Talking Points

Post-pandemic outlook for real estate – November 2021

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Is core real estate pricing overheating?

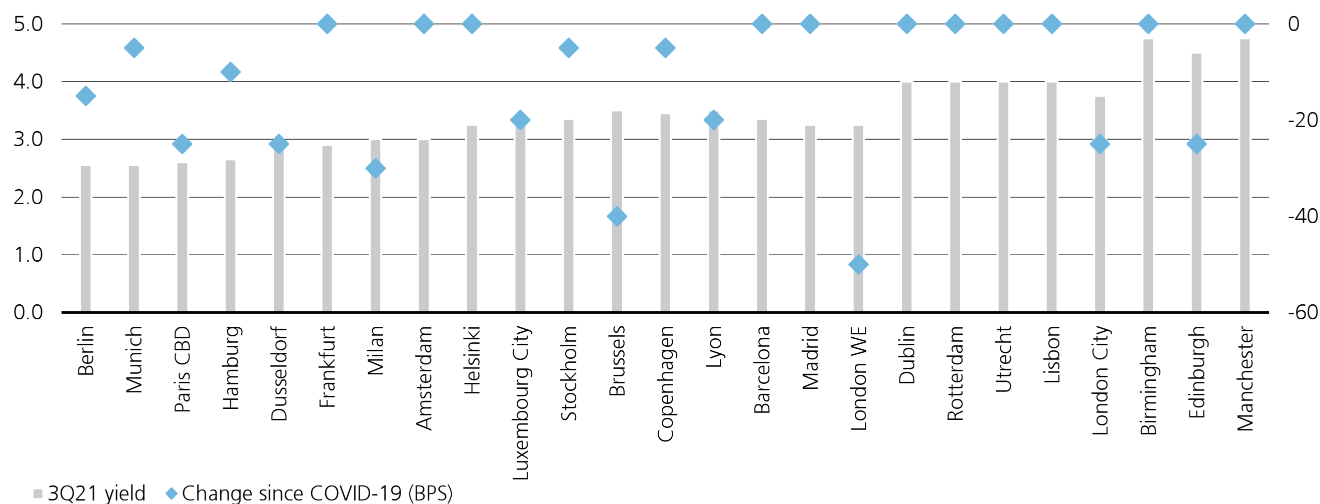
At the start of the COVID-19 outbreak, the idea that core European real estate pricing would in many markets be higher in 18 months' time would have been almost unthinkable. But with governments pumping liquidity into the financial system, economies rapidly recovering and interest rates stable at record low levels, that is the situation we find ourselves in.

However, as we come out of the pandemic there are still considerable challenges ahead for European real estate. Government support schemes are being wound down, construction costs are soaring, and pandemic induced structural shift in occupier markets are yet to be fully realized at the cash flow level. With core property yields at record low levels, we need to ask if those risks are being accurately priced in or whether a bubble is forming due to the surplus liquidity chasing the market.

Predictably, the sharpest price rises have been recorded in the sectors which were seen as the most defensive against the pandemic – namely *beds, sheds and meds* (residential, logistics, and life sciences). But the consequence of a vast amount of capital being pushed towards select sectors of the real estate universe is rapid price inflation. Prime industrial capital values in the eurozone have increased by 13% since 4Q19, whilst prime private rented sector (PRS) yields now stand as low as 2.1% in Germany.

Assets with a life sciences angle have been sold at 60% above their original quoting price. However, what is more surprising is that the office sector, which is facing rising vacancy rates as a major structural shakeup takes effect, has also seen prime office values increase by around 5% since the start of the pandemic. As Figure 1 demonstrates yields in all core European office markets are either the same, or below their pre-pandemic level.

Figure 1: Prime office yields (% p.a.)

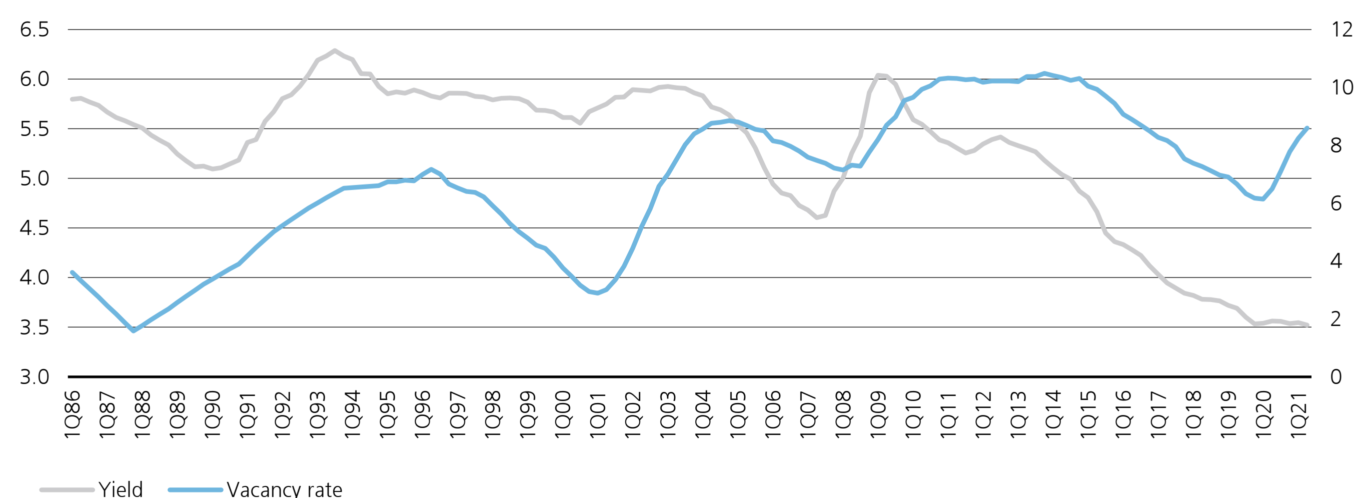


Source: CBRE ERIX; 3Q21

Although we do not anticipate the negative impact on offices to be as severe as the impact of e-commerce on retail, pricing is still not adjusting to the potential downside risks on the occupational side. Historically, office yields have been closely linked to the vacancy rate in the market. As vacancy rates fall, investors pay lower yields in anticipation of a strong occupier market and rental growth. The reverse is true when the vacancy rate rises.

But it is clear that during the COVID-19 pandemic, this rule has not applied. Figure 2 shows that despite the vacancy rate rising sharply from 2Q20, prime office yields have continued to move in. On the face of it yields compressing at the same time as a rapid increase in vacancy represents a disconnect between occupier fundamentals and investor sentiment.

Figure 2: EU-15 vacancy rate and yield (%)



Source: CBRE; 2Q21

Office availability is going to continue to rise as more companies have lease events that enable them to release surplus space back onto the market as they reconfigure their requirements. As companies usually have to wait for a lease event to do this, we are unlikely to see a peak in vacancy until late 2022 or 2023.

The counter-argument is that the market will polarize and occupier demand will continue to be strong for prime space, of which there is a limited supply. This forms much of the justification for the prime yield compression we have seen since the pandemic started. And although this is true, there are some issues over taking such a polarized view of the market. It implies that prime and non-prime markets will completely disconnect, and the sharp increase in secondary vacancy and rental decline will have no impact on rental levels for prime space. This is a big assumption given that prime and secondary rental values have always been correlated to some extent.

As large volumes of vacant secondary space accumulates, one solution will be to upgrade it to prime quality. Whilst this could be a viable strategy, the discounts we would expect to see on secondary assets with a value-add angle have not materialized. A sharp increase in construction costs means the capex required to transform the vast majority of the market which is not prime, into high quality space fit for post-COVID occupation will be substantial. Sustainability requirements will add further upward pressure to construction and refurbishment costs in the coming years. Tenants may pay higher rents for truly fit-for-purpose post COVID space, but finding the right entry price for value-add remains a challenge.

With entry yields for the highly demanded sectors prohibitively low and the office market not correcting to reflect potential downside risks, where do we see value in the market at the moment?

Despite the tight market, we still think there are a few angles. An income value approach would expect some interesting opportunities to emerge from retail. Initially, these will be highly selective and focused on the assets where rents have fallen to a sustainable level. Assets needs to be in locations that retailers continue to trade well in and can demonstrate profitability at the rebased rental levels. Initial returns are driven by the much higher income yields which are now available due to the very weak sentiment surrounding the sector. Combined with some leverage, it is possible to get the income return component alone into double digits.

The UK had seen the sharpest retail correction in Europe, but is now seeing some green shoots of recovery in the retail warehouse sector in parks where the rents are low, and the retail offering suitably matches the needs of the local catchment. Due to working from home, consumers are spending more time near their local retail park than in city centers. Capital values have already increased by 6% in the first eight months of 2021 as the weight of capital seeking high income assets has increased, and investors get comfortable again with this particular retail format.

In Europe, the retail correction has been less significant which is partly due to European leases being shorter and more adaptable to changes in market conditions. Hence, they never reached the unsustainable over-rent situation that much of the UK suffered with. But again, focusing on retail parks, income returns particularly in Southern Europe are high and for the parks which offer a functional product range and affordable rents to occupiers, we see some upside in the coming years.

For a growth strategy, although it is highly demanded, we do see further opportunities in European life science assets. The key difference between the traditional office market is that the work done on R&D sites cannot be replicated by a home office. As venture capital has poured into the sector, many companies require real estate to expand into but there is very limited, if any, available specialist space in the location in which they are active. Therefore, although the entry yields may seem low, there is a case for very strong rental growth which can justify them. And to avoid the sharp entry yields, a development led approach can unlock higher returns.

The sector is also relatively de-centralized, with hubs emerging outside the traditional core office markets and around key employers and universities where there is a focus on specific areas of research. Although there are risks on liquidity, these locations can again prove very defensive as the employees typically have a very specialized skill set which ties the research and manufacturing to that specific micro-location. And being outside the core markets means the entry yields also become more generous.

And for a niche sector play, we believe there are strong opportunities for growth in the European student accommodation market. Although it has been well established in the UK for over a decade, institutional purpose-built student accommodation has only recently started to emerge in Continental Europe. The supply-demand dynamics are extremely positive, partly driven by an increasing number of non-EU students who are attracted by the rising number of English taught courses in Continental Europe.

The UK market has demonstrated that even a significant pipeline of new rooms can be readily absorbed in strong university locations. And, being an early mover creates an opportunity to be at the forefront of a sector which is set to grow considerably over the next decade and expected to benefit from a stable income return supported by a supply-demand imbalance.

And lastly, for a development led-approach we still see some strong returns being on offer in the logistics space. An interesting angle here is to target speculative big box developments in key logistical locations. The lead times for occupiers requiring space are getting shorter, and although pre-let schemes can complete relatively quickly there are an increasing proportion of requirements which need to be satisfied quicker than the 12-18 months build time. Once stabilized, the very low exit yields are expected to drive attractive returns for a sector where the strength of the occupier market significantly reduces the speculative development risk.

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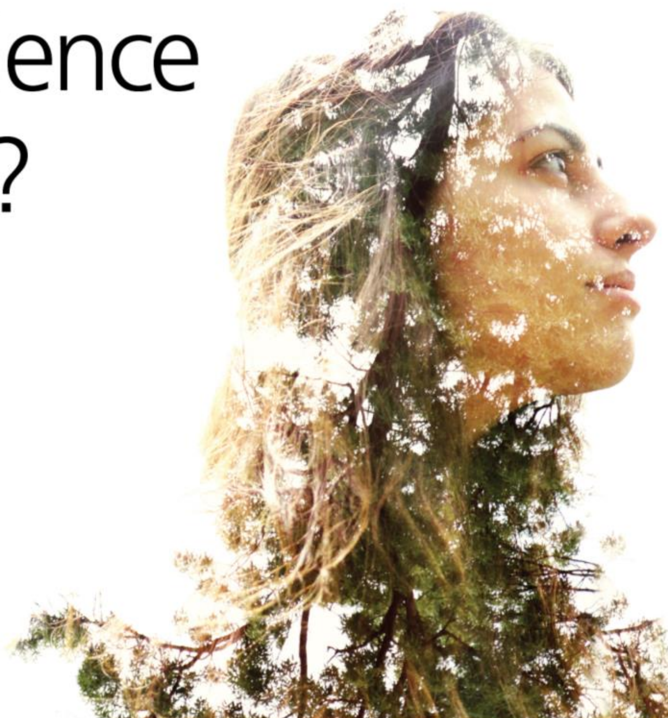

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