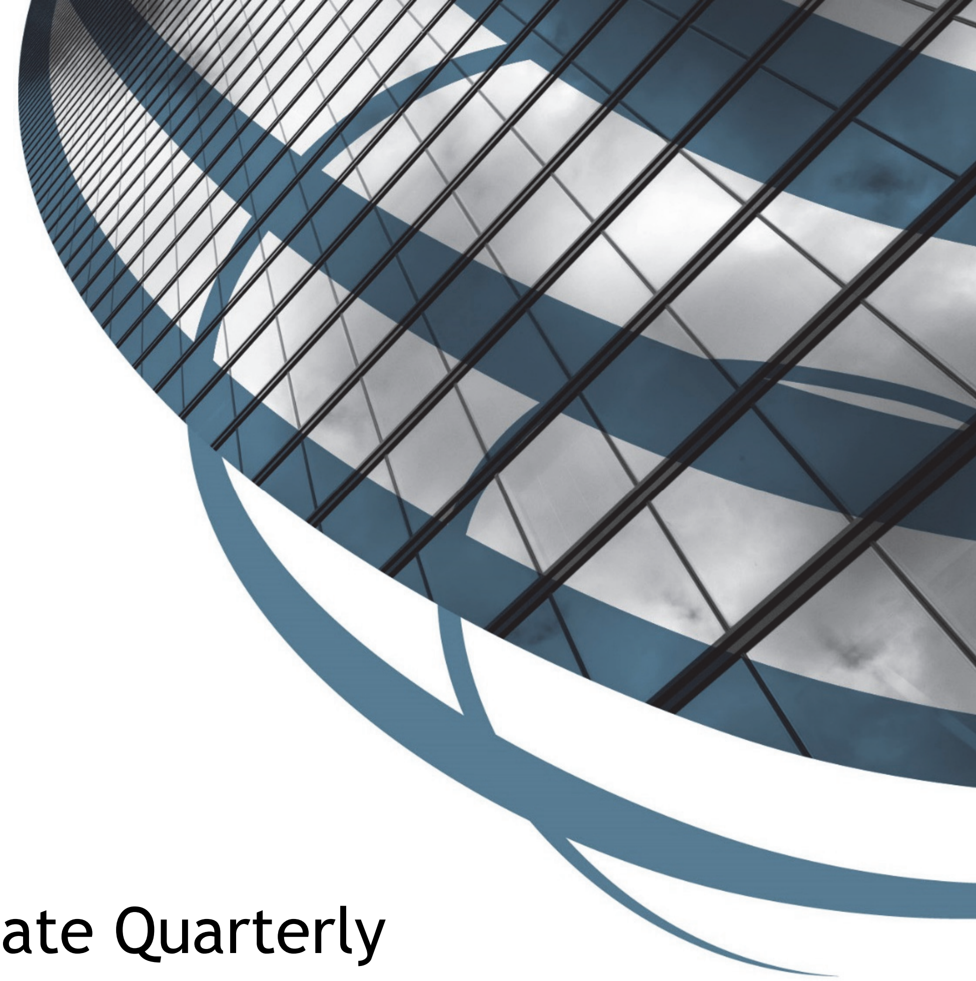


# European Real Estate Quarterly

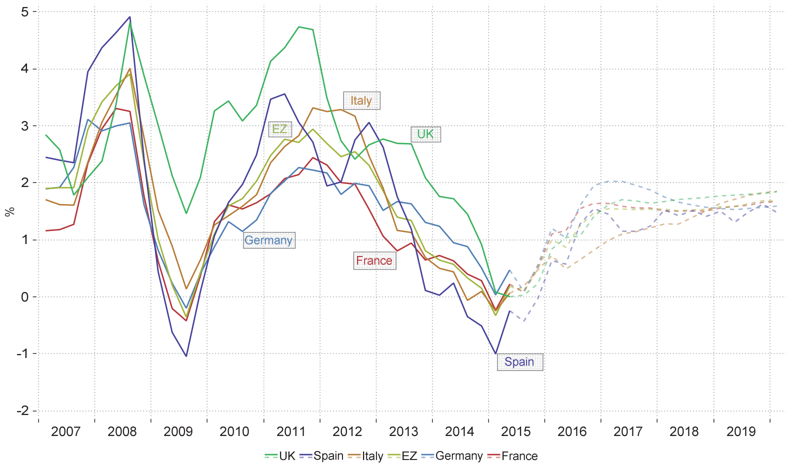
## Q4 2015

AEW EUROPE

# Economy and Capital Markets

- Towards the end of Q3 and during early Q4 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 stated that such a downturn is a material risk and financial markets' sentiment continued to deteriorate throughout late Q3, with equities and commodities prices declining noticeably;
- **Despite this negative sentiment and leading indicators moving slightly 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 Q2 and early Q3;
- While there is differing conjecture on the likely path of global demand over the short-term, the likely path of inflation over the next five quarters is much clearer as Figure 1. shows. **A continuation of the current 'lowflation' environment (and possibly further disinflation) is highly probable. Adding to the disinflationary pressures emanating from China and a number of other emerging markets are further declines in commodity prices;**

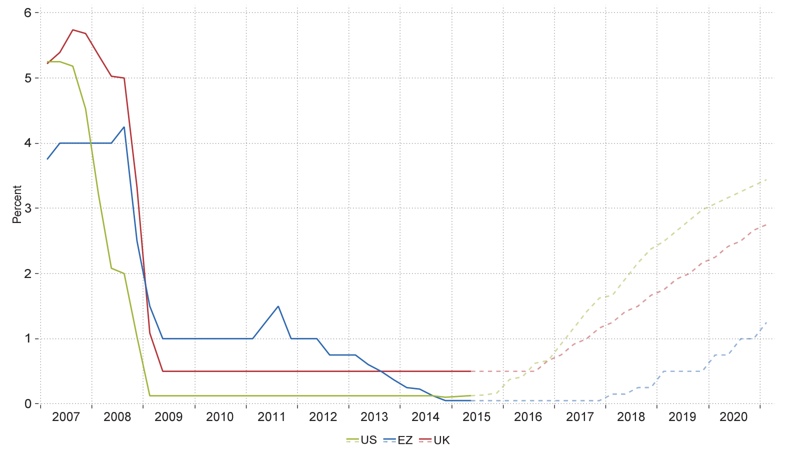
## Figure 1. Selected countries' headline consumer price inflation




*Source: Macrobond, Oxford Economics*

- Surprisingly, **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. Commenting after the moves, Mario Draghi emphasised that the bank is setting policy on the basis of achieving a sustained adjustment in the path of inflation, thereby almost committing the ECB to a rule-based policy framework. This seems to be a move away from his previous comments suggesting ECB policy was driven by a broader suite of factors;
- In contrast, unsurprisingly **the Fed raised the Fed Funds rate by 25bps in mid-December** as the majority of the market was anticipating. However as with many other central banks around the world, the path of tightening is likely to be slower than previous cycles. 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. Figure 2. illustrates expected rate paths;
- After experiencing a dip in growth during the end of Q2 and first half of Q3, the Eurozone is once again beating growth expectations. H1 GDP growth was a healthy annualised 1.8% and leading indicators and business surveys from early December suggest that that growth is further accelerating and the recovery continues on track;
- Positively, the Eurozone macro surprise index (which measures how data outturns compared with consensus forecasts) is once again in positive territory. And the European Commission's surveys have been noticeably trending upwards, recently achieving previous cyclical highs. **Eurozone GDP growth for the full year is still expected to reach 1.5%;**
- Strong consumer confidence has been a predominant driver in supporting Eurozone growth in recent quarters, with significant retail sales volume growth driving much of the increase in economic activity this year. This strong consumer spending has so far more than offset any negative flow-on effects from some parts of the slowing global economy. However, in the medium-term, for the recovery to sustain and deepen, wage growth outside Germany will need to take hold and growth will need to be balanced more evenly by business investment and the services sector;
- Whilst Eurozone fortunes are on the rise, recent high-frequency data suggests that the UK appears to have entered a soft patch. The weakness is not limited to the industrial sector, which has performed disappointingly this year as Sterling has strengthened. Growth in the services sector is now slowing, with order expectations lower due to global economic uncertainty;

## Figure 2. Central banks' base rates




*Source: Macrobond, Oxford Economics*

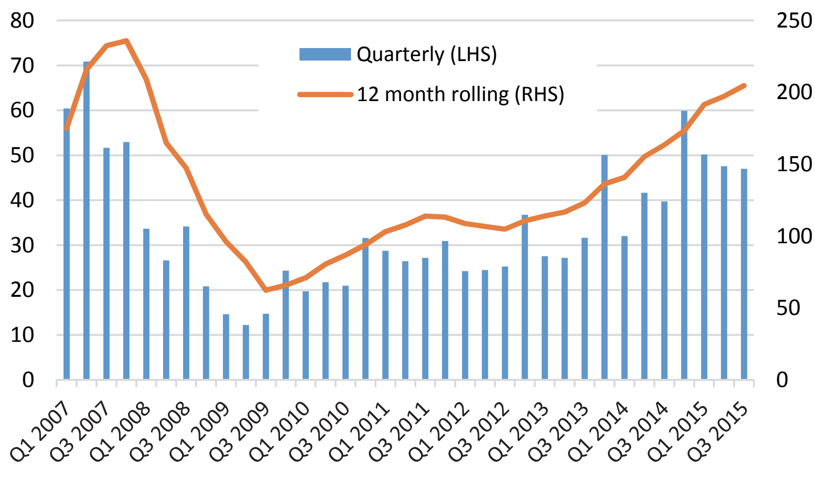
- Like in the Eurozone, growth in the UK has this year continued to be predominantly driven by very strong retail sales volume growth. However, whilst consumer spending is still strong by historical standards, there are early indications that consumers are becoming more cautious about leisure spending, which could put the internal demand-led recovery in jeopardy;
- It is certainly premature to form any such negative conclusions about the UK economy. Particularly healthy wage growth of 3% is expected to continue, supported by positive hiring intentions from the service sector. Continued job creation coupled with wage growth and very low levels of inflation, should be enough to keep consumer spending at elevated levels for the short-term at least. And there are reasons to expect growth to become more balanced over the medium-term if business investment picks up. **For 2015, UK growth of 2.5% is still expected - which is considerable given the current global context;**
- Whilst global risks to the downside have certainly increased over the last few months, the UK and the Eurozone continue to grow and recover. However, neither have decoupled from the rest of the world and remain open to external shocks. Many have suggested that recent activity in China provides such a shock. Though with UK and Eurozone GDP having direct exposure of around 1% and 2% respectively to China, recent Chinese troubles do not present materially significant downside risks in the immediate-term.

# Investment Market

## European CRE investment activity on track for the best year since the GFC[1]

- Despite the economic slowdown in China and other emerging markets and their impact on global economies, **investor appetite for European real estate continues to remain strong.** European commercial real estate investment volumes totalled EUR47 billion in Q3, an increase of 18% y-o-y. This brings the volumes for the first three quarters of this year to EUR145 billion, 28% higher than same period in 2014. As Figure 3. shows, 12 month rolling investment volumes to end-Q3 reached the highest level since Q1 2008;
- **The core markets of the UK, Germany and France remain dominant,** together accounting for 69% of the European total during Q3. Although the UK experienced an 8% y-o-y drop in investment volumes in Q3, it remains the largest market with EUR47.9 billion invested during the first three quarters of 2015, up 15% y-o-y. Germany and France saw investment activity increase by 75% and 51% y-o-y respectively during the quarter;
- Elsewhere, the Nordics and Benelux also attracted high levels of investment, with the 12 month rolling total to end-Q3 increasing by 58% and 51% respectively;
- Following a robust H1, investment activity in Spain fell during Q3, which was partially due to an increasing number of investors seeking out non-core investment opportunities in other markets of the Crisis Countries[2]. This is evident by increased investor demand in Portugal and Italy where investment volumes during the first three quarters increased by a significant 715% and 102% y-o-y respectively;

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




*Source: CBRE*

- **The European office sector continues to be the most sought after asset class, accounting for just over half of overall investment during Q3.** A broadening improvement in consumer confidence across Europe has helped boost retail investment activity during 2015, with Q1-Q3 2015 investment volumes increasing by 60% y-o-y;
- Robust investor demand across the European investment market combined with low bond yields have resulted in further yield compression across all main sectors during Q3, with the EU-15 all property prime yield falling by 16bps q-o-q and 51bps y-o-y. The industrial and logistics sector continued to lead the way in terms of yield compression, with the average yield across the sector now falling below its pre-GFC low;

## Outlook

- Due to continued strong investor demand and attractive pricing in the Crisis Countries, yields are expected to remain under downward pressure during 2016, especially in the industrial and logistics sector;
- Looking ahead, the yield gap between prime and secondary properties is expected to narrow further during 2016. Similarly, the gap in yields between properties in western Europe and the Crisis Countries is also likely to reduce, with prime capital values in the Crisis Countries expected to grow more strongly during the next five quarters;

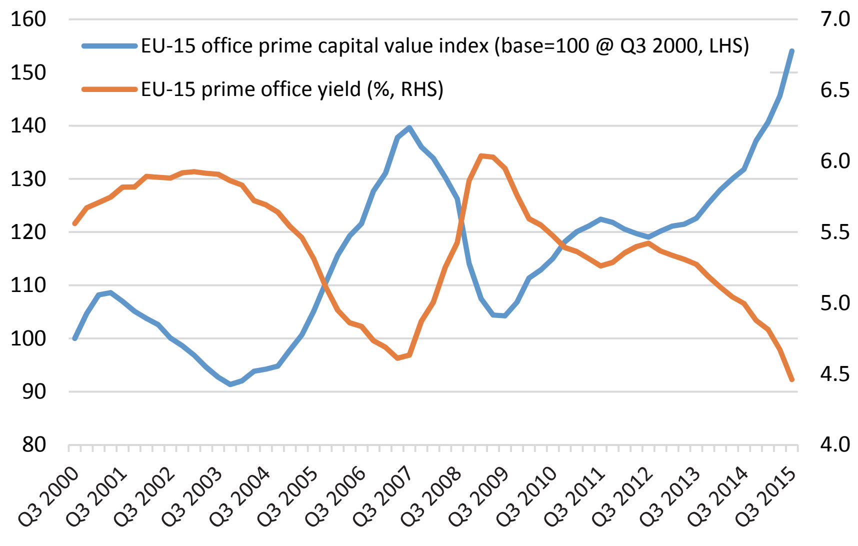
[1] Global Financial Crisis
[2] Greece, Italy, Spain, Portugal and Ireland

- The outlook for total returns is likely to be highly sector-dependent. Of the three main sectors, high street retail is expected to be the best performing sector in 2015, followed by logistics and offices. Over the next five years, logistics is forecast to experience the highest total returns, and the retail sector is expected to outperform offices;
- Investor focus is expected to see a shift away from core assets in core markets towards non-core markets that benefit from improving economic performance and assets offering active management or repositioning opportunities.

# Office Market

- **The European office occupier market showed increased letting activity during Q3 as occupier sentiment continued to improve across most office markets. Overall take-up reached c3m sq m during Q3, an increase of 29% y-o-y;**
- Occupier demand continues to improve in central Paris, with take-up rising for two consecutive quarters to reach 322,000 sq m during Q3. Take-up in the German top seven office markets totalled 2.2m sq m during the first three quarters of 2015, representing an increase of 16% y-o-y. Dusseldorf and Munich significantly outperformed the other German markets, with take-up growing by 59% and 33% y-o-y respectively during the first three quarters;
- **The aggregate office vacancy rate across Europe fell by 20bps to 9.1% during Q3,** with grade A supply falling more significantly than secondary supply. **Vacancy rates in many European markets still remain above their long-term average, most notably in the CEE region and the Crisis Countries.** In contrast, centres with notably below average vacancy rates are central London, Dublin and all the major German markets;
- Rental growth across Europe continues to accelerate, with the EU-15 prime rent index rising by 3.9% y-o-y in Q3. Prime rental values remained largely stable in all major German centres during the quarter. The recovery in the Spanish occupier market is gaining momentum, with office rents increasing further in Madrid and Barcelona during Q3. A lack of high quality office stock has supported strong rental growth in Dublin and central London, with prime rental values now 82% and 66% above their post-GFC lows at EUR538 per sq m and EUR1,475 per sq m respectively;
- A total of EUR29 billion was transacted across the European office investment market during Q3, up 12% q-o-q and 27% y-o-y. This brings the year to date total to EUR76.8 billion, up 27% on the same period in 2014. The core markets continued to post solid results, with Q3 investment volumes in the UK increasing by 15% q-o-q to reach EUR10.6 billion. Following a very weak second quarter, the French office investment activity rebounded by a significant 220% in Q3 to reach EUR5.2 billion, boosted by two large transactions in Paris;
- As Figure 4. indicates, strong yield compression has led to continuing growth in prime capital values across the major European office markets, with the EU-15 average prime capital value index now 10% above its pre-GFC high. Significant inward yield movement has been a feature across the European office market during the last two years, particularly in core western European markets and, increasingly, in the Crisis Countries. Markets that recorded the strongest q-o-q yield compression during Q3 were Rome (-75bps), Milan (-50bps) and Lisbon (-50bps);

Figure 4. EU-15 prime office capital value index and yield




*Source: CBRE*

## Outlook

- **The occupier market supply-demand imbalance is expected to spur rental growth into the medium-term, particularly in those markets with stronger economic prospects.** For example, prime rental values in Madrid and Barcelona are expected to recover strongly during 2015-2017, mainly driven by low development completions and further recovery in tenant demand;
- Although there has been an increase in building starts since the beginning of 2015 in low supply markets such as central London and Dublin, on average the level of development completions across Europe is expected to remain modest over the next five years. All things being equal, this is supportive of rental growth prospects;
- 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.

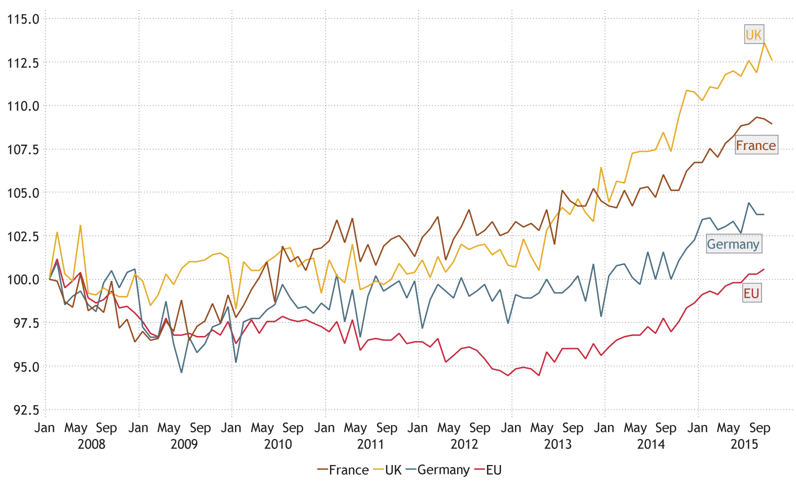
# Retail Market

- As Figure 5. shows, retail sales volumes in the EU increased in September 2015 (+0.3% m-o-m and +3.8% y-o-y). Whilst the highest y-o-y increases were recorded in Romania (12%), Ireland (8%) and Poland (6.3%), the core countries of the UK, Germany and France, all posted robust annual growth of 6%, 4% and 3.6% respectively;

## Occupier market

- **The recent improvement in overall retail sales has not yet fed through to trading performance metrics of Europe's leading retailers.** Net operating margins were down to 7.2% in H1 2015 from 8.3% in H1 2014;
- This has continued to affect store openings during H1 2015, which are lower compared to the previous 18 months, indicating that demand for new store space remains moderate and highly selective. Based on analysis of 14 major retailers with over 16,600 stores across Europe, net openings decreased from 372 in H1 2014 to 186 in H1 2015;

Figure 5. Retail sales volumes (base=100 @ Jan 2008)




*Source: Macrobond*

- Even amongst leading pan-European retail chains, winners and losers continue to emerge. Whilst some retailers (such as H&M and Inditex) continue to expand their store networks albeit at a more modest pace than 2014, others have expanded too quickly and are now closing down some stores (such as Geox, which closed 60 stores during H1 2015);

## Investment market

- The European retail sector continues to gain momentum, with EUR16.7 billion invested during Q3. With EUR52.8 billion invested, retail investment volumes increased by 55% y-o-y during the first three quarters of the year, accounting for 25% of the total real estate investment volume in Europe. The UK and Germany attracted almost half of European retail investment during this period, with EUR13.9 billion and EUR12.2 billion invested respectively;
- **Investor interest for European retail real estate has increased significantly over the past three years, with 12 month rolling investment volumes growing from EUR32.5 billion to end-Q3 2012 to EUR70.5 billion to end-Q3 2015.** Strong competition for assets has led investors to widen their geographical search to include markets outside the three core countries; benefitting particularly from this trend have been Portugal and Belgium, where 12 month rolling investment volumes to end-Q3 increased by 2,025% y-o-y and 336% y-o-y respectively. Investors have also targeted secondary cities in core countries, most notably in Germany, where retail investment outside the top seven cities accounted for almost 80% of German retail investment during the first three quarters of 2015;
- Across the retail sector, shopping centres remained the most sought after type of retail asset, accounting for 52% of total retail investment volumes during the three quarters, which is 44% higher than the 2000-2014 average;
- Domestic buyers only accounted for one-third of European shopping centre investment activity during the first three quarters of the year. Intra-European cross-border investor shopping centre activity reached a long-term high, accounting for 42.7% of investment volumes between Q1-Q3. Non-European investors were also active in the shopping sector segment, particularly investors from China and North America who focused on large deals;

## Outlook

- **Despite the extant threat online retail presents to the high street, the increase of online retail penetration may partly aid the revival of the high street, as the boundaries between online and physical formats become increasingly blurred.** One driver of this has been the growth in 'click-and-collect'. Another recent driver is the increasing number of pure-play online retailers opening physical space. Examples are Google in London, the online fashion group JD Williams across the UK, the online high-tech retailer LDLC.com across France and the online fashion retailer Spartoo in Grenoble;
- Lack of supply and high retail occupier demand for prime-pitch space has pushed prime rental values to long-term highs. European average prime rents[3] increased during Q3 by 3.5% y-o-y and by 7.6% compared with Q3 2013. Upward pressure on rental values is likely to continue across most European prime markets, predominantly driven by a lack of available high quality retail space.

[3] Source: PMA, Austria, Belgium, Czech Republic, Denmark, France, Germany, Hungary, Ireland, Italy, Netherlands, Poland Portugal, Spain, Sweden, UK

# Logistics Market

## Brisk occupier and investment activity but hampered by lack of prime assets

### Occupier market

- **Full-year 2015 pan-European industrial and logistics take-up is looking like it will achieve record levels. Retail-led logistics and online commerce fulfilment remain the main drivers of occupier demand;**
- **Although increasing, speculative development activity remains muted. Most key hubs experience low vacancy rates at the prime end of the market. This has triggered an increase in take-up into secondary properties and locations while maintaining growth in average rental values** at modest levels. Rental growth remains concentrated on markets with constrained development pipelines, such as the UK;
- In Germany, take-up during the first three quarters of 2015 totalled c4.6m sq m, the second best performance since 2011, representing a 21% increase y-o-y. New build space accounted for more than two-thirds of take-up, and with low levels of immediately available supply of modern and large-unit buildings, occupiers tend to opt for built-to-suit solutions;
- Take-up in France increased by 16% y-o-y during the first three quarters to reach c2.2m sq m, the best performance since 2008. The gap between net effective rental values and headline rental values has narrowed, which forebodes a likely gradual increase in rental values in 2016 for prime assets;
- In the UK, Q3 take-up was low for the second successive quarter totalling c502,000 sq m . Take-up for the first three quarters totalled c2.1m sq m. Built-to-suit transactions accounted for 43% of grade A take-up during Q3, compared with 90% in Q1. Conversely, take-up from speculative development picked up during Q3;

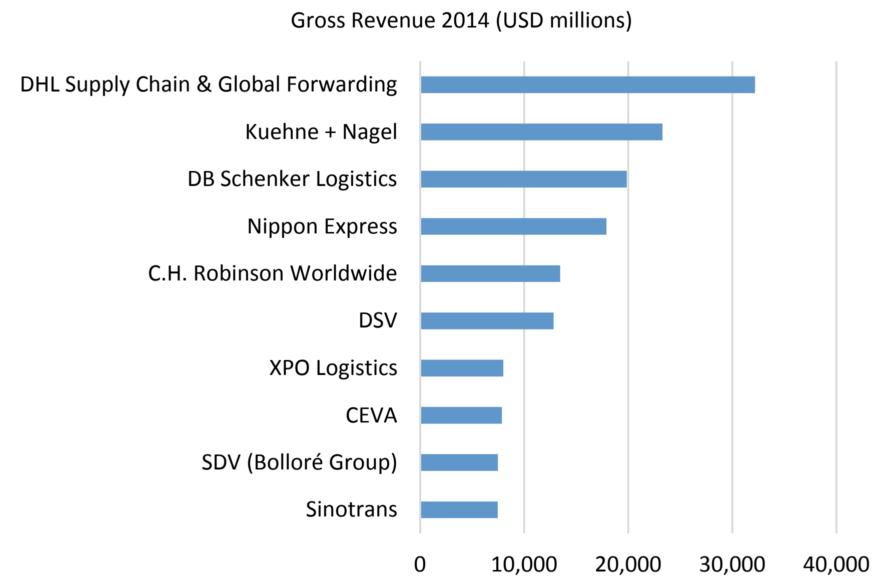
### Investment market

- Industrial and logistics investment volumes declined q-o-q, from cEUR6.1 billion in Q2 to cEUR4.1 billion in Q3. Total investment over the first three quarters reached cEUR14 billion;
- While markets such as France recovered from a weak H1, and Germany and Spain continued to deliver high industrial investment volumes, the UK experienced a summer slowdown. In the UK, portfolios, which are usually a strong source of industrial investment activity, were 69% below their five year quarterly average during Q3. The East Midlands were an exception, recording a high volume of investment during Q3. This strong investment activity for the East Midlands is expected to continue into 2016;

### Outlook

- The wave of mergers and acquisitions in the 3PL industry continues globally and across Europe. 3PL M&A activity to date has already made 2015 a record year, particularly due to the XPO Logistics' acquisition of Con-way, New Breed Logistics, Norbert Dentressangle and UX Specialized Logistics. These acquisitions have made XPO Logistics the seventh largest global 3PL provider behind DSV, as illustrated in Figure 6. Other M&A activity in 2015 includes the pending acquisition of Uti-Worldwide by DSV and the pending purchase of TNT Express by FedEx;
- This **brisk M&A activity is driving further consolidation and centralisation, in turn increasing demand for two types of industrial assets: XXL fulfilment centres and modern parcel hubs around big cities;**
- Although European logistics yields have substantially compressed, the yield gap between government bonds and other real estate classes (including logistics) largely remains in place. Similarly, the yield gap between the higher yielding European logistics sector and lower yielding US and Japanese logistics sectors remains in place too. Fundamentals continue to suggest gradual rental growth in Europe for the sector throughout 2016 and 2017 is likely.

Figure 6. Largest global third-party logistics providers (3PLs)

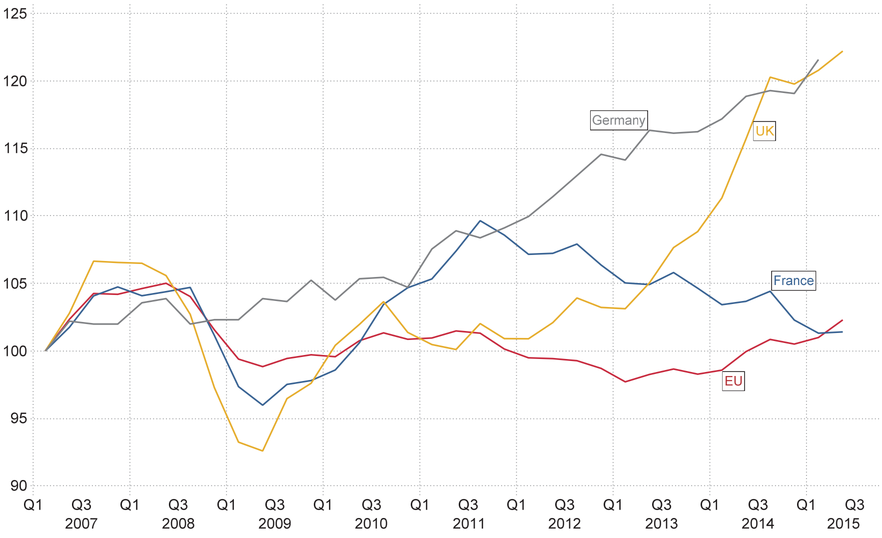



*Source: Armstrong & Associates, Inc.*

# Residential Market

- Eurostat's EU house price index[4] rose by 1.3% q-o-q and 2.3% y-o-y during Q2. As Figure 7. shows, the recovery in EU house prices appears to have been relatively broad-based during Q2, despite French house prices notably declining. The rise in the EU indicator from early 2013 is not only a result of house prices in the UK and Germany rising, but also a result of abating negative house price growth in the Crisis Countries;

Figure 7. European house price index (base=100 @ Q1 2007)




*Source: Macrobond*

## United Kingdom

- In the UK, the number of residential property transactions on a seasonally adjusted basis continued to increase for the third quarter in a row during Q3. Sales in the three months to September grew by 3.6% y-o-y to reach 313,560 dwellings;
- Despite a 5% m-o-m fall in September, the monthly number of mortgage approvals has been trending upwards since the beginning of the year. At the end of September, the number of mortgage approvals over the preceding 12 months totalled 493,923, an increase of 1.5% since the end of January 2015;
- New instructions by home sellers declined in September for the eighth successive month. As a result, the number of homes available for sale remains at low levels. The number of properties available for sale dropped marginally to 37 per estate agent branch in September. This was followed by a significant fall in the availability of housing stock in August, when the number of properties available for sale fell from 55 in July to 38;
- **Although activity has picked up, the ongoing lack of new instructions coupled with limited stock on the market continues to be an issue for the sustainability of the market, maintaining upward pressure on house prices;**

## France

- **Existing house prices in France decreased by 2.8% y-o-y during Q2, the strongest fall since the beginning of the current period of price falls (which began in Q2 2012).** Ile-de-France fared slightly better than the regions, with existing house prices falling by 2.6% y-o-y during Q2, whereas the fall was 2.9% for the regions. Existing house prices in Ile-de-France have continuously fallen q-o-q since Q4 2011, with house prices falling by 6.1% between Q4 2011 and Q2 2015. Similarly, existing house prices have been falling since Q3 2011 in the regions, posting a decrease of 7.9% between Q3 2011 to Q2 2015;
- The 12 month rolling volume of existing house sales in France increased for the seventh successive month during August, reaching 740,000, an increase of 1.4% y-o-y and in line with the 10 year average of 740,500;
- The growth in French house sales continued with 26,500 new dwellings being reserved off-plan during Q2, which is an increase of 21.8% y-o-y. During the same period, the number of new dwellings being put up for sale decreased 3.9% q-o-q and 1.6% y-o-y. All in all, the stock of new dwellings for sale decreased by 8.8% q-o-q during Q2 to reach 97,500;

## Germany

- Residential investment volumes in Germany reached EUR2 billion during Q3, slightly above the Q3 five year average of EUR1.9 billion. Overall residential investment volumes reached EUR19.5 billion during the first three quarters of 2015, almost matching the 2005 full year long-term high of EUR20 billion;
- **The German residential investment market was dominated by domestic investors during the first three quarters of the year, with foreign investors only accounting for 15% of direct investments;**
- After several listed German residential property companies merged during H1, Deutsche Wohnen announced its plan to merge with LEG-Immobilien in September. The combined group will be the third largest listed European property company in terms of portfolio value, behind Unibail-Rodamco and Vonovia. (Deutsche Annington was recently renamed Vonovia after it merged with GAGFAH earlier this year).

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

AEW EUROPE

*An affiliate of Natixis Global Asset Management*

www.aeweurope.com

*AEW Europe is a leading European real estate investment manager with 10 offices throughout Europe. AEW Europe is focused on the creation, execution and management of discretionary commingled investment vehicles, separate account strategies and real estate securities funds to both institutional investors and private clients.*

*The group has over 280 employees who are responsible for €16.8 billion of assets under management. The integration of AEW Europe with the resources and capabilities of North American-based AEW Capital Management creates a truly global real estate investment management platform with aggregate gross assets under management of more than €44 billion.*

## Research & Strategy Contacts


AEW Europe
8-12 rue des Pirogues de Bercy
75012 Paris, France

AEW Europe
33 Jermyn Street
London SW1Y 6DN, UK

AEW Europe
Steinstraße 1-3
40212 Düsseldorf, Germany

Sam Martin MSc MRICS
Executive Director
Head of Research & Strategy
Tel. +44 (0)20 7016 4753
sam.martin@aeweurope.com

Shan Shan Qi MSc
Associate
Tel. +44 (0)20 7016 4853
shanshan.qi@aeweurope.com

Ken Baccam MSc
Director
Tel. +33 (0)1 78 40 92 66
ken.baccam@aeweurope.com

Virginie Wallut MBA
Associate Director
Tel. +33 (0)1 78 40 95 07
virginie.wallut@aeweurope.com

Abraham Mboyo Mbango MSc
Analyst
Tel. +33 (0)1 78 40 92 65
abraham.mboyombango@aeweurope.com


## Investor Relations Contact


Alex Griffiths
Director
Tel. +44 (0)20 7016 4840
alex.griffiths@aeweurope.com