# EUROPEAN FORECAST & FAIR VALUE REPORT

*Q3 2020*

CUSHMAN & WAKEFIELD

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# ECONOMIC OVERVIEW

Over the last three months the economic outlook has marginally improved for 2020 but deteriorated for 2021. Economic data covering the summer and early autumn period paints a better recovery picture than expected in June 2020, but as infection rates increased over recent months restrictions were reintroduced, which will slow the pace of recovery over the winter.

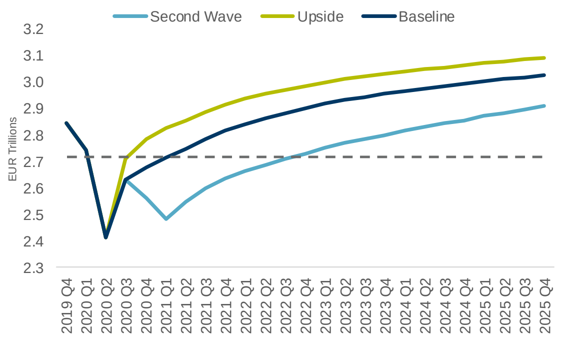
A return to the end-2019 economic output level is forecast for Q1 2022 for the Eurozone (Figure 1) and UK, the same as three months ago, (according to Oxford Economics) but downside risks have increased and will depend on the effectiveness of measures implemented by governments. If a second peak in infections does occur, and national lockdowns are re-introduced, then the recovery is delayed much further into 2025. Equally though, should there be a breakthrough in the vaccine and its mass production, then recovery could be as soon as the second half of 2021 as confidence rebounds. These scenarios illustrate the great uncertainty that comes with any economic forecast at the moment.

Total employment fell by 5.6 million in Europe for Q2 2020, a 2.4% fall, representing the largest quarterly drop on record and despite national efforts to protect jobs via various retention schemes. Office-using employment did not escape: Moody's Analytics estimates that office-using jobs contracted by more in Q2 2020 (1.2 million) than the entire GFC (0.9 million). A strong indication that future office demand will need to adjust to reflect the lower headcount of many firms. The impact by country is varied at this point with the largest falls being reported in the CEE, France, Spain and the Netherlands while Germany, the Nordics and UK have reported fewer job losses for Q2.

Over the next five years, the Eurozone economy is expected to grow on average by 1.1% p.a., marginally below the UK (1.2% p.a.). Growth in the region is varied with the CEE economies expecting growth of above 2.0% p.a. on average, while countries such as Germany, Portugal, Finland and Italy are all likely to record growth of 1.0% p.a. or lower (Figure 2).

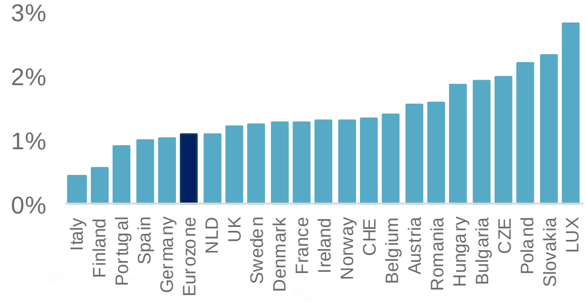
The ECB continues to provide monetary stimulus to try to ease financial conditions. The central bank will purchase €1.35 trillion of bonds until June 2021 and will also reinvest principal payments until end-2022, a move that will allow governments to increase their debt issuance substantially and reduce risk spreads in peripheral countries. Over the long-term, the weak growth and inflation outlook means that monetary conditions are expected to remain ultra-loose with the first interest rate rise not until 2024 (Figure 3).

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



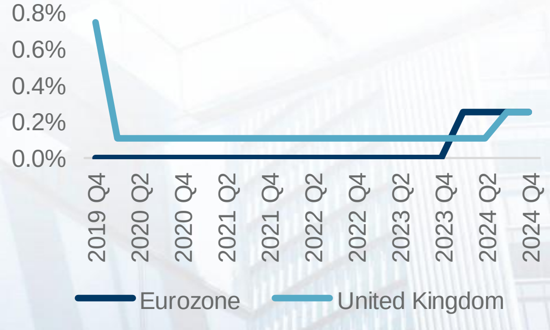

Source: *Oxford Economics, October 2020*

## FIGURE 2: GDP GROWTH%, 2020-2024




Source: *Oxford Economics, October 2020*

## FIGURE 3: CENTRAL BANK INTEREST RATE




Source: *Oxford Economics, October 2020*

# OCCUPIER OVERVIEW

Prime headline rents for European office's fell by 2.2% in Q3 versus -0.7% in Q2 (Figure 4). Some office markets across Europe have started to correct strongly reporting an increase in vacancy, particularly tenant-released space, and falling rents – for example, London (City) prime headline rents fell by 2.9% in Q3 meaning they are now 3.6% down since the peak in Q1 2020.

In contrast, the European logistics sector bounced back strongly in Q3 as demand outpaced supply creating upward pressure on rents. As such, prime headline rents grew by 1.0% in Q3, up from 0.2% in Q2 and in line with the quarterly growth rates seen in 2019 (pre-pandemic). The High Street retail sector continues to suffer with a further 7.0% contraction in prime headline rents in Q3 following a 7.3% fall in Q2. More locations across Europe are reporting softening rents as the effects of Covid-19 restrictions and online competition continue to impact the sector.

Looking ahead, European all sector* prime rents are forecast to increase by 0.3% p.a. over the next five years, with logistics showing faster growth than office and retail underperforming (Figure 5). The latter two sectors have seen their outlooks downgraded in Q3.

The pandemic has created several forces that directly impact the office sector's fundamentals. Some of the impacts are cyclical such as office-using job losses, lower take-up (Figure 6), and upward pressure on vacancy rates. Other impacts are structural, such as a greater share of employees who will regularly work from home. As such, European office headline prime rents are now expected to grow by an average of 0.7% p.a. over the next five years, down from 0.9% p.a. three months ago.

The European High Street retail rental outlook has been further downgraded this quarter as the re-emergence of travel restrictions and quarantine rules impact tourism. This has accelerated the correction in an already hostile retail environment with landlords reporting low rates of payment for Q3 rents**, increasing concerns about the ability for investors to make loan repayments, while many retailers continue to enter administration and/or close stores. As such, prime rents are now expected to fall by 1.8% p.a. over the next 5 years, down from -1.1% p.a. in Q2.

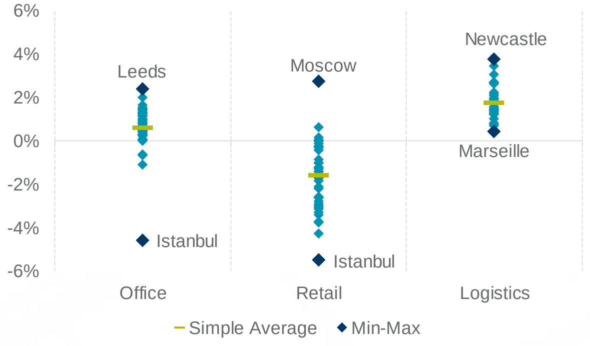
There is a continued severe lack of available logistics stock in most major markets across Europe. Thus, any space released through bankruptcies should quickly find a new tenant, provided that the asset is well located and to a competitive specification. Prime rents are forecast to grow by 1.7% p.a. over 2020-24, up from 1.5% p.a. last quarter.

## FIGURE 4: EUROPEAN PRIME RENTAL GROWTH, % Q/Q

| Sector | Q3 2019 | Q4 2019 | Q1 2020 | Q2 2020 | Q3 2020 |
|---|---|---|---|---|---|
| Office | 0.9% | 1.4% | 0.4% | -0.7% | -2.2% |
| Retail | 0.1% | 0.0% | -0.6% | -7.3% | -7.0% |
| Logistics | 0.7% | 1.6% | 0.1% | 0.2% | 1.0% |

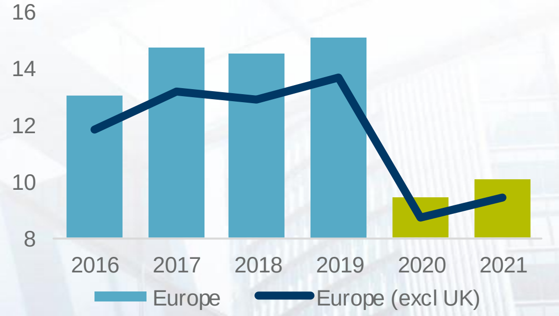
Source: Cushman & Wakefield

## FIGURE 5: PRIME RENTAL GROWTH, AVG 2020 – 2024 % P.A.




Source: Cushman & Wakefield

## FIGURE: 6 OFFICE TAKE UP, MILLION SQ.M.




Source: Cushman & Wakefield

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

***Q3 data from Remit Consulting shows rental payment rates for UK retail at 47%*

# CAPITAL MARKET OVERVIEW

The Covid-19 pandemic continued to impact the European property investment market over Q3 2020. Despite the broad easing of lockdown restrictions, low activity appears to reflect that investors have taken a wait and see approach and that there continues a mismatch in pricing expectations between buyers and sellers. That said, demand for prime assets continue to hold up in many markets, with little evidence of office and logistics repricing, suggesting that buyers still appear willing to pay pre-pandemic prices for the best assets.

Government bonds performed well as sentiment toward the region improved markedly after the EU announced a €750 billion pandemic recovery fund. The most notable development was a decline in the Italian 5-year bond yield of 38 basis points to 0.2% (Figure 7).

During the third quarter, the European investment market fell by 43% y-o-y in Q3 (RCA), with €44.4bn transacted during the quarter, 16% lower than Q2 (Figure 8).

Many of Europe's largest markets recorded very substantial third quarter drops in activity. In Germany, deals volume fell 47% y-o-y and touched a seven-year low, and in both France and the Netherlands volume retreated to 2014 levels.

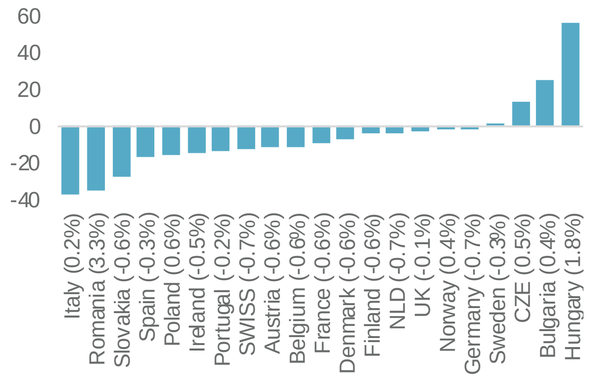
The picture was not completely uniform, and some markets have held up better than others. UK investment was down by only 30% y-o-y because of strong demand for London alternative and regional industrial property. Meanwhile, all the Scandinavian markets outperformed the European average. Denmark, year-to-date investment has risen 68% y-o-y on the back of interest in the alternative sector.

Deteriorating investor sentiment and the plunge in economic activity has seen an increasing number of prime market yields moving upwards (by an average of 38 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.

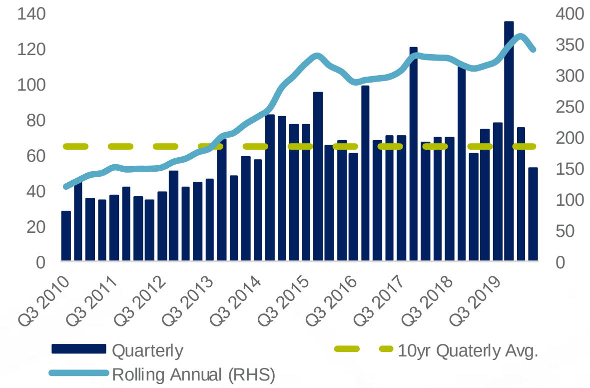
For the retail sector the outlook is less favourable, as Covid-19 has accelerated the structural change already underway in the sector. As such, retail yields are not expected to compress over the forecast period.

## FIGURE 7: 5-YEAR BOND YIELDS BPS CHANGE, Q3 2020 VS Q2 2020



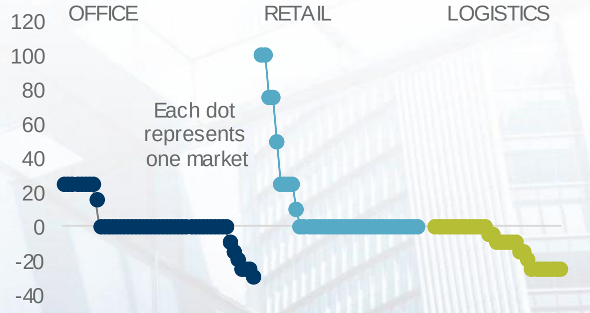

Source: Bloomberg

## FIGURE 8: EUROPEAN INVESTMENT ACTIVITY, € BN




Source: RCA, October 2020

## FIGURE 9: PRIME YIELD MOVEMENTS BPS, Q3 2020 VS Q2 2020




Source: Cushman & Wakefield

# FAIR VALUE INDEX RESULTS

The all-sector European Fair Value Index score was 75 in Q3, up from the Q2 figure of 61 (Figure 10). Commercial real estate valuations generally improved on a relative adjusted basis as an increasing number of prime market yields over the last two quarters started to move upwards (reducing the future negative impact from outward yield shift), with the majority from the retail sector. But risks are on the downside as infection rates are increasing across Europe and restrictions are being reintroduced.

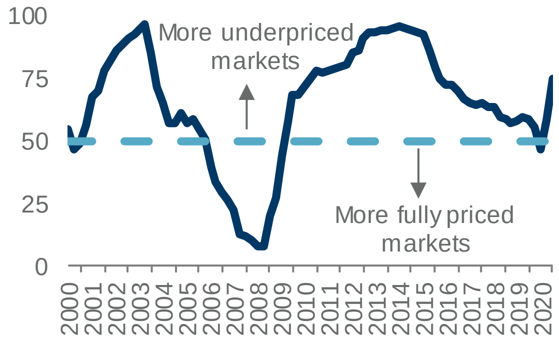
As such, a number of markets were upgraded this quarter (37 in total), with the largest component moving from fairly priced to underpriced (26 markets). The sector upgraded the most was the office, as the number of fairly priced markets rose to 30, from 15 (out of 49).

The combination of lower bond yields and illiquidity and risk premium, driven by a reduction in the risk multiplier, has decreased our fair total return component. In addition, in many of the Eurozone office and logistics markets we continue to see an improvement in capital growth expectations, reflecting the more dovish monetary policy environment. On the other hand, capital growth expectations for the retail sector have been downgraded, as Covid-19 accelerated the correction in an already hostile retail environment. The net impact of this was a broadly similar forecast total return component to previous quarter, improving property relative attractiveness and causing the index to increase.

As such, the majority of our 123 markets covered in the analysis are classified as underpriced. 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, there was broad-based improvement across the regions, with Germany, the UK, CEE and Benelux showing a greater share of underpriced markets (Figure 11).

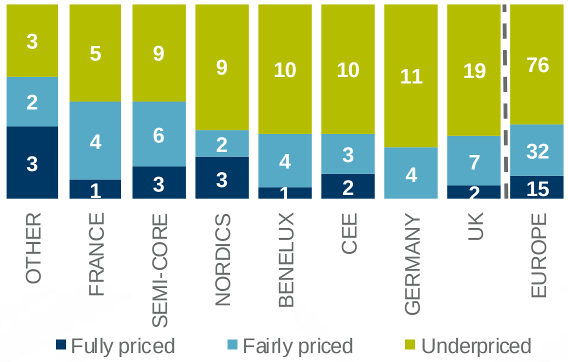
The most underpriced European markets in Q3 are Warsaw retail and the logistics markets of Newcastle, London, Copenhagen and Brussels (Figure 12), experiencing the highest medium-term rental growth forecast and yield compression. Conversely, the top five most fully priced markets in Europe are the retail markets of Copenhagen, Paris, London 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, Q3 2020




Source: Cushman & Wakefield

## FIGURE 11: NUMBER OF MARKETS IN EACH FAIR VALUE CATEGORY BY REGION, Q3 2020




Source: Cushman & Wakefield

## FIGURE 12: FIVE MOST UNDER/FULLY PRICED MARKETS IN EUROPE, Q3 2020

| TOP 5 MARKETS (MOST UNDERPRICED) | | BOTTOM 5 MARKETS (MOST FULLY PRICED) | |
|---|---|---|---|
| 01 | Warsaw retail | 119 | Copenhagen retail |
| 02 | Newcastle logistics | 120 | Paris retail |
| 03 | London logistics | 121 | London (WE) retail |
| 04 | Copenhagen logistics | 122 | Istanbul offices |
| 05 | Brussels logistics | 123 | Istanbul retail |

Source: Cushman & Wakefield

# MARKET IN FOCUS

Ranked 3rd overall in our Fair Value in Q3, London Logistics is underpriced by 23.4% according to our Fair Value analysis, which assumes that the EU and UK can achieve a free trade agreement.

The UK economy was severely hit by COVID-19 contracting in two months as much as it had grown in the previous 18 years. As such, it is forecast to contract by 9.5% in 2020 before rebounding by 8.3% in 2021, with activity expected to return to pre-pandemic levels by mid-2022. However, much will depend infection rates and on government policy.

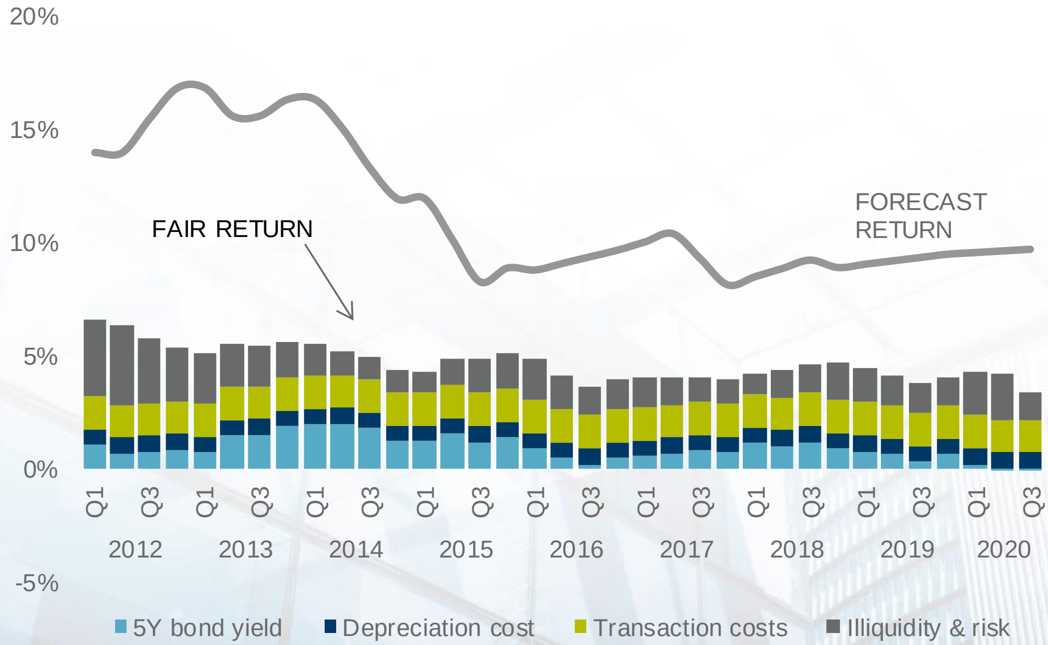
Some of the indicators most relevant for predicting demand for distribution space have been heading in the right direction. Markit's latest manufacturing PMI came in at 54.1 in September, slightly down on August's 55.2 reading, pointing to a solid growth in the manufacturing sector although slower than the previous month.

Likewise, retail sales have bounced back, and were nearly 3% up on the year in August in volume terms. Online sales have tailed off with the gradual reopening of the economy but, with a share of 26%, they remain well above pre-Covid-19 levels. Interestingly, online food sales appear to have held up better than other sectors like fashion. In August, 10% of food retail sales was made online, down from a peak of 11% at the height of the crisis. These statistics perhaps reflect the limitations of food retailers' supply infrastructure, and further growth is expected as the supermarkets react to consumer demand in this sector.

Following a busy Q2, demand for UK logistics and distribution space accelerated further in Q3, as retailers/3PLs continued to expand capacity to keep up with the boom in ecommerce and continued to invest in their supply chains. As a result, Q3 was the busiest quarter ever recorded, with 16.6 million sq.ft. transacted. At 36 million sq.ft., take up during the first nine months of the year is already running well above 2019 total take up of 33.2 million sq.ft., moving the sector from the potential for oversupply to a shortage of space, pushing up rental growth.

The low (negative) bond yield and positive logistics return outlook maintained the degree of underpricing for London in Q3. Our expectation is for yields to remain stable at 4% in 2020 and to compress by 10 basis points in 2021, 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. 9.7% p.a. over the next five years (Figure 13).

FIGURE 13: LONDON  LOGISTICS FAIR AND FORECAST RETURNS, 2020 Q3

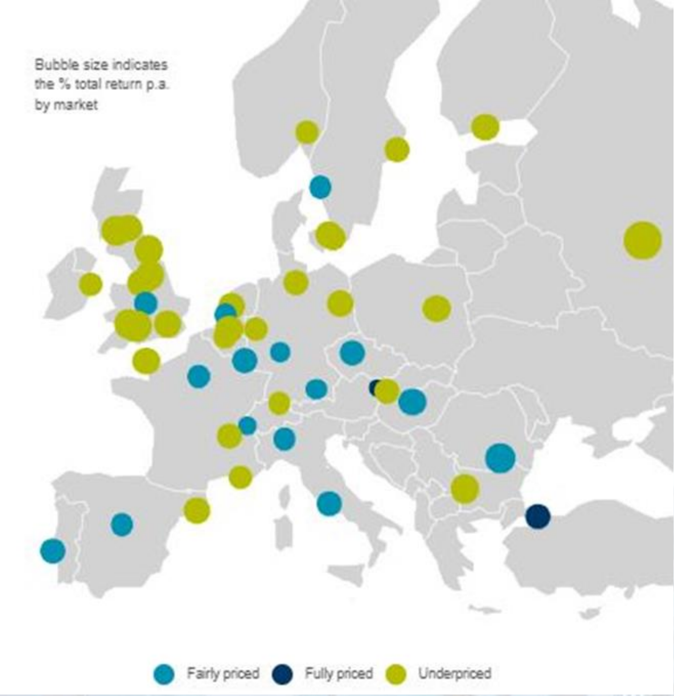



Source: Cushman & Wakefield

# SUMMARY

- The European Fair Value Index score was 75 in Q3, up from the Q2 2020 figure of 61. Commercial real estate valuations generally improved on a relative adjusted basis as an increasing number of prime market yields over the last two quarters started to move upwards, with the majority from the retail sector. But risks are on the downside as infection rates are increasing across Europe and restrictions are being reintroduced.
- Overall our fair total return ended lower in Q3 for the 123 markets covered in our analysis. Government bonds performed well as sentiment toward the region improved markedly after the EU announced a €750 billion pandemic recovery fund. The most notable development was a decline in the Italian 5-year bond yield of 38 basis points to 0.2%.
- Corporate bonds enjoyed a positive quarter, as riskier assets were broadly buoyant and monetary policy helped anchor yields at low levels, resulting in a lower 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, once they get over a short-term correction in certain locations, will continue their gradual path lower. Albeit following a shallower slope than between 2012-18.
- As a result the majority of the 123 markets covered in the analysis are classified as Underpriced (62%) followed by Fairly Priced (26%) and Fully Priced (12%). Sector level data revealed that the most opportunities can still be found in the logistics sector rather than offices and retail. Geographically, there was broad-based improvement across the regions, with Germany, the UK, CEE and Benelux showing a greater share of underpriced markets.

EUROPEAN OFFICE MARKET FAIR VALUE CLASSIFICATIONS, Q3 2020




Source: Cushman & Wakefield

## *About the Report*

This report was written by Mark Unsworth and 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 Q3 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.

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