UBS

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European Real Estate Summary.

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Despite uncertainties, occupational demand continues to strengthen.

Shortage of good quality CRE for occupation is driving prime rental growth.

Sharp slowdown in UK investment activity while rest of Europe sees a bounce-back on 1Q.

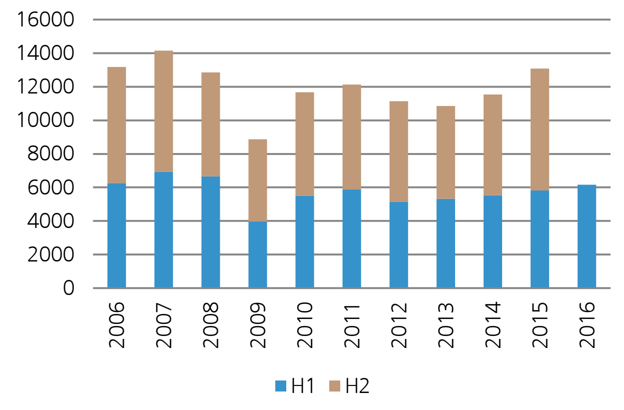
Market fundamentals remain strong but geopolitical risks are accentuated.

Demand

The potential consequences of the Brexit vote have dominated economic commentary in the aftermath of the historic decision. It is too early to assess the full implications for both the UK and Europe, although economic commentators unanimously expect that there will be negative short-term impacts on growth stemming from heightened uncertainty. The impact will be primarily felt in the UK, where under a soft Brexit scenario, between 0.5-1 percentage point (p.p.) is expected to be lost from GDP in 2017, but ultimately avoiding a recession. For the eurozone only circa 0.1-0.2 p.p. has been trimmed of the expected growth level as a direct consequence of the vote to exit.

Prior to the Brexit vote the eurozone economy was continuing to gather momentum, driven by further strengthening of the domestic economy. Employment has been growing at a steady rate of 1-1.4% since the second half of 2015, supported in part by a continual improvement in lending conditions which has encouraged corporate expansion. Excluding London, the quarterly aggregate take-up for European markets reached the highest 2Q level since 2007, and a 10% increase on the volume of transactions completed in 1Q. In London, occupational demand was impacted by uncertainty in the run-up to the referendum, with take-up falling to the lowest level since 2012.

Aggregate European office take-up volumes (including Central London)

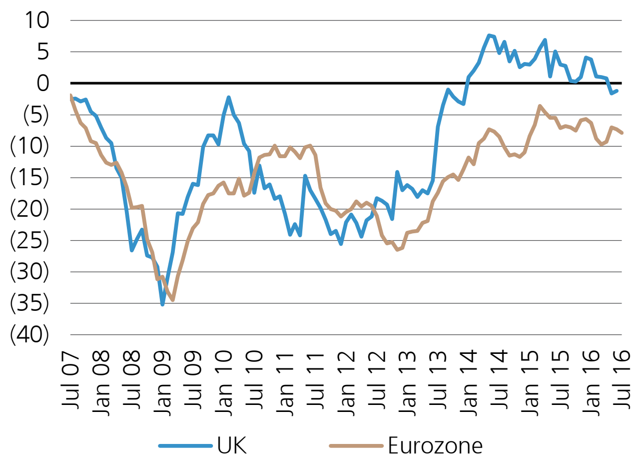


Source: JLL 2Q16

Consumer confidence in the eurozone trended down during June and July after a brief respite in the spring due to improvements in employment expectations. Confidence stands at -7.9 in July, down from -6.3 in January, although it did improve strongly during 2Q in Germany (+4.6), France (+4.5) and the Netherlands (+10.1) and to a lesser extent in Spain (+2.7). By contrast, confidence worsened markedly in Italy (-5.7). Similarly, consumers in the UK were also more downbeat during 2Q, linked to the uncertainty surrounding the EU Referendum result. The confidence indicator balance worsened in the UK (-2.2) during 2Q.

Retailer confidence also corrected during 2Q as a result of negative developments in recent business activity. From a country perspective, confidence worsened markedly in Italy (-9.0) and the UK (-13.4) and less so Spain (-1.5) and the Netherlands (-1.0). By contrast, confidence improved marginally in Germany (+0.6) and France (+0.7). Despite the reduction in consumer and retailer confidence during the quarter, retail sales volumes held up relatively well. However, there are concerns over the direction of future retail sales in the UK for the rest of the year. Further falls in consumer and retailer confidence are likely to impact retail sales volumes.

Consumer confidence - Outlook next 12 months (Balance – SA)



Source: Datastream, DG ECFIN

While it is clear that future occupational demand in the UK will be impacted to some extent by the Brexit vote, the impact on the wider European occupational market is less clear. Although the economic forecasts suggest the direct impact on the European markets may remain fairly limited, or even provide a boost to other competing financial markets, the event itself has accentuated the geopolitical risks and uncertainties hanging over European markets. Data for the end of 2Q16 suggests that the heightened uncertainty hasn't yet slowed the momentum in real estate markets; however, already in 3Q there has been several atrocities in France and Germany, an unsuccessful military uprising in Turkey, while although unrelated, the emergence of fundamental weaknesses within the Italian sector serves as a reminder that some countries are still struggling with the legacy from the financial crisis nearly a decade ago. These events in addition to the Brexit vote and subsequent negotiations have the potential to give further momentum to the rise of populist movements, which were already established across Europe. And with general elections in France, Germany and the Netherlands on the horizon in 2017, we have to highlight that while domestic market fundamentals generally remain supportive of real estate, the downside political risks have again accelerated.

Supply

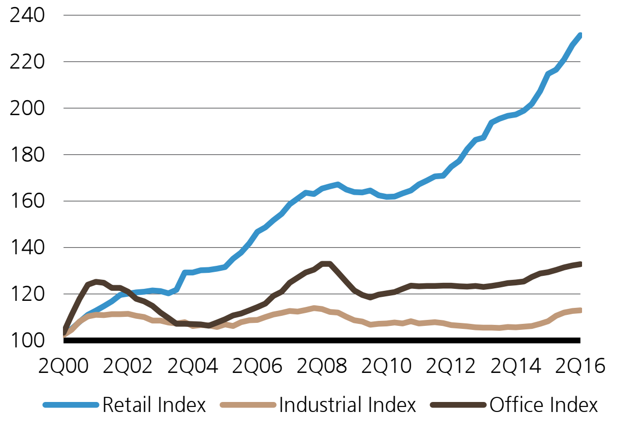
As occupier demand for office space in Europe has improved, the overall vacancy rate has been edging down from its peak of 10.3% in 2010, and now stands at 8.6% after falling by a further 0.1 p.p in 2Q16. However, some key markets recorded an increase in vacancy during the quarter, including London where the vacancy rate increased by 0.3 p.p, as the referendum-driven slowdown in demand coincided with the completion of a significant amount of new space, a trend we expect to continue for the next 18 months. The regional UK markets, however, generally saw vacancies come down as they have a much smaller supply pipeline coming through to the market. Other notable increases in vacancies were recorded in Milan (0.5 p.p), Rome (0.4 p.p.), Frankfurt (0.4 p.p.) and Stockholm (0.3 p.p.). Most of the other key markets continued to see vacancy levels reduce gradually, with particularly strong reductions coming through in Barcelona (-0.6 p.p), Munich (-0.5 p.p) and Amsterdam and Brussels (-0.3 p.p).

Despite the improved outlook for occupier demand, development activity remains constrained in most European markets. Total space under construction as a percentage of total stock stood at 3.6% at 2Q16, well below the 6% plus levels which were typical prior to the financial crisis. Furthermore, much of the space under construction in the current development cycle is pre-let, or contains a significant pre-let component, reflecting the restricted access to finance for purely speculative schemes. Much of the space under construction in Europe is focused in London, where it accounts for 7% of the total stock and in some CEE markets, in particular Warsaw and Moscow. In core western European markets development levels are typically around or below 2% of stock, even in markets such as Munich where vacancy levels are at historic lows.

This is contributing to a continuing polarization of available space in CBD and CBD fringe sub-markets, which are now in many cases under-supplied. Peripheral sub-markets are also still suffering from high vacancy rates left over from the previous cycle in combination with a weakness in occupier demand for this type of office space. Structural oversupply in these areas is maintaining overall vacancy rates at a high level, and even markets which have seen a strong recovery in demand are still seeing vacancy rates in some peripheral sub-markets at above 20%.

Conversely, due to the lack of new supply in central locations, we are continuing to see positive rental growth coming through in the prime segment of the market. The Weighted Average EU-15 Office Market Rent Index rose by 0.4% in 2Q, taking annual growth to 2.7%. While this is unexceptional growth compared to previous recovery periods, it is nonetheless encouraging that rents are moving in an upward trajectory after several years of stagnation and decline. With a limited speculative development pipeline, most markets should continue to see an improvement in rental levels for high-quality, well-located office space. The outlook for secondary property, particularly assets in challenged locations, remains weak in most markets.

Prime rent index (1Q00 = 100)



Source: CBRE 2Q16

In the retail sector, prime supply is restricted in major cities across Europe as demand remains robust from global retailers focused on big cities and dominant shopping centers. Luxury retailers are also an important feature of demand for prime retail markets, particularly in major tourist destinations across Europe; however, value/discount retailers are becoming increasingly prominent, albeit away from the prime pitch in more cost effective secondary space. Food and beverage retailers are also forming a greater proportion of demand in major cities and are shaping European high streets, especially those with large tourist populations.

As a direct result of strong demand for prime space, prime rents in major European retail markets have grown this year. Rome and Milan recorded substantial increases in rents during the first quarter, with rents now 23% and 16% higher than at the start of the year. Rome benefited from most new market entrants and Milan from increased visitor numbers.

Capital Markets

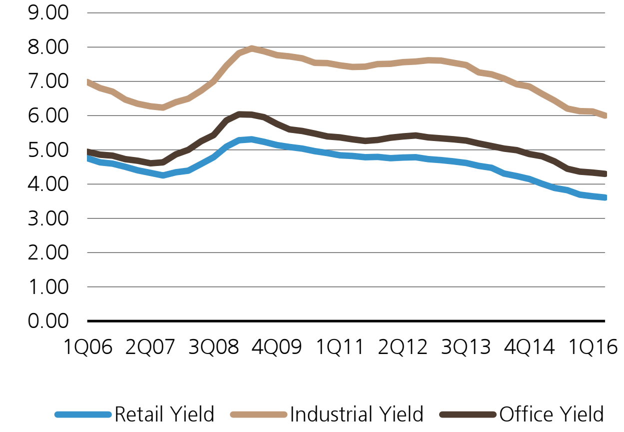
The outcome of the Brexit vote came as a surprise to a market which had already experienced a relatively fraught first six months of the year, with concerns about pricing, financial market volatility, geopolitical risks and an emerging market slowdown. As with the occupational side, it is too early to fully quantify the impact, although preliminary evidence suggests assets in London are trading at a discount due to the heightened risk. Nonetheless the majority of UK institutions are currently bidding their time, and the only market evidence has come from the small pool retail funds with daily dealing liquidity requirements, and which have had to rapidly sell some assets in order to meet redemptions.

Up until the referendum result itself, sentiment in Europe had been cautious but broadly positive. Overall transaction volumes in the second quarter more or less matched those of the first, bringing the half-year total to circa EUR 107 billion – down on the exceptionally high levels reached in 2015 but comfortably above the long-term average. Most markets saw activity increasing in the second quarter, but the 2Q volume was held back by a slow quarter in the UK where volumes declined in the UK by about 45% compared with the same period last year, reflecting both uncertainty due to the referendum and the UK's relatively advanced position in its cycle. Accordingly, CBRE yields on London City offices, as well as in a selection of regional office, industrial and retail markets, have provisionally moved out by 25 bps to 4.25%.

Although the UK is the only western European market now experiencing outward yield movement, we are starting to see yield compression ease in both the prime office and retail sectors. In both of these sectors, all of the five main German centers experienced yield compression, perhaps reflecting the perceived safe haven status of the market in the heightened uncertainty. The only other market to experience yield compression in 2Q was Vienna. There was, however, more widespread inward movement within the logistics markets with yields in the main French, German and Spanish markets moving in by 20-25 bps while the markets in the Netherlands and Italy saw smaller inward movements of 5-10 bps.

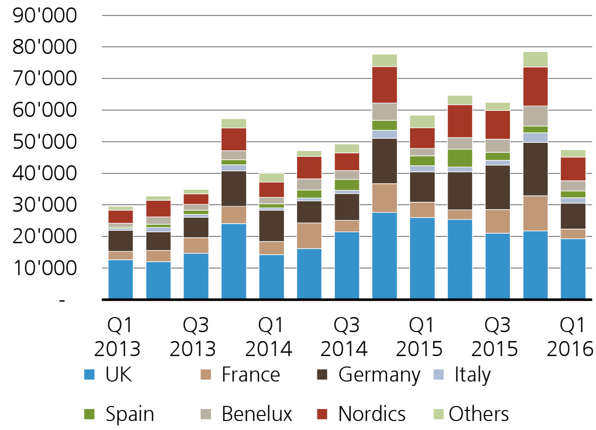
Investors appear willing to look at non-core markets to try and generate returns, although there appears to still be a marked preference for core, "best-in-class" assets, a tendency which is only likely to become more entrenched in the wake of Brexit. Unlike 2007-08, investors do not appear to have the risk appetite to purchase more secondary assets and LTV ratios are generally much lower across markets. In light of this, we would expect there to potentially be very limited further yield compression, particularly given the lower interest rate environment, and the attractive risk premium property still offers over government bonds. Considering the current volatility in equity markets, it is therefore difficult to see a mass outflow of capital from property occurring over the next 12 months. That said, we are likely to see considerable geopolitical challenges over the next half year, which may deter investment from overseas buyers, who have previously been attracted to Europe for its relative stability.

EU-15 Yield Index



Source: CBRE 21Q6

European investment volumes (EUR million)



Source: CBRE 21Q6

Viewpoint

NPLs in the Italian banking sector
Solvencies of Italian banks have recently been attracting investors' attention as since the beginning of Global Financial Crisis (GFC), non-performing-loans (NPLs) have been on the increase. With a NPL ratio to total loans of more than 16% (equivalent to more than EUR 320 billion in total) and low Tier 1 ratio, the Italian banking sector is considered weak by the market. Although this is undoubtedly a threat for the Italian banking sector and economy, the direct contagion risk to institutional commercial real estate might be limited. Circa 9% of NPL volumes are in the retail residential sector and more than 80% of NPLs are in the corporate sector. Real estate comes in to play because ca. 90% of corporate NPLs are collatorized by real estate. On the face of it, this seems to be a concern; however, most of the real estate is outside the institutional universe in manufacturing facilities.

However, we believe that sentiment towards the Italian real estate market may suffer, and the ability to secure financing may get even more restrictive. On the positive side, improving occupier demand meets low supply, and this should support rental growth, with real estate market fundamentals in balance. A pausing of the Italian investment market may create opportunities for equity rich investors or alternative lenders.

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