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Aberdeen Standard Investments

European Real Estate Market Outlook

Q4 2018

"Our overall European real estate outlook remains positive in relation to other global markets, but is generally slowing as we have moved further through the capital market cycle."

Executive summary

- European direct real estate is set for another positive year of performance, thanks to strong demand and supply-side fundamentals and supportive financing conditions. While risks remain tilted towards the external environment and domestic growth drivers are in good shape, we believe risk-adjusted returns will continue to be attractive to many pools of capital.
- The overall economic environment is more benign than in 2017, but closer inspection shows that the bulk of the weakness is coming from external factors outside Europe. Stronger domestic fundamentals, more relevant to real estate, are holding up well and we still expect Europe to grow by 2% in 2018 and by 1.7% in 2019.
- Leasing conditions remain favourable in the office markets, with rental growth better than expected in most cases. Logistics market conditions are also thriving, particularly in fringe locations close to major conurbations, where ecommerce is boosting demand. Retail conditions continue to become more benign overall. Rental discounts or rents linked to turnover are increasingly common.
- Investment demand remains strong, with over €290 billion invested over the year to Q3 2018. Competitive bidding on the best assets continues to support pricing. However, sector differentiation is the widest ever recorded according to the latest investor sentiment surveys, with logistics in high demand and retail out of favour. Prime yields have fallen further from the all-time lows of late 2017, as investors compete for income and increasingly the income growth prospects in some segments.
- Our overall return outlook remains positive in relation to other global markets, but is weaker as we have moved further through the cycle. Our most-favoured investment themes in the Eurozone include the private rented residential sector, which benefits from strong population growth in winning cities, restricted supply and limited sites for new development. We also favour logistics (urban and big box), which is being supported by the growth of online retail; dominant retail locations; and alternative sectors, such as student halls and senior living.

Economic outlook

- The European economy has slowly ground into a more sustained period of lower growth. The negative external environment has been the main cause, with political factors such as Brexit, the Italian budget deficit hike and the trade war between the US and China taking their toll on sentiment. The Eurozone composite Purchasing Managers' Index (PMI) fell to 54.1 in September, its lowest level for four months. While our full year 2018 GDP growth forecast remains at 2%, it is likely to end up slightly lower.
- However, in the context of real estate demand drivers, taking a closer look at what is driving economic performance gives a more positive picture. Seasonally adjusted unemployment in the European Union (EU) stabilised at 6.8% in August 2018, its lowest level for over 10 years. The Eurozone equivalent fell to 8.1%, down from 9.1% a year ago. The further tightening of the labour markets in Europe is helping to support occupier demand in business space and also supports cash running through tills in the retail sector. Stronger domestic economic performance is also supported by stronger credit growth, with liquidity in loans to the private sector, non-financial corporations and households all growing steadily at between 4% and 5% per annum.
- European leases with indexation have supported net operating income growth in recent months. Eurozone consumer price inflation (CPI) broke through the European Central Bank (ECB) target of 2% in June recording 2.1%, the first time it has exceeded the target since December 2012. While the rate has remained elevated through to September, the key driver of higher inflation has been strongly rising energy prices. The oil price in Euro terms increased by over 40% over the year to September 2018. As energy price inflation begins to drop out of the numbers, we believe modestly rising core inflation, supported by a more consistent level of wage growth, should underpin a level closer to 1.5%.
- Given the modest outlook for inflation, the ECB is expected to continue to maintain a very gradual tightening in monetary policy. Forward guidance suggests quantitative easing will be fully tapered by the end of 2018, with the base rate first increased by 10 to 15 basis points in the Summer of 2019. Forecasts suggest the base rate will remain below 1% until 2023.

Occupier market trends

Leasing conditions remain buoyant in the commercial real estate market. In offices, demand hit the highest level on record across the key European markets, totalling more than 10.5 million square metres over the year to Q2 2018. This has pushed the vacancy rate down to 7.6% on aggregate, also a record low. In some submarkets, vacancy is now negligible, which is sustaining competition for space amongst tenants and squeezing take up into secondary locations either as a result of price pressures due to high rents or due to a lack of options. The rise of flexible office operators is also eroding headline levels of supply, albeit artificially in some cases.

“Stronger domestic economic performance is supported by stronger credit growth too, with liquidity in loans to the private sector, non-financial corporations and households all growing steadily at between 4% and 5% per annum.”

- Despite the vastly improved labour market conditions and retail sales growth of 2.4% p.a. in the EU, retail segments continue to produce subdued performance, stemming from the powerful negative impact of ecommerce on in-store sales. Prime high streets have been more robust although rental growth is now more benign, bringing into question the low yields. Dominant mall operators continue to report modest like-for-like sales growth and some income growth, with Unibail Rodamco Westfield recording 4.3% net rental income growth across its shopping centre portfolio.
- Logistics remains the star sector, assisted by a growing economy and the evolution of online retail, which is sustaining annual take-up volumes above 10 million square metres. Ecommerce fulfilment now represents roughly 20% of total take-up per annum, while contract logistics operators are also reporting a growing demand for their services from online retail activity. Logistics vacancy rates are falling across Europe and for prime space are around 5% on an aggregate level. Speculative development has increased but on the whole it is focused in areas where demand is clearly strong enough to support it.
- Rental growth continues to exceed expectations in the office sector, with prime rents hitting new records in many markets, including Berlin, Paris and Stockholm. A 5% annualised increase in secondary office rents reflects the highest rate since 2007 and represents the depth of the market. Total vacancy has fallen by over a third since the Eurozone crisis. Logistics rents have been relatively flat on the whole, as developers have been happy to concede lower rents in favour of securing longer tenancies. Retail rents are split between the best dominant locations (where above inflation growth has been evident from listed shopping centre reports) and other formats, particularly poor-quality secondary retail which remains challenged.

Investment market trends

- Investment demand remains strong, with competitive bidding on the most wanted assets continuing to support pricing. Total investment volumes are lower but holding up well, with €290 billion transacted in the year to Q3 2018. This represents a 5% fall over the previous 12 month period. Indeed, the most recent quarterly numbers show deal flow is slowing, as investor demand is increasingly focused on smaller segments where opportunities are less prevalent, particularly in logistics and residential sectors.
- While volumes in the office and retail segment remain the highest by sector, only logistics and residential experienced an increase in investment over the year to Q3 2018. This highlights the increasing demand for assets in segments with the strongest long-term structural demand fundamentals. Q3 2018 investor intentions surveys highlight that the spread between logistics and residential at the top and retail at the bottom has never been wider.
- Prime office yields have begun to stabilise after an unprecedented period of compression, fuelled initially by huge monetary policy stimulus and more recently by income growth prospects. Logistics values continue to rise at a fair pace with the weight of capital pouring into the sector forcing yields down further. Unweighted average logistics yields across Europe have fallen from 5.6% in Q3 2017 to 5.1% in Q3 2018.
- In the listed market, European real estate investment trusts (REITs) are trading at a discount to net asset value (NAV) of -10.2% in September 2018 in aggregate, compared to a long-term average of -6.4%, although stark sector and regional differences remain. UK REITs continue to trade at a sharper discount to NAV, particularly in the retail sector, suggesting some concern over valuations. Indeed, European retail names continue to be priced at a wider discount on the whole.

Short-term indicators: positive in most continental European markets; flat for UK and Italy

Q3 2018	REITs	Availability of Funding	Economic Outlook	Rental Value Outlook	Bond vs. Prop Yields	Property Investor Sentiment	Direction of Capital Values
Eurozone	+		+	+	+	+	+
Nordics	+	+		+		+	+
Central Europe	Not Covered	+	+	+		+	+
France		-	+	+		+	+
Germany	-		+	+		+	+
Italy	Not Covered	+	-		-	+	
Spain	+		+	+	+	+	+
UK	-	-	-	-	+		

Note: Capital value direction is determined by a net result of six indicators, with a double weighting applied to property investor sentiment.
Across the six short-term indicators, net scores are calculated by subtracting negative results from positive results. Capital value direction is judged as follows: net score of +3 or greater is up, net score between -3 and +3 is stable, and a negative score of -3 or weaker is down.
Source: Reuters Ecowin, IPD, RICS, IFO, Aberdeen Asset Management, September 2018.

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- Real estate debt funds continue to raise capital, although most of the strategies announced are focused in the UK. However, there is a growing role for specialist lenders entering continental Europe. Most capital is focused on core assets, but much higher margins on development are attracting some funds into that space. Maximum loan-to-value ratios (LTV) remain relatively conservative at around 60%-65% in most markets, while there is a growing prevalence of "whole-loan" lenders where both mezzanine and senior debt are provided in order to source higher fees. Margins on core, senior loans remain stable at very low levels – close to 100 basis points in Denmark and Germany.

Performance outlook and risk tolerance

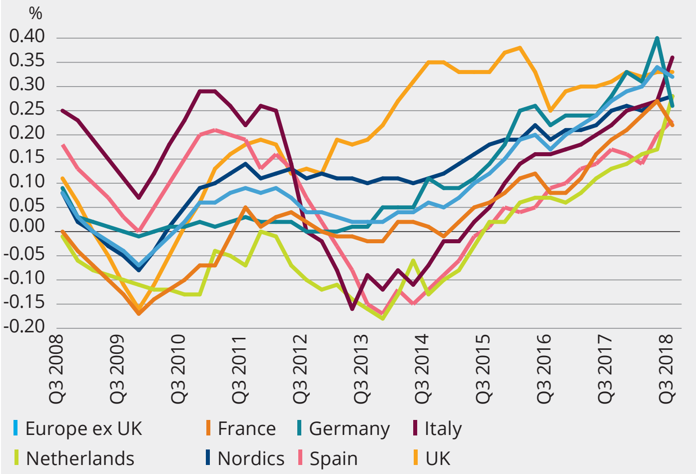
- We expect the trend for above-average but slowing returns to continue in continental Europe and Ireland over the next 12 to 18 months. In general, prime asset yield compression has now run most of its course, although the best secondary assets are now benefiting from the trend and by sector, logistics still has further to run. Prime office rents continue to grow steadily, a trend also filtering out to secondary markets, where availability is particularly scarce.
- The range of forecast returns between segments is narrowing, with logistics expected to be the best performing segment. Low-yielding and low-growth segments, including some high street retail, are expected to deliver the weakest performance. Despite the very low yields, above-average returns are forecast for office markets in Amsterdam, Stockholm, Berlin, Lisbon and Madrid, as rising rental income is helping to sustain values and total returns for investors. We expect the prospects for cyclical market segments to weaken fairly rapidly from here, with outperformance expected to come over the next year.
- Our overall return outlook remains positive in relation to other global markets, but is slowing as we move further through the cycle. This is corroborated by our measure of long-term worth. We are moving through the strongest phase of the cycle, and we do not see any specific triggers for a correction in values at this stage, although there are risks that could bring forward a more cautious investment market scenario.

Investment themes, house view and recommendations

Our key stock selection themes remain unchanged and are as follows:

- **Residential** – private rental sector. Strong population growth in winning cities, restricted supply with tight planning controls and limited sites for new development. Maturity and market size can be an issue when venturing outside Germany, Austria, Switzerland, Netherlands and the Nordics.
- **Student halls and senior living.** These can provide durable, high-quality income because of limited vacancy risks and typically strong covenants, while the demand drivers offer funds genuine diversification of cash flows. Covenant strength is a key risk that needs to be tested rigorously.
- **Prime logistics units and multi-let estates in supply-constrained urban areas.** There is strong demand for 'last mile' delivery hubs for retail goods bought online; vacancy rates are low and competition from higher-value land uses is limiting supply too. However, falling yields have reduced the initial income return and future income growth is often harder to generate.
- **Dominant, well-located retail assets with a convenience anchor, good food and beverage offer or strong and diversified customer base.** Changing consumption patterns and technology are making some retail assets overpriced relative to future income potential. However, we believe certain retail formats still offer strong cash flows, diversification and leasing tension. Close attention needs to be paid to competing centres and rent levels, especially when considering the impact of re-letting potential voids.

Chart 1: Aberdeen Standard Investments long-term leading indicator: All property market prices versus fundamental value[1]



Source: Aberdeen Standard Investments, September 2018.

[1] The indicator does not translate into a short-term market forecast because momentum and investor sentiment can lead to marked and prolonged periods of over or underpricing. Our pricing calculations only indicate how stretched prices are relative to fundamentals. Prices do not need to fall or rise for our indicator to reach a neutral position. A change in income growth expectations or in the risk free interest rate, can also lead to such adjustment, or indeed a combination of all three. We use the indicator to establish risk tolerance at a very broad level. Past performance is not a guide to the future.

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