EUROPEAN FORECAST & FAIR VALUE REPORT

Q2 2020

CUSHMAN & WAKEFIELD

CONTENTS

ECONOMIC OVERVIEW

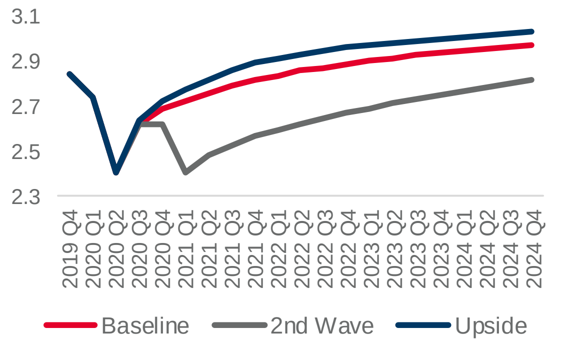
Over the last 3 months the economic outlook has continued to deteriorate. The contraction expected for 2020 has deepened and the recovery for 2021 has reduced. Oxford Economics baseline scenario now expects the Eurozone to recover to pre-crisis levels by mid-2022, a year later than was forecast 3 months ago (Figure 1). If a second peak in infections does occur then the recovery is delayed to 2025. Equally though, should there be a breakthrough in the vaccine then recovery could be as soon as the second half of next year. These scenarios illustrate the great uncertainty that comes with any economic forecast at the moment.

Q2 GDP data confirmed the shock to activity from lockdowns, with all major eurozone economies recording their worst GDP contraction in decades. However, the impact in Q2 was uneven across countries. For example, the 18.5% plunge in Spanish GDP was almost double the 10.1% fall in Germany. The recovery path is also expected to be uneven among economies given the different policy responses across the region, but also as a result of the different economic structures across countries. Southern European countries, such as Italy or Spain, are less well-positioned to ensure a solid recovery due to their dependence on tourism and SMEs, and given their limited fiscal space. In contrast, the German economy is likely to recover more swiftly thanks to its meaningful fiscal package that was rapidly put in place by the government. All this highlights the importance of the €750bn EU recovery plan to support the most affected economies agreed in July by European leaders but which still needs approval from the European parliament.

Over the next 5-years, the Eurozone economy is expected to grow on average by 1.0% p.a., below the UK (1.3% p.a.). Growth in the region is varied with many CEE economies expecting growth of above 1.7% p.a., while countries such as Germany, Portugal, Finland and Italy are all likely to record growth below 1% p.a. (Figure 2).

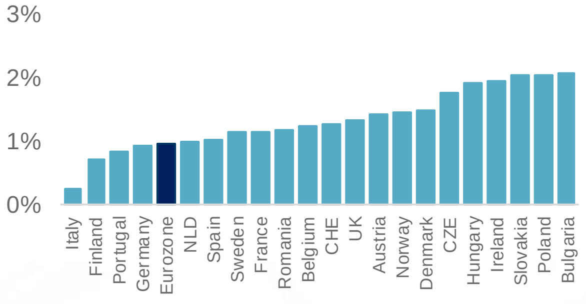
The ECB continues to announce new measures in order to ease financial conditions. The central bank will now purchase €1.35 trillion of bonds until June 2021, and will also reinvest principal payments until the end of 2022. The weak growth and inflation outlooks mean that monetary conditions are expected to remain ultra-loose, with interest rates not expected to start to rise until 2023 (Figure 3). In the UK the MPC cut Bank Rate by 65bp to its effective floor of 0.1% in March and restarted quantitative easing. The BoE has purchased £200bn of gilts and private sector securities, with £100bn more to be bought by the end of the year. UK interest rates are not expected to start to rise until 2022 at the earliest.

FIGURE 1: EUROZONE GDP SCENARIOS Q4 2019 – Q4 2024, € BILLIONS



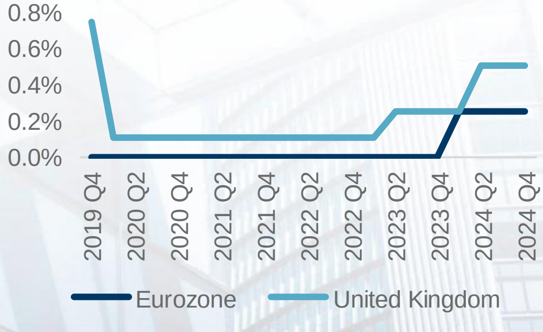
Source: *Oxford Economics, July 2020*

FIGURE 2: GDP GROWTH%, 2020-2024



Source: *Oxford Economics, July 2020*

FIGURE 3: CENTRAL BANK INTEREST RATE



Source: *Oxford Economics, July 2020*

OCCUPIER OVERVIEW

With only modest economic growth forecast and positive but slower growth in employment, limited rises are forecast for commercial property rents across much of Europe.

As such, European all sector* prime rents are forecast to increase by around 0.3% p.a. over the next five years with logistics showing faster growth than office and retail underperforming (Figure 4).

In the office sector, prime headline rents held up well in H1 2020 but some prime headline rental decline is expected in H2 albeit modest (-1.4%) with a larger adjustment to be made via incentives rather than the headline rent itself.

Over the medium term, the outlook for core office property still looks positive. Although demand will be severely hit in 2020 (Figure 5), new development will also moderate, and with very low vacancy rates, particularly Grade A, and above average levels of pre leasing, which is limiting the risk of excesses new supply from speculative development, prime office headline rents are expected to grow by an average of 0.8% over the next 5 years.

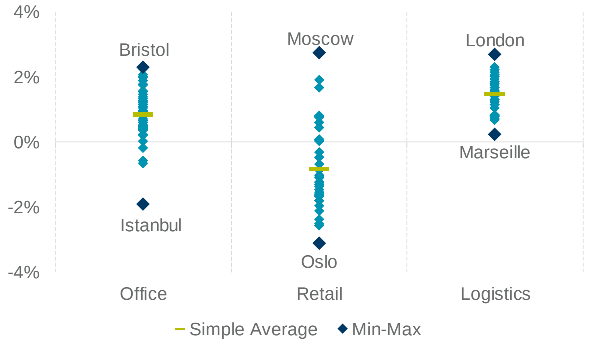
Unsurprisingly, we have made further downgrades to our High Street retail forecasts (-0.8% p.a. over the next 5 years) as Covid-19 induced lockdown accelerates the correction in an already hostile retail environment with landlords reporting low rates of payment for Q2 rents and many retailers entering administration and/or closing stores. This is partially reflected into our Risk Multiplier which depends on the spread between corporate and 5-year bond yields, and is used as a proxy for tenant risk (Figure 6).

More and more retail markets are turning to variable rents linked to turnover or a nominal base rent plus a turnover related top-up. Going forwards, this will make it increasingly difficult to estimate the traditional rental tone used to track and compare markets.

On the other hand, e-commerce has been a big winner out of the crisis, accelerating a trend already evident for a number of years. In addition it's possible that many businesses will look to hold more inventory in the short term as a cushion against a potential second virus wave in the winter, boosting demand.

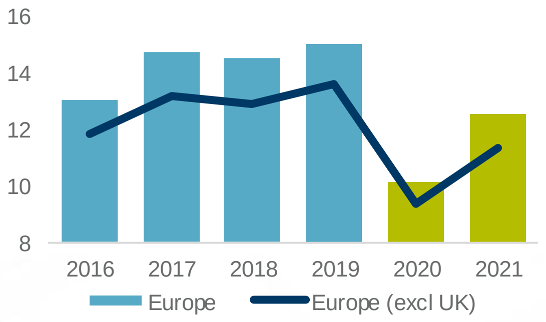
This is supporting logistics rents in key cities across Europe, with some even expecting upward pressure this year and next, where vacancy rates are particularly low. Thus, our view is that prime rents for major logistics location in Europe will largely remain resilient in 2020, and to grow by an average of 1.5% p.a. over the next 5 years.

FIGURE 4: PRIME RENTAL GROWTH, AVG 2020 – 2024 % P.A.



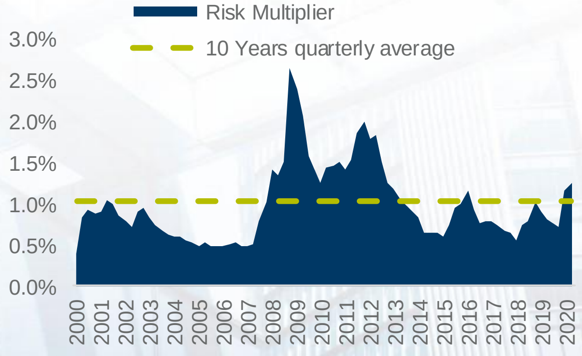
Source: Cushman & Wakefield

FIGURE 5: OFFICE TAKE UP, MILLION SQ.M.



Source: Cushman & Wakefield

FIGURE 6: EUROPEAN RISK MULTIPLIER, %



Source: Cushman & Wakefield, Bloomberg

123 European markets: 49 office, 41 high street retail and 33 logistics

CAPITAL MARKET OVERVIEW

The lockdown period caused quarterly transaction activity in Europe's commercial property market to drop to its lowest since 2014. However, now that most of the continent's confinement rules are easing, assuming that there are no major outbreaks and no more lockdowns, momentum should pick up in the second half of the year.

Government bonds were mostly stable over the quarter, with the exception of countries that were more sensitive to risk sentiment, where bond yields declined. The most notable development was a decline in the Italian 5 year bond yield of 36 basis points to 0.5%, benefitting from hopes of moves toward a more coordinated support measures in the Eurozone (Figure 7).

During the second quarter, the European investment market fell by 32% y-o-y in Q2 (RCA), with € 50.1bn transacted during the quarter (Figure 8).

Despite the drop in activity, volumes across Europe held up better than some other markets in North America and Asia Pacific. Among European countries, Germany and Denmark stand out during the troubled second quarter. Both have bucked the Europe wide trend to record an increase in investment volume versus last year.

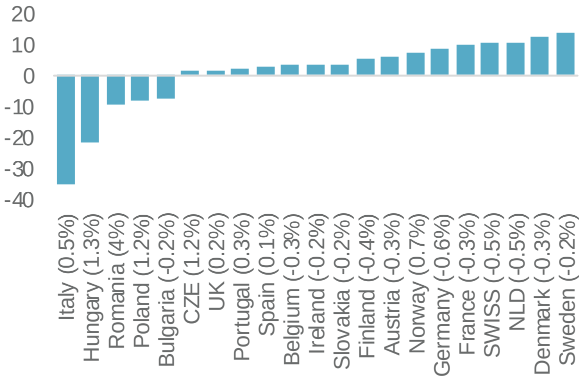
In both countries, lockdown was both less severe and shorter than in other European countries. For real estate assets this can make the difference between a deal being completed or not. Moreover, Germany outperformance can be also explained by the size, scale and sophistication of the domestic investor base where demand was sustained for German assets.

Deteriorating investor sentiment and the plunge in economic activity has seen an increasing number of prime market yields moving upwards (by an average of 25 basis points), with the majority from the retail sector (Figure 9).

However, we expect that office and logistics yields will reverse some of their gains over next year as sentiment recovers and virus-related restrictions are eased. Moreover, property valuations will continue to be supported by low bond yields on the back of ultra loose monetary policy.

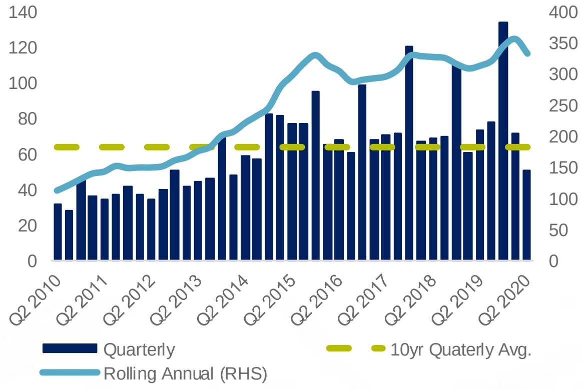
For the retail sector the outlook is less favourable, as Covid-19 has accelerated the structural change already underway in the sector. As such, retail yields are not expected to compress over the forecast period.

FIGURE 7: 5-YEAR BOND YIELDS BPS CHANGE, Q2 2020 VS Q1 2020



Source: Bloomberg

FIGURE 8: EUROPEAN INVESTMENT ACTIVITY, € BN



Source: RCA, July 2020

FIGURE 9: PRIME YIELD MOVEMENTS BPS, Q2 2020 VS Q1 2020

Source: Cushman & Wakefield

FAIR VALUE INDEX RESULTS

The all-sector European Fair Value Index score was 61 in Q2, up from the Q2 figure of 41. Commercial real estate valuations generally improved on a relative adjusted basis as an increasing number of prime market yields in Q2 started to move upwards (reducing the future negative impact from outward yield shift), with the majority from the retail sector (Figure 10).

As such, a number of markets were upgraded this quarter (48 in total), with the largest component moving from fully priced to fairly priced (30 markets). The sector upgraded the most was the retail, as the number of fairly priced markets rose to 21, from 6 (out of 41).

The combination of stable bond yields and higher illiquidity and risk premium, driven by a rise in the risk multiplier, has increased the our fair total return component. However, in many of the Eurozone office and logistics markets we continued to see an improvement in capital growth expectations, reflecting the more dovish monetary policy environment. The net impact of this was a boost to our forecast total return component which more than offsets the increase in the fair total return, improving property attractiveness and causing the index to increase.

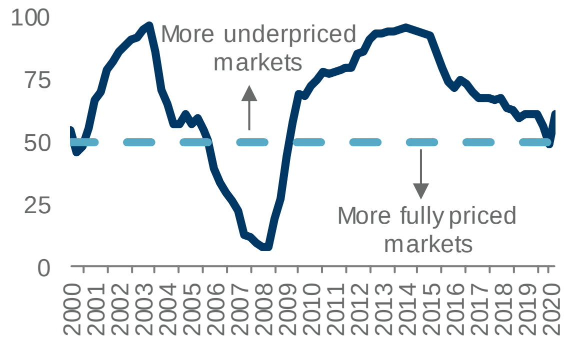
As such, the majority of our 123 markets covered in the analysis are classified as underpriced and fairly priced. The most opportunities can still be found in the logistics sector rather than offices and retail, with the latter showing now more fairly priced markets than fully or underpriced.

Geographically, the UK and the CEE have a greater share of under-priced markets while Germany, France and Benelux have a higher share of fairly priced markets.(Figure 11).

The most underpriced European markets in Q2 are Warsaw retail and the logistics markets of Helsinki, Bratislava, London and Birmingham (Figure 12), experiencing the highest medium-term rental growth forecast and yield compression.

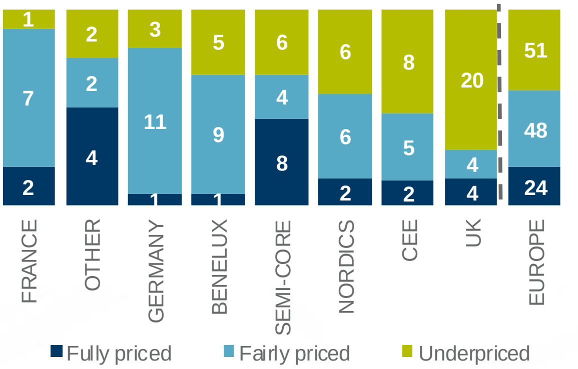
Conversely, the top five most fully priced markets in Europe are the retail markets of London, Copenhagen, Paris, and Istanbul (offices and retail). A very high bond yield in Turkey has pushed fair returns for property to more than two times our forecast returns. While prime retail in London, Copenhagen and Paris are projected to experience short term yields correction and negative rental growth expectations making them look unattractive on a relative pricing basis.

FIGURE 10: EUROPEAN FAIR VALUE INDEX ALL PROPERTY, Q2 2020



Source: Cushman & Wakefield

FIGURE 11: NUMBER OF MARKETS IN EACH FAIR VALUE CATEGORY BY REGION, Q2 2020



Source: Cushman & Wakefield

FIGURE 12: FIVE MOST UNDER/FULLY PRICED MARKETS IN EUROPE, Q3 2019

TOP 5 MARKETS (MOST UNDERPRICED)		BOTTOM 5 MARKETS (MOST FULLYPRICED)	
01	Warsaw retail	119	London (WE) retail
02	Helsinki logistics	120	Copenhagen retail
03	Bratislava logistics	121	Paris retail
04	London logistics	122	Istanbul retail
05	Birmingham logistics	123	Istanbul offices

Source: Cushman & Wakefield

MARKET IN FOCUS

Ranked 6th overall in our Fair Value in Q2, Berlin Logistics is underpriced by 16.4% according to our Fair Value analysis.

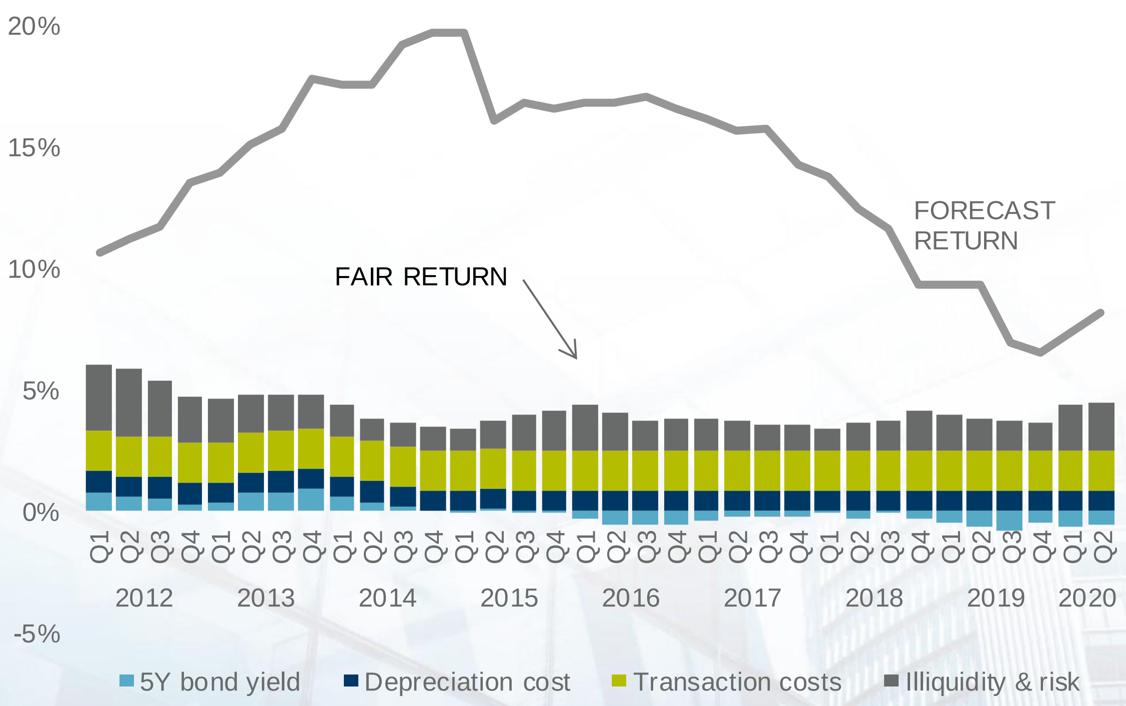
Oxford Economics expects the German economy to contract by 6.1% in 2020, before a rebound to growth of 5.2% in 2021. The easing of lockdown measure in Germany and in most of Europe have boosted recent economic data, which is now showing a strong rebound in activity. The most impressive evidence of a swift rebound in economic activity was the surge in retail sales in May, up 14% m/m and 4% y/y. In addition, industrial output rose 7.8% m/m in May, the composite PMI rose to 47 in June (from 32.3 in May and just 17.4 in April) and ifo expectations jumped close to their early-2020 levels.

Newly published data show that the Berlin economy grew by 3.0% in 2019, with employment rising by 2.4%. However, Oxford Economics expect Berlin's GDP to contract by 4.7% in 2020 due to the lockdown measures, albeit the capital will suffer less than most other German cities. This is thanks to Berlin's large public services sector holding up the economy, and its lower concentration of manufacturing. The city is well-placed for a strong recovery, with GDP forecast to grow by 5.9% in 2021. Over the next five years GDP is expected to grow by an average of 1.7% per year, with Berlin remaining the best-performing major German city.

Q2 German logistics take-up appeared resilient to the difficult economic situation, as demand for warehouses and distribution space remained at a high level, mainly driven by demand from retailers and e-commerce distribution. In Q2, new leases and construction starts for owner occupation reached 1.3 million sq.m, making Q2 almost 8% stronger than the first quarter of the year.

The low (negative) bond yield and positive logistics return outlook maintained the degree of underpricing for Berlin in Q2. Our expectation is for yields to compress 10 basis points to 3.80% by 2020, supported by healthy investment demand for high quality income producing assets, and continued rental growth, aided by healthy occupier demand. This leads us to forecast prime total returns of c. 8.2% p.a. over the next five years (Figure 13).

FIGURE 13: BERLIN LOGISTICS FAIR AND FORECAST RETURNS, 2019 Q3



Source: Cushman & Wakefield

SUMMARY

- The European Fair Value Index score was 61 in Q2, up from the Q1 2020 figure of 41. Commercial real estate valuations generally improved on a relative adjusted basis as an increasing number of prime market yields in Q2 started to move upwards, with the majority from the retail sector.
- Overall our fair total return ended slightly higher in Q2 for the 123 markets covered in our analysis. Government bonds were mostly stable over the quarter, with the exception of countries that were more sensitive to risk sentiment, where bond yields declined. The most notable development was a decline in the Italian 5-year bond yield of 36 basis points to 0.5%.
- Corporate bonds, despite a strong performance in June, underperformed government bonds resulting in a slightly increase in our illiquidity and risk premium. The illiquidity and risk premium partly depends on the spread between corporate and 5-year bond yields, and is used as a proxy for tenant risk.
- A key policy response to the crisis has been further loosening of monetary policy and lower interest rates. This continues to support the relative attractiveness of real estate, which is a story that has been in place for most of the period since the GFC. There are a number of factors which suggest that the market will experience a temporary and modest correction in prime yields, such as the capital raising activity of recent years (dry powder) and the attractive spread relative to bonds. Clearly there are also counter-arguments especially around the security of income and medium/longer term office sector demand, which means risks are still to the downside. Nonetheless, our baseline assumes that prime yields will continue their gradual path lower from 2021 with no outward yield shift in 2024, as forecast in Q1, owing to the flatter bond forecast. This marginally increases the prime total returns versus 3 months ago.
- As a result the majority of the 123 markets covered in the analysis are classified as underpriced (41%) followed by fairly priced (39%) and fully priced (20%.The most opportunities can still be found in the logistics sector rather than offices and retail. Geographically, the UK and the CEE have a greater share of underpriced markets while Germany, France and Benelux have a higher share of fairly priced markets.

EUROPEAN LOGISTICS MARKET FAIR VALUE CLASSIFICATIONS, Q2 2020

Source: Cushman & Wakefield

About the Report

This report was written by Riccardo Pizzuti in the EMEA Research & Insight team.

The report has been prepared using Cushman & Wakefield historical and forecasting data, Oxford Economics, Bloomberg and Real Capital Analytics (RCA) as at Q2 2020.

The report includes the latest Cushman & Wakefield forecast outlook & fair value index results.

Fair value is the value at which an investor is indifferent between a risk free return and the forecast return from holding property, taking into account the extra risk of investing in the property asset class.

Our forecast and fair value analysis focuses on prime assets and a five-year investment horizon.

CUSHMAN & WAKEFIELD RESEARCH SERVICES

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