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DTZ FORESIGHT
Opportunities remain even though yields continue to fall
European Fair Value Index Q2 2015

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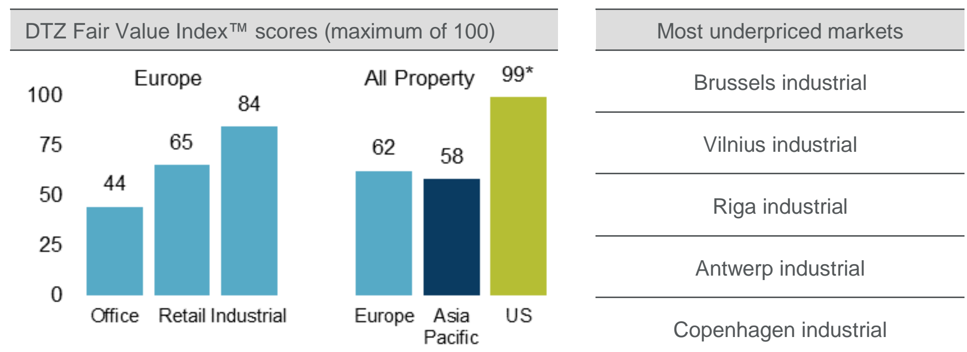
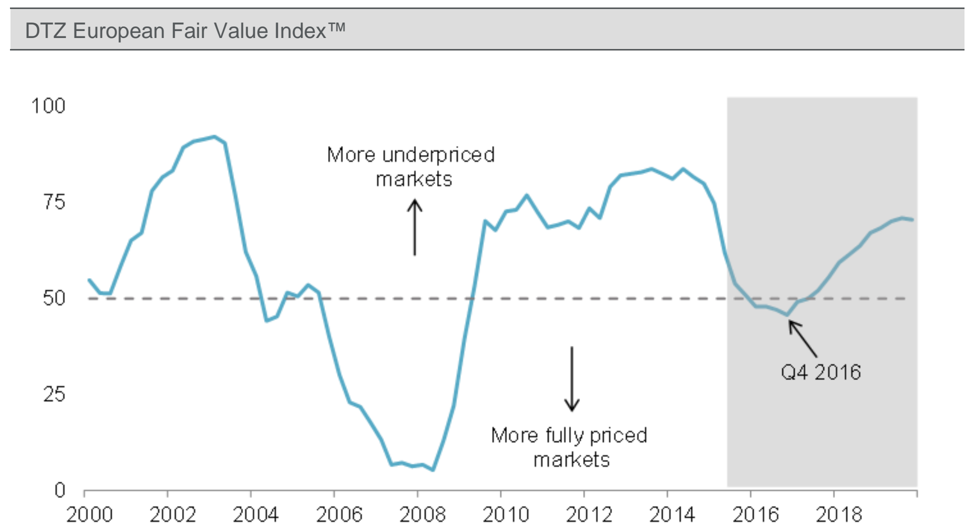
- DTZ's European Fair Value Index™ score fell to 62 this quarter from 69 in Q1 as strong investment activity pushed property yields lower;
- Europe still offers plenty of opportunities to invest though, with 46 markets classified as underpriced, and industrial rated the most attractive sector;
- We expect European property's attractiveness to continue to diminish as yields fall further and more markets become fully priced;
- Progress made towards a new Greek bailout agreement has removed some uncertainty over the Eurozone, but Greece's long term future remains in question.

Figure 1

DTZ European Fair Value Index™ overview Q2 2015



*US score based on projection for Q2 2015



Source: DTZ Research

European Fair Value Index Q2 2015

Overview

The all property Fair Value Index™ score for Europe fell further this quarter, dropping to 62 from 69 in Q1. This means that although European property markets are still attractively priced compared to government bonds on the basis of a five year hold period, their relative attractiveness is decreasing (a score of 100 indicates that all markets are underpriced for investors and zero that all markets are 'fully priced', Table 1).

This quarter five year government bonds yields remained at very low levels (still negative in Switzerland), supported by solid demand and the European Central Bank's quantitative easing (QE) programme. However over the last three months, bond yields increased slightly in several European markets due to worries over the Greek situation and greater uncertainty in general.

Strong investor activity saw European property become more fully priced. In Q2 yields fell in over 40% of the 117 markets covered in our European Fair Value Index™. For those markets in which yields fell, the average decline over the quarter was 21 bps.

As property yields keep falling, we expect the European Fair Value Index™ to continue trending downwards given the only moderate uplifts in rents projected. We expect the index to fall below 50 at the beginning of next year (Figure 2).

As a result of strong yield compression, five markets have been downgraded from 'fairly priced' to 'fully priced' this quarter, with a further markets 15 downgraded from 'underpriced' to 'fairly priced'. Three markets were upgraded, although almost 40% of the markets in the index are still 'underpriced'.

CEE, Benelux and the Baltics have the highest share of 'underpriced' markets (Figure 3). Germany has a good balance of 'fairly priced' and 'underpriced' markets, while in contrast, the UK, Nordics and France have only a few 'underpriced' markets.

This quarter, the most 'fully priced' markets in Europe are still Turkey, Russia and Switzerland. Very high bond yields in Turkey and Russia have pushed fair (required) returns for property in these markets to nearly double our forecast returns for them. While in the Geneva, Zurich and Paris CBD office markets very low prime property yields of 3.5% make them look unattractive on a relative pricing basis.

We expect prime office yields in core Western European markets such as the UK, France and Benelux to reach a cyclical bottom this year and then remain broadly stable in 2016. In other European markets, including Germany and Sweden, we expect falls in yields to continue into next year. However, from 2017 we expect yields to rise gradually due to less favourable investment conditions.

Table 1

DTZ Fair Value Index™ scores

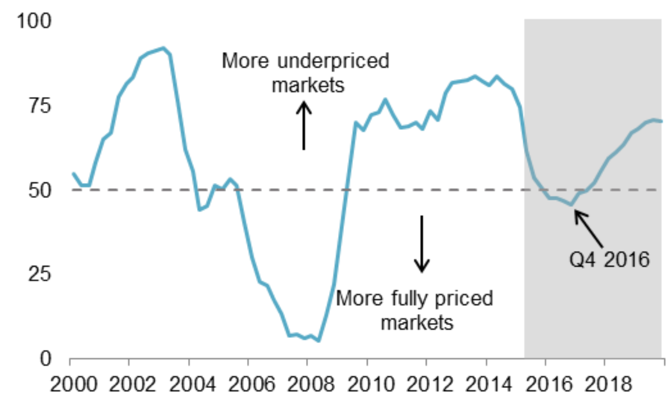
Geography/Sector	Q1 2015	Q2 2015
Europe all property	69	62
Europe offices	50	44
Europe retail	72	65
Europe industrial	93	84
Asia Pacific all property	54	58
US all property	100	99

Source: DTZ Research

Note: Q1 scores refer to those published in Q1 report; charts show revised index scores, which may differ due to property forecast changes. US refers to Q1 actual results and projection for Q2.

Figure 2

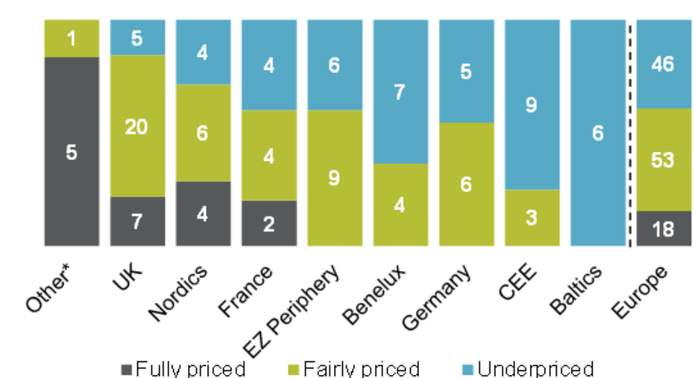
DTZ European Fair Value Index™



Source: DTZ Research

Figure 3

Number of markets in each category by region/country



*Other includes 6 markets from Turkey, Russia and Switzerland.
Note: we have changed our classification terminology from 'overpriced' to 'fully priced'.
Source: DTZ Research

European Fair Value Index Q2 2015

Classifications and context

Of the 117 markets included in our European Fair Value Index™, in Q2 46 were classified as 'underpriced', 53 as 'fairly priced' and only 18 as 'fully priced'. In contrast to last quarter, 20 markets this quarter have been downgraded, while only 3 markets were upgraded; the majority of markets (94) saw no change to their Fair Value categories.

Of the 20 downgraded markets, 15 moved from 'underpriced' to 'fairly priced', with the remaining five moving from 'fairly prices' to 'fully priced'. This quarter there are 18 'fully priced' markets compared to 14 last quarter. Cardiff (offices and retail), Edinburgh offices, Birmingham offices and Gothenburg offices were downgraded to 'fully priced' this quarter.

The top five most 'underpriced' markets this quarter are all industrial, but located in different parts of Europe: the Baltics, Benelux and Nordics (Table 2). The top three markets show as underpriced by 20% and more according to our fair value analysis, with Brussels industrial the most 'underpriced' market, being 24% below fair value.

At the other end of the scale, the top five most 'fully priced' markets in Europe are in Russia, Turkey, France and Switzerland. Moscow retail and Istanbul (retail and offices) are at the bottom of the ranking as a result of continued geopolitical risk pushing their 'fair' returns to well above our forecast returns; moreover the Russian economy is in recession this year.

On a global basis the US is still the most attractively priced overall, with an index score of 99 expected this quarter, meaning nearly all of its markets are underpriced. While Europe's index score was 62 this quarter, Asia Pacific's was much lower at 58, although we expect the latter's score to increase, and be higher than that of Europe by the end of this year (Figure 4).

Table 2

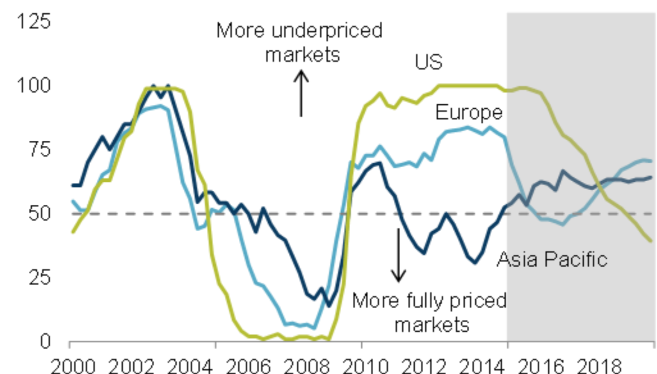
Five most under/fully priced markets in Europe

Rank	Market
1 (most underpriced)	Brussels industrial
2	Vilnius industrial
3	Riga industrial
4	Antwerp industrial
5	Copenhagen industrial
113	Zurich offices
114	Paris (CBD) offices
115	Istanbul retail
116	Moscow retail
117 (most fully priced)	Istanbul office

Source: DTZ Research

Figure 4

DTZ regional Fair Value Indices™



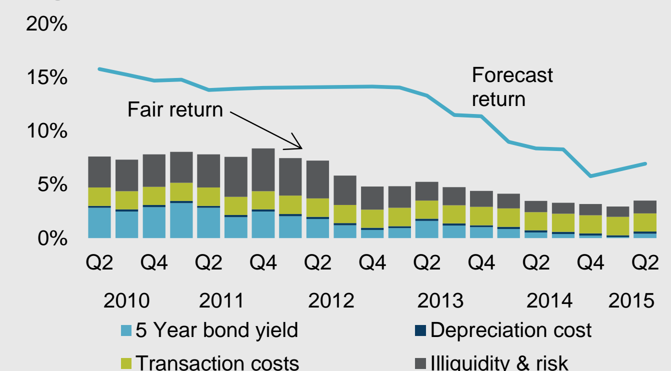
Source: DTZ Research

Market in focus: Prague Retail

- Ranked 16th overall in our Fair Value Index™ this quarter, Prague retail is currently underpriced by 13% according to our Fair Value analysis.
- The Czech economy is expected to average growth of 3.0% p.a. over the next five years, driven by consumption and investment.
- Consumer confidence is high, which is encouraging further increases in consumption and investment.
- Record retail sales volumes and strong growth in consumer spending, expected to accelerate to 2.7% this year, is boosting retailer demand for space.
- Expectations for further yield falls and moderate rental growth lead us to forecast prime total returns of around 7.0% p.a. over the next five years (Figure 5).

Figure 5

Prague retail fair and forecast returns



Source: DTZ Research

European Fair Value Index Q2 2015

Fair and forecast returns

The ECB's EUR 1.1 tn QE programme introduced in March this year to tackle the threat of economic stagnation and deflation in the Eurozone seems, so far, to be having the desired results, with a sharp reduction in bond yields and a weaker euro currency.

However, the big surprise of this quarter has been a reversal in the trend in bond yields, which increased fair (required) returns on property used in our European Fair Value Index™.The upward movements in bond yields (Figure 6), despite the QE programme, can be explained by several factors, such as the escalation of the Greek crisis around quarter-end and an uncertain economic environment in the Eurozone. The prospect of US interest rate rises also probably had an impact.

Regardless of this upward movement, bond yields remain at ultra low levels, making real estate attractive in comparison. There were wide divergences in the extent of the rises in bond yields though, with peripheral and Southern European markets seeing the sharpest rises, compared to more modest increase in Germany and the Nordics. This was due to concerns over these economies as Greece flirted with a Eurozone exit.

Looking forward, interest rates and bond yields are expected to increase over the next five years (Figure 7). As such, required returns on property are expected to increase in the near future, paring the attractiveness of European property.

In our European Fair Value Index™ in Q2 2015, 40% of the markets that we cover saw their prime yields fall. Those that fell did so by an average of 21 bps. The impact has been a reduction in our forecast returns compared to our 'fair' returns for those markets, and the overall European Fair Value Index score fell by seven points from 69 in Q1 to 62 this quarter.

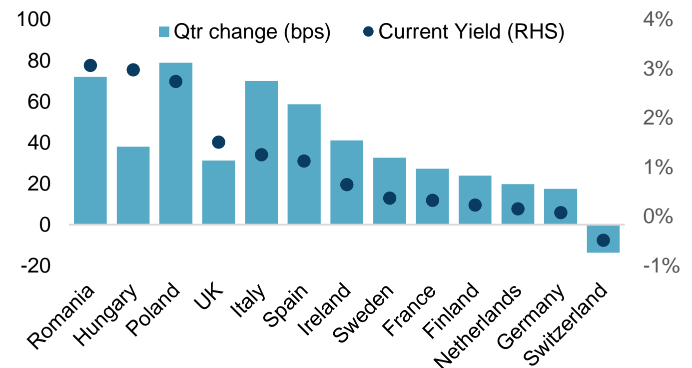
Going forward, we expect the European Fair Value Index™ score to continue to decline as yields fall further and European property's relative attractiveness compared to bonds continues to diminish. The window of opportunity for investors is beginning to close, and we expect the European Fair Value Index™ score to fall to below the 50 mark (a balance of under- and fully priced markets) by the beginning of next year.

Over the next five years, industrial and retail markets in the Baltics, CEE and Benelux are expected to continue to have the most favourable risk-adjusted returns. At the moment they are currently the most 'underpriced' markets in our European Fair Value Index™, with good economic growth prospects as these markets recover and mature further (Figure 8).

'Fairly priced' markets, offering lower risk-adjusted return, are predominantly concentrated in Germany, the Eurozone Periphery and the UK. Notable exceptions are Cardiff and Edinburgh offices, which have moved from 'fairly priced' to 'fully priced' this quarter, while the Turkish and Russian markets continue to look the most 'fully priced' markets, due to geopolitical risk.

Figure 6

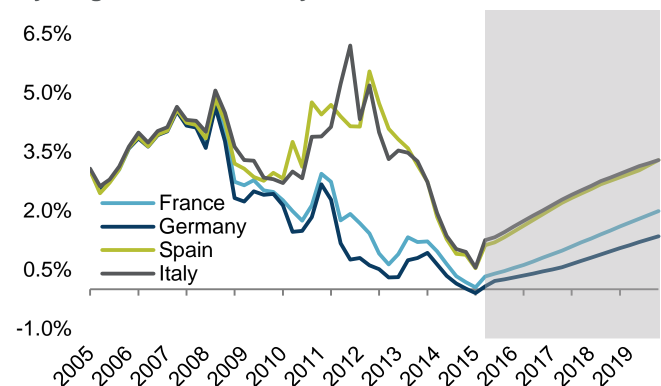
5-year government bond yields Q2 2015



Source: Bloomberg

Figure 7

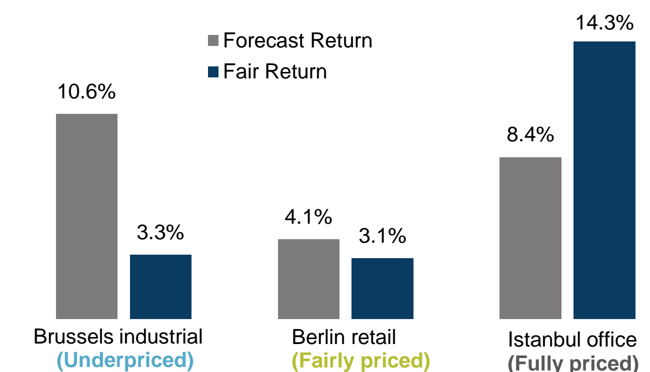
5-year government bond yield and forward rates



Source: Bloomberg

Figure 8

Fair and forecast returns – Q2 2015



Source: DTZ Research, Bloomberg

Rental growth forecasts

The occupier market is set against a backdrop of improving economic conditions in the Eurozone, despite renewed turbulence in Greece.

The Eurozone recovery is continuing to gain momentum and Oxford Economics expects GDP growth of 0.5% in Q2. This would mark the strongest quarter since the start of the recovery. Looking forward, Spain and the UK are expected to see faster GDP growth, averaging 2.5% over 2015-19, while France and Germany average significantly below 2%. The fastest growth is expected in CEE countries (Figure 9).

The drop in oil prices continues to boost consumers' purchasing power, which in turn is beneficial for the retail sector. Consumer spending is expected to grow by 1.7% this year, and to continue to be a pillar of the European recovery. The labour market is slowly improving, with firms expressing positive employment intentions, and nominal wage growth starting to pick up. Euro depreciation is boosting export volumes, which showed a solid performance in the early stages of Q2, and are feeding through to increased demand for industrial space across the Eurozone.

Q2 was characterized by tense negotiations between Greece and its creditors, resulting in Greece agreeing to creditors' terms. As a result, our Q2 European forecasts assume that Greece remains in the Eurozone. However, since the negotiations on the final bailout terms are ongoing, the risk of a Grexit cannot be ruled out. Oxford Economics has run two scenarios regarding the possibility of a Grexit, assuming "Orderly" and "Disorderly" exits (Figure 10). The first would lead to limited contagion and has only a modest short term effect on Eurozone GDP growth; whereas, the "Disorderly Exit" results in a bigger hit and pushes the Eurozone into recession.

For all the European markets we cover we forecast rents to rise by 2.4% p.a. over the next five years. The retail sector is forecast to show the fastest rental growth, averaging 3.1% p.a., compared with 1.9% p.a. for both offices and industrial. However, although the vast majority of markets are clustered around sector averages, there are significant outliers.

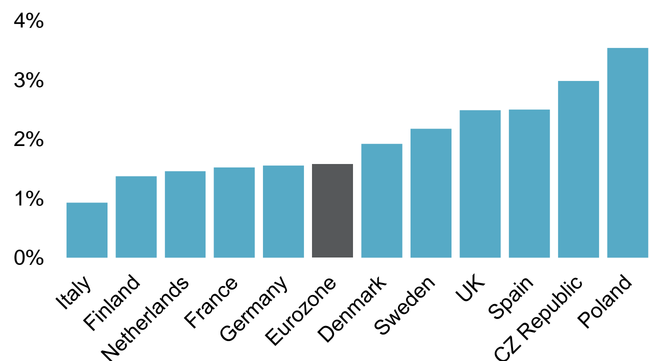
In the office sector, London Midtown has the strongest rental growth prospects of 5% p.a., driven by rising employment and tight supply; The Hague has the weakest outlook, with rents projected to fall by 1.5% p.a. due to high space availability and consolidation in the public sector (Figure 11).

In the retail sector, Dublin rents are expected to grow at 10% p.a., driven by strong demand and tight supply, whereas Moscow retail rents are forecast to fall by 2.6% p.a., led by large declines in both consumer spending and investment.

In the industrial sector, Dublin has the strongest outlook, with rental growth of 6.7% p.a. forecast, again driven by solid demand for modern spaces and a lack of supply; Rome is a very stable market, and rents are expected to continue to remain at their current levels.

Figure 9

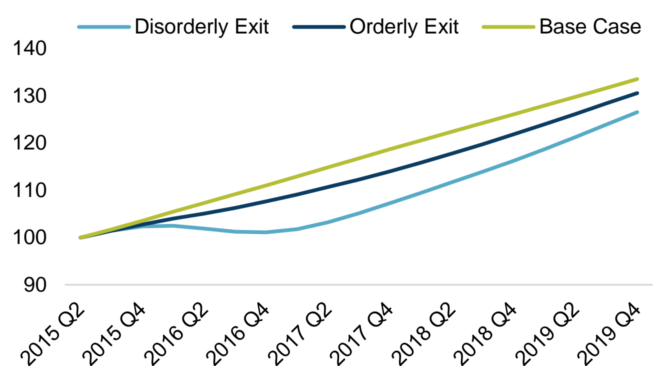
GDP growth forecasts (2015-19, p.a.)



Source: Oxford Economics

Figure 10

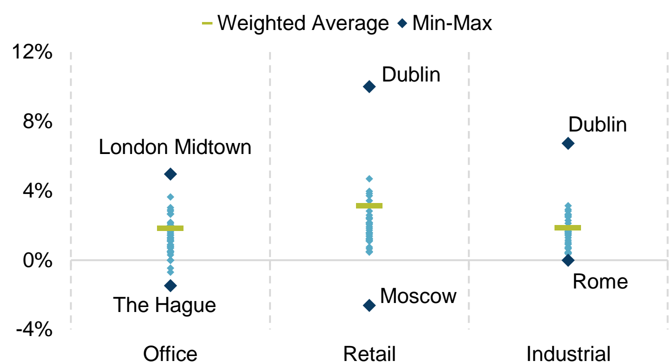
Eurozone GDP index Grexit scenarios (2015 Q2 = 100)



Note: Orderly Exit is a well-managed Grexit
Source: Oxford Economics

Figure 11

Prime rental growth forecasts (2015-19, p.a.)



Source: DTZ Research

European Fair Value Index Q2 2015

Investment market forecasts

Following a strong start to the year, the European investment market has maintained the momentum. Figure 12 shows that in Q2 investment activity totalled EUR 57 bn, up from EUR 55 bn in Q1. The pace of growth is accelerating, with investment volumes in Q2 last year totalling EUR 42 bn. On an annual rolling average basis, investment volume in Europe reached a record EUR 227 bn this quarter, and is approaching the peak level of EUR 235 bn recorded in Q3 2007 - it is now only 3% below that record.

There are four main reasons for the good performance of the market: 1) high liquidity 2) an improvement in the lending market and a wide range of investors targeting commercial real estate 3) stronger demand has seen potential sellers become more active in putting more opportunities on the market and accelerating asset rotation 4) commercial real estate remains attractive relative to other fixed income asset classes, despite the continued falls in yields and a slight increase in government bond yields in some European countries.

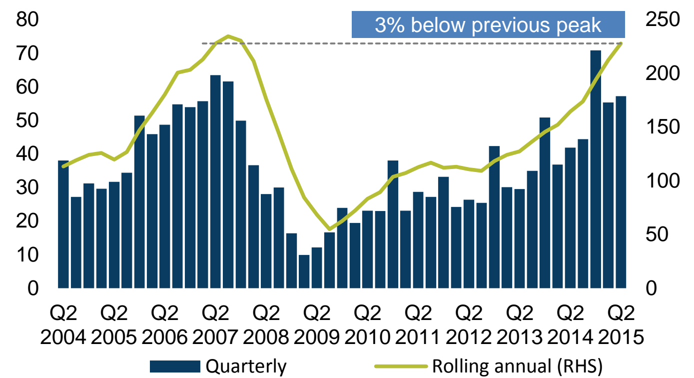
The UK remains by far the most active European market, with EUR 92 bn invested over the last 12 months, corresponding to a share of 40% of the European total. Germany is the second largest market, with a share of almost 20% of the European total. However, more capital continued to flow into Southern Europe (Italy and Spain), which have experienced an increase in capital invested of 160% and 96% respectively over the last 12 months, bringing their combined total investment volume to EUR 6.1 bn. In contrast, in Eastern Europe, which includes markets such as Russia and Ukraine, there was a significant decrease in investment volumes due to political tensions.

Strong investment activity is seeing property yields continue to fall in many European markets. The Paris La Défense office market saw the largest drop in yields this quarter, of 50 bps (Figure 13); other markets such has Bristol & Leeds offices and Berlin industrial saw yields drop by 30-40bps. No markets experienced rises in yields this quarter. At the end of Q2 there were seven European markets with yields below 4%; London West End retail has the lowest yield of 3%.

Figure 14 shows European prime yields for the three commercial sectors. We expect yields to level off between this and next year. Generally speaking, next year we expect yields to continue to fall in non-core markets, albeit at a slower pace. It is interesting to note that Germany is the only core market in Europe where we expect yields to keep falling in 2016. Less favourable investment conditions and rising global interest rates lead us to expect yields to start to increase from 2017, but to remain below their 2012 levels at the end of the forecast period. We expect the premium between industrial (highest yielding) and retail (lowest yielding) will remain wide during the forecast period.

Figure 12

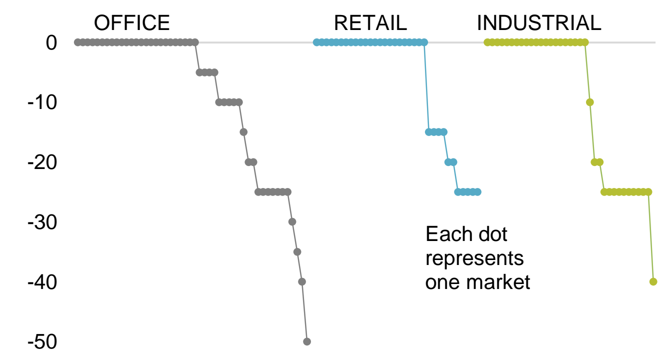
European Investment activity, EUR bn



Source: DTZ Research

Figure 13

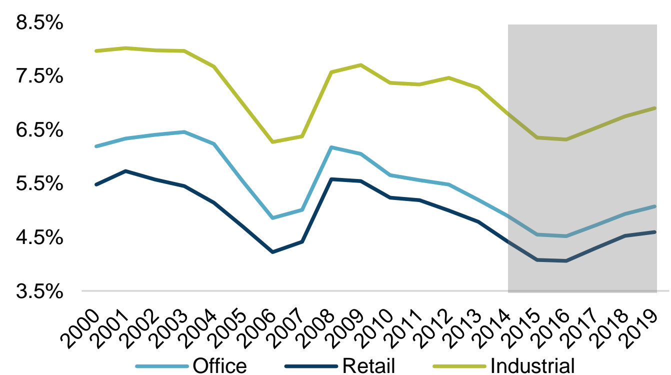
Prime yields movements Q2 vs Q1 2015, basis points



Source: DTZ Research

Figure 14

European prime yields (year end, weighted average)

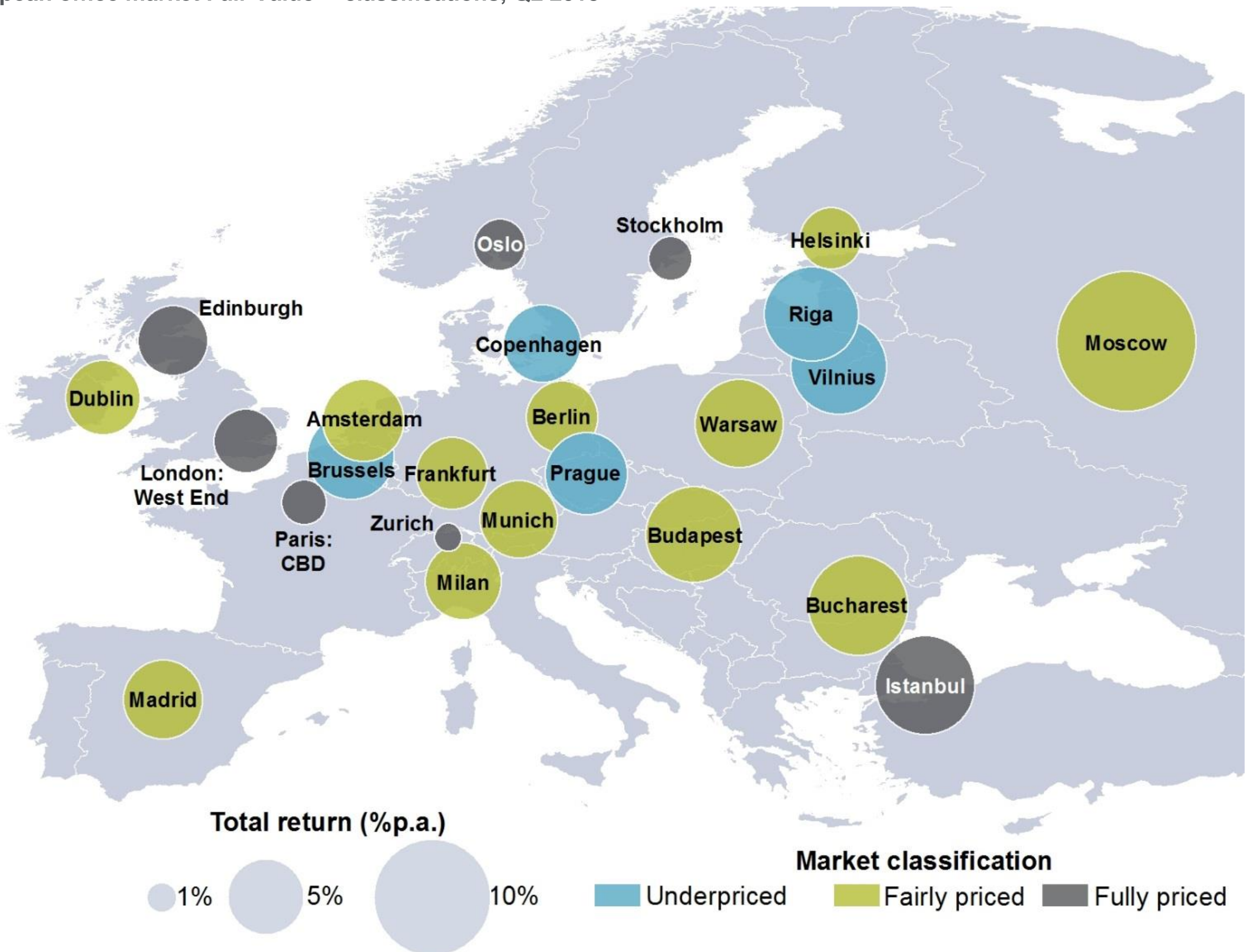


Source: DTZ Research

European Fair Value Index Q2 2015

Figure 15

European office market Fair Value™ classifications, Q2 2015



Source: DTZ Research

DTZ Fair Value Methodology:

The DTZ Fair Value Index™ was launched in August 2010 and covers all 229 markets globally.

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.

When a property price is at fair value, an investor is being adequately compensated for the risk taken in choosing to purchase real estate; similarly, when the property price is below the fair value price, an investor is being more than compensated for the risk taken in choosing to purchase real estate.

When buying at or below fair value, an investor does not necessarily buy at the bottom of the market.

Our Fair Value analysis focuses on prime assets and a five-year investment horizon, and hold for the market overall; individual transactions may provide opportunities and risks beyond the average market view.

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