CAPITAL VIEWS
THE ALLURE OF EUROPE

A Cushman & Wakefield Capital Markets Publication

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THE ALLURE OF EUROPE

Europe has been the global market of choice for some time now – importing capital from all other areas and accounting for 60% of inter-regional investment last year. However, with the US now in growth mode and the euro weakening, how long can this last?

In theory, the fundamentals should have started to swing away from Europe last year as more investors began to take on risk and economic prospects brightened in a range of other markets. However, with property investment supply improving thanks to deleveraging, restructuring and rising prices, Europe has had an edge that has kept it at the forefront of investors' minds. Quantitative easing has only added to that.

At the same time, while activity has spread rapidly around Europe– from the core, on to the south and now towards Central Europe – global money has lagged behind, staying close to the biggest hub markets. The UK, Germany and France took three quarters of all global money in Europe last year for example. Change is afoot however: Spain is now drawing capital from all global regions - the only country other than the UK to do so – while Italy has outgrown the big guns and was number four in Europe for global capital last year.

Based on the continuing importance of actually having stock to sell as well as the significant boost coming from QE, Europe will remain the centre of attention for some time yet. Indeed, with the economy improving and the occupier cycle marginally closing the gap with the capital cycle, the market could have a two year window of high activity and attractive relative pricing.

In terms of opportunity, as ever this depends on risk tolerance, but we see three clear tiers of potential where liquidity, an improving occupier and/or attractive pricing point to better than average gains. In the first tier, the core markets of London, Paris and Germany continue to lead the way, followed in the second tier by a focus on the leading cities of smaller countries, notably Madrid, Barcelona, Milan and Brussels. Next, meanwhile, comes a look east, focussing on the EU but not just stopping at Poland and the Czech Republic.

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INVESTMENT FLOWS IN THE REGION

Cross-border investors took a 43% share of the European market last year, the highest since 2007 as the allure of higher yields for some, and security through diversification for others, pulled people back across borders.

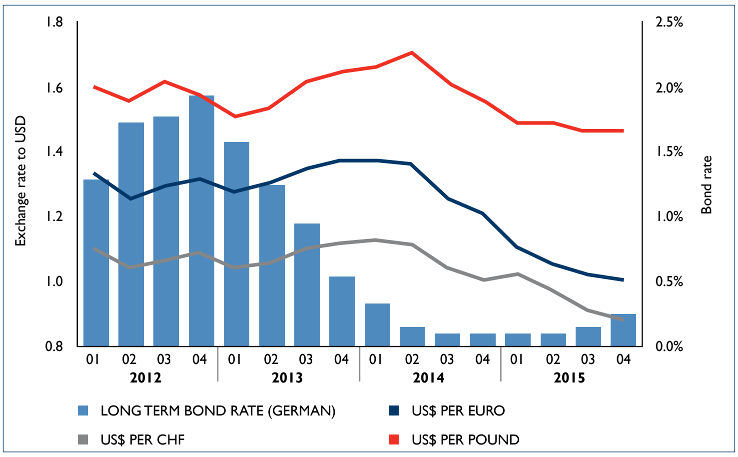
What is more it has not just been regional players moving from market to market but global players driving these volumes, some well-established, others new to the region. Indeed, it is now global buyers who are in the ascendancy. In USD terms, global investment into Europe rose 35.5% in 2014 while European cross border investment within the region rose 14.4% and domestic investment was up just 1.4%.

But is this shift sustainable? With quantitative easing squeezing all investment yields and a weaker currency hitting repatriated values, the advantages of investing into Europe could in fact soon be under pressure for some investors, particularly with political worries to add on top. European bond markets have already witnessed an outflow of capital in recent months as savings institutions have turned to other global markets given the lower or negative yields available in Europe. This trend started in mid-2014 when ECB deposit rates turned negative. To date, equities and real estate has been less impacted but that could change if currency falls continue and low returns relative to other markets are sustained.

Europe is increasingly

at the centre of global real estate capital flows. But is this sustainable?

Figure 1: The Monetary Squeeze



Source: Cushman & Wakefield, Oxford Economics

In that light, expectations for continuing low exchange rates are not positive but look likely to persist for some time given the divergence in monetary policy that is taking place. After a 19% fall since mid-2014, the euro has potentially seen the worst of the decline it faces against the dollar but a further fall of 9% to end 2015 is forecast and falls against other currencies are also in store.

Interestingly, after a 13% fall since last year, the Pound is forecast to be fairly stable on the dollar for the rest of this year and to appreciate against the euro: although the upcoming election may impact on these assumptions.

On balance, the macro drivers for demand are more positive for real estate than for bonds and indeed the relative yield from property should continue to draw in both short and long-term investment interest.

If anything, international demand is likely to rise further as institutional fund allocations have tended to rise among global players of late and regulations continue to change to allow or encourage property and international investment. Even for those players where oil and commodity price falls may reduce their net cash position in the short term, many are still active buyers.

A strategic shift is in fact taking place in favour of property and much of the current investment upturn is therefore driven by long-term players.

At the same time however much is also accounted for by shorter-term portfolio flows seeking the best returns available globally today.

This hotter money will just as easily flow away from Europe and from property when the time is judged right.

That judgment on timing will to a large degree be driven by interest rates and hence it is important to note that bond yields are expected to stabilize in the coming months and ease up very modestly by year-end. However with €60bn of QE to allocate each month, bond yields overall are likely to rise only slowly and hence are unlikely to pressurize property yields before 2016/17 at the earliest if these current forecast are right.

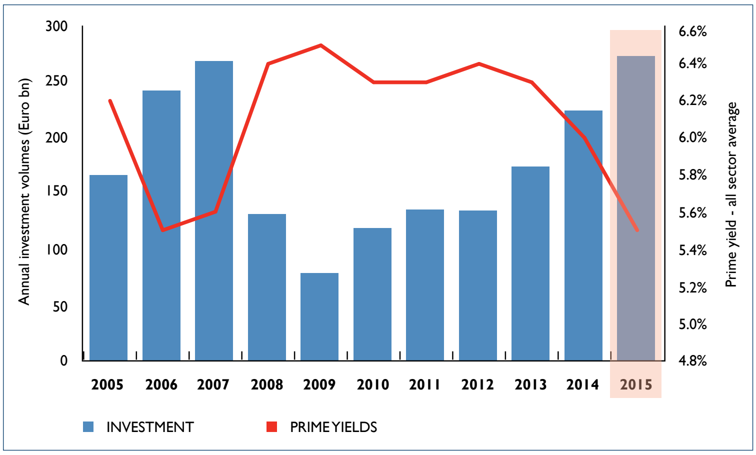
As a result, European property faces a further 1-2 year window of attractive relative pricing, particularly from assets enjoying the start of an occupational upturn, and with low relative risk and diversification gains on offer, high demand will be sustained.

What is more, whilst quality supply is restricted, overall choice for investors is increasing as banks deleverage, portfolios are turned and development comes back to the agenda. This heightened availability in a stabilizing economy will continue to underpin activity for domestic and foreign buyers, with potential for the market to deliver a new peak for trading in excess of the previous record of €275bn and a further fall in yields likely across a broader range of markets, potentially averaging some 50-75bp.

European property

faces a further 1-2 year window of attractive relative pricing, particularly from assets enjoying the start of an occupational upturn

Figure 2: European Investment Market Outlook

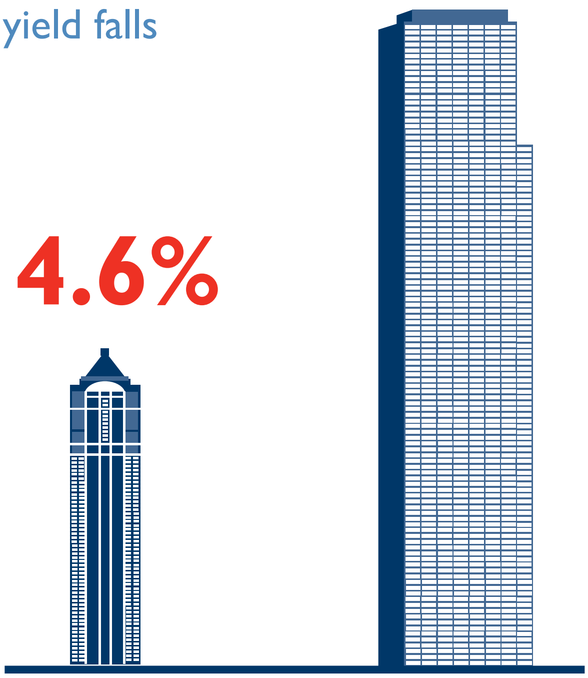


Source: Cushman & Wakefield, RCA

Capital Gain in Europe from yield falls

9.8%

4.6%



2014 2015

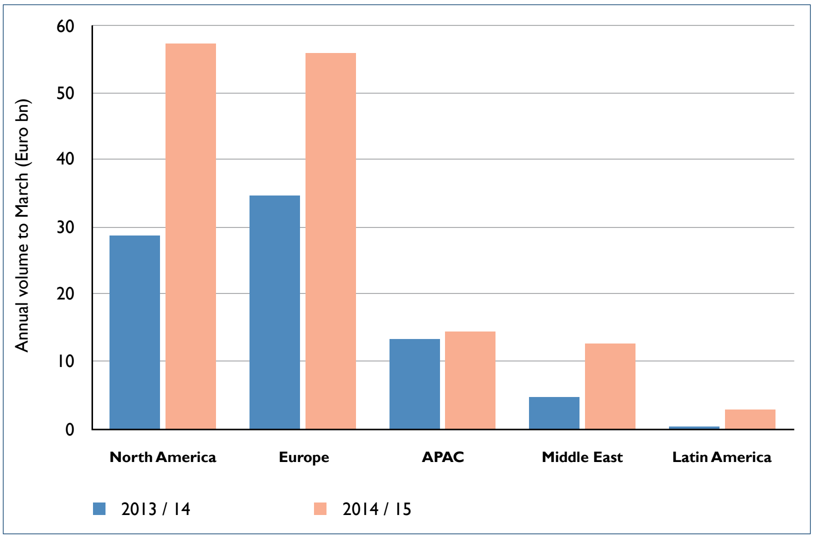
Interest is growing

from all points around the globe

THE INVESTORS

The make-up of the investors driving this upturn is expected to remain very global. In the past year, North American investors have been dominant, as they have globally, with rapid growth (99.5% in the year to March) in their already significant market share leading them to actually overtake Europeans as the largest regional source of cross border capital in Europe. The US is the largest individual source overall but Canada ranks third and also grew strongly last year.

Figure 3: Sources of international capital in Europe by region

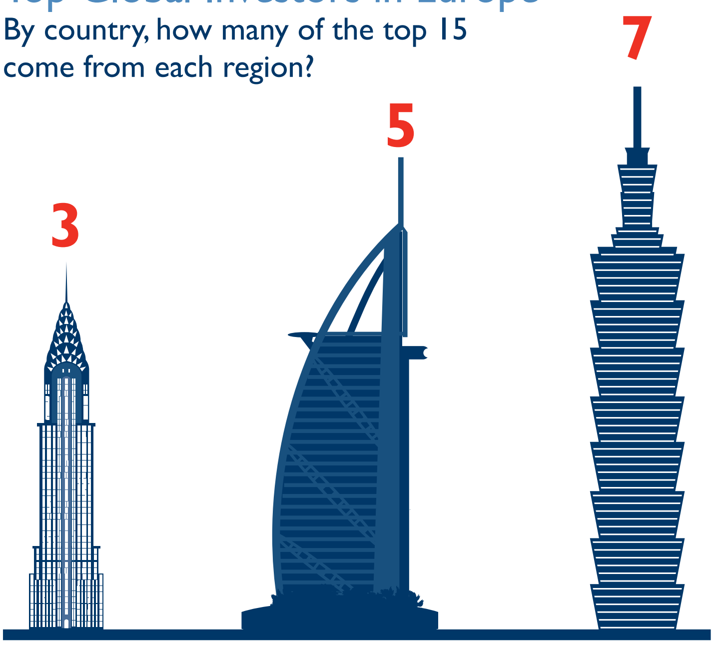


Source: Cushman & Wakefield, RCA

At the same time, interest is growing from all points around the globe – with Latin American investment virtually trebling for example, largely flowing into the UK and Spain. Middle Eastern investment rose 72% despite the fall in the oil price as demand to diversify continues to grow, with Qatar in particular highly active in the past year, moving into second place in the league table of global investors coming into Europe.

Top Global Investors in Europe

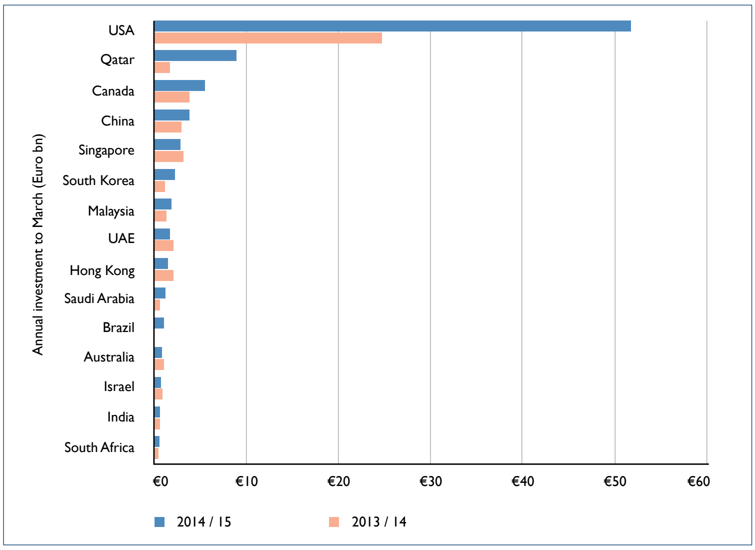
By country, how many of the top 15 come from each region?



The penetration of different investor groups varies,

with only a small number of countries seeing the full range of investors taking advantage of their markets to date

Figure 4: Top Global Investors in Europe



Source: Cushman & Wakefield, RCA

Five of the top 15 investors in Europe in the year to March were from the Middle East and Africa while 7 were from Asia, led by China in 4th place.

Asian investment overall nonetheless rose at a more subdued pace of 8% in the year to March and indeed dropped back in 2014 in some areas, with a lack of opportunities in certain target markets emphasising the patient and long-term nature of many Asian investors.

TARGET MARKETS

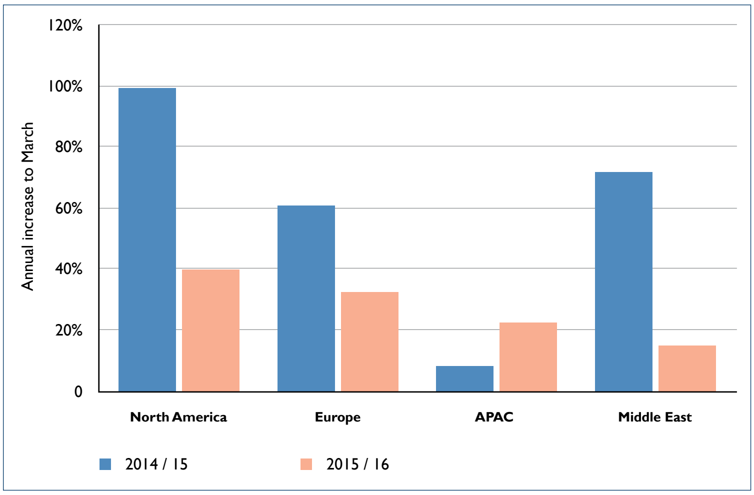
While the number of sources of capital has significantly increased, the penetration of these different investor groups within Europe varies significantly. Only a small number of countries have seen the full range of investors taking advantage of their markets, led by the UK but with Spain also a target for all regions including Latin America.

Germany, France and Italy are unsurprisingly targets for the main investor regions and multiple purchases have additionally been seen in other areas including the Netherlands, Poland and Russia. As can be seen from table 2 however, many countries are yet to see significant global penetration.

Europeans have been crossing borders into most areas of their own region bar some of the least developed eastern markets. North Americans are also well travelled, buying in the past year in 22 of the 25 markets listed in table 2 for example. Asian investors brought in 16 of the 25 while Middle Eastern players purchased in just 12 and Latin Americans in 3.

Looking forward, QE should ensure that European investment across borders grows at a strong rate but North America is likely to remain in the ascendancy even though growth may be slower than last year as opportunities at home are pursued in a strengthening economy.

Figure 5: The Outlook for Growth in Investment by Source Region



Source: Cushman & Wakefield, RCA

Asian buyers may be more notable in the market this year as they continue to seek diversification opportunities and to reduce portfolio currency risk. What is more, fresh sources of Asian capital are still emerging; from Taiwanese insurance companies to Chinese HNWIs and at some point, increased Japanese pension fund investment.

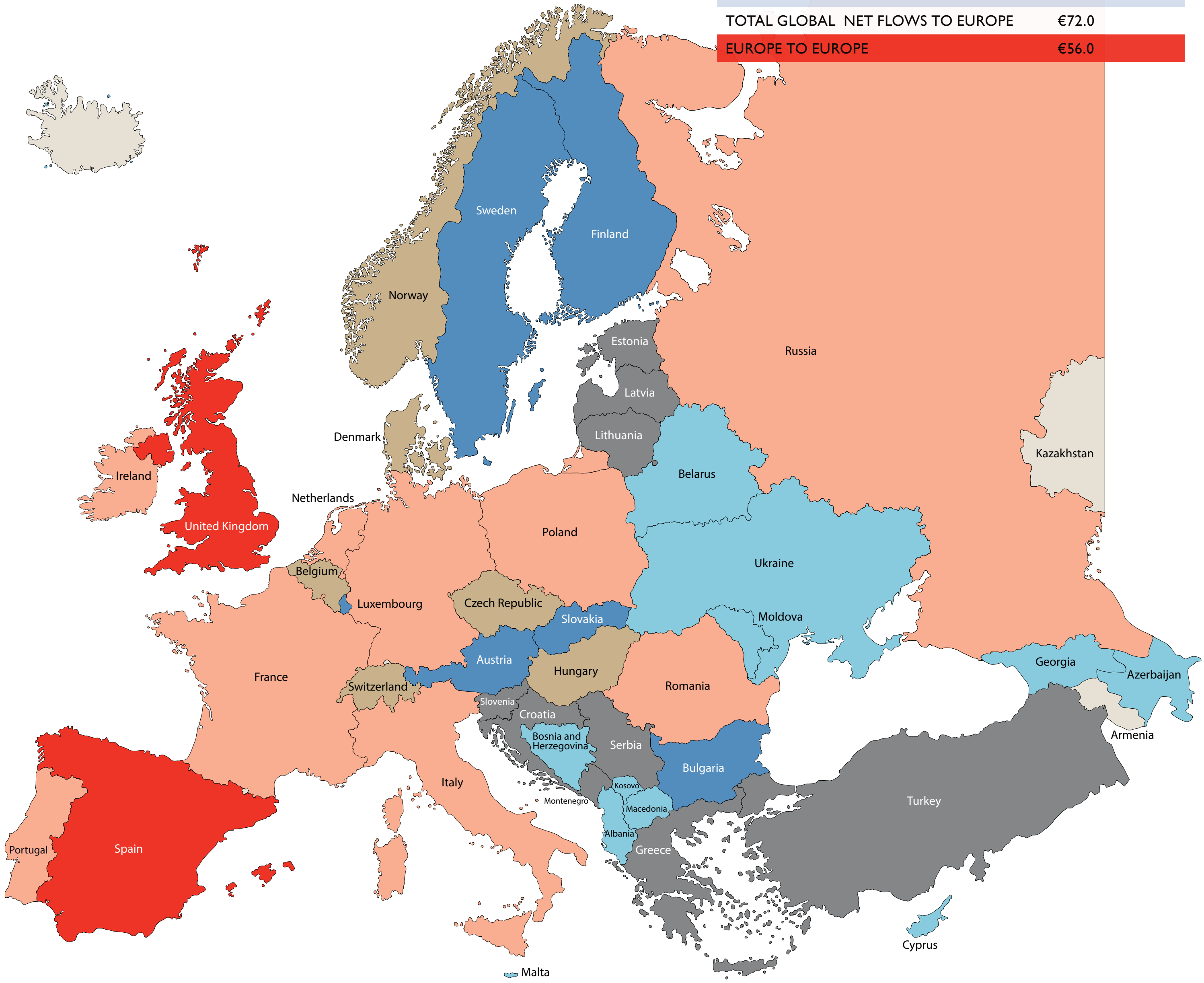
Investment from the Middle East may proceed at a slower pace in the short-term as the fall in oil prices hits revenues and diverts investment into home markets. Not all investors or countries will be similarly affected however and some funds will clearly remain very active, while others are increasing their target real estate allocations.

FOREIGN INVESTORS ACROSS THE EUROPEAN PLAYING FIELD

The map below shows the penetration of foreign investors into different European markets in the past year, emphasising that most are open to European as well as domestic players. However while global investors are broadly spread, only a small number of markets are currently being targeted by players from all regions.

Table 1

NET INVESTMENT FLOWS INTO EUROPE, YR TO MARCH 2015	NET FLOWS (€BILLIONS)
NORTH AMERICA TO EUROPE	€46.1
SOUTH AMERICA TO EUROPE	€0.6
MEA TO EUROPE	€12.6
APAC TO EUROPE	€12.6
TOTAL GLOBAL NET FLOWS TO EUROPE	€72.0
EUROPE TO EUROPE	€56.0



- Largely a domestic market
- A domestic and European target
- A target for domestic and European players plus 1 other global region
- A target for domestic and European players plus 2 other global regions
- A target for domestic and European players plus 3 other global regions
- An active target for all regions

SOURCES OF CAPITAL: CURRENT HIGHLIGHTS

JAPAN

One of the largest pension funds in the world, Japan's Government Pension Investment Fund, is reallocating capital from domestic bonds to equities and overseas markets to boost returns and other pension funds are being encouraged to follow suit. Much of the focus to date has been on equity markets but funds are chasing income stabilised real estate assets as well, contributing to marked downward yield compression in Japan. With the domestic real estate market at last seeing a return of rental growth and development potential, a domestic focus will remain for the short term but such is the depth and weight of demand that as capital gets harder to deploy more will flow overseas - including to Europe, with buyers possibly gearing up later this year.

CHINA

China has now emerged as a net exporter of capital and while the USA has been the main beneficiary of this to date, Europe, led by the UK, is increasingly on the agenda for private as well as state-owned enterprises. Investment growth was slower in 2014 but is likely to significantly increase going forward, with further reforms from the government in Beijing and good potential as the focus moves from the big names currently active abroad to a new wave of small to medium sized players and new funds.

Volumes in 2015 are likely to be notably ahead of 2014 as the patient approach of many Chinese players in the past gives way to more activity following their careful research of the market and potential partners. With the euro looking relatively cheap and demand growing for non-RMB assets for diversification, interest in core cities will be maintained but corporates and HNWIs as opposed to insurance funds are likely to continue to spread into new markets and sectors and take on development, as they have been happy to do in the USA.

MALAYSIA

Falling oil prices are a positive for most of Asia but one exception is Malaysia, a major gas and oil exporter where Petronas, the state oil company, accounts for over 30% of government revenue via taxation, royalties and duties. With growth forecasts and budgets having to be revised, the currency has weakened and fears of capital flight have increased. It was therefore little surprise that the Finance Ministry asked government-linked companies and statutory bodies to temporarily halt purchases of foreign assets late last year in a bid to contain capital outflows. While this has influenced some, it has not stemmed the flow of Malaysian money into Europe. Indeed in the last 6 months this accelerated to €1.7bn versus a 6 month average of €0.45bn in the previous 1-2 years. However, this does include deals underway prior to the Finance Ministry announcement and new investment from government backed funds is clearly now reducing while private buyers remain active. At the same time, inward foreign investment to Malaysia is remaining robust – offsetting in part the need to encourage more Malaysian capital to remain at home. Slower investment overall may therefore result but disinvestment looks a limited possibility other than to allow recycling of capital into new projects.

CANADA

Canada is the third largest cross border investor in the world after the USA and Hong Kong and while much of this investment targets other markets in the Americas, investment in Asia and Europe is now growing at a faster pace. Indeed, global investment overtook regional spending in the Americas for the first time last year as Canadians truly go global in pursuit of the right opportunities.

Some investment flows may be impacted by the fall in oil revenues but the significant volume of outbound capital for real estate is largely attributable to Canadian pension funds, with increasing allocations to real estate, seeking "core" opportunities that simply are not available in the open market in Canada. What is more, the Canadian market is also increasingly going to be a two way street as its low risk characteristics attract more inward investment. Over the last two years, the flow of real estate equity leaving Canada has far outweighed the incoming capital invested - notwithstanding increased capital inflow more than 7 times the capital is leaving the country than entering through foreign investors. However, it is expected that the declining value of the dollar and a significant wave of Asian equity, predominantly from Chinese life insurance companies, will see the inbound volumes continuing to rise in the coming years.

USA

US investor surveys point to a further gain in real estate allocations and several major funds have announced further plans to reduce exposure to sectors such as hedge funds in favour of an increased property allocation. However, how that increased pot is divided between domestic and overseas markets is uncertain and what is more, the problem of sourcing opportunities is notable in some surveys and hence the rate of growth in investment may be less for US pension funds than for pension funds in other regions. Nonetheless, most surveys do still point to a steady increase in overseas allocations over time and while US opportunities are more appealing for some at present, the falling euro and yield compression in the USA are making European property more attractive. What is more, many money managers are sat on funds raised in previous years and hence overall, we expect US investors to remain dominant in the European market this year.

MIDDLE EAST

Middle Eastern investment has been strong of late despite the fall in oil prices but clearly allocation and investment decisions are in many cases only now being influenced by lower energy revenues. In the first instance of course, the impact will be to reduce government budgets for domestic expenditure. However the overall impact will depend on the local break-even price of oil e.g. KSA has still announced a significant budget for domestic infrastructure projects.

At the same time, the volatility in oil and gas is only serving to remind many Middle East Sovereign Wealth Funds of the need to diversify and some are increasing real estate allocations. Most are planning multi-year investment programmes and have been through similar periods of oil price volatility in the past. On balance therefore, unless such low prices are sustained into 2016, the impact in general should be to slow rather than halt the pace of growth but also perhaps to maintain a fairly conservative view on target geographies in light of the need to sustain capital and given ongoing geopolitical tensions.

AREAS OF OPPORTUNITY

Overall growth looks set to remain volatile but a modest improvement should result from factors now in play boosting lending and employment and cutting operating costs. As far as real estate markets are concerned, this should help to start a rebalancing between occupier and investor markets.

Retail may be the sector that gains most from the changing fortunes of the European economy, with consumer confidence at its highest since before the Global Financial Crisis. Retailers and consumers are however likely to remain cost conscious and hence it will be the best retailers and retail areas that are rewarded with better performance in the year ahead.

In particular, it may be those markets which have been on the edge of recovery so far which benefit most, with potential gains in Germany and France but also Spain, Italy and Portugal as their recoveries start to catch up.

Any gains in the consumer market will at the same time be a further spur for the logistics sector which is already benefitting from changing demand trends thanks to the impact of ecommerce and efforts generally to improve business efficiency.

Larger, core markets led by the UK and Germany as well as Sweden may be particular beneficiaries short-term but most, larger urban areas offer opportunities as does Central Europe as transportation and production patterns continue to develop.

Office markets meanwhile may be slower to see demand side benefits flowing from increased employment but corporate investment is showing signs of improvement and with many markets supply constrained, clear growth opportunities exist in a range of markets led by London.

Development potential is therefore increasing but interest will also focus on short-term opportunities to deliver quick refurbishment gains in core markets.

A re-balancing

between occupier and investor cycles is set to begin in European real estate markets

Plenilunio, Spain

Opportunities

within the region come with risks attached but those risks and the timescales attached are quite variable and we see a clear distinction into three main tiers:

***TIER 1** – LONDON AND PARIS FAVOURED*

Our reading of the market currently is that tier 1 core markets – the UK, France and Germany – are still areas of excellent opportunity from a risk adjusted point of view. Low risk, long-term investors have a range of markets to consider offering sustainable yields, high in comparison to other investment asset classes. For those seeking a higher return meanwhile, the preferred risk may be developing in gateway cities rather than seeking stabilised investments in second tier markets now that the yield gap between gateway and regional cities has closed.

In Germany, distribution property as well as retail looks a good target in stronger cities while a shortage of modern office accommodation will benefit key cities led by Frankfurt and Berlin. For retail and offices meanwhile, Europe's leading gateway cities, London and Paris, have a strong draw and are likely to see further price appreciation as global demand swells further. London offers the better near term growth thanks to supply pressures in all sectors of the market but Paris also offer medium to long term gains from infrastructure improvements and a similar role to London as a global luxury/cultural/tourism hubs. Short-term rental growth in the French capital may be limited but there will be a boost from the weaker euro. Indeed, demand conditions are already stabilising ahead of a likely improvement in employment growth and with the core in particular supply constrained, sustained growth is likely for the medium term.

***TIER 2** – FOCUS ON CITIES NOT COUNTRIES*

Looking further afield, notably higher yields are still achievable than in tier 1 core cities and what is more there are a range of cities with high quality living, working and educational environments as well as strong tech and environmental credentials – such as Copenhagen, Stockholm, Amsterdam, Dublin, Madrid, Brussels and Warsaw.

In our view, markets such as Madrid, Milan, Barcelona and Brussels would be our next selection, offering 100-200bp yield premiums compared to London or Paris. While yield pricing in Spain is frequently now aggressive, growth potential is good given supply shortages in some areas and the seeming success of the reform programme, which will benefit all sectors. Italy too is a favoured market despite much slower progress on reform and recovery. The market has less modern space than it needs and a requirement for partners and capital and the World Expo event in Milan this year should provide a real focus for global capital.

***TIER 3** – TIMING IS RIGHT TO LOOK EAST*

Europe's central and eastern fringe is by and large again outperforming economically and has a relative shortage of debt which can open up opportunities for equity investors. Each market is of course different in the risks and opportunities it brings but as a generalisation the region is developing a stronger technology presence and offers access to good quality, built, leased stock in larger cities with good risk-adjusted margins in the yield.

Prague and Warsaw are the leading markets from a risk perspective and offer good long term potential, particularly Poland if reforms further liberalise the economy and encourage investment after this year's election. Other markets should however be targeted, with obvious geopolitical risks to consider but also high potential returns, available modern stock and improving liquidity. Budapest is perhaps the most notable example, but Bucharest and Sofia are also stirring on the side-lines.

Opportunities in Russia – centred on Moscow – will begin to emerge as the economy hits bottom but this will be slow to happen for European investors due to wider political issues. In Turkey meanwhile, the ability to develop a platform with local partners can be attractive and while economic and political uncertainty have increased, growth and development continue apace. Istanbul is shaping up as a strong long-term contender for investment and what is more, it will benefit from major infrastructure developments.

Source of Global Investment in Europe

Table 2: Market data (year to March 2015)

		SOURCE OF GLOBAL INVESTMENT €BN				VOLUME GROWTH PA	
		NORTH AMERICA	ASIA PACIFIC	MIDDLE EAST	EUROPE (NON-DOM)	GLOBAL	EUROPEAN
"CORE" EUROPE	UK	28,579	8,853	6,986	10,068	76%	51%
	Germany	6,876	2,422	789	12,743	97%	58%
	France	6,395	959	2,077	7,674	79%	118%
	Sweden	487	-	-	2,002	3%	63%
	Finland	198	-	-	758	395%	-31%
	Austria	375	-	-	879	357%	-22%
	Norway	264	-	50	732	62%	3%
	Denmark	124	16	-	1,088	Na	79%
	Switzerland	46	28	-	322	-36%	171%
RECOVERING "FRINGE" EUROPE	Spain	3,280	265	61	2,721	46%	160%
	Italy	2,954	682	1,988	2,808	136%	177%
	Ireland	1,421	9	4	1,108	-18%	139%
	Portugal	775	145	-	448	263%	403%
	Greece	-	-	-	15	na	-98%
BENELUX	Netherlands	2,232	69	239	4,699	32%	169%
	Belgium	269	284	-	1,642	-13%	149%
	Luxembourg	185	-	-	351	na	32%
CENTRAL EUROPE	Poland	1,500	380	37	1,465	44%	-48%
	Czech Republic	1,049	5	-	1,542	130%	360%
	Hungary	55	-	103	174	850%	102%
	Slovakia	9	-	-	215	-69%	-5%
EASTERN EUROPE	Russia	196	319	267	567	28%	-6%
	Romania	122	19	15	949	154%	54%
	Turkey	-	-	-	299	na	-3%
	Bulgaria	-	12	-	123	na	306%
EUROPE OVERALL	Inward	57,406	14,467	12,732	55,981	72%	61%
	Outbound	11,277	1,852	83	55,981	25%	61%
	Net	46,129	12,615	12,649	0	86%	na

Source: Cushman & Wakefield, RCA

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CUSHMAN & WAKEFIELD

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The Capital Markets team provides trusted commercial advice and execution services to those engaged in buying, selling, investing in, financing or building real estate. We work closely with our clients in order to accurately advise them on maximising the value of their real estate. Our services include investment sales and acquisitions, sale and leasebacks, arranging senior debt and mezzanine finance, private placements, loan sales and indirect investment.

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THE REPORT

This report has been prepared by David Hutchings, head of the Investment Strategy team in Cushman & Wakefield's EMEA Capital Markets group, based on desk research together with input from Cushman & Wakefield professionals in the Capital Markets teams across Europe.

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