Executive Summary

With the year drawing to a close, we turn our attention to the outlook and identify the major occupier and investment trends that we expect to influence market conditions and investment performance in 2020 and beyond.

In Europe, we identify three region-specific trends that reflect opportunities to benefit from diversification by strategy and geography.

1. More Rental Growth in Low Vacancy Office Markets: Vacancy rates in major European office markets are below average and set to remain low enough to support further rental growth in 2020.

2. Further Signs of Retail Distress to Emerge: As online retail share continues to grow across Europe, recent experience in the United Kingdom suggests a challenging period ahead in other core countries.

3. Apartment Volume Share Set to Level Off: The apartment sector remains popular but recent growth may be curbed by headwinds including low yields and increased rent controls in major markets.

These region-specific trends, alongside our four key global trends, are set to have a significant aggregate impact:

1. More Employment Growth to Come: The current cycle continues to be driven by employment rather than productivity, while the stable outlook for global GDP growth points to another year of steady real estate returns.

2. Low Supply Environment Persists: The ongoing low supply environment continues to support prospects for rental growth, enhanced by a strong link with employment growth in the current cycle.

3. Further Scope for Yield Compression: Past interest rate increases have been weighing on real estate pricing, but the shift toward looser monetary policy paves the way for further yield compression in 2020.

4. Cross-Border Flows Weakening: Cross-border investment flows are weakening in the Americas and Europe, reflecting a wider slowdown in trade liberalization. Asia Pacific is bucking the trend.

In this excerpt we review the European trends in detail.
EUROPE

In Europe, 2020 looks set to be a year in which caution and optimism battle for supremacy. So, while there are concerns about the pace of economic expansion, the prospect of further employment growth in a low supply environment means that office vacancy rates are set to remain at levels consistent with ongoing rental growth.

Real estate should continue to attract capital in this environment, but there are some challenges too. If the UK example is anything to go by, the retail sector is set to face more distress across Europe in 2020 as online penetration reaches a level that starts to affect physical store requirements.

As in many parts of the world, regulation is becoming an issue. Along with logistics, the apartment sector has been attracting capital on the back of declining retail prospects, but the possibilities of rent controls being imposed are casting a shadow on the outlook. Opportunities and threats are set to go hand in hand in the months to come.

Europe Trend 1: More Rental Growth in Low Vacancy Office Markets

Vacancy rates in major European office markets are below average and set to remain low enough to support further rental growth in 2020.

One of the most notable features of the current cycle is that vacancy rates across European office markets have fallen significantly below historic averages (see exhibit EUR1). Echoing global-level trends, employment growth has been elevated through the cycle, driving demand, while supply growth remains low, pushing down availability.

After averaging 9.5% in major office markets in the early part of the cycle between 2010 and 2014, vacancy has subsequently fallen to about 5% today. Meanwhile, a simple analysis demonstrates that periods of below-average vacancy rates are normally accompanied by sustained rental growth.

Even as economic growth is easing in major European countries, markets like Amsterdam, Berlin, and Frankfurt are reporting steep increases in headline office rents as tenants compete for scarce available space.
There are some differences in the current cycle. Employment growth has been more focused on lower value-added services and small businesses, rather than traditional CBD occupier groups such as finance or insurance. Flexible office providers have also been commanding a significant share of take-up. As a result, non-CBD markets have fared well, delivering stronger rental growth than their CBD counterparts since 2015.

Looking ahead, there is some supply growth coming through — notably in markets like Berlin and Paris — but the pace of construction remains modest compared to past cycles.

While there are some risks that availability may rise, on our simple projection even if demand fell back to a cyclical low, the overall vacancy rate would remain well below average, pointing to further rental growth potential in 2020 and beyond.

**Europe Trend 2: Further Signs of Retail Distress to Emerge**

As online retail share continues to grow across Europe, recent experience in the United Kingdom suggests a challenging period ahead in other core countries.

Among European markets, the UK is clearly the furthest ahead in terms of the development and influence of the online retail sector. The question is whether its recent experience can give us an insight into future performance in other markets.

While recent real estate market performance in the UK has been dampened by macro uncertainty — not least owing to an as yet unresolved Brexit process — consumer spending has held up reasonably well. However, the UK retail real estate sector is struggling.

Retail capital value growth began to lose momentum in 2014, well before Brexit was even on the radar, and values across all retail formats are now falling at an annual pace of -10% (see exhibit EUR2).

At the point momentum first started to falter in 2014, UK online sales were about 11% of the total retail market. While most other European countries are further behind, online penetration is now approaching this 11% “threshold” in major core European markets — including France, Germany, and Sweden — and 2020 is set to be the crossing point.
There are already signs that momentum is slowing. Our estimates suggest that retail values in Europe, excluding the UK, fell by nearly 1% in 2019, compared to an average increase of 2% per year in the previous three years. On the occupier side, vacancy is edging upwards across all retail formats, including for units on previously sought-after prime in-town shopping streets.

Experience in the UK demonstrates that pricing is difficult in this environment. Uncertainty about what the physical retail market of the future will look like — and the durability of its cashflows — requires a higher risk premium today.

Across Europe, yields at the prime end are just about holding up, albeit based on much lower transaction volume, while average transaction yields are rising rapidly, up 75 basis points over the past year.

Opportunities will arise eventually. In the UK, retail vacancy has even started falling again, although this reflects a combination of stock withdrawals and sharp reductions in rents being charged to attract tenants, which are weighing heavily on NOI growth.

While countries like Italy and Spain have much lower online penetration and may offer some resilience in the near-term, the signs are that major European core markets will not be immune from the challenges facing the sector for too long.

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**Europe Trend 3: Apartment Volume Share Set to Level Off**

The apartment sector remains popular but recent growth may be curbed by headwinds including low yields and increased rent controls in major markets.

In recent years, interest in investing in apartments across Europe has grown significantly. The share of apartment demand in overall investment volume has risen from 12% in 2014 to 20% in 2019 (see exhibit EUR3).
INREV’s survey of investor preferences has consistently shown that a significant share of investors is targeting the residential sector. Not only does the sector offer a defensive income stream and diversification against holdings in other sectors, but a combination of favorable demand growth and constrained supply in major cities means it has been recording rental growth.

Based on the results from the INREV survey, which have closely tracked investment activity two years ahead during the current cycle, the apartment sector should continue to grow its share of activity in 2020. However, some headwinds are appearing, and the most recent survey showed a slight drop in investors targeting the sector, which is set to weigh on deal volume further out.

Investors are worried about low yields in the sector, a concern exacerbated by the prospect of rent controls being introduced in several markets. In such a scenario, overall returns would be damped as investors would not be able to easily capture market-level rent movements, and there would be pressure on yields to adjust upwards to compensate for the prospect of lower future income receipts.

The push for increased rent controls is notable in Germany, Europe’s largest apartment investment market, where rental growth has been elevated in major cities in recent years.

There are some signs that investors are responding. Germany is taking a lower share of the apartment market, while cross-border investors that have been broadly neutral on German residential through much of the cycle, became significant net sellers in 2019. However, pricing is holding up for now as domestic institutions, encouraged by negative yields on domestic government bonds, remain net buyers.

Elsewhere, other markets and segments are gaining share. Apartment investment volume outside Germany has doubled in the past five years, notably in Spain, where a number of large portfolio deals have occurred. France and the UK offer significant potential for growth in the sector in the coming years, while investors are also deploying more capital into operational asset types in the living sector, such as student and senior housing.
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