Real Estate Outlook

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Caution required.

UBS

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European outlook

Nearly out of the woods?

The European economy ends 2020 fairly battered and bruised as the second wave of the COVID-19 pandemic hit hard, both in terms of infections and the wider economy. Offices are showing some weakness on the occupier side, while retail continues to struggle. Logistics has been going from strength to strength, however, as have alternative sectors such as residential. Overall, capital markets remain buoyant as there is significant dry powder targeting real assets.

Real estate fundamentals

Uncertainty remains high.

Economy

The eurozone endured an especially torrid 2020, with an outbreak in 4Q necessitating the reimposition of quarantine measures across the bloc. This derailed the mechanical bounce back from 3Q, meaning GDP shrank by 0.7% in the fourth quarter, with an expectation that the first quarter of 2021 will see further falls. Overall, European countries are faring worse than other locations in terms of restrictions, especially Asia which appears to have largely contained the virus.

The recovery in 2021 is likely to be more muted than initially projected due to issues with vaccine distribution. The only exception to this is the UK, which at the time of writing has dispensed over 9 million doses of the vaccine. This briefly caused a spat between the newly separated UK and its former spouse the EU, which was quickly resolved. As a result, we are expecting a GDP recovery of around 4.6% this year, which will mean the economy is still smaller at end-21 than it was at end-19.

The silver lining at this stage is that governments, companies and consumers appear to have adapted somewhat to the challenging conditions as GDP is not falling by anything like the double-digit figures seen in the first lockdown. Manufacturing PMIs were reasonably robust in January and indeed industrial production has been far more robust this time round.

There has actually been signs of a capacity shortage in global shipping as companies which sold off old container stock were hit by a surge of demand in the run-up to Christmas, causing prices to increase significantly. Indeed, retail sales were only around 1% down for the year, as consumers found ways to rotate spending away from areas such as hospitality and travel into things like DIY and groceries.

However, the economic damage of the various lockdowns is starting to become apparent with unemployment ticking up in the official figures, and surging in various other alternative measures such as hours worked. This suggests that the actual level of inactivity may be greater than the headline figures suggest, which are nonetheless expected to exceed 10% this year according to Oxford Economics.

Offices

In terms of real estate occupier markets, offices have understandably taken a hit in leasing demand. Anecdotal evidence suggests letting markets had been quiet for most of the fourth quarter, as renewed lockdown measures forced companies to be more cautious about taking on new leases. There has also been a significant amount of lease breaks exercised in the City and West End of London, as occupiers have taken the opportunity to re-evaluate their office needs. In terms of rental performance, growth for the year was still fractionally positive at 0.2%.

However, the only growth was recorded in the first half of the year, with 3Q and 4Q seeing rental declines, though it is a fairly mixed picture across Europe. Central London has seen a YoY decline of around -8% as home working has been especially widespread in the UK capital, whilst values saw growth of around 6% over the course of 2020, possibly receiving a boost from pan-European occupiers selecting a new HQ after Brexit. The major German markets were broadly flat with only previous fast-growers, Berlin and Hamburg, seeing rental declines.

Elsewhere, Milan and Rome saw rents unchanged while Barcelona and Madrid both saw declines of around -1% YoY. We would expect rents to stay largely flat over the next couple of years, due to the impact of the pandemic on work/life habits. We anticipate there will still be a place for the office, but major occupiers will most likely require fewer and better-quality spaces, which will lead to a polarization in performance between prime and secondary.

Retail

Retail continues to suffer in the wake of ongoing structural changes and the impact of the pandemic on trading operations. Up to this point the retail apocalypse has been regarded as a predominantly Anglo-Saxon phenomenon, with the biggest impacts seen in the UK and the US. There are now signs that the continent is catching up, with pan-European prime rents down by around 8% YoY. Another former narrative has been that prime will most likely outperform secondary. This appears to no longer to be the case, with multiple prime schemes in Europe seeing asking rents fall away.

According to CBRE, the UK continued to bear the brunt of falls with most major centers seeing declines of between 20-30% YoY. What was different this quarter, is that London also took its share of the pain, with the ballast of high tourist flow taken away. Rents in the City and West End both fell by 24% YoY. Other European cities were not exempt, however, as prime high street rents in the major German markets fell by 15-20% YoY, Paris by 15% and Madrid and Barcelona by 13% and 17% respectively. The only major centers to hold firm were Milan and Rome, where rents remained stable.

Shopping centers were similarly impacted with rental declines of between 10-20% YoY in the major French cities, ~20% in Germany and 25-30% in the UK and Spain. The Netherlands saw slightly more moderate falls of 5-10%, while Italy once more managed to hold the line, with prime rents stable in Milan and Rome.

We would expect rental declines to continue into 2021, especially in mainland Europe which has further to go than the UK. The one silver lining of the pandemic is that it will most likely force retail landlords to confront their problems head on and focus on repositioning and repurposing assets so that they are better suited to the new normal.

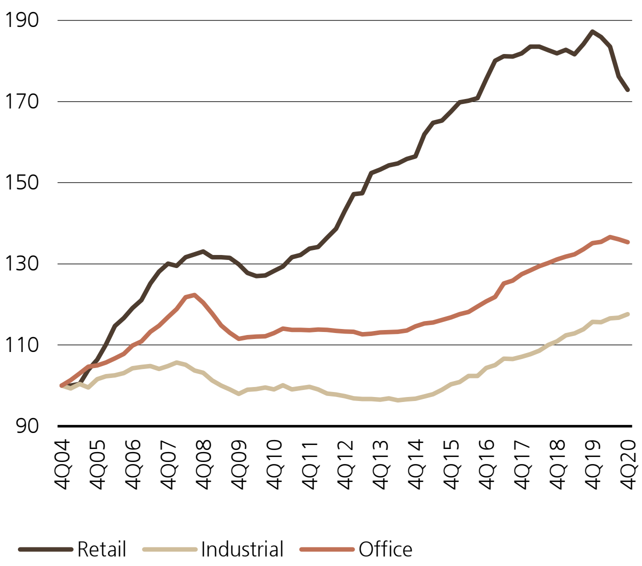
Industrial

Industrial and logistics has very much received a second wind in the wake of the COVID-19 pandemic, as e-commerce occupiers have been stretching to deal with a surge in demand from homebound shoppers and manufacturers keen to de-risk their supply chains by keeping more inventory closer to their home markets. As a result, rent shave continued to grow at a brisk, if unspectacular, pace of 1.6% YoY (see Figure 1). The UK has seen particularly strong growth with rents increasing by around 4.8% in the South East and 4.3% in the North West. Germany also saw relatively strong performance with Dusseldorf achieving growth of 5.2%, while Paris (4.5%) and Marseille (6.4%) in France also enjoyed a good year.

In terms of supply, European markets are still seeing relatively low levels of vacancy, particularly in and around urban areas where rental has been especially strong. The exception to this is Polish centers, where logistics stock has grown very rapidly in the past two years and Madrid which has also seen high levels of building construction.

Going forward, we would expect industrial and logistics to still be a strong performer with the supply and demand imbalance in the market likely to drive further expansion in rental values.

Figure 1: Eurozone rental index (4Q04 =100)



Source: CBRE, 4Q20

Capital markets

Still healthy activity despite fundamentals.

While investment volumes have understandably taken a hit in the wake of the COVID-19 pandemic, the impact has been less pronounced than in the occupier markets especially for well-located, good-quality assets. European investment volumes were down by around 27% when compared with the previous year (see Figure 2), however, December showed a year-end boost to deal flow. Single asset and portfolio deals were down considerably when compared with the previous year, however, the 10% upturn in entity level deals demonstrates the resilience in the industrial sector, as investors became frustrated with the lack of individual buying opportunities in the most prized sector.

As a result, it's hardly surprising that industrial fared the best, with volumes showing a very moderate 6% decline on the previous year. The other favored sector – apartments saw just a 15% decrease – while development sites were also fairly resilient at -8%. At the other end of the spectrum, offices saw volumes tail off by around 35% as the largest asset class became mired in uncertainty over the future direction of homeworking.

At the same time, hotels saw volumes collapse by 65% as lockdowns posed an almost existential threat to some operators. Retail surprisingly only saw volumes decline by around 21%, but that must be taken in the context of precipitous declines in recent years meaning retail is now the smallest of the three main commercial sectors in terms of trading volumes.

Ironically, the fall in volume has yet to really impact pricing. While the effects of the pandemic have actually injected more liquidity into financial markets due to central banks keeping rates at near-0 levels, governments are planning fiscal stimulus and increased savings have given rise to a new army of retail stock investors. The GameStop saga in which an organized band of Reddit users successfully instigated a short squeeze on an established US hedge fund demonstrates the power of this trend.

However, it is unclear if this will become a permanent feature as with retail investors' loss aversion tends to be high and patience low. Nonetheless, this demonstrates the potential of new low-cost trading apps, disposable income and internet organization.

As a result, yield movements have been relatively minimal with most European office markets still seeing prime yields compress over the year, despite the likelihood of rental declines over the next few years. Prime office yields ended the year at 3.45%, largely consistent with where they were at end-2019. Most remarkably, yields actually compressed in 3Q and 4Q, having edged out in the first half of the year despite the ongoing concerns about the pandemic and home working.

There have been a number of high-profile transactions for core, long leased assets in major cities. The sale of the Finance tower in Brussels was the largest deal of the year at EUR 1.2 billion, while several large office towers exchanged in Frankfurt and Paris, including an acquisition of a largely vacant scheme by Allianz.

Retail investment remains highly restricted with liquidity disappearing from the market for all but the best in class assets. However, the decline was less pronounced than for other sectors, as the year saw several disposals by high profile shopping center Intu properties, including Intu Puerto Venecia in Zaragoza, Spain for EUR 475 million. Nonetheless, prime yields moved out by around 50bps on average, with non-core markets and secondary assets thought to have suffered more.

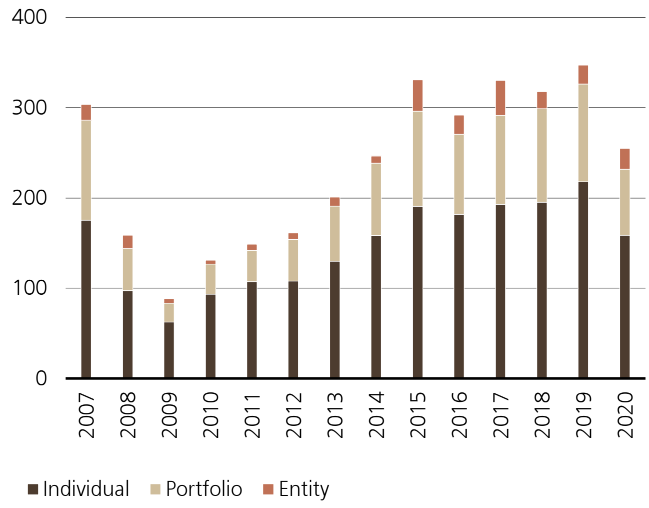
By way of example, the biggest outward movers were the UK regional cities, as Glasgow, Birmingham, Leeds and Liverpool all saw yields expand by 125bps. Prime London, conversely, saw yields expand by just 50bps, and this was from an exceptionally low level of 2.25%.

Industrial and logistics saw very resilient volumes, and considering sentiment in the market, it is likely the -8% decline on 2019 was more due to a scarcity of product than a fall in momentum. Indeed, yields compressed by 30bps on a pan-European basis, with much sharper declines for assets located close to major cities and key distribution areas. An urban logistics opportunity in London, for instance, traded for an initial yield of 2.9%.

The key indicator of demand surpassing supply was the high volume of entity level and portfolio deals in 2020, which were largely focused on the industrial sector. Goodman's acquisition by GLP and GIC's purchase of a JV created by Palmira and Apollo are a couple of examples of this trend as investors tried to efficiently scale their exposure to the industrial sector.

The alternative sectors remained popular, with apartment volumes only marginally down (-15%), although students and hotels have been hit by lockdowns across Europe. We would expect momentum to increase in these sectors as question marks remain over the viability of retail and office properties and industrial becomes increasingly keenly priced.

Figure 2: European investment volumes (EUR billion)



Source: RCA, 4Q20

Strategy viewpoint

A sleeping giant? The UK Build-to-Rent sector.

Despite being the largest commercial real estate investment market in Europe, until very recently the UK did not have an established institutional build to rent (BTR) sector. This is starting to change – in 2020 investment volumes in the sector reached a record high at GBP 10 billion, accounting for 10% of total volumes. But even at this record level it remains well behind established BTR markets such as the US and Germany, where it accounted for 33% and 27% respectively.

This relative immaturity is a key attraction of entering the UK market now. Development to date has been focused in London, and although there are a few schemes emerging in the main regional markets the proportion of genuine purpose-built rental space across much of the UK is very small compared to the non-institutional market. The UK is a fundamentally undersupplied residential market – the government has a target of building 300,000 new homes per year yet since the Global Financial Crisis (GFC) completion levels have rarely exceeded 200,000 homes per year.

The demand side is also strong. Although the UK has a strong culture of home ownership, there are signs that renting for longer periods is becoming more acceptable and, in some cases, preferable. Part of the issue has been a very negative conception of the rental market, which has been dominated by small scale *Mom and Pop* investors.

But with institutional schemes following in the models of the US and other parts of Europe the benefits, particularly to young professionals renting in high quality, fully managed accommodation with a strong range of amenities on site are starting to be appreciated. Renters may still aspire to home ownership, but with the average age of a first-time buyer now standing at 35 in London and 32 in the rest of the UK, there are many years of accommodation which still need to be provided.

And for some, the ease of having rental accommodation rather than some of the restrictions and challenges which come with home ownership, may support further demand for rental space beyond the point they could afford to step onto the housing ladder.

Part of the challenge for investors has been accessing the sector. There are relatively few stabilized schemes in the UK, and as most of these have been developed in the past few years, they are not available to trade. And when stabilized schemes do start to come to the market, they are going to be very expensive. To build diversified exposure to the UK market, a development partner with pan-UK coverage is essential. Without a skilled partner in place with local expertise in the key markets, navigating the UK's convoluted planning system and delivering the right quality of product could prove challenging.

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