Real Estate

European Real Estate House View

Second half-year 2017

EXECUTIVE SUMMARY

Retailers raise concerns, office markets perform well

European Economic Environment

- Europe's economies are benefitting from the first simultaneous global upswing since 2009.
- Purchasing Managers Indices (PMI) suggest strong momentum in the industrial sector.
- Falling unemployment, low interest rates and pent-up demand underpin strong consumer spending.

Office Markets

- Ongoing healthy conditions for the leasing markets due to enduring tenant demand and low levels of new supply.
- In continental Europe, vacancy rates continued to decrease in H1 2017 resulting in marginal rent escalation.
- Lack of supply is creating opportunities for developers leading to a moderate increase in building starts.
- The UK and especially London saw a slight recovery in H1 2017 take-up, while rents were largely stable.
- Overall in Europe, we expect slight rental growth.

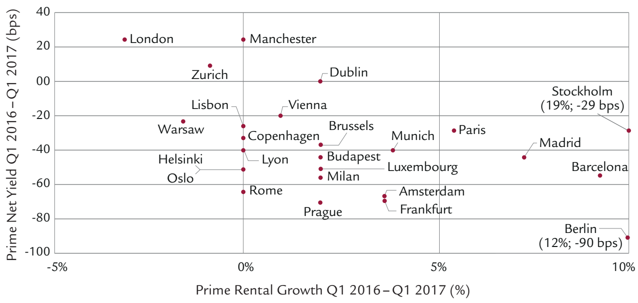
Retail Markets

- The evolution of trade formats from 'bricks and mortar' to online or multi-channel results in divergent prospects for retail segments despite consumer spending holding up overall.
- High street retail performs well in top locations such as central London or Paris – but challenges are growing and rental growth may not occur in the short-term.
- Large, prominent regional shopping centres also remain attractive for shoppers and tenants, as they provide a range of activities in addition to retail.

Residential Markets

- High demand and insufficient new supply mainly in the large cities has boosted rents and house prices.
- In Switzerland, the market is changing for the first time in years and becomes more tenant friendly – supply is still increasing but net immigration is declining.

Prime Rent & Prime Yield – The European Office Market



Source: PMA, Wüest Partner AG

The attractiveness of the real estate markets in Europe remained high in the first half of the year. Investors were keen to buy real estate so transaction volumes increased on an annual as well as on a quarterly basis. Despite regional and deal variability, continental Europe has seen rissing demand for real estate investment. Activity in the UK is weaker but remains in-line with historical averages Transaction activity in the London office market during the first half of 2017 was comparable to activity for the whole of 2016. This is partly due to some large single transactions from overseas investors, who may be taking advantage of the weak pound. Transaction volumes in Germany increased markedly over the period whilst activity in France remained muted. Investors are focusing on the secondary European markets for higher-yielding investment opportunities given high pricing in primary markets. We have seen increased transaction activity in the Netherlands or Italy, which have typically lagged behind other markets in the cycle. Prime net yields were under pressure during the first 6 months of the year, staying stable or recording reductions up to 50 bps (Amsterdam) in the office sector since the beginning of 2017. European high streets have also seen yield compression during H1 2017 albeit more selectively. The retail sector is subject to headwinds all over Europe although to a varying extent and consumer spending holding up. Changing consumer behaviour such as growth in online shopping challenge the traditional retail business; space is therefore increasingly occupied by the leisure sector. We believe that the retail sector will sustain but will need to adapt significantly. Given the low interest rate environment we expect yields to remain low and less volatile. In the prime European markets, we see limited risk of yield increase compared to the secondary countries and locations.

UNITED KINGDOM

Three years or more of uncertainty

Economic Environment

- Exporters benefit from strong global dynamics and the competitive advantage of a weak currency.
- Real disposable incomes are being held back due to high inflation.
- We expect subdued capital expenditure by the corporates given the uncertainty of Brexit negotiations.

Office Market

- Prime rents edged down slightly in London over Q1 2017. Rental values in regional markets are stable or growing.
- Overseas investment demand is maintaining low yields for prime real estate in London.
- Leasing activity was subdued in Q2 2017 in London but is 12% ahead of the 10-year average, suggesting that underlying demand remains robust.
- Vacancy rates in London are in line with long term averages but there is a significant volume of space coming through the development pipeline.

Retail Market

- London's retail leasing market has been resilient over the last year.
- Vacancy rates have been stable in the prime areas around Bond Street, Oxford Street and Regent Street.
- Prime Zone A retail rents in the West End stood at GBP 2'200 per sq. ft. per year as at Q4 2016.
- Strong overseas investor demand for prime central London retail has driven investment yields to exceptionally low levels.

Residential Market

- UK house prices rose 4.9% in the 12 months to June 2017.
- Shortage of available homes to purchase continues to constrain activity.
- UK residential price growth is forecast to be in the region of 14% over the next five years. UK rental values are forecast to increase around 10% over the next five years.

Expected Trends (next 6 months)

	Office		Retail		Residential	
	Rents	Yields	Rents	Yields	Rents	Yields
London	↘	→	→	→	↘	→
Birmingham	↗	↘	→	→	↗	→
Bristol	↗	↘	→	→	→	→
Edinburgh	→	↘	→	↘	→	→
Glasgow	→	↘	→	↘	→	→
Leeds	↗	→	→	→	→	→
Manchester	→	→	→	→	↗	→

With the unexpected outcome of the election in June 2017, with the incumbent government losing their outright majority, at the time of writing it is too soon to be certain about the implications. We have therefore based our view on the developments so far. Although investment volumes have been relatively subdued since the UK voted to leave the EU in June 2016, there continues to be strong demand for good quality assets. Average deal size has been rising as the number of transactions has fallen. This reflects the impact of a smaller number of larger transactions as market liquidity has fallen. However, in our view it is a shortage of sellers rather than buyers that has driven this transactional decline. International capital is the main driver of demand in London accounting for around 80% of transactions. Appetite from domestic buyers remains as the income component of property remains attractive given low gilt rates.

The office tenant base in London is increasingly diverse and Brexit is expected to accelerate the move away from financial service towards technology occupiers. The UK retail sector is facing challenges, particularly due to proportionally high online spending. So far, the retail market in London has been resilient, supported by inbound tourism spending due to the weak pound. House buyer sentiment is expected to be fragile during the UK/EU negotiation period but the prolonged low interest rate environment will provide support for those with a mortgage and should reduce the risk of a housing market correction. However, affordability in the housing market is already stretched and buyers are unlikely to want to stretch their finance much further against an uncertain economic backdrop. The outlook for rental growth within the residential sector is weaker as household incomes are likely to be squeezed by higher inflation and weaker employment growth. The average buyer in London borrows four times their income and their ability to do so has been dependent on low interest rates. The affordability pressures in London mean that price growth is expected to underperform the UK average over the next five years.

GERMANY

Good prospects for economy and real estate markets

Economic Environment

- Germany's economy strongly benefits from a weak currency and growing global demand.
- Employment numbers continue to rise, yet wage growth remains subdued given its position in the economic cycle.
- Annual inflation surpassed 2% in Q1 2017, but this is likely to be temporary.

Office Market

- In the first quarter of 2017, office take-up activity remained high with regional differences driven by the number of large lettings.
- On the supply side, completions are expected to remain subdued overall but could start to rise in selected markets as a reaction to the increasing scarcity of available modern space.
- Office vacancy decreased over the last quarters, mainly in the Top 7 markets, reaching 6% on average in Q1 2017.
- For the next quarters we expect further rent escalation, with significant growth in Berlin and moderate growth rates in the other Top 7 markets as well as regional markets with a strong economic basis.

Retail Market

- The changing of trade formats from pure 'bricks and mortar' to online or multi-channel results in divergent rental growth prospects by segment.
- For the majority of high street locations and shopping centres rents are expected to remain at current levels or remain under pressure. Only prime areas and centres are likely to provide upside potential in the medium term. In contrast, there is ongoing positive momentum for rental growth in retail warehousing.

Residential Market

- In Q1 2017, asking rents rose by 0.9% on average in Germany and 1.2% in the Top 7 markets. The purchase prices for flats were equally strong.
- We expect an increase in average rents of just over 2% p.a. in the next few years, as well as an increase of around 1% p.a. in less popular regions.

Expected Trends (next 6 months)

	Office		Retail		Residential	
	Rents	Yields	Rents	Yields	Rents	Yields
Berlin	↗	↘	↗	↘	↗	↘
Cologne	↗	↘	→	↘	↗	↘
Dusseldorf	↗	↘	→	↘	↗	↘
Frankfurt	↗	↘	→	↘	↗	↘
Hamburg	↗	↘	→	↘	↗	↘
Munich	↗	↘	↗	↘	↗	↘
Stuttgart	↗	↘	→	↘	↗	↘

The German investment market has started strongly into the 2017 with transaction volumes of EUR 12.5 bn for commercial and EUR 3.5 bn for residential property in the first quarter. However, the figures may be somewhat misleading since many transactions were agreed in 2016 but only recently completed. After years of strong demand, the investment market is characterised by insufficient supply. New record sales figures are unlikely to be achieved in 2017. As a result of the strong competition among investors, prime yields continued to fall noticeably in 2016. Prime yields in the top locations fell not only in the office but also the retail and residential sectors below 4%. In 2017 so far prime yields have continued falling, mainly in the top locations. Examples are offices in Berlin with yields about 3% and Munich with 3.25% which the lowest yields in Europe. By contrast, secondary markets offer considerable high initial yields of 5% on average compared to 3.75% in the Top 7 markets (figures for year-end 2016). For all asset classes a further decline in prime yields is expected in 2017. In the following years, yields are anticipated to remain more or less stable, with some upward pressure. There are clear leasing activity differences between sectors. While the office markets benefit from the good economic performance, a large number of traditional retailers are subject to intense competition through e-commerce and consumers' changing consumption preferences and leisure expectations. The consequences of structural changes are not only visible in secondary cities and locations but also in a growing number of high street locations and shopping centres. Demand for space is declining whilst vacancy rates and rental periods are rising resulting in stagnating or decreasing rents in less attractive locations.

In the residential sector, migration to the economically strong regions remains a strong driver. A growing population in these locations are counterbalanced by inadequate new construction of housing.

FRANCE

Stronger economy and resilient real estate markets

Economic Environment

- France is benefitting from the global economic upswing and a favourable exchange rate.
- Investor sentiment has improved after the presidential & parliamentary elections.
- Macron's success depends on successful implementation of his reform promises, yet opposition from the street remains a key risk.

Office Market

- The strengthening economy is noticeable in the Greater Paris Area and large regional cities supporting occupier and investment demand.
- The Greater Paris Area remains the main investment market, totalling 60 % of the EUR 3 bn. investment volume in office properties in Q1 2017.
- Prime office yields in Paris CBD remain low at 3 % down 25 bps year-on-year. Rents remain stable at EUR 790 in Paris and EUR 300 in Lyon. They are expected to grow in the medium term.
- Regional cities continue to offer a combination of attractive prime yields (e.g. 4 % in Lyon), resilient markets and a lack of quality properties.

Retail Market

- High street retail is sought-after by tenants looking for maximum exposure in a very competitive market.
- Clothing and footwear retailers are seeing strong competition from e-commerce while cosmetics and food retailers have seen turnovers increase (turnover index +10 % YoY).
- Small and medium-sized shopping centres are under pressure, seeing month-on-month decreases of between 1 % and 4 % since the end of 2015.
- In this context, rents remain flat and prime retail yields remain low at 2.5 % in Paris and 3.5 % in large regional cities.

Residential Market

- 2016 was exceptional with 9 % more units sold compared to 2015. This increase is expected to continue in 2017 and 2018 but at a lower rate.
- Investors have become increasingly interested in the residential market due to attractive yields (2.5 % – 3 %) and a liquid, resilient market.
- Rents recorded a modest increase of 1.7 % in 2016.

Expected Trends (next 6 months)

	Office		Retail		Residential	
	Rents	Yields	Rents	Yields	Rents	Yields
Paris	↗	↘	→	→	↗	↘
Lyon	↗	↘	→	→	↗	→
Marseille	→	↘	→	→	↗	→
Lille	→	↘	→	→	↗	→
Bordeaux	→	↘	→	→	↗	→

On the 7th of May 2017, France elected Emmanuel Macron as its new president. His pragmatic and pro-business political line has created hopes for his ability to implement structural reforms. The strengthening of the economy is expected to have positive impacts on the real estate markets too. The French office market remains one of the main investment markets in Europe as it is resilient and offers high liquidity. As a result, well located prime offices in large cities are sought-after by investors and prime yields fell in all cities to record lows. Despite these low levels, prime yields remain attractive as the risk-free interest rate spread remains flat at 3 % in Paris and +/- 4 % in other large regional cities. Rents remain flat although growth is expected in the coming years as vacancy rates are falling and developments remain limited. In the Paris region, vacancy rates decreased from 7.1 % in March 2016 to 6.5 % in March 2017. This drop is due to Inner Paris and La Défense markets, reflecting the popularity of high quality properties with tenants.

The retail market in France has seen some recovery in investment activity, with EUR 5 bn. invested in 2016. However, the retail market is facing challenges from rising online shopping and new consumer habits. In terms of rents and footfall, the trend is positive for very large shopping centres, factory outlets and high-street retail stores with grade A tenants. Small and medium-sized shopping centres and retail parks may experience falling footfall due to increased competition from larger centres and e-commerce. Food and beverage and cosmetics retailers have been performing strongly.

The residential market was dynamic in 2016 compared to 2015 and the trend is expected to continue in 2017 and 2018. As prime office yields tend to equal residential yields, investors are returning to this market which is very liquid and resilient. They also stand to benefit from a lack of housing placing upwards pressure on pricing (+3.7 % increase in the price per square meter in Paris in 2016).

SWITZERLAND

Retail market challenges increase

Economic Environment

- The strong Franc continues to weigh on manufacturers and parts of the tourism industry.
- Switzerland experiences a jobless recovery.
- Earlier stimuli like those from low interest rates, falling import prices and migration are fading out.

Office Market

- Supply of office space increased in the five largest markets.
- Take-up continues to be low leading to increasingly large tenant incentives.
- Rents were stable, but we expect rents to be flat or slightly decreasing in the short-term.
- Desk sharing increasingly reduces demand of large companies for office space.

Retail Market

- The retail sector is facing headwinds in both prime and secondary locations.
- We expect rents to decrease over the course of this year.
- Physical clothing and footwear retailers are under pressure, whereas the food sector will be important for the future development of the retail sector.
- There is uncertainty on how much and what kind of space is needed in the future.

Residential Market

- Quoted rents for rented apartments are decreasing, in new buildings they fell roughly 2 % and in existing stock by approximately 1 %.
- Rental price decline for apartments has been consistent across different locations including city centre, suburb and rural locations.
- Residential supply volumes are still high and growing in some peripheral regions.

Expected Trends (next 6 months)

	Office		Retail		Residential	
	Rents	Yields	Rents	Yields	Rents	Yields
Zurich	↘	↘	↘	↘	→	↘
Geneva	↘	↘	↘	↘	→	↘
Bern	→	→	↘	→	→	↘
Basel	→	→	↘	→	→	↘
St.Gallen	↘	→	↘	→	↘	→
Lausanne	→	→	↘	↘	→	↘

In Switzerland's five largest urban areas, supply of office space is still increasing. The additional office space is hardly expected to be fully absorbed by the market (availability rate ranges from 2.4 % to 5.4 %), resulting in rising vacancy rates particularly in Zurich, Geneva, and Bern. The market situation can be considered a tenants' market and tenants increasingly require high fit-out standards. However, the office market seems to be stabilising in the current environment of higher vacancy rates, which are still relatively low in comparison to other European countries. In Zurich, for example, more leasing activity has been recorded, although the vacancy rate is still elevated.

The situation on the retail market remains tense. We witness headwinds in the retail sector, also in prime locations, although individual good deals are closed. In contrast to other European countries, Switzerland is not only faced by increasing online shopping but also challenges resulting from continuing shopping tourism. Both factors drive the reduction of productivity in retail spaces. How the sector evolves is unclear. The food sector has been relatively immune to both online shopping and shopping tourism but even their market share may be under threat of erosion. Landlord investment will be increasingly important as retailers seek more efficient space. However, trends are subject to rapid change and the retail sector is already well behind the level of service found in other European countries, same day delivery for example.

Price momentum in the residential real estate market has slowed further over the last 12 months, whereas imbalances remain at high levels. We expect the market for rented apartments to remain tense without further escalation. Without consideration of the change in the reference interest rate, quoted market rents are likely to drop by 0.9 % over the course of 2017. Residential supply is still high in some peripheral regions. Rents decreased slightly in the past year and we expect them to be stable or decrease a little further due to a high level of construction activity and decreasing net migration.

AUSTRIA, BENELUX AND IRELAND

Strong export momentum with risks of domestic overheating

Economic Environment

The region benefits strongly from the simultaneous global upswing. All countries are comparably small and open and thus depend on their exports. Exports in countries that use the euro are benefitting from the weak currency. Prospects of rising public infrastructure spending on both sides of the Atlantic will be a positive driver for all these economies. Belgium is the weakest performer in the group as a combined result of its comparably softer economic fundamentals, poor reform progress since 2008 and high exposure of its export portfolio to other Eurozone members. However, economic prospects for Brussels differ from the rest of the country and are much more positive. Low interest rates and falling unemployment suggest that the risk of domestic economies overheating is growing. We expect the following average annual growth rates over the next ten years: Netherlands: 1.1 % – 1.6 %, Belgium: 1.0 % – 1.5 %, Ireland: 2.5 % – 3.0 %. With the exception of Belgium, inflation rates remain well contained for the time being. Nevertheless, ultra-loose monetary policies by the ECB look increasingly inappropriate for this region.

Real Estate Markets

Looking at the markets in Western Europe apart from the Swiss Life home markets, office markets appear to be fairly resilient. Looking at the Benelux countries, vacancy rates have decreased in Brussels and Amsterdam, the latter reporting rates of 12.8 % in Q1 2017 down from 18 % in 2011. Luxemburg's vacancy rate slightly increased during 2016, but the office market is well oriented with a take up of 77'000 sqm in Q1 2017. It has benefited from growing demand from finance and service sector companies. In all three capital cities, further rental growth is expected, although the trajectory in Brussels is anticipated to be flatter than in Amsterdam and Luxembourg. For Amsterdam, it is important to note the decline in incentives, which put effective rents more under upwards pressure after 2009 than the nominal values show. The Dublin office leasing market has been strong with activity ahead of the 10 year average. Occupiers have focused on the city centre with the TMT and Financial sectors accounting for 50 % of the market. Supply in the city centre is limited and consequently market conditions are landlord favourable. Prime rents in the city centre have broadly doubled since 2012 to around EUR 630 per sqm. Although sustained office demand is expected there has been a pick-up in development. This is likely to limit the scope for further prime rental growth this year. The Vienna office market recorded robust demand in 2016, just below the 10-year average, but started with low leasing activities in 2017. As a result of a lack of completions within the last few years, office vacancies decreased to 5.4 % in Q1 2017, accompanied by a slight increase in rents. The prospects for further rental growth in the coming quarters are still in place. However, a number of projects under construction may raise the vacancy rate again and dampen rental growth in the following years.

The prospects for the retail markets in the region are comparable with competition between traditional and online trade or rather the transformation to multi-channel being the main driver. Rents are expected to remain stable or marginally increase in high street locations only. The recovery of the Irish and Dutch economy led to recent rental increases in the main shopping areas in Dublin and Amsterdam. However, forecasts for Dublin are subdued whereas Amsterdam still offers moderate potential for rental growth due to further economic recovery as well as increased tourism spending. Tourism is also important for Vienna, which is increasingly a focus for retailers. Rental dynamics have already slowed in 2016, such that we expect no short-term change. Brussels has exhibited stable prime rents for some years now, but a lack of demand suggests no short-term rental increase.

Expected Trends (next 6 months)

	Office		Retail	
	Rents	Yields	Rents	Yields
Amsterdam	↗	↘	↗	↘
Brussels	→	↘	→	↘
Luxembourg	↗	↘	↗	↘
Dublin	↗	→	→	→
Vienna	↗	↘	↗	↘

DENMARK, FINLAND, NORWAY AND SWEDEN

Expectation of a convergence of the economies and real estate markets in the Nordic countries

Economic Environment

The Nordic countries were characterised by divergent economic trends after the global financial crisis but all economies have started to recover recently. Sweden reached above-average GDP growth with rates up to 4 % in the last few years although a slight slowdown is expected in the short and medium term (1.2 % – 1.7 % over the next ten years). Sweden's Riksbank has successfully prevented Krona appreciation with a negative interest rate policy. In contrast, Finland was strongly affected by slowing exports after 2009 and only started to recover as recently as in 2016 (+1.6 %). In the years between 2008 and 2015, the competitiveness and reform willingness of Finland fell behind other Euro member states. A general agreement with labour unions to tackle wage pressure was successfully implemented and benefits the Finish economy in the current global cyclical upswing. Norway has suffered from the low oil price and Denmark due to weakness of the extraction industry. For the next five years Consensus Economics forecasts converging growth rates in the Nordic countries, with Sweden and Norway leading the upturn and Finland still lagging behind. Employment should rise moderately by 0.5 % – 0.7 % per annum.

Real Estate Markets

In the last few years the office markets in the Nordic capitals have reflected overall economic trends. In Stockholm noticeable net absorption of office space resulted in a decrease in vacancy and strong rental growth. Copenhagen, Oslo and particularly Helsinki have experienced muted demand and rising vacancy rates. This picture started to improve from 2016 resulting in decreasing availability in Oslo and Copenhagen in the first quarter 2017. Ongoing weakness in the Helsinki office market remains. Prime rents remained stable in the major markets, but rental growth escalation continued in Stockholm in the first months of this year (+2 % to EUR 48 per sqm and month). The prospects for the office markets are moderately positive. A further recovery in the economy, stabilisation of demand, vacancy rates and moderate rental growth are expected for the Nordic capitals. The exception is Stockholm where an increase in construction activities should increase office vacancy so that rental growth will slow down at medium term.

Retail markets in the Nordics have correlated again significantly reflective of the overall economic trends. However, in the last few years, rental growth has been seen in high street shops in Copenhagen, Oslo and Stockholm. In Stockholm, for example, prime rents for high street shops have risen by 15 % over the last 5 years. Average rents in Swedish shopping centres also increased by around 1.5 % p.a. Meanwhile, in Finland, rents in Helsinki's prime areas as well as in shopping centres have shown stagnation and slight decline respectively. In the context of the ongoing recovery in all countries, rental growth is to be expected in all retail segments for the short and medium term.

The investment markets in Northern Europe are very liquid, with a volume of EUR 30 bn invested in commercial property in 2016, significantly exceeding the 10-year average of EUR 22 bn. In Q1 2017 transaction volume of approximately EUR 9 bn suggests sustained demand by both domestic and international investors. Prime yields have been under pressure in the first months of 2017, particularly in the office sector and the Helsinki market with its comparatively high yields (4.25 %). Stockholm has also seen marginal yield compression to new record levels of about 3.3 %. In the retail sector high street yields remained stable in the last quarter – with yields particularly low in Copenhagen and Stockholm at levels of 3.0 % and 3.25 % respectively.

Expected Trends (next 6 months)

	Office		Retail	
	Rents	Yields	Rents	Yields
Copenhagen	→	↘	↗	↘
Helsinki	→	↘	→	↘
Oslo	→	↘	↗	↘
Stockholm	↗	↘	↗	↘

CZECH REPUBLIC, HUNGARY AND POLAND

The cyclical hot spot but diverse real estate markets

Economic Environment

Economic momentum is exceptionally strong due to low interest rates, strong foreign demand and wage growth. We expect the following average growth rates over the next ten years: Czech Republic: 1.9 % – 2.4 %; Hungary: 1.8 % – 2.3 %; and Poland: 2.5 % – 3.0 %. The Czech Republic economy is particularly exposed to overheating risk and the start of a monetary policy tightening cycle which already seems likely this year. All countries have their own domestic political challenges which may be the unwillingness to implement structural reforms. Once the global cyclical momentum moderates, unsolved problems in the domestic labour markets and banking systems will reappear.

Real Estate Markets

Central Europe's property market has taken almost 10 years to recover from the financial crisis. After a bumper year in 2016, investment levels are within touching distance of their 2007 peak. Drawn by the region's growth prospects and attractive yields, investors pumped 40 % more money into Central European real estate markets in 2016 than in 2015. This trend has continued in 2017.

The Budapest, Prague and Warsaw office markets have seen a significant increase in annual take-up since 2015 together with ongoing strong demand and letting activities in the first quarter of 2017. For Budapest and Prague the result has been a decline in vacancy rates which fell below 10 % at the beginning of this year, in contrast to double-digit figures in 2015. Moderate growth in prime rents has also occurred. By contrast high levels of construction activity supported a high vacancy rate in Warsaw at approximately 15 % in Q1 2017. Rents are still under pressure, declining by about 18 % since 2012. Another 12 % of current total stock is expected to complete within the next 3 years. Office vacancy in Warsaw is expected to increase further in the near term resulting in a sustained rental decline.

Poland is the region's biggest office market. It is expected to benefit from the positive outlook on economic growth within Europe. The combination of a well-educated workforce and relatively low wages means it is also well placed to benefit from macro trends. For example, the rise of e-commerce has led big firms like Amazon and Zalando to build distribution centres in Poland. The outsourcing drive of international companies will also positively impact the office market. Budapest has seen a recovery in its office market after experiencing 23 % vacancy and only very limited supply in 2010 – 2014. The vacancy is now at 8 % and a pipeline of around 37'000 sqm is recorded for 2017. Demand is driven by outsourcing and it is important that new buildings are of good quality. With the recovery, rents have increased and further growth is anticipated in the short-term, but with high building starts limiting growth expectations in medium-term. The same development trend holds true for Prague.

A significant increase in consumer spending has supported the retail market over the last 3 years. Prague in particular has also benefited from growing inbound tourism as source of retail spending. In all capitals, prime rents for retail space in the pedestrian areas increased by an average of 5 % in 2015 and 2016. Positive economic prospects suggest that rents in the top locations will continue to improve in 2017 as well as in the medium term.
The investment markets in CEE have gained liquidity in 2016 reaching a level of EUR 10 bn, double the 10-year average of EUR 5 bn. Yields in Central Europe declined sharply in 2016, in line with the general trend in Europe – particularly in the retail sector. Prime yields for high street assets in Prague are remarkably low at approximately 3.25 %, while levels in Budapest and Warsaw are significantly higher at about 5 %. Doubts about the political stability of the country are likely to create a risk premium, particularly in Hungary.

Expected Trends (next 6 months)

	Office		Retail	
	Rents	Yields	Rents	Yields
Warsaw	↘	↘	↗	↘
Budapest	↗	↘	↗	↘
Prague	↗	↘	↗	↘

ITALY, PORTUGAL AND SPAIN

Highly dependent on central bank assistance

Economic Environment

Italy, Spain and Portugal are the fundamentally weaker economies in the European Monetary Union. In response to the sovereign debt crisis, Portugal and Spain have achieved significant reform progress mainly in the form of lowering labour costs and opening domestic markets. Italy still lacks comparable reform willingness. In all countries, austerity fatigue threatens recent fiscal discipline. Yet the simultaneous global economic recovery and pent up demand in the domestic economies will ensure the return to positive real GDP growth over the medium term. We expect the following average growth rates over the next ten years: Italy: 0.7 % – 1.2 %; Spain: 1.5 % – 2.0 %; and Portugal: 1.0 % – 1.5 %. Such growth rates exceed their current potential which would ensure a continued recovery of the labour market and easing deflationary risks. For all three economies, favourable financial conditions like a weak exchange rate and low refinancing costs for sovereign debtors remain indispensable. All three are the main beneficiaries of financial repression and ECB monetary policy.

Real Estate Markets

Spain is seeing the return of core investors especially in Madrid and Barcelona, the two strongest real estate markets in the country. Benefitting from the positive economic outlook, the occupier market is strengthening with the vacancy rate in prime CBD locations at 6.4 % in Madrid and 3 % in Barcelona. Prime office rents have been regularly increasing for three years at an average rate of 2 % and are expected to increase further. This increase is partly due to the lack of grade A buildings that make quality properties very attractive to tenants. Retail properties have also posted strong performance as consumer spending has grown (+2 % annual average in 2016). This is attributable to increasing inbound tourism flows (+25 % of foreign visitors between 2013 – 2016) and increasing household disposable incomes (+ 4 % annually 2014 – 2016). In office and retail properties, yields both decreased to 3.5 % in Q1 2017. They are expected to remain stable as investors now expect rent growth to increase capital values.

Italy is sought after by foreign investors who represented 64 % of the investment volume in Q1 2017. Foreign investors have focused on office and retail investments in the north-western Italy (70 % of investment volume) and especially Milan as this region remains the economic heart of Italy. Consequently, prime office yields are decreasing and have reached 3.5 % in Milan. Rome is less attractive to investors due to difficult economic conditions, lack of quality buildings and a changing legal environment. Rents remain flat and no increase is expected in the medium term as the vacancy rate remains high in prime CBD locations at 8.2 % in Milan and 8.9 % in Rome as of Q1 2017.

Portugal is rather a small investment market, especially for office properties, with total stock of 4.6 million sqm in Lisbon (Paris' stock is 54.8 million sqm) but is very active. The country, economically structured around its capital Lisbon, offers attractive prime yields at 4.75 % in Lisbon and prime rents grew 3 % per year since 2014. They are expected to keep rising in the medium term. Tourism is expanding with an 8 % annual average increase of inbound visitors since 2014 that is supporting the hotel industry and retail sector.

Expected Trends (next 6 months)

	Office		Retail	
	Rents	Yields	Rents	Yields
Madrid	↗	↘	↗	↘
Barcelona	↗	↘	→	↘
Rome	→	↘	→	↘
Milan	↗	↘	↗	↘
Lisbon	→	↘	↗	↘

Authors

Swiss Life Asset Managers

Francesca Boucard
Economist Real Estate
francesca.boucard@swisslife.ch

Swiss Life REIM France

Claire Beghin
Head of Analysts
claire.beghin@swisslife-reim.fr

Charlie Jonneaux
Financial Analyst
charlie.jonneaux@swisslife-reim.fr

CORPUS SIREO

Andri Eglitis
Director Research
andri.eglitis@corpussireo.com

Emanuel Eckel
Senior Manager Research
emanuel.eckel@corpussireo.com

Livit AG

Martin Warland
Project Manager Research & Data
martin.warland@livit.ch

Mayfair Capital

Frances Spence
Head of Research, Strategy and Risk
fspence@mayfaircapital.co.uk

Tom Duncan
Senior Analyst, Investment Strategy and Risk
tduncan@mayfaircapital.co.uk

Released and approved by the Economics Department, Swiss Life Asset Management Ltd, Zurich
The contents of this document are based upon sources of information believed to be reliable but no guarantee is given as to their accuracy or completeness. This document may include forward-looking statements which are based on our current opinions, expectations and projections. We undertake no obligation to update or revise any forward-looking statements. Actual results could differ materially from those anticipated in the forward-looking statements. This document is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. France: This publication is distributed by Swiss Life REIM (France), 153 rue Saint Honoré F-75001 Paris, France, to its clients and prospects. Germany: This publication is distributed in Germany by Corpus Sireo Real Estate GmbH, Aachenerstrasse 186, D-50931 Köln and Swiss Life Invest GmbH, Zeppelinstrasse 1, D-85748 Garching b. München. UK: This publication is distributed in the UK by Mayfair Capital Investment Management Ltd., 2 Cavendish Square, London W1G 0PU. Switzerland: This publication is distributed by Swiss Life Asset Management Ltd., General Guisan Quai 40, CH-8022 Zurich.