DTZ Foresight
Europe Fair Value Q4 2013
Window of opportunity closing

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Contents

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- The DTZ European Fair Value Index™ remained relatively stable in Q4 at 72, down slightly from 74 in Q3. This is the third quarter in a row that the European index has fallen, with declines having been accompanied by improving confidence in prospects for the eurozone.

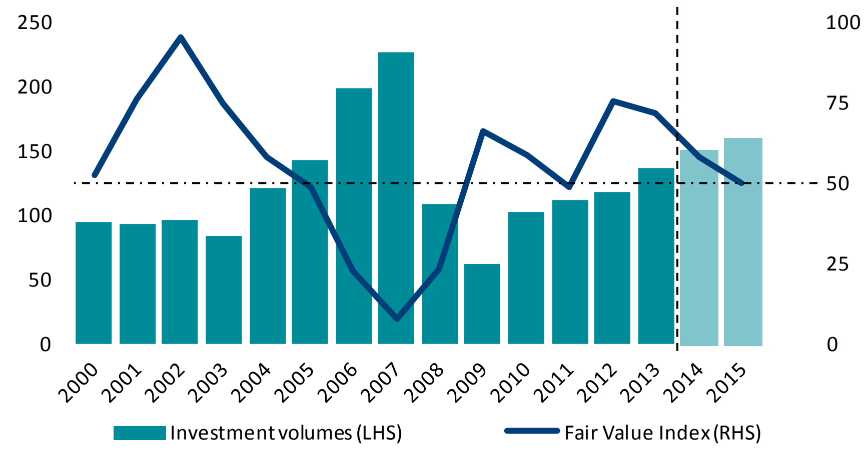
- At the sector level the Fair Value indices for office, retail and industrial have diverged over the past year, suggesting that investors have needed to be more selective in their allocations to different property types. Currently industrial is the most attractive sector, with an index score of 88, followed by retail at 84, while offices are the least attractive, with an index score of 55.

- We expect the European Fair Value Index™ to fall until at least the second half of 2015, dropping to 50 (Figure 1). A key factor which will diminish the attractiveness of property over the coming years is the rise in bond yields anticipated across Europe. This will make property look less attractive in comparison. At the same time we expect European investment volumes to rise 10% in 2014 to EUR150 bn.

- Investors are increasingly looking to Spain for investment opportunities on the back of more positive news on the economy. The Fair Value Index™ results support this move, with property markets in Spain and Italy looking attractively priced. There were only 6 European markets upgraded to Hot this quarter, all of which were located in either Spain or Italy. Falling bond yields have reduced required returns in these countries, while a slightly stronger economic outlook for both saw upgrades to expected returns on property. However, there are still risks that need to be considered in both countries, such as the 25% unemployment rate in Spain, and weak domestic demand in Italy.

Figure 1

DTZ Fair Value Index™ and Investment Volumes (EUR bn): Europe



Source: DTZ Research

Europe Fair Value Q4 2013

Fair Value highlights

European Fair Value Index™ falls slightly in Q4

The European DTZ Fair Value Index™ score has remained relatively stable, falling slightly from 74 in Q3 to 72 in Q4 (Table 1). This is the third quarter in a row that the European Index has fallen and signifies the growing confidence surrounding prospects for the eurozone going forward. Europe and the UK now have a similar proportion of Hot, Warm and Cold markets, which has brought their Fair Value Index™ scores more in line with each other. The score in Asia Pacific has experienced a steeper drop than that of Europe or the UK due the slowdown in emerging markets.

Spain and Italy upgraded again

There are currently 58 Hot markets, 35 Warm markets and 12 Cold markets in Europe. The appetite for risk continues to strengthen in peripheral economies such as Spain and Italy, with both having scores of 92, compared to 67 last quarter. This is a significant upgrade compared to a year ago when there were 8 Warm and 4 Cold markets between the two countries, with a collective score of only 33. The combination of decreased required returns due to a fall in bond yields, and increased expected returns due to a stronger economic outlook, have caused the upgrades. Two downgrades in France have seen the French index fall to 45 from 55, while in the UK, yields tightened in the regions sooner than previously expected. This gave rise to 5 downgrades from Hot to Warm and the index score dropping from to 73 from 85 (Figure 2).

Sector allocation has become more important

The Fair Value Index™ scores of the three sectors, office, retail and industrial have been diverging over the last year, suggesting that investors have needed to be more selective about their allocations to particular sectors of real estate. The Fair Value score of European offices is the lowest due to the high demand for the safest assets. This demand has caused yields to edge downwards making them less attractive. On the other hand, industrial is the most underpriced sector, with a score of 88, showing subdued demand in times of economic uncertainty (Figure 3).

Table 1

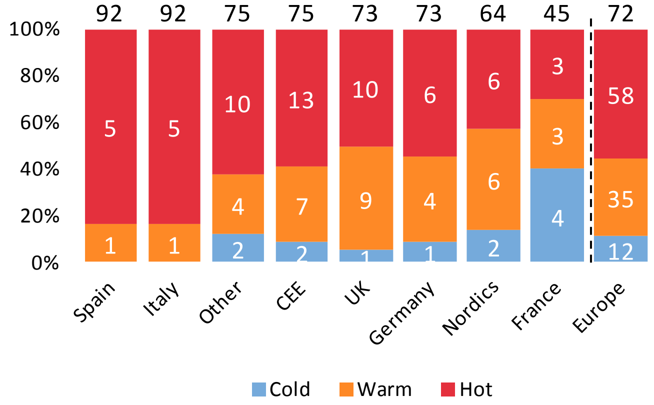
Fair Value Index™ scores

	Q3 2013	Q4 2013
Europe all property	74	72
Europe offices	60	55
Europe retail	79	84
Europe industrial	91	88
Asia Pacific all property	65	60
UK all property	85	73

Source: DTZ Research

Figure 2

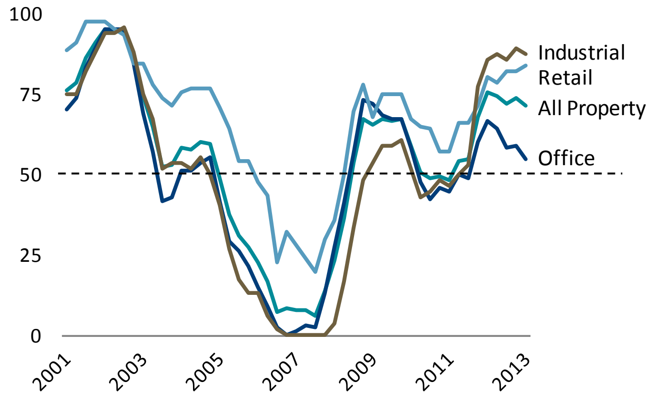
DTZ Research European Fair Value Index™



Source: DTZ Research

Figure 3

Fair Value Index™ European sectors



Source: DTZ Research

Europe Fair Value Q4 2013

Fair Value projections

Europe expected to retain value compared to Asia Pacific and the UK

Fair Value Index™ scores for Europe, Asia Pacific and the UK are expected to drop until at least the second half of 2015 (Figure 4). In Europe however, the index is expected to remain higher for a longer time. The UK is expected to see a significant deterioration in investment prospects in 2014 and is expected to be below 50 by Q2, meaning that there will be more Cold markets than Hot markets. This highlights that the recovery in the UK has led the rest of Europe, with high levels of capital flow expected to keep UK yields at their current low levels until interest rates increase.

Expected rise in bond yield to push required returns upwards

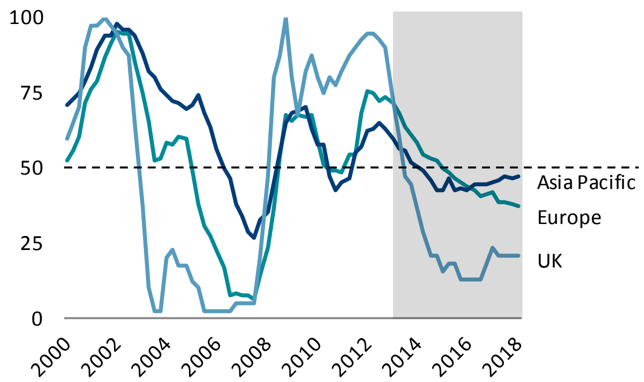
One of the primary factors that is expected to diminish the attractiveness of property over the coming years is the anticipated rise in bond yields across Europe (Figure 5). Although the spread has been narrowing between core and peripheral economies, this is not expected to continue for very long going forward. As investors begin to realise that safe returns can be achieved outside the bond markets, demand is expected to subside. This will push bond yields higher and the required returns in our Fair Value Index™ upwards, diminishing the attractiveness of European property markets.

Rising investment demand to push Fair Value down

Investor demand for real estate is expected to gain momentum in the coming years on the back of attractively priced assets and a sustainable economic recovery. We expect investment volumes to increase by 8% in 2014 to EUR 150bn. This expected growth in demand is accompanied by a decrease in the European Fair Value Index™. By 2015, we expect there to be an equal number of Hot and Cold markets in Europe and the Fair value score to be 50 (Figure 6). This suggests that opportunities to find excess returns in European real estate are quickly running out and that demand will subside as interest rates and bond yields eventually rise.

Figure 4

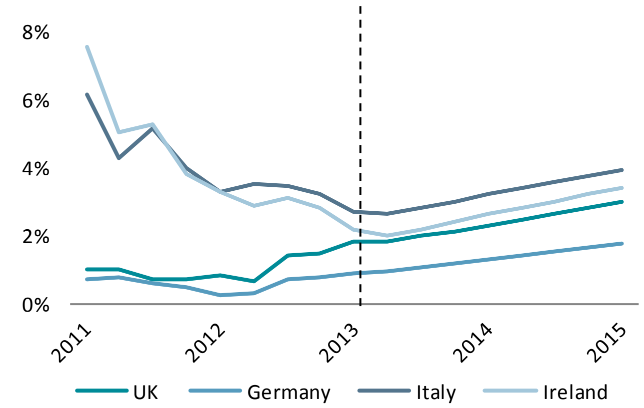
DTZ Fair Value Index™: European, Asia Pacific and UK projections



Source: DTZ Research

Figure 5

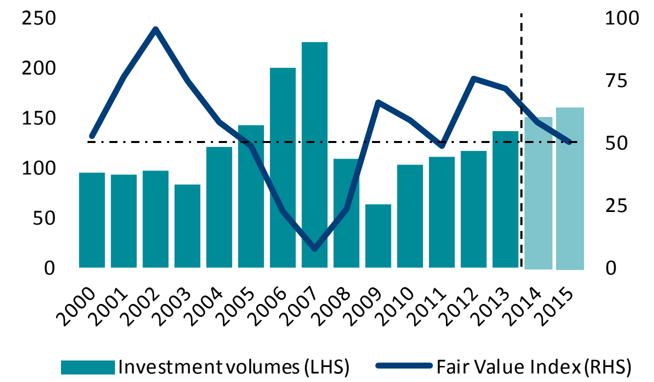
European historical bond yields and forward rates



Source: Bloomberg

Figure 6

DTZ Fair Value Index™ and Investment Volumes (EUR bn): Europe



Source: DTZ Research

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Required and expected returns

Bond yields edged down significantly in peripheral countries in Q4

Ireland, Italy and Spain all saw large falls in their 5 year government bond yields in Q4, while core countries including Germany and the UK saw a rise (Figure 7). This highlights the continued narrowing of the yield gap in Europe and a sign that investors are continuing move up the risk curve as the economy shows signs of recovery. This has had a significant effect on the required returns of the peripheral markets and has made many of them seem more attractive as an investment opportunity.

Appetite for risk continues to increase

The spread between eurozone composite AA corporate bond yields and German government bond yields continued to narrow this quarter, despite both rising over the last two quarters. This demonstrates that the appetite for risk is increasing in Europe. The spread between corporate and government bond yields, which directly affect our property risk premium, has fallen for 9 consecutive quarters, after hitting a peak in Q3 2011 (Figure 8).

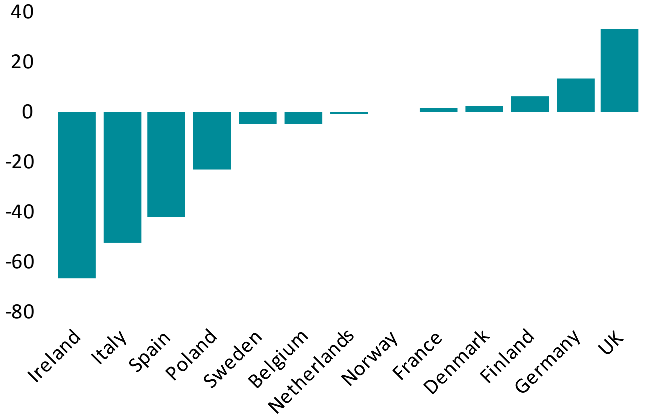
By comparison, the current 65 basis points spread is still higher than the pre-2007 average of 36 basis points, pointing to further falls in the spread as the recovery gains momentum.

Unemployment expected to hinder total returns

Despite favourable indicators bringing down the required returns in Europe, structural problems still remain in the eurozone, namely unemployment. In Spain, the rate is above 26% and in the eurozone, it is 12.2% (Figure 9). The primary issue with these high rates is that they are expected to remain high for at least the next couple of years. The consequence of this is that demand will suffer, keeping our expectation of total returns subdued.

Figure 7

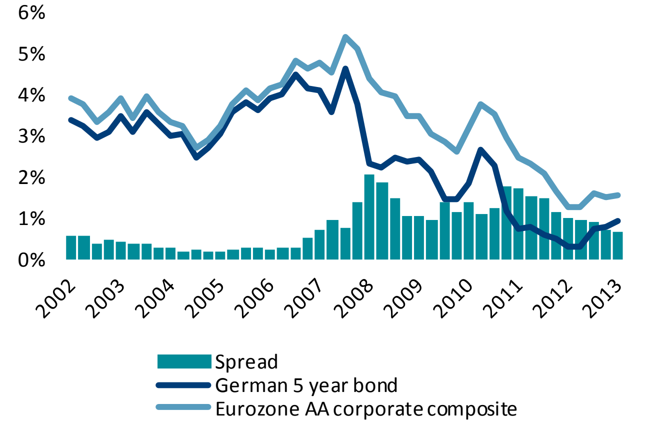
Movements in five year government bond yields from Q3 2013 to Q4 2013 (Bps)



Source: Bloomberg

Figure 8

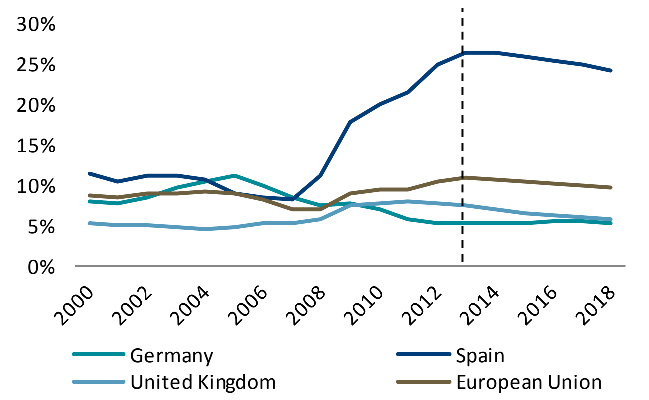
Spread between eurozone AA corporate bonds and German 5 year government bond yields



Source: Bloomberg

Figure 9

Unemployment rates



Source: Oxford Economics

Europe Fair Value Q4 2013

Market classifications

6 Spanish and Italian markets upgraded to Hot

There were only 6 European markets upgraded to Hot this quarter, and they were all located in either Spain or Italy (Figure 10). Falling bond yields have reduced required returns in these countries, while a slightly stronger economic outlook for both saw expected returns on property upgraded. This combination has made these markets look more attractive from an investment perspective. However, there are still risks that need to be considered in both countries, such as the 25% unemployment rate in Spain, and weak domestic demand in Italy.

10 markets were downgraded from Hot to Warm, including Munich and Moscow offices, while two French markets, Marseille offices and Paris CBD retail were downgraded from Warm to Cold. In Paris, strong rental growth recorded in Q4 2013 means that the opportunity for excess returns has been diminished going forward.

Dublin remains the most underpriced market in Europe, but Spain is catching up

Dublin industrial is the most underpriced market in Europe having both strong expected returns and a low hurdle rate due to an ever decreasing bond yield. Barcelona and Madrid retail saw significant upgrades this quarter due to an upgrade to average expected returns over the next five years and a decrease in the bond yield in Q4 (Figure 11).

On the other hand, Zurich offices remain Cold as strong investor demand keeps yields low at 3.5%.

Strong capital growth in Dublin

Irish 5 year government bond yields are currently 2.2% compared to 2.7% in Spain and 0.9% in Germany. Strong capital growth in Dublin, supported by expected yield compression and strong rental growth, has elevated expected returns. On the other hand, low bond yields in Germany mean that required returns in Frankfurt are exceptionally low, and the market looks attractive as a result (Figure 12).

Figure 10

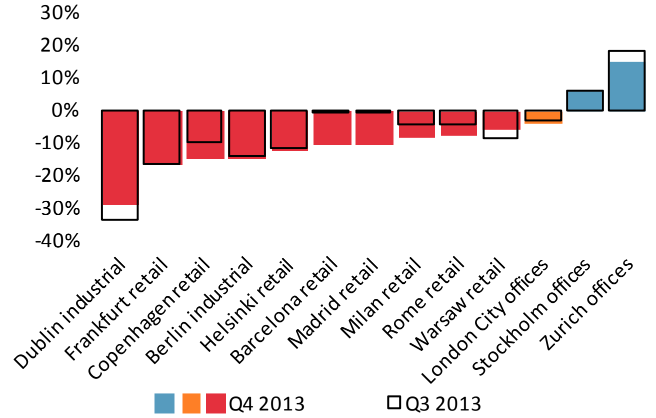
Movements in market classification from Q3 2013 to Q4 2013

Q3 2013 \ Q4 2013	Cold (12)	Warm (35)	Hot (58)
Cold (12)	10 Geneva offices London WE retail Paris CBD offices	2 Dusseldorf offices	
Warm (31)	2 Marseille offices Paris CBD retail	23 London City offices Barcelona offices Berlin offices	6 Madrid offices Milan retail Barcelona retail
Hot (62)		10 Munich offices Moscow offices Warsaw industrial	52 Dublin offices Berlin retail Milan offices

Source: DTZ Research

Figure 11

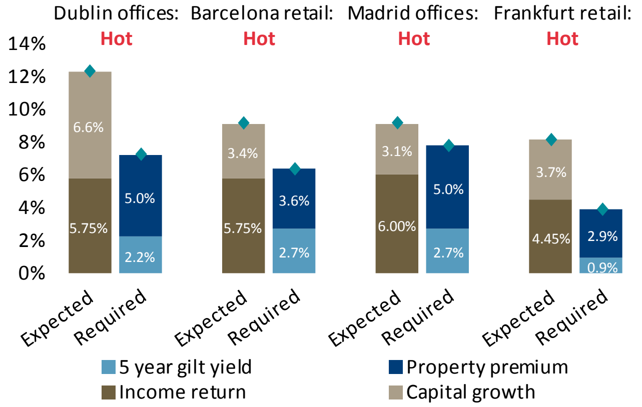
Degree of over/under pricing in European markets Q3 2013 versus Q4 2013



Source: DTZ Research

Figure 12

Five year expected and required returns – Q4 2013 (p.a.)

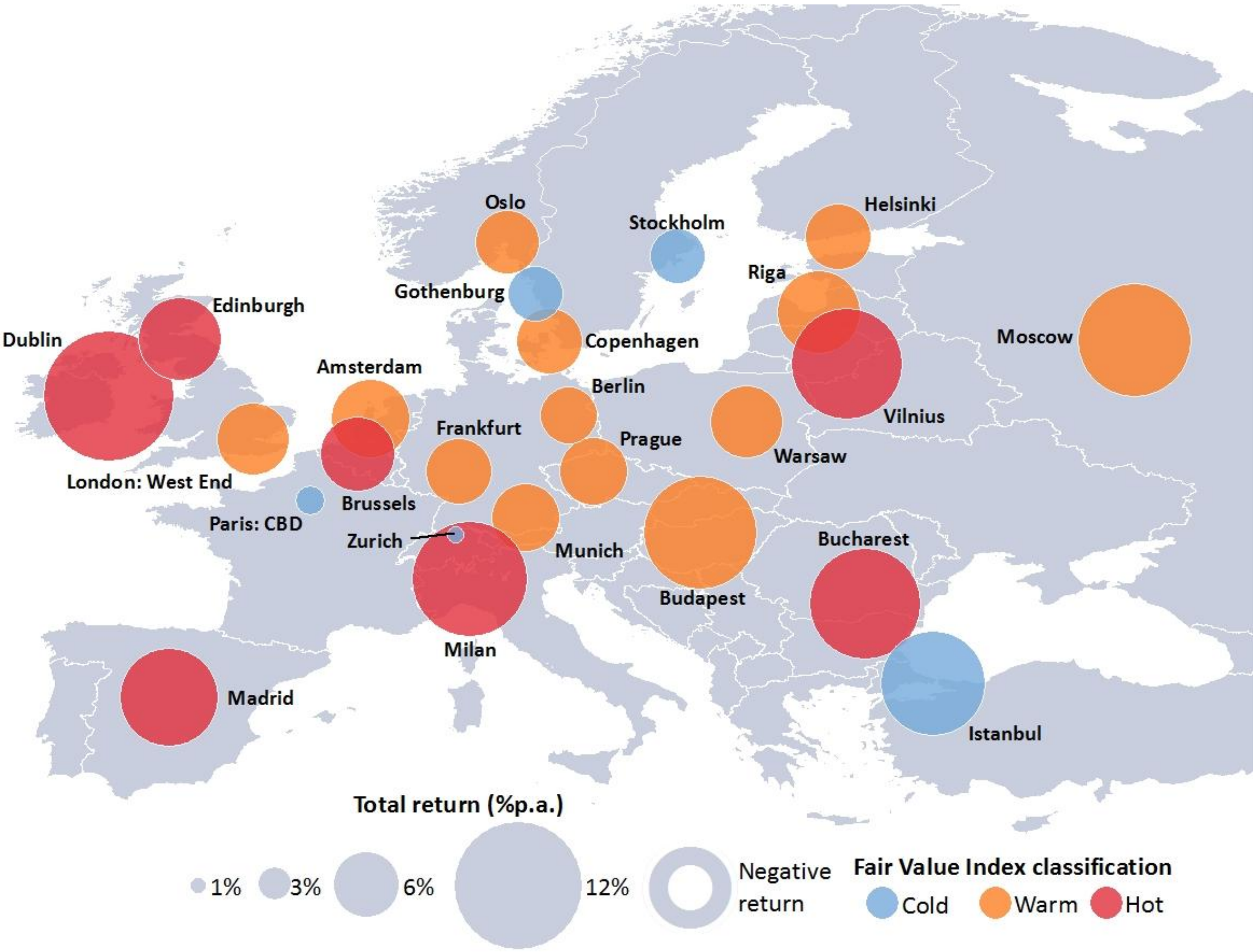


Source: DTZ Research

Europe Fair Value Q4 2013

Map 1

European office market Fair value classifications and five year total return forecasts Q4 2013-Q4 2018 (% p.a.)



Source: DTZ Research

Europe Fair Value Q4 2013

Office forecasts

Macro measures improve but risk of deflation

The eurozone ended 2013 on a mixed note. Overall macro-economic measures improved, but by less than expected. With regional inflation expected to stay well below the ECB's 2% inflation ceiling, there is considerable concern over whether or not Europe has will enter a period of deflation.

On the upside there has been significant progress with fiscal policy as financial markets and the European Commission have moved on from close scrutiny of budget plans and focus on fiscal austerity. Also, at the start of the year Spain and Ireland accessed debt markets at significantly lower yields than the last few years, with bond offerings being oversubscribed.

Overall European office rental forecasts have decreased, and are 1.4% p.a. for the 2014-2018 period. This reflects downward revisions in some core markets such as Geneva, Hamburg and Paris (Figure 13).

Investors moving up the risk curve

As investors are gaining greater access to debt and equity, there has been a significant increase in appetite for non-core markets. This movement up the risk curve will lead to yield compression in secondary markets and an increase in yields in some of the core markets.

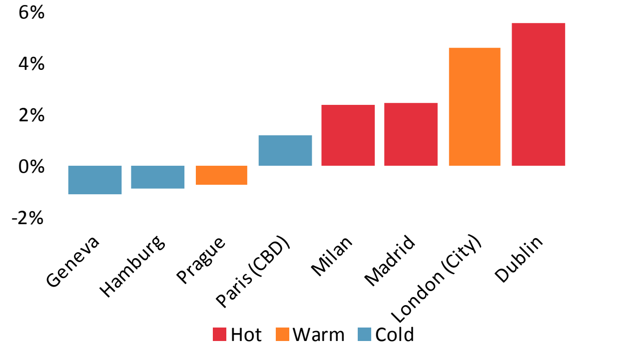
This is reflected in our forecasts, where yields in core markets such as London, Geneva and Paris are expected to remain relatively static in 2014 and then increase in 2015. We also expect that over this period yields in non-core markets such as Istanbul and Milan should begin to compress (Figure 14).

Non-core markets forecast to outperform core

Total returns in the Dublin office market are expected to be the highest of any office market across Europe, at 12.3% over the forecast period. This is mainly driven by strong capital growth of 6.6% p.a., as the Dublin office market continues its robust recovery. Other markets of particular interest include Milan, Moscow and Manchester, which are forecast to see total returns of 10.8%, 10.5% and 8% p.a. respectively. This is in contrast with core markets such as Geneva and Paris (CBD) which have weaker growth prospects. Consequently, we expect total returns in both markets to be -2.5% and 2.8% p.a. respectively from 2014 to 2018 (Figure 15).

Figure 13

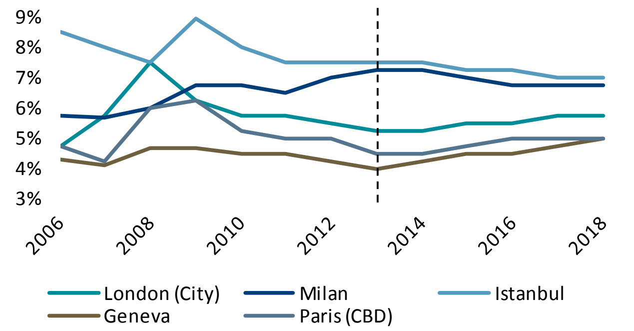
Average office rental growth forecasts (2014-18 p.a.) and Fair Value classifications



Source: DTZ Research

Figure 14

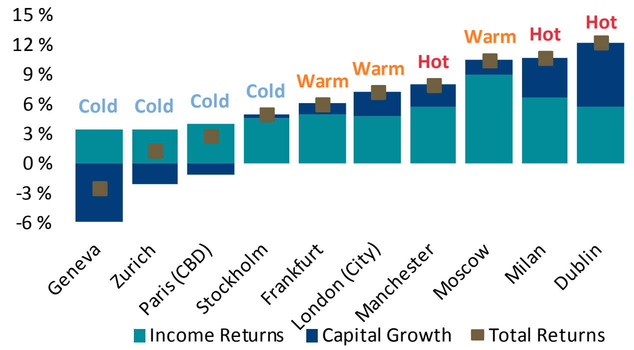
European office yield forecasts (Q4)



Source: DTZ Research

Figure 15

European office average total returns breakdown (Q4 2013- Q4 2018 p.a.) and Fair Value classifications



Source: DTZ Research

Europe Fair Value Q4 2013

Retail forecasts

Positive sentiment maintains strong outlook for retail

The December European Commission (EC) Economic Sentiment Indicator (ESI) increased by 1.6 points for the eurozone (to 100) and 1.4 points in the EU (to 103.5), thus bringing sentiment back to its long-term average for the first time since July 2011. Also, the December (EC) flash consumer confidence indicator improved in the euro area (-13.6 after -15.4 in November 2013) and the EU (-11.1 after -12.4 in November 2013). Given this economic backdrop, we maintain our positive outlook for our on the average European retail rental forecasts, and expect rents to rise by 1.8% p.a. over 2014-18.

Frankfurt is expected to show the strongest rental growth of any European retail market at 4.1% p.a. over the 2014-18 period. European rental growth is generally being driven by non-core markets such as Dublin and Barcelona, reflecting a recovery in consumer confidence and improvements in occupier demand (Figure 16).

Prime prices drive investors into secondary markets

The rise in prime retail property prices in Europe is encouraging many investors to look for assets in cities such as Dublin and Barcelona. As such, we expect yields for both these markets to drop by 100 bps and 25 bps respectively over 2014-18. On the contrary, for the likes of London and Paris, yields are expected to increase by 50 bps and 25 bps respectively over the forecast period (Figure 17).

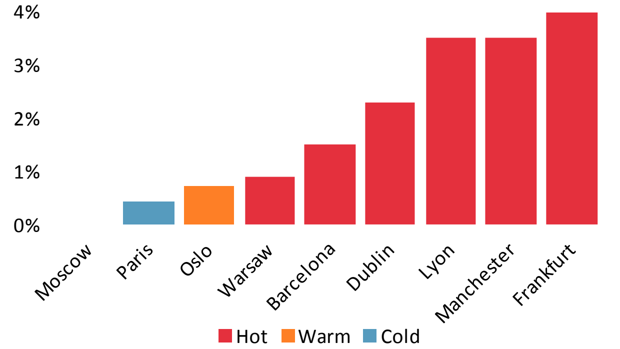
Dublin offers highest total returns over the next five years

Dublin is expected to show the highest capital growth potential of 7.2% p.a. over the forecast period. This in turn would deliver total returns of 13.2% p.a.. Other markets which are showing promising total returns include cities from the CEE and other peripheral countries. Budapest and Barcelona are forecast to give returns of 12.1% p.a. and 9.1% p.a. respectively over the 2014-18 period. This is mostly driven by income returns, with each market expected to deliver 7.5% p.a. and 5.8% p.a. respectively.

In contrast, core market such as London (WE) and Paris (CBD) offer much lower upside potential over the forecast period. Total returns for these markets are 2.1% p.a. and 3.2% p.a. respectively over the next five years (Figure 18).

Figure 16

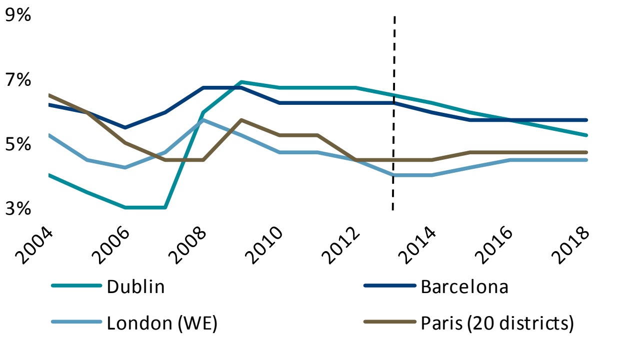
Average retail rental growth forecasts (2014-18 p.a.) and Fair Value classifications



Source: DTZ Research

Figure 17

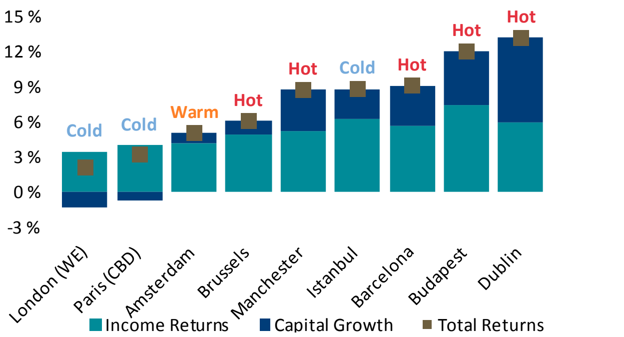
European retail yield forecasts (Q4)



Source: DTZ Research

Figure 18

European retail average total returns breakdown (Q4 2013- Q4 2018 p.a.) and Fair Value classifications



Source: DTZ Research

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Industrial forecasts

Occupier demand expected to drive secondary markets

Eurozone industrial production rebounded strongly in November, growing by 1.8% on the month after two consecutive declines. Moreover, the eurozone manufacturing Purchasing Managers Index (PMI) in December 2013 posted its highest reading since May 2011, indicating strong industrial production growth in the last month of 2013.

Overall, European industrial rental growth is expected to be the same as last quarter at 1.3% p.a. over the forecast period. We now expect Dublin industrial rents to grow at a rate of 5.6% p.a., considerably less than the 7.3% p.a. expected last quarter as some rent increase was already achieved in Q4. Rent growth in core markets such as Amsterdam and London are expected to remain relatively subdued at 0.6% p.a. and 0.8% p.a. respectively over the forecast period (Figure 19).

Yield gap expected to close

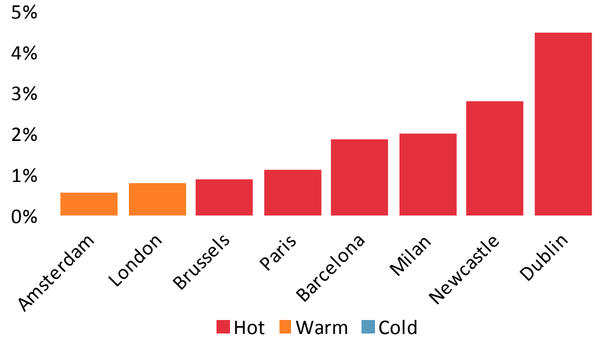
Industrial yields in peripheral and CEE markets are expected to see considerable compression over the forecast period. Dublin, Barcelona and Budapest are expected to see their yields compress by 100 bps, 50 bps and 40 bps respectively over 2014-2018. This is a result of increasing investor interest in these secondary markets as prime property becomes scarce at affordable prices. Overall, this will result in tightening of the yield gap between core and non-core markets over the forecast period (Figure 20).

Total returns are being driven by income returns

Much the same as the previous few quarters, total returns for the industrial market are being driven by income returns. All markets are expected to achieve similar income returns with capital growth being the main differentiator across the markets. The average income return for the industrial markets covered is expected to be 7.8% p.a. over the forecast period. This is accompanied by average capital growth of 1.4% p.a. over 2014-2018. London (Heathrow), Antwerp and Amsterdam are expected to see relatively low total returns with all three markets expected to see negative or no capital growth over the forecast period (Figure 21).

Figure 19

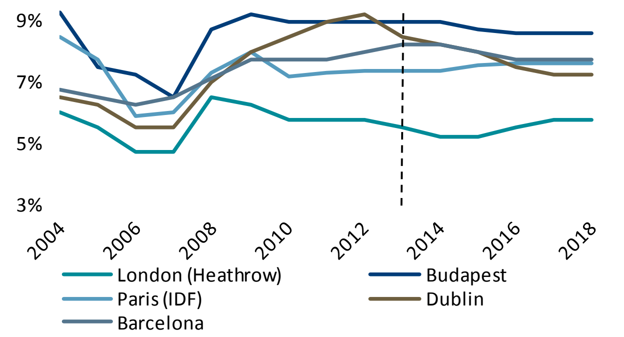
Average industrial rental growth forecasts (2014-18 p.a.) and Fair Value classifications



Source: DTZ Research

Figure 20

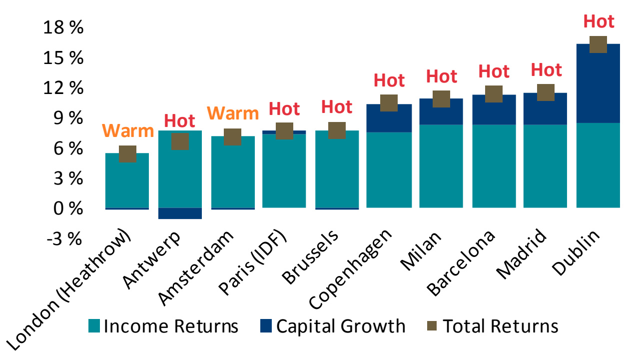
European industrial yield forecasts (Q4)



Source: DTZ Research

Figure 21

European industrial average total returns breakdown (Q4 2013- Q4 2018 p.a.) and Fair Value classifications



Source: DTZ Research

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Fair value methodology

The DTZ Fair Value Index ™ was launched in August 2010 and has now been rolled out for all 201 markets covered by DTZ forecasts.

Fair value is the value at which an investor is indifferent between a risk free return and the expected return from holding property, taking into account the extra risk of investing in the property asset class.

When the 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.

For more information see the note DTZ Fair Value Estimates – Methodology and Examples at www.dtz.com

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Global Occupancy Costs Logistics
Obligations of Occupation Americas
Obligations of Occupation Asia Pacific
Obligations of Occupation EMEA
Global Office Review
India Office Demand and Trends Survey 2012-13
Regional Headquarters Asia Pacific November 2013
Poland Banking Sector - January 2013
Motorways of the Sea - January 2013

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Singapore Government Land Sales - September 2013
UK lending market -September 2013
Quantitative Easing - August 2013
Property Investment Guide Asia Pacific 2013-2014
Singapore Insight – Residential – July 2013
China Insight - The Healthcare Sector - April 2013
City of London occupier demand - April 2013

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