

EUROPEAN FORECAST & FAIR VALUE REPORT

Q1 2021

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ECONOMIC OVERVIEW

During Q1 2021, revisions to the economic outlook diverged for the Eurozone and the UK. The UK has experienced a severely restricted winter but with infection rates dropping during spring, an advanced vaccine rollout and the economy gradually re-opening, the growth outlook reached a better position. The Eurozone, on the other hand, was facing a third wave of infections with associated restrictions and a slower vaccine rollout which resulted in a downgrade to the growth prospects for 2021. Nonetheless, both the Eurozone and UK are expecting growth in 2021, at 3.8% and 4.8%, respectively.

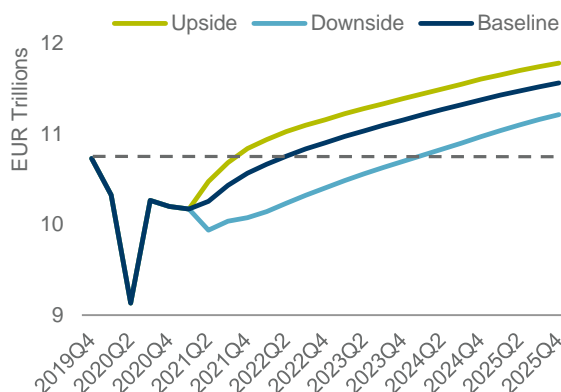
Economic output is forecast to reach pre-crisis levels in Q2 2022 for the Eurozone and Q3 2022 for the UK, one quarter earlier than expected 3 months ago. If the vaccine rollout continues to be delayed and/or more transmissible variants spread more persistently, then the recovery is delayed much further into 2023-24. Equally though, if the recent round of restrictions are more successful than expected and the vaccine rollout progresses quickly, then recovery could be as soon as Q4 2021 in the Eurozone and the UK (Figure 1).

The Eurozone economy is expected to grow on average by 2.9% p.a. over the 2021-2025 period, below the UK (3.5% p.a.). Growth in the region is varied with the CEE economies expecting growth of above 4.0% p.a. on average, while Finland, Russia, Denmark, Sweden and Netherlands are all likely to record growth of 2.0% p.a. or lower.

Labour markets recovered to a certain extent in H2 2020 as Covid-19 restrictions were relaxed (Figure 2), registering an increase in employment of 2.2 million jobs (0.9%). However, total employment fell by 4.2 million in Europe during 2020, reflecting a 1.7% fall. Most countries re-imposed restrictions during Spring 2021, which will make the recovery short lived and lead to further extensions of job retention schemes. Moody's Analytics estimates that office-using jobs contracted by 510,000 in 2020 (-1.1%). The impact by country has been varied with the largest falls being reported in Czech Republic, Ireland, Netherlands and Portugal, while Bulgaria, Finland, Poland and Slovakia have reported growth in 2020.

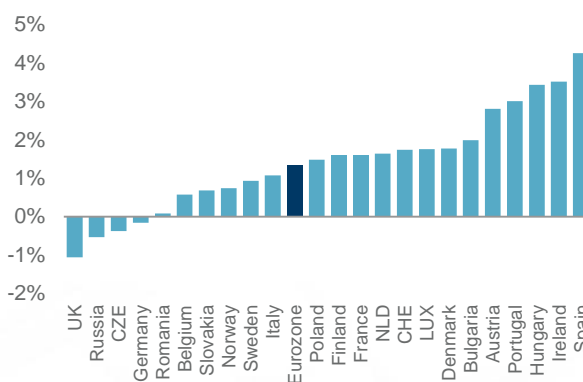
The ECB increased bond-buying via its pandemic emergency purchase program (PEPP) to €1.85 trillion in December and extended it to March 2022 or when the coronavirus crisis phase is over. The central bank believes that higher inflation is transitory, linked to energy price rises and a degree of economic normalisation. This suggests that the ECB will maintain the ultra-loose monetary policy environment, with the first base interest rate rise forecast to be in 2024-25 (Figure 3).

FIGURE 1: EUROZONE GDP SCENARIOS



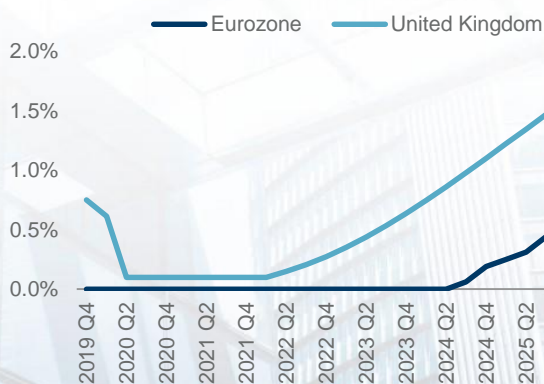
Source: Moody's Analytics, April 2021

FIGURE 2: H2 2020 TOTAL EMPLOYMENT GROWTH, %



Source: Moody's Analytics, April 2021

FIGURE 3: CENTRAL BANK INTEREST RATE



Source: Moody's Analytics, April 2021



OCCUPIER OVERVIEW

The latest quarterly data shows a re-emergence of prime rental growth for the European office sector, the first quarter of growth since the start of the pandemic. In Q1 2021, prime headline rents increased by 0.3% versus -0.5% for the previous quarter (Figure 4). Some caution is needed here though as only a handful of markets registered growth with the vast majority recording no movement. Increasing office vacancy rates are still being reported, particularly for tenant space, with many occupiers still holding off on decision-making.

The High Street retail sector continues to suffer albeit the rate of decline slowed to -1.3% in Q1 down, from -2.9% in Q4. Growth is unlikely to re-emerge before travel restrictions are lifted, quarantine rules are removed and workers begin returning to the office.

In contrast, the European logistics sector bounced back strongly last summer and continued that performance in Q1, although the European average has been significantly supported by the strong performance of the UK markets. The pandemic has turbo-charged demand, particularly for ecommerce occupiers, which is outstripping supply and creating upward pressure on rents. Prime headline rents for Europe grew by 1.0% in Q1.

Looking ahead, European all sector* prime rents are forecast to increase by 1.1% p.a. over the next five years, with logistics showing faster growth than office and retail (Figure 5). While Logistics' outlook was upgraded, retail's was downgraded in Q1. Logistics' prime rents are expected to grow by 2.1% p.a. over the 2021-25 period, office to remain stable at 1.1% p.a., while retail should post an average growth per year of 0.1%, driven by growth in the later years.

Structural shifts accelerated by Covid-19 will impact various geographies and asset qualities differently. High quality offices in core locations offering hybrid workspace and strong environmental standards will continue to perform well while retail destinations with the right size and mix of entertainment, amenity and shopping will recover as restrictions are lifted and travel returns.

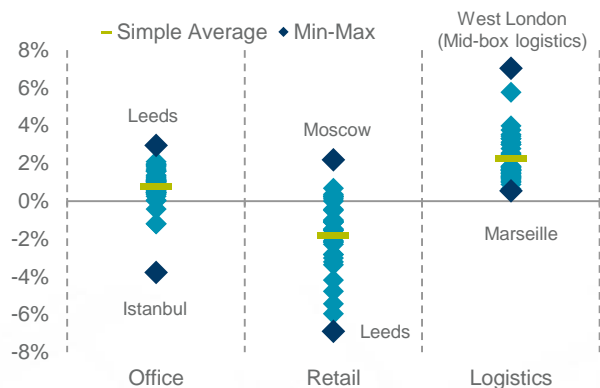
Our detailed city-level study on the impact of remote working for offices suggests that aggregate levels of take-up** (gross demand) will be c.15% lower by 2025 relative to pre-pandemic (Figure 6). However the market bifurcation becomes more evident when we look at vacancy rates for best quality space (Grade A or CBD) versus an average of all qualities of space (overall market). Grade A or CBD vacancy is set to be more resilient, with the spread widening to overall vacancy rates, peaking in 2021, before narrowing to the 2019 spread by 2025.

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

Sector	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021
Office	0.5%	-0.7%	0.0%	-0.5%	0.3%
Retail	-0.6%	-5.4%	-2.8%	-2.9%	-1.3%
Logistics	0.1%	0.2%	1.2%	1.5%	1.0%

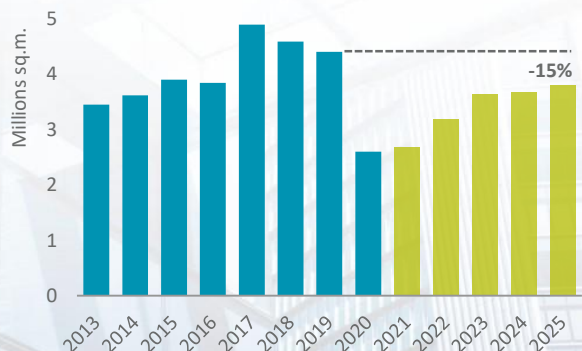
Source: Cushman & Wakefield

FIGURE 5: PRIME RENTAL GROWTH, AVG. 2021 – 2025 % P.A.



Source: Cushman & Wakefield

FIGURE 6: OFFICE TAKE UP*, INCLUDING REMOTE WORKING IMPACT



Source: Cushman & Wakefield



CAPITAL MARKET OVERVIEW

Commercial property investment across Europe was almost one-third down in the first quarter of 2021 compared with the same period 12 months ago. A resurgent viral infection brought renewed lockdown restrictions in Europe, affecting many of the largest countries.

A year on from the start of the pandemic and this is the last quarter where the year-over-year figures will look almost overwhelmingly negative, but it is also clear now that the effects from the pandemic are varied.

One of the most meaningful market dynamics through the first quarter was rising government bond yields. This is mostly due to concerns over rising inflation expectations, which led to a bond sell off, especially for longer dated bonds. However, the ECB believes that higher inflation is transitory and decided to increase the pace of purchases under the PEPP helping again to keep the cost of funding low. In Europe, the CEE markets have seen the stronger yield correction with an average of 70 basis points increase. On the other hand, the German 5-year bond yield increased from -0.74% to -0.62%. Italy's 5-year bond yield rose from -0.008% to 0.02%, reflecting some political uncertainty, while Spain's rose from -0.39% to -0.27% (Figure 7).

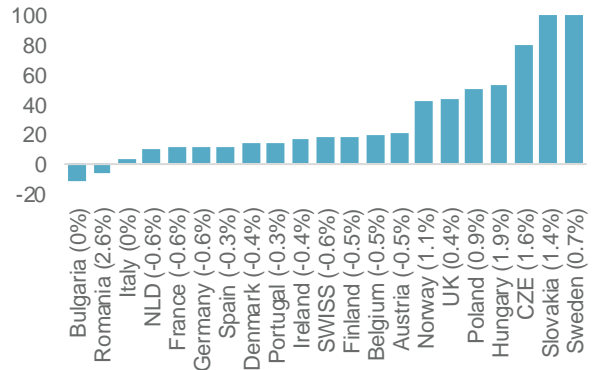
During the first quarter, the European investment market fell by 32% y-o-y in Q1 (RCA), with €53.3bn transacted during the quarter (Figure 8).

Many of Europe's largest markets recorded a relatively slow start to the year and transaction activity was down by more than 30% in Germany and France and by 13% in the U.K. On the other hand, the Danish market recorded the strongest quarter ever recorded for transaction volume, boosted by exceptionally strong demand from cross boarder investors for apartment properties.

Many of the largest institutional investors in European real estate are reorienting themselves away from office and retail and towards alternative sectors like apartments, food retail, student housing, senior living, data centres, R&D and medical offices.

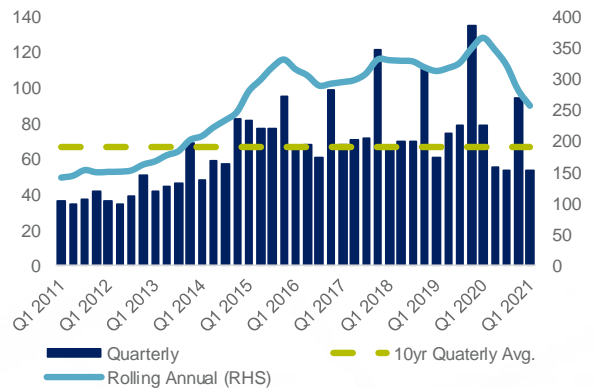
Despite the recent jump, bond yields remain at low levels on the back of ultra-loose monetary policy, supporting the relative attractiveness of real estate. Strong competition for office and logistics assets drove office and logistics yields down by an average of 17bps, while retail sector has seen yields correcting by 26bps (Figure 9). For this year we expect all property yields to stall, with retail yields rising further and office and logistics yields edging lower.

FIGURE 7: 5-YEAR BOND YIELDS BPS CHANGE, Q1 2021 VS Q4 2020



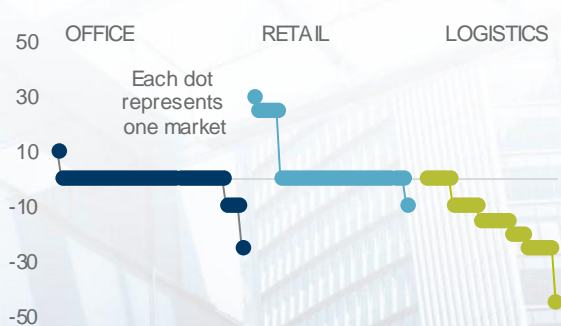
Source: Bloomberg

FIGURE 8: EUROPEAN INVESTMENT ACTIVITY, € BN



Source: RCA, April 2021

FIGURE 9: PRIME YIELD MOVEMENTS BPS, Q1 2021 VS Q4 2020



Source: Cushman & Wakefield



FAIR VALUE INDEX RESULTS

The all-sector European Fair Value Index score was 80 in Q1, mostly holding steady from the Q4 2020 figure of 81 (Figure 10), indicating that commercial property valuations remained still attractive on a relative adjusted basis.

Overall, our fair total return ended higher in Q1 for the 122 markets covered in our analysis. After a long period of falling bond yields across Europe, we have seen some levelling off this quarter mostly due to concerns over rising inflation expectations, which led to a bond sell off. Corporate bonds, despite making negative total returns as yields rose, outperformed government bonds. As a result, our illiquidity and risk premium ended lower, mitigating the increase in the fair total return driven by higher bond yields.

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 forecast total return improvement, compensating the increase in the fair total return component causing the index to remain broadly stable.

As a result, the majority of the 122 markets covered in the analysis are classified as underpriced (69%) followed by fairly priced (22%) and fully priced (9%).

Sector level data revealed that the most opportunities can still be found in the logistics sector rather than offices and retail. Valuations held steady for logistics and retail, while they deteriorated slightly for offices with a handful number of markets moving from underpriced to fairly priced classification. Geographically, markets classifications remained in line with previous quarter, with Germany, the UK, CEE and Benelux showing a greater share of under-priced markets (Figure 11).

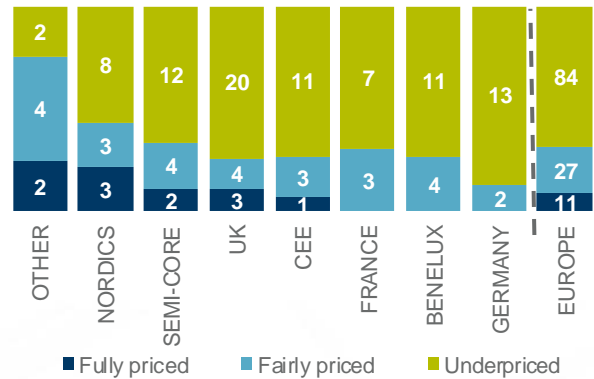
The most underpriced European markets in Q1 are the logistics markets of East and West London, Birmingham, Leeds and Manchester (Figure 12), experiencing the highest medium-term rental growth forecast and yield compression. Conversely, the top five most fully priced markets in Europe are the retail markets of Copenhagen, Oslo, London and Istanbul (offices and retail). A very high bond yield in Turkey has pushed fair returns for property to more than three times our forecast returns. While prime retail in London, Copenhagen and Oslo 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, Q1 2021



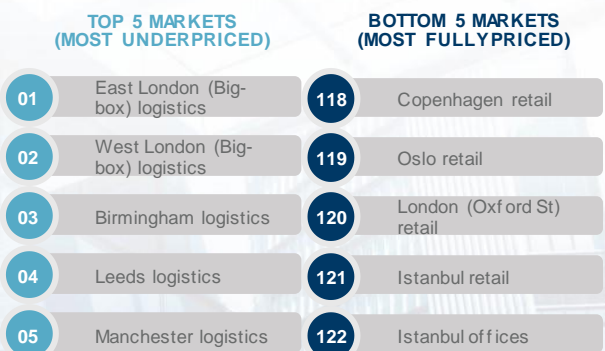
Source: Cushman & Wakefield

FIGURE 11: NUMBER OF MARKETS IN EACH FAIR VALUE CATEGORY BY REGION, Q1 2021



Source: Cushman & Wakefield

FIGURE 12: FIVE MOST UNDER/FULLY PRICED MARKETS IN EUROPE, Q1 2021



Source: Cushman & Wakefield



MARKET IN FOCUS

Ranked 5th overall in our Fair Value Index in Q1, Manchester Logistics is underpriced by 26.1% according to our analysis.

During Q1 2021 the outlook for the UK economy has improved. The UK has experienced a severely restricted winter but with infection rates dropping during Spring, an advanced vaccine rollout and the economy gradually re-opening, the growth outlook reached a better position. According to Moody's Analytics the UK is set to grow by 4.8% in 2021, with activity expected to return to pre-pandemic by Q3 2022. However, much will depend on infection rates and government policy.

The Greater Manchester and the North West logistics market in general continue to benefit from high levels of demand, particularly from ecommerce operators.

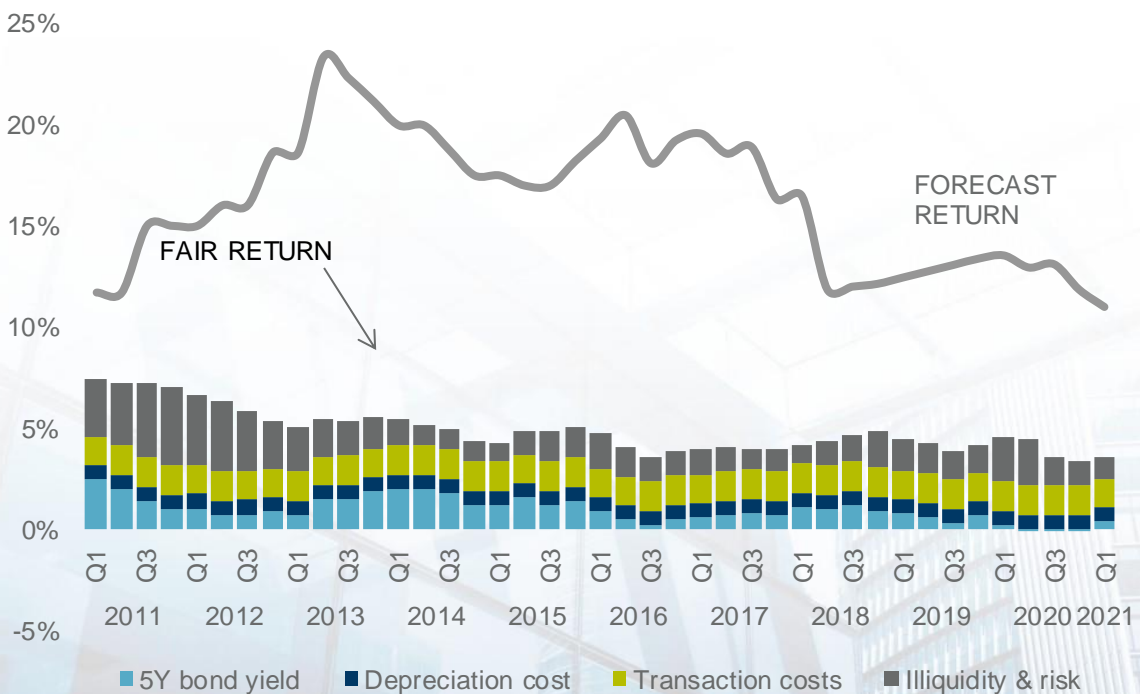
Q1 2021 take-up was the strongest on record for the quarter at 3.2 million sqft. Ecommerce and parcel delivery operators accounted for some 40% of take-up volume. Amazon and Manchester-based The Hut Group are some of the ecommerce companies that have expanded aggressively in the region lately.

Robust demand has curtailed supply by nearly 30% since the end of beginning of the first UK lockdown. As at end of Q1 availability stood at 7 million sqft, not too far off the record low levels seen in 2012 when the post-GFC freeze in speculative development coupled with a rebound in demand lead to a severe shortage of distribution space.

Developers are trying to fill in the gap between demand and supply but, at current rates of development, availability is likely to remain tight for the foreseeable future. As a result, we expect continued upward pressure on rents, especially in key locations.

The low bond yield and positive logistics return outlook maintained the degree of underpricing for Manchester in Q1. Our expectation is for yields to compress by 50 basis points to 4.0% in 2021, and to compress by a further 10 basis points in 2022, 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.11% p.a. over the next five years (Figure 13).

FIGURE 13: MANCHESTER LOGISTICS FAIR AND FORECAST RETURNS, 2021 Q1



Source: Cushman & Wakefield



HOT TOPIC – RISING INFLATION EXPECTATIONS: WHAT DOES IT MEAN FOR CRE?

Inflation expectations have risen recently due to commodity and energy price increases, spillover effects from the huge US fiscal stimulus package, predictions of surging consumer demand as restrictions are eased on the back of the vaccine rollout, and the potential for supply restrictions due to business failures/downsizing and sticky labour mobilisation.

Rising inflation expectations can partially be attributed to a normalisation of expectations in the economic outlook but there has also been concern that persistently higher inflation will lead to a tightening in monetary policy and rising interest rates. Our belief is that the fears of unanchored or persistently strong inflation appear overblown but sovereign bond yields have already moved higher in many European economies, while Moody's Analytics is forecasting a steady rise in the 10-year rate over the next 5-years, which would return bonds to their 2014-15 levels by 2025.

Historically, property performance has been more sensitive to the economic demand environment than to inflation, despite many leases being linked to inflation. Over the longer term inflation adjusted property returns tend to be positive, suggesting that property keeps up with inflation, albeit returns are sticky to price changes in the short term. Similarly, when we analyse property yield movement versus government bond yield movement we see a delayed reaction at turning points, suggesting a lag between any change in the risk free rate and property pricing.

As such, any future increase in inflation and government bonds will eventually lead to a rise in property yields, but this will not occur concurrently, particularly in an environment where the economy is expanding, jobs are being created and rents are growing, as these are important determinants of future property performance and therefore it's pricing. Thus, we expect prime yields to edge down further for office and logistics over the coming years, resulting in a narrowing yield gap between prime yields and 10-year government bonds (Figure 14).

FIGURE 14: YIELD GAP BPS BY SECTOR AND YEAR, 2001 - 2025



Source: Cushman & Wakefield; Moody's Analytics, April 2021

SUMMARY



- The European Fair Value Index score was 80 in Q1, mostly holding steady from the Q4 2020 figure of 81, indicating that commercial real estate valuations remained still supportive on a relative adjusted basis.
- Overall, our fair total return ended higher in Q1 for the 122 markets covered in our analysis. One of the most meaningful market dynamics through the first quarter had been rising government bond yields. As the economic recovery has continued to gain momentum, appetite for safe-haven assets has moderated. Moreover, rising inflation expectations led to a bond sell-off, especially for longer dated bonds. Corporate bonds, despite generating negative total returns due to yield expansion, outperformed government bonds. As a result, our illiquidity and risk premium ended lower.
- 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 forecast total return improvement, compensating the increase in the fair total return component causing the index to remain broadly stable.
- The ECB increased bond-buying via its pandemic emergency purchase program (PEPP) to €1.85 trillion in December and extended it to March 2022 or when the coronavirus crisis phase is over. The ECB believes that higher inflation is transitory, linked to energy price rises and a degree of economic normalisation. This suggests that the ECB will maintain the ultra-loose monetary policy environment for an extended period, with the first base interest rate rise forecast to be in 2024-25. 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. Therefore, as the investment transaction market recovers it's likely that yields will continue their gradual path lower, albeit following a shallower slope than between 2012-18.
- As a result, the majority of the 122 markets covered in the analysis are classified as underpriced (69%) followed by fairly priced (22%) and fully priced (9%). Sector level data revealed that the most opportunities can still be found in the logistics sector rather than offices and retail. Valuations held steady for logistics and retail, while they deteriorate slightly for offices with a handful number of markets moving from underpriced to fairly priced classification. Geographically, markets classifications remained in line with previous quarter, with Germany, the UK, CEE and Benelux showing a greater share of under-priced markets.

EUROPEAN OFFICE MARKET FAIR VALUE CLASSIFICATIONS, Q1 2021



Source: Cushman & Wakefield

About the Report

This report was written by Mark Unsworth, Riccardo Pizzuti and Guilherme Neves in the EMEA Research Insight team.

The report has been prepared using Cushman & Wakefield historical and forecasting data, Moody's Analytics, Bloomberg and Real Capital Analytics (RCA) as at Q1 2021.

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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