MAY 2023

EUROPEAN CRE FORECAST

STEADY THE SHIP

CUSHMAN & WAKEFIELD

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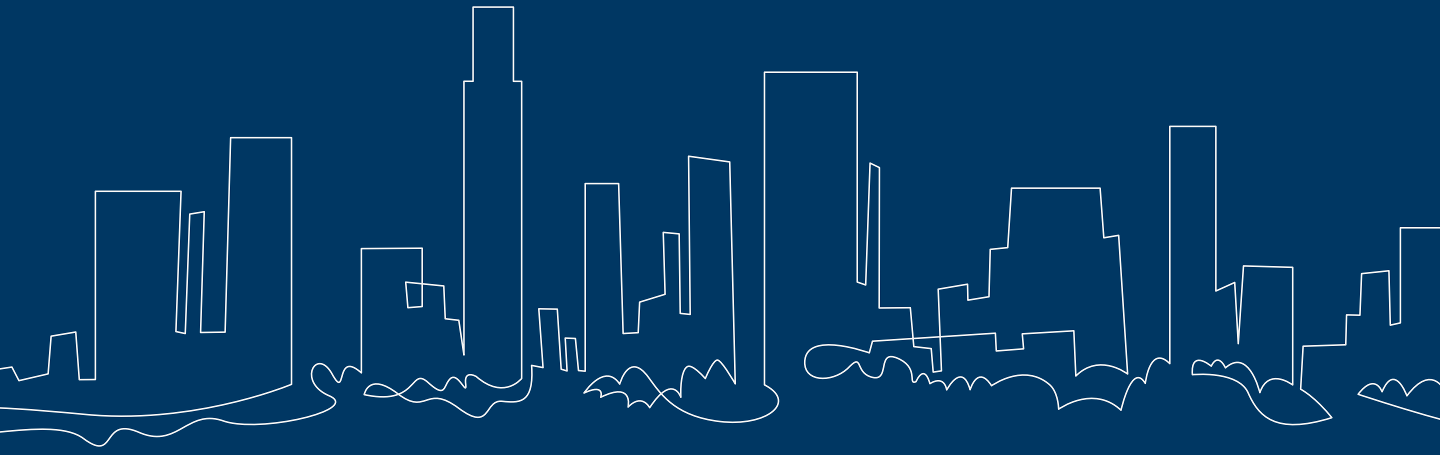


FOREWORD

Steady the Ship: we are entering a period where real estate market conditions are expected to "settle" in H2 2023—that is, real estate markets find a new equilibrium.

While market equilibrium often refers to the balance of supply and demand when referencing fundamentals, here we refer to the equilibrium between the buyers' and the sellers' expectations.

**European aggregates refer to the average of our European forecast coverage for each sector excluding Turkey (Office: 46 markets, Retail: 37 markets, Logistics: 36 markets) unless stated otherwise.*
Benelux refers to Belgium, Netherlands and Luxembourg; Semi-Core - Spain, Italy, Ireland and Portugal.

KEY TAKEAWAYS:

- Since our Q3 2022 forecasts, we have witnessed a period of resilience, the resurgence of concerns about a potential financial crisis, and reassurance from central banks.
- There is uncertainty surrounding monetary policy, as central banks will need to balance additional tightening via policy rates with the tighter credit conditions that have emerged from the banking sector. Both are likely to slow the economy further toward the end of the year.
- Our baseline remains largely the same: growth has surprised on the upside with some markets avoiding 'technical' recessions, but underlying growth remains low.
- Against the backdrop of anaemic growth, high interest rates and tighter credit conditions, investment is expected to remain subdued and pick up in the latter half of 2023.
- Downside risks include sticky core inflation (and thus a risk of higher rates) as well as further tightening in credit conditions because of the recent turmoil in the banking sector. If more clarity on the interest rate outlook emerges sooner than we expect, investment momentum could gather steam and yield compression could commence sooner. This is an upside risk.
- Central banks will need to contemplate when to pause. The journey back to inflation targets has not been smooth: despite headline inflation cooling, core inflation has been stubborn and rising. Markets are still pricing further tightening from the European Central Bank (ECB) and the Bank of England (BoE).
- Although there is great uncertainty about where bond yields go from here, 10-year German Bund yields will trend around 2.5%, and UK 10-year Gilts will average just above 3% in the medium-to-long term.

KEY TAKEAWAYS:

- With the sharp adjustments in yields since H2 2022, commercial real estate valuations are heading towards fair value (we will be publishing our Fair Value Index following the forecast update). The property to 10-year government bond yield spread is lower than it was during the post-GFC period where policy rates were at the zero bound. It is now at 153 bps as of Q1 2023: this compares to the 30-year average of 208 bps and an average of 122 bps from 1992-2010 (the era prior to policy rates at zero).
- Further re-pricing will be front-loaded in the first half of this year. Prime yields across all sectors will continue to move outwards as higher costs of debt continue to filter through in 2023, albeit to a lesser extent as seen in 2022. Retail yields are the exception and are expected to move out +44 bps this year, versus +24 bps in 2022. For office and logistics, we expect yields to expand by +54 bps and +40 bps, respectively, in 2023 (compared to outward movements of +61 bps and + 88 bps in 2022, respectively).
- Although these figures were not far from our prior forecast, prime rental growth was upgraded for European prime office (5.5%) and logistics (14.5%) in 2022 despite low economic growth. This has been largely due to undersupply of high-quality space within these two sectors. In some markets we expect the undersupply to continue as higher capital costs are delaying development starts. Both sectors face the challenges of obsolescence as decarbonisation gathers momentum. This will widen the prime and average markets further.
- European prime rental growth is expected to ease in 2023 across all sectors, averaging 3.3% for office, 7.3% for logistics and 0.4% for retail.

ECONOMIC OUTLOOK
KEY ASSUMPTIONS

Our views remains largely unchanged since our European Macro Outlook

Key Macroeconomic Assumptions

Economic growth surprised on the upside in Q1, with euro area growth achieving growth of 0.1%. This follows a downward revision to the previous quarter, now estimated to have registered -0.1% Q/Q. As a whole, the euro area looks to have narrowly avoided a 'technical' recession for now, however, there is no denying that growth remains muted. We expect growth of 0.4% for the euro area and -0.3% in the UK for 2023 as a whole.

Bond yields started 2023 on a better footing. As economic activity is expected to remain low, yields are expected to finish the year only marginally higher than in 2022.

The journey back to inflation targets has not been smooth. Euro area inflation edged up in April to 7.0% from 6.9%, with core inflation easing to 5.6%. Recent data shows UK inflation has fallen less than expected in March, remaining stubbornly above 10% (10.1% Y/Y) and core inflation remaining unchanged at 6.2% Y/Y. Although underlying inflationary pressures remain elevated, we continue to expect inflation to trend downwards, albeit gradually particularly due to energy base effects. As a result, markets have priced in further tightening from the ECB and the BoE.

Risks to the Outlook

The recent turmoil in the banking sector has introduced additional downside risk to our baseline (to read more click here), however direct effects in Europe appeared to have waned given the highly idiosyncratic nature of the Credit Suisse event and the ECB's reassurance. An additional downside risk includes sticky core inflation and therefore the prospect of higher interest rates.

Alternatively, if inflation is not as sticky and interest rates are cut sooner, yield compression will commence sooner. Furthermore, as more clarity on the interest rate outlook emerges despite the higher interest rates, providing more conviction in pricing, investment activity will gain momentum. These are upside risks.

IMPACT ON COMMERCIAL REAL ESTATE

OFFICES

European office yields have already moved out significantly, as such we expect minimal outward movement in H1 with yields to begin stabilising in H2 2023.

We expect office prime yields in the remaining quarters of 2023 to move out at a much lesser extent than they have since H1 2022, with European office yields expanding another 34 bps.

Prime rental growth will moderate in 2023 as new demand eases, however low availability of prime and continuing flight to quality will help maintain upward pressure on prime rents.

LOGISTICS

Rising financing and material costs have triggered price volatility, impacting yield premiums for the logistics sector. However, given the sector's responsiveness in recent quarters we expect yield decompression to normalise.

Looking ahead, 2024 will be a year that will provide more pricing and market stability. Our baseline view is that interest rate cuts will be unlikely to occur until 2024, as per our previous forecasts, logistics will see yield compression in 2025.

Despite demand for the sector easing, rental growth will remain strong in the forecast horizon due to limited quality supply and greater occupier needs.

RETAIL

Retail yields had been edging higher for the past few years due to structural shifts, making valuations look less stretched than in other sectors.

As a result, the yield recalibration for retail is significantly smaller relative to offices and logistics.

Given the weakened sentiment and consumer outlook, we expect prime rents to stay muted across Europe in 2023.

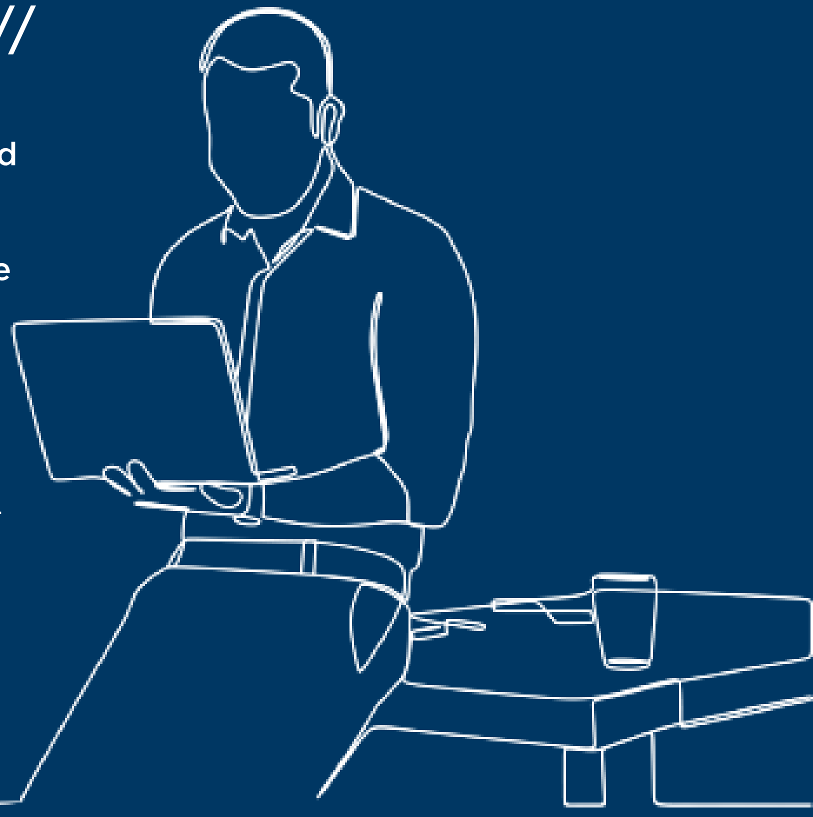
Nonetheless, we continue to forecast positive rental growth across Europe in 2024 and beyond, averaging 1.4% across Europe in the 2024-2027 period.

OFFICES

COMMERCIAL REAL ESTATE

Europe prime offices registered strong rental performance in 2022. Germany, Benelux, and the Semi-Core markets saw the largest Y/Y growth of 8.7%, 8.1% and 7.0%, respectively, compared to the European average growth of 5.5%.

Prime rental growth will moderate in 2023 as new demand eases, however low availability of prime offices and continuing flight to quality will help maintain upward pressure on prime rents.



COMMERCIAL REAL ESTATE
OFFICES

The latest quarterly data is showing encouraging signs of resilience, prime rent growth averaged 1.6% Q/Q growth in Q1 2023 across Europe. Looking ahead, prime office rents on average are expected to grow on average, by 3.3% this year across Europe, with 85% of markets within our coverage registering positive rental growth. The remaining markets have a stable outlook, and thus, no market is expected to face rental decline.

The 2023 rental performance breakdown reveals the Nordics, UK, CEE, and Germany are expected to witness the strongest rental growth prospects, achieving 4.7%, 4.0%, 3.9% and 3.7% Y/Y rental growth, respectively.

Beyond 2023, the drive for sustainability from both occupier and EU-wide ESG initiatives will continue to provide support for the sector in Europe. This includes the growing bifurcation in the sector, which will provide opportunities for older office buildings to benefit from ESG improvements given the cost advantages of refurbishment or repositioning. Further details can be found in our latest Obsolescence Equals Opportunity paper.

In response to prime office markets having contained vacancy due to the aforementioned reasons, prime office rental growth will stabilise, averaging 1.6% (2024-2027). London is expected to be the strongest and most consistent market - West End and the City averaging rental growth of 2.6% over 2024-2027, and Nordics second to that at 1.9% compared to all remaining markets which are around or below the European average.

Rental Growth

	2022 (Y/Y % chg)	2023 (Y/Y % chg)	2024-2027 Avg
France	2.7%	0.5%	1.6%
Germany	8.7%	3.7%	1.6%
Benelux	8.1%	3.0%	1.3%
Nordics	4.5%	4.7%	1.9%
Semi-Core	7.0%	3.7%	1.1%
CEE	5.2%	3.9%	1.8%
Switzerland	0.0%	0.6%	1.0%
UK	4.5%	4.0%	1.9%
Europe	5.5%	3.3%	1.6%

Source: Cushman & Wakefield Research

COMMERCIAL REAL ESTATE
OFFICES

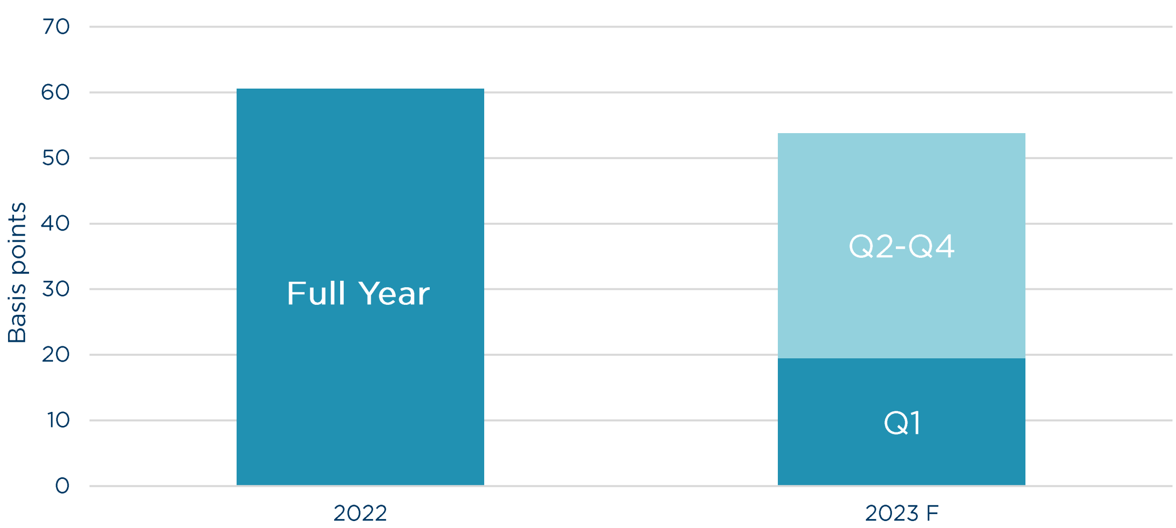
Rising financing costs have led market repricing across all property sectors. Prime office yields across Europe settled at 4.6% in Q1 2023, which is 81 bps higher than Q1 2022. As a comparison, prime office yields moved out 158 bps from 5.0% to 6.6% from Q2 2007 to Q2 2009 during the GFC.

Since prime office yields across Europe have already moved out significantly, we expect minimal outward movement in H1 with yields to begin stabilising in H2 2023. Transaction levels will remain suppressed in the near term as the real economy and investor confidence continues to adjust to a higher interest rate environment. **Given that, we expect yields in the remaining quarters of 2023 to move out at a much lesser extent than realised so far, with European office yields decompressing another 34 bps.**

We expect yields to remain stable in 2024 and 2025 as interest rate expectations stabilise and terminal rates are priced in. Yield compression will follow in the latter years of the forecast horizon as demand builds momentum in the fundamentals, occupiers and investors alike adhere to ESG practices (which benefits prime office in particular) and interest rate fluctuations dissipate.

Additional downside risks emanate from the growing impacts of the rising cost of finance for businesses which can have a potential negative knock-on effect on demand for labour. On the other hand, upside risks include occupiers upgrading to higher quality space in order to maximise employee wellbeing and experience, as well as the future-proofing tighter green building regulations which will continue to be phased out across Europe.

Office Yield Shift



Source: Cushman & Wakefield Research

LOGISTICS

COMMERCIAL REAL ESTATE

Logistics rents by far saw the strongest single year growth in 2022.

Across all our European market coverage, rents grew 14.5% Y/Y in 2022, on average, following 6.9% Y/Y growth in 2021. London (West & East London) and CEE witnessed the largest rental gains of 23.6%, 21.8% Y/Y respectively. Rental growth in the Benelux, Nordics, and the Semi-Core markets were below the European average albeit still achieving 8-9% on the year.

COMMERCIAL REAL ESTATE
LOGISTICS

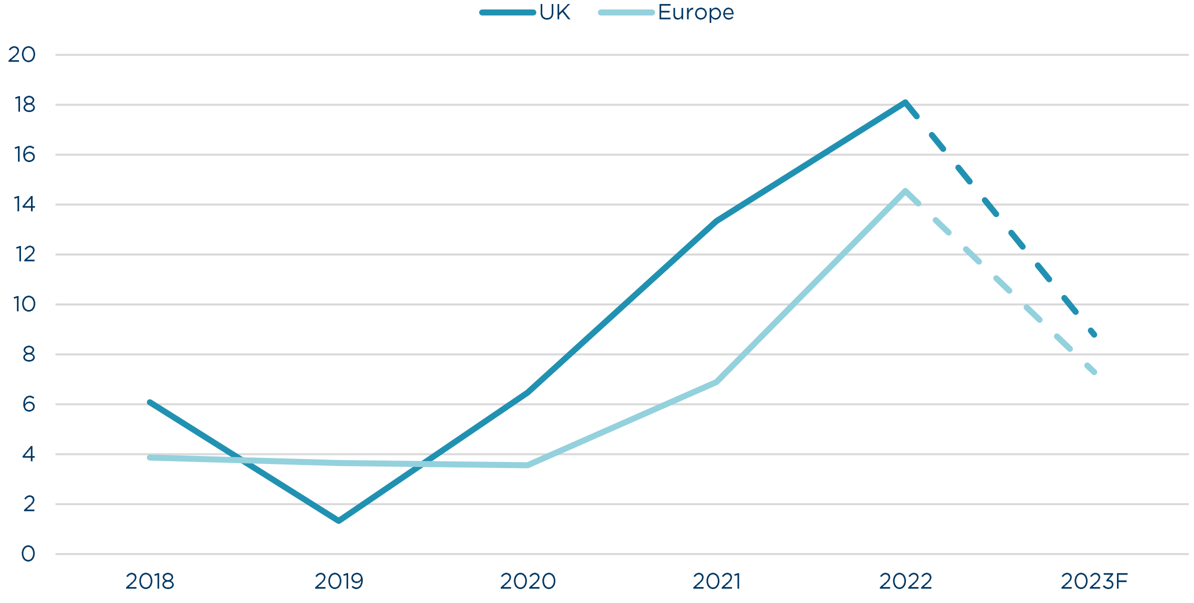
Despite the demand for the sector tempering, rent growth will remain strong in the forecast horizon due to limited quality supply and greater occupier requirements. In fact, Q1 registered a 2.2% Q/Q increase, and we expect momentum to hold throughout the year leading to 7.3% rental growth for 2023 overall.

All logistics markets we cover will experience rental growth in 2023 – France, CEE and the UK will witness the strongest rental growth, with average annual gains of above 9% (9.7%, 9.3% and 9.2%, respectively) reflecting favourable landlord market conditions.

Over the medium term, demand for high quality (akin to trends in the office sector) will also be the focus for logistics. Occupiers will look to seek out strategic locations, technology, and facilities that maximise efficiencies and contain operating costs. As such, we expect rental growth for UK regions to keep up with London, with the former achieving an average rental growth rate of 2.7% over 2024-27, compared to 2.8% for London over the same period.

As for continental Europe, we hold the view that CEE is the region that will provide the strongest growth prospects. Although the markets within the region are at different stages of maturity, given the region's scope to access and facilitate wider distribution across the single market with its geographic location, demand for logistics within the region will remain robust. Our CEE rental growth forecast over 2024-27 shows an average growth of 2.4%, compared to our European (excl. UK) average rental growth of 1.6%.

Logistics Rental Growth
(% Y/Y growth)



Source: Cushman & Wakefield Research

COMMERCIAL REAL ESTATE
LOGISTICS

A substantial shift in the financing conditions led to the sharpest adjustment in yields, stretching prime yields across Europe to average 4.9% in Q1 2023, with yields moving out by 113 bps. In contrast, office and retail yields moved out 81 bps and 38 bps respectively in the same period.

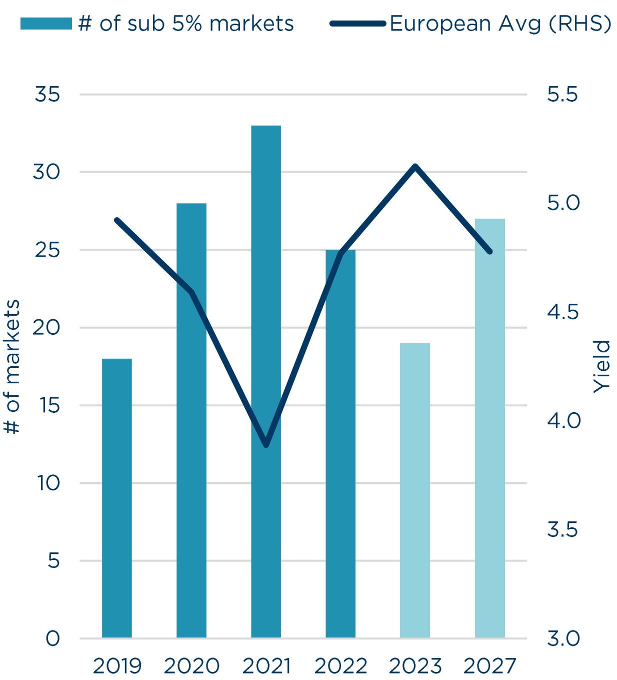
However, given the sectors' responsiveness in recent quarters, we expect yield decompression to moderate somewhat normalise and prices to gain more stability in the remaining quarters of 2023. (This represents a 40 bps yield shift in 2023 compared to the 88 bps one recorded for 2022). Nonetheless, given the sharp adjustment to yields that has already occurred, prime logistics yields across Europe will average 5.2% at the end of 2023, moderately higher than the 5.0% and 4.8% European average for prime office and retail yields, respectively.

The UK, France, and Germany are expected to experience the largest total yield shift over the period 2022 and 2023 largely due to less market liquidity and investor exposure via higher debt costs. Yields reached lows of 3.0% in France and Germany and with yields below 3.5% in the UK in 2021.

By the end of 2023 just over half of the markets will maintain a sub-5% yield this is in contrast to 92% of markets in 2021 and 70% in 2022. Budapest, Bratislava, Cardiff, and Central Scotland on the other hand are expected to generate the highest yield returns of above 6.0%.

Looking ahead, 2024 will be a year that will provide more pricing and market stability. Our baseline view is that interest rate cuts will be unlikely to occur until 2024, however, we assume the effects of monetary policy will be gradually phased out and vary by sector and market. That is, as per our 2022 Q3 forecasts, logistics will see yield compression in 2025, earlier than the office and retail sector which are both expected to witness yield compression in 2026.

Sub-5% Logistics Yields



Source: Cushman & Wakefield Research

RETAIL COMMERCIAL REAL ESTATE

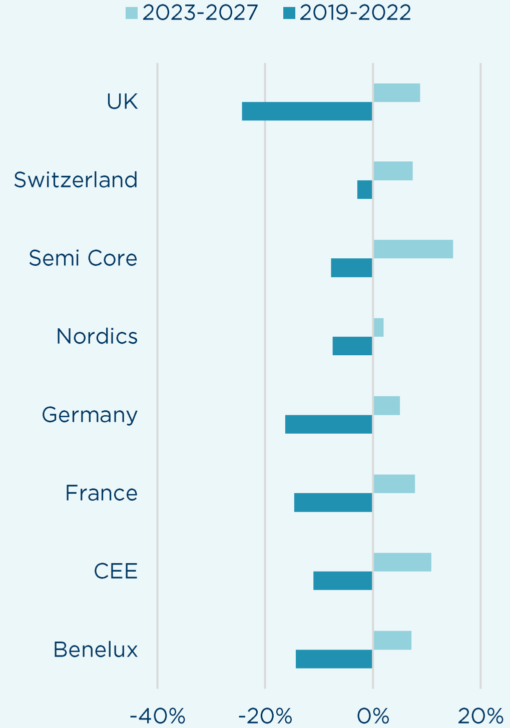
Retail prime rents in Europe fell in 2022, following three consecutive years of rental decline.

In Q4 2022, prime rents were 0.1% below Q4 2021. This was mainly driven by rental declines in Hungary, Finland, Germany, and France. While the majority of the remaining markets registered stable rents, positive rental growth was witnessed in a few markets, namely Ireland, Spain, and Italy. As a result, the Semi-Core group led retail rental growth, growing by 5.1% on average in 2022.

COMMERCIAL REAL ESTATE
RETAIL

Prime retail rental growth for Europe averaged 0.1% Q/Q during the first three months of 2023. Only six markets registered positive rental growth during this period (a few UK regional markets, Geneva, Vienna, and Lisbon), three registered a decline (Helsinki, Amsterdam, and Rotterdam), while the remaining markets witnessed stable rents.

Retail Rental Growth



Source: Cushman & Wakefield Research

Due to adverse economic conditions in the second half of 2022, private consumption growth in the euro area decelerated to 1.2% Y/Y in 2022, from 6.0% in 2021. Retail sales were significantly affected, posting a 2.5% Y/Y decline. Within the major economies, for example, Germany posted a 5.2% decline. Germany has been hit hard given the energy crisis. As inflation remains high and interest rates continue to rise, pressures remain on household disposable incomes, which will weigh down demand and consumer spending this year. As a result, private consumption is expected to remain fairly flat this year (0.1%), while retail sales are expected to decrease by 0.9%.

Given the backdrop of a weak consumer outlook and current low sentiment, we expect muted rental growth across Europe in 2023. There are some exceptions including the Nordics where prime rent growth for retail will be below the European average. Alternatively, Southern European markets provide a more optimistic outlook. In fact, the prime high street of Milan and Rome have been performing well; in these cities, prime rents did not decline during the pandemic, and are already 9.5% and 2.4% above pre-pandemic levels, respectively.

Chinese tourists, who are amongst the biggest spenders, will also play an important role in high streets across Europe, particularly in luxury markets such as Paris and Milan. Before the pandemic, Chinese tourists accounted for 10% of non-European travellers to the EU. Therefore, as the benefits of an improving consumer and tourism outlook emerge as we head into 2024 and beyond, we continue to forecast positive rental growth across Europe, averaging 1.4% across Europe over the 2024-2027 period.

COMMERCIAL REAL ESTATE
RETAIL

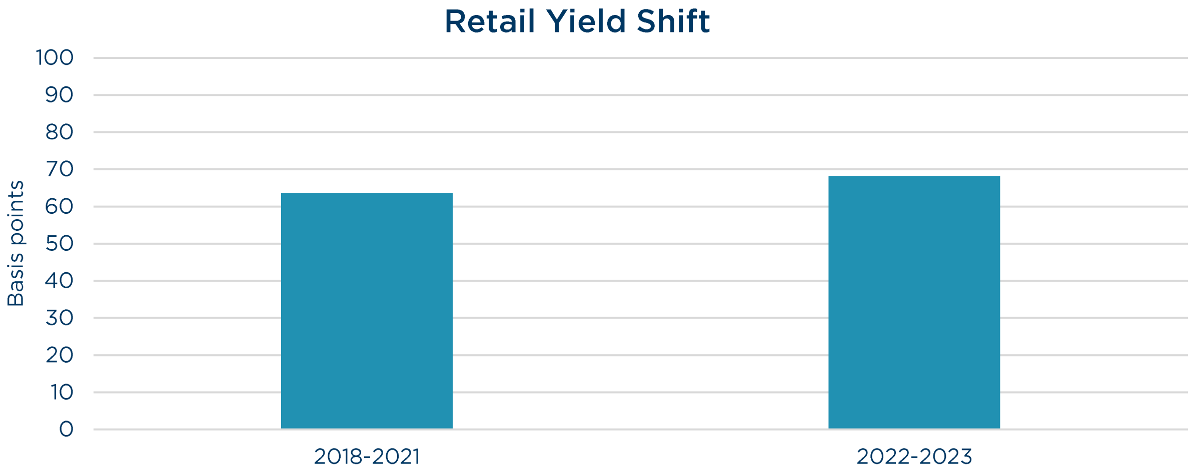
After being hit heavily by the pandemic, the CEE markets are expected to have the strongest rental growth performance over the forecasting period, averaging 2.1% in the 2024-2027 period. Semi-Core economies will follow at 1.8%. Markets such as Spain and Portugal are expected to perform well, with the average growth expected to be above 2%. This is mainly due to the nature of these markets driven by strong tourism activity and low online sales penetration, which should support a swifter recovery.

Retail yields had been edging higher for the past few years due to structural shifts, making valuations look less stretched than in other sectors. For this reason, we expect retail yields to move the least overall. Indeed, since Q1 2022, retail yields only moved outwards by 38 bps, compared to office (81 bps) and logistics (113 bps) yields. In 2023 overall, we expect to see yields moving out 44 bps in Europe before stabilising.

Hungary, Czech Republic, Italy, and Poland are amongst the most impacted markets, where we see yields moving out by approximately 100 bps from 2021 to 2023, while London will witness the least outward shift (35 bps). Performance amongst the retail subsectors will vary, with retail warehouses faring better.

The retail sector turned out to be one of the few positives in commercial real estate investment in 2022. Across the region, retail investment stood at €41 billion in 2022, only 6% below the 2019 investment volume and representing a 10% increase over 2021, while overall investment volumes fell by 17% in 2022. The majority of regional groups posted higher volumes, with Semi-Core, CEE, France, Benelux, and Germany registering increases from 2021.

The retail sector has been in its own slump for a long period as it underwent structural shifts, as such particular retail markets with higher yields will begin to look attractive. Furthermore, as consumers re-orientate spending towards goods and the recovery in tourism gathers pace, this should help support investor momentum in the sector moving forward.



Source: Cushman & Wakefield Research

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CONTACTS

SUKHDEEP DHILLON
Head of EMEA Forecasting
EMEA Research
Sukhdeep.dhillon@cushwake.com

GUILHERME NEVES
Senior Research Analyst
EMEA Research
guilherme.neves@eur.cushwake.com

STEPHEN WAN
Senior Research Analyst
EMEA Research
stephen.wan@cushwake.com

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