

Real Estate House View

Europe

Second half-year 2018

Key takeaways

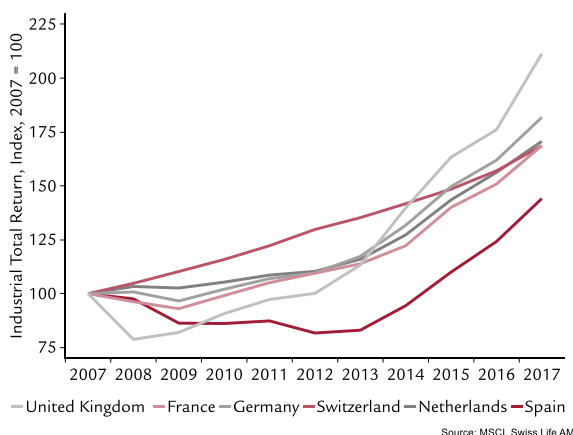
- Real estate markets in Europe are still booming. As the maturity stage of the cycle is unclear, uncertainties about future market trajectories are growing.
- Investors are continuing to focus on alternative sectors to achieve higher returns after real estate price levels in the core markets and sectors have reached record highs.
- Retail and logistics are increasingly merging with e-commerce as an anchor and are becoming a major area of interest for investors.
- Due to demographics, housing remains a major trend in Europe. New forms of housing with high flexibility for younger people are being developed as well as senior-friendly facilities for older people.
- Overall, prospects for real estate markets appear to be positive given the stable economic environment, but geopolitical risks as well as medium-term weakening of the economic cycle must be monitored.

Co-living – a trend to stay?

Co-living is a term we can expect to hear more often. Driven by housing shortages and elevated prices in metropolitan areas that are growing due to urbanisation, the number of operators providing rented accommodation space for a community of similar individuals is increasing. It is not just prices and a lack of

residential availability that are driving the emergence of this sector but also a change of mind-set: boundaries between the different sectors are blurring as a new generation of mainly young city dwellers want to live, work and socialise with like-minded people without having to travel. This is a trend to be watched.

Chart in focus



Investors have been focusing on logistics properties to a large extent and the sector has generated high returns. For some time now, the sector has improved its performance in most countries, even outperforming other sectors. This trend is driven not only by fast-growing e-commerce but also by the need for highly flexible buildings due to modern operating processes.

Momentum slowed in most European economies during the first half of 2018. Purchasing managers indices for the Eurozone suggest that the business cycle peaked in 2017. A stronger euro, higher commodity prices and the trade dispute with the US are impacting business sentiment. Nevertheless, the Eurozone, Eastern Europe and Switzerland are all growing above their potential rates. An exception is the UK, which barely grew at all in the first quarter. This year and in 2019, we expect the UK economy to expand below its potential growth rate. Elsewhere, the corporate sector continued to invest in machinery and the labour force. Tight labour markets are bringing about accelerating wage growth in Northern and Eastern Europe, thus boosting domestic demand. Firm private consumption and pro-cyclical fiscal policy should ensure positive quarterly GDP growth rates until end-2019. Recently, energy prices have contributed significantly to inflation. Headline inflation in the Eurozone climbed to 1.9% in May 2018, a level consistent with the ECB's inflation target. Nevertheless, we consider the rally in the oil price to be temporary and continue to expect a very gradual monetary policy normalisation by the ECB over the coming years. To prevent their domestic economies from overheating, however, central banks in Norway or the Czech Republic could embark on a faster tightening cycle than previously thought.

Uncertainty about the cycle

Although economic data have cooled somewhat from heightened levels, the market environment for real estate is still positive. Investment volumes were moderate in early 2018 but we expect this year's level to be in line with previous years, as the lack of investment alternatives, the relatively high risk spread and the aforementioned economic fundamentals should support demand. As the cycle is already quite extended, investors are increasingly uncertain as to where the momentum is heading. This is why they still have an appetite for property, though at somewhat lower risk. Also, the elevated price levels limit the options in almost all regional markets and asset classes. In this environment, the story of every individual property is key and it remains the question to be answered by the investors, if and to what extent they should broaden their (core) scope to a wider, more risky but yield-generating universe. We also repeat our prediction that some markets will peak in 2018, as yields remain

stable at historical lows and hardly show any signs of moving out in the shorter term. Witness Germany: it is one of Europe's top performers with sentiment increasingly pointing to a peak. The same holds true for Paris, whereas smaller markets such as Dublin and Helsinki and laggards such as Lisbon may see further yield compression.

Office rental growth peaking

The economic environment is still supporting office take-up all over Europe, though at a lower rate since the beginning of the year. As the shortage of new supply has become more acute in 2017 we expect rents to grow in 2018. However, when supply picks up and the economy cools, rents will fall. The office sector is also undergoing structural changes – for companies, space is no longer just a cost factor but reflects their culture and contributes to their employees' productivity. They are looking for buildings that are flexible, attractive and very well located. Although space per employee will decrease, companies want to create an inspiring work environment that attracts motivated staff. This office format differs from the existing stock offer and is limited in availability, creating modest rental pressures for the new space. This holds true for the main capital cities such as Berlin and London and for up-and-coming dynamic cities such as Leipzig, Cambridge and Edinburgh.

One's curse, another's blessing

The retail sector is frequently branded as the real estate's "problem child", given its structural changes. Whilst we believe these are still ongoing, the retailers who are adapting to change are benefiting from high consumer confidence and increased retail sales, which are supporting the sector. The economy has already driven wage growth in tighter labour markets and is expected to do so again in the near future. Continuing low inflation should buoy up retail sales. The only exception is the UK, where e-commerce, an economic slowdown and low wage growth are strongly impacting the sector. Overall, we believe in the creativity and adaptability of store-based formats to compete with e-commerce in the long run, but we remain sceptical for the medium term given the challenging situation and

high levels of supply in many markets. Retail sector headwinds provide the tailwinds for the logistics sector. With e-commerce operators growing, 3PL firms and retailers have been forced to improve their distribution channels to keep up with their competitors. Although the trend is ongoing and performance figures are enticing (e.g. 20% total return in the UK in 2017), the availability of assets may be limited as most assets are built to hold.

Spotlight on residential

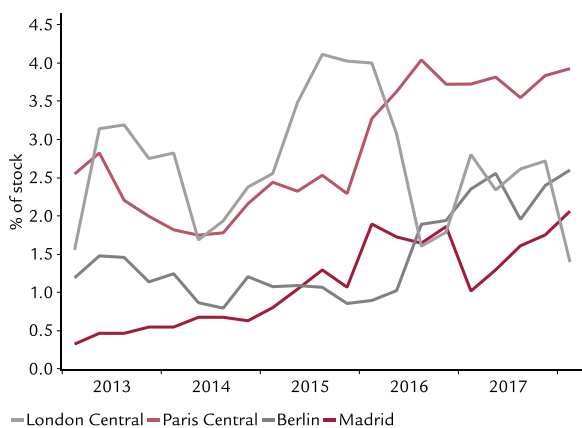
The outlook for our core residential investment markets – Germany and Switzerland – varies. Whilst the total return in the German residential market increased from 7.9% in 2016 to 16.6% in 2017, performance in Switzerland edged down from 6.4% to 5.9% in the same period. Germany needs 400,000 new apartments every year and in 2017 just 285,000 were built. By contrast, Switzerland has seen ongoing construction activity, leading to increased vacancy rates – mainly in the peripheral areas. We thus expect rents to increase by 2% in Germany and to decrease in Switzerland by roughly 1% this year. Other markets that are less known for residential investment are attracting attention. Demand for housing in Dublin, for instance, has seen a strong turnaround owing to high growth since the global financial crisis. Ireland's population grew by an average of 3.8% p.a. between 2011 and 2016, with Dublin experiencing the strongest increase. Thus demand is greatly outstripping new house-building starts. This, combined with compressing yields in more traditional commercial property

sectors has spurred interest in alternatives – particularly the private rented sector (PRS) and student housing. In countries such as France, Spain and Italy the residential sectors are looking resilient: strong demand and low supply point to capital gains in the medium and long term. Urbanisation and declining home ownership provide a supportive backdrop for PRS.

Solid base case needed

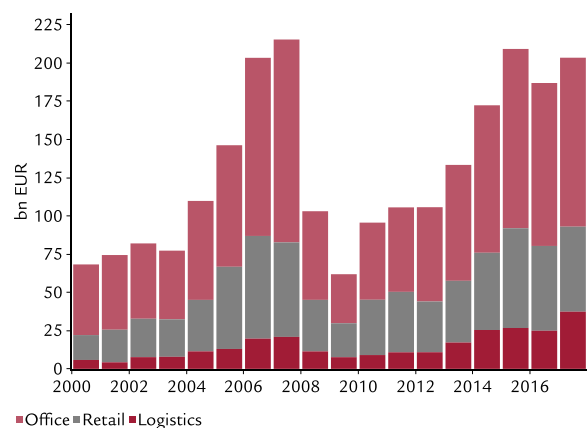
In this early stage, the residential market may qualify as an alternative sector in these countries, so investors need to be cautious. The growing importance of the residential sector underlines the shift to other alternative segments such as hotels and healthcare, which is increasingly prevalent across Europe. The mature phase of the cycle has prompted some investors to focus on the higher-yielding alternative sectors. Hotels and student housing have become institutionally preferred sectors in many European countries. Reflecting that, the European hotel investment market reached a volume of EUR 21.6 billion, an increase of 16% compared to 2016, according to CBRE. However, the hunt for higher yield only accounts for part of these sectors' growth, given that they also have a compelling investment case. Healthcare is well positioned to benefit from Europe's ageing population and the hotel sector is set to see greater demand due to increasing travel activity.

Chart 1: Office building starts in selected markets



Source: PMA

Chart 2: European investment volumes in commercial real estate by sectors



Source: PMA

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