DTZ FORESIGHT

Market becoming more fully priced

European Fair Value Index Q1 2015

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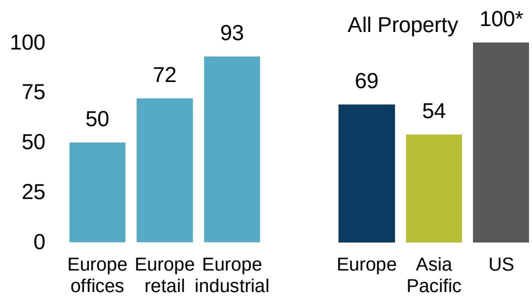
- Keener pricing and falls in property yields saw DTZ's European Fair Value Index™ score fall to 69 in Q1 2015 from 79 the previous quarter.
- Although European property continues to look attractive overall, the window of opportunity for attractive investment is starting to close.
- Industrial markets in the eurozone periphery, Central Europe and the Baltics are still the most underpriced in Europe. In contrast, in addition to Swiss, Russian and Turkish markets, some core European markets have become overpriced.
- We expect European property's attractiveness to continue to diminish as property yields fall and bond yields eventually rise.

Figure 1

DTZ European Fair Value Index™ overview Q1 2015

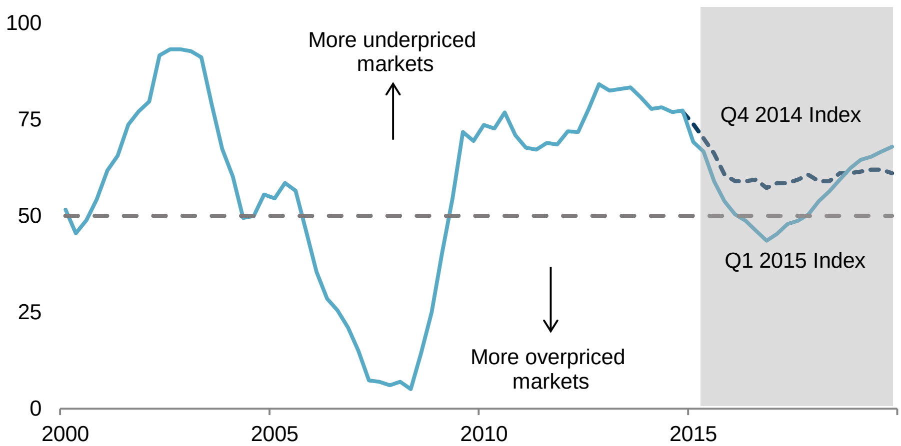
DTZ Fair Value Index™ scores (maximum of 100)



*US score based on projection for Q1 2015

Most underpriced markets
Riga industrial
Vilnius industrial
Bucharest industrial
Bucharest retail
Antwerp industrial

DTZ European Fair Value Index™



Source: DTZ Research

European Fair Value Index Q1 2015

Overview

This quarter represented a turning point for the all property Fair Value Index™ score for Europe, as it fell from 79 in Q4 to 69 in Q1, meaning that although European property markets are still attractively priced compared to bonds, their relative attractiveness is starting to diminish (a score of 100 indicates that all markets are underpriced for investors and zero that all markets are overpriced, Table 1).

The European Central Bank's quantitative easing (QE) programme, which began in March this year, saw €52.5bn of government bonds being bought by the ECB in the first month of its launch. Increased government bond buying has resulted in yields and forward rates falling to unprecedentedly low levels, with bond yields in some core markets turning negative. This has continued to increase property's relative attractivess to investors searching for higher yields.

Due to increased investor demand European property yields fell this quarter in over half of the 117 markets in our European Fair Value Index™, by an average of around 20 bps, as markets become more fully priced.

As property yields fall over the short term towards and even below their historical lows, we expect the European Fair Value Index™ to continue trending downwards given the only moderate uplifts in rents projected. We expect the Fair Value Index™ to fall to 44 by the end of 2016 (Figure 2).

As a result of strong yield compression, nine markets have been downgraded from 'fairly priced' to 'overpriced' this quarter, with a further 17 downgraded from 'underpriced' to 'fairly priced'. Three markets were upgraded, although half of the markets in the Index are still 'underpriced'.

Peripheral eurozone, Central European and Baltic markets are still the most underpriced in our European Index, with each having the majority of its markets rated as 'underpriced' (Figure 3). In contrast, only around half of the French markets are classified as 'underpriced'. Other mature western European markets such as the UK and the Nordics now have only around a third of their markets classified as 'underpriced'.

Similar to last quarter, the most overpriced markets in Europe this quarter are in Turkey, Russia and Switzerland. Higher bond yields in Turkey and Russia, due to increased investor risk aversion towards these markets, have pushed fair (required) returns for property to nearly double our forecast returns for those markets. In Switzerland very low prime property yields of 3.5% in the key office markets of Geneva and Zurich continue to make them less attractive on a relative pricing basis.

We are forecasting prime office yields in core western European markets such as the UK, France, Germany and the Nordics to reach a cyclical bottom this year and then remain broadly stable in 2016. From 2017 we are then expecting yields in core markets to begin rising modestly, by around 25 to 50 bps to the end of 2019. We expect yields in peripheral and Central European markets to also rise from 2017 onwards, but at a more modest pace than the core western European markets.

Table 1

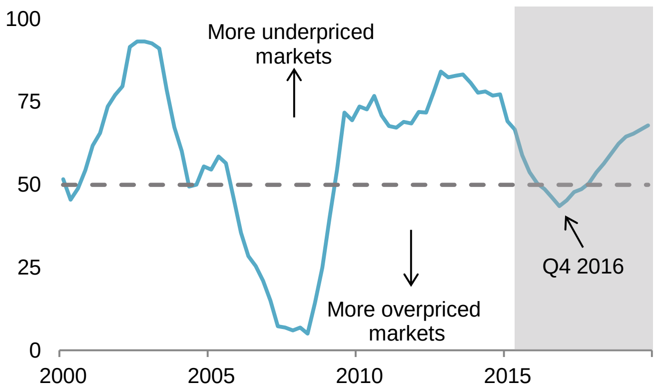
DTZ Fair Value Index™ scores

Geography/Sector	Q4 2014	Q1 2015
Europe all property	79	69
Europe offices	64	50
Europe retail	82	72
Europe industrial	97	93
Asia Pacific all property	56	54
US all property	100	100

Note: Q4 scores refer to those published in Q4 report; charts show revised index scores, which may differ due to property forecast changes. US refers to Q4 results and projection for Q1.
Source: DTZ Research

Figure 2

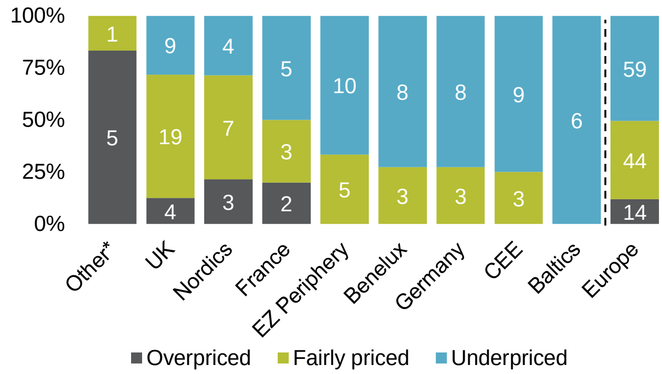
DTZ European Fair Value Index™



Source: DTZ Research

Figure 3

Number of markets in each category by region/country



* Other includes 6 markets from Turkey, Russia and Switzerland.
Note: We have changed our classification terminology from 'Hot' to 'Underpriced', 'Cold' to 'Overpriced' and 'Warm' to 'Fairly priced'.
Source: DTZ Research

European Fair Value Index Q1 2015

Classifications and context

Of the 117 markets included in our European Fair Value Index™ in Q1 2015, 59 were classified as 'underpriced', 44 as 'fairly priced' and only 14 as 'overpriced'. In contrast to last quarter, 26 markets this quarter have been downgraded, while 3 markets were upgraded. The majority of markets (88) saw no change to their Fair Value categories.

Of the 26 downgraded markets 17 were downgraded from 'underpriced' to 'fairly priced', with the remaining nine downgraded from 'fairly' to 'overpriced'. This quarter there are now fourteen 'overpriced' markets compared to eight last quarter. London's West End offices and some of the UK regional markets, in adition to Paris CBD and Western Crescent offices, are some of the most significant markets which were downgraded to 'overpriced' this quarter.

Four out of the top five most underpriced markets this quarter are industrial markets, with Riga industrial at the top of the ranking, underpriced by 25%. Bucharest retail is the only non-industrial market in the top five. With the exception of Antwerp industrial in fifth place, the other industrial markets in the top five are all in Central Europe and the Baltics (Table 2).

At the other end of the scale, the top five most overpriced markets in Europe are in Russia, Turkey, Sweden and Switzerland. Moscow retail is at the bottom of the ranking as as result of continued geopolitical risk and economic recession increasing our 'fair' returns for this market to well above our forecast returns.

On a global basis the US still has the most attractively priced markets overall, with an index score of 100 expected this quarter, meaning all of its markets are underpriced. While Europe's index score was 69, Asia Pacific's was much lower at 54, although we expect the latter's score to increase and to be higher than that of Europe by the end of 2016 (Figure 4).

Table 2

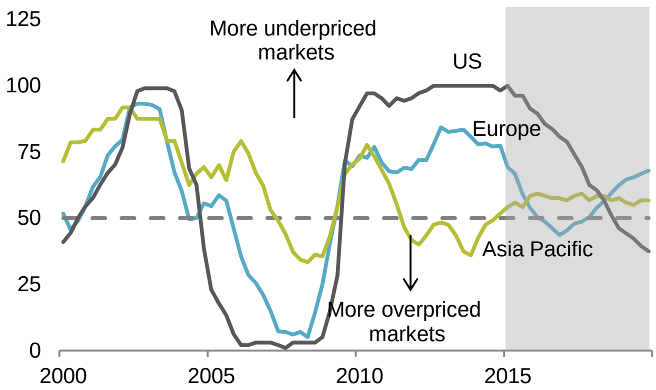
Five most under- and overpriced markets in Europe

Rank	Market
1 (most underpriced)	Riga industrial
2	Vilnius industrial
3	Bucharest industrial
4	Bucharest retail
5	Antwerp industrial
113	Stockholm offices
114	Geneva office
115	Istanbul retail
116	Istanbul office
117 (most overpriced)	Moscow retail

Source: DTZ Research

Figure 4

DTZ regional Fair Value Indices™



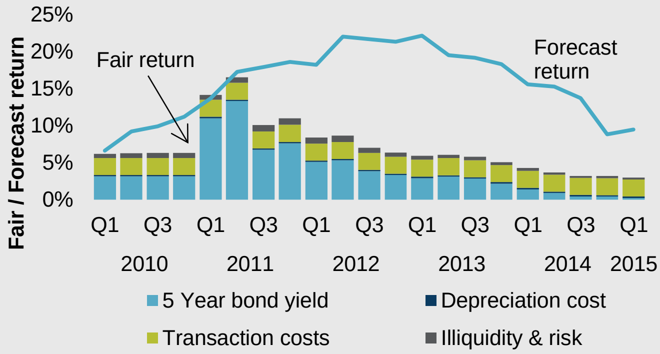
Source: DTZ Research

Market in focus: Dublin Retail

- Ranked 8th overall in our Fair Value Index™ this quarter, Dublin retail is currently underpriced by 20% according to our Fair Value analysis.
- The Irish economy is expected to grow by 3.1% p.a. for the next four years. Consumer confidence is high, which is encouraging further increases in consumption and investment.
- Strong retail sales volume growth of 8.2% y-o-y to March 2015 is also boosting retailer demand.
- Further yield compression and increased rental growth expectations lead us to forecast prime total returns of around 9.5% p.a. over the next five years (Figure 5).
- Key downside risks include high levels of household debt and those associated with membership of the eurozone.

Figure 5

Dublin retail fair and forecast returns



Source: DTZ Research

Fair and forecast returns

The ECB's €1.1tn QE programme was introduced in March this year as policymakers sought to to tackle the threat of economic stagnation and deflation in the eurozone. The impact of increased bond buying has been to reduce government bond yields substantially this quarter. There were wide divergences in the extent of the falls though, with peripheral and southern European markets seeing the sharpest falls, compared to more modest declines in Germany and the Nordics, where they are already close to zero or even negative (Figure 6). Forward rates are also substantially below those projected a year ago (Figure 7).

Very low or negative government bond yields in traditional 'safe haven' markets such as Switzerland, Germany and the Nordic markets have further enhanced European property's attractiveness relative to bonds due to favourable yield spreads. However, as a result of increased investor demand for European property, not only because of more attractive pricing, but also as investors are increasingly positioning themselves to take advantage of the modest recovery taking place in the European economy and occupier markets, property yields fell sharply across Europe this quarter.

In our European Fair Value Index™ in Q1 2015, around half of the markets that we cover saw their yields fall, by an average of 20 bps. The impact has been to reduce our forecast returns compared to our 'fair' returns for those markets, which has resulted in our overall European Fair Value Index score falling by ten points from 79 in Q4 to 69 this quarter.

A key exception to the falls in property yields in Q1 was Moscow offices, where prime yields rose by 75 bps from 9.75% to 10.5%. When combined with rental levels falling by 12% quarter-on-quarter to reach USD750 per sqm p.a., this resulted in this market moving from 'overpriced' to 'fairly priced' during the quarter, as 'fair returns' were roughly equivalent to our forecast returns.

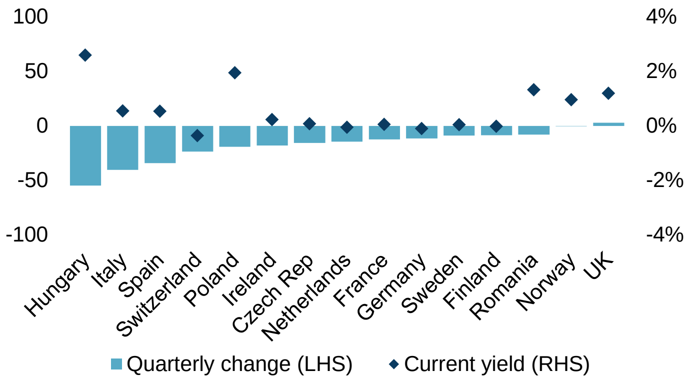
Going forward, we expect the European Fair Value Index score to continue to decline as yields fall further and European property's relative attractiveness compared to bonds continues to diminish. The window of opportunity for investors is beginning to narrow, and we expect the European Fair Value Index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

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

In general core markets such as those in Germany, France and the UK are currently fairly priced and offer stable, albeit lower, risk-adjusted returns. Notable exceptions are London West End and Paris CBD offices, which have moved from 'fairly priced' to 'overpriced' this quarter due to less attractive pricing and very low prime yields compared to their historical average (around 3.75%).

Figure 6

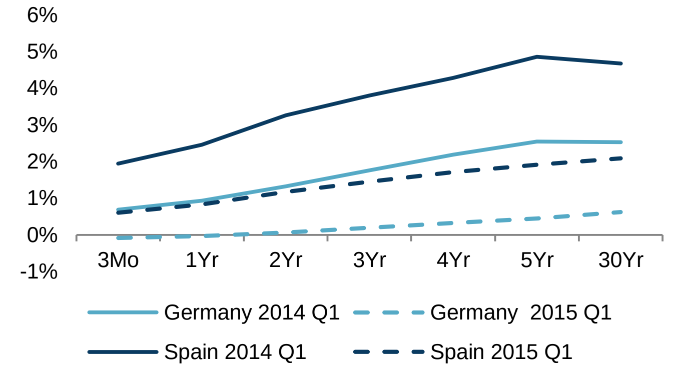
Five year government bond yields Q1 2015



Source: Bloomberg

Figure 7

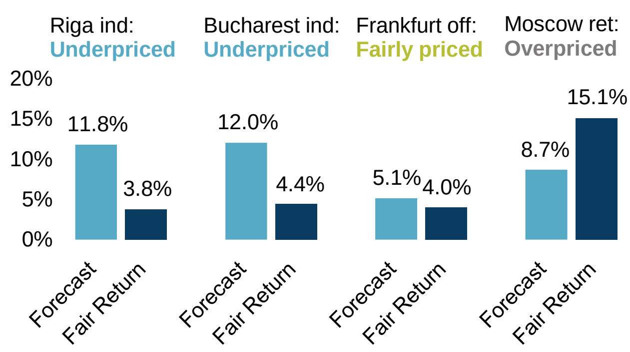
Germany and Spain 5-year government bond forward rates



Source: Bloomberg

Figure 8

Fair and forecast returns – Q1 2015 (% p.a.)



Source: DTZ Research, Bloomberg

European Fair Value Index Q1 2015

Rental growth forecasts

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

According to Oxford Economics, for the eurozone as a whole, unemployment remains stubbornly high, at 11.2%, with significant differences among member states. The lowest unemployment rates are recorded in Germany (4.7%), while the highest are in Greece (25.8%). However, latest survey data from the European Commission show that employment intentions in the services sector have risen back to 2010 levels. Expectations in industry remain weaker, and below the high levels recorded in 2010.

Looking forward, Spain is expected to see faster GDP growth, averaging 2.4%, than Italy, France and Germany, all averaging significantly below 2% over the next five years. The fastest growth is expected in Central and Eastern Europe and the Baltic states (Figure 9).

Despite an improving economic environment, concerns abound as to whether Greece will make payments to its international creditors on time. This has raised tensions between Greece and its international creditors, who are negotiating a new programme with Greece's international creditors. Overall, a third bailout programme will most likely be required.

The drop in oil prices is boosting consumers' purchasing power, which in turn will be beneficial for the retail sector. The European Central Bank's QE programme has caused the euro to depreciate, which will boost export volumes and demand for industrial space across the eurozone, and also lower transportation costs (Figure 10).

With only modest growth in the economy forecast and labour markets remaining sluggish, limited rises are forecast for commercial property rents across much of Europe. For all the European markets we cover we forecast rents to rise by around 1.6% p.a. over the next five years, with retail showing slightly faster growth on average (1.9%), than office (1.3%) and industrial (1.6%). However, although the vast majority of markets are clustered around the sector averages, there are significant outliers (Figure 11).

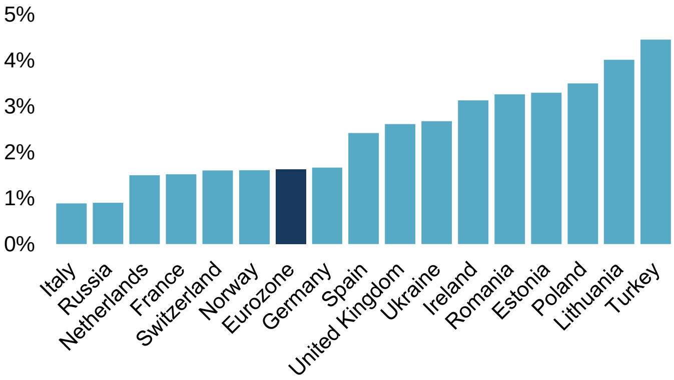
In Dublin, for example, we expect the ongoing economic recovery to feed through to the fastest rent rises in the industrial sectors of 3.7% p.a.. Meanwhile in London, relatively tight supply and rising employment are expected to propel Midtown office rents to a pace of 4.4% p.a.. At the other end of the scale we expect Moscow retail rents to fall by 2.6% p.a. as the oil price plunge and western sanctions push the Russian economy deeper into recession.

In the industrial sector rents in Vilnius are forecast to increase by just 0.3% p.a. due to renewed political tensions between Lithuania and Russia, which have caused a decline in export volumes in early 2015. It will take time for Lithuania to recover relations and trading with Russia.

In the office sector rents in The Hague are forecast to fall the most, by 2.0% p.a. due to future consolidation in the public sector and new space coming onto the market.

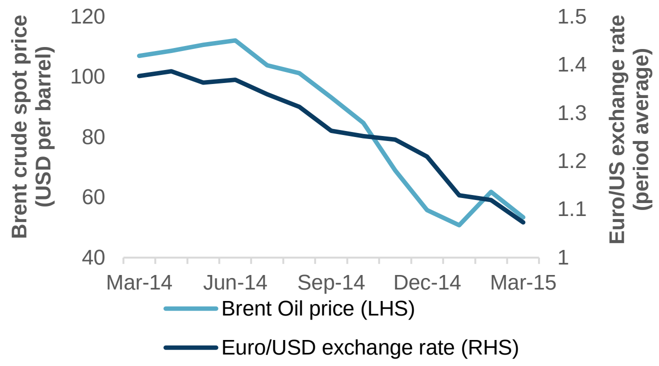
Figure 9

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



Source: Oxford Economics

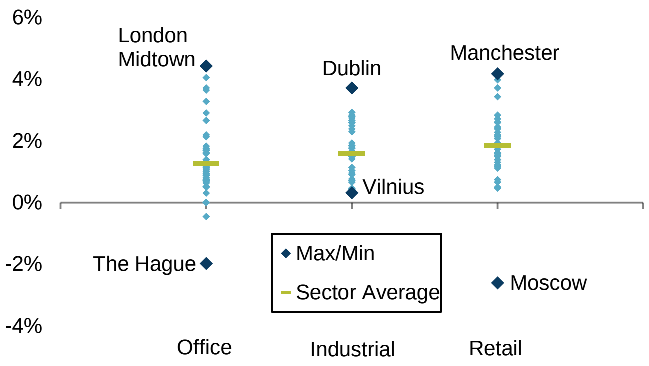
Figure 10



Source: DTZ Research, Bloomberg

Figure 11

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



Source: DTZ Research

Investment market forecasts

The most important change in Europe over the last quarter has been the implementation of the European Central Bank's QE programme, which is seeing massive government bond purchases by the ECB, pushing bond yields to their lowest historical levels. The QE programme has had a profound impact on the European economic environment, which is now characterised by ultra-low or even negative bond yields. Very low interest rates have also boosted investment activity, creating higher liquidity in the market and stimulating lending to the real economy. Against in this economic context commercial property investment looks attractive for investors hunting for yield, although property yields have seen significant compression recently due to increased investor demand.

For 2014 as a whole, total investment volumes of EUR208bn were recorded in the European real estate market, a strong increase of 33% year-on-year compared to 2013. This represents the highest level since the market downturn of 2008. Moreover, in Q1 2015 total investment volumes reached €51.4bn, an increase of 40% compared to Q1 2014.

The UK remains by far the most attractive European market, with EUR73.1bn invested in 2014, corresponding to a market share of 38% of the European total. However, more capital continued to flow into Spain, which experienced an increase in capital invested of 164% over the past year, amounting to a total of EUR8.4bn. This trend continued in Q1 2015, when investment volume totalled EUR2.3bn.

The increase in investor interest in the Spanish market is backed by the recovery in the economy, with both the service and manufacturing sectors continuing to improve. In contrast, in Eastern Europe, which includes markets such as Russia and Ukraine, there has been a significant decrease in investment volumes due to political tensions (Figure 12).

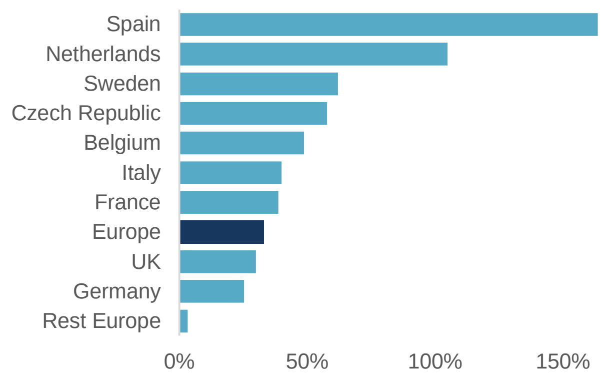
We expect property yields to come under further downward pressure throughout Europe in 2015, reflecting strong demand for commercial real estate (Figure 13). We then expect them to level off by 2017, as investors start to price in the likely increase in interest rates over the medium term. Industrial property yields are likely to see the sharpest fall over the next two years since they have not seen the same level of declines to date compared to the office and retail sectors.

Further declines in office yields are expected to be largely focussed on non-core markets, with investors being attracted by the higher risk-adjusted returns on offer in those markets. This is reflective of stronger economic growth prospects going forward. As such, investors are willing to invest in these previously underperforming markets in the belief that occupier demand is in the process of recovering. For example, we expect Madrid office yields to fall by 60 bps over the course of 2015, reflecting strong capital flows into this market.

On the other hand, office yields in core markets are expected to remain either relatively flat or start moving out over the forecast period, as investors see these markets as being fully priced. For example, over the next five years, London West End office yields are expected to increase by 50 bps and Stockholm office by 45 bps (Figure 14).

Figure 12

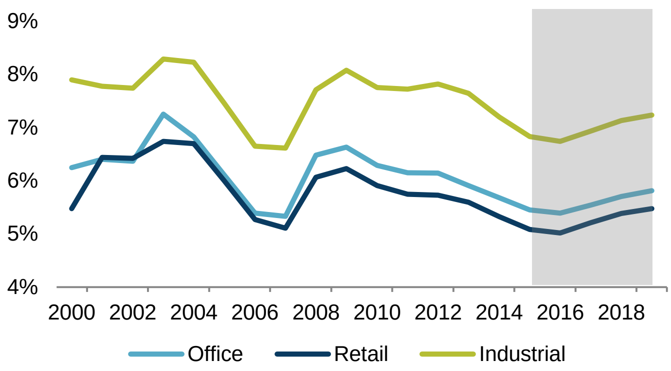
% Change in Investment Activity (2013-2014)



Source: DTZ Research

Figure 13

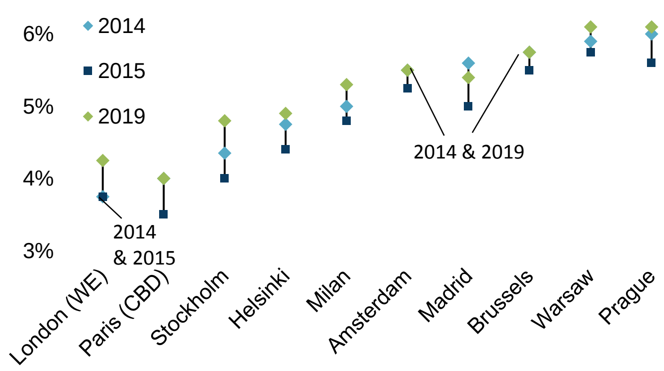
European prime yields (year end, average by sector)



Source: DTZ Research

Figure 14

Prime office yields (year end, selected markets)

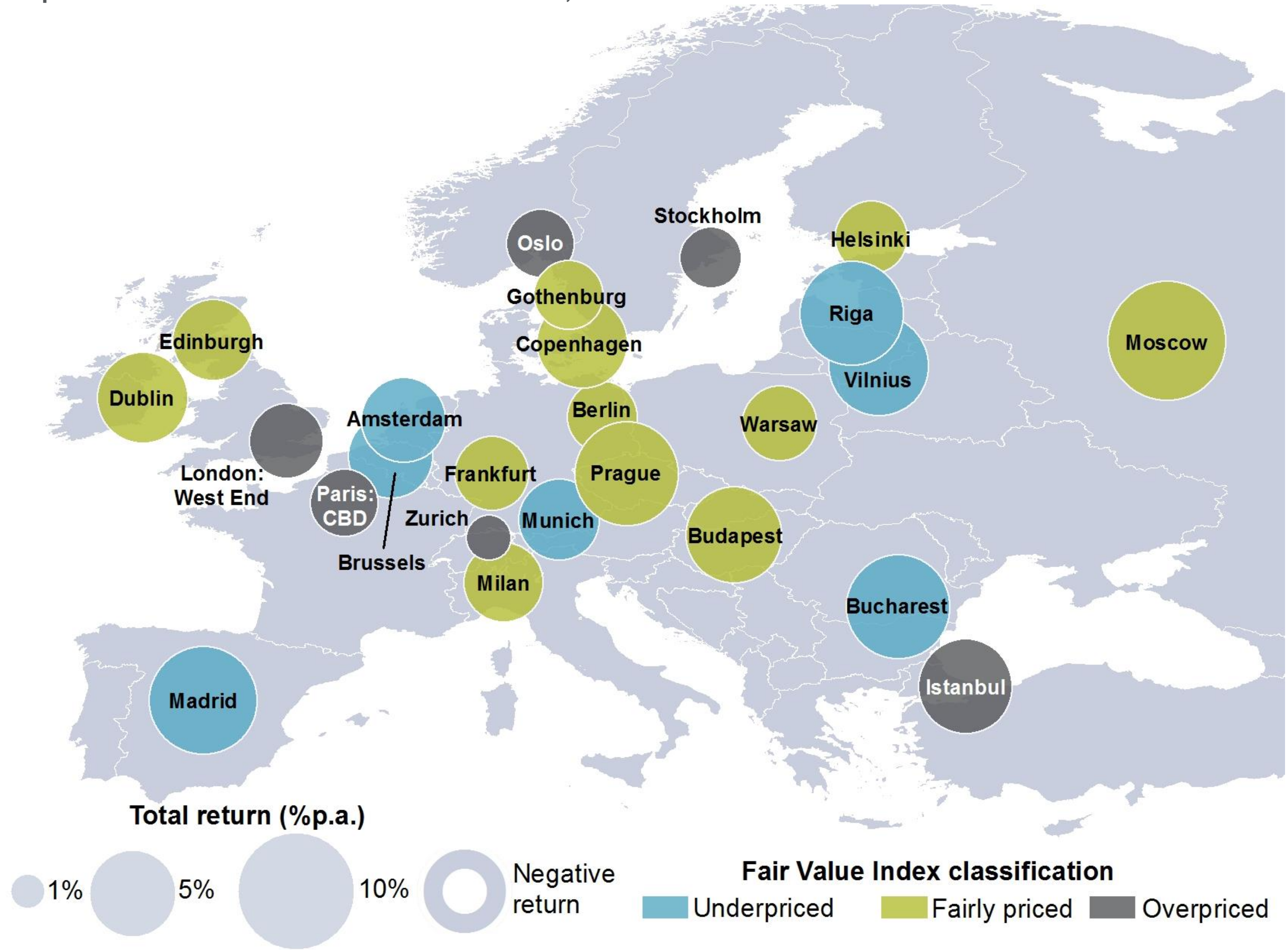


Source: DTZ Research

European Fair Value Index Q1 2015

Figure 15

European office market Fair Value™ classifications, Q1 2015



Source: DTZ Research

DTZ Fair Value Methodology:

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

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

When 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.

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