March 2015

Real Estate Market Outlook
Continental Europe

M&G REAL ESTATE

Part of the M&G Group

Executive summary

- Euro zone economic growth forecast to accelerate to 4-year high in 2015
- ECB's QE programme should support the real estate market
- Strong investment flows set to continue
- Retail rental growth prospects expected to overtake offices as deflation benefits consumers
- Weaker euro boosts rental prospects for the industrial sector, which will lead to further expected yield compression
- Cheap financing to boost pre-let development as a means of creating scarce prime core product

€116bn
invested in continental European real estate in 2014

1.2%
euro zone GDP growth forecast in 2015

20%
the gap between current industrial capital values and their peak

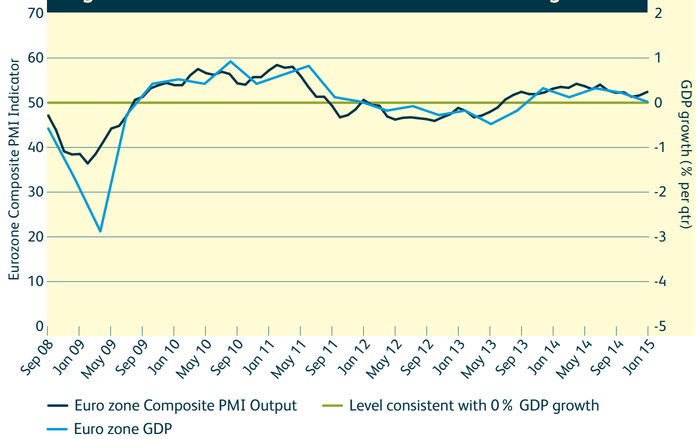
Effects of ECB QE programme to support European recovery

The euro zone formally came out of a recession in 2014, growing at a modest rate of 0.9%. Output in the peripheral countries is supported by healthy private consumption and falling unemployment. In Germany, after a sluggish summer, a solid finish to GDP performance for the full year (1.5%) raises optimism for 2015.

We expect the recovery to gather pace in the coming months, spurred by the European Central Bank's €1.1 trillion quantitative easing (QE) programme from March 2015 to September 2016. Partly thanks to the stimulus, consensus forecasts see economic growth in 2015 accelerating to a 4-year high of 1.2%.

The adoption of QE is likely (as seen in the US, UK and Japan) to be supportive of real estate asset prices in Europe as interest rates stay low for longer.

Fig 1: Private sector confidence remains strong



Source: Bloomberg.

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The QE programme itself was partly prompted by the advent of euro zone deflation, with consumer prices falling by 0.2% in December, driven largely by tumbling oil prices. Despite deflation, the euro zone economic outlook in 2015 is underpinned by positive growth across all member states.

Indeed, consumers and industry are set to benefit from lower prices of goods. The pick-up in retail sales volumes throughout 2014 already highlights that deflation is supporting spending across the region by boosting real incomes and this trend is likely to continue into 2015.

Most recently, headline news has focused on Greece, where the Syriza election victory caused Greek 10-year government bonds to rise above 9% but world equity and bond markets largely shrugged off the result. While talk of the possibility of a Greek euro zone exit ('Grexit') has re-emerged, this remains only a tail risk, particularly given public support in Greece for the single currency.

At this stage, the euro zone's future relies less on Greece staying in the bloc, and more on the effectiveness of the ECB's QE programme which should also help to limit any contagion effects beyond Greece.

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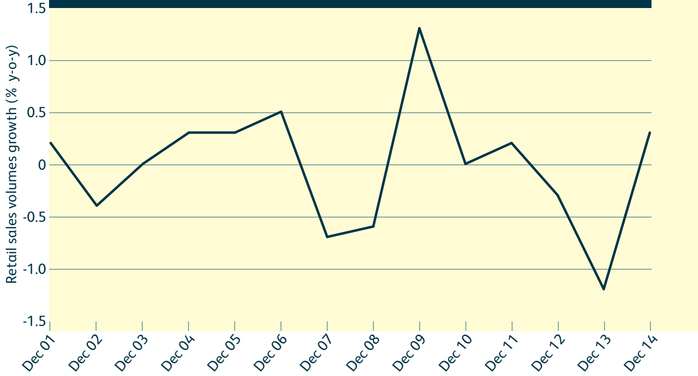
Fig 2: Signs of deflation boosting euro zone retail sales volumes



Source: Bloomberg.

Occupational market views

Retailers strengthen European presence

Amid expectations of improving consumer spending, retailers continue their online and physical expansion across Europe. Fashion group Inditex for example, has opened flagship stores in Krakow and Milan, while H&M has launched online trading in Spain and Italy. We expect high street shops to see the healthiest prime rental growth in the short and medium term, with occupier demand further supported by the limited supply of prime pitch space.

Fig 3: Average 2015-17 rental growth forecasts (% pa)

Average 4% to 6%

Dublin, Lisbon

Average 2% to 4%

Amsterdam, Barcelona, Berlin, Copenhagen, Dusseldorf, Frankfurt, Hamburg, Madrid, Milan, Munich, Paris, Prague, Stockholm, Warsaw

Average 0% to 2%

Brussels, Helsinki, Lyon, Rome

Source: M&G Real Estate.

Cities with some of the strongest forecasts for retail shop rents include Dublin, where they are still 50% below their previous peaks. Similar growth rates are expected in Lisbon, where improved economic prospects and a rise in private consumption are likely to put upward pressure on the main shopping streets of Chiado and Avenida da Liberdade.

Paris, driven by international tourist flows and luxury retailer demand, will continue to see above average prime retail rental growth over the forecast period. Similarly, Milan remains a favourite among international luxury retailers. But despite rental levels remaining stable on Via Montenapoleone, both luxury and high-end retailers are opening new stores on secondary pitches. At the other end of the scale, mid-market retailers continue to expand in Berlin where the city's young and growing population is sustaining property fundamentals across all sectors.

In the Nordics, better than expected economic prospects in Denmark will see consumer spending levels improve as households continue to deleverage. Retailer interest is already evident with European fashion groups due to open their flagship stores in Copenhagen, where we expect robust growth in prime rents over the coming few years.

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Pre-let office developments back in fashion

In our last European Outlook publication six months ago, the office sector led the recovery with the best front-loaded rental growth prospects. As we forecast, many of the office markets reviewed, such as Frankfurt and Dublin, have since benefitted from some of the strongest rental growth across Europe. Going forward, the prime rental growth profile for the sector still looks positive overall, but more varied. Core markets are now slowing down, while the Nordic and Benelux countries are set to benefit from improved occupier fundamentals beyond 2017.

Occupiers' preference for modern, centrally-located premises continues to drive rent increases in major service-based cities such as Paris, Munich and Madrid. Given the limited availability of such space, development can be an option where finance is available (see p.6).

The occupational market for offices in Central and Eastern Europe (CEE) remains healthy, but the large volume of new office developments will hinder any substantial rental growth until the new space is absorbed.

Industrial sector to benefit from weaker euro

In the industrial sector, we expect positive but modest prime rental growth, mostly driven by e-commerce related businesses. In addition to this well-reported and on-going structural change, we believe the ECB's QE programme will help create a more competitive euro exchange rate, driving the industrial sector by stimulating export-led economies – particularly Germany, where exports of goods and services account for up to 45% of GDP[1].

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The recovering peripheral countries are also likely to benefit from a weaker euro. This is especially true for Ireland and Spain, where rents are set to rebound strongly following their previous severe declines.

In the CEE, the logistics market will continue to expand on the back of infrastructure improvements and the rapid growth of e-commerce. The Czech Republic and Poland in particular are likely to benefit from their strategic locations between the east and west of Europe.

Investment themes

Strong transaction volumes

In 2014, investors deployed €116 billion of capital into European property markets – up from €97 billion a year earlier and the highest level of inflows since 2007. Larger average lot sizes (over €40 million) featured markedly during the last quarter suggesting that investors are looking to deploy capital at a faster rate.

In our last European Outlook, we highlighted the lack of prime real estate investment product across many European markets. Indeed by year-end, some vendors had started to venture into more secondary locations within core markets.

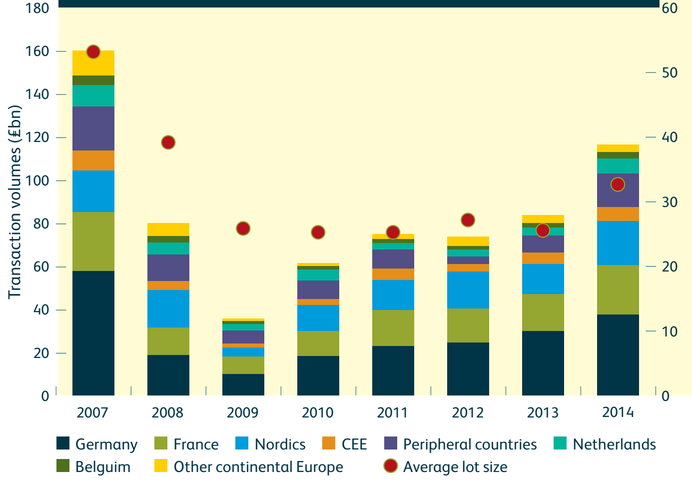
Prime yields continued to compress by as much as 100bps across all property sectors in the last quarter of 2014. At the same time, 10-year government bond yields also edged down, supporting property's healthy premium over fixed-income assets. In our view, the

Fig 4: Short-term prime occupational market drivers

Retail	Office	Industrial
Spain and Portugal: European fashion groups continue physical and online expansion in peripheral markets	**Lisbon and Spain:** tight pipelines, falling unemployment rates and economic recovery potential	**Ireland and Spain:** ample scope for rental levels to recover following severe declines
	Stockholm: preference for Grade A space and tight supply pipelines in the CBD but cost conscious occupiers seeking modern space in the suburbs	**Germany:** a controlled pipeline and a likely increase in exports due to a weaker euro to help industrial rents grow modestly
	Belgium and Poland: overhang of supply limiting rental growth	

[1]World Bank.

Fig 5: Continental European transaction volumes

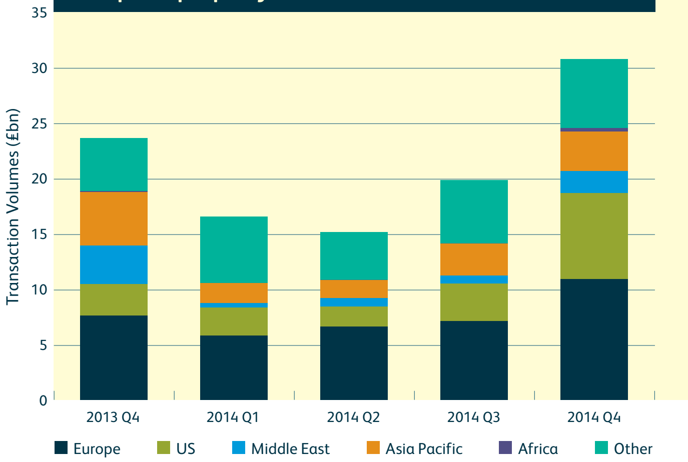


Source: DTZ.

ECB's QE programme should encourage more capital to be allocated towards real estate, intensifying bidding wars particularly among core investors. We therefore expect the growing weight of capital to lead to prime yields compressing further in the short term.

We expect US investors to be increasingly active buyers in Europe owing in part to the cheaper euro but also to concerns about pricing in their domestic market following five straight years of double-digit returns. Indeed the growing share of US, Asian and Middle Eastern investors is already evident, supported by signs of the economic recovery feeding into property fundamentals.

Fig 6: US investors increasingly targeting European property



Source: DTZ.

Industrials offer the best performance potential

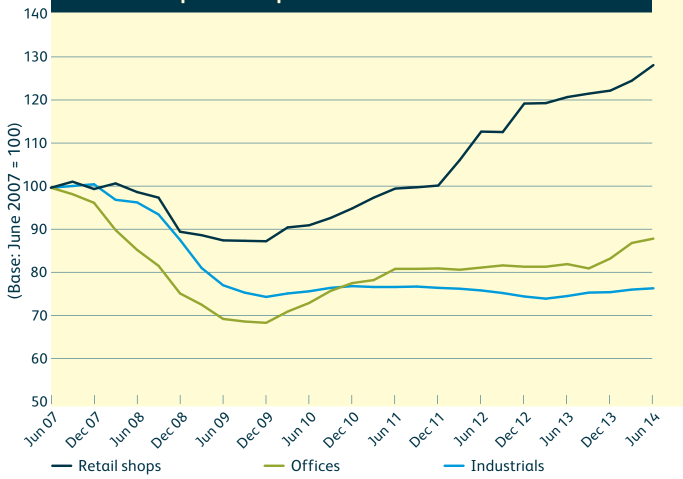
In terms of prime capital values, the industrial sector continues to look the most attractive relative to history, although the gap from the 2007 peak has narrowed to 20% at the end of 2014 from 25% six months earlier.

In contrast, prime high street retail capital values continue their trajectory above their pre-financial crisis peaks.

For some time we have anticipated further yield compression in the industrial sector in the medium term, given their relatively attractive pricing. The effects of QE and the weaker euro are now expected to boost the recovery in occupier fundamentals. Coupled with the on-going rise of e-tailing and the high income return nature of the sector, industrials will appeal to investors in the short and medium term.

Already in the final months of 2014, the industrial sector – along with the peripheral markets in general – experienced some of the strongest yield compression.

Fig 7: Industrial capital values remain the furthest from their previous peak



Source: JLL.

Lower bond yields resulting from QE improve property's relative attractiveness, which will likely drive more capital into the sector.

The lack of prime investment product is evident in many European markets but it is largely private equity funds who are actively seeking higher-risk product in the CEE and peripheral Europe. Elsewhere in core markets, the relative appeal of real estate continues to be justified in a low bond yield environment. Increased capital flows, therefore, are likely to intensify, especially at the core end of the market. This should further boost capital values across all property sectors.

Creating core product

Against a backdrop of increasingly expensive fixed income opportunities, the supply of suitable real estate stock remains the only barrier to further growth in investment volumes into the European core markets.

One way to meet investor demand for prime product in core locations is to create it. The continued low interest rate environment may see European office pipelines pick up, particularly on a pre-let basis, over the medium term.

In Milan, for example, the new Porta Nuova office district is proving popular among cost-conscious TMT and creative industry occupiers although approval of any new schemes is still subject to pre-let agreements. In Stockholm, meanwhile, large floor plates in the CBD are hard to come by and some finance-based companies are choosing to move to recently delivered buildings in the northern suburbs. Conversely, developers are cautious about launching new projects in Amsterdam and Brussels, where the overhang of supply hampers rental growth in the medium term.

Pre-let forward-funding is starting to become a more feasible option to core investors who want to place capital away from prime locations into secondary areas of tier-one cities without the expense of moving up the risk ladder. Nevertheless, investors will still need to ensure that pricing is justified by strong covenants, as well as by long term fundamentals, particularly in countries where the economic recovery is still on shaky foundations.

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In conclusion

We see strong prospects for European real estate in the coming months, supported by a strengthening economic recovery and the stimulus from the ECB's QE programme.

The retail sector has overtaken offices to offer the best rental growth in the short to medium term. Fashion brands in particular are expanding across Europe as low or negative inflation fuels consumer spending.

In terms of capital values, the industrial sector continues to look the most attractive relative to history. With the rapid growth in e-commerce and exports set to benefit from the weaker euro (helped by QE), we see good prospects for investment demand and yield compression. Industrials in Germany, as Europe's export powerhouse, are set to benefit the most.

Falling unemployment rates and the demand for Grade A space continue to be the driver of office markets. In supply-constrained CBDs particularly, we may see a modest pick-up in pre-let development supported by competitive financing terms in order to meet both occupational as well as investor demand for core product.

Overall in 2015, the cheaper euro as well as the sustained yield premium between property and government bonds should continue to justify investment into European real estate. We see scope for further yield compression as well as the potential for investment volumes to reach new record highs. Coupled with improving occupational fundamentals, European property is likely to see continued healthy returns throughout 2015.

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