UBS Asset Management

Diversification with opportunity

European real estate | White paper

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European real estate offers Swiss investors the opportunity to diversify their existing portfolio while participating in long-term trends.

Swiss private investors usually focus very strongly on the domestic real estate market. However, institutional investors have recognized the opportunities and advantages of European real estate in recent years and have started to introduce foreign investments into their existing portfolios. There are also good reasons for Swiss private investors to invest in European real estate. On one hand, the European real estate market opens up access to a large investment universe with many opportunities to participate in long-term trends. On the other hand, European real estate is ideal for diversifying an existing real estate portfolio. In addition, European core real estate is a defensive investment offering long-term stable returns.

European real estate from a Swiss investor's perspective

Summary

The European real estate market offers access to an investment universe that is around 10 times larger than in Switzerland, and the opportunity to participate in various megatrends.

Due to its low correlation to Switzerland, the European real estate market is ideally suited for diversification as a complement to Swiss real estate.

European core real estate has defensive characteristics such as forecasted real rental growth in the coming years, stable returns, inflation protection and a low correlation to other asset classes.

Megatrends and their impact on real estate

Real estate investments that focus on megatrends exhibit a high level of stability that endures market cycles and uncertain times.

Real estate investments are long-term and therefore affected by social change. Megatrends are long-term social, economic and political developments that have a lasting impact on our way of life. While digitalization has been influencing our lives for at least two decades, environmental issues are becoming increasingly important. The events of recent years have in turn triggered long-term developments. The COVID-19 pandemic and the war in Ukraine have highlighted the need to strengthen security of supply.

Real estate offers a good opportunity to benefit from these developments, as this is where these megatrends take place. In order to benefit from these developments in the most targeted way possible, implementing an investment strategy in a large, cohesive economic area such as Europe, can offer a wealth of investment opportunities. In addition, a multi-sector strategy is ideal in order to be able to participate in several megatrends at the same time. Since megatrends are only slightly affected by short-term fluctuations, real estate investments based on them exhibit a stability that lasts through market cycles and uncertain times. In the following, the opportunities of these megatrends in relation to real estate will be examined in more detail.

Megatrends and their impact on real estate

	Housing Socio-demographic change	– The desire for flexibility and working from home are changing the demand for space (e.g. micro-apartments, co-living in central locations, medium-sized apartments enabling working from home in more affordable locations). – Demographic change increases the demand for assisted living projects.
	Logistics Changing supply chains and security of supply	– E-commerce continues to grow and is increasing demand for logistics space for cargo handling. – The crises of recent years have led to the need to increase the security of supply, resulting in a relocation of supply chains to Europe.
	Office Changing working and living environments	– Office locations in city centers or in other well-developed locations remain in demand. – Demand for flexible office space is increasing as office space becomes more of a place for communication and innovation as a result of the growing trend for working from home. – Tenant demand for ESG-compliant office space is increasing.
	Retail Retail as a defensive sector	– Despite the growth of e-commerce, there are defensive sectors in retail, such as food retail, which is barely affected by e-commerce and offers very attractive returns. – Since the pandemic, shopping combined with other leisure activities has become hugely popular, which means that retail spaces in city centers, mixed-use properties or tourist towns offer opportunities.
	ESG Sustainability from trend to standard	– Sustainability is a topic that has permeated all areas of life in recent years and will become even more important going forward. – Due to its environmental impact and its high social relevance, the real estate sector is the focus of this change. – Properties that take ESG requirements into account are likely to benefit from this in future.

Socio-demographic influence on the housing market

The housing sector offers a wide variety of socio-demographic developments to participate in.

The housing market is being affected in many respects by a variety of developments that will change demand for housing. The growing demand for flexibility, as well as the rising cost of home ownership, is driving the rental housing sector in Europe's agglomerations. Society's rising individualization and the pressure of urbanization are increasing demand for small residential properties in metropolitan centers (e.g. micro-apartments, co-living). In the conurbations, on the other hand, medium-sized apartments in more affordable locations are becoming increasingly attractive, mainly due to the growing trend to work from home. The aging society and the growing independence of active senior citizens is another driving factor behind the demand for age-appropriate living space. Assisted living projects have therefore become established among real estate investors and are no longer merely a niche segment. The residential sector is at the heart of this transformation, which is opening up long-term opportunities for investors.

Changing supply chains and security of supply

The relocation of supply chains to Europe will increase demand for logistics space in the coming decade.

After experiencing a boost during the pandemic, e-commerce in Europe is expected to grow further in the coming years. Continued pandemic-related disruptions in global supply chains and a tense geopolitical environment, support strengthening security of supply and a relocation of operational activities back to Europe combined with increasing automation. According to the ABB Supply Chain Survey 2022, 74% of European executives plan to relocate their business back to Europe due to the increased focus on sustainability and prevailing supply chain difficulties. This process of near- and re-shoring is expected to take over a decade, with the logistics sector being the main beneficiary. Another factor favoring the logistics sector is the concentration of population in urban areas, which makes prime logistics locations in agglomerations and near strategic transport hubs increasingly attractive. Restrictive planning policy will severely limit the expansion of available space, which creates a favorable environment for long-term investments and is likely to lead to continued rent increases for prime logistics locations.

Changing working and living environments

Office properties are increasingly becoming a place of communication and innovation for companies and are becoming an important meeting place in a home office environment.

The long-term effects of the COVID-19 pandemic have led to an acceleration of digitalization in work processes. For the office sector, this trend means increased demands on flexibility, real estate and location quality. Office properties are increasingly becoming an important meeting place of communication and innovation for companies.

Office properties in the centers of large cities and office locations in conurbations as well as in growing medium-sized towns that are easily accessible by public transport, are likely to remain resilient in the post-pandemic world. Office properties with a high proportion of medical practices, other healthcare facilities or consulting professions also exhibit a defensive character due to the stability of the business. The availability of flexible space and properties, as well as the ESG features of the office properties, will become increasingly important in order to offer tenants added value.

Retail as a defensive sector

Certain parts of the retail sector are barely affected by e-commerce and offer real estate investors good opportunities for attractive returns.

The food retailing industry remained stable at the height of the COVID-19 crisis thanks to its essential range of products. Despite the anticipated rise in online purchases after the outbreak of the pandemic, the food retail industry has so far been less affected by e-commerce than other sectors. However, there are also segments in the non-food sector that are holding their own against e-commerce. Pharmacies or prime-location furniture or DIY stores remain very popular with clients. They offer added value due to the advice and the possibility to physically test a product, which gives the client a better understanding of the goods. In addition, shopping in combination with various leisure activities is gaining in importance, which favors properties in city center locations or tourist towns that also have corresponding leisure facilities in addition to their shopping facilities. The retail sector in the aforementioned areas offers real estate investors good opportunities and attractive returns, but a strong differentiation must be made between the investment opportunities.

Sustainability from trend to standard

It is becoming increasingly apparent that properties that take sustainability requirements into account will benefit in future.

Growing environmental and social challenges are leading to a more holistic view of sustainability. Due to its environmental impact and its high social relevance, the real estate sector is the focus of this change. Legislators, investors and tenants are setting new sustainability requirements. For this reason, establishing sustainability standards along the entire value chain and over the entire life cycle of a real estate, from purchase and re-letting to refurbishment, is of central importance. It can be assumed that properties that take sustainability requirements into account will benefit more than average in future, as they will be in greater demand on both the tenant and capital markets and will be less affected by regulatory pressure.

European real estate as a strategic investment

Access to a large investment universe

The size of the European real estate market makes it easy to implement an investment strategy based on megatrends.

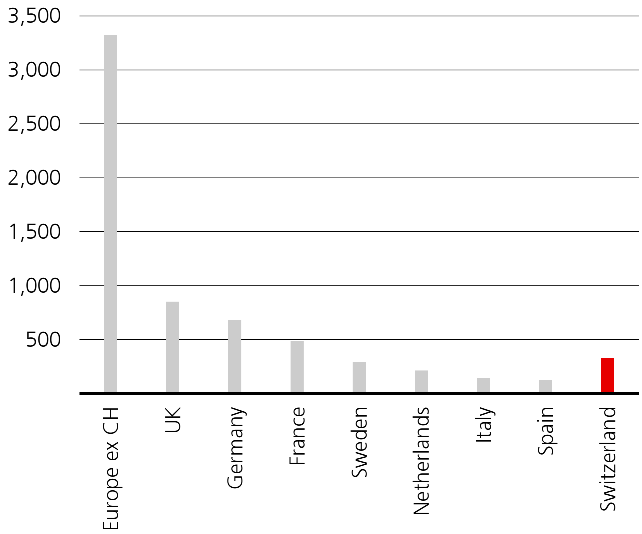
Europe offers access to one of the largest real estate markets in the world. The European real estate market accounts for about one third of global markets in terms of invested volume (see Figure 1). Compared to Switzerland, the European real estate market provides access to an investment universe that is around 10 times larger. Accordingly, the size of the market generates greater investment and growth opportunities in different countries and sectors, especially when focusing on megatrends.

Diversification advantage

For reasons of diversification, European real estate highly complements Swiss real estate.

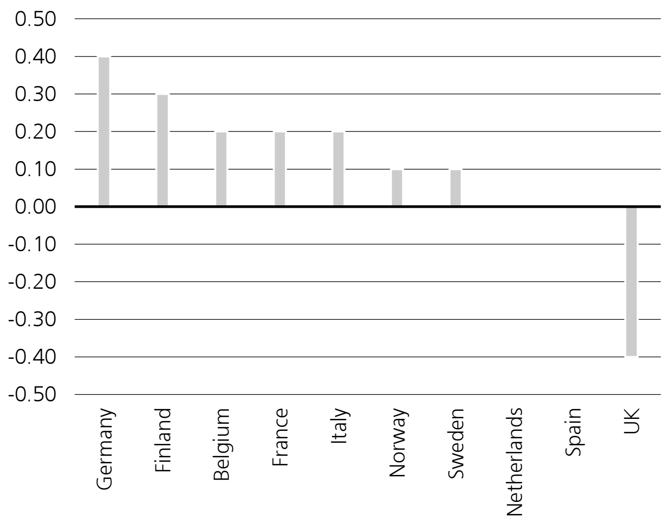
Historically, real estate cycles take place over longer periods of time. A geographically narrow real estate strategy can therefore pay off for years, but involves a risk as soon as the real estate cycle comes to an end. It has also been shown that real estate cycles in national economies occur independently and/or with a time lag. For this reason, diversifying the real estate strategy geographically can better protect against declining real estate sub-markets. A geographically broadly diversified portfolio can often include real estate markets that perform better than others (see Figure 2). This cushions the downturns in individual real estate markets.

Figure 1: Sizes of European real estate markets
(CHF billion)



Source: MSCI Real Estate Market Size Estimate History, December 2021

Figure 2: Correlations of total returns
(2004–2020)**, direct real estate investments**



Source: MSCI; UBS Asset Management, Real Estate & Private Markets (REPM), June 2021.
Note: All real estate total returns have been de-smoothed by UBS. Past performance is not a guarantee for future results.

Legal and economic environment

European legal and economic frameworks and geographical proximity, facilitates better implementation of real estate investment in a global context.

Even if Europe is divided into numerous jurisdictions, the institutions of the EU, a common currency and additional state agreements form a common framework. This and the geographical proximity to Switzerland considerably simplify the implementation of a direct European real estate strategy compared to a global strategy.

Resilience and defensive characteristics of real estate investments

Core real estate is forecast to provide real rental growth in the coming years, stable returns and good inflation protection.

The global macroeconomic environment has been defined by multiple challenges since the beginning of 2022. The outbreak of the Omicron variant of COVID-19 led to renewed restrictions and strains on international supply chains at the beginning of the year, especially with the severe lockdown measures in China.

Shortly thereafter, the Russian invasion of Ukraine led to further economic disruption, particularly with regard to the security of the supply of energy and raw materials. As a result of the energy shortage, there was a sharp increase in inflation rates, last seen at the time of the oil crisis. All these challenges are impacting further economic development. Real estate has various defensive characteristics that enable it to perform well in the current market environment.

Resilience and the defensive characteristics of real estate

Real rental growth	– Rising interest rates lead to a reduction in construction activity, limiting the supply of space. – Vacancy rates for core office properties are currently very low. In the residential market, there is a structural deficiency in central locations and agglomerations. – This combination of reduced construction activity and low vacancy rates is leading to a shortage of space and rising rents. – Over the next few years, real rental growth of 1.3% p.a. is expected in the eurozone (weighted average of sectors, see figure 3).
Stable returns in uncertain times	– Properties in prime locations are characterized by stable returns, which are even generated in more volatile market phases. – Properties in prime locations benefit from megatrends and thus exhibit a resilience that endures market cycles and uncertain times.
Real estate inflation protection	– Commercial properties often have lease clauses that allow rents to be adjusted for inflation. This provides good direct protection against inflation. – In the case of core real estate, market rents tend to rise in line with inflation, providing indirect protection against it. – This is particularly important in times of a turnaround in interest rates, as rising rental income can compensate for higher interest rates.
Correlation to other asset classes	– Real estate has a relatively low correlation to other asset classes, which makes it an excellent way to diversify a portfolio.

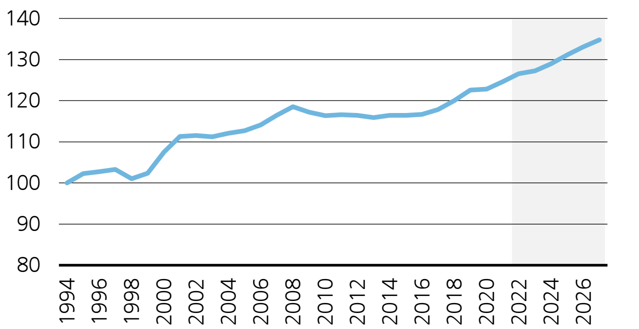
Real rental growth

Rising interest rates and low vacancy rates are creating a shortage of space with rents rising in real terms.

The European real estate sector is currently solid with good fundamentals. Rising interest rates due to inflation have increased construction costs, which means that construction activity is already being significantly throttled back. Despite a possible economic slowdown, an oversupply of space is not expected.

On the contrary, the vacancy rate for core office properties is currently at a low level. Due to the megatrends described above, the supply situation is likely to become even more acute, causing rents to rise further. In the residential sector, which already showed a structural deficiency even before a turnaround in interest rates, the supply situation is unlikely to ease. This is due to the megatrends and the low level of construction activity as a result of increased construction costs, meaning that further rent increases can be expected. Overall, real rental growth of 1.3% p.a. is expected in the eurozone in the coming years until 2027 (weighted average of sectors, see figure 3). Well-placed real estate investments should benefit from this in the coming years.

Figure 3: Rental price index (real) real estate eurozone
(2022-2027 forecast, 100 = 1994)



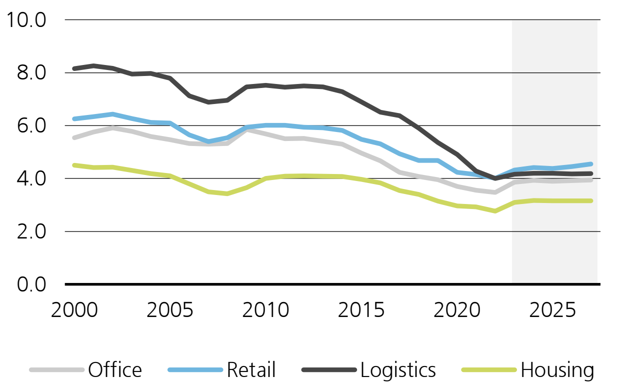
Source: Real Estate & Private Markets (REPM), Global Real Estate Forecast 1H22; Oxford Economics, August 2022

Stable returns in uncertain times

Core real estate is a defensive investment offering stable long-term returns, even in economically uncertain times.

Core real estate refers to real estate in prime locations with long-term rental contracts without major vacancies and no refurbishment backlog. It is characterized by a stable long-term earnings profile. Prime locations are distinguished by stable demand on the rental and capital markets throughout the economic cycles. Stable demand on the rental market means that larger vacancies can be avoided due to rapid re-letting, which leads to stable returns over many years (see Figure 4). Due to the constant demand on the capital market, the value of core real estate is also less volatile in difficult market phases.

Figure 4: Rental yields in the eurozone
(2022-2027 forecast, %)



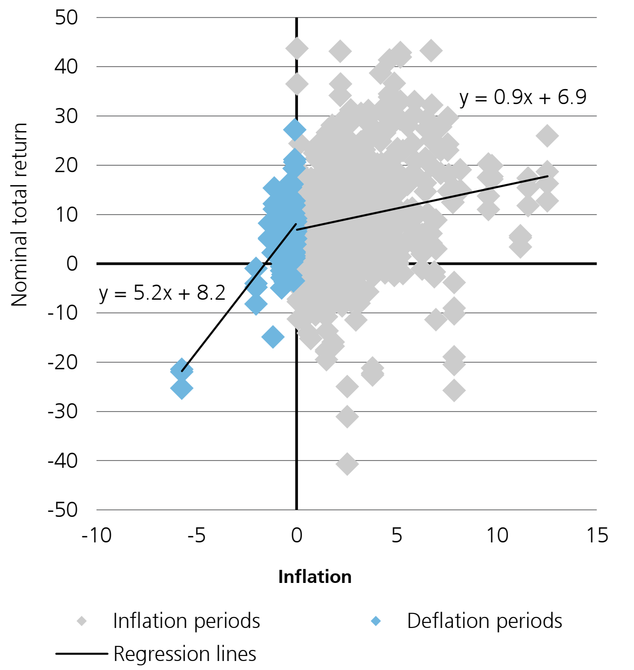
Source: Real Estate & Private Markets (REPM), Global Real Estate Forecast 1H22; Oxford Economics, August 2022. Past performance is not a guarantee for future results

Real estate inflation protection

As a real asset, real estate offers strong protection against inflation through lease clauses.

In recent years, real estate's inflation protection attributes has only been considered to a limited extent as an investment criterion due to price stability. However, this has changed in the current market environment with increased inflation rates and rising interest rates. Commercial properties usually have leases with indexation clauses that allow the landlord to increase the rent depending on inflation. Although such clauses differ in terms of the size and timing of the increase, they provide direct protection against inflation (see Figure 5). If there are no contractual options to increase the rent due to inflation, core real estate as a real asset still offers long-term protection against inflation. Market rents for core real estate tend to rise in line with inflation. Therefore, the landlord benefits from inflation compensation at the latest when the property is next re-let. This is particularly important in times of a turnaround in interest rates. Rising rental income can compensate for higher interest expenses.

Figure 5: Nominal total return vs. inflation
(% of annual data points)



Source: MSCI; Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), July 2022.
Note: Based on 1814 annual data points from the office, retail and industrial sectors of 26 countries. Oldest data point from 1980. Past performance is not a guarantee for future results.

Correlation to other asset classes

Real estate has a low correlation to other asset classes such as equities and bonds.

Real estate is the third largest asset class besides shares and bonds, with a share of around 10% in the global investment universe. Comparing the historical returns of real estate with equities and bonds, real estate has a relatively low correlation to these asset classes.

One reason for the low correlation is the above-mentioned characteristics of real estate, such as real rental growth, stable returns and good inflation protection. The low correlation can be exploited in a cross-asset class portfolio to reduce volatility while maintaining the same return. Therefore, real estate can be an excellent addition to any investor's strategic allocation.

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