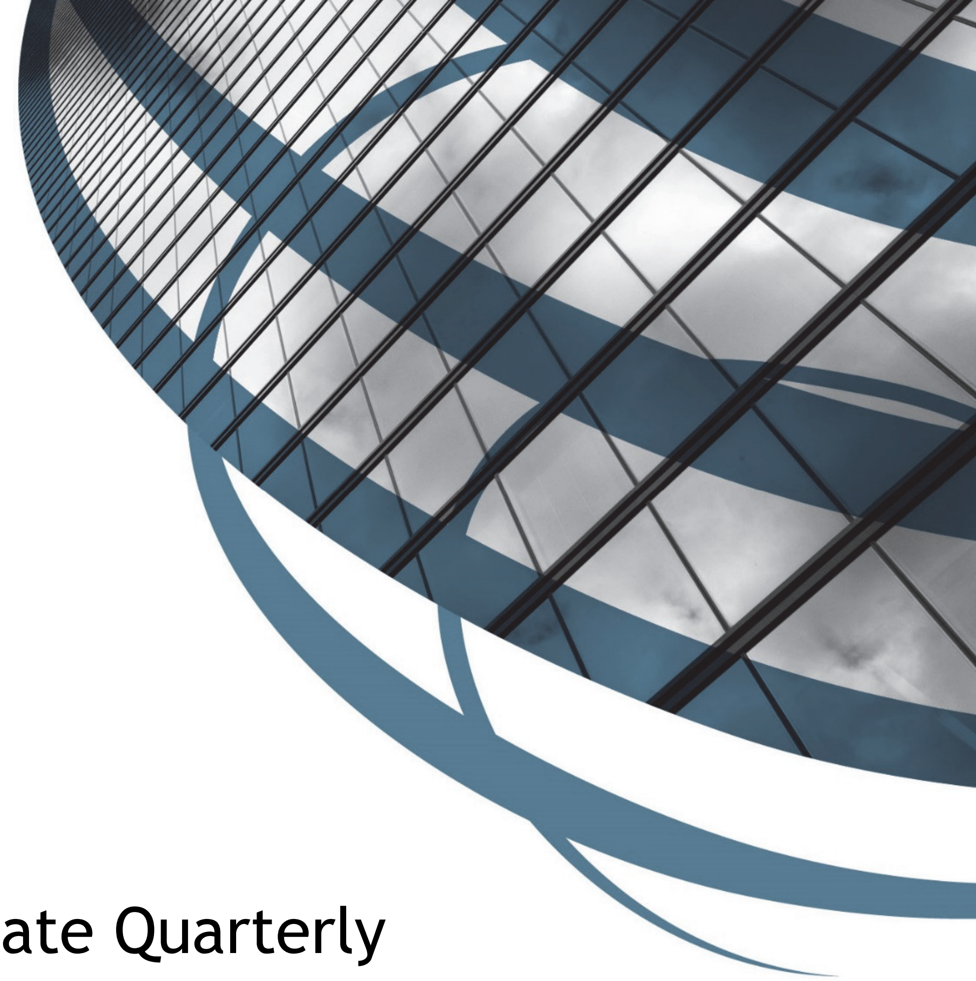


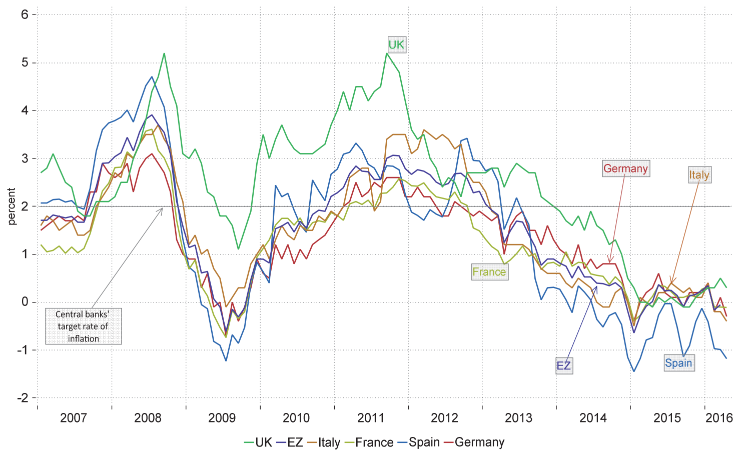
European Real Estate Quarterly

Q2 2016

Economy and Capital Markets

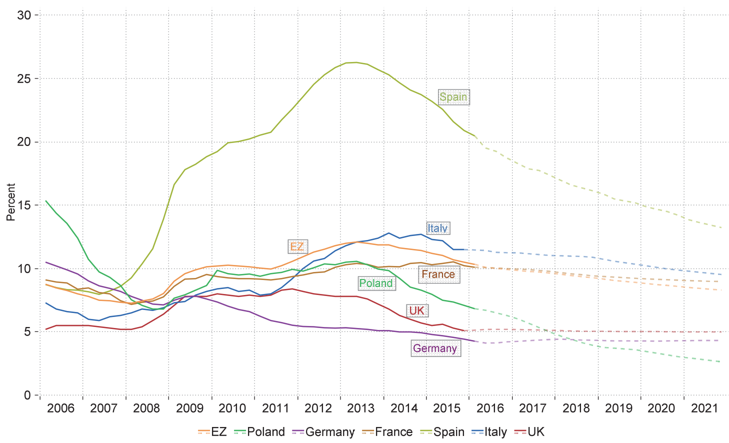
- **The weakness in some parts of the global economy towards the end of last year and into Q1, particularly in developing economies, has started to alleviate.** Trade volumes picked up from mid-Q1 and into Q2, with developing economies driving the improvement. Leading indicators confirm this more positive outlook and are consistent with an increase in the rate of growth that is expected to materialise during H2;
- **However, longer-term growth concerns persist**; particularly those countries that are reaching or at the limit of monetary policy stimulation, such as Japan and the Eurozone;
- ECB policy has been successful in generating a swifter pace of private sector lending. However, such highly accommodative monetary policy, especially very low or negative interest rates, is proving somewhat detrimental to the institutions responsible for transmitting that policy to the real economy, as the policy has the negative consequence of limiting banks' profitability;
- Eurozone GDP expanded by 0.6% q-o-q during Q1. This was roughly twice the rate expected by the Bloomberg consensus. Once the detailed breakdown is released, it's expected to show that robust consumer spending and business investment was behind the rise in activity. Given the fears of a European slowdown from late last year and early Q1, this is an impressive result;
- However, the well-known downside risks for the Eurozone economy remain and the improvement may not last. One more recent downside risk stems from the rebound in the price of oil, given that parts of the Eurozone economy look somewhat over-reliant on the boost from cheap energy, and it may prove difficult for consumer spending growth in particular to maintain its recent pace;
- The European Commission's Economic Sentiment survey has moved downward recently, but it continues to suggest solid growth over the next one or two quarters. This is in contrast to the weaker composite PMI readings for the Eurozone, which indicate lower growth ahead. (That said, the Services PMI indicator remains robust.);
- **Despite the overall moderately positive short-term growth outlook for the Eurozone, the ECB continues to telegraph its concerns about inflation**, which persists at levels close to zero as Figure 1. shows. Core inflation decreased to a mere 0.7% in April, reverting to mid-2015 levels;
- Eurozone unemployment continues to slowly decline as Figure 2. depicts, but significant spare capacity remains, which complicates the ECB's plan to raise headline inflation to its 2% target rate. With the Euro edging higher, there is potential for suppression of import prices, which could further complicate the ECB's efforts in generating higher levels of inflation;
- As with the Eurozone, UK consumer spending growth rates may come under pressure during the remainder of the year. Particularly as the UK economic cycle is starting to appear increasingly mature. The UK household net savings rate is now below its pre-GFC[1] low. With this boost to consumer spending and the wider economy now almost spent, the slowdown in real income growth witnessed since the start of the year is likely to begin negatively affecting household spending. This outlook is corroborated by a decline in consumer confidence in April;
- **Brexit risks also continue to negatively affect the UK outlook.** With spare capacity now fully absorbed and demand growth, albeit slowing, remaining robust, this would be the point in a normal UK cycle when growth would evolve from consumption-led to investment-led;
- However, uncertainty generated by the June 23 EU referendum is weighing significantly on UK business capital expenditure, M&A activity, and property investment volumes. While the global uncertainties that were prominent during Q1 are likely to continue to dissipate, Brexit fears will almost certainly rise as the voting date nears. Regardless of the referendum outcome, some of this pent-up investment demand is likely to deploy during H2, with any potential 'catch-up' being particularly noticeable if the UK votes to remain in the EU.

Figure 1. Selected countries' headline consumer price inflation



Source: Macrobond

Figure 2. Selected countries' unemployment rates
(ILO definition)



Source: Macrobond, Oxford Economics

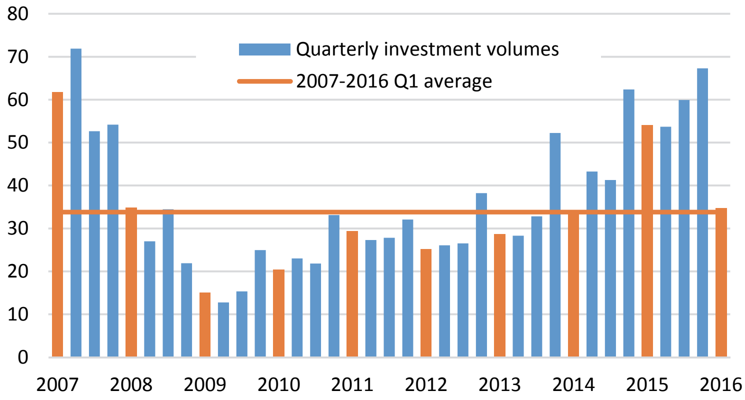
[1] Global Financial Crisis

Investment Market

A broader slowdown for the European CRE investment market following a record 2015

- Following a strong end to 2015 when EUR235 billion was transacted across the European commercial real estate market, investment activity fell by 36% y-o-y to reach EUR34.8 billion during Q1 2016. Figure 3. compares the European first quarter investment volumes with their quarterly average between 2007 and 2016. With the exception of a very strong Q1 2015, Q1 2016 still remains the strongest first quarter since 2008 and is in line with the long-term Q1 average;
- **Most European markets experienced a slowdown in investment activity during Q1.** France in particular saw investment activity fall by 56% y-o-y to EUR3.1 billion during the quarter. German investment volumes declined by 22% y-o-y to reach EUR6.4 billion in Q1, with domestic investor activity falling sharply. Elsewhere in Europe, the Crisis Countries[2] and the Nordics, which both performed strongly last year, saw declines in investment activity, with volumes falling by 40% and 24% y-o-y respectively during Q1;

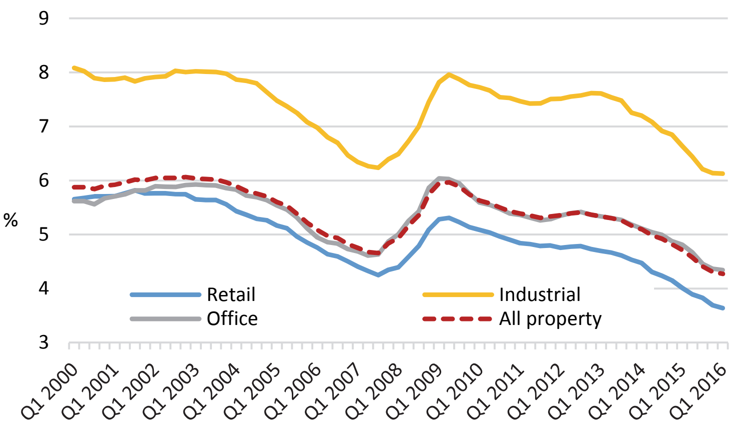
Figure 3. European commercial real estate investment volumes (EUR billions)



Source: RCA

- **Uncertainties about the outcome of the UK's referendum on EU membership are weighing heavily on investment decisions, and this has contributed to a weak start to the year for the UK investment volumes.** Overall transactions in the UK dropped by 29% y-o-y to EUR10.9 billion, with investment volumes falling across all three main sectors. Concerns about Brexit will continue to place a drag on investment volumes in the short-term, with overall investment activity in the UK expected to remain subdued during Q2;
- Of the three main sectors, only industrial and logistics managed to post an increase in investment activity, with Q1 transactions rising by 8% y-o-y to reach EUR6.2 billion. The retail sector saw the biggest decline in investment activity, with Q1 volumes declining by a significant 56% y-o-y, reflecting a fall in the number of single asset transactions. The office investment market also experienced a slowdown, with volumes falling by 31% y-o-y during the same period;
- **Despite the fall in investment activity since the beginning of the year, prices are holding up**, which is evident by further yield compression across Europe. As Figure 4. indicates, prime yields continued to compress across all main sectors during Q1, with the EU-15 all property prime yield falling by 3bps q-o-q and 44bps y-o-y. However, there are indications that the pace of yield compression has started to slow down compared to the previous four quarters;

Figure 4. EU-15 prime yields by sector



Source: CBRE

Outlook

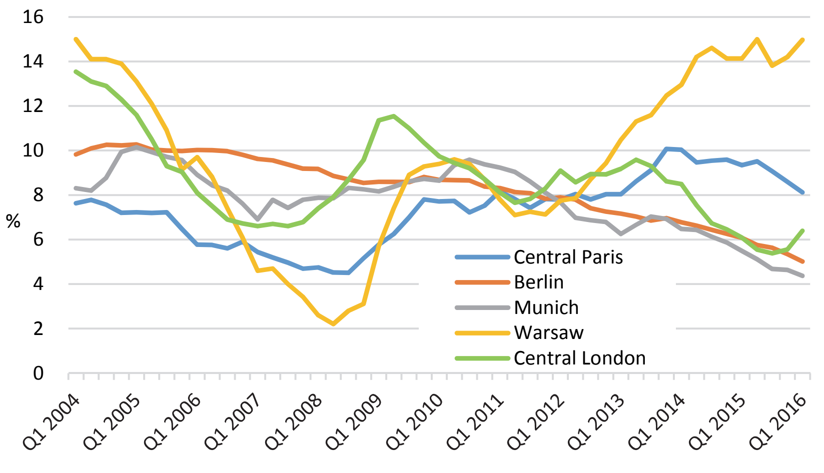
- The strong capital value growth over the last two years is mainly attributable to yield compression, which is expected to continue throughout 2016, albeit at a more modest pace. Although yields are set to stabilise and start to soften beyond 2017, net initial yields are forecast to be at a lower level than they were pre-GFC in most European markets;
- Looking ahead, the Irish logistics and retail sectors have the strongest forecast total returns over the next five years. Other markets and sectors that are expected to perform well include logistics markets in Benelux, central Europe and France and retail markets in Germany. In contrast, after the strong performance over the last two years, the core office markets are expected to see more modest total returns during the forecast period;
- It is most likely that investor focus will remain on the largest and most liquid European markets. However, smaller markets that are performing well, such as parts of the CEE and Spain, will also continue to attract investor interest, especially cross-border investors.

[2] Greece, Italy, Spain, Portugal and Ireland

Office Market

- **Occupier demand continued to improve across most of the European office markets**, with aggregate take-up totalling c2.6m sq m during Q1 2016. This presents an increase of 14% y-o-y and is the strongest first quarter since 2011;
- Following a robust 2015, the German office market experienced a strong start to the year, with Q1 take-up reaching 755,000 sq m for the top seven markets, up 10% y-o-y. Dusseldorf and Berlin are the best performing markets, which saw take-up increase by 50% and 35% y-o-y respectively;
- Central Paris saw take-up improve by 38% y-o-y to reach 298,000 sq m during Q1. La Defense in particular recorded a strong first quarter, boosted by several big transactions above 5,000 sq m;
- After a strong finish to 2015, central London office take-up decreased by 22% q-o-q and 2% y-o-y to reach 3.1m sq ft during Q1. This fall is partly due to uncertainties concerning Brexit, with Q1 take-up in the City office market falling by 16% y-o-y. Occupiers are expected to remain cautious ahead of the EU referendum, with central London letting activity likely to remain low in Q2;

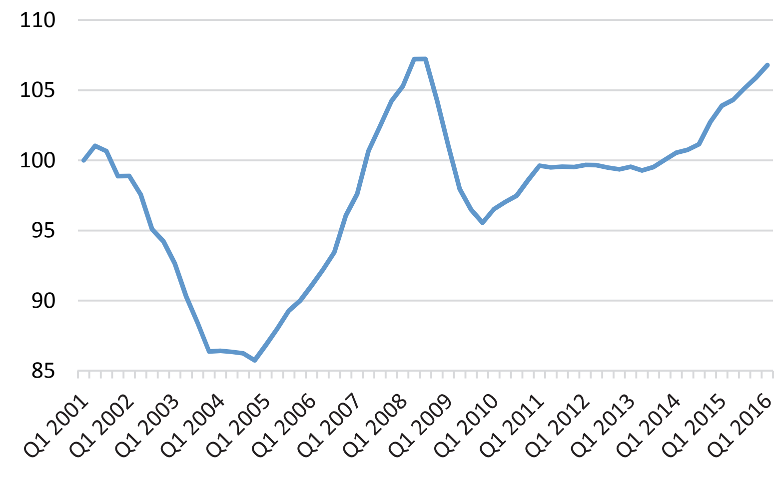
Figure 5. Selected European office markets' vacancy rates



Source: PMA

- As Figure 5. shows, **vacancy rates in the core office markets such as central Paris and the major German markets continued to edge down during the first quarter.** Vacancy rates are on the rise in central London as more completions reached the market. Warsaw continued to experience a rising vacancy rate, mainly due to the substantial development pipeline;
- As Figure 6. indicates, the EU-15 office prime rental index rose by 0.8% q-o-q during Q1 2016. Prime rental values remained largely stable in central London and the major German cities, while Madrid and Barcelona recorded modest rental value growth during the quarter;
- Office investment volumes across Europe totalled EUR19.2 billion during Q1 2016, a fall of 30% from the same period last year. The weak start to the year was driven by falling investment activity in western Europe and the Nordics, where volumes declined by 33% and 55% y-o-y respectively;

Figure 6. EU-15 office prime rental index (base=100 @ Q1 2001)



Source: CBRE

- The pace of yield compression during Q1 started to slow in the core office markets, with net initial yields remaining largely stable in the UK and the major German cities. The Crisis Countries and central Europe saw further yield compression during the quarter, led by Warsaw (-25bps q-o-q), Barcelona (-14bps q-o-q) and Prague (-14bps q-o-q);

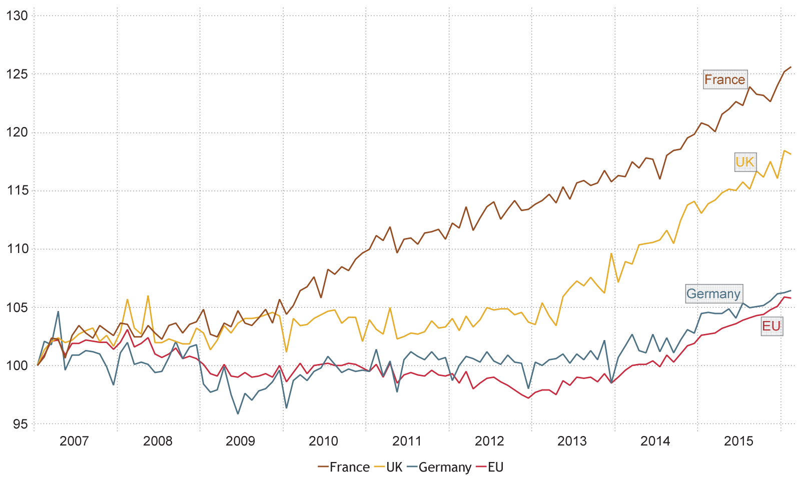
Outlook

- Vacancy rates are expected to fall in most European office markets during the next two to three years, led by markets with low levels of development completions (Madrid and Barcelona), and high conversion of office space to alternative uses (such as Amsterdam, Stockholm and M25 West);
- Office development activity has gradually picked up during the last four quarters across Europe. Although improving occupier market conditions combined with a lack of grade A supply in core markets will encourage developers to bring forward more speculative schemes, the development pipeline is expected to remain modest during the forecast period;
- **The pan-European office market is expected to record modest rental growth over the next six quarters. However, the pattern of growth between each individual market is different.** Rental value growth is expected to accelerate in Paris CBD, Madrid, Barcelona and Amsterdam, while slowdown is expected in London City, Dublin and the major German cities.

Retail Market

- Retail sales volumes in the EU continued to post solid growth in February, increasing by 2.9% y-o-y, supported by a gradually recovering labour market and low inflation. The increase in retail sales was driven by the food component (food, drinks and tobacco) which grew 3.2% y-o-y, while non-food products grew 2.8% y-o-y, and automotive fuel sales remained stable;

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



Source: Macrobond

Occupier market

- **Retailers continue to streamline their store networks by focusing on the most profitable and accessible locations**, while also relying on their online distribution channels to continue to achieve nationwide coverage. In this context and despite the positive fundamentals driving retail sales, the continuing growth of online retailing means that only dominant retail locations are likely to see any significant rise in retailer demand for units. Secondary locations may continue to suffer disproportionately from the growth in online retailing, particularly in countries such as Spain and Italy where online retailing growth prospects are stronger and growing off a lower base;
- Aside from the growth of e-commerce, the most significant trend within physical retail is the expansion of space occupied by food and beverage operators in shopping centres. Following expansions of Immergrün and Grünzeugs (a salad bar chain) in Germany and Chipotle (a Mexican restaurant chain) in France, 2016 is likely to see the market continue to respond to consumer demand towards better quality, more innovative and healthier catering concepts;
- **In Europe, accessible luxury retailers, including Milan-based Furla, were particularly active in 2015**, reflecting increasing occupier demand from two groups of luxury consumers: middle-class tourist shoppers from emerging markets and cash-strapped fashion conscious 'millennials'. In most markets, the rise of affordable luxury should outperform the 'real' luxury segment in 2016;

Investment market

- European retail investment volumes reached EUR9.4 billion during Q1, a drop of 55% y-o-y and the lowest quarterly volume since Q2 2013. Investment volumes fell in all countries during the quarter, except Poland where the quarterly volume increased by 39% y-o-y;
- The decrease in European investment volumes comes in the wake of a buoyant 2015 with Q1 2015 investment volumes being the second highest quarterly total on record. This fall was also due to a shortage of quality products in the UK, Germany and France, which drove cross-border investors to invest in other locations, notably in Poland, the Nordics and Spain, which saw these countries' contributions to total investment volumes increase by 200%, 60% and 49% y-o-y respectively;
- **With prime retail yields across Europe having been on a downward trend for six years, further compression is likely to be limited.** In Q1, only 17 markets out of the 36 cities monitored by CBRE recorded a quarterly prime yield decrease, whereas 20 recorded a decrease a year ago;

Outlook

- It is likely that 2016 European retail real estate investment volumes will be lower than in 2015, as the UK is expected to have passed its peak investment level and sourcing core deals on the continent becomes more challenging. However, with Europe still posting moderate, but steady economic growth and the outlook for interest rates set to continue to be lower-for-longer, the weight of capital targeting European retail real estate should remain significant;
- Major European retail occupier markets are expected to remain robust for prime high street pitches and Pan-European average prime rental growth is forecast to be 3.5% for 2016;
- Given the large amount of capital waiting to be deployed, prime retail yields are expected to compress further in 2016, albeit at a slower rate and in fewer markets than 2015. **Combined with rental value growth, this moderate yield compression is likely to see property prices rise during 2016, albeit at a slower rate than in 2015.**

Logistics Market

Logistics sector refuelled by two structural trends: e-commerce and 3PL restructuring

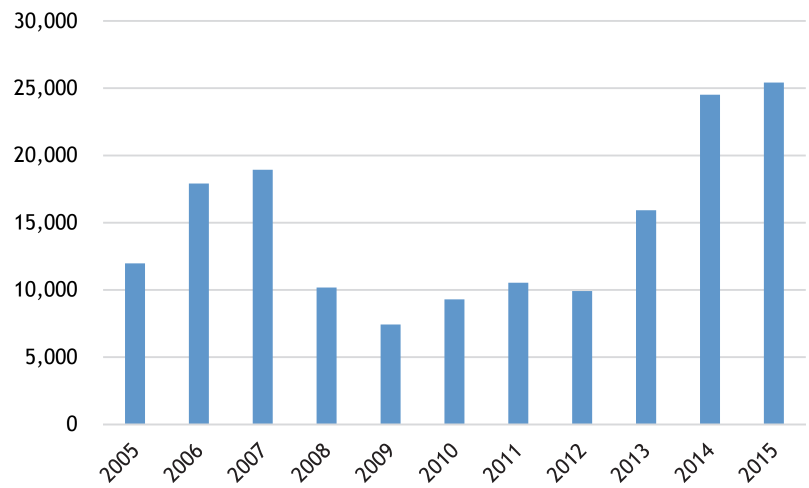
Occupier market

- **During Q1, the level of occupier demand for logistics space remained high, driven by structural changes such as e-commerce and the 3PL sector restructuring;**
- In Germany, c1.5m sq m was taken-up during Q1 in the warehousing and logistics sector (comprising both owner-occupiers and lettings), an increase of 3% y-o-y. Opel started construction of a c95,000 sq m distribution centre in Bochum, while the Dutch retailer Action pre-let over 82,000 sq m in a development project in Biblis for its new logistics centre;
- Total take-up of warehouse space in the UK reached c650,000 sq m in Q1, 24% above the long-term quarterly average of 520,000 sq m. This increase in take-up has predominantly been driven by a number of significant mega-shed letting deals, including Amazon's 93,000 sq m distribution fulfilment centre in the Midlands;
- In France, take-up totalled c720,000 sq m, with strong activity in the Paris and Lyon regions. Retailers signed the largest leases, including Carrefour (59,000 sq m), Intermarché (67,000 sq m) and Leclerc (54,000 sq m);

Investment market

- **Investment capital continues to flow into the logistics sector, attracted by relatively higher yields and sustained occupier demand;**
- Q1 industrial and logistics investment in Germany reached EUR780m, EUR560m of which was for logistics assets. Warehouse and logistics properties recorded an 80bps yield compression during the course of 2015 and the Q1 2016 average prime yield for the Big Seven regions (Berlin, Düsseldorf, Franfkurt/M, Hamburg, Cologne, Munich and Stuttgart) remained stable at c5.30%;
- Q1 investment volumes for logistics warehouses in the UK totalled cEUR865m. Overall, with cEUR2.3 billion invested, the industrial sector has been the only market in the UK to see investment volumes increase during Q1. Prime yields for distribution warehouses stood at 4.75% during Q1;
- In France, a total of EUR450m was invested in the industrial and logistics sector during Q1. Investment volumes for logistics warehouses reached EUR340m during the quarter, with portfolio sales representing 65% of this total. Investment volumes are expected to remain high, driven by a number of portfolios coming onto the market. The prime yield stood at 5.70% during Q1;

Figure 8. European industrial and logistics investment volumes (EUR millions)



Source: PMA

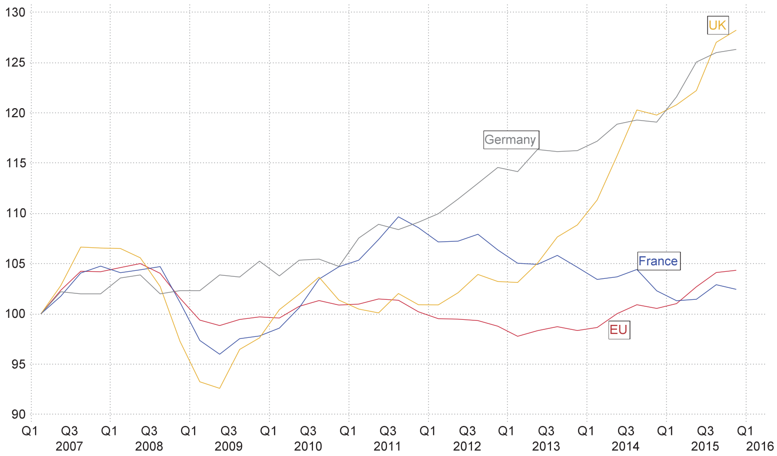
Outlook

- E-commerce has evolved to become the most important driver of occupier demand for logistics space, alongside 3PL mergers & acquisitions, reshaping the sector through asset segmentation (distribution centres, cross-docking and urban logistics) and location selection;
- Prime locations will be defined by attributes such as land scarcity, skilled labour availability, access to regional and intra-European motorways, proximity to airports and/ or major ports, and access to e-commerce consumers in large population centres;
- Supply chain reconfiguration will continue to increase the average size of regional and pan-European distribution centres;
- **Speculative development is picking up in the UK and may start to increase in other primary European markets that have tight land supply and low grade A vacancy rates;**
- With occupier demand set to remain strong, short-term leases in primary markets and locations where demand is stable provide better opportunities to grow rental income without significant exposure to leasing risk.

Residential Market

- The Eurostat's EU house price index[3] recorded its highest annual increase during 2015 (+3.8%) since Q1 2008, although it nearly stalled in Q4 2015 (+0.2% q-o-q) after three quarters of solid growth. Of all the major member states, the UK recorded the largest increase at 7.1% y-o-y during Q4 2015. Similarly, Germany recorded its highest annual growth since 2005, increasing by 6.1% y-o-y during Q4 2015. By contrast, France only managed an increase of 0.1% y-o-y during Q4 2015, following 14 quarters of y-o-y decreases;

Figure 9. European house price index (base=100 @ Q1 2007)



Source: Macrobond

United Kingdom

- **UK house sales totalled 392,000 units during Q1 2016, an increase of 31.5% y-o-y.** This increase is largely due to a surge in the number of transactions during March, which was at least partially due to buyers transacting prior to a rise in the rate of stamp duty on second properties in April. One non-tax contributing factor is likely to have been the BoE[4] plan to curb buy-to-let mortgages;
- New instructions by house sellers increased for the third successive month in February, following ten consecutive monthly falls. However, this rise was not sufficient to prevent the number of existing dwellings for sale falling as sales increased. The current number of existing properties for sale remains close to record low levels;
- Uncertainty ahead of the UK's June referendum on EU membership could result in some softening in the number of transactions in Q2. Yet, given the low interest rate environment and the healthy labour market, it's quite possible transaction volumes could recover in H2;
- Furthermore, despite an improvement in the number of properties available for sale in recent months, continuing under-supply is likely to put upward pressure on house prices;

France

- **The annual volume of existing house sales in France increased by 16% y-o-y to reach 809,000 during 2015. This increase in demand halted the downward trend in prices;**
- French house prices saw signs of stabilisation after declining for three years. It's expected that, given the ongoing low interest rate environment, an increase in transaction volumes is likely, but it's yet unclear whether this might lead to an increase in prices in the short-term;
- Furthermore, the expansion of eligibility criteria for the new interest-free loan (PTZ) is likely to bring new buyers to the market, which in turn could lead to further increases in volumes;
- The number of new dwellings sales in 2015 increased by 18% y-o-y to reach 102,500 units. The average time to sell a new dwelling decreased from 4.9 quarters at end-2014 to 3.9 quarters at end-2015;
- However, developers remain cautious in launching new projects. While the number of building permits increased by 6.7% q-o-q during Q4 2015, the actual number of construction starts contemporaneously decreased by 0.8% q-o-q;

Germany

- With EUR2.1 billion (21,600 apartments) transacted in Germany during Q1, residential investment volumes declined by 66% y-o-y, after 2015's record high due to Deutsche Annington's acquisition of Gagfah in Q1 2015;
- Despite this considerable decrease in large transactions, lot sizes of less than EUR100m per transaction increased, with the number of transactions and transaction volumes increasing by 30% and 36% y-o-y respectively;
- **Given the steady reduction in supply of larger existing portfolios for sale, forward sales of development projects have increasingly contributed to investment volumes. They accounted for c20% of total number of deals in Q1 2016 compared to 6% in Q1 2011;**
- Q1 trends are likely to continue throughout 2016. The ECB's policy of maintaining highly accommodative monetary policy is likely to continue to support demand for the residential investment market. Supply is expected to remain tight, which is likely to encourage investment in developments and confine activity more to the small and mid-range market segment.

[3] Weighted average of the national house price indexes, using as weights the GDP at market prices (based on purchasing power) of EU 28 countries
[4] Bank of England

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