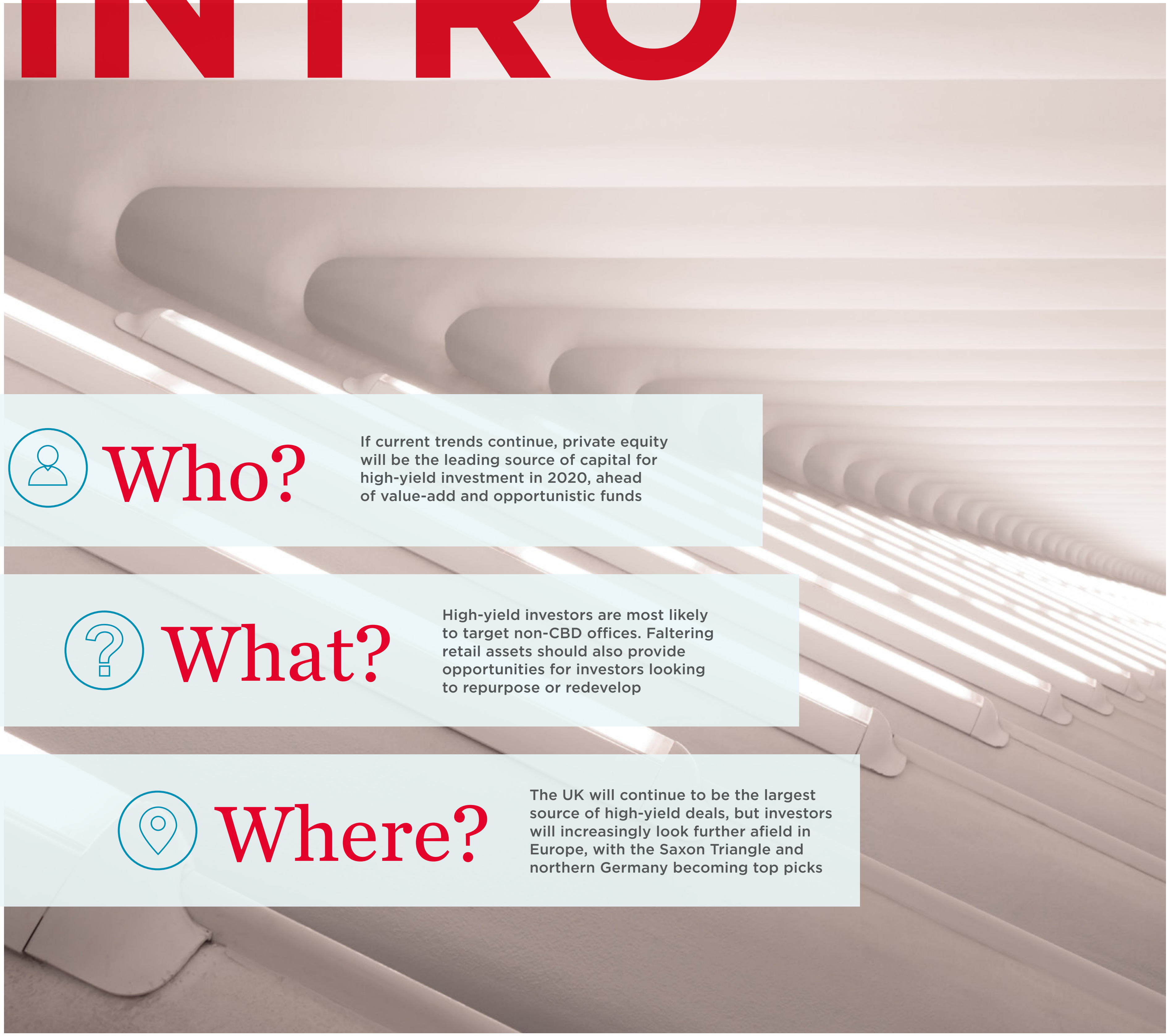
CUSHMAN & WAKEFIELD

INVESTMENT OUTLOOK 2020

Who will be the risk takers in 2020?

INTRO



Who?

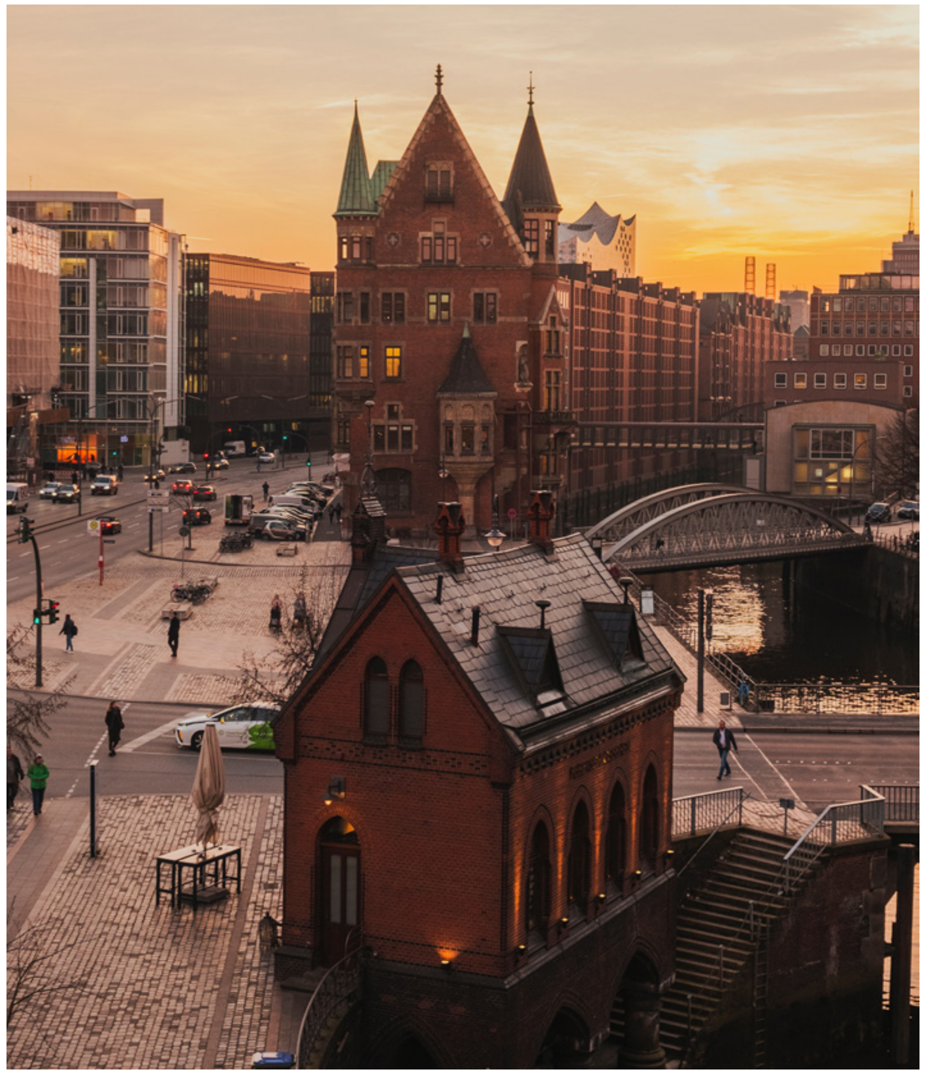
If current trends continue, private equity will be the leading source of capital for high-yield investment in 2020, ahead of value-add and opportunistic funds

What?

High-yield investors are most likely to target non-CBD offices. Faltering retail assets should also provide opportunities for investors looking to repurpose or redevelop

Where?

The UK will continue to be the largest source of high-yield deals, but investors will increasingly look further afield in Europe, with the Saxon Triangle and northern Germany becoming top picks



LOW GROWTH, HIGH YIELD?

When thinking about what investment trends could happen in 2020, it is best to start with what is most certain. Yields will remain near historical lows. Economic growth and investment returns will slow. There will be a lot of capital chasing too few opportunities, and that competition could drive investors into pushing yields lower.

For investors in core real estate, this stage of the cycle is the time to reduce risk and accept lower returns. But investors with a higher risk appetite may not want to settle for low income returns. There are properties for sale with higher yields, and there is a peer group of investors willing to buy them.

However, any asset with a high yield comes with risks that need to be understood.

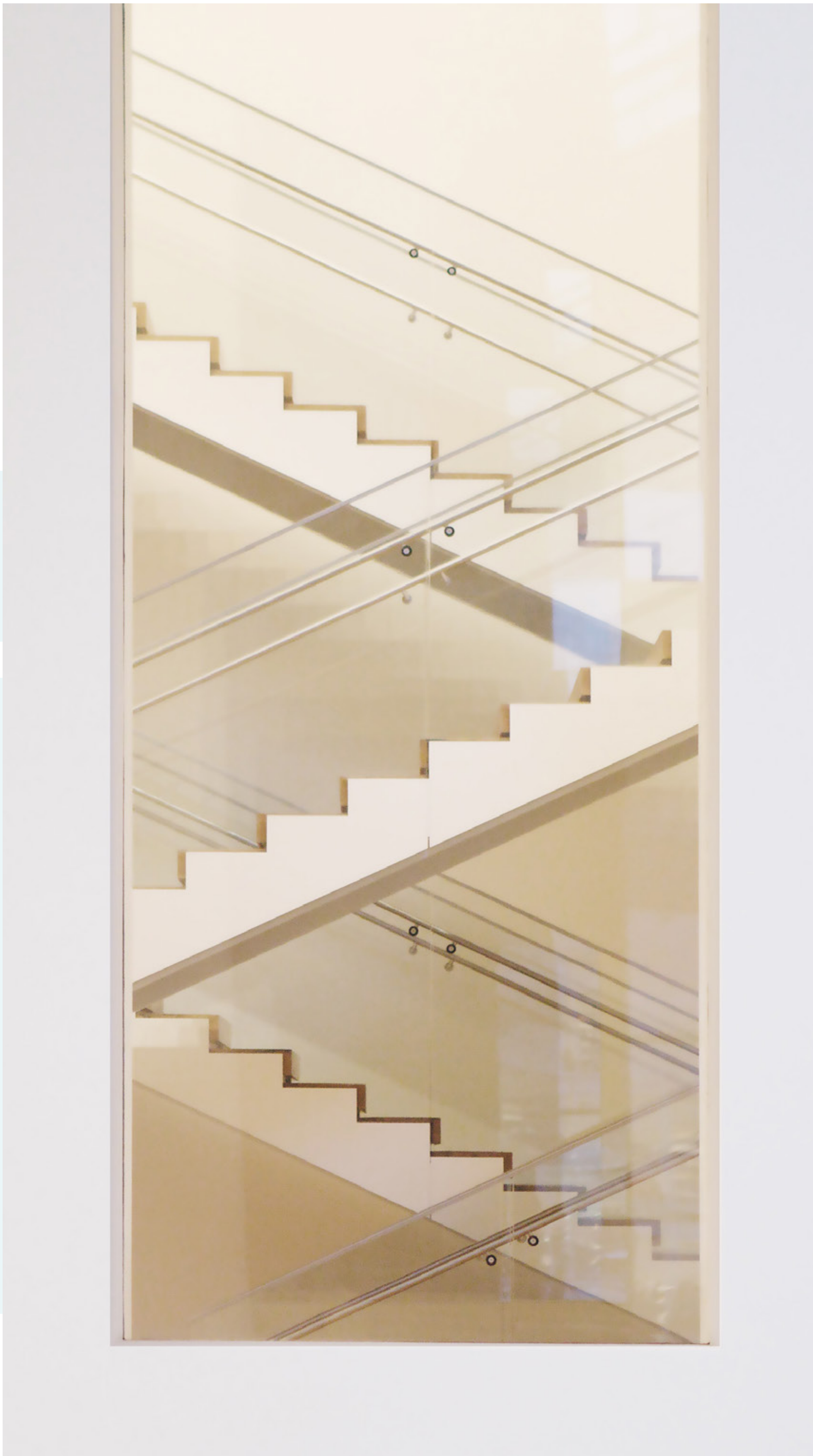
RISK FACTORS

Investors will apply a heavy discount to the value of properties that have tenants with weak credit ratings, short leases and poor building quality. And so, a higher income return compensates for these risks.

Buyers of high-risk properties, therefore, must be comfortable with the tenant's ability to pay the rent over the holding period. The investor may use relatively cheap finance to leverage this income and boost returns, but otherwise the strategy is often basic.

Other investors will try to improve the asset. The spread between low-risk and high-risk yields is wide and, although there isn't a magic trick to turn the worst building into the best, actively improving a property in this environment can be profitable.

But who are the investors willing to take on these risks? And which assets offer high yields? Most importantly, what impact will this investment activity have on our market in 2020?



THE SAMPLE

To find our peer group of high-yield investors, we looked at deals with top quartile yields each quarter from Q1 2006 to Q2 2019. The threshold yield in this sample varied over time. In 2009, top quartile properties had a yield over nine percent, today it is seven percent.

We looked at deals across Europe but found most high-yield deals took place in the UK with a smaller number in France, Germany, Netherlands, Spain and Italy. And so, our analysis is limited to these six countries.

Volumes for this group were EUR4.4bn in 2018 and average lot sizes were around EUR20m. Volumes for 2019 are down – only EUR1.2bn traded in H1 2019.

WHO ARE THE RISK TAKERS?

> Private equity has spent 58% of its capital on non-CBD offices so far this year.

Funds and private equity have dominated high-yield investment since 2006. Listed real estate companies (i.e. REITs) and institutions have been less active and sovereign wealth funds have been almost entirely absent.

Funds seem to be the main culprit for lower investment volumes in recent years, as their share of high-yield investment dropped from a 10-year average of **54%** to **37%** in the first half of 2019. This fall leaves private equity volumes at near parity with those of funds for the first time since 2008. That said, the number of fund managers willing to invest with a value-add or opportunistic strategy remains steady, with new managers coming to the market in recent years.

The fall in fund activity and the relative stability of private equity investment will have an influence over what assets will be popular in 2020. Private equity has spent **58%** of its capital on non-CBD offices so far this year (end Q2 2019), with retail warehouses and shopping centres a distant second and third with around a **12%** share each.

Meanwhile, funds have shown a greater preference for retail, which attracted a **43%** share of their investment, versus **39%** for offices. Industrial has suffered from a lack of high-yielding stock since investors pushed yields lower.

If these trends and preferences persist, private equity would be the leading source of capital for high-yield assets in 2020 and non-CBD offices would be top of their buying list.

In the UK, for example, there were just 40 assets offering yields of seven percent and above on the market at the end of August 2019[1].

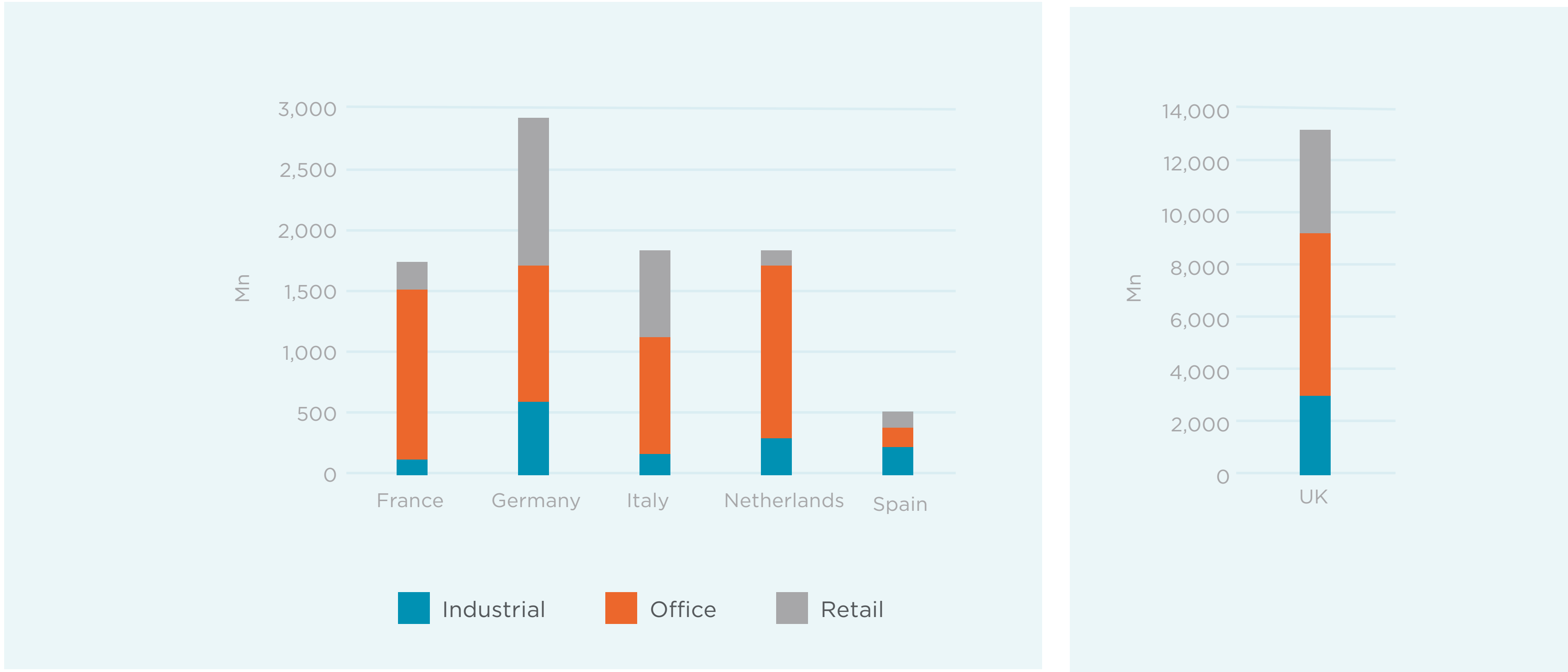
Over half of this stock were offices and around 20% were retail properties. This supply profile is in line with private equity investors' preferences but could be a barrier to funds looking for suitable retail assets.

1 Source: According to CoStar data. Limited to assets of £5m and above

WHAT ARE THEY BUYING?

Investment trends by property type differ by country. The high yield investment volumes in UK, France, and Netherlands slant towards offices. Retail is more prevalent in Germany and Italy than is usual in Europe, while industrial and logistics form a larger share of high-yield opportunities in Spain.

FIGURE 1: CUMULATIVE HIGH YIELD INVESTMENT VOLUME (2014-2018)



Source: RCA, Cushman & Wakefield

Overall, the share of high-yield office investment, shown in Figure 1, is slightly higher than offices' typical share of all investment in each country.

For investors considering the "manage and improve" route to higher returns, a refurbished office could appeal to new tenants from a wide range of industries. Meanwhile, owners of retail assets have the tougher job of driving footfall on behalf of their retail tenants.

WHERE ARE THEY BUYING?

By country, the UK is the main high-yield market in Europe with a 15-year average annual volume of EUR2.2bn. Germany is the second largest market, typically seeing EUR0.7bn of investment each year.

However, Germany used to be a major source of high-income investments. In 2006, when the German economy was coming to the end of its "sick man of Europe" phase, volumes peaked at EUR4.3bn. As high yields have become harder to find in Germany and France, there has been a steady increase in investment activity in The Netherlands and more sporadic investment in Italy and Spain. And, although we have focused on the most liquid European markets, many high-risk investors would consider a wide range of geographies, including central and eastern Europe.

But most investors look for opportunities from city to city, rather than employ a country-level strategy. We have tiered our European markets into:

- **Tier 1:** Sixteen major cities, examples include London, Madrid and Lyon
- **Tier 2:** Twenty-one smaller towns and cities – Eindhoven, Hanover, Aberdeen for example
- **Tier 3:** Twenty-one regional markets – South East England and Eastern Germany for example

Note: A full list of markets is at the end of this report.

Investment has mainly focused on Tier 1 cities and Tier 3 regions, while Tier 2 cities received less interest from investors.

SHARE OF HIGH-YIELD INVESTMENT VOLUMES OVER THE LAST 15 YEARS:

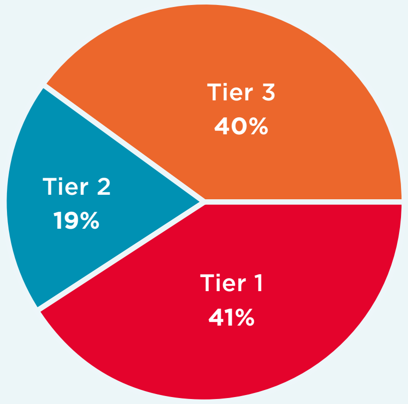
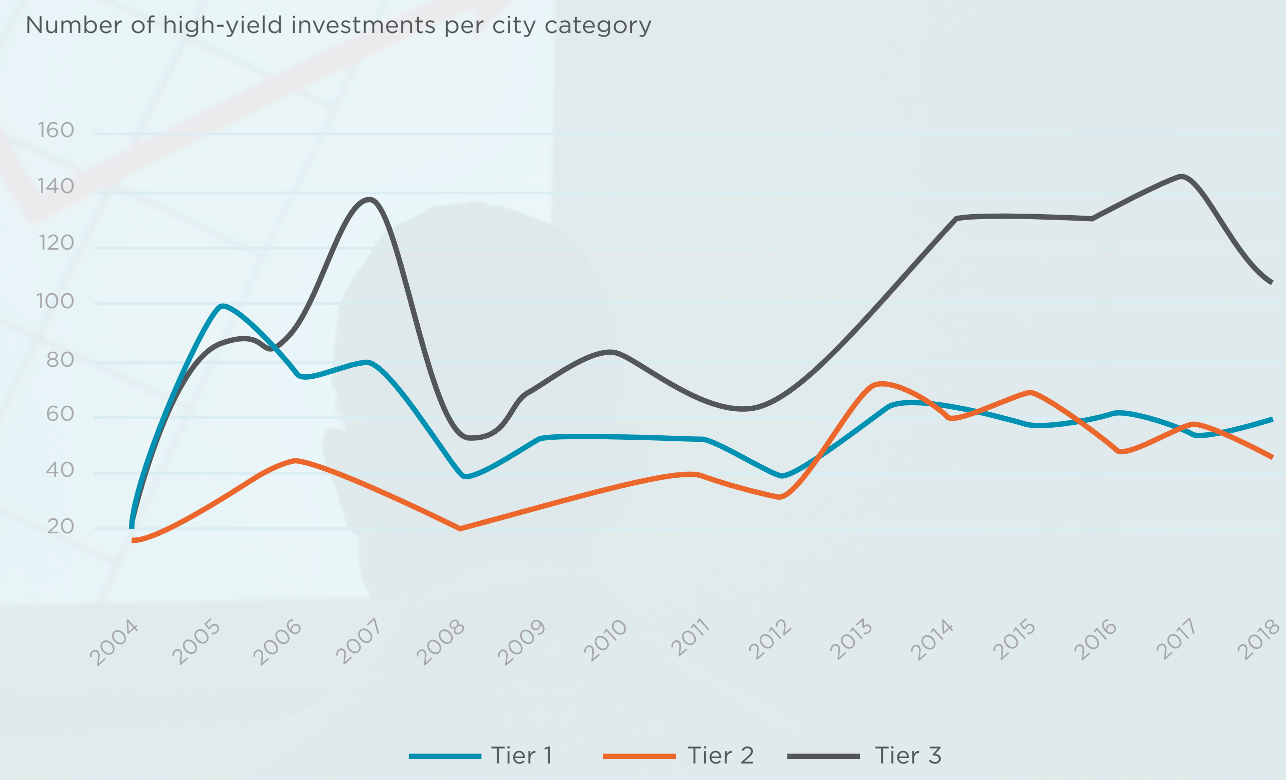


Figure 2 shows investors made a distinct move into lower-tier regions in 2013. This change in intention is especially clear when we look at the number of deals, rather than volumes. Over half of all deals were in Tier 3 regions over the following five years.

Investors maintained this momentum until 2018, when activity dropped quite sharply. This could indicate that investors are hesitant because of the higher risk in some popular regional markets, like South East England for example. Another possible cause could be the absence of opportunities in these areas, such as the non-CBD parts of the Rhine-Ruhr region.

FIGURE 2: LOOKING FURTHER AFIELD

High-yield investment market



Source: RCA, Cushman & Wakefield

Instead, we have seen an increase in investment in Glasgow and Cardiff within the UK in recent years, and we expect that interest to continue in 2020. Outside the UK, we expect Northern Germany and, to the east, the Saxon Triangle to remain popular.

WHAT YOU NEED TO KNOW IN 2020

- It will be difficult to find a balance between what investors want and what is likely to be on the market in 2020.
- The UK will remain the largest source of high-yield deals, but its share of investment will fall as some investors wait to see what opportunities will surface after an uncertain 2019.
- Retail has represented around a quarter of high-yield investment, but this share is likely to rise in 2020. As retail continues to evolve in response to e-commerce, some retail assets may fall out of favour with shoppers. As such, these retail assets might need to be repositioned, repurposed or perhaps redeveloped entirely.
- Overall, high-yield investment volumes will be lower in 2020 than in previous years. Private equity is likely to be the main source of capital for the first time on record. Value-add and opportunistic funds will stay active, but we do not expect any REITs or other institutional investors to step up activity.
- Investors have a tough decision to make at this point in the cycle: should they compete for regional office assets across continental Europe or take on the riskier UK retail assets as they come to market?
- Fund raising for high-yielding assets will have plenty of momentum in Europe's capital markets. But if investors shy away from the UK, then we expect to see another wave of yield compression in Tier-2 and Tier-3 markets in continental Europe. Conversely, if investors stick with the UK, they could create a ceiling to rising UK retail yields. Either way, the industry's risk takers will have an important role in how 2020 plays out.

APPENDIX

CITY TIERING

TIER 1	TIER 2	OTHER
Amsterdam/Randstad	Aberdeen	Birmingham - Midlands Other
Barcelona	Belfast	East Midland - Other
Berlin-Bradenburg	Bremen	East of England - Other
Birmingham	Bristol	Eastern Germany - Other
Edinburgh	Cardiff	France - Other
Frankfurt/Rhine-Main	Eindhoven	Italy - Other
Hamburg	Glasgow	Manchester - NW - Other
London Metro	Hanover	The Netherland - Other
Lyon	Leeds	North Germany - Other
Madrid	Lille	Northeast - Other
Manchester Metro	Liverpool	Northeast Ireland - Other
Milan	Marseille	Rhine-Rurh
Munich	Milton Keynes	Saxon Triangle
Paris	Newcastle	Scotland - Other
Rome	Nice	Southeast - Other
Stuttgart	Northampton	Southeast - Other
	Nottingham	Southwest - Other
	Nuremberg	Spain - Other
	Reading	Wales - Other
	Sheffield	Western Germany - Other
	Southampton	Yorkshire - NE Other

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Outlook 2020 was researched and written by the Cushman & Wakefield Research & Insight team members from across EMEA.

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