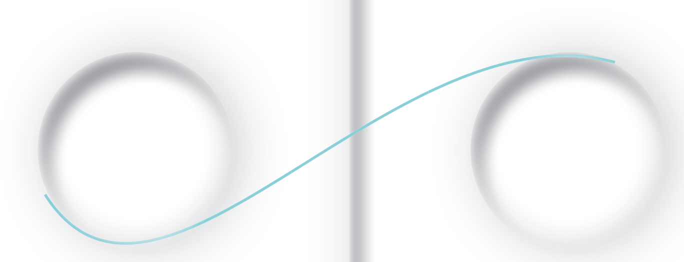
CAPITAL VIEW

BREXIT & THE EUROPEAN PROPERTY INVESTMENT MARKET



JULY 2016

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Summary: A World of Certain Uncertainties

Despite speculation to the contrary, the UK has not "collapsed" since the referendum result was announced, not yet at least. Distress is palpable but it is also largely emotional rather than real or linked to actual assets and a need to trade or move. Some prices have been chipped or deals delayed but those waiting for blood on the streets have longer to wait.

There is a clear warning of course that populist outcomes can prevail, but markets will at least have to **wait and see what happens after the summer** before a detailed view can form: when the UK's new Prime Minister will have had time to set the country's agenda for negotiations and EU leaders will also have had time to reflect on the vote and the need for reform.

The referendum result does nonetheless pose more new questions than it answers and clearly brings a **significant downside risk not just for the UK** but also for the rest of Europe and beyond. The likely course of events is still very unclear though and for many it is too early to reach conclusions beyond the need to proceed with caution, be alert to risk, hedge exposures and **focus on the fundamentals** that make property work for the long term.

In many ways we face similar conditions to those we had before the vote – a **lower for longer cycle with slow growth**, low interest rates and ongoing demand for core property. If anything, that **core demand may be set to rise** but the search for new opportunities in new markets will remain risk-averse.

Occupiers will similarly be in a cautious mood, albeit with a search for new markets by some and lower costs by others, as well as **deflected demand from the UK** leading to some change in focus.

Financial implications such as a weaker currency will attract buyers to the UK and the eurozone – but will there be the opportunities they seek? Secondary sales may go ahead but **a fall in yields may be needed** to get more prime profit takers to come forward.

Economically the outlook for inflation may pose some questions – and draw more buyers towards real assets – but reform to deliver a greater degree of popular support and more productivity will be key in all of Europe, while for the UK, steps towards **creating a more "Global Britain"** are clearly needed to offset any dilution in European linkages.

Regardless, some demand and activity will still be diverted away from the UK to other areas of Europe, even if only for the short term. The **"winners" may be defined more at a city than a country level** – led by Frankfurt, Berlin, Paris, Luxembourg, Dublin and Amsterdam – at a country level, Germany is perhaps the biggest winner overall as the largest, most liquid but also most secure alternative target.

Market Outlook	*UK*	*Rest of EU*
INVESTMENT VOLUMES VS. 2015	DOWN CIRCA 25%	UP CIRCA 10%
YIELDS	STABLE FOR PRIME, UP FOR SECONDARY	DOWN FOR PRIME, STABLE/UP SECONDARY
RENTS	STABLE FOR PRIME BUT WITH HIGHER INCENTIVES	STABLE/UP
OCCUPIER DEMAND	STABLE/DOWN AS SOME DECISIONS ARE DEFERRED AND SOME OCCUPIERS CONSOLIDATE	STABLE/UP BUT COST SENSITIVE

What is the macro landscape?

What do we know?

The referendum votes may be in but we are little closer to knowing what the future holds, with a lack of certainty on the exit process or its timescale, the likely deal the UK can achieve or, indeed, what the UK's priorities will be across areas as diverse as trade, immigration, security, growth and social protection.

- The initial shock felt across global markets is easing but we now face a short-term slow down as well as medium term uncertainty. Indeed, **a state of heightened uncertainty** is set to be the new normal – adding a new layer to an already changing era of geopolitics.
- **No need to panic.** While forecasts are being revised down, a crash is not the most likely outcome given where the economy stands and how many different conclusions can be drawn. For example many voted for the break-up and some will be more optimistic as a result. However, while a Lehman-like crash may be avoided, events are still unprecedented and a major structural change is underway that will take years to work through the system.
- It will also take time for the direction of travel of the UK to be revealed. Given the relatively slim margin of the referendum vote as well as the broad range of views sheltering under the "leave" campaign, the **UK's priorities are not clear** and uncertainty will continue until Theresa May, the UK's new prime minister, gets a chance to establish the aims and objectives of the government.
- **Over the next few weeks**, the new government's approach to the Brexit negotiation in particular will slowly emerge. Following that, Article 50 may or may not be triggered but there appears every prospect that the process will not begin before the end of the year and the negotiations to leave thereafter could clearly take longer than 2 years (see table overleaf).

Second vote to come?

The very likelihood of Brexit occurring is still open to question according to some; parts of the "leave" campaign have said from the beginning that an "out" vote would be used to get a better deal for the UK to remain in the EU. What is more, others within the EU are now calling for reform.

- In the meantime, the debate within the UK is likely to polarize. Moves by the Scottish government are already underway while the position of Northern Ireland is clearly complicated and even some in London have expressed an interest in separation. Alongside clear divides in society by age, social status and gender, the potential for both a **breakup of the UK** and for less social harmony are clear.
- Populism has increased in all areas of Europe of course and while the exact causes differ across anti-austerity, anti-globalization, anti-migrant and anti-EU, it is clear that a growing portion of the populace do not feel they are adequately benefiting from economic growth and do not feel their voices are being heard. Such feelings could well lead to a further rise in anti-EU sentiment and fears that Brexit opens the way to a deeper unravelling of the EU are very real. Once again, **the threat of contagion** stalks the continent.
- The question therefore clearly remains as to **what negotiating stance the EU** will adopt with the UK. Will it look to create a bad precedent for anyone else to follow or will it look to minimize the damage and get on with life without the UK – including giving higher priority to reform? There is also of course potential yet for a new solution – a second vote or a broader EU reform that provides a rationale for a UK rethink.
- Whatever happens the slow moving **EU looks set for change** of one sort or another and while that will bring opportunities, it will not happen quickly or without pain.

THE POSSIBLE TIMEFRAME

Letter or notice from the UK government to trigger article 50 and start the exit process	The new Prime Minister will need time to establish policies and Merkel has called for calm over the summer - suggesting both sides will not be ready to start talks until the latter part of the year	Q1 2017
Negotiation of exit and the new relationship in areas such as trade	Assumed the full 2 year period will be needed and this may have to be extended	Q1 2019
Extended negotiation	Assumed may take at least 5 years for all areas to be agreed	Q1 2022
Agreement	Put to a vote by all EU governments	Q1 2022
Transition	Transitional arrangements are likely in some areas and businesses will take time to react	End 2027
Getting on with business		

The Economic Backdrop

No recession.... for now.

The near term economic outlook has weakened both in the UK and much of the rest of Europe, with very real risks ahead as volatility and uncertainty hit confidence and push the recovery backwards. Nonetheless, for now at least, it seems the impact will be to slow rather than reverse short-term growth. Decisions may be delayed and positions hedged but until businesses know more, many will not yet make cuts. Indeed, some in fact have little spare capacity as it is and need to invest to raise productivity.

- Uncertainty will persist over the UK economic outlook as we wait to see how decision-making is affected. A **recession is clearly possible but it is not automatic** from where we are today. The end of the Referendum may in fact free some to make decisions – signs of which are already emerging – and there could be an additional boost in some areas from the cheaper Pound, potentially helping exports, tourism and inward investment.
- On balance nevertheless, slower growth must be anticipated for the short term, with a question mark over how long and how deep the growth hit will be. Long term no one can know until **the terms of the divorce** – if that is what it will be – are known.
- Corporate investment is of course a key area of risk if decision-making freezes and there will be impacts all the way **along the supply chain** from raw materials and semi-finished inputs to delivery and e-commerce, with cross border supply chains under most pressure. Business planning will be under scrutiny and concerns will need to be faced on procedures, costs and the overall impact on efficiency.
- The **emergency budget** that had been discussed in the UK before the vote now looks more likely to be stimulatory rather than austere, with plans to balance the budget pushed back and the chancellor announcing his intention to cut corporate tax and boost investment – notably with a focus on the UK's global position in terms of strengthening links with China.

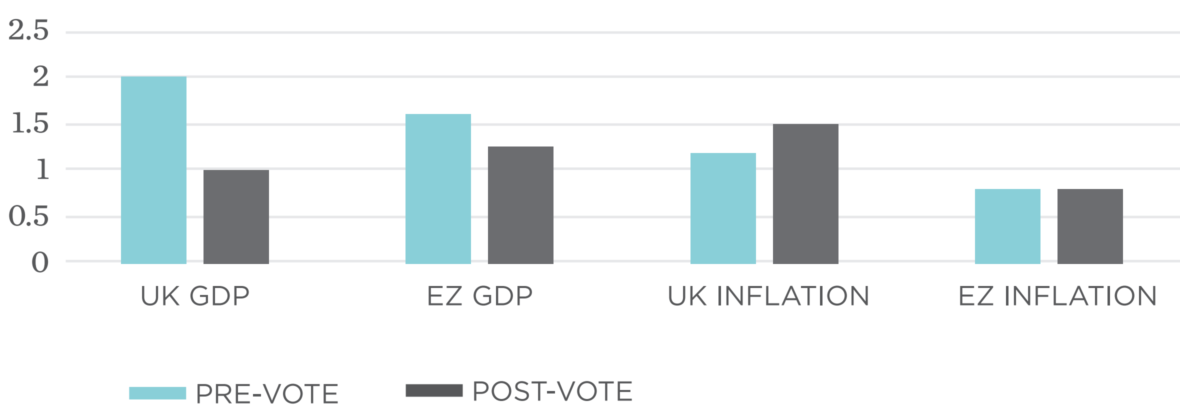
Medium term pain.

Some of the potential short-term weakness may be pushed out and it could be 2 to 3 years before the most severe impacts are seen. While in the long term there will be a solution and a new system to assess, many of the question marks along the way to this point to a very uncertain medium-term picture; whether over the new rule book, finding recruits as immigration is impacted or the appetite of funds and venture capital when new money needs to be raised.

- In the EU and beyond, growth patterns will be affected both directly by lower UK growth as well as by heightened uncertainty. However **the wider impact** may be less than many feared, with some businesses ready to act and stimulus measures being readied.
- Those EU markets with **strong trading links** to the UK may suffer somewhat (see page 12) but generally, the impact should be small. Forecasts for 2016/17 GDP growth in the eurozone were circa 1.5% pa and have now fallen to around 1.25%. In the UK meanwhile, forecasts have dropped from 2.0% pa in 2016/17 to around 1% pa now.
- **Inflation is likely to ease upwards** in most areas due to the weaker currencies that are one clear outcome – with the UK most threatened due to the heavier slide in the Pound. However given the usual pass through from currency to prices – particularly in an environment of subdued demand – this is unlikely to signal a return to high inflation and may be viewed relatively favorably in that it will steer much of Europe away from deflation.
- In short therefore, the ongoing economic environment remains quite similar to that of the last few years– **low growth, low inflation and low interest rates** – but the recovery has been pushed back unless reform plans have real teeth and/or QE and similar measures are greeted with a better response from lenders and investors.

The Economic Backdrop

ESTIMATED SHORT-TERM ECONOMIC IMPACT
2016/17 % PA



Source: Cushman & Wakefield, Consensus Economics

Sectors and Markets at risk in the UK

HIT TO CONSUMERS AS SENTIMENT SLOWS but also as spending power is hit by the weaker Pound and potentially by a further round of austerity.

A LOT OF COMMENT has centered on what model for trade the UK may adopt outside the EU but many of the trade arrangements in place do not cover all products – with services in particular often left out. This could disadvantage not just the UK's strong financial and professional services sector but also growing sectors such as Fintech.

PHARMACEUTICALS AND BIOTECH MAY BE IMPACTED, with uncertainty over future UK regulations relative to those in the EU and also a potential impact on funding and research.

LOOKING FORWARD, the UK's ability to influence the development of European trade to embrace e-commerce and the digital world will be hit. The nascent Digital Single Market could add €415bn to the EU economy according to some estimates. However half of the EU's existing digital market is controlled by US headquartered firms – so the ability to win while being outside of the EU is proven.

THERE MAY BE UNCERTAINTY OVER MAJOR INFRASTRUCTURE INVESTMENTS - such as the new nuclear power station planned at Hinckley Point or the second high speed rail line, HS2. Plans for new runway capacity in the South East could be hit, with a decision on this already delayed.

LONDON IS A MAGNET FOR GLOBAL TALENT and the free movement of people within the EU makes recruitment easier still. A greater bias towards non-EU students and migrants may help some industries but an Australian points system could also be too bureaucratic. The risk therefore exists of a talent shortage and even a brain drain as other centres lure away London's talent.

LONDON IS A LEADING CENTRE FOR VENTURE CAPITAL and this has been key to its emergence as a tech powerhouse in the past decade. Will this continue? Much is backed by the EIF who will need to reconsider their involvement. Hence in the short term there may be no changes, but in the medium term funding conditions may tighten.

THE FINANCIAL SERVICES SECTOR is clearly an area of downside risk across the UK given the need for firms to be based in the EU to have the right to sell their services and products across the region. These so called "passporting" rights may still be available depending on the type of trade deal that is agreed but with question marks in the meantime over the degree of unobstructed access that the UK will enjoy, the case for international financial firms to base their operations in London or the UK is diminished. On top of this there will also be a threat to some of the services offered by London – Euro trading for example – again depending on the type of deal finally agreed. However while some new businesses may be deterred, the other advantages offered by London in terms of the scale of resources available, means wholesale relocation is less likely than a selective or partial relocation until a clearer picture is available on future rights and access. Some banks and insurance companies for example have suggested that 15-25% of their workforce could be moved.

Finance Markets

Lower for longer.

Global interest rates are likely to be pushed lower as central banks act to support the economy, even in areas where inflation may move higher such as the UK. Longer-term rates are also likely to fall as the yield curve flattens and quantitative easing continues – or even increases.

- A further **hit to Sterling** may be seen given the scale of the political dislocation that has taken place. What is more, the size of the current account deficit together with the threat to trade and potential for interest rates to fall, are all reasons for caution over the Pound.
- Ongoing **Euro weakness** against the dollar and other major currencies is also likely which may of course help exporters, although strength against the Pound will disadvantage those exporting into the UK. Secondary impacts will be felt more widely - globally in fact - notably through trade and currencies as well as heightened uncertainty.
- **Commodity prices** will see mixed trends: rising due to Dollar strength and investment speculation, but falling due to the expected impact on the global economic recovery.
- With further risk aversion and softer economic projections, **the yield curve will flatten,** with bond yields remaining low. Peripheral markets in the eurozone may however benefit less due to ongoing risk aversion and a renewed focus on areas of potential financial stress.
- Brexit may lead to renewed **quantitative easing** in the UK and an expanded programme in the eurozone as the authorities react to maintain liquidity and stability.
- Bank lending is likely to be cautious and costs may rise, resulting in an even more **pronounced two tier lending market,** favouring core opportunities. However pressure will remain for banks to lend, from central banks but also from owners as they look to generate more profitable business. What is more, after a slow H1, many banks and funds are behind target.

Currency-led pricing opportunity.

Currency was always going to be the key conduit for stress and fear to be manifest in this situation and the risk of further weakness in European currencies will preoccupy investors as well as central banks. For others such as the US, Japan and Switzerland, currency gains will have to be factored in. With such volatility however comes opportunity and particularly for the UK, currency falls will bring in eager buyers in the weeks ahead.

Market Risk

All of Europe faces a common threat but the risk of contagion from a UK exit does vary significantly – both in terms of its direct economic impact and the potential for other countries to consider leaving. The first stress points for the EU to consider probably lie in Italy and the Netherlands before the heavyweights – France and Germany – go to the polls later next year.

- **Risks outside the UK** may be felt most immediately in its closest trading partners such as Ireland, the Netherlands, Belgium, Germany and Spain. However impacts will not be limited to the strength of their dealings with the UK: the degree of euro-scepticism will be looked at closely to see who else may favour a vote to leave while areas of stress whether from economics, unemployment or indebtedness will be keenly watched.
- On balance across a range of variables (see table overleaf), the most exposed countries appear to be Greece, Bulgaria, Romania, the Netherlands, Portugal, Hungary and Italy. Three of these will also face an **electoral test** in the months ahead that could play on these stresses. Romania faces the earliest election, but major tests lie ahead in France, Germany and the Netherlands in 2017 and there may also be a contest in Italy if October's referendum on constitutional change goes against the government.
- Reform needs are clearly being further exposed, and deepened, with the EU itself under pressure to initiate changes to alter the economic and the democratic dynamic. Immediate targets appear to be aimed at controlling immigration and perhaps loosening fiscal restraint but what will be done to boost **competiveness and productivity?**

CONTAGION RISK?

	TRADING LINKS WITH UK	SUPPORT FOR THE EU	NEXT ELECTION	CONSUMER CONFIDENCE	FINANCIAL RISK
	UK share of total exports 2015	% feeling attached to the EU, Nov 2015	Parliamentary, maximum allowed term	Balance of respondents, Eurostat, Jun 2016	Credit Rating 20=AAA, Oxford Economics
Austria	3.1%	38%	Oct 2018	-8.8	19.6
Belgium	8.8%	56%	May 2019	-6.0	17.7
Bulgaria	2.5%	44%	Oct 2018	-27.4	11.4
Czech Rep	5.3%	35%	Oct 2017	+2.9	16.3
Denmark	6.2%	46%	Jun 2019	+9.8	20.0
Finland	5.1%	39%	Apr 2019	+15.2	19.6
France	7.0%	55%	Jun 2017*	-12.6	18.0
Germany	7.4%	53%	Sep 2017	-1.6	20.0
Greece	4.2%	34%	Oct 2019	-20.8	3.3
Hungary	4.0%	59%	Apr 2018	-18.2	10.2
Ireland	13.7%	51%	Apr 2021	+12.5	14.8
Italy	5.4%	40%	Feb 2018*	-12.3	12.0
Luxembourg	4.8%	74%	Oct 2017	+10.1	20.0
Netherlands	9.3%	39%	Mar 2017	+6.3	20.0
Poland	6.8%	58%	Oct 2020	-9.4	14.0
Portugal	6.7%	54%	Oct 2019	-14.1	10.0
Romania	4.4%	60%	Dec 2016	-19.6	11.0
Slovakia	5.5%	49%	Mar 2020	-7.5	15.7
Spain	7.3%	56%	Jul 2020	-2.4	12.4
Sweden	7.2%	44%	Sept 2018	+10.9	20.0
The UK	Na	40%	May 2020	-1.2	10.7

**Note:*
French presidential elections take place in April 2017.
Italy holds a referendum on constitutional reform in Oct 2016, which could trigger an election if the government is defeated.
Cushman & Wakefield, sources various.

Real Estate Implications

Yields to fall.

Although we have to wait for events to unfold, Brexit will clearly affect investment and occupational strategies across Europe as a whole. In the short term, the result is more likely to affect activity than values however, with the latter supported by limited supply and lower interest rates. If anything in fact, the property investment market faces higher demand across the board for prime assets in core markets as uncertainty and quantitative easing drive buyers. Supply will be key to determining what activity we see, but prime yields, at least outside the UK, are likely to fall further.

- Signs of unease are clearly emerging in the UK market, with reports of occupier and investor deals delayed, an increase in outflows from retail funds forcing some to suspend redemptions and the Bank of England warning that property may be a key conduit for distress – and one that could be amplified by a rash of forced sales by the funds. Half of the £24bn **open-ended fund sector** is now suspended but to put this in perspective, the sector represents less than 3% of the UK market and is around a third the size of the OEF segment in Germany. More importantly, the wave of suspensions represents part of a well-planned defense by these fund managers and signals a real **intent to avoid distressed sales.**
- Overall in fact, the referendum result adds to the pressure for core investing. At the same time, while it does little to boost tenant demand by confusing the economic outlook, many occupiers are being driven by a need to act in the face of structural changes not just growth and inflation. So the pressure will remain to act even if the future is less clear and a return to **"normality"** further delayed.
- At the same time, with development likely to slow, the **choices open to occupiers** will remain limited and hence a tight supply and demand balance will continue to favour landlords in core locations.

Transactional activity down.

The referendum vote will delay some activity and the UK is set to be less favoured by some investors and occupiers, with other locations, globally as well as in Europe, gaining at its expense. UK investment volumes are therefore forecast to settle at a notably lower level than in 2014/2015 and this will offset higher volumes elsewhere, driving a modest fall in pan-European trading, with a 6% drop currently envisaged for the EU as compared to our projections for a 9% gain assuming the vote had been to "remain".

- Increased demand is likely from opportunistic foreign capital seeking **safe havens**. Currency moves make these opportunities real but wider distress may be less than some expect, resulting in fewer forced sellers and less potential for yields to increase.
- While the market faces a continuation of the recent investment environment in terms of high but cautious demand focused on core, the slow expansion of interest towards new markets may slow or higher yield premiums will be demanded and the prime to **secondary yield gap** may widen, pushed also by a two tier financing market.
- Some players will hope to stand back to see how the situation develops but for many there is a need to act with **investment capital building** up and secure homes for investment needed. In addition, **different opinions are emerging** on what is likely to happen and this should create a more active market of buyers and sellers. After an initial shock therefore, activity may start to rise once more.
- **On the occupier side**, the UK may face some degree of demand shock as businesses react but while some occupiers will defer decisions, others will act, rolling out contingency plans for example, and with a shortage of modern stock in many areas, slower growth rather than a rental decline is most likely.
- In the long term, all areas could expect to lose some occupiers. However, London could still be a **winner overall,** able to stand alone as an independent financial megacity: the Singapore of the north perhaps, continuing to rival New York as the foremost global hub market. Many regional UK markets, however, would face a tougher ride until more certainty emerges over the UK's international role.
- **Potential winners** in the rest of Europe who could gain at the UK's expense include Paris, Frankfurt, Luxembourg and Dublin as well as Amsterdam, Milan, Madrid and Berlin while more widely, global hubs such as Singapore, Sydney, San Francisco and New York could gain.
- Capital value trends are harder to judge as **new assessments of risk** are considered. Over time the UK may face a higher risk free rate for example, offset in the short term by lower interest rates. Elsewhere meanwhile, risks to financial stability and to the EU may be factored in to pricing in some markets, resulting in a real need to focus on the fundamentals of a location and what makes it work for business, rather than just what political union or country it lies in.

Real Estate Implications

Implications in London

LONDON EPITOMIZES THE TRENDS WE NOW SEE EMERGING, with downside risk in the short term but strong upside opportunities longer term if the city builds on its business and cultural strengths to become an even more important global market hub.

INDEED WHILE THE CAPITAL WILL FACE A STRONGER THREAT from other European cities due to any change in its EU status, its strategic lead would take considerable time to erode given its relative size, infrastructure and ease of doing business relative to other areas of Europe and the world.

IN THE SHORT TERM, uncertainty is clearly a negative and London occupiers and jobs growth must be hit. However, as the table on page 8 outlines, trends will be very uneven by sector and so too will the pattern of winners and losers when that is translated onto the London property landscape.

MORE IMMEDIATELY, there does appear to be a greater threat to the City than the West End due to its banking and financial market exposure and less diverse tenant base. However these differences are less notable than in the past and City losses are likely to be quite building specific given the now more attractive working environment, lower relative costs and less loyal Central London user base as a whole.

OCCUPIERS WILL BE DELAYING DECISIONS where they can meanwhile and even some which have lease events will kick that decision down the road if possible. However, the market has tight supply with 5% vacancy in the City and 3% in the West End, so even with delayed decisions, the market will remain stable. Development supply is likely to slow and as a result, we expect prime rents to flatline in the short-term..

NEW SUBMARKETS OF LONDON FACE MIXED TRENDS, with some infrastructure schemes in doubt or possibly delayed but others nearing completion and locations linked to them are potentially set to be in more demand as businesses seek a competitive advantage. However those principally benefiting from overflow demand from core areas will be most exposed to any change in the market– so a focus on fundamentally what is attracting occupiers needs to be maintained.

RESIDENTIAL MARKETS MAY BE MOST IMPACTED, with high-end schemes in some areas already slowing and now facing a temporary fall in overseas demand from some quarters. In the mass market there may also be a short term hit to activity and pricing as vendors react to the news and some choose to take profits and cut pricing to sell. However once events settle down, the fundamentals of limited supply and low borrowing costs should come back to support the market and there are already signs of renewed interest from some overseas players.

INEVITABLY THE HIGH LEVELS OF UNCERTAINTY surrounding the financial markets will cause some investors to hesitate and this will most likely lead to subdued turnover levels in the market for Q3. However, there are clearly a group of investors who see London as a buying opportunity and given the fall in the value of Sterling, overseas investors will continue to seek to invest in high quality core assets and, potentially, new development opportunities.

STRATEGY POINTS

Portfolio Level

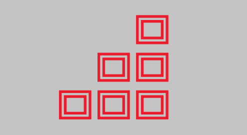
REVIEW VALUE PRESERVATION STRATEGIES
under differing scenarios

CONSIDER TENANT EXPOSURES AND RISKS
eg European HQs of US and Asian groups, banking and insurance companies etc

CONSIDER LEASE PROFILES

CONSIDER CURRENCY DIVERSIFICATION/EXPOSURE

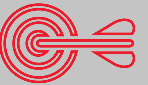
RECONSIDER IDEAL PATTERNS OF INTERNATIONAL DIVERSIFICATION,
inside and outside Europe



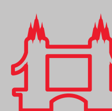
CONSIDER FINANCING STRUCTURES

Trading Policy

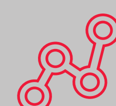
WAIT FOR DUST TO SETTLE
but be ready to take advantage of uncertainty or market over-reactions where possible



TARGET DOMESTICALLY ORIENTATED SECTORS
such as retail and last mile logistics



IN THE UK, TARGET TRULY GLOBAL HUBS
eg London, Cambridge and globally competitive locations or industries/companies



RE-CONSIDER EUROPEAN SUPPLY LINES

TARGET POTENTIAL WINNING EUROPEAN CITIES –
Frankfurt, Paris, Dublin, Luxemburg, Milan, Amsterdam, Berlin and global markets led by Singapore, Hong Kong and New York

BE ALERT TO ANY SHIFTS IN SENTIMENT AND GEOPOLITICS –
eg greater alignment with Asia or doubts over UK/Scotland etc.

CUSHMAN & WAKEFIELD

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A recognized leader in real estate research, the firm publishes its market information and studies online at www.cushmanwakefield.com/knowledge

THE REPORT

This report has been prepared by David Hutchings, head of the Investment Strategy team in Cushman & Wakefield's EMEA Capital Markets group, based on desk research together with input from Cushman & Wakefield LLP professionals in the Capital Markets teams across Europe.

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Cushman & Wakefield
43-45 Portman Square
London W1A 3BG

For further information on our services, please contact:

Capital Markets

CARLO BAREL DI SANT'ALBANO

CHIEF EXECUTIVE GLOBAL CAPITAL MARKETS & INVESTOR SERVICES

carlo.santalbano@cushwake.com
+44 20 7152 5846

Capital Markets

JAN-WILLEM BASTIJN

EMEA CAPITAL MARKETS

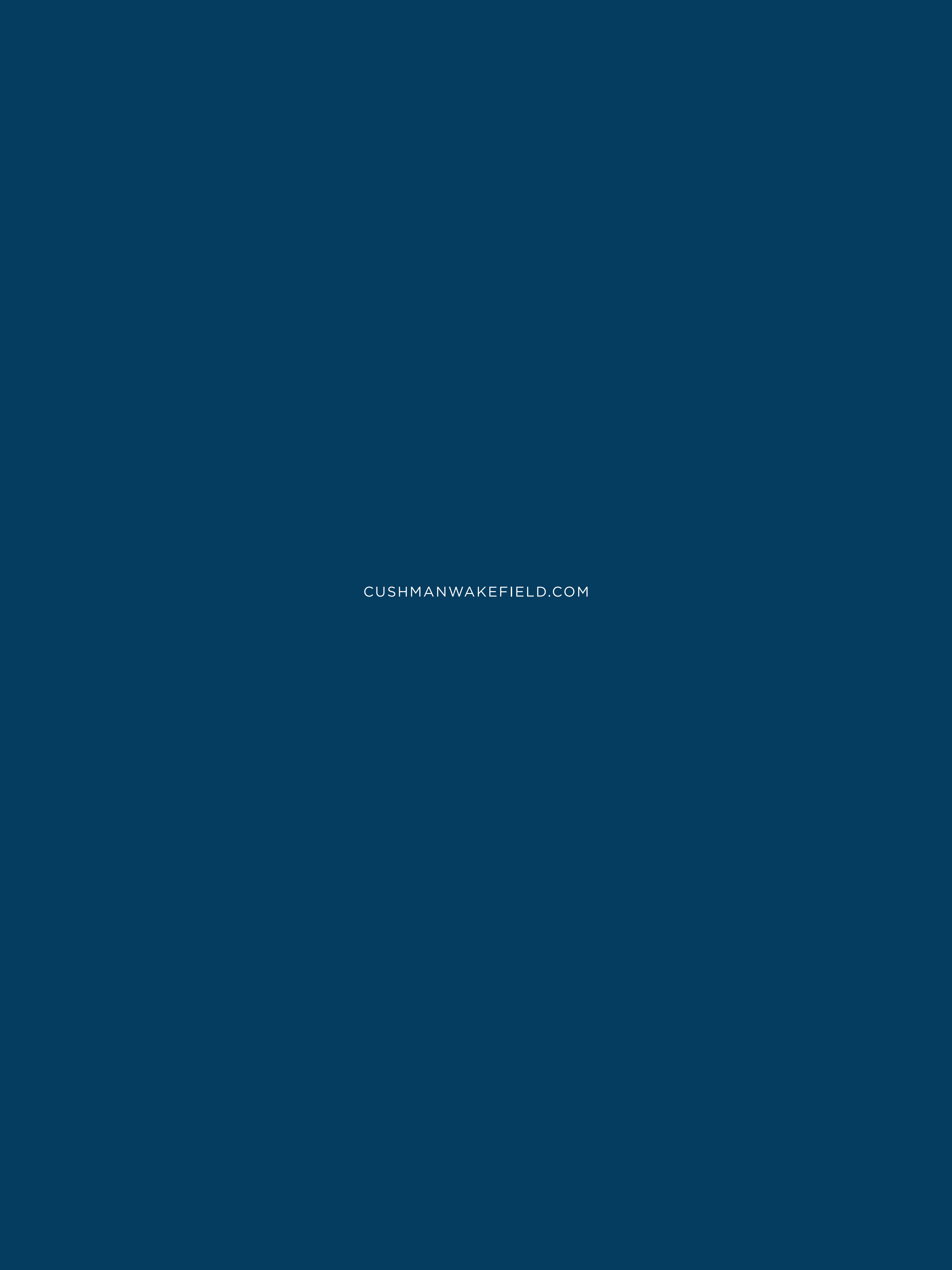
janwillem.bastijn@cushwake.com
+31 20 800 2081

Investment Strategy

DAVID HUTCHINGS

EMEA INVESTMENT STRATEGY

david.hutchings@cushwake.com
+44 20 7152 5029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