the much-anticipated March meeting, the ECB dramatically changed tack and unveiled a major stimulus package:** announcing four new TLTRO[1] programs, cutting the deposit rate by another 10bps, and adding EUR20 billion to its monthly QE program which has now been expanded to include non-bank corporate bonds;
- The BoE in contrast continues to leave its base rate steady at 0.5%. The most likely timing for a BoE rate rise remains H2 2016, though this could slip to early 2017 should oil prices fall further during 2016 or the UK votes to leave the EU;
- **The UK public are set to vote in a referendum on 23 June to decide whether the UK should remain in or exit the EU;**
- **As such, investors have had a large amount of uncertainty injected into their decision making;** particularly around the referendum outcome, the process of exit, and the substantive consequences of exit. Moreover, if the referendum result is to exit, then at least some uncertainties are likely to extend into the medium-term, and much of the detail of what form a post-exit UK might take, are ex-ante, essentially unknowable;
- Given this uncertainty, Sterling has been the first and is likely to remain the primary shock-absorbing conduit for Brexit risk, both before the referendum and after it if the result is to leave;

Figure 2. Exchange rates



Source: Macrobond

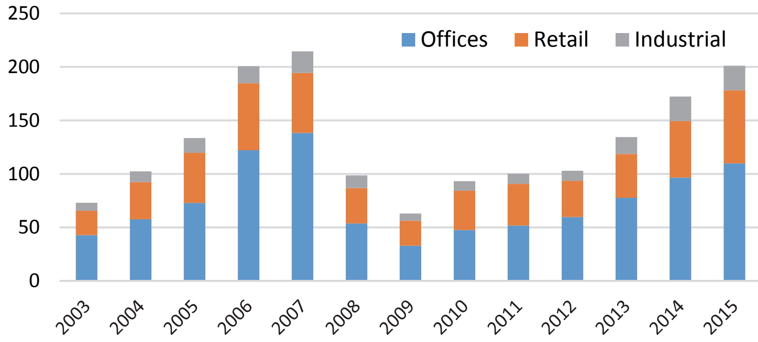
- Figure 2. shows that the GBP has lost c15% against the EUR and c11% against the USD between late last year and late Q1. Under Brexit it's likely that the GBP could weaken a further 15-20% against the USD in the immediate aftermath of the referendum;
- Since the referendum date was announced on 21 February, unlike the big moves in Sterling, Gilt yields have only moved very slightly upwards across the two, five and 10 year durations. Even under Brexit, it's unlikely Gilts would become a credit-risky asset, as there are no immediate solvency risks for the UK government associated with the cessation of EU membership;
- However, there would be economic uncertainty and potential risks to growth and inflation. So, Gilts are likely to continue to reflect these traditional risk premia and they're likely to continue to behave as a perceived safe haven asset;
- **Many of the potential Brexit downside risks for real estate in the UK would affect the London West End and London City office markets most in a 'worst case' scenario.** A large number of European headquarters are located in the West End and London City has a large number of financial services occupiers - both locations could see occupiers relocating to the Continent. Conversely, under such a scenario, Paris and Frankfurt in particular, could gain and see an influx of new tenant demand;
- **However, ultimately and in the longer-term, the biggest consequences and risks under Brexit might be for the rest of the EU.** These could be existential given the EU would be losing c10% of GDP, around half its military capability, and its primary conduit into the Anglo-Saxon world.

Investment Market

New record year of investment activity since the GFC[2]

- European commercial real estate investment volumes totalled EUR61 billion during Q4, an increase of 21% q-o-q and in line with the same period in 2014;
- **Strong investor sentiment in all parts of Europe coupled with increasing cross-border capital inflows continue to drive growth in the European investment market,** with 2015 full-year investment volumes across the region rising by 17% y-o-y to reach EUR201 billion. This is only 6% below the pre-GFC high of EUR215 billion in 2007;
- The UK recorded a 21% decline in overall commercial investment activity during Q4. This slowdown in activity was mainly due to a fall in investment volumes in the industrial (-38% y-o-y) and office (-27% y-o-y) sectors. Despite the quarterly fall, 2015 was a strong year for the UK investment market, with a total of EUR61.4 billion transacted, marginally above the 2014 volume;

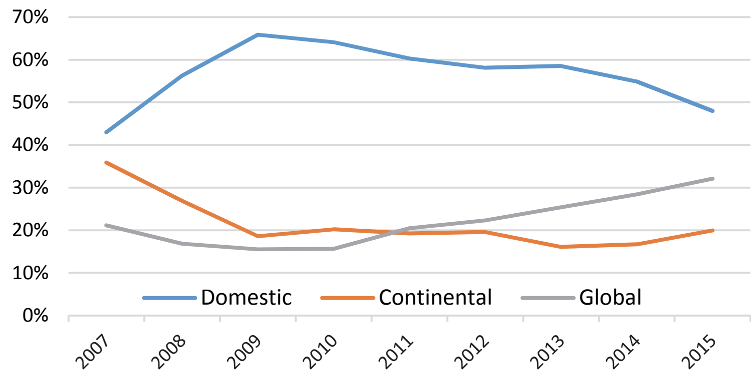
Figure 3. European commercial real estate investment volumes by sector (EUR billions)



Source: CBRE

- **Investment activity increased across the three main sectors in Germany,** with total investment volumes reaching EUR44.7 billion during 2015, up 36% y-o-y. The retail sector is leading the investment boom in Germany, which saw investment volumes rise by 75% y-o-y in 2015, boosted by large portfolio deals and the buoyant shopping centre segment;
- **The Nordics had a very strong year,** with investment volumes totalling EUR25.9 billion during 2015, up 45% y-o-y. Norway in particular saw investment activity increase by a significant 152% y-o-y to reach EUR11.6 billion in 2015, overtaking Sweden as the largest Nordic property market. The strong investment activity was supported by strong cross-border capital inflows and large transactions in the office and retail sectors;
- **The Crisis Countries[3] continued to attract strong investor interest** during 2015, with investment activity increasing by 21% y-o-y to reach cEUR19 billion for the year as a whole. Portugal in particular saw investment volumes increase by a significant 103% y-o-y, boosted by a strong performance in the office and retail sectors;
- As Figure 4. indicates, cross-border investment continued to increase across Europe during 2015, with cross-border European and global capital together accounting for just over half of overall investment volumes. The share of non-European sourced cross-border investment has increased significantly over the last five years to a record 32% in 2015, compared with only 21% in 2007;

Figure 4. Sources of capital into Europe (% of investment volume)



Source: RCA

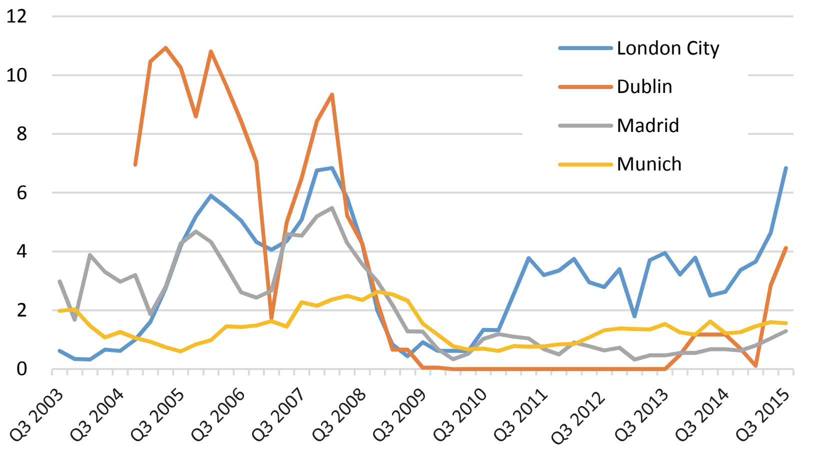
Outlook

- **Despite the strong yield compression which has led to significant capital value growth, prime capital values in the Crisis Countries still remain well below their pre-GFC peak levels for all three sectors,** suggesting there is room for further value appreciation. Spain (offices, retail and logistics), Ireland (offices, retail and logistics) and Italy (retail and logistics) are expected to be the top performing locations and sectors in terms of capital value growth over the next eight quarters;
- Higher yielding development and refurbishment projects are becoming increasingly attractive as investors take advantage of strong rental growth prospects, a lack of prime stock, and attractive debt financing options. Examples of such value-added opportunities can be found in the Madrid office market and the UK regional office markets, with the latter having seen development site sales increase notably during 2015;
- Despite the continuing fall in yields in some markets, European commercial real estate is expected to remain attractive relative to other asset classes for at least the short to medium-term, largely due to an improving occupier market, a still considerable yield gap vs. government bonds, and a still weak EUR vs. the USD.

Office Market

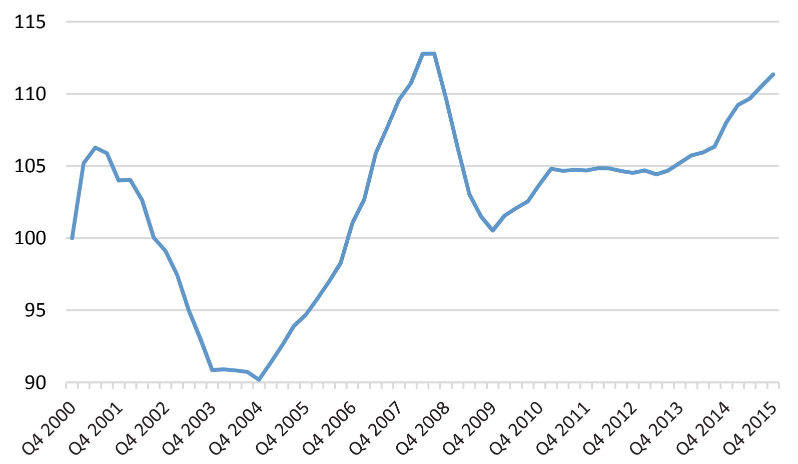
- **The continuing Eurozone economic recovery led to further improvements in occupier demand during 2015,** with a strong Q4 performance pushing 2015 European office take-up to its strongest level since 2008;
- The top seven cities in Germany recorded a 20% y-o-y increase in take-up during 2015, while annual take-up in Ile-de-France improved slightly on 2014 levels to reach 2.2m sq m. Elsewhere in Europe, letting activity continued to recover in the Crisis Countries and CEE, with take-up in Budapest, Barcelona and Prague increasing by 62%, 49% and 35% y-o-y respectively during 2015;
- On the supply side, availability across Europe has been falling consistently over the last 12 months, with the aggregate vacancy rate now reaching its lowest level since Q3 2009. The fall has mainly been driven by high competition for quality stock and low levels of completion. Most western European markets experienced a decline in vacancy rates during 2015, while some CEE markets still suffer from excess supply;
- **In response to the low level of supply in the prime end of the market, development activity has started to rise in some markets** which saw strong prime rental growth over the past few years. As Figure 5. indicates, construction starts have picked up significantly since the beginning of 2015 in Dublin and London City in particular;
- As Figure 6. shows, **office rental values across Europe have been rising for 10 consecutive quarters,** with the EU-15 prime rent index nearly reaching its pre-GFC high. Rental value growth was strong in the Crisis Countries during 2015, most notably in Dublin (+22% y-o-y), Barcelona (+16% y-o-y) and Madrid (+13% y-o-y), while rents continued to edge up higher in the core European markets;
- A total of EUR35.4 billion was transacted across the European office investment market during Q4 2015. This strong final quarter of activity brings the 2015 full-year total to EUR110 billion, an increase of 14% y-o-y. The Crisis Countries recorded the strongest increase in investment activity during the year, with volumes rising by 116%, 80% and 78% y-o-y in Portugal, Italy and Spain respectively. The Nordics and Germany performed strongly, with investment volumes growing by 26% and 22% respectively during 2015;
- Office yields continued to compress further throughout 2015, with the EU-15 prime office yield falling below its pre-GFC low during H2 2015. Crisis Country yield compression has been strong and yields reached historically low levels across a number of core markets during Q4, particularly in central London, central Paris and the major German cities;

Figure 5. Selected office markets' building starts (% of stock)



Source: PMA

Figure 6. EU-15 office prime rental index (base=100 @ Q4 2000)



Source: CBRE

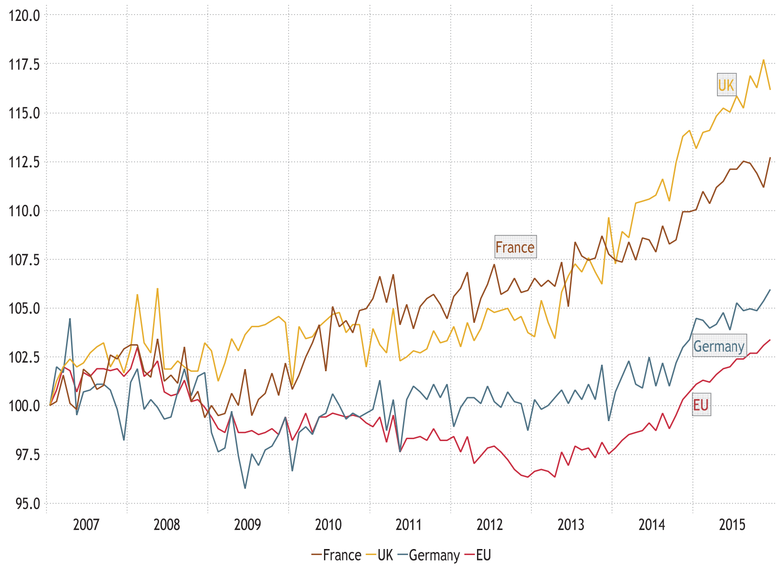
Outlook

- As rents become more expensive in core European city CBDs, occupiers are increasingly considering good quality office space in secondary locations. This trend is expected to continue in markets such as London, Dublin and Munich where net additions have been low or negative and rental growth has been considerable;
- **Improving occupier demand combined with falling vacancy rates are expected to support further rental recovery over the next three years.** The Crisis Countries are forecast to experience notable levels of rental value growth during 2016, with Madrid (+17.7%), Dublin (+12.8%) and Barcelona (+11.8%) to be the top prime rental growth performers;
- Most office markets across Europe are forecast to experience positive capital value growth during 2016, with Madrid (24.2%), Dublin (19.6%) and Barcelona (16.3%) leading the way. Capital value growth is forecast to slow down in the core markets after 2016 as yield compression is expected to abate.

Retail Market

- As Figure 7. shows, retail sales volumes in the EU increased by 2% y-o-y in December 2015. The highest rises were observed in Romania (+14.3%), Ireland (+6.1%), and Poland (+5.5%), while decreases were recorded in Portugal (-1.3%), Belgium (-1.2%) and Denmark (-0.3%). In France, monthly retail sales volumes rebounded sharply in December, offsetting the fall in November that was due to Paris terrorist attacks;

Figure 7. Retail sales volumes in selected countries (base = 100 @ Jan 2007)



Source: Macrobond

Occupier market

- For the third consecutive year, 2015 European shopping centre development activity remained modest, growing by only 1.8% y-o-y, well below the 10 year average growth rate of 3.7% y-o-y. The highest increases were recorded in Poland and Sweden. Unibail-Rodamco opened the Mall of Scandinavia in November 2015, which is now the largest shopping centre in Sweden (at 101,000 sq m). Despite this, **it's expected that average shopping centre rental growth in Europe will remain constrained during 2016, notably due to retailers' net operating margins remaining under pressure;**
- Some shopping centres in weaker locations are struggling from a combination of poor footfall, retailer consolidations and relocations. Many are facing higher competition from retail parks, with several European and global fashion retailers increasingly looking at out of town formats for expansion;
- As at the end of 2015, there was a total of 159 Factory Outlet Centres (FOC) across Europe. There are significant differences by country for the development and permitted density of outlet centres. Due to restrictive planning permission regulations compared to those in the rest of Europe, Germany has only 12 FOC totalling 186,000 sq m, which corresponds to a rate of 2.2 sq m of sales space per 1,000 inhabitants. This compares to 8.7 sq m per 1,000 inhabitants in the UK (36 FOC), 7.7 sq m per 1,000 inhabitants in Italy (23 FOC), and 4.7 sq m per 1,000 inhabitants in France (21 FOC). Furthermore, with higher yields than other retail assets, FOC are gaining interest from investors and developers. In Germany for example, eight FOC with a gross lettable space of nearly 120,000 sq m are in the pipeline, with two currently being built – Montabaur (between Frankfurt and Cologne), and Brehna (near Leipzig);

Investment market

- **European retail investment activity has steadily increased over the past three years, with 2015 volumes reaching a record high of EUR72.2 billion,** which is 4% higher than the previous peak of EUR69.4 billion in 2007. This reflects a y-o-y growth of 39.3%, which is the largest rise since 2010;
- Around EUR30 billion was invested in the shopping centre retail segment during 2015, boosted by several substantial shopping centre portfolio sales. Notable examples are the sale of the Oslo city shopping centre portfolio to a joint venture between Steen & Strøm and Entra in Q4 and the sale of the Klepierre Dutch shopping centre portfolio to Wereldhave for EUR730m;
- Market segmentation and investor appetite for exploring new niches were important drivers to the retail sector during 2015. Investor interest into retail parks, retail warehouses and FOC increased during the year, as these segments are integral to the ongoing structural changes in 'bricks and clicks' retail. Prime high street units, particularly core locations occupied by luxury retail brands, also attracted strong investor interest as they offer long-term income security;

Outlook

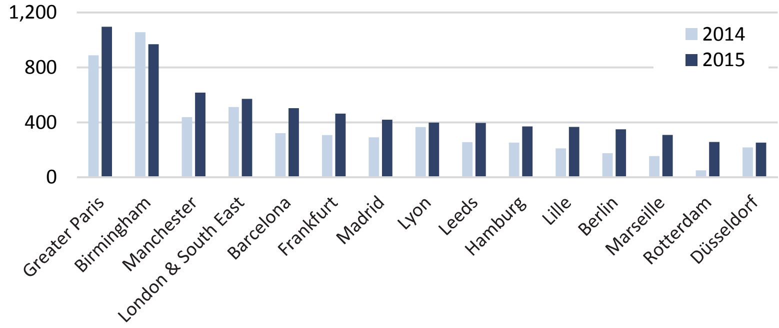
- **For the remainder of H1 2016, the macroeconomic outlook for the retail market is expected to remain positive. Persistent low inflation and record low interest rates, coupled with wage growth, is likely to lead to higher household disposable income;**
- However, uncertainties regarding global economic growth could further focus investor demand to core assets in the gateway markets of western Europe and the best second tier markets.

Logistics Market

Occupier market

- **2015 recorded the highest level of European logistics take-up on record, despite a marked slowdown in Q4 2015;**
- In Germany, take-up exceeded 6.1m sq m in 2015, an increase of 15% y-o-y and 5% above the previous annual record set in 2011. One large and exceptional deal was the BMW letting of more than 400,000 sq m in three locations, increasing the share of manufacturers' demand, in particular the automotive industry;
- Take-up in the UK reached nearly 3m sq m in 2015, an increase of 5% y-o-y. Although speculative developments are picking up, the availability of new supply remains well below pre-GFC levels. With this persisting shortage of new supply, further rental growth is expected throughout 2016;
- The French market recorded its highest level of take-up since 2008. The volume of transactions increased by 17% y-o-y during 2015 to reach 3.1m sq m. Contemporaneously, the availability of new grade A warehouses dropped to a 10-year low with less than 100,000 sq m available;

Figure 8. 2015 take-up in the top 15 European markets (000s sq m, warehouses over 5,000 sq m)

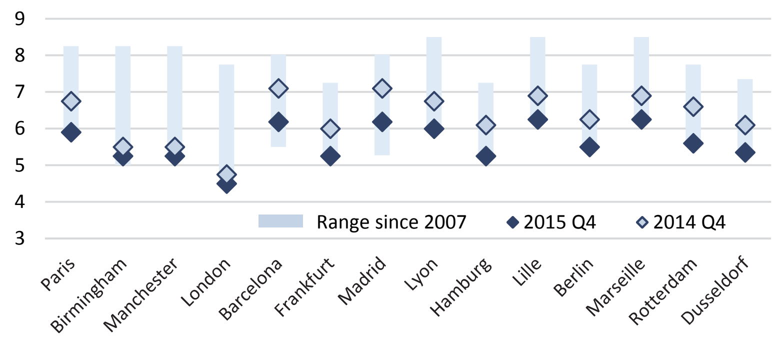


Source: BNP Paribas Real Estate

Investment market

- Industrial and logistics investment across Europe reached the second highest quarterly volume on record during Q4 2015 (cEUR7.2 billion), with the record still being held by Q4 2014 (cEUR8 billion);
- 2015 investment volumes in Europe are estimated to be between EUR24 and EUR27 billion. This is the second consecutive year of annual volumes exceeding the previous record of EUR20 billion set in 2007;
- **Investor demand for distribution warehouses remains high, but growth in investment volumes is being limited by a lack of grade A stock available for sale;**
- Germany continued to attract strong investment interest in 2015, with volumes reaching cEUR4.7 billion, an increase of 10% y-o-y;
- Although investment volumes declined 33% y-o-y during 2015 to slightly below EUR10 billion, the UK remains the largest European market in the sector, accounting for almost 40% of overall industrial and logistics investment;
- France (cEUR2.5 billion) and the Netherlands (cEUR1.5 billion) saw investment volumes grow by a significant 52% and 85% y-o-y respectively during 2015;

Figure 9. Prime net initial yields (%, warehouses over 5,000 sq m)



Source: PMA, AEW Europe

- 2015 saw a steady downward move in logistics yields, particularly for yields in non-core locations which have compressed considerably in markets such as Spain, Portugal, Italy and Ireland;

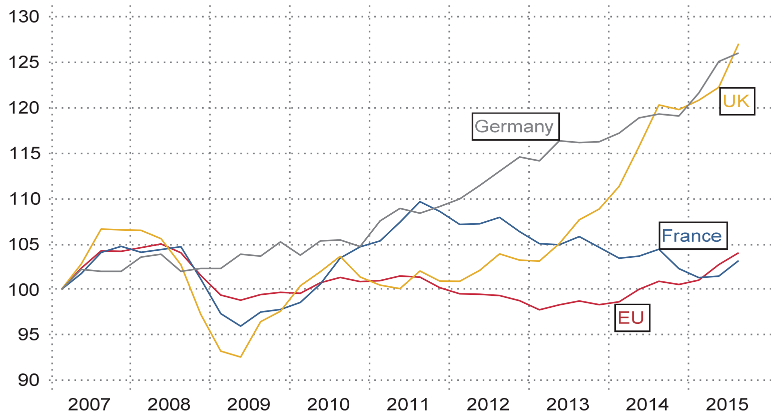
Outlook

- 2015 saw a wave of mergers and acquisitions across continents: American logistics operators purchased European counterparts and vice versa. The year began with the acquisition of French Norbert Dentressangle and Dutch Menlo Logistics by American XPO Logistics. Swiss-German Kuehne+Nagel proceeded to buy Memphis based ReTrans in July while Geodis acquired Nashville based Ozburn-Hessey Logistics in November. These deals illustrate the continuing trend of logistics operators seeking global size and scale in order to grow capacities in the freight forwarding business and e-commerce fulfillment capabilities;
- **Logistics operators are likely to increasingly develop their multichannel services in order to fulfil orders from both physical retail stores and online purchases.** The latter is growing steadily, boosted by smartphone and tablet purchases and new click-and-collect consumer purchasing. At the property level, this strategy is pushing operators to move into new and larger warehouses adapted to multichannel activity;
- Prime rents are expected to increase in land constrained areas. In other locations, the gradual increase in speculative development activity is likely to inhibit rental growth.

Residential Market

- Eurostat's EU house price index[4] rose by 1.3% q-o-q and by 3.1% y-o-y during Q3 2015. As Figure 10. shows, the EU house price index is still slightly below the long-term peak reached in Q1 2008. However, house prices in Germany and the UK have reached the long-term highs of 21.3% and 20.3% above their Q1 2008 levels respectively. Despite an increase in Q3 2015, **French house prices are still 1.2% below the level seen in Q1 2008 and 6% lower than the previous peak reached in Q2 2011;**

Figure 10. European house price index (base=100 @ Q1 2007)



Source: Macrobond

United Kingdom

- UK house prices in the three months to December grew by 1.6% y-o-y. The quarterly rate of growth remained below 2% for the second successive month, indicating a possible softening in the underlying rate of house price inflation;
- However, **there remains a substantial gap between the demand and supply of dwellings** with the latest figures showing a further decline in the number of properties available for sale. **This situation is unlikely to change significantly in the short-term, putting further upward pressure on house prices;**
- Despite a slight increase in the number of additional houses being put up for sale, the total number of houses available for sale declined to a record low for the ninth consecutive month in December 2015, due to an even higher increase in the number of houses sold. UK house sales totalled 1.23m units during 2015, marginally higher than the 1.22m recorded in 2014. Sales picked up during 2015 with transactions during H2 2015 6% higher y-o-y;

France

- Existing house prices in France rose by 0.3% q-o-q during Q3 2015, offsetting the price falls over the previous six months. Ile-de-France continued to perform slightly better than the regions, with existing house prices rising by 0.8% q-o-q during Q3, whereas the increase in the regions was 0.3% q-o-q;
- The upturn in annual investment volumes, which began in mid-2015, continued to accelerate in Q3 2015. The 12 month rolling volumes of existing home sales in France during September 2015 was 792,000, an increase of 4.2% y-o-y. However, 2015 annual volumes of existing home sales in Ile-de-France and the regions are still 12.5% and 8% respectively below the annual average volume recorded during the highs of 1999 and 2007;
- The number of new and existing dwellings for sale is expected to continue to increase, driven most notably by growth in development activity. During Q3 2015, the number of dwellings approved for construction grew by 4.2% q-o-q following a 3.8% q-o-q increase during Q2;

Germany

- **With EUR25 billion (almost 360,000 apartments) invested in Germany, residential investment volumes reached a record high during 2015, twice the volume recorded in 2014 and more than two and half times the five year and 10 year averages;**
- Almost half of the total transaction volume was generated by four mega portfolio deals of more than 15,000 apartments per transaction. The largest deal was the over EUR8 billion takeover of GAGFAH by Deutsche Annington;
- Record investment activity was also registered in smaller portfolio deals of less than 4,000 residential units per transaction, with a total of EUR9.8 billion invested across over 450 such deals during 2015;
- At the regional level, EUR5 billion was invested in the greater Berlin area, accounting for 20% of overall German residential investment volumes during 2015. This was followed by Hamburg (EUR880m) and Frankfurt (EUR780m). In addition to these traditionally favoured locations, significant transaction volumes were generated by high value sales in other regions including Kiel (EUR620m) and Stuttgart (EUR500m);
- As a result of house prices rising faster than rental values, net initial yields for traditional residential investment have compressed, causing some investors to shift their focus to alternative residential deals offering higher yields.

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[1] Targeted Longer-term Refinancing Operations
[2] Global Financial Crisis
[3] Greece, Italy, Spain, Portugal and Ireland
[4] Weighted average of the national house price indexes, using as weights the GDP at market prices (based on purchasing power) of EU 28 countries

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