

# Real Estate Outlook

Europe – Edition 3, 2021



What lies beneath the waters?



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# European outlook

Go with the flow, or swim against the tide?



Economic recovery is well underway in Europe, although the Delta variant dampens some of the promise from the first half of the year. Investor sentiment is more resilient than the underlying occupier markets, but is heavily targeted towards the “beds, sheds and meds” sectors. We continue to expect stronger returns away from the most crowded part of the market, or through development targeting markets and sectors with the strongest occupational dynamics.

## Market overview and outlook

# Delta variant muddies the water.

### Economy

Much of the second quarter of 2021 was filled with positive economic news and upgrades to GDP forecasts. Vaccine rollouts accelerated, economies re-opened and a glut of pent-up savings and demand was released. As this demand has coincided with some global supply-chain issues, there has been sharp price inflation for some specific products and commodities. Based on Oxford Economics forecasts, Eurozone CPI inflation will peak at just under 3% this year. However, once the distorting effects of the pandemic subside it is expected to drop back to below 2% from mid-2022.

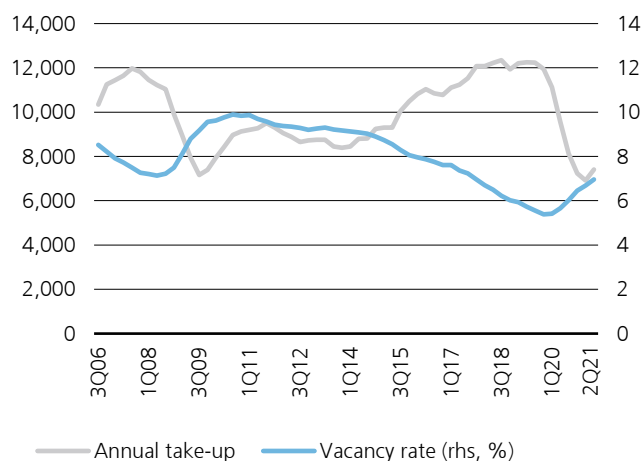
More concerning is the widespread prevalence of the highly transmissible Delta variant. This has already resulted in several European countries reinstating some restrictions. The vaccines appear to be effective at limiting serious illnesses from the variant, but with cases on the rise it will be a testing few months. If hospitalizations were to increase in the coming months, further major lockdowns cannot be ruled out and this would dent the positive momentum which developed in the first half of the year.

### Occupier markets

European office markets continued in the same vein in 2Q21. Based on data from JLL, take-up only increased by a small margin and remains 35% below pre-pandemic levels (see Figure 1). Vacancy continued to edge up in 2Q, by 0.3ppps, but is still low in a historical context.

**Figure 1: European vacancy rate and take-up**

(000 sqm, %)



Source: JLL, 2Q21

The lack of high-quality supply kept prime office rents stable in virtually every market. On the retail side, there was finally some positive news, with stores able to open across much of Europe. A few markets recorded prime rental declines, but this was far less widespread than in previous quarters. And whilst demand for logistics space remains very strong, prime rents have not taken off in the way that the pricing levels have implied. It suggests that despite all the strong fundamentals, logistics may not be a naturally high rental growth sector – particularly in markets where there is significant land availability.

### Capital markets

Investment markets continue to demonstrate stronger characteristics than the underlying occupier markets. Data from CBRE shows that European investment volumes in 2Q21 reached EUR 69 billion, a 26% increase on 1Q21 and just 5% below the comparable pre-COVID-19 investment level. Nearly half of the investment volumes were accounted for by the much sought-after *beds and sheds* sectors. With a large weight of capital chasing a limited pool of assets, there has been sharp price inflation for both sectors. In addition, industrial transaction yields dropped below office CBD yields for the first time in history.

Despite ongoing questions around the future of the office, transaction volumes for the sector showed some recovery, coming in at EUR 22 billion, but remained 22% below the level in 2Q19. Within the sector, investor appetite is heavily skewed towards core assets with defensive income streams. Prime yields were flat in most markets, but further compression was recorded in Brussels, Paris, Berlin, Cologne, Stuttgart and Milan. However, outside of the very core space, the situation is more challenged. Quarterly valuation data is not available in most markets, but pricing of assets in more secondary locations are under pressure except those with a long lease in place to a low-risk tenant.

Retail investment volumes remain well below historical levels, but there was an increase of 35% QoQ in 2Q21. There are still challenges ahead but the reopening of retail assets should encourage further liquidity into the sector. And after generally moving out since the start of the pandemic, prime yields were mostly stable in 2Q21. Although COVID-19 related closures are hopefully behind us, the continental European retail market is still yet to face the full revaluation from the structural shift to e-commerce. We do not expect this to retrench too far from the levels hit during the pandemic.

## Strategy viewpoint

# Different strokes for offices and retail.

### Keep the fundamental differences in mind

It only took e-commerce penetration to reach around 15% to start a sharp correction of global retail real estate values. With consensus assuming that most office-based companies will take a hybrid approach to home working, we can realistically expect average working from home (WFH) days to increase from 1 to 2.5 day per week. This equates to a potential fall in day-to-day occupancy of 1.5 days per week. This potential reduction in corporate demand for offices is double the level of e-commerce penetration that led to a sharp correction in retail values. *So shouldn't landlords of office space be worried?*

Not necessarily. Retail and office businesses are fundamentally different. Bricks-and-mortar retailers all share the same business model – to sell products from a shop. The office by contrast is a unit in which to do business, but those businesses vary considerably. What this means is that when retail suffered from a structural shift, it was a systematic risk that negatively affected all bricks-and-mortar occupiers. Whereas the industries of most office occupiers have not been negatively impacted by the pandemic. And rather than the structural shift to WFH having a negative impact on their cash flow, it can actually improve it if they reduce their occupation through more remote working.

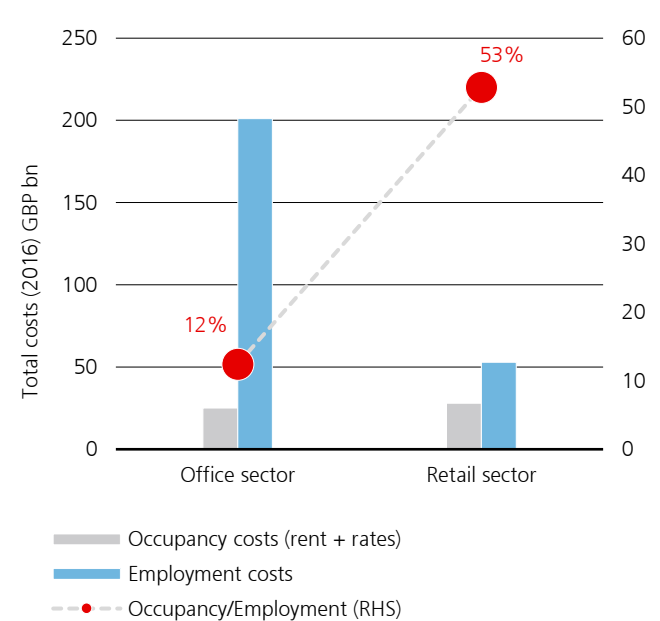
A further difference is the far higher relative real estate costs for retail, compared to offices (see Figure 2). Reduced retail occupancy has a greater impact on the bottom line than reduced office occupancy. If an office occupier needs to save costs, its first call is nearly always to reduce headcount, before space. With most office-based companies in a healthy position financially, we're not envisaging significant reductions in headcount leading to lower office requirements.

Instead, there will be reorganizing and consolidation, as real estate teams accommodate more staff into less space. This will be gradual and new demand will negate some of the challenges caused by a shift to flexible working. While COVID-19 will lead to longer-term shifts in occupation, this impact will be uneven.

Office-based companies are recruiting again, and the war for talent in many sectors is as fierce as before the pandemic. The space they occupy to support growth will need to be accretive to the value of the company and the experience of the employees. Buildings will need to accommodate changing usage, moving from functional workspaces to an interactive

and collaborative environment. The most relevant locations will facilitate a range of features that add value to the employee making the commute.

**Figure 2: Occupancy costs for offices and retail in the UK (GBP, %)**



Source: IPF PIA Property Data Report; 2017

Many office buildings will not meet these criteria. Repurposing well-located city-center space to meet future demand can protect values. But in weak, secondary markets, particularly with poor transport connections, the outlook is less positive. Deals in out-of-town locations which add little value to the workplace experience are generally going through at discounts to their pre-COVID-19 valuations. Furthermore, the more established locations with a wide range of amenities and transport connections are proving to be far more defensive.

One exception is life sciences, where there is vast investor demand. This space is often in out-of-town business parks and there is a key differentiator between traditional office space. The work done at a life sciences facility has to be within a highly controlled environment – traditional office work is much more transferable. And it is the more functional, workstation-led offices that are likely to suffer the most as we come out of the pandemic.

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