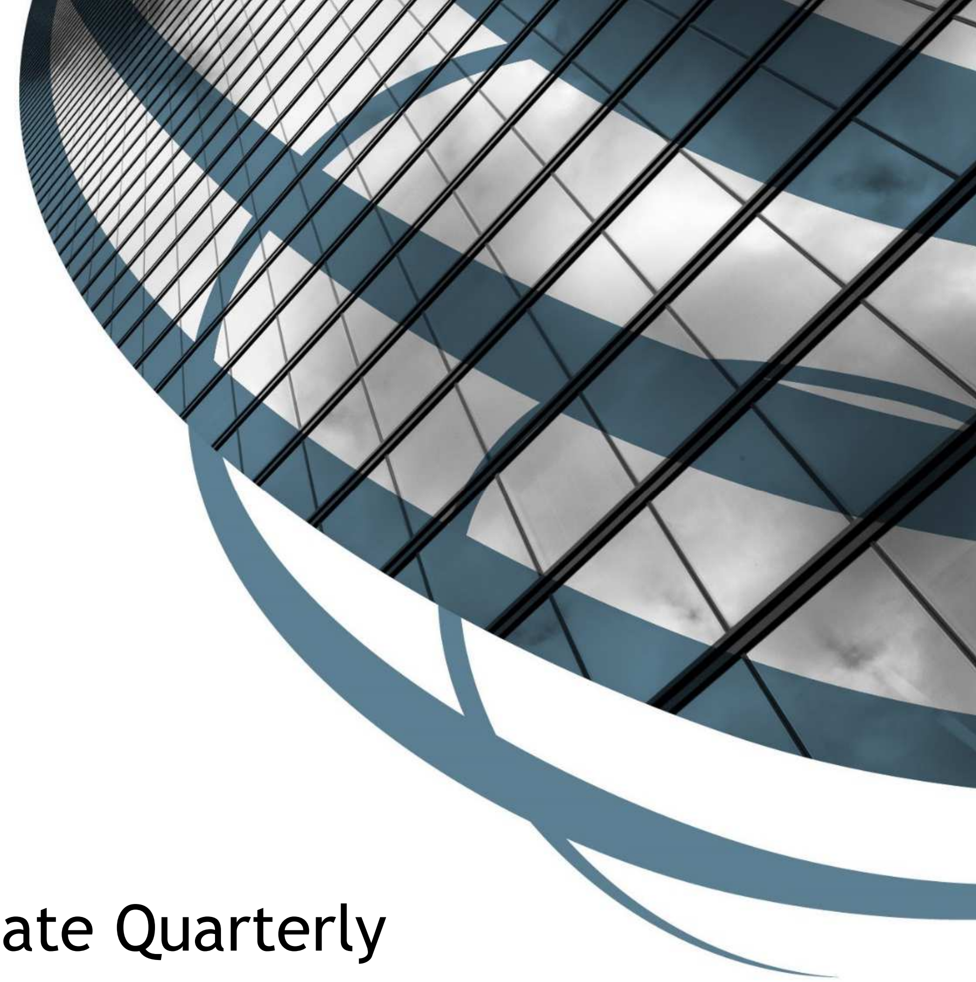


European Real Estate Quarterly

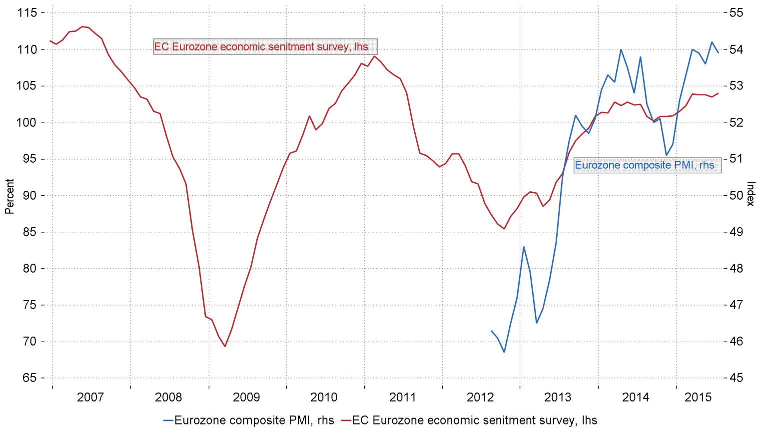
Q3 2015

AEW EUROPE

Economy and Capital Markets

- With Chinese growth somewhat stabilising and an uptick in US growth, it's expected that Q2 global growth will have increased to 2.5% q-o-q on an annualised basis. This is despite the general slowdown in economic activity that continues to occur in many emerging economies, partially driven by the ongoing decline in commodity prices;
- **Current leading indicators are somewhat mixed, but suggest that global growth has further picked up during Q3** and that the acceleration in growth that's occurred more recently is likely to be maintained. Weak oil prices should help underpin stronger growth in developed economy consumption throughout Q4 and into Q1 2016;
- In the Eurozone during the few months leading up to early-Q4, leading indicators have weakened slightly, suggesting that short-term growth expectations at a regional level should be tempered. Indeed, Q2 GDP growth was 0.3%, a little below that of Q1 and consensus expectations;
- However, **over the longer-term, a continuation of the Eurozone recovery remains the consensus expectation**. Indeed, EC and PMI indicators being at positive levels is supportive of this view as Figure 1. indicates, and the Eurozone recovery continues to make gains;
- This softening in short-term Eurozone growth expectations is likely to be a result of the negative flow-on effects from the short-lived US slowdown earlier this year, and the lagged effects of the Chinese slowdown on the Eurozone industrial sector. The most recent flare-up in the Greek situation during June and July almost certainly had a negative effect on economic sentiment across the region;

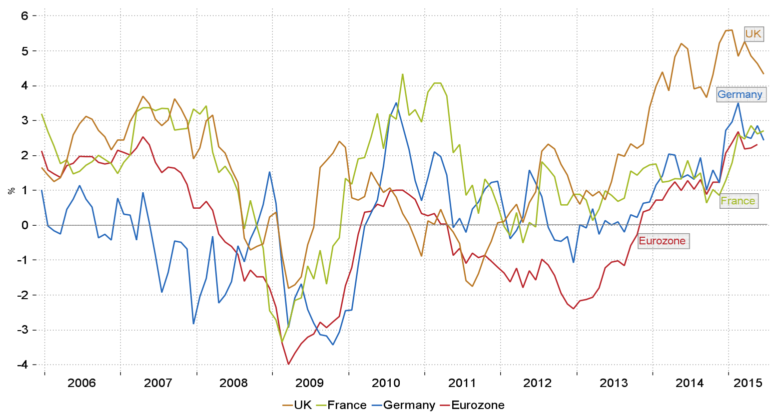
Figure 1. Eurozone composite PMI and European Commission Eurozone economic sentiment survey



Source: Macrobond

- **Ongoing robust levels of consumer demand across the Eurozone remain a considerable driver of the economic recovery**. The outsized decline in the price of oil and the bout of negative CPI have significantly raised real incomes which has flowed through to much higher retail sales volume growth, as Figure 2. shows;
- The recovery in retail sales volumes is expected to continue through to at least the end of Q4 if not into H1 2016, though this source of growth is not without increasing risks to the downside. Whilst improving, real wage growth is still weak throughout much of the Eurozone, unemployment rates remain elevated in a number of countries, and the boost to real incomes will diminish if inflation reverts towards more normal levels, as it is expected to;
- **If consumer demand wains over the next four quarters, there are encouraging reasons to think that business investment may revive** and help offset the decline. Investment intention surveys indicate that an increase in business capex is likely, the existence of both a weaker Euro and higher profit margins, and that non-financial business lending terms have become more accommodative – all point to such a positive eventuality. Moreover, years of under-investment by businesses suggests plenty of latent demand;
- Outside of the Eurozone in Europe, the UK economy grew at an annualised rate of 2.8% during Q2 after a disappointing Q1 result. As with the Eurozone, consumer demand accounts for a considerable proportion of current UK growth. Also like the Eurozone, leading indicators have softened slightly, but still indicate above-trend growth for H2.

Figure 2. European retail sales volume growth (3MMA)



Source: Macrobond

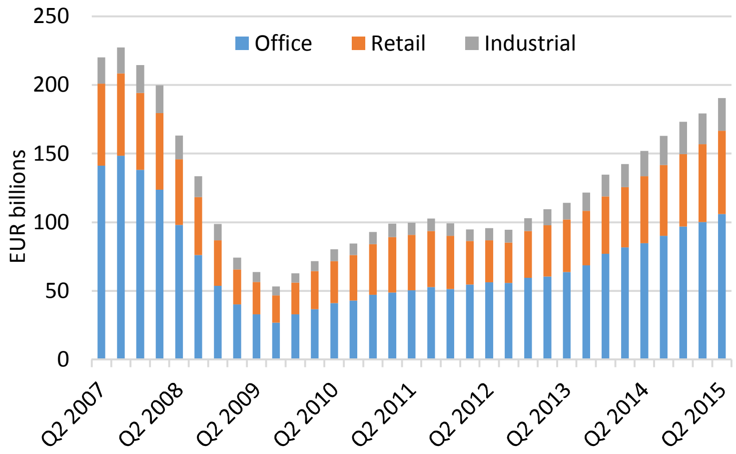
Investment Market

European CRE investment market goes from strength to strength

- **Following a strong start to the year, growth in investment activity continued into Q2**, with a total of EUR47.7 billion of commercial real estate transacted across Europe (an increase of 18% q-o-q and 31% y-o-y). As Figure 3. shows, this brings the 12 month rolling investment volumes to end-Q2 to EUR190.5 billion, the highest level in nearly seven years. Such buoyant investment volumes reflect still growing investor demand and increasing capital flows into the European real estate market;

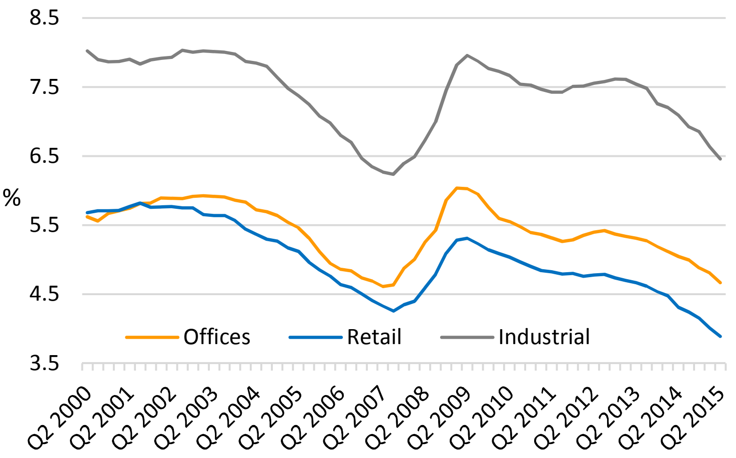
- **Germany and the UK continued to lead the European investment market**, with H1 investment volumes reaching EUR19 billion (+34% y-o-y) and EUR30.5 billion (+32% y-o-y) respectively, together accounting for 55% of the European total. By contrast, France recorded a 40% y-o-y fall in investment volumes to EUR6.8 billion during H1, largely due to a weak second quarter and a lack of large transactions;
- **Investor interest has further expanded to the Nordics**, which saw investment volumes grow by 70% y-o-y to reach EUR12 billion during H1. International investors have been particularly active in the region, mainly due to the perceived resilience of Nordic economic fundamentals and the continued weakening of the Nordic currencies;
- **Recovering from a low base, the Spanish market experienced one of the fastest growth rates in investment activity**, with H1 investment volumes more than doubling compared with the same period in 2014. Cross-border investment into Spain continued to account for a large proportion of overall investment during H1;
- The European office sector saw investment volumes increase by 27% y-o-y to EUR47 billion during H1 and continued to account for the largest share of overall European commercial investment volumes at 52%. Industrial volumes remained largely stable at around EUR9 billion during the same period. Retail was the fastest growing sector, with H1 investment volumes surging by 44% y-o-y, largely due to a number of large shopping centre portfolio transactions;
- As Figure 4. shows, Q2 continued to see further yield compression across all property sectors. As a result of the ongoing increase in investor demand for industrial assets, industrial yields have declined sharply, with prime yields falling by 18bps q-o-q and 63bps y-o-y during Q2. Similarly, investor demand continues to put downward pressure on retail and office yields, led by strong yield compression in the major markets of the Crisis Countries[1];

Figure 3. European commercial real estate investment volumes by sector (four quarter rolling)



Source: CBRE

Figure 4. EU-15 prime yields by sector



Source: CBRE

Outlook

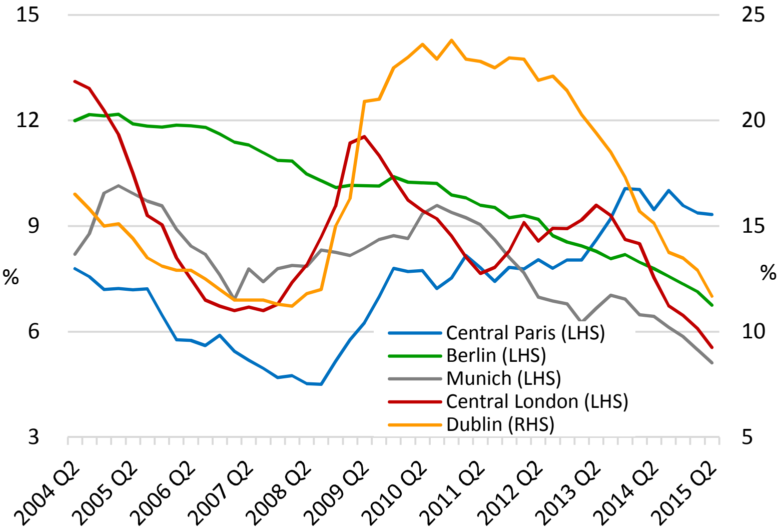
- Despite the ongoing yield compression and a slight increase in government bond yields in some European countries, the yield gap remains near historical highs. European commercial real estate is expected to remain attractive relative to other asset classes and continue to benefit from the weakening of the Euro in a prolonged low interest rate environment;
- The considerable yield compression in the core office markets has led to strong capital value growth over the last two to three years, with prime capital values in central London and all the major German cities exceeding their pre-GFC[2] peaks. However, capital values still remain at a significant discount to their previous peaks in some of the Crisis Countries and parts of the CEE region;
- **Despite narrowing somewhat over the last two years, the outsized yield gap between core and non-core assets remains largely in place across many European markets.** The Paris and Munich office markets provide illustrative examples, where the current yield gap is 160bps and 200bps respectively between the city centre and out of town markets. Considering a lack of investment stock for sale and strong competition for assets at the prime end of the market, investors are likely to increasingly target non-core assets and non-core locations to take advantage of perceived mispricing;
- Looking ahead, Spain (offices and retail), central Europe (retail and industrial) and Ireland (retail and industrial) are predicted to offer the highest total returns, due to a strengthening economic outlook, further yield compression and improving occupier market fundamentals.

[1] Greece, Italy, Spain, Portugal and Ireland
[2] Global Financial Crisis

Office Market

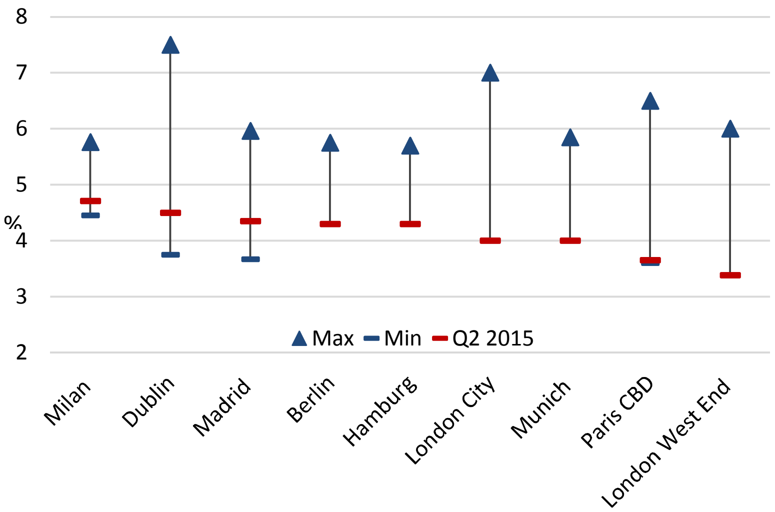
- **Momentum across the European office occupier market continues to improve, being underpinned by the broad-based economic recovery and stronger business sentiment**. Q2 saw aggregate office take-up increase by 2% y-o-y, which is the strongest second quarter since the onset of the GFC;
- Letting activity in the German office market continues to remain robust, with a total of 767,000 sq m taken up during Q2, an increase of 17% y-o-y. All the top seven cities except Munich (-12%) registered a y-o-y increase in take-up during the quarter, with Dusseldorf (+69%) and Cologne (+48%) experiencing the strongest growth;
- Following a subdued first quarter, central Paris office take-up increased by 33% q-o-q to reach 289,000 sq m in Q2. However, letting activity during the first half of the year was down 22% y-o-y and 7% lower than the 10 year H1 average;
- **The aggregate office vacancy rate across Europe fell during Q2, mainly driven by strengthening occupier demand and modest levels of new completions**. As Figure 5. indicates, the largest falls were seen in Dublin and central London where vacancy rates declined by 350bps and 200bps respectively during the 12 months to the end of Q2. Central London vacancy rates are now 110bps below the pre-GFC low of 6.6%;
- **Improving occupier demand combined with falling availability is driving further rental growth in the Spanish office market**. Most notably, rental growth accelerated further in Madrid and Barcelona during H1. Dublin too, continues to see strong rental growth due to low availability of quality stock, with prime rental values increasing by a significant 27.5% y-o-y during Q2;
- Investment into the European office market totalled EUR25.5 billion during Q2, up 18% q-o-q and 33% y-o-y. The increasing investment volume is driven not only by solid performance in the core markets of the UK and Germany, but also a significant y-o-y increase in transaction levels in Spain and Italy;
- Strong investor demand continues to put downward pressure on office yields, with prime net initial yields hitting new lows in London West End (3.38%), London City (4.00%) and the major German cities (average 4.38%) during Q2, as Figure 6. shows. The Crisis Countries saw further yield compression during the quarter, driven by perceived attractive relative value and strong levels of cross-border investment. Dublin and Madrid in particular saw prime net initial yields compress by 25bps and 23bps q-o-q respectively;

Figure 5. Selected European office markets' vacancy rates



Source: PMA

Figure 6. Selected European office markets' prime net initial yield evolution (2000-2015)



Source: PMA

Outlook

- As occupier demand gradually recovers across the European office markets, a lack of large and high quality stock is expected to drive more pre-let activity, especially for occupiers with larger space requirements in the prime locations;
- The large development pipeline is expected to persist in the CEE region over the next five years, and thus likely to hold back rental growth prospects in the short-term. Most notably, vacancy rates in Moscow and Warsaw, which are forecast to increase over the next 18 months given the over-supply problems in these markets, will only start to decline from 2017;
- **The Crisis Countries are forecast to deliver the highest prime office total returns across Europe during 2015**, with Dublin (31.9%), Madrid (24.9%) and Barcelona (21%) expected to be the best performing markets.

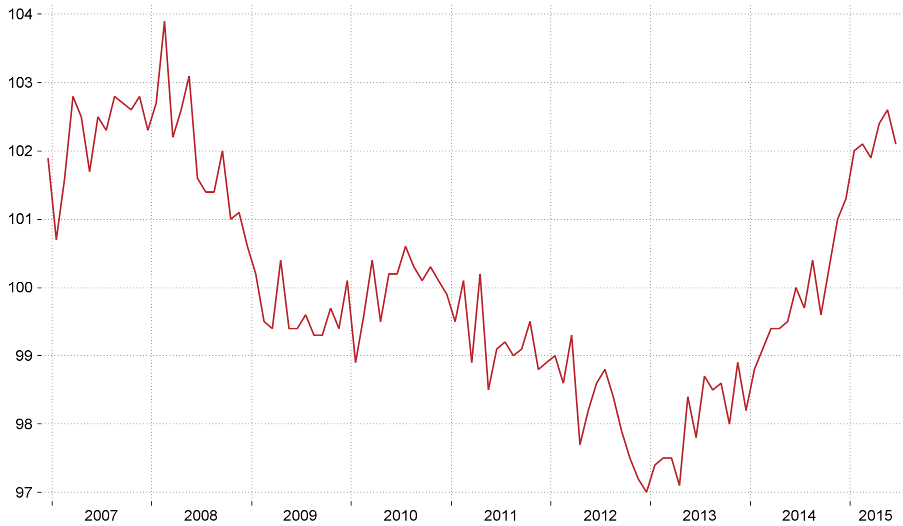
Retail Market

- As Figure 7. shows, retail sales volumes in the EU fell 0.5% m-o-m in June, recorded an increase of 2.1% on a y-o-y basis. This was the largest monthly fall since September 2014. The largest m-o-m declines came from Ireland, Luxemburg, Germany and Poland, all experiencing falls in excess of -1%;
- The 2.1% y-o-y increase in retail trade volume was due to the 3.4% rise in non-food products, the 1.4% rise in automotive fuel, and the 0.8% rise in food, drinks and tobacco;

Occupier market

- **Demand for retail space remains uneven between prime and secondary locations**. The fall in the Euro has increased the attraction of the Eurozone as a tourist destination. Partially as a result of tourist spending and Euro depreciation, tenant demand for prime and off-prime units adjacent to prime pitch locations has increased;
- Similarly, **space in larger, more dominant European shopping centres remains the most sought after segment of the shopping centre sector**, due to their critical mass, lower vacancy rates and higher associated footfall. Indeed, the European[3] average vacancy rate for shopping centres smaller than 40,000 sq m stands 30% higher than the vacancy rate for shopping centres greater than 40,000 sq m;
- Whilst delivery of new shopping centres during 2015 is projected to fall short of the 10 year average in all major European market [4] except Spain and France, European shopping centre development activity is gaining momentum and is expected to increase by 8% y-o-y. This increase is likely to put the performance of smaller and/ or high-obsolescence shopping centres at further risk - particularly centres lacking a supermarket or leisure anchor tenant;

Figure 7. EU retail sales volumes (SA, base=100 @ 2010)



Source: Macrobond

Investment market

- Boosted by large portfolio deals, European retail investment volumes reached EUR35.1 billion in the first half of 2015; an increase of 45% y-o-y. The UK led the region, accounting for 28% of this, followed by the Nordics, Germany and France accounting for 16%, 15% and 8% respectively;
- Notably, in Norway, Citycon acquired Sektor Gruppen, the country's second largest shopping centre owner and manager for EUR1.05 billion. In Germany, the Hudson's Bay Company of Canada and owner of Saks Fifth Avenue, acquired Galeria Kaufhof, a department store chain, from the Metro Group for EUR2.85 billion. In contrast, in France, the lack of very large transactions during H1 has resulted in a decline in investment volumes;
- Remaining under pressure from the weight of investor capital, prime retail yields have reached long-term lows in all major European markets. In Q2 2015, the western European[5] average prime yield contracted from 4.05% in Q1 to 3.81% at the end of Q2;

Outlook

- Continued upward pressure on rental values for prime European retail space is likely, due to a combination of under-supply and ongoing occupier demand from top-tier retailers;
- **The continuing and significant recovery in retail sales volumes is one significant factor that's expected to further drive gains in retail investment volumes.** Considering the elevated pricing for prime assets in the core markets of western Europe, investors are increasingly likely to target quality secondary retail assets with asset management potential, particularly in the UK and Germany.

[3] Key shopping centres in Czech Republic, Denmark, Finland, France, Germany, Hungary, Italy, Poland, Portugal, Spain, Sweden and United Kingdom
[4] Finland, France, Germany, Ireland, Italy, Netherlands, Portugal, Spain, Sweden and United Kingdom
[5] London, Paris, Munich, Hamburg, Frankfurt, Berlin, Dublin, Amsterdam, Madrid, Brussels, Milan and Lisbon

Logistics Market

Strong rebound in industrial and logistics investment volumes across Europe

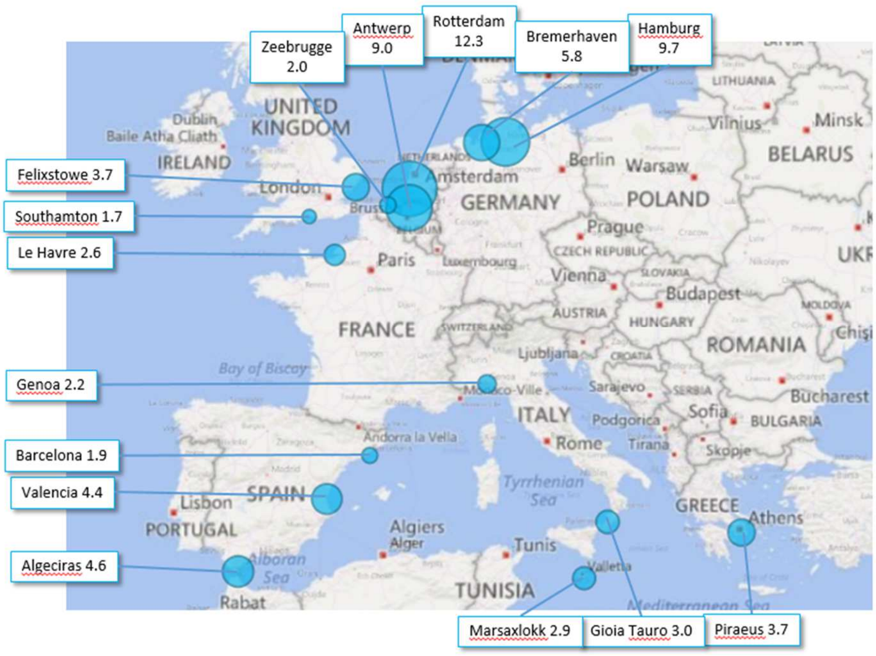
Occupier activity

- **Industrial occupier demand continues to be supported by private consumption and export growth across Europe. Germany, France and the UK all recorded y-o-y increases in industrial and logistics take-up during H1**;
- In Germany, logistics warehousing take-up totalled c2.9m sq m during H1 2015. Demand is being fuelled by e-commerce and increased outsourcing of logistics activities. Newly built warehouse space accounted for two-thirds of total take-up during H1, confirming the demand for new space and build-to-suit solutions;
- French take-up during H1 increased by 9% y-o-y to reach c1.4m sq m. Demand has been driven by retailers reorganising their supply-chains and large deals over 40,000 sq m. Grade A supply is at a 10-year low and all markets on the North-South axis are suffering from the lack of quality stock;
- UK H1 take-up totalled 16.7m sq ft (c1.6m sq m), which was largely driven by a strong Q1 demand. Take-up is expected to increase during H2 due to the large number of outstanding occupier requirements that have yet to be satisfied. Occupiers are increasingly moving out of Grade B space and into prime buildings;
- Outside the three western European core markets of Germany, France and the UK, notably the Netherlands and the CEE markets performed strongly;

Investment activity

- Although European industrial investment volumes were somewhat subdued during Q1, Q2 saw a strong rebound, delivering a record high Q2 volume of cEUR6.1 billion;
- The UK accounted for 40% of overall industrial investment volumes. Germany, Sweden, Finland, the Netherlands and Spain also reported strong quarterly investment activity. However, France and the CEE markets experienced a decline in prime investment transactions due to a lack of prime stock available for sale (rather than a decline in robust investor demand);
- **The logistics market continues to experience yield compression, with prime net initial yields in many European markets currently at or below their previous record lows**. This ongoing trend in yield compression is even occurring in some relatively higher yielding markets, such as France, Italy and central Europe;

Figure 8. 15 busiest container ports in Europe in 2014 (million TEU[6])



Source: PortEconomics, Theo Notteboom, based on statistics from individual port authorities

Outlook

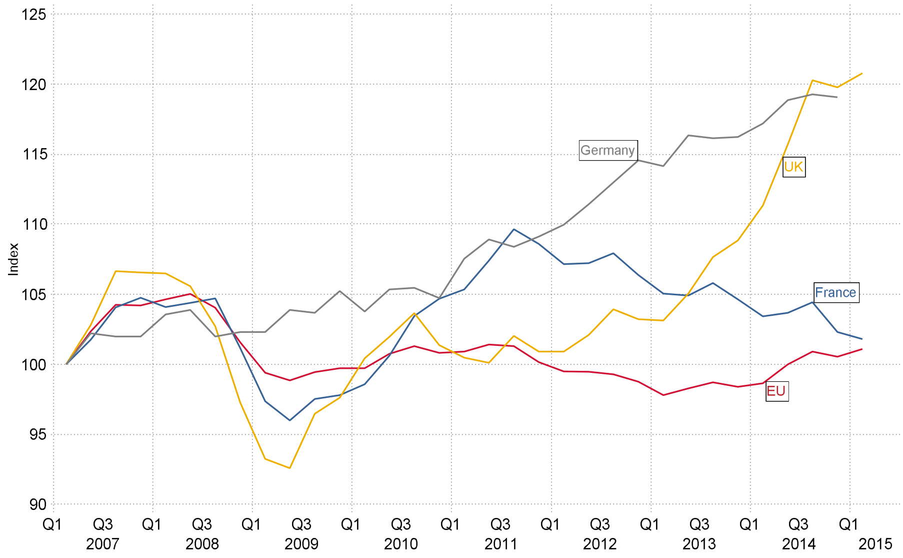
- The European logistics market recovery remains largely in place, and continues to be driven by an improving economic backdrop and resilient consumer activity;
- **North-western Europe is likely to remain the main focus of logistics investors, partially due to the largest container ports being located in this part of Europe**, as Figure 8. shows. These locations benefit from the thriving logistics activity resulting from global and European trade flows. The areas around Rotterdam, Antwerp, Hamburg and Bremen are the most notable for such activity;
- The growing occupier demand for e-commerce fulfilment centres is expected to also fuel the development of new large warehousing space;
- **With the level of new supply still falling, some operators/ investors are starting to seriously consider speculative development opportunities.**

[6] Twenty-foot equivalent unit

Residential Market

- **Eurostat's EU house price index[7] rose by 2.5% y-o-y during Q1, compared to the trailing 10 year Q1 average of 1.6%.** Buyers' confidence has been supported by burgeoning growth in real wages and low mortgage interest rates;
- Ireland (+16.8%), the UK (+8.5%) and the Nordics (+6.5%) recorded the strongest y-o-y house price growth during Q1. Conversely, house prices in France fell by 1.6% y-o-y for the twelfth quarter in a row. Growth remains solid in Germany, with house prices increasing by 2.4% y-o-y during Q4 2014 (latest data available);

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



Source: Macrobond, Eurostat

United Kingdom

- **In the UK, activity in the housing market picked up during H1, after having fallen throughout most of 2014.** The number of mortgage approvals has continuously risen m-o-m since the beginning of the year, posting an increase of 20.7% from the beginning of January to the end of June. Yet despite this increase in activity, the level of mortgage approvals remains historically subdued: June approvals were 15.9% below the long-term monthly average (2000-2015) and still 10.4% below the January 2014 monthly figure;
- The number of residential property transactions (seasonally adjusted) totalled 104,590 in June, an increase of 4.7% m-o-m and 3.2% y-o-y, but remains below the 2007 peak of c150,000 per month;
- According to the latest Buy-to-Let Index, average per dwelling rental values across England and Wales reached a new record high of GBP789 per month in June, which was 1.4% higher than the previous month and an increase of 5.6% y-o-y;

France

- **The French residential market has remained volatile and large differences in regional performance persist.** At the end of May, the number of transactions for existing houses over the preceding 12 months was estimated at 711,000, a 4% y-o-y decline. However, an increase in transactional activity of 3% was recorded during the three month period to the end of May, compared to the three month period prior to this, as vendors lowered price expectations and buyers continued to benefit from attractive mortgage interest rates;
- Growth in new house sales was confirmed during Q1 with 23,900 new houses being purchased off-plan, which was an increase of 14.4% y-o-y (following the increase of 3.4% y-o-y during Q4). Yet, this increase in sales may prove to be short lived as the number of building permits issued from the beginning of February to the end of April declined 1.9% y-o-y;

Germany

- **In June 2015, Berlin became the first German city to impose a cap on rental value increases in areas with housing shortages. Rental value increases on new leases are now limited to 10% above the local rental value benchmark.** However, new housing developments and refurbishments have been exempted from this cap. The Hamburg and North Rhine-Westphalia regions have both followed Berlin, with Bavaria and Rhineland-Palatinate scheduled to soon follow suit;
- H1 German residential investment volumes grew by 125% y-o-y to reach EUR16.9 billion, notably exceeding office sector investment volumes. Activity was boosted by large takeovers of listed residential property companies, including the acquisition of more than 144,000 residential units by Deutsche Annigton after its merger with GAGFAH. Further market consolidation is likely to take place with a small number of major housing companies expected to dominate the market;
- Investors looking for higher returns are focusing on small student apartments under 40 sq m and new housing development in the major cities, with investment volumes for the latter totalling almost EUR1 billion during H1 2015.

[7] EU 28 GDP weighted average of national house price indices

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