



In the Balance

EMEA
2017





No matter what your outlook, 2016 was an extraordinary year. While political change is nothing new for the real estate investment community to contend with, the potential for market disruption resulting from recent events is clearly significant. Alongside the typical late-cycle features including a maturing economic cycle, low yields, high pricing and a lack of product for sale, it wasn't a surprise to see the investment market slowdown which ensued in 2016 – both globally, and in Europe. Are things really in the balance? Politically, and as a result economically, it is difficult to argue that the future of Europe is anything but. Yet despite all the political rhetoric, the market facts and fundamentals suggest things are more balanced than they may seem. On the downside, the UK vote to leave the European Union, the rise of populist politics across Europe, and a new political regime in the US all signify the prospect of major change. Yet on the upside, we continue to see economic growth in Europe, and investment capital continues to build its appetite for real estate globally – primarily driven by the continued search for yield and income. Equally, as the natural level of short-term interest rates continues to be compressed by long-term demographic change and slower economic growth, a market comprising low yields is becoming the new normal. Coupled with very low levels of leverage, and a lower threshold for return expectations amongst some of the bigger global players, things don't look so bad after all. The changes the market faces continue to provide new opportunities to invest in. It's a case of acting on those opportunities and holding on for the ride.

Ten years on...

2017 will mark ten years since the onset of the global financial crisis. Given that eight years is the average length for an investment market cycle, the EMEA market has had a good innings, as it were.

Overall, EMEA volumes and deal activity dropped by around 27% year-on-year in 2016. After a record year for the EMEA investment market in 2015, it was always going to be a tough ask to match these volumes in 2016. The combination of late-cycle economic maturity, low yields, high pricing, a gradual reduction of product for sale and a series of major geo-political events have been enough to curb investor activity.

EMEA volumes in balance: 50:50

Investment volumes within EMEA draws a very mixed picture despite an overall reduction in both deal-flow and volumes. Over the year, there was a 50:50 split between those which saw investment activity rise, versus those reporting a reduction in trading. (fig.1)

Markets on the way down

The 27% fall in overall investment volumes was driven by a reduction in activity across the major Tier 1 markets of the UK, France and Germany – markets which historically account for the lion's share of EMEA investment activity (over 60% of all investment, over a 10-yr period). There were also reductions in other large markets facing a range of political and economic challenges, including Italy, Russia and Turkey. Elsewhere, diminishing product availability and high pricing were key determinants of a drop in volumes, with activity down in the safe-havens of Norway, Denmark and Switzerland.

Markets on the way up

It wasn't all bad news, with over 50% of markets recording positive growth in activity in 2016. The Netherlands, Spain, Ireland, Finland, the Czech Republic and Hungary all saw a positive jump in growth, with more modest expansion in Sweden, Poland and Romania. Further afield, some big jumps were witnessed in the peripheral markets of the Baltics, Greece, Ukraine and Croatia as capital continued in the search for yield.

This runs in line with many of the findings presented in our 2015 Capital Flows Report, which pointed to good risk-adjusted pricing opportunities existing in the Netherlands and Nordics, and for the more opportunistic investors out in Europe's more peripheral markets.

Looking forward: 2017 and beyond

Although opportunities will exist in the markets that witnessed investment growth in 2016, the limited critical mass of the majority of these markets will result in shorter investment cycles, as opportunities dry up. Only Spain, the Netherlands and Poland appear to have the scale to continue attracting investment, yet each has political (and thus market) challenges to contend with.

Political uncertainty clearly heads the investment agenda in 2017 with all eyes on the shape of Brexit to come, the future of the European Union, US policies and the overall impact on global and European trade and investment. Clarity over the confluence of this change is unlikely until at least the end of H1 2017, giving investors time to prepare for the opportunities that arise as a result.

In the meantime there are other key major trends to remain aware of, as ongoing demographic, technological and consumer behaviour change the dynamics of real estate demand. This is illustrated by investment and occupier activity in this current economic and investment cycle.

Which sector?

Although offices and retail remain the most popular and widely accessible investment grade assets, there is continued evidence that their popularity continues to diminish in favour of other asset types across EMEA. (fig.2)

- > Since 2007, commercial office investment has dropped from 46.2% of all investment activity to just under 41.8%, while residential has jumped from 5.8% to 14%.
- > Retail investment has declined from 23.2% to 21.7%, whereas industrial/logistics investment has gained in popularity by around the same proportion, from 10.9% to 11.5%.
- > Hotels have remained static.
- > Appetite for development sites has almost halved from 6.7% to 3.5%.

These changes are worth highlighting as they provide evidence of the impact of demographic, technology and consumer behaviour trends on the changing use of, and demand for, real estate. Residential is the clear growth sector, to the detriment of offices. Industrial is growing to the detriment of retail, and from an average yield perspective, continues to offer the most attractive income generating proposition.

On average, retail and offices have seen their average trading yields plateau, but are yet to reach the lows of 2007. Residential is the lowest-yielding asset type, and back to where it was in 2007. Hotel trading yields have now surpassed their previous peak. Although activity in the hotel sector looks to have been limited across the region, when we look more closely at city-based investment activity, it too shows an increase in popularity.

Major city markets

As with country-wide investment, a broad geographic representation of major European cities shows an almost even split between those which saw a downturn vs upturn in activity during 2016, (fig.3)

When we get down to the sectoral shifts at a city level, however, the composition of activity and changes witnessed generally across Europe are similar, but with some clear differences, (fig.4)

Offices

Despite seeing a similar drop in popularity of around 10% over the last investment cycle, offices continue to dominate investment activity across Europe's major markets. Representing almost 60% of investment activity across the twenty five cities listed as of the end of 2016. The importance of office space, and thus office-based jobs, to major city economies goes without saying.

Retail

Still the second most popular asset class but only just, retail comprised almost 13% of all investment activity in 2016, jumping up from 9.6% in 2007. As cities urbanise and grow they will rely increasingly on community retail to support their daily needs. Equally, consumer spending patterns show an increase in spending on eating out/dining, which is helping to drive life back into many high streets. When coupled with a growth in tourism, it's a bit of a no-brainer that high street retail investment activity is growing despite the onset of e-retailing and logistics.

Industrial/Logistics

Investment in this sector has remained static over time, if not declined very marginally, despite significant growth in investor appetite. New multi-storey schemes have only just started to appear on the edges of major towns and cities, as retailers and logistics providers look to maximise their use of higher land values. However, getting the last mile to work within cities is proving challenging. Competing with other use types to generate a profitable and competitive existing-use value is requiring some creative thinking in this area, with mixed-use looking the only realistic option.

FIG.1
EMEA investment volumes by country: 2015 to 2016 Y-O-Y %

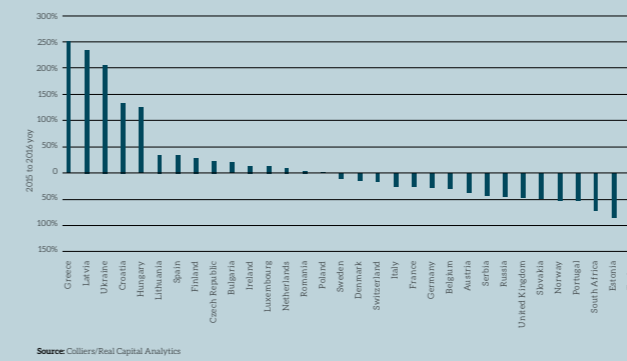


FIG.2
EMEA-wide sectoral shift in investment activity

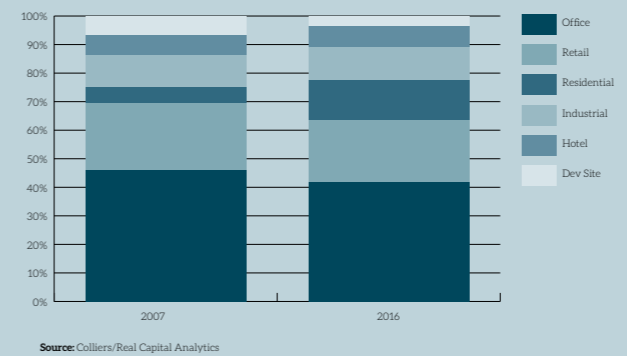


FIG.3
Investment volumes by major city market: Cyclical average; 15-16 Y-O-Y %

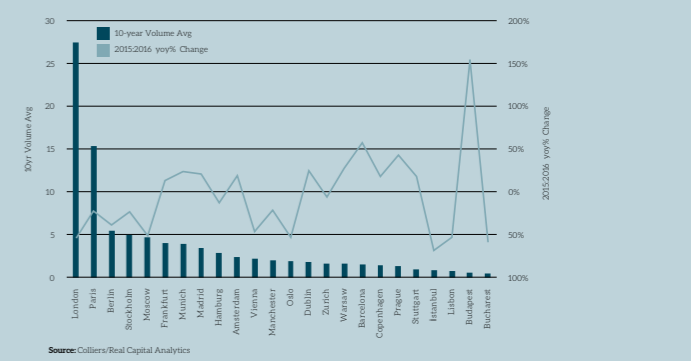
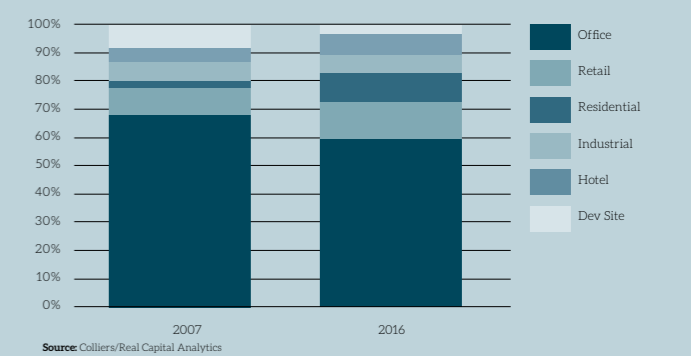


FIG.4
Major European cities: sectoral shift in investment activity



Residential

Residential investment expansion in these major cities far exceeds growth of any other sector. It now comprises over 10% of city investment volumes. Demographic change, urbanisation and the ability to support or complement other uses in terms of both existing use-value and functionality: be it retail, offices or clean urban logistics, provide residential with the fundamentals to be a key growth driver of investor activity in major cities long-term.

Hotels

Despite posting no real change in activity generally across Europe, the popularity of hotel investment has risen in major cities. Driven by considerable growth in tourism and overnight stays, and continued improvements in the overall performance of hotels on an occupancy and RevPAR basis, hotel investment has increased from 5.08% to 7.39% since 2007.

Development sites/Land

One surprisingly consistent trend is the lack of development / land sales. In line with a decline in land sales across Europe, development land sales in Europe's major cities has fallen from 8.13% of all activity in 2007 to only 3.25% at end 2016. Investors and developers will be concerned about buying or delivering new assets into a market towards the end of a maturing economic and investment cycle. History shows they should be adopting caution. However, with vacancy rates in many cities at all-time lows, across almost all asset classes - particularly in the more mature western and northern European markets - what the investment community needs is more development, not less of it.

Where do we go from here?

The availability of product for sale is likely to remain low in the year ahead. Investors now take longer-term holding positions and factors forcing sales remain thin on the ground. A dearth in much needed development is only going to slow the pace of investment activity further, which could act to further tighten already low yields. So building more investment grade assets is essential, but cities will need the right type and mix of product to support the needs and demands of city workers, residents and visitors alike.

The priority for major cities has to be focused on generating more high-quality, value-added office-based jobs to drive occupier and investment demand for assets. An analysis of the correlation between growth in office-based jobs and office investment turnover during the last economic and investment cycle is absolutely clear. As figure 5 shows, the cities which generated the most office-based jobs over the last ten years, and the resulting growth in investment grade product, are the markets which have seen the strongest levels of office investment activity, and investment activity overall. More higher-paid jobs simply generate demand and spending for other uses including residential, retail, logistics and hotels. Tourism complements demand for these uses. (fig.5)

So producing more investment-grade office stock must be the number one priority. Notably assets built around key mass-transit infrastructure, providing for flexibility of use and layout alongside the right mix of other supporting uses. The generation of new, investment grade stock will in itself free up older assets for redevelopment into other uses, with residential and hotel-driven mix-use schemes looking to be the way forward for many modern cities, planning allowing.

FIG.5
Estimated value of historic requirement vs cyclical volumes avg

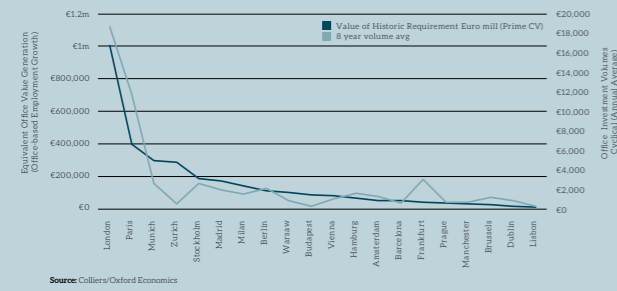
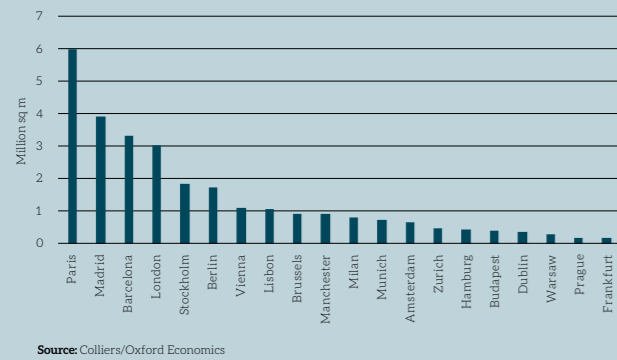


FIG.6
Latent skilled talent: estimated office requirement (sqm)



It is easy to say this is what is needed, but getting investors and developers to commit to providing new space in the current climate of uncertainty is difficult. Although a number of new speculative schemes are in the pipeline, we may not see much new active large-scale office and mixed-use development until the future path of UK and European economies and employment is made clear via Article 50. The changes which are enacted as a result, and subsequent political reform across Europe will re-shape the future path of European economies, office-based jobs growth and investment markets along with it. Occupiers, and thus developers and investors will want to be clearer on where the growth markets will be before they start placing bets.

Cities of Influence: Tracking demand growth

As detailed in our recent *Cities of Influence* research, how cities are set up to compete, in a modern digital and increasingly tech-driven economy requires the consideration of a broad range of factors.

This last economic growth cycle in Europe has seen office-based employment expand across the region, but unevenly. In some markets we now have very low levels of unemployment, reaching 5% or below what would traditionally be regarded as full employment.

The challenge to increase job growth is exacerbated by long-term demographic trends, which point to a declining workforce: those traditionally aged 15-65 will reduce 10% in size by 2030. The 20-40 year old bracket faces the biggest declines, creating a clear war for talent across Europe.

Where to build and buy?

If development and investment activity were focused on the volume of latent, skilled workforce potential alone, we would see different economic and investment trends emerge to the one seen in the past decade.

Paris, Madrid and Barcelona would become Europe's most attractive growth markets, based on the size of the skilled talent pool and their typical office needs. London would drop to number four, Stockholm stays in at number five. Berlin, Manchester and Lisbon also move higher up the rankings. But the other major German cities and core-CEE cities all drop back due to the dearth of existing skilled talent availability now in situ. Dublin also drops back, highlighting the lack of immediate capacity to grow significantly in the wake of any post-Brexit relocations. (fig.6)

Potential however is just that, until it is realised. The attractiveness of a city to occupiers is much more than just the size of the immediately available, skilled talent pool. Occupiers (and employees) take a balanced approach to understand which cities are best set-up to their needs as a place to live, work and play. Cost, infrastructure and contractual employment factors remain a key consideration.

The full results of our *Cities of Influence* put London out on top, followed by Paris, Manchester, Dublin and Stockholm. But holding on to these positions remains very much in the balance. Article 50 has the potential to significantly disrupt the status quo, primarily through a potentially negative impact on future migration patterns and thus economic / jobs growth across Europe. This is the primary unknown facing occupiers, developers and investors operating across the European market. The challenge is, it is not the only one.

Other market considerations

Aside from broader political change, a period of 'lower for longer' is also in the making in almost every sense of the term. The good news is that the combination of ageing demographics and a declining workforce, lower economic growth, and a reduction in savings versus income all point to a long-term suppression of short-term interest rates. Although inflation is increasingly apparent in the US and UK and some parts of Europe, an uptick in inflation is not universal. Short-term interest rates will rise in the year ahead in the US and UK, but the scale of increases is also set to remain lower than in previous economic and investment cycles.

When combined with the continued growth in the weight of capital looking at real estate and real assets, an environment of low yields look set to stay. This in turn is likely to have an impact on returns, a fact which some of the bigger global players are coming to terms with. Norges (NBIM) recently announced they have reduced their overall target return to 3% from 4%. As the world's third largest institutional investor, with a growing appetite for global real estate and real assets, this is setting a new benchmark for core return expectations.

It's down to investors to adjust to this new normal, whilst dealing with the myriad of factors influencing global economies, trade and capital flows in the years ahead.

Lower For longer

The other challenge for Europe is how it will compete with other global regions as a destination for capital in the coming years, especially North America. The US has a very different demographic growth pattern to Europe, whereby the population is not ageing as

vociferously and youth population growth adds to the workforce. This is likely to lead to higher savings, forcing up interest rates. Higher interest rates and a stronger dollar are already in action, which combined will equate to higher yields. This will attract and retain income-seeking capital, particularly if assisted by active policies to attract more investment into new infrastructure and real estate opportunities, supported by high tax credits.

The good news is real estate remains an attractive asset class globally. Investors should however ready themselves for a number of twists and turns in global and European investment cycles in the months and years ahead, as markets take clearer, new economic paths.



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