

BARINGS

Can Residential Fill the Retail Investment Gap?

European Real Estate Research Quarterly



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Executive Summary

ECONOMY

- In the wake of the COVID-19 pandemic, we expect Europe's economic recovery to be varied, primarily reflecting the vaccination pace but also economic exposures. For example, those countries with a reliance on tourism remain vulnerable to on-going travel restrictions, while the more manufacturing orientated, especially with a high level of digital readiness, are likely to rebound sooner.
- Highly accommodative monetary policy and fiscal stimulus will help to sustain the recovery, with additional support from the European Recovery Fund for those countries hit hardest by the pandemic.

PROPERTY MARKETS

- The pandemic has benefited the industrial sector through a lockdown initiated e-commerce boost, and the residential sector through large scale economic support programs. These sectors were already in a strong structural position pre-COVID.
- Uncertainty exists in the office sector, but we are now seeing corporates backtrack from plans to slash footprints, even before workers return to the office. For retail, extended lockdowns/restrictions have intensified pre-COVID structural challenges.
- Property investors and their lenders are shifting down the risk curve and becoming highly selective about property sector exposures and asset quality. It will likely be these trends that will drive sector-pricing prospects through 2021 and beyond.

Economic Outlook

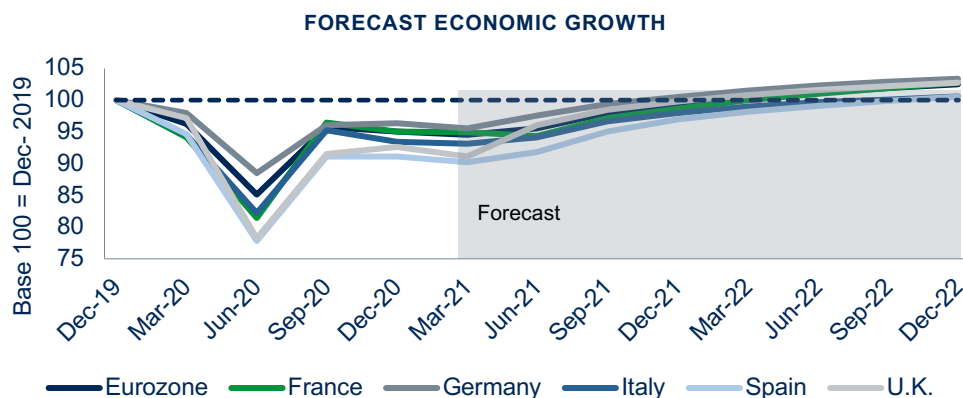
Rising COVID cases continued into 2021, which has necessitated the re-introduction of restrictions (and lockdowns); this is expected to weigh on near-term growth. A double-dip recession is now likely for the Eurozone economy, with the expectation that growth will have been negative in Q1 2021 (-0.5% (f)). Even with the sluggish start to the EU vaccine rollout program, Oxford Economics is forecasting accelerated growth from Q2, with annual 2021 growth projected at 4.1% pa, and the economy returning to its pre-pandemic size by the end of 2022.

The speed of recovery will likely vary across Europe and will be largely determined by:

1. Vaccination pace and ability to remove social distancing measures;
2. Relative economic structures (e.g. local tourism versus manufacturing exposures);
3. Any disproportionate exposure to smaller businesses struggling to access bank debt;
4. Digital readiness, with places able to readily accommodate high levels of working-from-home and e-commerce most likely to rebound first.

This should support a recovery back toward normal economic activity, initially in the core manufacturing orientated countries—Nordics, Germany and the Netherlands. The U.K. is also expected to rebound early, despite ongoing headwinds of Brexit, due to its rapid vaccination program and high degree of digitalization.

Unemployment continues to rise, with the rate now at 8.3% (versus 7.4% in Q4 2019); this is not commensurate with the scale of pandemic economic contractions, thanks to local job support schemes that remain largely in place. Oxford Economics expect unemployment to peak in mid-2021 at around 9%, which is not much higher from where it stands today. However, these projections are subject to abnormally large policy risks, should national governments withdraw support before the recovery has built a solid footing.



Source: Oxford Economics. As of April 2021.

Economic Outlook

In addition to elevated policy risks, another vital component helping to generate a self-sustaining recovery is the unwinding of 'pandemic wealth', with Moody's estimating that this could be as high as 6% of GDP globally. These elevated savings could potentially be converted into retail and investment spend, as economies start unlocking restrictions as vaccinated numbers rise.

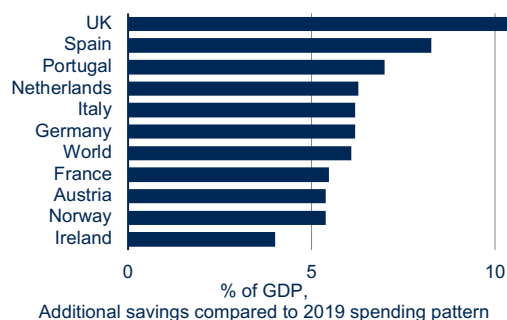
Over the mid-term, inflation is expected to remain below the European Central Bank's (ECB) 2% target, providing headroom for ECB policy to remain ultra-accommodative for the foreseeable future. Bond purchasing programs are extended to at least March 2022, which should support the recovery. Oxford Economics expects that 2021 will end with GDP growth of 4.1%, followed by 4.8% in 2022. Risks remain to the downside with new strains and vaccine hesitancy clouding the outlook.

GDP COUNTRY FORECASTS (% PA)

	2019	2020	2021	2022	2023	2024	2020-24
Eurozone	1.3%	-6.8%	4.1%	4.8%	2.1%	1.3%	1.1%
France	1.5%	-8.2%	4.9%	5.3%	2.6%	1.7%	1.2%
Germany	0.6%	-5.3%	3.8%	4.3%	1.5%	0.9%	1.0%
Italy	0.3%	-8.9%	4.5%	4.6%	1.7%	0.6%	0.5%
Spain	2.0%	-10.8%	5.5%	6.3%	2.7%	2.1%	1.1%
UK	1.4%	-9.9%	7.2%	5.7%	1.9%	1.4%	1.3%

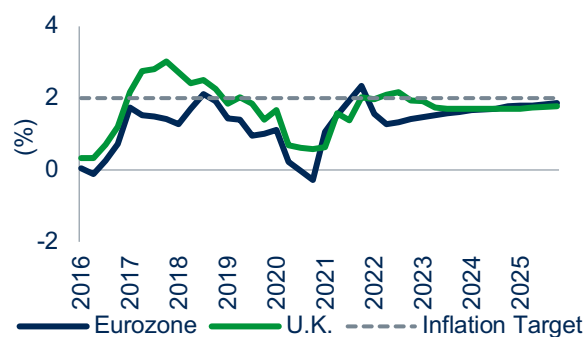
Source: Oxford Economics. As of April 2021.

HOUSEHOLD SAVINGS RATE



Sources: Financial Times, Moody's. As of April 2021.

INFLATION OUTLOOK



Source: Oxford Economics. As of April 2021.

Capital Markets

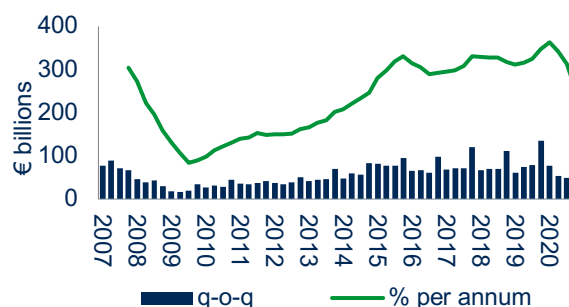
Real Capital Analytics (RCA) reports European investment volumes totalled €254 billion in 2020, down -27% on the previous year. Q4 2020 activity improved (but remains soft), with €76 billion transacted—a -44% decrease from a year ago. Plummeting pandemic-induced interest rate expectations mean property is still attracting plenty of capital for better quality asset sectors. Preliminary RCA figures indicate that Q1 2021 could be down around -35% from the same quarter last year, which is unsurprising given a resurgent virus and slow vaccination program.

The pandemic has solidified a number of existing real estate capital market trends. For instance, while the pivot to residential and industrial assets has been present for some time, in 2020 investor interest increased markedly, with the combined segments accounting for a record 37% of total European transactions—exceeding office investment for the first time. Retail (with the exception of the grocery sector) is off-limits to many investors, with little demand from buyers and little incentive for asset-holders to test the market.

Against the backdrop of a soft economic climate, core real estate pricing relativities reflect both fiscal responses that have shielded sectors to various degrees and longer-term structural sector outlooks. Retail's e-commerce structural difficulties have been exacerbated and yields have unwound, while pandemic resilient supermarkets have bucked this trend because of their essential nature and online resiliency. The flipside of this dynamic is tightening yields on logistics assets, underpinned by accelerating occupier and investor demand. Of the main sectors, office yields have mainly held steady, partly reflecting uncertainty around future use of office space and working-from-home—but we anticipate a polarization within this sector.

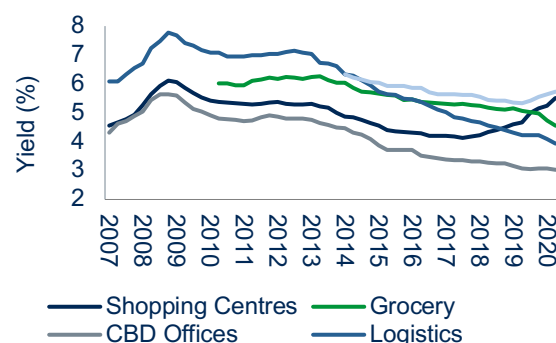
The widening in prospective returns across property sectors was clearly evident in the 2020 MSCI European Annual Index returns. The All-Property capital growth series was negative at -0.8%. There was capital appreciation in the industrial (5.7%) and residential (3.1%) sectors. Capital growth for office assets was broadly stable (0.4%), while the retail sector recorded a hefty fall (-9.3%).

EUROPEAN CRE INVESTMENT VOLUMES



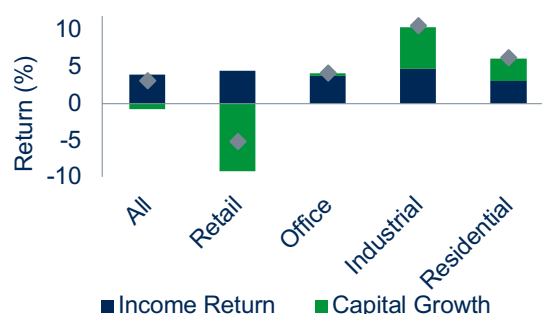
Source: RCA. As of February 2021.

EUROPEAN CRE: PRIME YIELDS



Source: CBRE. As of March 2021.

MSCI EUROPEAN ANNUAL PROPERTY INDEX



Source: MSCI. As of April 2021.

Occupier Market

OFFICE SECTOR

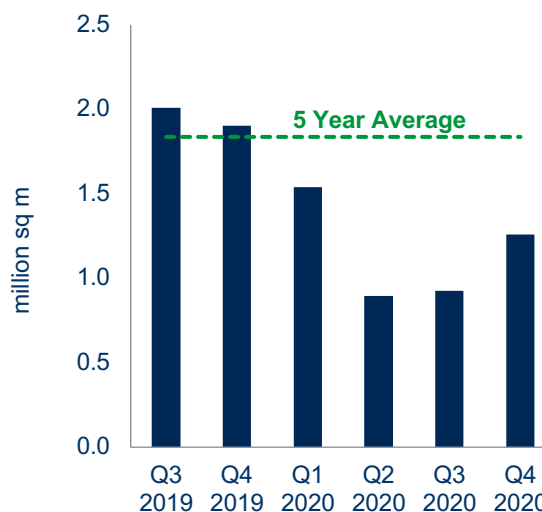
Restrictions and lockdowns have weighed heavily on office demand through the pandemic. Lettings activity did begin to pick up at the end of last year, with Q4 2020 take-up increasing by 36% from the previous quarter (albeit from a low base). However, activity remains about 34% down on the five-year average. This has been a remarkably uniform picture across the major European cities, but given the variation in timings of national macro recoveries, this may now begin to change. We thus expect northern European office markets to significantly outpace their southern peers in the near term.

Lower demand for office space has placed upward pressure on vacancy rates, which have increased by 1.1 percentage points to 6.5% over the last 12 months. This is perhaps a surprise given that actual physical occupancy has run at a mere fraction of that.

Upon the return to the office, we expect occupiers to downsize, but have noted a shift in corporate tone of late. For example, a KPMG survey of 500 CEOs of the world's most influential companies this March, suggests that "only 17% of global executives are looking to downsize their office space as a result of the pandemic." That compares with 69% in August 2020. Nonetheless, an occupier 'flight to quality' still looks likely, driven by health and safety, a productivity drive and also the corporate ESG/green agenda. Only ultra modern fully flexible space can deliver all three.

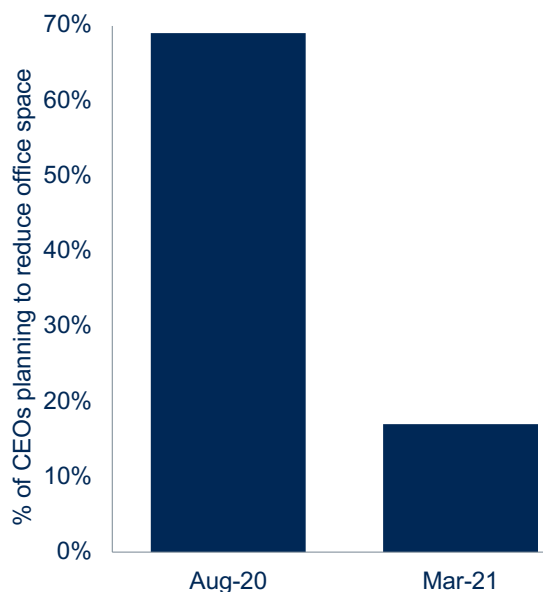
With bank lending largely focused on the wider corporate sector recovery, the current dearth of bank development finance—which is partly driven by regulations e.g. Basel III—will deteriorate. That suggests that the already acute low supply of modern office accommodation, in most European cities, is likely to become chronic. While the near term is likely to remain soft in recovery, the case for strong performance of European grade A office rents over the mid- to longer-term is therefore already building.

EUROPEAN OFFICE TAKE-UP



Source: Cushman & Wakefield. As of April 21, 2021.

CEO INTENTIONS TO REDUCE OFFICE FOOTPRINT



Source: KPMG CEO Outlook Pulse Survey. As of March 23, 2021.

Occupier Market

RETAIL SECTOR

The continuation of restrictions and lingering lockdowns into 2021 add to existing structural challenges for physical retail stores. As the severity of the health crisis passes, stores can begin trading as normal, and footfall should return and normalize over the next year or so.

Despite the immediate challenges for retail, consumer confidence has clawed back some ground. In March, household sentiment reached its highest level since February 2020, although it still remains subpar. This partial recovery speaks to the huge fiscal policy response, which has insulated consumers from the full negative impacts of sharp economic contractions, on scale which is 'unprecedented in modern times'.

The ramping up of restrictions have curtailed the ability for consumers to spend, and unsurprisingly sales have continued to soften into 2021, with January retail sales down -6.3% year-on-year. The temporary closure of non-essential retail stores will further exacerbate the cash-flow pressures that retailers were already facing, making rental collection extremely challenging for property owners.

One outlier for retail is supermarkets, which have been a pandemic beneficiary; their essential status meant they could remain open throughout lockdowns. Restrictions on other retail and leisure activities have also encouraged more supermarket turnover. Structurally, grocery is also more resilient to e-commerce, given high delivery costs (goods are often bulky and require refrigeration) and the ultra-competitive high turnover/low margin business model adopted by food retailers. In fact, despite a boom in online grocery delivery in 2020, operator margins have been hammered—a dichotomy that even the most heavily automated and technologically minded market participants are yet to solve.

The restrictions on physical retail should ease as the health threat recedes, thus reducing the compulsion to shop online. One positive dynamic is the high level of savings that consumers have built over the pandemic, which should continue to drive spending in physical stores.

EUROPEAN RETAIL SALES VS CONSUMER CONFIDENCE



Source: Eurostat. As of April 2021.

Occupier Market

INDUSTRIAL SECTOR

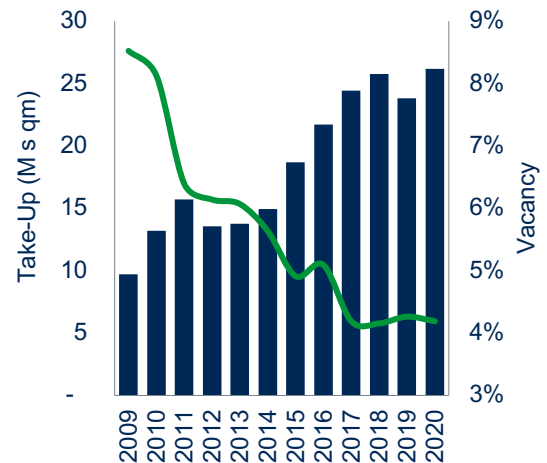
Despite the magnitude of recent economic contractions, overall market fundamentals for the industrial sector remain favorable. COVID-related measures restricted (or prohibited) the ability for physical stores to trade as normal, thus consumers were pushed into online channels—perhaps for the first time for many older cohorts. This has been immensely positive for logistics demand, which was already undergoing an e-commerce initiated structural boost over several years.

Unprecedented economic contractions were not enough to curtail lettings in 2020, with CBRE reporting that take-up reached a new record, totalling over 26 million sq m. Although strong demand and rising rents have sparked some development response, European vacancy remains tight.

Germany and Italy saw strong lettings activity last year, but the U.K. was the standout with almost 4 million sq m of satisfied demand in 2020, dwarfing the previous 10-year average (2.3 million sq m). Brexit trade frictions lengthening supply chains were probably at play here, in addition to e-commerce.

In 2020, annual rental growth remained positive, with industrial rents rising 2.6%, as structural factors obliterated any negative economic cyclical pressures. Longer term, the sector looks set to remain a pandemic beneficiary, with the prospect of increasing global trade frictions, supply chain fragility concerns, and perhaps even some re-shoring of production back from the East to the West, which could underpin future demand.

EUROPEAN LOGISTICS SUPPLY & DEMAND



Source: CBRE. As of February 2020.

Occupier Market

RESIDENTIAL SECTOR

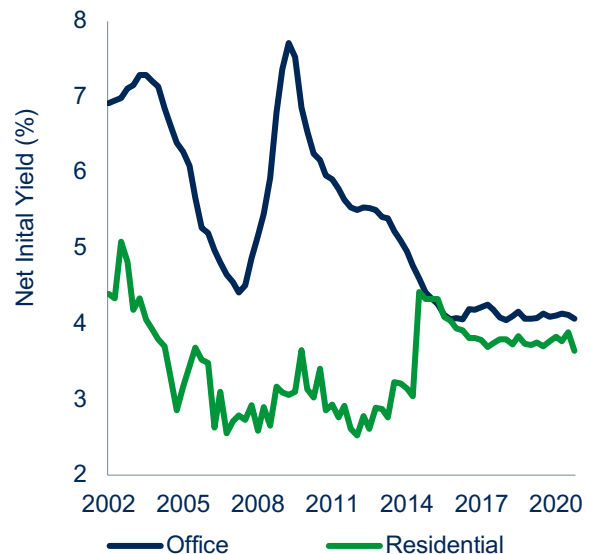
Given the scale of the recessions in Europe, housing would ordinarily be expected to be hit hard, however this has not been the case, with house prices continuing to rise. A key difference with this particular downturn is the amount of fiscal support policy makers have provided households and the housing market—including job retention schemes, mortgage holidays and targeted property transfer tax cuts.

The residential sector was already the beneficiary of a number of positive long-term structural factors, including supply shortages, along with perennially low interest rates. In 2020, the OECD House Price Index for the Euro Area increased by 5.4%, more than double the 10-year average (2.0%). Growth was particularly strong in Sweden (10.1%), Germany (8.1%) and the U.K. (6.8%).

With much of the retail sector “off the menu” for diversified investors, the pre-pandemic property investment universe has shrunk. In countries where residential was less established as an institutionally acceptable asset class, investors have turned to residential assets to help fill the gap in their property allocations. The move toward convergence between core commercial and residential yields means residential is becoming a viable alternative to retail.

The outlook for the sector remains favorable, with the caveat that the fiscal response—which has significantly supported the housing market—remains vulnerable to policy error. In this instance, the feedback loop into the housing market would be an unexpected spike in unemployment. Winding up job support programs too early, or pursuing austerity measures at a time that stifles the recovery, could create challenges for the sector. This risk may however be partially offset by the amount of savings that consumers have accumulated, which could be converted into further demand for housing.

U.K. OFFICE VS RESIDENTIAL YIELDS



Sources: MSCI. As of April 2021.

About the Team

Barings Real Estate's research team is structured by sector and geographic expertise, with efforts led by Philip Conner in the U.S. and Paul Stewart in Europe. The team has a diverse background covering various industries, asset classes and countries, which is complemented by an analytics function enhancing the team's ability to collect, augment and analyze data to inform better decision making.



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