UBS

August 2016

Eurozone Real Estate Outlook.

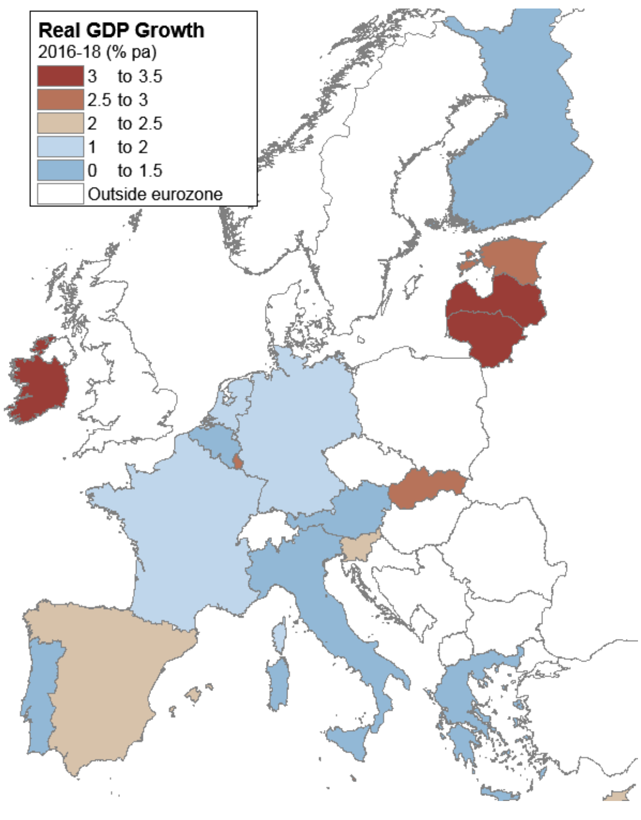
2H16

Economic environment & expected occupier demand

The slowdown in China and other emerging markets viewed in conjunction with the uncertainties surrounding Brexit, has led to a downward revision of economic growth prospects in the eurozone. However, the threat of contagion appears limited for now. Domestic demand in the eurozone has expanded at a healthy rate so far in 2016, and the recovery has broadened away from household spending. While Brexit could be a shock that brings the current self-sustained recovery to halt, it seems to be far too soon to assume that this is inevitable. Overall, GDP growth forecasts have been revised downward by ca. 20 bps for 2017 and 2018. Brexit, the continuing rise of populist parties across continental Europe and geopolitical threats at Europe's doorsteps (Russia, Ukraine, Turkey) all pose significant threats to the underlying progress of the eurozone economy.

The economic recovery in the eurozone is still fragile, and monetary policy set by the European Central Bank (ECB) will reach its limits should national policies not follow suit.

Eurozone GDP growth forecasts 2016-18



Source: Oxford economics, MapInfo August 2016

The improving domestic economy supports the labor market in most eurozone markets. For 2016 total employment is forecast to grow by 1.2%, but is expected to moderate in 2018 to 0.7%. The slowdown is likely to come from Germany, which is moving towards full employment and would need support from immigration, something which is politically very difficult currently. Labor market reforms in southern eurozone markets are likely to contribute positively to job growth; however, in the case of Spain, the strong recovery phase is expected to moderate as well. While overall unemployment remains high in many markets, it is now on a downward trend. Furthermore, there are tightening sectors in the labor market, which are starting to place upward pressure on wages. Inflation expectations remain low (2016: 0.3%) and should support rising disposable incomes, which consumers are feeding back into the economy in the form of very strong retail sales (2016: 2.0%).

The more domestically-driven recovery is starting to have positive implications for eurozone occupier markets, and we expect occupier demand to continue to improve across the main markets. At this stage however, the recovery has been primarily focused in central business and dominant retail locations, and targeted towards better quality commercial real estate. And while the pace of growth is encouraging compared to more recent times, it is not forecast to reach a level which can drive positive net absorption in poorer quality space and less established locations.

In the majority of the eurozone office markets, improving employment growth pushed office take-up upwards over the first half year of 2016. Some of the sharpest increases were recorded in the eurozone financial centers of Amsterdam, Frankfurt and Paris. Milan also recorded a strong increase in office take-up of above 20% compared to the first six months of 2015. After a very strong year, the Spanish markets of Madrid and Barcelona experienced a stabilization of office demand. With employment growth in the eurozone set to maintain its pace of around 1.2% in 2016, we would expect another relatively strong year of take-up. Even though employment growth is expected to moderate next year. we believe that office demand is likely to be above the long-term average in 2017. However, employment growth is expected to vary significantly between regions. Employment in Brussels and Paris is forecast to grow only by 0.4% to 1%. After two strong years job growth in the Spanish centers Barcelona and Madrid may moderate but should still see growth of 1.4% to 1.8% in 2017. Also the major German office markets are likely to see another year of strong employment growth of above 1%. The implemented labor market reforms in Italy will eventually pay off, and employment growth in Milan is expected to grow by 1.3% supporting office occupier demand in 2017.

The rise in disposable income, triggered by the drop in inflation, has given a substantial boost to private consumer spending in the eurozone, which rose to its highest level since 2007 in 2015 (1.7%). Continuing low inflation provides additional support for rising real salaries and translates into robust retail sales growth for the next three years of close to 1.4% p.a. Despite the positive economic environment for retailers, retailer demand continues to be heavily polarized between the dominant high street locations and shopping centres, and tertiary retail destinations, are suffering disproportionately from the growth in online retailing. Going forward, retailers will typically require fewer stores to achieve nationwide coverage and focus on larger floorspace to show their full product range. This development could lead to a sharp reduction in demand for retail units in secondary retail destinations and smaller towns and cities as retailers focus on shopping destinations with the highest footfall and turnover.

A challenge for retail is an opportunity for the logistics sector, which could benefit from the growth in online retailing. Economies of scale and supply chain optimization on the back of strong M&A activity have been key drivers of very large scale logistics take-up, which has boosted the overall figures. On the smaller end of the scale, logistics hubs around big cities are also recording strong demand for units to service the final distribution process, to either the physical store or home delivery address. On the other hand, lower growth of manufacturing and export activities in many eurozone markets limits occupier demand from the business-to-business logistic sector.

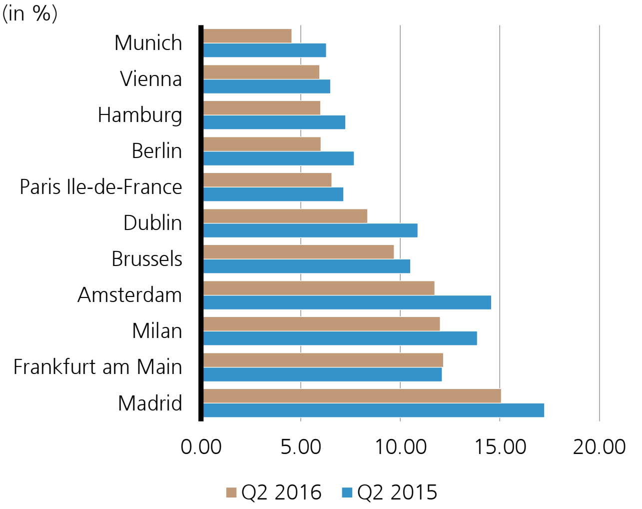
Supply

Improving occupier demand has pushed vacancy levels across eurozone downward. The aggregate EU15 office vacancy rate fell by 0.34 percentage points over the first half of 2015, and at 9.1% is at its lowest level since the Global Financial Crisis (GFC). Some of the sharpest declines were recorded in southern European markets including Milan, Madrid and Barcelona, but also in the German markets of Berlin, Hamburg and Munich.

Despite the overall positive trend, there continues to be significant polarization based on quality and location of stock. While absorption of space has started to be positive in most central sub-markets, many eurozone office markets continue to suffer from an oversupply of office space in peripheral sub-markets, particularly those which have poor public transport connections to central and surrounding areas. Consequently, overall vacancy rates in these areas remain high, and even markets which have seen a strong recovery in demand for the last two years are still seeing high vacancy rates in peripheral sub-markets.

Office vacancy rates 2Q15 and 2Q16

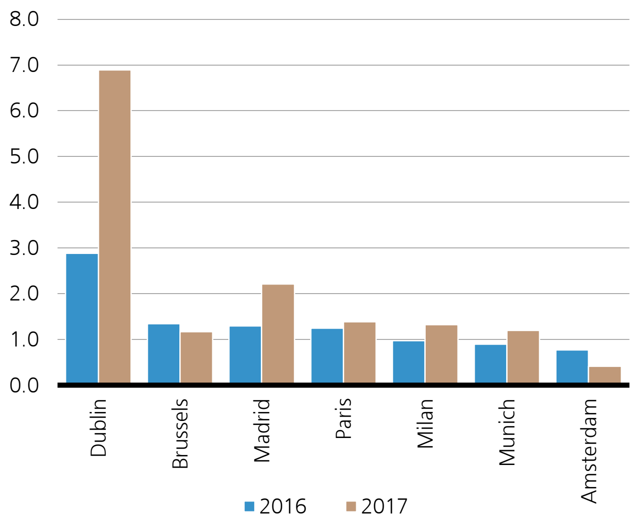
(in %)



Source: CBRE, Erix 2Q16

So far, increasing occupier demand and declining vacancy have not lead to significant development activity in most eurozone markets. Expected office development completions are expected to increase only slightly in 2017, which should move established office locations to an even more undersupplied situation and should support rental growth. The biggest exception is Dublin which is in a development cycle. However, the Irish capital may benefit from any company movements from the UK due to Brexit and could move the market fairly easily back to undersupply.

Expected office completions as % of total office stock



Source: CBRE, Erix 2Q16

The low availability of office space in city centres has led to a strong divergence between prime office rental values and the IPD average rental growth for eurozone offices. While prime office rents in the eurozone increased by 1.8% in 2015, average office rents experienced only a moderate growth by 0.5%. During the first six months of 2016 prime office recorded continued growth of 1.3% while UBS Asset Management, Global Real Estate forecasts are anticipating a rental growth of ca. 0.7% for the whole year. While we expect the eurozone average rent profile to gather further momentum, this will primarily be off the back of well-performing, good quality space, while secondary grade space in less established locations will continue to affect overall performance. As the pace of economic growth is not forecast to drive a recovery in demand in peripheral areas, a significant amount of current vacant space may become redundant in its current form.

The structural changes in retailer demand have accentuated the polarization in the retail sector between good quality, well located stock and secondary stock. While non-dominant retail locations are experiencing a consolidation of networks, there continues to be strong competition for the very few available units on prime eurozone high streets, and this is driving prime rental growth. But while the prime retail segment has seen the strongest rental growth of all property sectors, secondary and tertiary retail locations continue to suffer from much higher vacancy levels, which is in turn subduing any capacity for rental growth. Even though construction activity has come down recently, the changing dynamics in the retail market may lead to a situation that a reasonable proportion of retail space across Europe will be deemed surplus to requirements in its current form.

Since the beginning of the GFC, the eurozone logistic sector has hardly seen any speculative development. Due to positive occupier demand dynamics vacancy rates for industrial property have maintained a downward trend. Even though the development pipeline has expanded further during 2016, this has largely been fuelled by bespoke projects. Logistics operators continue to seek supply chain optimisation through a reconfiguring and upgrading of their network capacity to accommodate the growth in cargo volumes and remain competitive on cost in a very low margin industry. In this low margin business there is only limited potential for rental growth, despite the positive supply-demand dynamics. By the end of 2Q16, CBRE's eurozone prime industrial rent index was still more than 4% below its previous peak in 2008. Low growth in the prime logistic segment also restricts the forecast for average ERV growth, which is expected to be over the next three years on average of 0.6% p.a. However, as with the retail and office sectors, prime industrial space is expected to see stronger than average growth, particularly in locations surrounding key urban conurbations.

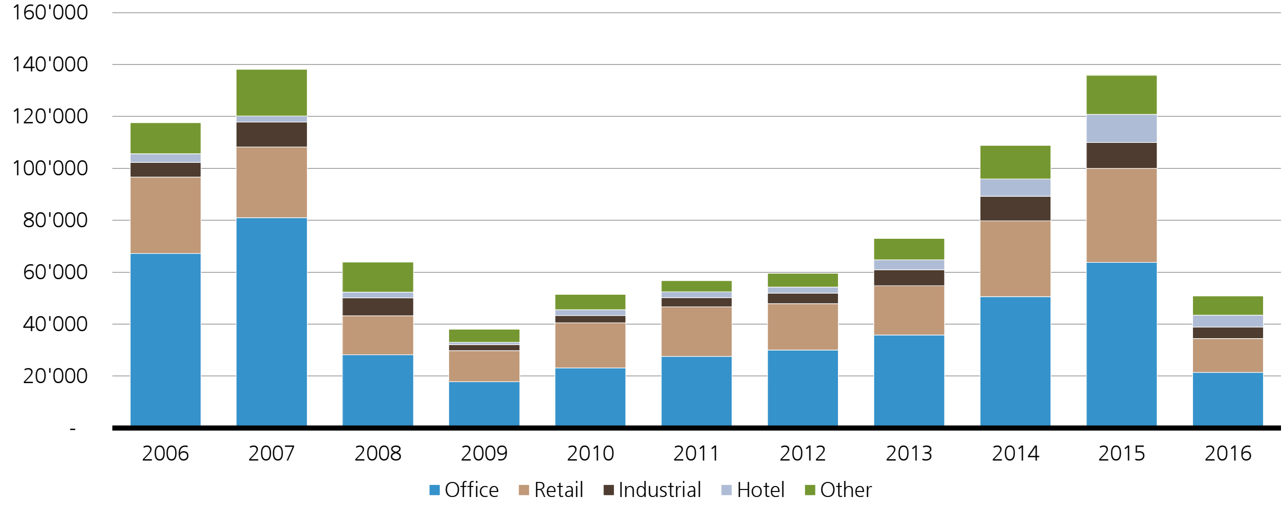
Capital flows

The pace of recovery in the investment market in the eurozone has outpaced that of the occupier market during the last years. The ECB's monetary policy has not only been supporting the eurozone's economic recovery but is encouraging eurozone investors to look for alternative investments to government bonds. The introduction of negative deposit rates and acceleration of quantitative easing measures has increased the pressure on investors even further. However, investment volumes declined by almost 10% in the eurozone to ca. EUR 50 billion. However, this decline in investment volumes was not evenly spread across the eurozone. In Germany, lack of investment product and not lack of investor's interest in eurozone's largest economy has pushed investment volumes down by almost 20% during the first half of the year. Following a slow start in to 2016, France recorded an 8% increase in investment volumes by mid-year. Even though investor demand from outside the region has become slightly more cautious since the UK's EU Referendum, investor demand from within the eurozone is as strong as in the previous years.

Reflecting the weight of capital targeting European assets, prime yields have continued to contract across eurozone markets. In most markets prime yields have now fallen below, or are very close to, record low levels. Continuing monetary easing policies may lead to even more yield contraction even though we believe that we are reaching the peak of pricing in this cycle. The lower for longer outlook for central bank interest rates means that the attractive spread between European government bonds and real estate will be maintained for at least the next 12 months, extending the period of capital growth well in to 2017.

Eurozone investment volumes

(EUR '000)



Source: CBRE, Erix 2Q16

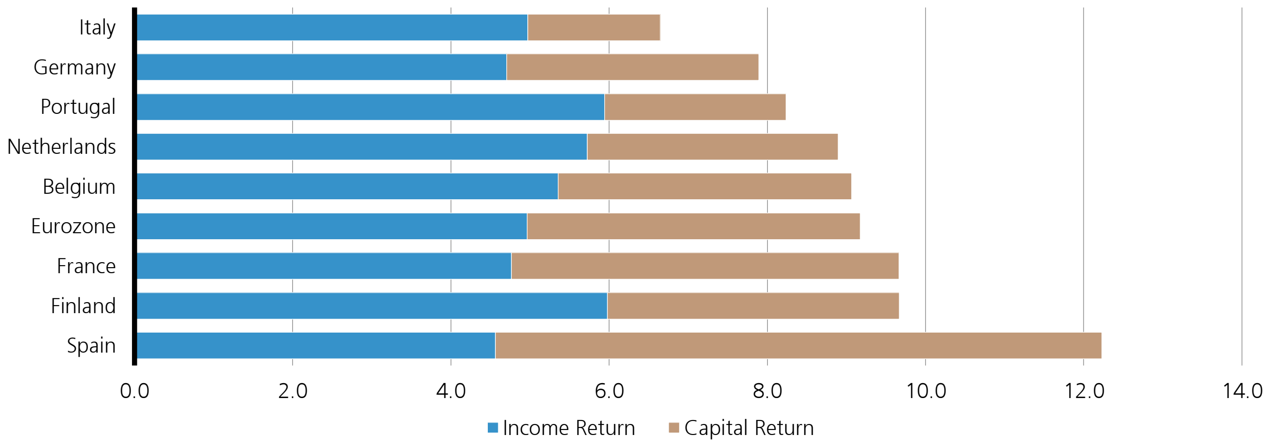
Outlook

Over the next three years, we expect a total return of eurozone all commercial real estate of ca. 9% p.a. This forecast is stronger than our expectations six months ago, as we are now expecting to see some stronger capital growth continuing into 2017 driven by further yield compression in the low interest rate environment which continues to inflate asset prices. With fixed income returns likely to remain lower for even longer than previously anticipated, we may not get any upward pressure on property yields from rising bond yields until the very end of the forecast period, if not later. However the small deterioration in the outlook for economic growth in the eurozone has resulted in a slight downgrade to rental growth expectations. The industrial sector remains the strongest performer, but is now followed by the office sector and then retail.

Over the next three years, Spain is expected to be the strongest performer by some distance, with the market still seeing some strong rental growth recovery while the income return component remains comparatively high. France and Finland are also expected to see above average returns supported by strong front-loaded capital growth rather than any particularly positive dynamics on the rental growth side. .

Total return forecast 2016-18

(% annual average)

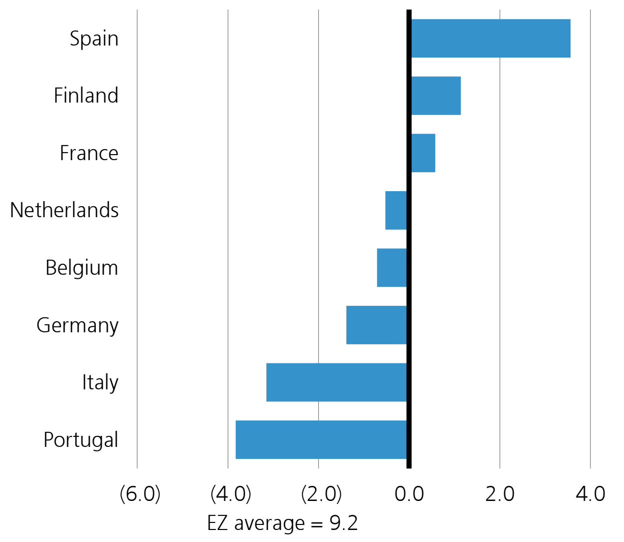


Source: UBS Asset Management, Global Real Estate, August 2016

Office
Over the next three years the Spain, Finland and France office markets are expected to outperform the eurozone average. The weaker economic outlook has generally meant downward revisions to rental growth expectations; however, office yields will continue to be supported by a lower for longer interest rate environment which is continuing to inflate asset values and particularly those with long-term secured income.

Even with a slightly weaker demand, outlook we still expect positive rental growth to come through with nearly all the eurozone markets expected to see rental growth turn positive in 2016 and some moderate acceleration into 2017. Positive rental growth is being supported on the supply side by an absence of any significant speculative development across the majority of key western European office markets. Availability of good quality space in central locations is already constrained in many markets, which is generating positive momentum for prime rental growth. However, with availability of secondary grade space in non-central areas generally remaining much higher, the polarization in performance between the different segments is set to continue. The weak outlook for secondary locations in most of the eurozone is holding back the capacity for stronger overall rental growth in the short term. The structurally low levels of economic growth, which are expected going forward are not anticipated to deliver sufficient jobs creation to drive positive net absorption outside of the better locations over our forecast period.

Relative peformance of office markets against the eurozone average 2016-18

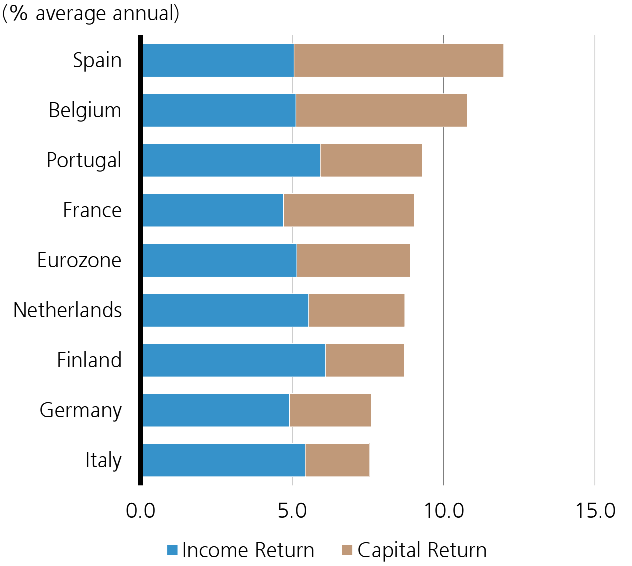


Source: UBS Asset Management, Global Real Estate, August 2016

Retail
Over the 2016-18 period, we expect retail in Spain, Belgium and Portugal to outperform the eurozone average while Netherlands, Finland, Germany and Italy are forecast to underperform due to lower capital growth prospects.

The retail sector in the eurozone has been undergoing significant structural change in recent years, and this is expected to continue in the short-to-medium term. The development of online retailing is continuing at pace, particularly in northern Europe and this is starting to negatively impact smaller city centers via reduced levels of demand and increased vacancy. Total retail sales have grown strongly across the eurozone in recent years but in-store retail sales have started to fall, particularly in Germany where online retailing is well developed and to a lesser extent in France, Netherlands and Sweden. Secondary towns and pitches are the most affected and this represents a key risk to real estate investors in the retail sector. The southern eurozone countries of Spain, Portugal and Italy are less affected but not immune to this trend, and it is likely that there will be a delayed response due to the relative immature nature of online retail in these countries at present. Therefore, retail centre dominance within its catchment area will be vital to outperformance within the retail segments. While keeping an eye on the supply-demand balance in established retail locations will also help to identify asset management opportunities of well located, dated retail stock suitable for repositioning.

Retail total return forecast 2016-18
(% average annual)



Source: UBS Asset Management, Global Real Estate, August 2016

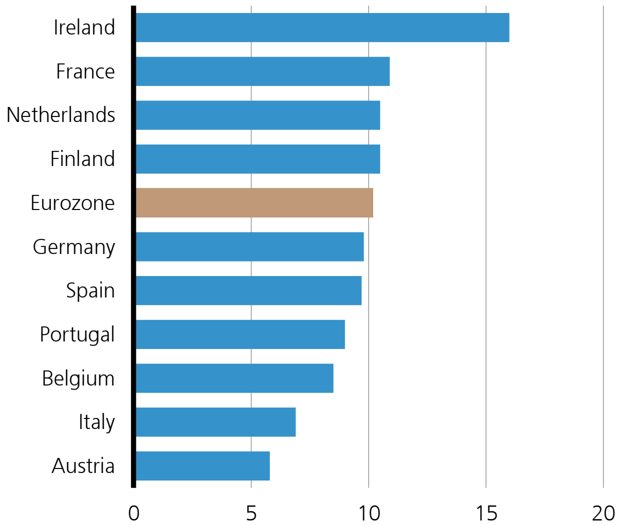
Industrial/Logistics

Over the 2016-18 period we expect Ireland, France, the Netherlands and Finland to outperform the eurozone average with the weakest relative performance expected to come in Austria and Italy. Front loaded capital returns are expected to support total returns in 2016 and 2017 while rental growth is likely to remain muted on a national level.

E-retailing has been a major factor in eurozone logistics in recent years. However, a major part of the eurozone's logistic industry is manufacturing related and thus business-to-business (BtoB), not business-to-consumer (BtoC). BtoB logistics chose locations close to assembly lines, often not in densely built-up areas. Land availability for BtoB operations is less scarce than for a BtoC operation, which requires proximity to the end consumer. Consequently, BtoB logistics offer less rental growth opportunities than BtoC. With a slightly weaker outlook for manufacturing and exports real estate, investment in BtoB logistics relies mostly on the current income return with relatively low potential for income growth. With yields at historic low levels and low rental growth prospects in the BtoB segment, this real estate sub-segment may have a higher exposure to outward yield movements once the ultra-low bond rate environment comes to an end.

Industrial/logistics total returns forecasts 2016-18

(% average annual)



Source: UBS Asset Management, Global Real Estate, February 2016

Viewpoint

The Italian banking sector is seen as one of the weakest in the eurozone, with the European Banking Authority reporting a Tier 1 ratio of 12% and a Return of Equity (RoE) 3.3% in their 1Q16 Risk Dashboard. Since the beginning of the GFC, Non-Performing Loans (NPL) have risen in Italy, with solvencies of Italian banks attracting investor attention with an NPL ratio of more than 16% (equivalent to more than EUR 320 billion in total), which is well above the European average of 5.7%. Circa 9% of NPL volumes are in the retail residential sector, while more than 80% are in the corporate sector. Real estate comes in to play because approximately half of corporate and retail NPLs are collatorized by real assets, and particularly by real estate.

On the face of it, this seems to be a concern but even if greater details of underlying asset characteristics are currently not available, most of the real estate is likely outside the institutional investment universe in manufacturing facilities of small and medium sized companies or residential developments in provincial cities. Therefore, direct contagion risk to institutional commercial real estate might be limited. However, we believe that sentiment towards the Italian real estate market may suffer, and the ability to secure financing might become even more restrictive. While in other European markets, loan-to-value (LTV) ratios of 60-70% for core assets are achievable, in Italy it is barely possible to get above 50%. Financing outside the core real estate segment is even more restrictive to hardly existent. Domestic institutional investors, such as pension funds and insurance companies, are traditionally used to low LTV (rarely above 30%), thus the banks' deleveraging is not having significant impacts on their real estate investment strategies.

There are undeniably serious issues with the Italian banking sector. A weaker economic environment will influence occupier demand negatively, with supply and development activity in the core segment remaining constrained. Thus the rental growth outlook may weaken but not deteriorate as real estate market fundamentals, in particular future supply, are in balance. Should the situation in the Italian banking sector worsen, the consequences are likely to be felt mostly outside the institutional real estate segment. Uncertainties may lead to a pausing of the Italian investment market and may even place some limited pressure on capital values in the core real estate segment. On a positive side, however, this may even create opportunities for equity rich investors or alternative lenders.

Real Estate Research & Strategy Team – Europe

Gunnar Herm
Zachary Gauge
Melanie Brown
Sean Rymell

For more information please contact

UBS Asset Management
Global Real Estate Research
Gunnar Herm
Tel. +49-69-1369 5317
gunnar.herm@ubs.com

www.ubs.com/realestate

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