

Real Estate Outlook

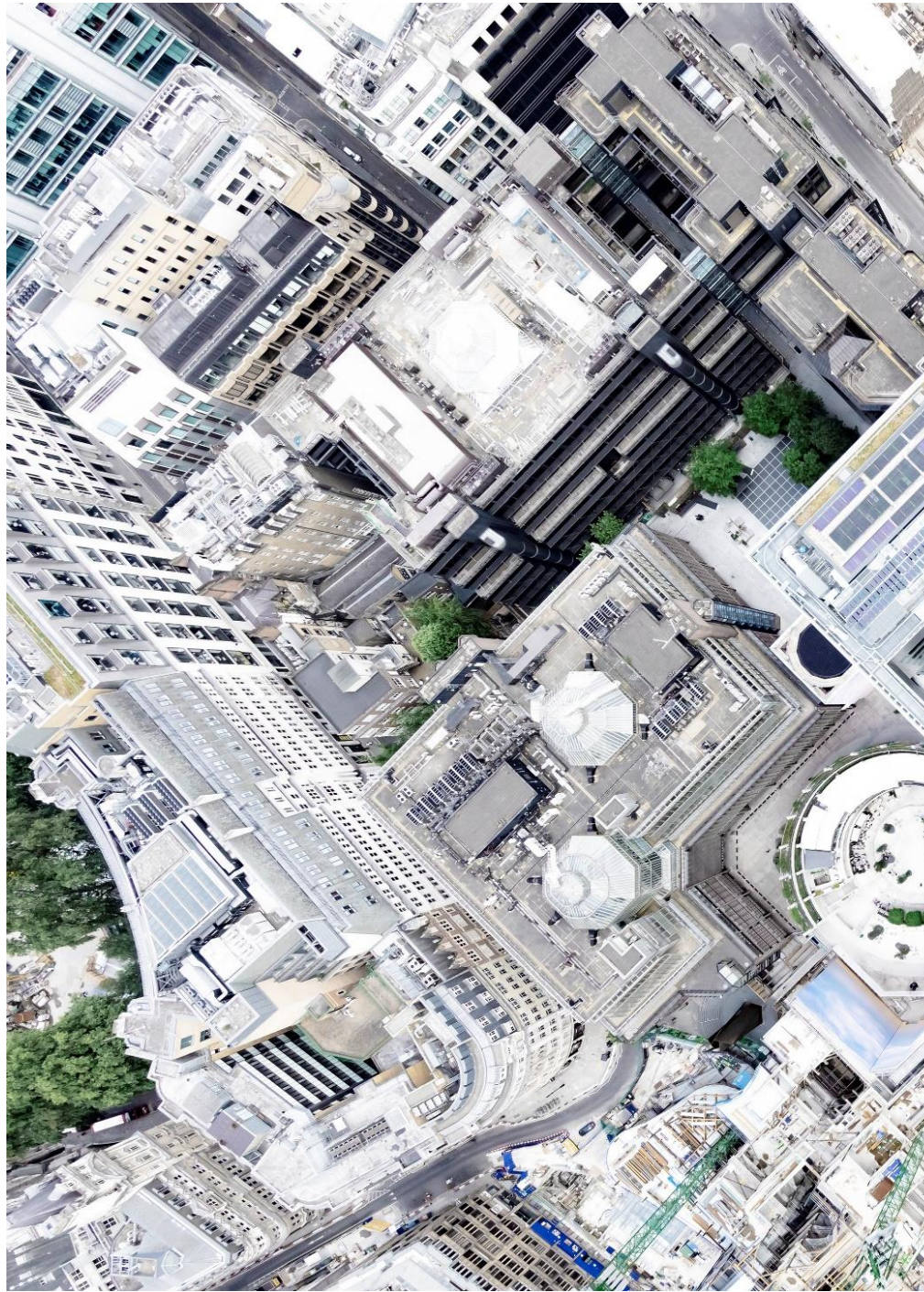
Europe – Edition 2, 2021



Sentiment begins to warm.



Zachary Gauge
European Research Analyst



European outlook

Opportunities for contrarian investors.



After a tough start to the year, there are some causes for optimism for the European economy and real estate markets. The vaccine rollout is finally gathering steam, giving hope that some degree of normalization can be achieved in the second half of the year. Capital markets remain healthy, although in-demand sectors and assets are seeing heavy price inflation. Sourcing value will be a key challenge for the rest of 2021.

Real estate fundamentals

Varied performance driven by virus progress.

Economy

The anticipated rate of economic recovery in 2021 is highly correlated with the pace of the easing of lockdowns, which is itself essentially driven by the relative speed of vaccination roll-outs. In this regard, we have seen a complete two speed outlook emerge between the UK and Continental Europe. Based on data from Our World in Data as at the 8 May, the UK has vaccinated 52.1% of its total population with at least one dose, compared to 27.8% in the EU. Whilst the UK economy is starting to open up, many European countries are still facing some degree of lockdown measures to combat the third wave of the virus which has emerged since the winter.

This has had a significant impact on the short-term economic outlook for the two areas. The UK has seen significant upgrades to its short-term outlook, with Oxford Economics now forecasting GDP growth to come in at 7.2% in 2021 and 5.7% in 2022. The EU by contrast won't see the bulk of its' recovery coming through until 2022, with GDP growth anticipated to hit 4.7% after 4.0% in 2021.

However, there are some causes for optimism across Europe. Anecdotal evidence from the UK and other countries which have started to ease economic restrictions, strongly suggests that consumers are eager to go out and spend on both leisure and retail. This gives weight to the argument that there will be a strong consumer led bounceback in economic growth when the pent-up forced savings from lockdowns are released.

Unemployment has also remained much lower than originally feared, supported by the extensive government support schemes. Unemployment rates in both the UK and EU are forecast to peak in 2H21, at 5.7% and 7.7% respectively, before easing back in 2022. And after a slow start, European countries have picked up the pace of vaccinations, with Germany and France hitting a daily vaccination rate of 0.81% and 0.64% of their population respectively (based on data from 7th May).

There are still significant downside risks, largely associated with the virus itself. The emergence of a new strain which demonstrates immunity to any of the main vaccines which have been rolled-out could set the recovery back considerably. And although issues around vaccine supply have eased in recent months, the threat of a drop in supply and protectionist policies remains a background threat.

Offices

There was no significant change in direction for European office markets in 1Q21. Aggregate take-up from JLL was around 25% above the trough recorded in 2Q and 3Q20, but remained 40% below pre-pandemic levels for the first quarter. And, also according to JLL, the aggregate vacancy rate continued to move up, although the quarterly pace of increase slowed to 0.21pps from 0.4pps in 4Q20 and 0.33pps in 3Q20. The aggregate vacancy rate for Europe stood at 6.3% in 1Q21, which is comfortably below its long- term trend and significantly lower than other regions.

The very low levels of supply are the main reason that prime office rents have remained stable, despite the collapse in occupier demand. No market reported a decline in prime rents in 1Q21 according to CBRE, whilst Paris CBD, Luxembourg, Leeds and Manchester all recorded small increases. However, as is common during economic downturns, we are hearing anecdotally that incentives are increasing in many markets, which helps support a *stable* headline rent profile.

For secondary offices, the situation is certainly more challenged. Office buildings which only provide functional workspaces, and particularly those in non-central locations which are not easily accessible by public transport, are likely to face increasing obsolescence as occupiers prioritize buildings which add value to the working day experience as we move out of the pandemic. Sustainability credentials are going to become of ever greater importance to both occupiers and investors, and assets with a heavy reliance on cars for accessibility will struggle against stricter criteria.

Retail

Although retail valuations in mainland Europe have finally started to move down, the numbers still appear to have a significant lag. MSCI data suggested that retail rents in France only dropped by 2.3% in 2020, and by just 0.9% in Germany. To put this in context, retail rents in the UK have fallen by 18% since the shift towards e-commerce started to be reflected in the valuation numbers. Unfortunately, it may be some years until realistic rental values are applied to retail assets across Europe, which makes it more challenging for investors to underwrite deals.

CBRE's prime data perhaps give a more accurate reflection of the market. Across the main European high street markets, rents have declined by at least 5% in the past twelve months, and by double digits in many markets. Shopping centers have fared even worse and have the added challenge of requiring significant capex to remain operational and relevant to retailers and consumers against a drop in operational income.

Going forward, we believe there may be very selective opportunities in the UK market this year as valuations for certain assets have reached a point where the entry yield is extremely attractive. However, in Europe valuations remain completely out of sync with market reality, and it may be some time before values bottom out and sensible risk-adjusted opportunities emerge.

Industrial

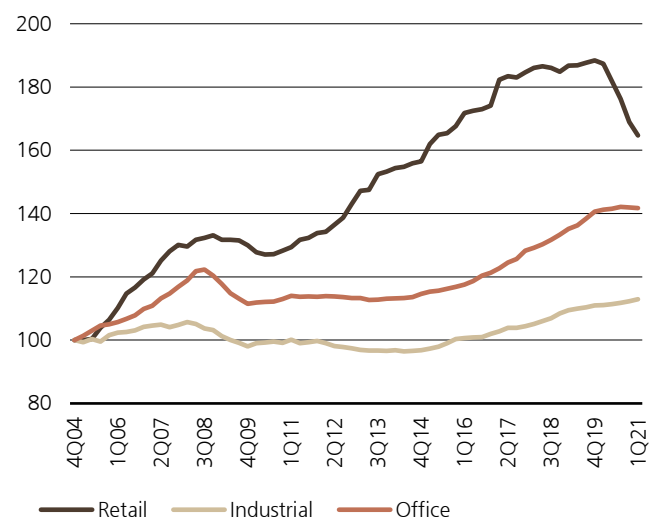
Despite all the furor around the European logistics sector since COVID-19 accelerated the structural shifts towards e-commerce, the prime rent index for the eurozone continues to only gradually edge up (see Figure 1). Based on data from CBRE, prime rents were flat in most markets. However, some significant growth QoQ was recorded; in Brussels (+5.5%), Amsterdam (+4.3%), Tilburg (+4.5%), Yorkshire, UK (+4.2%) and Berlin (+3.3%). More moderate increases of between 1-2% were also recorded in the UK Midlands region, Munich and Hamburg.

Industrial demand is in a strong position and in certain locations is benefitting from increased e-commerce related demand. But there are caveats to this which explain why rental growth has not accelerated in the manner that may have been anticipated. Logistics occupiers operate on notoriously thin margins, and significant increases in rental growth can have a noticeable impact on their bottom-line and place affordability constraints on the market.

The sector is also continuously evolving, with requirements for the type and location of unit changing significantly in a relatively short space of time. The largest operators typically sign for new pre-let units, as opposed to renting existing stock.

Thus, it is land supply rather than existing warehouse supply, that is the key driver of rental growth. With a tendency to pre-let, the supply constraint on rental growth we have seen in other sectors historically is less common with logistics space. Sharper increases in rents are generally found in urban logistics hot spots, where new-build opportunities are scarce and land constraints do create that intense pressure on available space.

Figure 1: Eurozone prime rental indices (4Q04 = 100, to 1Q21)



Source: CBRE, 1Q21

Capital markets

Robust sentiment in capital markets.

Despite the clear challenges in occupational markets, sentiment surrounding commercial real estate capital markets has proven to be very robust during the pandemic. Data from Real Capital Analytics shows that European annual investment volumes declined by 15% in 2020 to around EUR 250 billion (see Figure 2). But taking into account the physical constraints on transacting real estate due to the lockdown restrictions and the limited capacity for overseas travel, a 15% decline can be seen as relatively modest.

With strict lockdown measures implemented again in 1Q21, quarterly volumes fell by -30% YoY. But there are optimistic signs for the second half of 2021 assuming restrictions are eased over the summer. Investor sentiment surveys continue to show positive indications for further exposure to European real estate, largely supported by the ultra-low interest rate environment and the attractive yield spread of property to fixed income holdings.

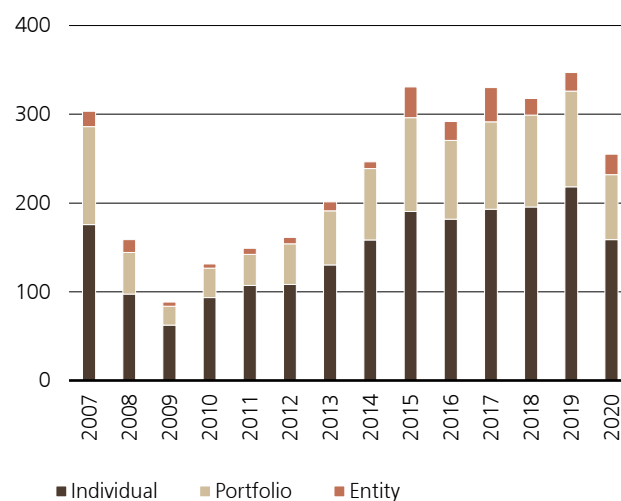
However, there is significant variation in sentiment on a sector, and asset quality basis. Office investment volumes declined by 30% in 2020 YoY. The situation has not improved in 1Q21, when quarterly volumes fell to the lowest level since 2012 and undergoing a 56% decline YoY. Investors are evidently cautious on buying office buildings which are currently largely unoccupied, and the future structural patterns of home working remain uncertain. Having said that, demand for core offices appears to be holding up well, provided that income and lease lengths are robust.

Perhaps surprisingly, the majority of core markets in Europe have actually seen prime office yields compress in the last 12 months, with none of the major markets recording outward movements. The availability of cheap finance at the very core end of the market has certainly helped justify yields which are now extremely low. Outside the core segment, however, pricing appears to be softening although valuations continue to be conservative in factoring in declining values.

Retail transaction volumes actually recorded a smaller decline in YoY activity in 2020, of 15%. But with volumes already in decline, this is largely because activity was coming off a low base, rather than any resilience within the sector. In 1Q21 volumes dropped to just EUR 3.9 billion, equaling the record low level recorded in 2Q09. We expect activity to remain very weak until there is further price discovery and values reach a level that could tempt more opportunistic buyers could back into the market. Valuations in Europe remain way off the mark, but in the UK there are indications that a trough in values have been reached, particularly for the retail warehouse segment. This has resulted in a mini-surge of investment activity from a range of investors, recognizing the attraction of the now very high yields for some relatively strong performing parks.

Unsurprisingly, the much touted *beds and sheds* have seen the strongest relative levels of investment activity. Industrial volumes actually increased in 2020 YoY by 10%, with a further increase in 1Q21 despite the lockdowns. This has driven yields down across the board, particularly given the relatively limited volume of institutional stock in Europe. Core markets in the Netherlands, France and Germany now have yields below 3.5%, with many markets in Europe seeing between 50-100bps of compression in the past 12 months.

Figure 2: European investment volumes (EUR billion)



Source: RCA, 4Q20

Despite a rapid increase in demand for residential assets, the sector reported a decline of 8% in volumes in 2020 YoY. As with the logistics sector, there is a finite amount of available standing stock in the sector and the increase in sentiment towards the sector in various surveys suggests volumes would be much higher if more stabilized schemes were available to trade. That sentiment has followed through into 1Q21, which was actually the strongest first quarter for apartment sales in Europe ever recorded. As would be expected, yields have compressed and are as low as 2.2% for a prime PRS scheme in a market like Munich or Berlin.

Although the drivers behind these sectors are undeniably strong, we are becoming slightly cautious over the herd mentality of investors in Europe. With so many investors chasing a relatively small proportion of the market, inevitably the prices paid are becoming hugely inflated. When there are downturns and market challenges, often the best returns are achieved by thinking in a slightly contrarian manner, rather than simply following the crowd to the most obvious sectors and assets.

Strategy viewpoint

Multifamily strategies based on market maturity.

Real estate investor interest in European multifamily assets has been growing continuously in the last decade. In our view, resilient income-driven performance, supported by strong occupier market fundamentals and long-term socio-demographic trends, will continue to fuel the rise of this asset class in the coming years. In terms of implementation, investment strategies for building direct exposure to the European multifamily sector vary depending on the maturity level of the targeted markets (see Figure 3).

Thanks to their depth, established European multifamily markets typically offer a wide investment spectrum in terms of investable macro-locations. Given the actual investment pressure in prime locations and the potential effects of increasing home and near-office activities, attractive micro-locations in the agglomeration areas and well-connected secondary cities are likely to be preferred over large city locations, both in terms of initial yield level and rental growth prospects. Thanks to the high level of institutionalization of these markets, sizeable direct exposure can be efficiently

achieved through the acquisition of an existing professionally managed portfolio. Single assets should also be considered as these are likely to offer some extra-yield compared to large portfolio deals. Once the initial exposure has been achieved, active asset management strategies can be applied in order to create value within the existing stock in the long run.

The investment approach in frontier markets is set to be somewhat different given that institutional-grade products are likely to be either not available, or so scarce that pricing and availability of quality multifamily assets will probably be inadequate in the existing stock. Also, the geographical scope of frontier multifamily markets tends to be focused on a few gateway cities and locations in close proximity. Therefore, partnering with local residential developers who have access to building plots in these targeted areas and can deliver the expected building quality, is an interesting strategy for core residential investors seeking multifamily exposure in frontier markets.

Figure 3: Level of multifamily market maturity and proposed strategic approach

	Countries	Strategic focus
Established markets 	Austria Denmark Finland Germany Sweden The Netherlands	<ul style="list-style-type: none">– Target robust micro-locations in metropolitan areas (outside of core urban centers) and attractive secondary cities– Build up exposure by acquiring portfolio of established properties and consider selected single asset deals offering an extra yield– Apply active asset management strategies to unlock untapped potential of existing properties in the portfolio
Frontier markets 	Belgium France Ireland Italy Luxembourg Norway Poland Spain United Kingdom	<ul style="list-style-type: none">– Use a geographically focused strategy on a limited number of gateway cities and surrounding municipalities– Partner with established local players to access desired product quality through forward-purchased deals– Selectively reposition existing properties lacking professional management using a manage-to-core approach

Source: UBS Asset Management, Real Estate & Private Markets (REPM), May 2021

Notes: Switzerland is not considered in this analysis due to legal constraints (Lex Koller) on foreign investments in the Swiss multifamily market.

Our research team

Darnesha COLLIER
Matthew DECKER
Kurt EDWARDS
Nicola FRANCESCHINI
Zachary GAUGE
Tiffany GHERLONE
Gunnar HERM
Fergus HICKS
Brice HOFFER
Amy HOLMES
Courtney LEE
Shaowei TOH

For more information, please contact:

UBS Asset Management

Real Estate & Private Markets (REPM)
Research & Strategy

Zachary Gauge
+44-20-7901 5534
zachary.gauge@ubs.com



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