The wheel of the European economy is turning much faster these days. The weak economic recovery since 2009 has given way to a strong growth since mid-2016 with quarterly annualised pace of growth averaging 2.2%. We anticipate that European growth will strengthen over the years of our forecast period, driven by a considerably improved domestic demand. This development is to the great benefit of the occupational markets that have lagged in Europe as well as supporting those that are already healthy.

European Occupational Drivers

Solid take-up, but diverging demand outlook

Demand for office space across Europe has been robust with an average growth of 7.4% in each of the past three years. 2017 has been no different and we anticipate that the year as a whole will record a similar level of growth. Of course at city level the momentum and volatility differ because of the different stage of the property cycle. For example cyclical differences in the two largest markets, Paris and London, mean that over the next 3 years whilst Paris is likely to see reduced take-up after two good years of demand, London will begin to see a recovery from Brexit induced slowdown over the past four years.

A contrast may be made with the German cities where demand is projected to fall back over the forecast period, on the back of historical highs in most of the markets. The other cities such as Milan, Rome, Amsterdam and Brussels are showing demand momentum on the back of improving European economy. These markets belong to a set of countries whose economies have taken longer to improve in the European context.

Stock addition may outstrip net absorption

The high level of space overhang in the post financial crisis European market is all but a distant memory. Much of Europe’s vacant space then has been absorbed, helping to drive down the vacancy rate in most markets. Again here there is a wide variation across markets from the low of 2.2% in Berlin to the highest 14.0% in Helsinki. These are reflective again of demand momentum and local supply/demand conditions. In Berlin for example regulations make speculative construction difficult, helping to constrain supply. Milan had many projects underway for the Expo exhibition. The lack of grade A space in the CBD area is a common feature across many European cities (London being an exception).
In some markets there is the case for increased developments to replace ageing buildings. Among the top 15 European markets net addition as percentage of stock has been falling, gradually, from the high of 2.4% in 2008 to 0.2% in 2016. This situation is encouraging development and we anticipate that these markets will see growing net additions to the stock over the next five years (+ 1% pa), that may outstrip net absorption. That is certainly the case for London, Paris and East European cities whilst German cites ought to see vacancy reduce again before rising.

German cities likely to stay mid-priced and see the fastest rental growth

Cost of space mirrors vacancy patterns and economic growth. The largest cities will remain the most expensive in terms of prime rents; London and Paris. The German cities, despite a fall in the vacancy rate do not command the highest rents however they will post some of the fastest rental growth over the forecast period, most of it front loaded; Berlin (7%, pa), Frankfurt (4.2%, pa) Hamburg (2.2%) and Munich (2.0%). This is driven by a continued stable economic environment. The CEE nations post the lowest rents and are seeing substantial amounts of development occurring. Although prime rental growth is likely to remain low at best, the effect of the increased supply will be felt most in average rents, as tenants take advantage of low prime rents. Average rents may fall across the period, while prime rent holding steady.

Yields are set to expand across Europe...

The story of European investment since 2013 has been one of continued yield compression and accelerated capital growth, supported by record transaction volumes. As we move into 2018, the cycle in Europe broadly is likely to be at a point of inflexion. Similar to the occupational market, cities across Europe are all at different stages in the cycle and the rapidity and magnitude of change will differ. UK cities, even without Brexit, are expected to see capital growth fall back and yield expansion over the next two years. Initially, German and French cities are likely to see stable yields, followed by an expansion. We are anticipating that the only way is up for CEE, Spanish and Italian office markets. Capital growth for average and prime assets for most cities are expected to be negative at the end of the forecast period.

There is nothing like a changing cycle to bring the defensive attributes of real estate to the fore. As we move from an upswing cycle to one of inflexion (in some markets) and downswinging in others, investors’ attention is turning to the income component of property total return. We are not expecting growth in income to be large over the forecast period. And combined with movement in pricing, we think that prime total returns for most cities will come down quickly from 2018. A stable income will be enough to ensure that total returns do not turn negative for most cities. Dublin may flirt with negative returns over the forecast period as will some sub-markets in London.

Over the forecast period we expect total return across Europe to average 5.8% per annum, of which 1.8% and 4.0% are contributed by capital growth and income return, respectively. This return will range between 1.4% in Dublin (with most of the downside back loaded) and 11.7% in Berlin (with most of the positivity frontloaded).
Global Interest Rate Cycle

Global monetary policy has reached a juncture in 2017 with central banks aiming to normalise policy. There is a difference in both the speed and magnitude of the normalisation process. In the US monetary policy normalisation is already well underway with two rate rises thus far. We expect further rises in the medium term as inflation pressure gathers pace. In the UK the BoE has only just reset its policy to pre-Brexit level with any further tightening likely only at the end of 2018. In contrast the ECB has extended its QE programme until the end of 2018, to protect the infant economic recovery.

We have anticipated this situation in our forecasts and do not believe that this is significant enough to make an impact on property yields.

Catalonia

Catalonia’s long running political disagreement with the central government of Spain came to a head in October when following a referendum (unrecognised by the rest of Spain), the regional parliament unilaterally declared independence from Spain. Spain is the poster child for reform in the European Union and has attracted investor interest since 2013. Investors are attracted by the story it offers: the combination of good economic growth and employment gain.

This has been the Spanish story thus far. Now a more nuanced situation is emerging. The Catalan crisis (essentially a systemic risk) is injecting uncertainty into investor perception of the Spanish market, particularly Barcelona. The actions that the Spanish government has taking so far, with seemingly wide spread support from the populace across Spain, mean that this uncertainty will most likely be short lived.
BNP Paribas Real Estate is working on producing indicators which are as comparable as possible. This is a complex issue, due to cultural differences from market to market. Nevertheless, as we aim to actively contribute to the transparency of the markets, we have highlighted those definitions and indicators which are strictly comparable, so that our readers can understand what the indicators mean.

Furthermore we have decided to adopt the PEPICGI definitions, on which most of the following indicators published by BNP Paribas Real Estate are based. Other indicators are from INREVT and from BNP Paribas Real Estate.

Central Business District average rent is the average of each of the last four quarters' average headline rent in the CBD. Each quarterly average rent is weighted by the surface of each lease signed during the quarter, in either new or second-hand premises. The definition of CBD corresponds to local conventions.

Completions represent the total amount of floor space that has reached practical completion and is occupied, ready for occupation or an occupancy permit where required has been issued during the survey period.

Central London includes the following districts: West End, Midtown, City, Docklands, Southbank, Western Fringe and Northern Fringe.

Central Paris includes the following districts: CBD, Paris out of CBD, La Défense, Western Crescent and Inner Rim.

Core Investment Vehicles target returns at 11.5% and lower, with gearing level up to 60% of Gross Asset Value.

Closed Ended Fund is a vehicle that has a targeted range of investor capital and a finite life.

Development Pipeline represents the total amount of floor space for all developments under construction and/or schemes (including major refurbishments) that have the potential to be built in the future through having a secured level of planning permission but remain unimplemented at the survey date. It includes all proposed new buildings, those constructed behind retained facades and buildings (or parts of buildings) undergoing a change of use to offices.

Exchange Rate from £ into € for rents is the average value observed over the quarter.

Exchange Rate from £ into € for investment volumes for each quarter is the average value over that period. Full-year investment volumes in both currencies are made up by adding the four quarters of each year.

German Open Ended Fund is a public vehicle that does not have a finite life, continually accepts new investor capital, and makes new property in-"tainment. The list of German Open Ended Funds is published by the BVI (Bundesverband Investment und Asset Management e.V.).

Gross Asset Value is the sum of the Gross Capital Value of properties, cash and marketable securities and other (non-operating) assets.

Investment volume takes into account all commercial properties BNP Paribas Real Estate is aware of, whose owner has changed during the studied period, whatever the purchasing price. It includes Office buildings, Retail (supermarkets, hypermarkets), Industrial and Logistics Warehousing and Others (Hotels, Cinema, Leisure, Car Parks, Care Homes, parts of portfolio which can not be split up by product, and Development Sites in Germany). Quoted investment volumes are not definitive and are consequently subject to change.

Initial Prime Gross Yield is defined as Gross income (i.e. income before costs of ownership) over purchase price excluding costs of acquisition.

Initial Prime Net Yield is defined as Net income (or NOI) over purchase price plus all other costs of acquisition.

Prime Rent represents the top open-market rent at the survey date for an office unit:
- of standard size commensurate with demand in each location
- of the highest quality and specification
- in the best location in a market

Investment volume by investor/seller type refers to the following categories: Insurance, Private Investors, Public Sector, Corporates, Property Companies & REITS, Consortium, Funds and Other.

Investment volume by investor/seller nationality refers to the following categories: Eurozone, Non-Eurozone, North America, Other America, Asia, Middle East, Australia, International and Other.

Major Refurbishments represents refurbishments, where building work must involve either structural alteration, and/or the substantial replacement of the main services and finishes. The quality of the floor space must have been substantially improved from its previous condition so as to offer accommodation of a modern standard - although not necessarily to the standard of a completely new building.

Opportunistic Investment Vehicles target returns in excess of 17%, with gearing levels above 60% of Gross Asset Value.

Actual transactions are used in France, Germany and Belgium to support the headline prime rental quoted, but one-off deals, which do not represent the market, are disregarded. In the UK & Spain, if there are no prime transactions during the survey period a hypothetical rent is quoted, based on expert opinion of market conditions.

Space calculation differs in Spain, where figures in m² (Take-Up, Vacancy, Pipeline, Completions) as well as Rental values are based on Gross Letting Area space, contrary to the other main European markets, which use Net Letting Area. In order to make the Spanish figures comparable across all monitored markets, they should be multiplied by 0.82 (NLA = 0.82 GLA). This ratio is applied by BNP Paribas Real Estate to produce international indices and benchmarks.

Take-Up represents the total floor space known to have been let or pre-let, sold or pre-sold to tenants or owner-occupiers during the survey period. It does not include space that is under offer:
- A property is deemed to be "taken-up" only when contracts are signed or a binding agreement exists
- Pre-let refers to take-up that was either in the planning or construction stage
- All deals (including pre-lets) are recorded in the period in which they are signed
- Contract renewals are not included
- Sales and leasebacks are not included as there had been no change in occupation
- Quoted take-up volumes are not definitive and are consequently subject to change.

The breakdown of take-up by business sector is compatible with the European NACE code.

Under Construction represents the total amount of floor space in properties where construction has commenced on a new development or a major refurbishment (see separate definition) at the survey date. It includes properties for owner occupation, which are reported separately. It does not include sites being cleared for possible development in the future.

Property that is under construction but pre-let or for owner occupation is recorded separately where appropriate.

Value-added Investment Vehicles target returns of 11.5% to 17%, with gearing levels between 30% and 70% of Gross Asset Value.

Vacancy represents the total floor space in existing properties, which are physically vacant, ready for occupation in the next three months (this period covers fit-out time) and being actively marketed at the survey date. Vacancy includes sublet space (except in Germany), but where possible, vacant sub-let space is recorded separately.

In France, vacancy excludes premises which the owner will renovate only once a lease is signed. Spain only counts immediately available space.

Vacancy Rate represents the total vacant floor space including sub-lettings divided by the total stock at the survey date.

1 Pan-European Property Common Interest Group. This group assembles a wide range of European advisors and investors and major agents.

2 European Association for Investors in Non-listed Real Estate Vehicles.

BNP Paribas Real Estate Disclaimer clause

BNP Paribas Real Estate cannot be held responsible if, despite its best efforts, the information contained in the present report turns out to be inaccurate or incomplete. This report is released by BNP Paribas Real Estate and the information in it is dedicated to the exclusive use of its clients. The report and the information contained in it may not be copied or reproduced without prior permission from BNP Paribas Real Estate.

Should you no longer wish to receive this report, or wish to modify the conditions of reception of this report, please send an e-mail to: unsubscribe.mailing@bnpparibas.com
6 BUSINESS LINES in Europe
A 360° vision

Main locations*

EUROPE
FRANCE
Headquarters
167, Quai de la Bataille de Stalingrad
92867 Issy-les-Moulineaux
Tel.: +33 1 55 65 20 04

BELGIUM
Avenue Louise 235
1000 Brussels
Tel.: +32 2 290 59 59

CZECH REPUBLIC
Poběžní 630/3
186 00 Prague 8
Tel.: +420 224 855 000

GERMANY
Goetheplatz 4
60311 Frankfurt
Tel.: +49 69 2 98 99 0

HUNGARY
117-119 Vaci ut.
A Building
1123 Budapest
Tel.: +36 1 487 5501

IRELAND
20 Merrion Road,
 Ballsbridge, Dublin 4
Tel.: +353 1 69 11 233

ITALY
Piazza Lina Bo Bardi, 3
20124 Milano
Tel.: +39 02 58 33 141

JERSEY
3 Floor, Dialogue House
2 - 6 Anley Street
St Helier, Jersey (JE8 8RD)
Tel.: +44 (0) 1 534 629 001

LUXEMBOURG
Avenue J F Kennedy 44
1855 Luxembourg
Tel.: +352 34 94 84

NORTHERN IRELAND
* January 2017

Alliances*

ALGERIA
AUSTRIA
CYPRUS
DENMARK
ESTONIA
FINLAND
GREECE
HUNGARY **
IVORY COAST
LATVIA
LITHUANIA
NORTH-MASTER
NORWAY
PORTUGAL
SERBIA
SWEDEN
SWITZERLAND
TUNISIA
USA

Contact
Samuel Duah
Head of Real Estate Economics
samuel.duah@bnpparibas.com

www.realestate.bnpparibas.com

PROPERTY DEVELOPMENT | TRANSACTION | CONSULTING | VALUATION | PROPERTY MANAGEMENT | INVESTMENT MANAGEMENT