KOUT

CAPITAL

GLOBAL PROPERTY OUTLOOK FOR 2019

WWW.KOUTCAPITAL.COM

KOUT CAPITAL LLC
INVESTMENT AND RESEARCH TEAM

MARCH 11, 2019

GLOBAL ECONOMIC AND PROPERTY MARKET OUTLOOK

GLOBAL ECONOMY FORECASTS FOR 2019

GROWTH PROSPECTS

Between 2016 until the beginning of 2018, growth increased in most of the major economies at a global level. However, it is predicted that in 2019 G7 economies will see a decrease in growth that would likely register within their long-time averages. In the US, the fiscal stimulus boost is expected to wilt with higher interest rates having a negative effect on consumer spending and the strong dollar may resume its strain on net exports. The Eurozone is also expected to struggle with uncertainty and global trade tensions due to the ongoing Brexit affair. The European Central Bank's quantitative easing policy is expected to cease, interfering with the overall support for growth. Emerging markets are expected to feel the pressure from the strong US dollar throughout 2019 until the US economy slows down as expected.

LABOUR MARKETS AND EMPLOYMENT

Advanced economies may witness a tightening in labour markets which will increase wages, and businesses may find it difficult to employ occupational shortages. In the US and Germany for example, unemployment rates are expected to decrease as employment continues to be strong. Flattening unemployment rates have been witnessed in countries such as Canada, Denmark, and Belgium. These economies have seen a decrease in joblessness, however the pace has nevertheless been slowing down. The case for the UK revolves around the Brexit situation – if an orderly Brexit is negotiated this year then unemployment rates would be stabilizing at its current level of 3.9%.

SOME UNEXPECTED EUROPEAN COUNTRIES ARE MOVING TOWARDS RECESSION

Multiple economists expect that Europe overall is likely to head into recession with Europe's largest economies Italy, Spain, and Germany having decreased their industrial production output by circa 1.5%, 1.5% and 1.9% respectively. The economic decline has been supported by European governments in their quest to cut fiscal stimulus and restrict deficit spending to balance budgets after the 2008 financial crisis. This austerity measure has in turn led to a contracted size of the European economy with less room to grow. Manufacturing sectors in Italy, France, and Germany have felt the pressure and seem unable to resuscitate against the economic plunge.

Due to ongoing conflicts in some economies across the EurozoneIn retrospect, the Euro now seems to be weakening against the British pound and the US dollar. This is largely due to Germany seeing its slowest economic growth in almost six years, and just narrowly avoided falling into recession during the end of 2018, Italy experiencing issues with their government and banking systems, and Spain undergoing it's upcoming general elections.

Furthermore, some other European member states have been undergoing political events that deem economically disastrous to the collective union such as the yellow vests protest in France, the upcoming European Commission elections in May 2019, and the renewed threat of the extreme Right Wing across Europe. These events, coupled with an unregulated Brexit may well decrease the growth of GDP in European states.

ECONOMIC OUTLOOK OF GROWTH PROJECTIONS FOR EUROPEAN ECONOMIES (DATA ISSUED BY THE INTERNATIONAL MONETARY FUND IN "WORLD ECONOMIC OUTLOOK REPORT 2019")

	REAL GDP			CUSTOMER PRICES[1]			CURRENT ACC BALANCE[2]			UNEMPLOYMENT[3]		
		PROJECTIONS			PROJECTIONS			PROJECTIONS			PROJECTIONS	
	2017	2018	2019	2017	2018	2019	2017	2018	2019	2017	2018	2019
EUROPE	**3.1**	**2.3**	**1.9**	**2.6**	**3.1**	**3.2**	**2.4**	**2.4**	**2.4**	**...**	**...**	**...**
Advanced Europe	2.4	2.0	1.9	1.7	1.8	1.8	3.0	2.9	2.8	7.9	7.2	7.0
Euro Area[4,5]	2.4	2.0	1.9	1.5	1.7	1.7	3.5	3.0	2.9	9.1	8.3	8.0
Germany	2.5	1.9	1.9	1.7	1.8	1.8	7.9	8.1	7.9	3.8	3.5	3.4
France	2.3	1.6	1.6	1.2	1.9	1.8	-0.6	-0.9	-0.7	9.4	8.8	8.5
Italy	1.5	1.2	1.0	1.3	1.3	1.4	2.8	2.0	1.6	11.3	10.8	10.5
Spain	3.0	2.7	2.2	2.0	1.8	1.8	1.9	1.2	1.2	17.2	15.6	14.7
Netherlands	2.9	2.8	2.6	1.3	1.4	1.6	10.5	9.9	9.7	4.9	3.9	3.8
Beigium	1.7	1.5	1.5	2.2	2.2	1.8	-0.2	0.1	-0.1	7.1	6.4	6.6
Austria	3.0	2.8	2.2	2.2	2.0	2.1	1.9	2.2	1.8	5.5	5.2	5.1
Greece	1.4	2.0	2.4	1.1	0.7	1.2	-0.8	-0.8	-0.4	21.5	19.9	18.1
Portugal	2.7	2.3	1.8	1.6	1.7	1.6	0.5	0.0	-0.3	8.9	7.0	6.7
Ireland	7.2	4.7	4.0	0.3	0.7	1.2	8.5	7.4	6.7	6.7	5.3	5.1
Finland	2.8	2.6	1.8	0.8	1.2	1.7	0.7	0.9	0.9	8.5	7.7	7.4
Slovak republic	3.4	3.9	4.1	1.3	2.6	2.2	-2.1	-1.8	-0.9	8.1	7.5	6.9
Litinuania	3.9	3.5	2.9	3.7	2.5	2.2	0.8	0.3	0.0	7.1	6.5	6.3
Slovenia	5.0	4.5	3.4	1.4	2.1	2.0	7.1	6.3	5.5	6.6	5.8	5.4
Luxembourg	2.3	4.0	3.5	2.1	1.5	1.8	5.0	4.9	4.8	5.8	5.4	5.2
Latvia	4.5	3.7	3.3	2.9	2.7	2.4	-0.8	-2.0	-2.6	8.7	7.9	7.8
Estonia	4.9	3.7	3.2	3.7	3.0	2.5	3.1	2.2	1.1	5.8	6.7	6.9
Cyprus	3.9	4.0	4.2	0.7	0.8	1.8	-6.7	-3.1	-5.2	11.1	9.5	8.0
Malta	6.7	5.7	4.6	1.3	1.8	2.1	13.6	11.6	11.1	4.6	4.1	4.1
United Kingdom	1.7	1.4	1.5	2.7	2.5	2.2	-3.8	-3.5	-3.2	4.4	4.1	4.2
Switzerland	1.7	3.0	1.8	0.5	1.1	1.4	9.8	10.2	9.8	3.2	2.8	2.8
Sweden	2.1	2.4	2.2	1.9	1.9	1.7	3.3	2.6	2.8	6.7	6.2	6.2
Norway	1.9	2.1	2.1	1.9	1.9	2.0	5.5	7.8	7.8	4.2	3.8	3.7
Czech Republic	4.3	3.1	3.0	2.4	2.3	2.3	1.1	-0.4	-0.9	2.9	2.5	3.0
Denmark	2.3	2.0	1.9	1.1	1.4	1.7	7.6	7.7	7.5	5.7	5.4	5.3
Iceland	4.0	3.7	2.9	1.8	2.5	2.6	3.5	2.4	2.0	2.8	3.2	3.3
San Marino	1.9	1.9	1.9	1.0	1.5	1.6	...	...	...	8.1	8.2	8.3
Emerging & Developing Europe	6.0	3.8	2.0	6.2	8.3	9.0	-2.6	-1.4	-1.4	...	...	...
Turkey	7.4	3.5	0.4	11.1	15.0	16.7	-5.6	-1.4	-1.4	10.9	11.0	12.3
Poland	4.6	4.4	3.5	2.0	2.0	2.8	0.3	-1.3	-1.3	4.9	4.1	4.0
Romania	6.9	4.0	3.4	1.3	4.7	2.7	-3.4	-3.4	-3.4	4.9	4.7	4.8
Hungary	4.0	4.0	3.3	2.4	2.8	3.3	3.2	2.1	2.1	4.2	3.9	3.5
Bulgaria	3.6	3.6	3.1	1.2	2.6	2.3	4.5	1.6	1.6	6.2	5.6	5.5
Serbia	1.9	4.0	3.5	3.1	2.1	3.3	-5.7	-5.6	-5.6	14.1	13.8	13.5
Croatia	2.8	2.8	2.6	1.1	1.6	1.5	3.9	2.3	2.3	12.4	12.0	11.2

Note: Data for some countries are based on fiscal years. Please refer to Table F in the Statistical Appendix for a list of economies with exceptional reporting periods.

1 Movements in consumer prices are shown as annual averages. Year-end to year-end changes can be found in tables A6 and A7 in the Statistical Appendix.

2 Percent of GDP.

3 Percent. National Definitions of unemployment may differ.

4 Current account position corrected for reporting discrepancies In Intra-area transactions.

5 Based o Eurostat harmonized index of consumer prices except for Slovenia.

6 Included Albania, Bosnia and Herzegovina, Kosovo, FYR macedonia, and Montenegro.

OVERALL PROPERTY INVESTMENT MOMENTUM AND OCCUPIER MARKETS

Investment and corporate occupier activity for Global real estate markets have surpassed expectations in 2018, reaching its highest levels since 2007. This however is due to change in 2019 as the real estate market is showing signs of activity slowdown, and volume moderation and general caution. Commercial assets and office leasing markets remain buoyant and are expected to remain well above the 10-year average. Office leasing markets have remained active with year-to-date volumes 8% higher than that of 2017. The global logistics market has been performing well and has maintained continued demand which has kept vacancy rates low while driving further rental growth. Global retail markets have been slightly subdued with the rise of retailers going into administration, partially due to the influence of the internet.

For prime commercial real estate markets, rental growth continues to be strong, reaching circa 4% in 2018 and the pace is expected to remain positive into 2019. However, rental growth may possibly slow down to circa 2.6% because of the decrease of supply options. Most notable areas showing top performances are San Francisco and Boston, Sydney, and Singapore. With regards to European markets, Madrid, Moscow, Amsterdam, Berlin, and Stockholm (who are known as the tech-cities) forecast to show above market trend rental growth for prime offices.

In terms of global construction activity, end-user demand is expected to drive new development in the next couple of years which is estimated to be 20%-25% higher than the 10-year average. Hence, the global vacancy rate is expected to increase thereby reaching 12% in the second half of 2019.

EUROPEAN PROPERTY MARKET, 2019

REAL ESTATE BUSINESS ENVIRONMENT, PERFORMANCE, AND INVESTOR SENTIMENT

Although European real estate leaders have demonstrated less confidence in light of uncertainty and caution in the economic and political aspects of the region, they nevertheless remain optimistic about their business prospects. The most eminent concern amongst industry experts is the availability of proper assets and the selectivity of those properties in the market. With regards to equity, an over allocation in real estate global markets remain available with a large portion of capital coming into Europe.

Moreover, prices for every asset class in the European property market has soared to historic levels which has been a cause for concern for some investors, and not so much for others. Many investors view the issue for the availability of assets and the soaring prices as an indicator that the real estate industry is doing well and that financial controls are in place, especially for 2019. The occupier market remains healthy which is supporting strong property valuation.

In terms of speculative development, there will be continued restraints due to the construction costs (labour and materials). Construction prices are increasing which have impacted activity for developers in some European countries. While in previous years, developers were almost certain that development costs would be compensated by higher end-product asset pricing along with yield compression, it is not the case anymore for new developments whereby developers must be aware and would have to thoroughly calculate the cost versus final sale.

OVERALL POLITICAL RISK AMID BREXIT NEGOTIATIONS AND ITS POSSIBLE EFFECT ON THE EUROPEAN PROPERTY MARKET

Apart from international stability, Brexit is another main reason for the cause of concern in the real estate industry in 2019. However, national political instability has been diffused compared to previous years when there was a general fear over the threat of nationalism in Europe. Industry experts believe that the UK economy is likely to underperform in the short term after its departure from the European Union. It is also likely possible that there will be business relocations from the UK to continental Europe in 2019 and that there will be an evident divergence in economic performance between the UK and the European Union. Some banks have already moved people and services out of the City of London's financial district such as Barclays group who have moved to Dublin to use their existing EU-based bank subsidiary to serve clients within the EU regardless of the Brexit outcome. Nonetheless, it is also apparent that non-European investors have demonstrated indifference by Brexit compared to European investors.

This does not mean that there is no lingering concern on other aspects for the Eurozone. The governments of Italy and Turkey have created somewhat of a worry as to their viability in the Eurozone. International instability has further caused concern for both the industry and the overall business environment. The trade war between the US and China has been seen as a detriment to some European markets. For example, Germany as an exporting country may be affected if trade wars escalate and tariffs

TOP EUROPEAN REAL ESTATE MARKET TRENDS

THE PROPERTY MARKET WHICH IS OPERATING IS DRIVEN BY INCOME- STREAM CREATION RATHER THAN OF CAPITAL GROWTH

As the trend of commercial property values rising and are arguably at peak prices due to the end of quantitative easing, negative interest rates and high liquidity, the European property industry has now prioritized one goal: securing income. The late stage in the current cycle has led cap rates and yield shifts to become less of a driver of real estate values so asset managers must work towards income growth and creation. In that sense, sustainable cash flows are targeted and industry players are now looking at a 'build-to-core' strategy, especially with commercial real estate. This is likely to push down overall returns. Moreover, a shift of capital has been allocated to residential and alternative assets with a likelihood that these asset classes will grow with regards to the availability and price suitability of core assets. This is all dependent on how interest rates increase and the pace of rental growth.

Optimistically speaking, the European real estate industry has now moved towards recovery from the 2008-09 crisis whereby supply and demand at an occupier level remains in a balance and both lenders and investors are maintaining a steady pace of investment while carefully treading the market without the need to accumulate large amounts of debt on thin equity foundations for their assets. Industry leaders are also avoiding the attraction of increasing prices and some are selling to non-European investors based on different return and/or risk criteria.

That being said, investors are now looking at alternative assets and niche areas. Student accommodation is one example which requires a more operational management approach. We are in a stage where investors must be looking at assets where both income and sector growth is moving to be less exposed to risk. Other industry investors are looking at value-added build to core development in markets where there is tight supply and growing rents to compensate for initial development/lease-up risk. This is especially prevalent in the office sector. According to JLL, in 24 European cities, completed office developments will increase between 2019 and 2020 until this trend lightens up in 2021. How rents will change in that time will remain to be seen.

The obstacle that industry leaders are facing is the unwillingness for banks to fund speculative developments with strict requests on pre-let indications. This has created pressure on alternative lenders who currently make up a small portion of the debt market but charge more in margin and fees to reflect the risk profile.

DEMAND FOR AFFORDABLE HOUSING

Top cities in Europe have generally witnessed a lack of supply for affordable housing, social housing, and senior care facilities. This aspect has continued for some time and has now reached its highest level. The amount of capital allocated to the residential sector in all its forms has increased and has become widespread. Some industry players have now regarded the European private-rented sector from being a niche market to an institutionally acceptable market. Fundamentals for the residential sector across Europe seems most promising. This is especially because there has been no tangible improvement in housing affordability and that cyclical uncertainty may most negatively affect commercial property. Therefore, income in the residential property sector in all its forms, be it student housing or senior living, is the most durable sector when facing any economic outcome.

Another integral aspect of housing is related to commercial companies and the mobility of their employees. Sometimes, housing prices are too expensive for companies to move to certain locations. Moreover, alternative structures of housing have been introduced, especially for millennials and the younger generation. For example, micro-apartments and co-living space demand is now changing the way developers and investors in the market are thinking in that a range of accommodation types are becoming available.

TENANT SATISFACTION

The days when real estate investment meant to purchase a property, hold it for 10 plus years and sell is now over. Today, the market has changed and changed significantly. The wellbeing and happiness of tenants are put first if landlords want to attain the highest rent possible, attract loyal tenants and maintain occupancy at high levels. Sustainability and energy efficiency is key to establishing environmental and social governance which has turned the business of property into a service. To attract occupier demand, investors and asset managers must employ the skills that would cater to the needs of the tenants such as more flexibility, space enrichment, and sustainability. In the end, this would require more investment but added occupational value.

REAL ESTATE CAPITAL MARKETS

There has been positive sentiment towards capital markets in Europe for 2019 despite lowered expectations towards the availability of both equity and debt with the economic cycle in a phase of uncertainty. Strong competition for assets is evident from heavy amounts of capital allocated to European real estate. Some industry players believe that the availability of both equity for refinancing or new investment will increase. Further, with the exception of some sectors, most notably UK retail, the European market remains highly liquid. This comes despite the general concern that prime real estate has reached its peak compared to historical values.

Further, many sovereign wealth funds and high net worth individuals now view trophy assets as an opportunity taking into consideration their long-term value perspective. Many institutions and individual investors from Asia in particular are pursuing this objective and are not only investing in trophy assets, but also into funds and cross-sectoral real estate schemes with a belief that equity and bond markets are no longer providing satisfactory returns. The challenge here is that investors have been cautious on where to invest their money due to the market being more selective and the right properties becoming challenging to find. Some industry players have also been wary of investing equity and debt in the UK compared to major continental European markets due to Brexit uncertainty. However, direct investors from the UK and Asia are nevertheless purchasing core assets in the UK with the first half of 2018 recording the highest investment volume compared to other European real estate markets. This is not the same for secondary or anything below Prime UK real estate where investors have been treading extremely carefully due to weaker economic fundamentals coupled with high asking prices.

THE DEBT MARKET

There is somewhat of an evolution in the debt market in terms of sourcing. While banks have the upper hand in the market in terms of financing, alternative lenders who make up a minority of the market is growing. A study by Cass Business School in the UK has revealed that banks have 74% of the overall £164 billion of outstanding debt in the market for commercial real estate, compared to 98% recorded in 2007. Investors are more likely to undertake the conservative approach towards equity and lean more on debt as debt providers. With more capital coming into the market, loan-to-values (LTVs) are rising and banks are refraining from increasing the LTVs and pricing to avoid risk. This has provided a leeway for alternative lenders to grow by becoming more attractive to investors in terms of higher LTV and better financing terms. However, the European Central Bank heavily regulates the market to ensure that there is more equity against property loans; and as asset prices increase, more equity must be kept aside which also limits the quantity of new loans.

THE EQUITY MARKET

While Chinese capital has been reduced due to governmental capital control policies, other Asian investments into European real estate is set to grow and make up the highest number of international investors. Singaporeans and Koreans are currently investing in Europe while there are expectations that an inflow of Japanese capital from national pension funds, particularly Japan's Government Pension Investment Fund (GPIF) who owns $1.2 trillion of assets. GPIF is for the first time allowed to invest in international real estate which will hopefully assuage the decrease in transaction volumes from Chinese investors. However, the largest group of investors in the European real estate market were Western European, investing €63 billion in the market. UK investors also invested largely in the market, with approximately €21 billion invested in the UK itself. North Americans invested heavily as well, with €20 billion deployed in the European real estate market.

UK REAL ESTATE MARKET AND BREXIT

ECONOMIC GROWTH PROSPECTS AMID BREXIT UNCERTAINTY

The UK withdrawal treaty has been agreed but still far away from certainty as the Brexit withdrawal agreement has been rejected by the UK parliament on the first vote with a deadline set on March 29, 2019 which may lead to a no-deal Brexit. There is also the potential for an extension to be sought from the EU. No-one can know the outcome given the current position at this time.

In December 2018, Cushman and Wakefield provided an analysis of both best and worst case economic scenarios for the outcome of Brexit: the best scenario for the UK economy is for it to remain in the EU which is predicted to show an approximate growth of 4% this year for the economy. The worst scenario economic is a no-deal Brexit which is predicted to lead to a recession with GDP decreasing by 2%.

UK PROPERTY SECTOR PERFORMANCE FORECASTS FOR 2019

COMMERCIAL OFFICE MARKET

There is uninterrupted strong demand for London office space while overall vacancy rates have continued to decline and pre-letting activity has reached its peak, compared to records from the four previous years. The challenge however is the lack of availability of Grade A products which have in turn decreased absorption and hindered transaction levels. As a result, the vasta majority of space available in London now are second-hand assets.

On the other hand, in the outside of London strong leasing activity has limited the supply of all types of office assets. In Manchester for example, 1.5 million sq ft office take-up was recorded at the end of 2018. Moreover, prime rents have increased and are suspected to rise further during the years to come.

It is expected that office rental growth will slightly decline in 2019 due to the rental reductions around most of London markets while the rest of the UK, other areas in London, and the South East will continue positive rental growth between 2018-2022.

RESIDENTIAL MARKET

Build-to-rent units that are both completed and under construction recorded an increase of 30% per end of September 2018, with the outstanding buy-to-let mortgages recording only a slight increase of 1.1%. This shows that until just recently, small scale private investors dominated the residential housing market, now incorporating a significant number of institutional investors who in previous usually settled on large property portfolios. The large increase of interest coming from institutional players alongside private landlords has driven improvement in planning, design, branding, management and delivery of the products which indicates future strong growth in this sector. There has also been a diversification of product offering in build-to-rent schemes that will continue to drive the market. Instead of residential products solely being a standard investment, it has now become a competitive product that is capable of cultivating long-term income for investors as they deliver the products that match market demand.

As per market performance, the Midlands and North of England has outperformed the level of housing activity in London and the South. It is predicted that in 2019, house price movements will depend on consumer confidence and how much they can afford to purchase a residential property of their own. This is of course dependent on the outcome of final Brexit negotiations.

RETAIL MARKET

After a strong summer in 2018, retail sales volumes slowed down. This is due to many retail administrations witnessed last year which is continuing on to 2019. Retail investment volumes in 2018 have reached its lowest levels since 2000 with shopping centres trading at a poor pace with other retail assets recording a limited number of transactions. Moreover, rental rates fell in all main sectors of the retail market in the second half of 2018. However, with real wage growth and a reduction of oil prices, there is a possibility for consumer spending to grow which might impact positively on the market.

LOGISTICS AND INDUSTRIAL MARKET

There was subdued performance in the manufacturing sector towards the end of 2018. With Brexit uncertainty, exchange rate volatility, and a slowdown in the UK economy, export orders decreased which has slightly reduced confidence in the outlook for this sector.

Nevertheless, London saw the highest growth in industrial property rents at 7.5% y-o-y, while the South East and the North East recorded 6.3% and 6.2% growth consecutively. The lowest growth recorded were from the East and West Midlands at 1.9% and 2.1%, respectively recorded.

Total growth returns were recorded at 15.5% y-o-y for 2018 which maintains that the industrial sector is the best performer across the commercial property sector in 2018. This is set to continue as positive capital growth is expected to grow by 1.9% in 2019 and 1.7% in 2020.

REFERENCES AND FURTHER READING

“Global Market Perspective - Summary.” JLL Global Research, Nov. 2018. JLL.

“Emerging Trends in Real Estate - Europe 2019.” PWC/Urban Land Institute, 2019. PWC.

“REIF In Brief.” UK Research & Forecast Report, 2018. Colliers International.

“Brexit and UK Real Estate.” House View , Dec. 2018. Cushman & Wakefield.

Laurent Clavel, and Maxime Alimi. “Macroeconomic Outlook 2019: As QE Ends, Will the Global Cycle Turn?” AXA Investment Managers, Dec. 2018.

“World Economic Outlook: Challenges to Steady Growth.”
World Economic and Financial Surveys, Oct. 2018. International Monetary Fund.

“UK Cross Sector Outlook.” UK Residential, Commercial & Rural – 2019, 2019. Savills Research.