Real Estate Outlook

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See the wood for the trees.

UBS

UBS Asset Management

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European outlook

Will the leaves return?

With inflation back with a vengeance and central banks set to raise rates over the next 12 months, investors can no longer depend on the *buy and hold* model to deliver strong returns. Capex and sustainability requirements are going to weigh ever more heavily on NOI, but with property yields at ultra-low levels there is little buffer should a downside scenario play out. The asset class can still deliver strong returns, but managers will need to work harder to create genuine value from their real estate investments.

Market overview and outlook

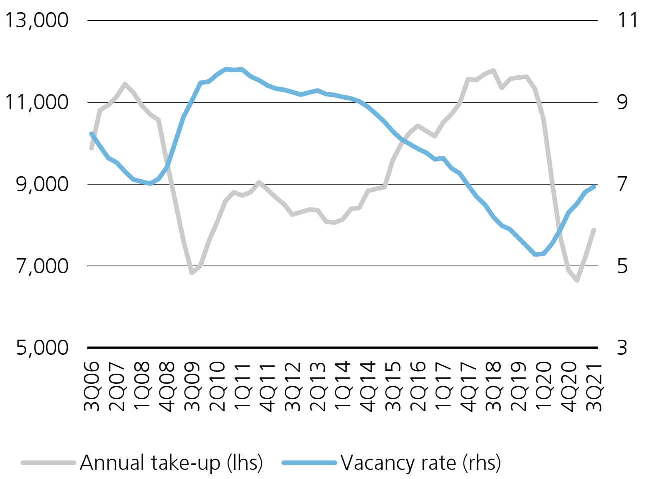
Inflation dominates discussion.

Economy

After the positive momentum which grew with the reopening of economies in 1H21, disrupted supply chains came under pressure in 3Q21. The consequence of this has been a sharp increase in inflation, which hit 4.1% in the eurozone in October and 3.1% in the UK in September. Both are expected to continue to rise, with UBS Investment Bank expecting the eurozone to hit a peak of 4.3% in November and Oxford Economics forecasting that the UK will reach 4.5% by the middle of next year. The vast majority of price increases continue to be either directly or indirectly linked to the impact of the pandemic, so we expect the higher levels to prove transitionary and fade away over the next 24 months.

But in response to the acceleration in economic growth and the potential threat of higher inflation, central banks have turned noticeably more hawkish. Markets are now pricing in the Bank of England to raise rates to 0.5% by the end of next year and are even anticipating a hike from the European Central Bank of 20bps by the end of 2022. Interest rates will remain at historically low levels, but pose a threat to the asset-price bull run, which has been fueled by falling interest rates over the past decade.

Figure 1: European office take-up and vacancy rate ('000 sqm, %)



Source: JLL, 3Q21

Occupier markets

The vacancy rate for European office markets continued to move up in 3Q21, although at a slower rate than previous quarters (see Figure 1). Interestingly, vacancy in the UK markets actually reduced slightly as some of the sub-lease space was taken off the market.

Demand continued to recover but remains well below pre-pandemic levels. Most occupiers are waiting to see how the return to office goes before making decisions. Prime retail markets continued to show signs of stabilization according to data from CBRE, with rents flat in most markets. Those which did see declines included the regional French and Netherlands markets. Demand for logistics space in 2021 is likely to hit another record high, driven in part by ecommerce which accounts for about 25% of the market. Unlike previous quarters, the supply-demand imbalance is starting to generate more widespread rental growth – markets in Germany, France, Belgium, Netherlands, Spain and the UK all recorded some quite strong growth in 3Q21.

Capital markets

Transactional activity in Europe continued to be fairly resilient in 3Q21 according to data from Real Capital Analytics, with quarterly volumes down by about 17% on the 2019 level. Investor appetite amongst institutional European investors remains strong, although travel restrictions continued to make it difficult for non-European buyers to transact. In particular, for family offices and HNW from Asia who typically need to see the asset before purchasing.

The sectoral composition of the investment universe continues to move away from the more traditional asset classes of offices and retail, and into logistics, residential and other alternatives. Within the office sector investors are still active, but heavily focused towards the core end of the market, where yields are continuing to compress. Prime retail yields are generally stable, although sentiment remains very weak outside of this segment and valuations should continue to move out in Europe. One exception is the UK, which has seen by far the sharpest correction. However, the UK is now seeing some stabilization and in the retail warehouse segment some very significant recovery in capital values. PRS yields remain at very low levels.

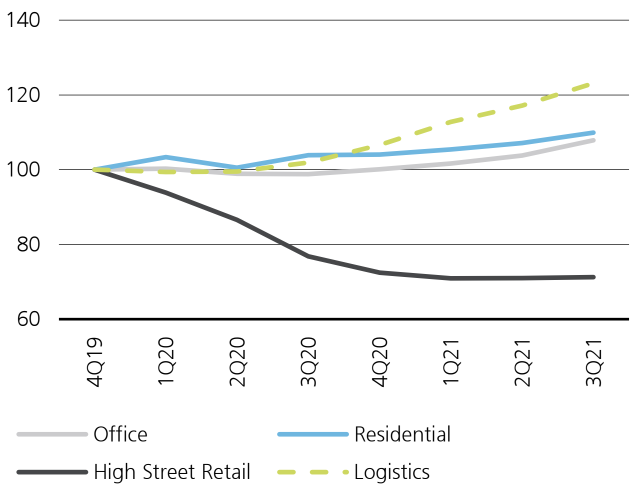
Property markets in Europe can no longer rely on falling interest rates to drive yield compression. And current yield levels represent very low returns. Our view is that investors will need to work much harder to generate the level of returns which they've enjoyed over the past decade in Europe, by creating real value from the real estate they own. With rising capex and sustainability requirements, the buy-and-hold model is likely to come under increasing pressure, particularly if inflation does prove higher and interest rates move out more quickly than anticipated.

Strategy viewpoint

Fallen leaves are nature's trick or treat.

Post-pandemic winners are *too obvious*
With structural trends accelerated by the pandemic, capital has flocked to those sectors best positioned to benefit – namely *beds, sheds and meds*. 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 have increased by 23% since 4Q19, whilst prime PRS values are 10% higher and yields below 2.5% in some parts of Europe. Assets with a life sciences angle have been sold at 60% above their original quoting price.

Figure 2: Prime European real estate capital value indices (4Q19=100)



Source: CBRE ERIX, 3Q21

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 8% since the start of the pandemic (see Figure 2). Although we believe in the long-term future of the office, the downside risks are not just associated with a structural shift to more homeworking. Capex costs have inflated rapidly, and with vacancy increasing tenants are in a strong negotiating position. They are still actively seeking space, but requirements are increasingly focused on assets which specifically match their post-COVID-19 requirements. Buying a prime asset in the current market and hoping for the market to move in your favor could cause severe difficulties as the interest rate environment turns. Investors will have to add value to their assets to remain competitive and achieve rental growth, which will only be realized in an increasingly narrow segment of the market.

Where do we see value?
The income value approach would indicate that some interesting opportunities in retail will emerge. Initially, these will be highly selective and focused on the assets where rents have fallen to a sustainable level in locations that retailers continue to trade well in and remain profitable. Initial returns are driven by the much higher income yields which are now available due to the very weak sentiment surrounding the sector. However, there is also scope for some inward yield shift as the sector recovers some of the lost ground. We are already seeing this in the retail warehouse segment of the UK market, which has recorded 7.2% capital growth during 1Q-3Q21. In Europe, the retail correction has been less significant so there is less capacity for a recovery. But again, focusing on retail parks, income returns are high, particularly in Southern Europe. 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 strategy focusing on growth, 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 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. So, although the entry yields may seem low, there is a case for very strong rental growth which can justify them. The sector is also relatively de-centralized, with hubs emerging outside of 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 underpins the research and manufacturing attributes of 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. 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 Europe. The UK market has demonstrated that a significant pipeline of new rooms can be easily absorbed in strong university locations. Further, 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 benefit from a stable income return supported by a supply-demand imbalance.

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