DTZ Foresight
Europe Fair Value Q3 2012
ECB action filters through to property market

DTZ a UGL company

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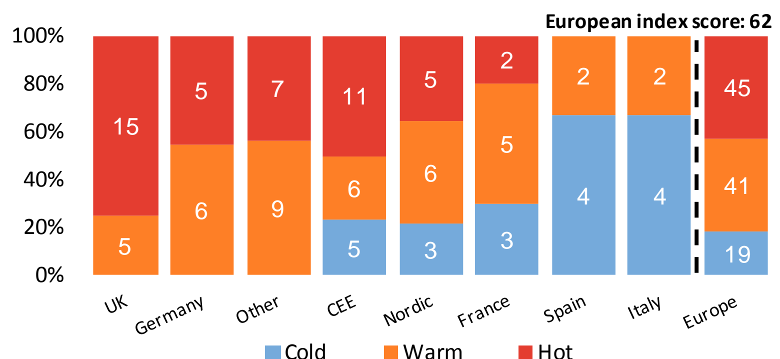
- The DTZ Fair Value Index™ score for Europe increased to 62 at the end of Q3, up from 53 at the end of last quarter (Figure 1). The improved market outlook is being driven by falling government bond yields which have lowered the return required to make property look more attractive.
- The upgrade is evident across all sectors. The retail sector achieved the highest score of 71 (up from 62 in Q2), closely followed by the industrial sector, whose score increased from 59 in Q2 to 69 in Q3, while the office sector increased from 44 in Q2 to 51 in Q3.
- The recent announcement by the ECB that it will support the bond markets of countries under a formal EU bailout programme, had a positive impact on both bond and stock markets across Europe. Lower government bond yields and a tighter corporate bond yield spread has put considerable downward pressure on the required returns for property across Europe compared to last quarter. With expected returns on property remaining relatively static, the attractiveness of European property has increased significantly.
- The reduction in required returns has resulted in a significant number of upgrades from WARM to HOT in Europe this quarter, mostly in the UK. The UK now has 15 HOT markets compared to 11 last quarter. In total, 17 European markets were upgraded from WARM to HOT across Europe, including 3 markets in Germany, 2 in France, and 2 in the Netherlands.
- Despite these positive movements, the economic outlook for Europe remains bleak. Eurozone GDP is forecast to decline in 2012 and 2013, by -0.6% and -0.1% respectively, followed by modest growth until 2017.

Figure 1

Fair Value market classifications by country/region



Source: DTZ Research

Europe Q3 2012

Fair value highlights

Fair Value Index Q3 overview

The DTZ Fair Value Index™ score for Europe increased to 62 at the end of Q3, up from 53 at the end of the previous quarter (Table 1). This improved market outlook is being driven by falling government bond yields which have lowered the return required on property, making it look more attractive .

This upgrade is evident across all sectors. The retail sector achieved the highest score of 71 (up from 62 in Q2), closely followed by the industrial sector, whose score increased from 59 in Q2 to 69 in Q3, while the office sector increased from 44 in Q2 to 51 in Q3.

Over the quarter the number of HOT markets increased from 31 to 45, with 86 out of the 105 markets in the Index rated either HOT or WARM (Figure 2).

UK and Germany continue to offer best fair value

Of those countries covered by the European Index, the UK and Germany have the best investment prospects as indicated by their absence of COLD markets (Figure 2). Over the quarter the UK saw the largest number of upgrades with five markets reclassified from WARM to HOT. This reflects the UK's early repricing ahead of the rest of Europe, with a more widespread correction expected to follow. Germany experienced three upgrades from WARM to HOT in Q3, while in France there were two upgrades.

Differential between property yields and bonds yields widens further

Apart from the UK, which has seen some upward movement in yields over the last quarter, prime property yields across Europe are generally holding firm. This, together with falling government bond yields, has made real estate investment look more attractive.

The Index is now at a similar level to Q3 2009 and Q3 2005, when the Fair Value Index™ score peaked at 61 in both years (Figure 3).

Table 1

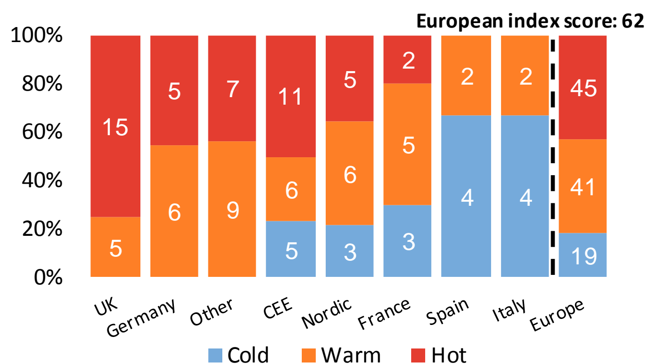
European Fair Value Index scores

	Q2 2012	Q3 2012
Europe all-property	53	62
Europe office	44	51
Europe retail	62	71
Europe industrial	59	69
Asia Pacific all-property	68	75

Source: DTZ Research

Figure 2

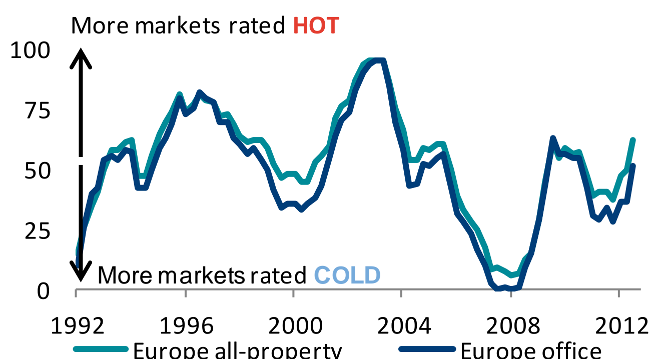
Fair Value Index rating by country, Q3 2012



Source: DTZ Research

Figure 3

European Fair Value Index score



Source: DTZ Research

Europe Q3 2012

Required and expected return drivers

Government bond yields have fallen across Europe

Government bond yields experienced downward pressure across Europe this quarter (Figure 4). These movements can be attributed to the recent announcement by the ECB that it will buy the bonds of economies under a formal EU bailout programme until their borrowing costs are reduced to a sustainable level. The announcement had a positive impact on both bond and stock markets across Europe. The ECB's focus is on bonds with a maturity of three years or lower. This is important for our Fair Value analysis, which is centred on a comparison of property to 5 year government bond yields.

Borrowing costs in Ireland have fallen by 147 basis points since June, from 5.31% to 3.84%. Over the same period, Italy and Spain's borrowing costs fell by 119 and 81 basis points, respectively (Figure 4).

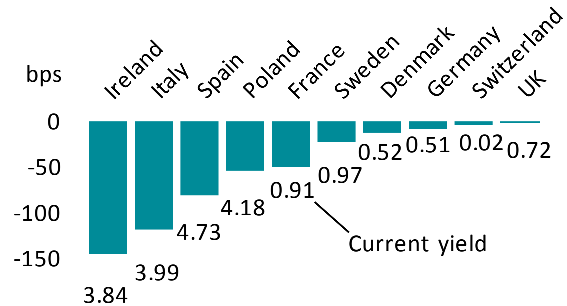
The spread between corporate and government bonds in Europe has tightened this quarter. The ECB's announcement was followed by share price rises, a fall in companies' borrowing costs and a lower risk premium (Figure 5).

The combination of lower bond yields and a tighter corporate bond yield spread has put significant downward pressure on the required returns for property across Europe compared to last quarter (Figure 6). With expected returns in property remaining relatively sticky, property has become more attractive in Europe compared to bonds.

Expected total returns remain high compared to required returns for Dublin offices, Warsaw retail, Edinburgh offices and Paris (CBD) retail, making these markets HOT this quarter. On the other hand, for Rome offices expected returns remain well below required returns and so remains a COLD market in Q3 (Figure 6). Most peripheral markets in Spain and Italy are rated COLD.

Figure 4

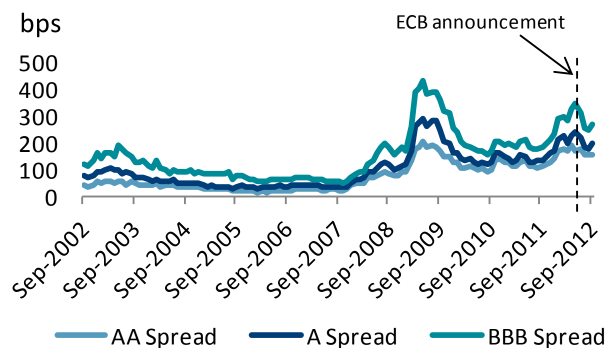
Basis point change of 5 year government bonds from Q2 2012 to Q3 2012, and current yields



Source: DTZ Research

Figure 5

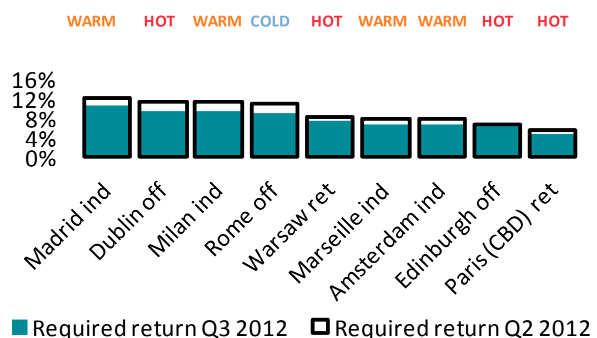
Spread of Eurozone benchmark corporate bond yields over German government bond yields



Source: Bloomberg

Figure 6

Required return for property has fallen in most markets



Source: DTZ Research

Europe Q3 2012

Market classifications

17 European markets upgraded to HOT in Q3

A reduction in required returns has driven a significant number of upgrades from WARM to HOT in Europe this quarter, mostly in the UK. The UK now has 15 HOT markets compared to 11 last quarter. Leeds offices and Glasgow offices were among those UK markets upgraded from WARM to HOT. In total, 17 markets were upgraded from WARM to HOT across Europe, including 3 markets from Germany, 2 from France, and 2 from the Netherlands.

Stockholm offices and Warsaw offices were the only markets in Europe to be downgraded to COLD. This is due to significantly weaker rental growth forecasts compared to last quarter (Figure 7). London (City) offices and Munich offices were both downgraded from HOT to WARM due to a combination of lower current yield and lower rental growth forecasts compared to last quarter (Figure 7).

While more markets were rated HOT in Q3 compared to Q2, the magnitude of underpricing was also greater than in the previous quarter. Last quarter, at the top end of the rankings, Dublin industrials were under priced by 25%, compared with Vilnius industrials, which was underpriced by 17%.

Last quarter, Rome offices were the most overpriced market in Europe, being overpriced by 27%. This quarter, although the market is still COLD, the degree of overpricing has become less severe, and now lies at 14%. Table 2 shows a selection of market pricing across the three classifications

Economic outlook remains bleak

Despite these positive movements, the economic outlook for Europe remains bleak. Eurozone GDP is forecast to decline in 2012 and 2013 by -0.6% and -0.1%, respectively, with only modest growth then expected until 2017 (Figure 8).

Figure 7

Movements in market classification – Q2 vs Q3

Q2 2012 \ Q3 2012	COLD	WARM	HOT
COLD	Madrid offices Rome offices Barcelona offices Rome retail	Warsaw Industrial Milan Industrial Madrid industrial	
WARM	Stockholm offices Warsaw offices	Berlin offices Munich retail West End retail Amsterdam retail	Dublin offices Leeds offices Frankfurt industrial Glasgow offices
HOT		London City offices Munich offices	Dublin retail Moscow offices Frankfurt retail

Source: DTZ Research

Table 2

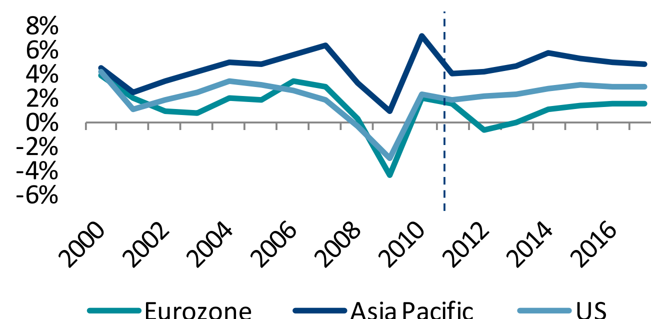
Selected market pricing relative to Fair Value

	Q3 2012	Degree of over pricing (negative is underpriced)
Vilnius industrial	HOT	-21%
Prague retail	HOT	-18%
Dublin offices	HOT	-15%
London city offices	WARM	-5%
Milan industrial	WARM	-2%
Warsaw offices	COLD	6%
Barcelona retail	COLD	10%
Rome offices	COLD	14%

Source: DTZ Research

Figure 8

GDP growth outlook bleak in the Eurozone



Source: DTZ Research

Europe Q3 2012

Office forecasts

Office rental growth plagued by European 'lost decade'

The ECB announcement of Outright Monetary Transactions (OMT) in September might be regarded by some as a significant move to save the Eurozone. However, the economic fundamentals are still yet to be tackled. Recent comments from the IMF report on austerity measures set the focus on economic growth. The weak outlook for the European economy is reflected in our forecast for office rents. For the period 2012-16 we expect European office rental growth to average just 1.9%p.a.

London City continues to show reasonable rental growth prospects of 3.4% p.a., and given the low yield environment in the UK gilt market, it is classified as WARM in the Fair Value Index (Figure 9). It is also worth noting that the Dublin office market has moved from WARM to HOT. This is due to compression of the 5-year Irish government bond yield, which subsequently leads to a lower hurdle rate.

Rental growth forecasts for the Madrid and Barcelona office markets have been downgraded. This reflects the on-going saga in Spain's public deficits and the desire for separatism from some of its autonomous communities.

Yields across Europe are expected to show little change in the short run. However, a 'North-South Divide' in yields between Western Europe and the South is expected to persist until at least 2015-16 due to the continuing lack of risk appetite from investors (Figure 10).

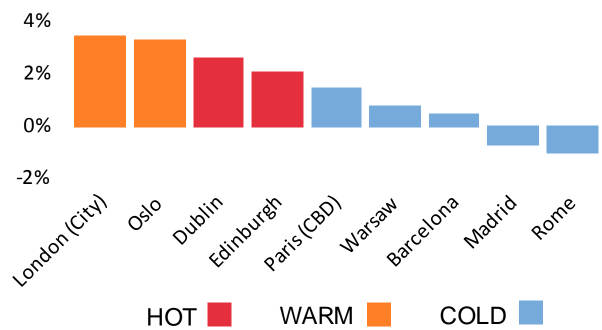
CEE: Strong total return performance but not so 'HOT'

Average total returns in Dublin over the five year forecast period are expected to be 12% p.a. as Ireland recovers gradually from the economic crisis. Prague and Warsaw office markets are relatively strong performers, with total returns expected to be 7.5% p.a. and 7.3% p.a. respectively (Figure 11). However, neither market is classified as 'HOT' in the Fair Value Index. Although government bond yields have fallen in both countries, so too have expected returns. In Prague, expected returns are weaker due to lower rental expectations, and in Warsaw, due to a lower expected degree of yield compression.

Capital values in Milan, Rome and Madrid are expected to fall over the forecast period. Low average capital and income growth, alongside substantially higher government bond yields compared to core European countries, has significantly reduced the attractiveness of these markets.

Figure 9

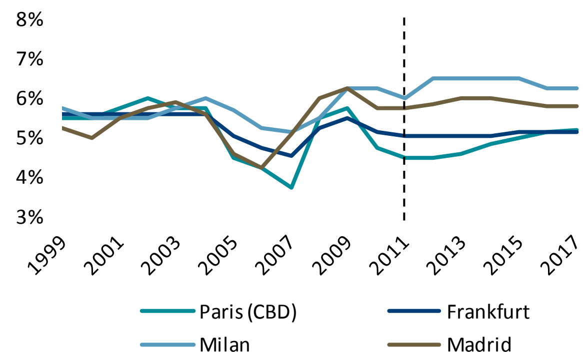
Average office rental growth forecasts (2012-16, %p.a.) and Fair Value classifications



Source: DTZ Research

Figure 10

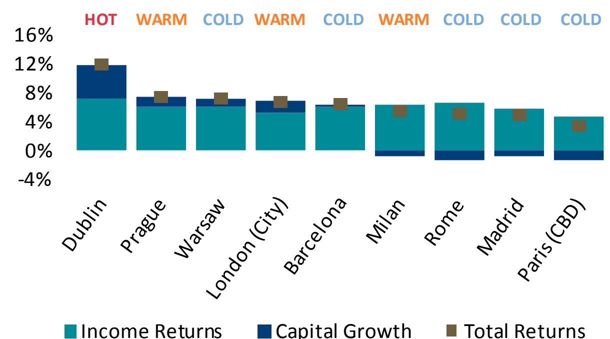
European office yield forecasts (%Q4): 'North-South Divide'



Source: DTZ Research

Figure 11

European office average annual total returns breakdown (2012-16, %p.a.) and Fair Value classifications



Source: DTZ Research

Europe Q3 2012

Retail forecasts

Rental growth prospects: 'South vs. Others'

The unemployment rate within the Eurozone stayed at a record high in August of 11.4%, while inflation remains above the ECB target of 2%. Consumer spending is expected to fall by -0.8% in 2012, an even faster rate than previously anticipated. Despite this, our average retail rental growth forecast across Europe is unchanged over the next five years at 2.1%p.a. Demand from international retailers for the best property is boosting rents.

Rental growth prospects vary within different European regions. However, a 'South vs. Others' division is prominent. Average rental growth over the five year period was upgraded in Western Europe and Central Eastern Europe (CEE). Whereas, downgrades are mainly focused on Southern Europe, reflecting their relatively gloomy macroeconomic outlooks (Figure 12).

Whilst average rental growth forecasts over the five year period in Frankfurt and Berlin have been upgraded (from 2.3% p.a. to 4.4% p.a. and from 2.5% p.a. to 3.1% p.a., respectively), Milan saw a sharp downgrade from 0.4% p.a. to -1.7% p.a. Several CEE countries also have a strong rental growth outlook. The Prague and Riga retail markets, for example, are attracting overseas retailers.

The sovereignty and flexibility of their own monetary policy enjoyed by certain CEE countries is regarded as a virtue by some investors in the current economic climate. Besides, due to their proximities to Western Europe, retail yields in Prague and Warsaw are expected to fall towards the level seen in Paris by the end of 2017 (Figure 13).

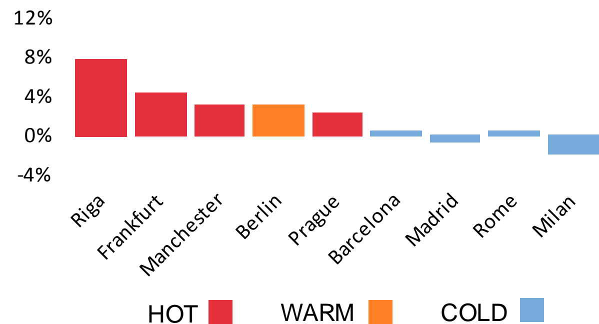
Strong capital returns for Core Europe and CEE

Similar to the office sector, CEE markets are expected to show high average total returns over the forecast period. Higher expected capital growth in markets such as Prague, backed by good rental growth prospects, make CEE retail markets look attractive relative to their required returns.

Average total returns in Core Europe over the next five year period, in general, show much better performances than southern European countries and thus remain attractive. The Lyon retail market has moved from WARM to HOT in the Fair Value Index (Figure 14), as rental growth is expected once rents have levelled by the end of 2012.

Figure 12

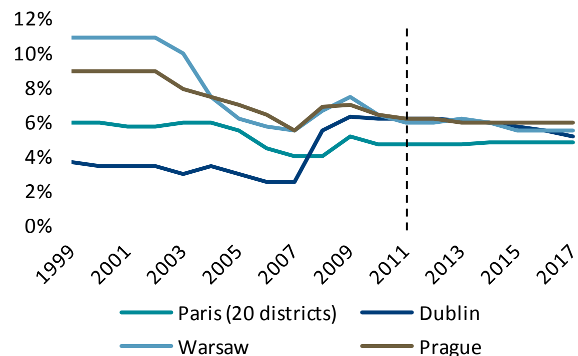
European retail average annual rental growth forecasts (2012-16, %p.a.) and Fair Value classifications



Source: DTZ Research

Figure 13

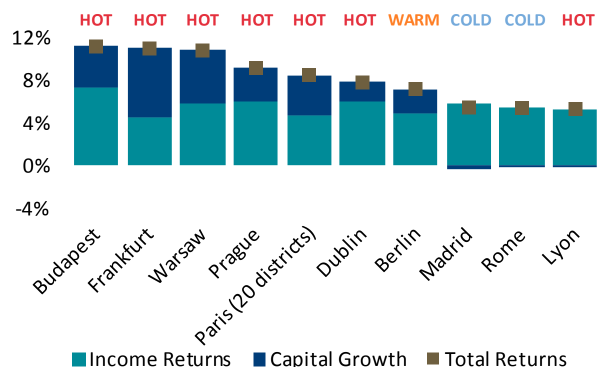
European retail yield forecasts (%Q4)



Source: DTZ Research

Figure 14

European retail average annual total returns breakdown (2012-16, %p.a.) and Fair Value classifications



Source: DTZ Research

Europe Q3 2012

Industrial forecasts

Modest recovery in industrial rental growth in medium run

Eurozone industrial output is expected to fall by 3% in 2012, despite a stronger-than-expected month-on-month rise of 0.6% in August. A negative reading in the German ZEW indicator suggests that investor confidence even in core Europe remains low. In addition, manufacturing output is expected to fall by 1.7% in 2012. As a result, the average industrial rental growth forecast across Europe over the next five years saw a downgrade from 1.5% p.a. to 1.2% p.a. (Figure 15).

During the current quarter, there was an increase in the number of markets that saw rental growth downgraded. This reflects our view that economic conditions and prospects worsened during Q3. Overall, thirteen markets have been downgraded, compared to only one downgrade in our 2012Q2 forecast. Southern European markets (including Barcelona, Madrid, Rome and Milan), several CEE markets and a handful of Western European markets saw downgrades in average industrial rental growth over five year period. Downgrades ranged from 0.4%pts to 3.1%pts.

Multi-tier yields across European Industrial markets

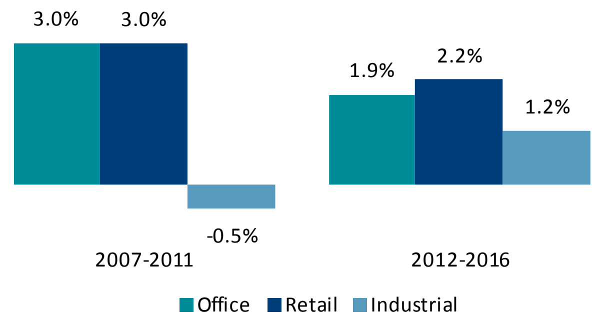
European industrial yields in several markets are expected to fall into three different groupings: A, B or C by the end of 2017 depending on the levels of yield, albeit their levels were different in the late 90s. London (Heathrow) and Dublin were at a relatively low yield. However, the economic downturn in Ireland saw yields rise sharply. The Dublin industrial yield is expected to hit a historical high of 9.25% in 2012 before falling to 8% by 2017. This is also the yield level expected for Milan (Figure 16). Frankfurt is expected to form another group of yields with some Nordic and core European markets (e.g. Helsinki and Hamburg) as group B by the end of 2017, whilst the yield of London (Heathrow) is expected to be the lowest amongst European industrial markets and is classified as a stand-alone group A.

High yield makes industrial relatively attractive

Despite the downgrade in our forecast for average industrial rental growth in Europe over the five year period, which leads to relatively low capital growth potential (some even negative) within the sector, only Budapest is classified as COLD in the Fair Value index. This is largely attributed to the high yield nature of the European industrial sector, combined with on-going policies by central banks to keep interest rates low, which in turn lowers the hurdle rate for property.

Figure 15

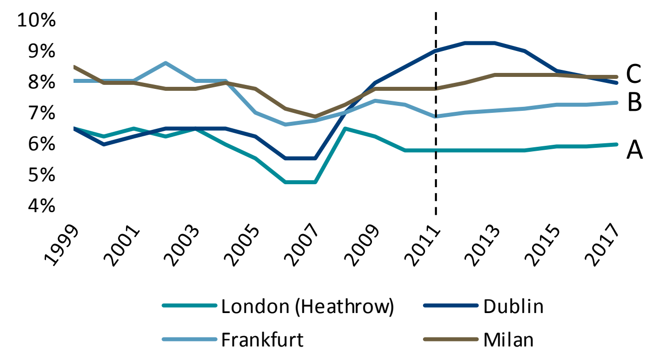
Average rental growth, across sectors 2007-2011 - 2012-16 (2012-16, %p.a.)



Source: DTZ Research

Figure 16

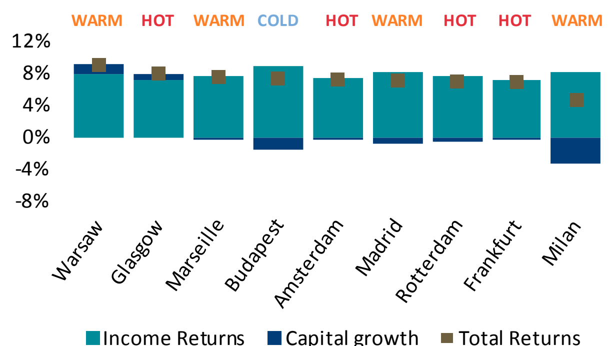
European industrial yield forecasts (%Q4): Multi-tier yields



Source: DTZ Research

Figure 17

European industrial average annual total returns breakdown (2012-16, %p.a.) and Fair Value classifications



Source: DTZ Research

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