Continental European real estate market commentary – September 2017

The eurozone economy is currently firing on all cylinders, driven by higher consumer spending, rising exports, increasing investment, falling unemployment and reduced political uncertainty. Schroders expects eurozone GDP to grow by 2.1% in 2017, its fastest rate in ten years and on a par with the USA. The recent appreciation of the euro may cause a slowdown in 2018, assuming exports moderate, but it will also restrain inflation and mean that the ECB is unlikely to raise interest rates until 2019. Germany and the Nordics are likely to lead, while Italy will lag behind. France could surprise on the upside if President Macron is able to reform the supply side of the economy.

Office vacancy fell in most European cities in the first half of 2017 and prime office rents rose. The main driving force has been the growth in media, professional services and IT. Oxford Economics forecasts that eurozone employment in these sectors will increase by 5%, or 750,000 people over the three years to end-2020. In addition, while occupiers are still keen to economise on workstations, there is a growing appreciation of the contribution which offices can make towards attracting staff and boosting productivity. Many employers are therefore now looking to increase the amount of informal space for mobile working and meetings. We expect Amsterdam, Berlin, Munich, Oslo and Stockholm to see the fastest growth in average-grade office rents over the next three years, thanks to low vacancy and modest levels of new building. The Frankfurt office market is likely to gain from investment banks and other financial services re-locating some of their operations from London, although Commerzbank and Deutsche Bank are currently shedding staff.

Retail rental growth has been weaker than in the office market, due to the changing dynamics of the retail environment and the shift from physical to on-line sales. As a result, we generally prefer grocery anchored schemes which are less vulnerable to the internet, although the food market is also evolving in response to social change. At the discount end, Aldi and Lidl continue to open new stores across Europe, while at the other end, organic food specialists such as Biocoop in France and Alnatura in Germany and Switzerland are also expanding, in part due to growing demand from wealthy pensioners. Furthermore, the shift away from the “big weekly shop” to more frequent “small basket” shopping means that groups like Ahold, Carrefour and Metro continue to re-configure their out-of-town hypermarkets and open smaller convenience supermarkets in town and city centres.

In the logistics sector, the increase in prime rents in the eurozone grew to 2-3% p.a. by mid-2017 (source CBRE). This is due to a cyclical recovery in manufacturing and the growth in on-line retail, particularly in northern Europe. Each extra € billion of on-line retail sales generates demand for around an additional 100,000 square metres of warehouse space. This also reflects the fact that on-line retailers require more space than traditional retailers, because they do not hold stock in stores and process a bigger volume of returned items. While the increase in demand has prompted more development, a lot of the big new warehouses are pre-let “build to suit” schemes and vacancy in most locations remains low.

In the investment market, the total value of transactions in continental Europe fell to €89 billion in the first half of 2017, 8% lower than in the first half of 2016 (source RCA). However, most of the decline was due to a temporary pause in France ahead of the presidential elections in May and competition for prime assets is still intense with strong interest from domestic institutions, REITs, real estate funds and international investors. In general we currently see better value in assets which have good bricks and mortar fundamentals, being well located for existing or new transport links (e.g. Grand Paris), located in mixed use areas, are let at affordable rents and have short unexpired leases. While government bond yields are likely to rise in the medium-term, it is not inevitable that real estate yields will follow suit, given the near record gap in yields between the two and provided that the outlook for the eurozone economy remains favourable.

Assuming the eurozone economy continues to grow, we forecast potential total returns of 5-7% p.a. on average investment grade European real estate between end-2017 and end-2021. We expect the main component part of this to be an income return of 4.5%, while capital value growth should be generated by rental growth. Our strategy is to focus on certain major cities which have diverse economies, a large pool of skilled labour, good infrastructure and are attractive places to live. Examples include Amsterdam, Berlin, Hamburg, Frankfurt, Madrid, Munich, Paris, Stockholm and Stuttgart. We also like certain smaller university cities which share many of the same characteristics.

Issued by Schroder Real Estate Investment Management Limited, 31 Gresham Street, London EC2V 7QA.
Registration No. 1188240 England. PRO00863

Authorised and regulated by the Financial Conduct Authority.