RESEARCH

Knight Frank

EUROPEAN
COMMERCIAL PROPERTY OUTLOOK **2019**

European outlook

2018 was a year of rising uncertainty but Europe still saw significant cross border investment activity. As we move further into the cycle, we identify some of the key risks and opportunities for the market in 2019.

In Europe a series of elections saw a shifting political landscape in countries as varied as Italy, Sweden, Hungary and Germany. France saw a rise in the Gilets Jaunes, while Italy faced a standoff with the European Commission around the proposed budget.

Across the Bosporus, Turkey battled a currency crisis, which saw its currency lose over half its value at its peak, spiking CDS spreads of exposed European banks.

However, this increasing turbulence is not unique to Europe. Arguably, more significant economic and geopolitical concerns are occurring away from the continent. Ripple effects of the US-China tradewar are being felt globally and spiking economic policy uncertainty in 2018 led to an increase in financial market volatility around the world.

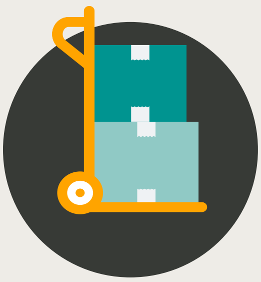
These global headwinds did soften GDP growth for Europe as a whole over 2018, which is expected to continue into this year, according to the European Commission.

However, on a country level there remains significant variation in performance. Spain for example, is earlier through the cycle and continues to enjoy its recovery from the 2013 / 2014 Eurozone crisis, while political challenges and banking sector exposures to Turkey contributed to a dampening of country level growth for Italy.

Ongoing urbanisation and agglomeration effects mean that country level indicators no longer tell the whole story. While Italy is seen by some as a problem child of Europe, on a city level it is possible to find improved economic performance. For example, on the

Opportunities

Logistics



Last mile logistics in urban centres which are seeing supportive economic growth.

Logistics centres along major transport corridors and the key cities of southern Europe that are enjoying double-digit ecommerce growth, albeit from a low base.

Logistics well placed to take advantage of China's one belt one road initiative.

Knowledge based cities

Well-connected cities that offer a good quality of life and are centred around long term 'knowledge anchors'; strongly established universities with good commercial linkages, tend to attract and retain talent. These factors promote population growth and wealth, which in turn support liquid, stable-income based commercial real estate markets. Examples include Cambridge, which houses the largest tech hub in Europe, Amsterdam and Berlin.

Second tier office markets

As pricing continues to encourage some investors to seek new markets, we are seeing opportunity in targeted second tier cities. For example, Warsaw in Poland enjoys an educated, yet relatively inexpensive workforce, which is attracting new entrants into the office market.

Spain saw an influx of US capital over 2018. Traditionally an early entrant, this is a leading indicator that additional capital could follow in 2019, as investors take advantage of its late cycle continued recovery.

Infrastructure

A lack of conventional policy tools to continue to boost economic growth and a global rise in populism are encouraging a push in large-scale infrastructure projects. For example, in Paris, the Grand Paris project will add 68 new stations and a 200km ring of new track around France's capital, which is anticipated to support over 3 million commuters. Phase 2 is due to complete in 2024, offering opportunity for longer-term investors around these newly connected areas.

back of an economy dominated by tourism and diversified international commerce, Milan enjoyed GDP growth of 1.6% in 2018, compared to overall GDP growth for Italy of 1.1%.

From a real estate perspective, amid a global environment of rising uncertainty, Europe continues to house amongst the largest, most liquid and trusted commercial real estate markets globally and offers both return and safe haven benefits to domestic and international investors alike. This is reflected in the investment flows, of which 54% were cross border in 2018.

According to Real Capital Analytics, all property European investment volumes for assets greater than EUR 5 million totalled EUR 277.7 billion in 2018. Of the cross border flows, just over one third were from the United States. South Korea comprised 5% of cross border flows, a small, but increasing proportion as they look to diversify. While overall volumes were down on the previous year, this was largely sector agnostic, apart from apartments which saw a small increase, reflecting a wider taking stock amid global uncertainty.

In the core CRE markets, a desire to deploy capital into a limited stock of real estate continues to provide downward pressure on yields. Tapering of the ECB's quantitative easing programme and the tick up in interest rates by the Federal Reserve last year, may limit scope for further yield compression. However, the Fed's policy stance is expected to become more dovish over 2019. The relative attractiveness of income and stability that real estate offers compared to the bond and equity markets, in addition to markets not pricing in significant interest rate hikes by the ECB in the near future, may also provide momentum to support yields over the coming year.

As we move further into the late cycle, we expect safe haven, liquid markets offering income to look attractive, which may lead to a divergence of yields in secondary locations that are missing the economic fundamentals required to support future growth. Secondary locations with strong demographic, economic and liveability indicators may provide a pricing opportunity for investors looking further up the risk curve.

Risks

Trade

The US imposed tariffs on USD 250 billion of imports from China over 2018, with retaliatory tariffs leading to sharp fall in US exports to China, according to Bloomberg and concerns for European manufacturers. However, at the start of 2019, there are indications of a thawing in relations and appetite for a deal.

Retailing

Apart from Germany, ecommerce penetration into mainland Europe has lagged levels seen in the US and the UK. Southern European countries and Poland have among the lowest levels of penetration, although they are seeing double digit growth. This may pose risks for retail offerings that are not able to adapt to a multi-channel approach, but also creates opportunity for industrials and retailers well positioned to adapt.

Politics

Brexit uncertainty continues for now. Apart from the well-discussed risks of potential for disruption, especially for manufacturing and financial sectors, there is an ongoing risk of lost investment as a result of resources being focused on contingency planning and investors operating a wait and see approach before deploying capital. However, we might expect a rebound in investment as this uncertainty clears.

Populism

A rise in populism has seen a move to the right in several countries, ranging from discussions on capping immigration, to bans on Sunday Trading. We expect there might be a continuation of such policies over 2019. While this does pose a downside risk, for example impact on footfall, we might see longer term upside risk where such policies translate into an infrastructure plan, such as in Italy.

COMMERCIAL PROPERTY PRIME RENTS AND YIELDS

	OFFICE		RETAIL		LOGISTICS	
	Prime rent (€/sq m/ annum)	Prime yield (%)	Prime rent (€/sq m/ annum)	Prime yield (%)	Prime rent (€/sq m/ annum)	Prime yield (%)
Amsterdam	425	3.25	3,000	3.00	85	4.50
Barcelona	270	4.00	3,480	3.50	82	5.25
Berlin	468	3.00	3,900	2.50	84	4.50
Brussels	320	4.25	2,000	3.75	55	5.50
Dublin	673	4.00	7,000	3.50	105	5.25
Frankfurt	516	3.10	3,780	3.60	80	4.50
Geneva	660	3.00	3,785	3.75	176	5.50
Hamburg	324	3.05	3,720	3.50	72	4.25
London	1,324 / 882*	3.50 / 4.25*	11,610	2.50	188	4.00
Madrid	366	3.75	3,600	3.00	66	5.25
Milan	585	4.00	11,500	3.25	55	6.50
Moscow	701	9.75	3,085	10.25	65	11.00
Munich	486	2.80	4,440	3.20	82	4.25
Paris	840	3.00	20,000	2.90	58	4.50
Prague	258	4.75	2,520	3.50	54	6.00
Vienna	309	3.75	4,320	3.40	72	5.30
Warsaw	288	4.70	1,200	5.50	60	6.75
Zurich	727	3.00	7,925	3.00	220	5.25

Source: Knight Frank Research
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