

BARINGS

# Has the Retail Sugar Hit Passed?

*European Real Estate Research Quarterly*



NOVEMBER 2021

## *Executive Summary*

### **ECONOMY**

- High-frequency business surveys softened, with supply side issues now impacting activity.
- Persistent bottlenecks and rising energy prices have driven stronger-than-expected inflation, but we think these pressures should subside.
- While the risk of an early QE reverse manoeuvre has risen, Oxford Economics maintains their expectation that policy rates will remain on hold through to 2025.

### **PROPERTY MARKETS**

- Commercial property investment volumes appear to have recovered to pre-pandemic levels.
- Residential and logistics volumes have increased, but offices remain the most-traded sector.
- Prime yield trends are following the longer-term structural drivers: yields on industrials and e-commerce resilient supermarkets have compressed; prime office yields edged slightly lower in some locations; and most retail yields continued to unwind.
- Office vacancy increases are slowing and lettings activity is now beginning to revive.
- While prime retail rents are showing signs of stabilizing, structural headwinds remain.
- Industrial occupier markets continue to break records.
- Near-term residential price prospects are dependent on interest rates and stable labor markets.

## Economic Outlook

The IHS Markit Eurozone Composite Output PMI continues to retreat from its 15-year high in July, as input shortages impede output. Despite the softening, the October (54.3) reading was still firmly in expansion territory—which is above 50—with services output (54.7) slowing less than manufacturing (53.2).

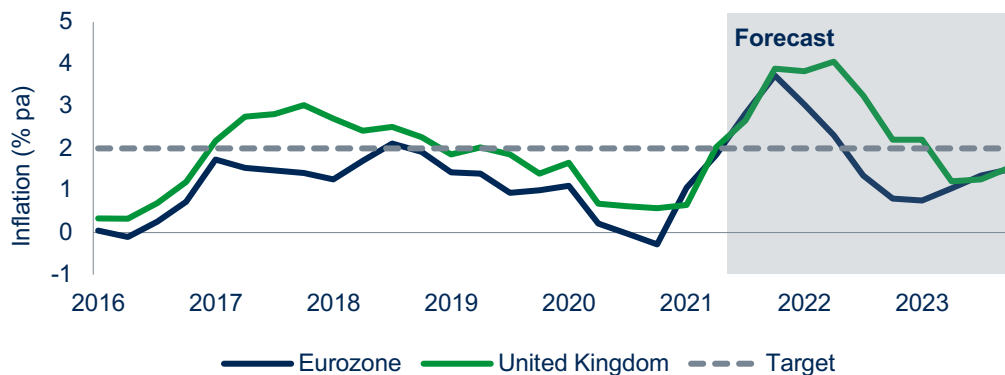
Shortages resulted in a record increase in company input costs over recent months and a surge in consumer price inflation for both goods and services, as firms pass higher costs on to their customers. Resurgent COVID cases are also a concern for some service sectors such as tourism, hospitality and leisure, should restrictions need to be re-imposed. On the upside, work backlogs, new orders and hiring intentions are strong.

Despite price pressures, Oxford Economics expects another strong quarter of economic growth for the Eurozone in the third quarter, of just below 2% quarter-on-quarter. A year-end growth rate of 5.0% per annum for 2021 remains on track for now. They are still predicting around 1% growth quarter-on-quarter next year, driven by the release in pent-up consumer demand/savings, a strong cycle for corporate capital spending and investment, ongoing ultra accommodative monetary policy from the European Central Bank (ECB), and an €800 billion pandemic recovery fund to be financed by ‘game changing’ common EU debt issuance.

Supply chain bottlenecks and rising energy prices are driving elevated inflation, with Eurozone CPI rising to 3.4% per annum in September 2021. Oxford Economics has increased their Eurozone inflation forecast to peak at 4% per annum by the end of the year, and remain above 2% through the first half of 2022. Thereafter, base effects and supply catching up with demand will likely see pricing pressures ease.

Despite the economic disruption, furlough schemes have managed to limit the damage to the labor market. The Eurozone unemployment rate continues to normalize and stands at 7.5%. Despite job creation levels rising sharply on PMI measures, the International Monetary Fund does not yet foresee a resultant inflationary wage spiral, with slack remaining in the labor market.

### CONSUMER PRICE INFLATION PROJECTIONS



Source: Oxford Economics. As of October 2021.

## Economic Outlook

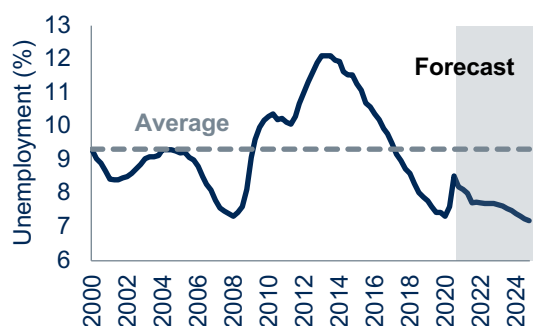
The ECB continues to provide ultra-accommodative monetary stimulus, but decided to reduce monthly PEPP purchases for the first time at their September meeting. While this was only a marginal slowing in the rate of purchasing, and definitely not a call to sell assets, it confirms that tapering discussions are now a central policy topic. Despite the rising risk of an earlier-than-anticipated QE reverse manoeuvre, Oxford Economics maintains their expectation that policy rates will remain on hold through to 2025.

### GDP COUNTRY FORECASTS (% PA)

Country	2020	2021	2022	2023	2024	2025	2021–2025
France	-8.0%	5.1%	4.7%	2.4%	1.7%	1.5%	3.1%
Germany	-5.1%	3.7%	4.4%	1.6%	1.0%	0.8%	2.3%
Italy	-8.9%	5.0%	4.7%	2.1%	0.9%	0.4%	2.6%
Netherlands	-3.7%	2.9%	3.3%	2.0%	1.2%	1.1%	2.1%
Spain	-10.8%	6.5%	6.1%	2.6%	1.9%	1.6%	3.7%
Sweden	-2.9%	4.4%	2.7%	2.1%	1.8%	1.7%	2.5%
United Kingdom	-9.8%	7.7%	6.2%	2.1%	1.5%	1.5%	3.8%

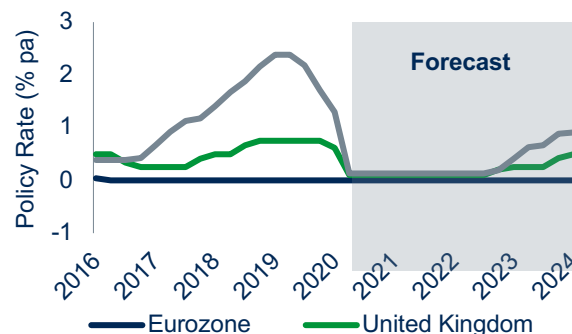
Source: Oxford Economics. As of October 2021.

### EUROZONE UNEMPLOYMENT RATE



Sources: Oxford Economics. As of October 2021.

### INTEREST RATES



Source: Oxford Economics. As of October 2021.



## Capital Markets

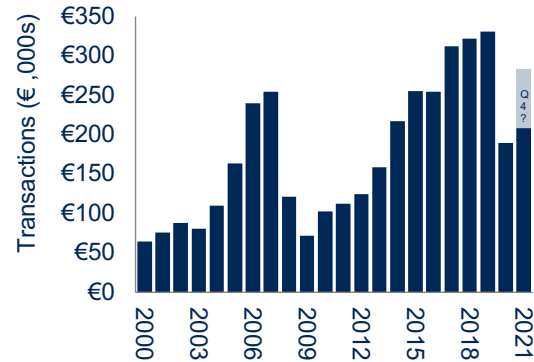
CBRE reports that third quarter real estate investment reached €77.3 billion—which is broadly a recovery to pre-pandemic levels. This is up 55% on the same quarter last year, and exceeds all the third quarters over the last five years. The pick-up in transaction volumes was primarily driven by increases in logistics and residential purchases. Despite property investor concerns around the pandemic-driven working from home (WFH) trend, offices remain the most traded sector, accounting for 31% of total sales.

At a country level, most major markets appear to be making up lost ground at pace. The rise in activity over the first three quarters is strong in the U.K. (+47% on the same period last year), the Nordics (+30%), Spain (+22%) and Germany (+8%). However, France (-13%), Italy (-8%) and the Netherlands (-3%) are lagging behind, at least for now.

During the third quarter, listed property companies and REIT share prices revealed the favored sectors, with industrial (+25%), self-storage (+17%) and residential (+7%) continuing to outperform. Offices (+3%) were just below their pre-COVID pricing levels, reflecting perhaps a neutral-to-uncertain outlook, with a positive outlook for prime, driven by a “flight to quality”—and a deteriorating outlook for secondary, with rising obsolescence risks and a need for higher capital expenditure. Retail & hotel (roughly -5%) have had the greatest unwinding of pricing during the pandemic, and continued to face poor REIT investor sentiment during the quarter.

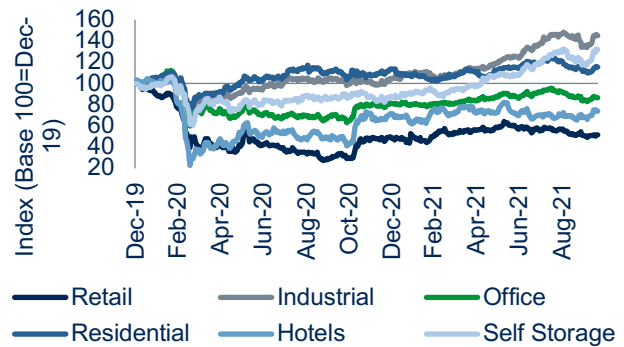
Over the past 18 months, CBRE European prime property yield data show shopping centers sharply rising 75 basis points (bps) to over 200 bps in the U.K., contrasting with aggressive compression in e-commerce resilient supermarkets, which were down 75 bps to 150 bps. Bulky goods retail warehousing in the U.K. has also seen inward movement in recent quarters. Perhaps confirming a bifurcated outlook (see office sector below), prime CBD yields edged lower by 5 bps to 20 bps, and despite worries about low yields even before the pandemic, logistics yields continued to fall, declining by a further 50 bps to 100 bps.

### EUROPEAN CRE INVESTMENT VOLUMES



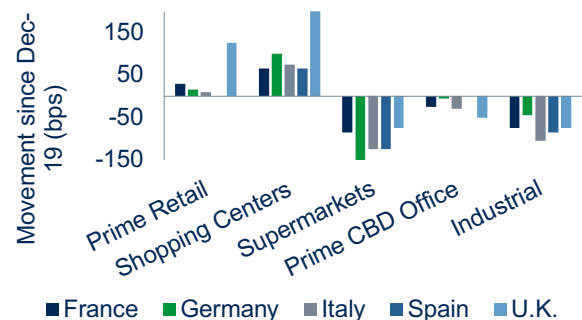
Source: CBRE. As of October 2021.

### EUROPEAN REIT: LISTED SHARE PRICE



Source: Bloomberg. As of October 21, 2021.

### EUROPE: YIELD MOVEMENT SINCE DECEMBER 2019



Source: CBRE. As of October 2021.

## Occupier Market

### OFFICE SECTOR

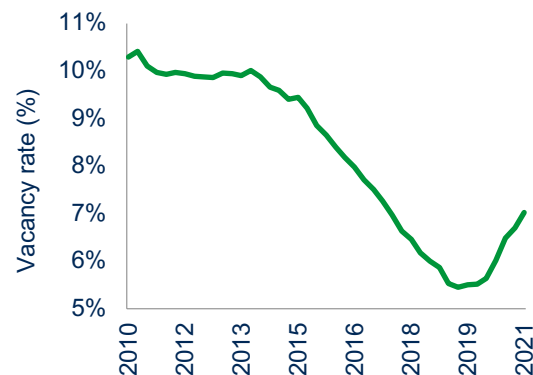
The availability of office space is still increasing across Europe. The Cushman & Wakefield European vacancy rate continued to move upward in the third quarter, increasing to 7.0%, from 5.6% in the second quarter. There are some signs of vacancy stabilization, with the 0.5 percentage point increase over the first half of the year—about half of that seen in the second half of 2020.

As vaccine rollouts gathered pace, a cautious return to the office was seen in more markets during the quarter. Mobility data from Google suggests that many workers are returning to their offices, albeit this is still down about a quarter on 2019 levels.

Demand has now passed its cyclical low, with rolling annual take-up in Europe at around 3.2% of total stock. This is up from 3.0% in the first quarter, but still around 30% below the long-run average of 4.5%. Copenhagen, Amsterdam and London remain around 50% below long-term average lettings, while Stockholm (where pandemic restrictions were more informal) and Berlin are back to roughly normal levels.

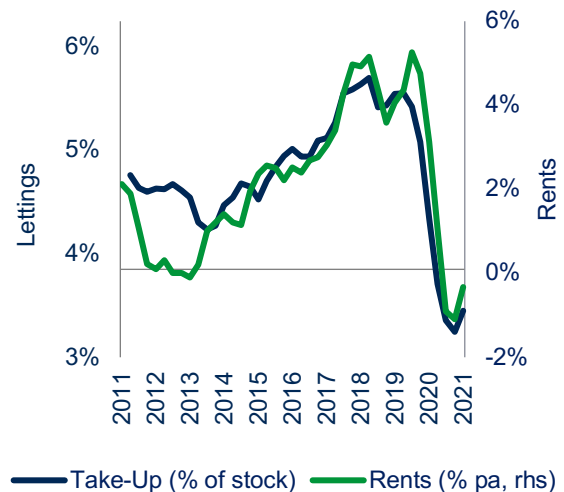
A confluence of forces is now building, and increasing minimum acceptable occupational requirements. These include lingering virus fears/increased hygiene standards, the need for fully flexible accommodation to facilitate more collaborative spaces, a societal shift toward wellness, and crucially, a corporate wake-up to the imminent dangers of global climate change. With real estate responsible for up to 40% of all global greenhouse gas emissions, operating from appropriate properties will be front-and-center for post-pandemic corporate agendas. Permanent WFH/hybrid working means central meeting spaces are more valuable than ever before. Ultimately, occupiers may require less space, but of a significantly higher quality. With the proportion of office stock built in the last 10 years at just 10-15%, and buildings with strong sustainability ratings in even shorter supply, the emergence of strong Grade A rental growth and a significant green premium looks inevitable. In contrast, the pace of obsolescence for older, more average quality space has also accelerated. As a result, a lot of this stock is now obsolete for modern business use.

### EUROPEAN OFFICE: VACANCY



Source: Cushman & Wakefield. As of Q2 2021.

### EUROPEAN OFFICE DEMAND VS. RENTS



Source: Cushman & Wakefield. As of Q2 2021.

## Occupier Market

### RETAIL SECTOR

The latest retail turnover figures reveal that pan-European sales volumes are still rising, albeit the growth pace is now normalizing to an above-trend 2.8% p.a. This follows a double-digit rebound due to base effects upon re-opening. In contrast, U.K. retail sales contracted for the fifth consecutive month in September. This is amid deteriorating consumer confidence, due to growing cost of living concerns and rising case counts.

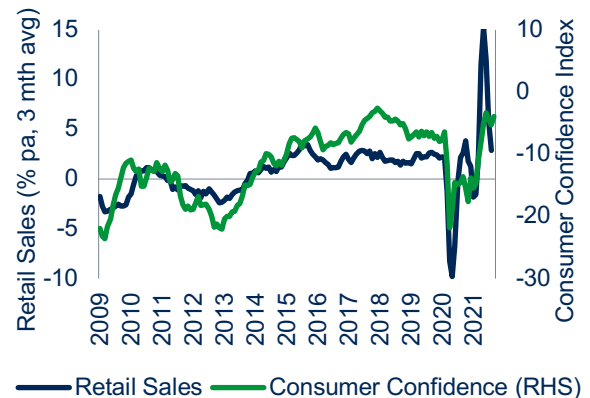
The consumption of accumulated pandemic savings and release of pent-up consumer demand are cornerstones of the broader macro recovery. While prime retail rents are showing signs of stabilizing, structural headwinds remain for physical shops, with e-commerce expansion still in its infancy in many parts of Europe.

All of this said, we believe a future for physical retail definitely exists. However, it will likely be focused on flagship store/on-line showrooms and mass market grocery-anchored convenience.

In the U.K., where the shift in online shopping patterns are among the furthest progressed in the world, food (which is a low margin and high delivery cost business), health & beauty (where services and samples are an intrinsic part of “the experience”); hardware (DIY), and garden centers remain highly resilient to e-commerce growth. This likely also explains falling yields, as noted earlier, in U.K. supermarkets and bulky goods retail warehousing.

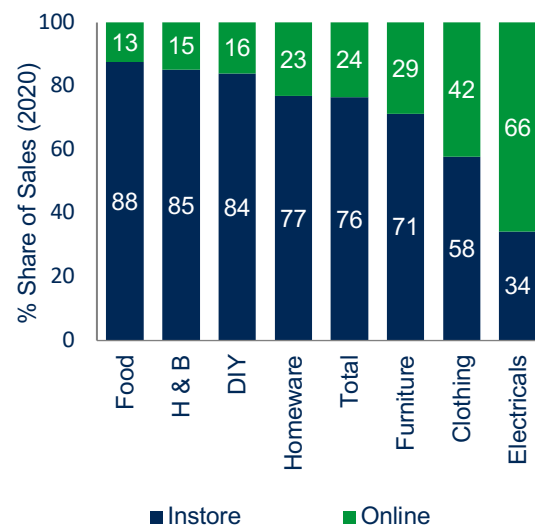
Some retail assets will remain relevant, perhaps more so than before. Others will be able to adapt to new consumer habits, while many will need a change of use or even complete demolition. The stabilization of most retail assets is still likely years away, and stock selection risks remain elevated—and thus, the sector is mainly the preserve of opportunistic capital for now.

### CONSUMER CONFIDENCE AND RETAIL SALES



Source: Eurostat. As of October 2021.

### U.K. ONLINE RETAIL SALES



Source: ONS. As of December 31, 2020.

## Occupier Market

### INDUSTRIAL SECTOR

The strong structural position of the logistics sector, driven by the steady adoption of e-commerce, received a further boost during the pandemic. A step change occurred across European markets, from the most mature, to those that are relatively early in their e-commerce transformation. With occupiers caught off-guard by the pandemic and seeking to close capacity gaps (subject to supply constraints noted below), lettings activity is likely to continue to set record levels.

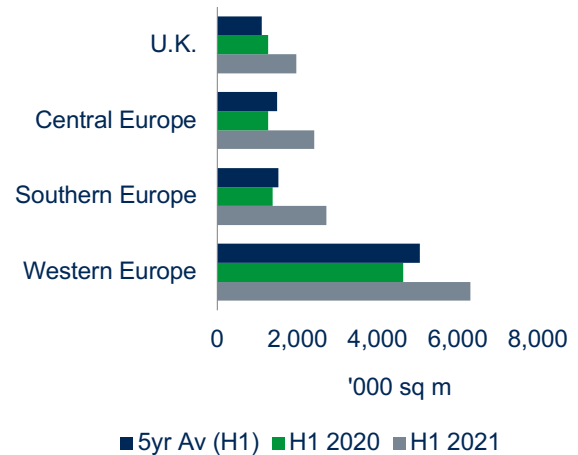
According to JLL, European logistics demand hit a record 14.8 million sq m in the first half of 2021, up over 50% on the same period last year. At a regional level, Western Europe lettings increased by over a third, while central and southern Europe doubled their take-up—albeit from a lower base. E-commerce accounted for almost 25% of lettings during the first half of 2021.

Availability remains low across Europe, with BNP Paribas noting that vacancy rates are below 5% in most key cities and hubs. JLL also reported that available supply (vacant space plus speculative development) equated to just one year or less of recent take-up levels.

According to JLL, European speculative development was running at just over 5 million sq m through mid-2021. This is around one third of the current total amount of logistics space under construction, with the balance being built-to-suit schemes. Suitable development sites remain a constraint on future development activity, especially in core logistics hubs where occupiers are increasingly having to look at alternative locations.

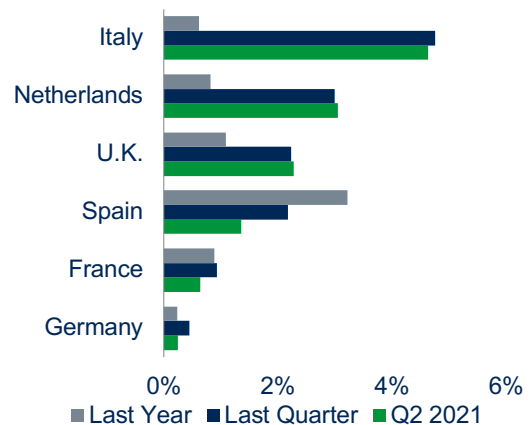
Prime logistics rents increased by 4.3% per annum through to the second quarter (up from 2% per annum a year ago). Rental growth is broad-based and occurring in most key markets, but strongest in Prague, Greater London, the larger German cities, and key Dutch hubs. Occupier markets, where there are both strong demand and a lack of development, will likely continue to place upward pressure on logistics rents for some time.

#### EUROPEAN LOGISTICS TAKE-UP



Source: JLL. As of August 2021.

#### EUROPEAN LOGISTICS SPECULATIVE DEVELOPMENT



Source: JLL. As of August 2021.



## Occupier Market

### ACCOMMODATION SECTOR

Average European house prices increased by 2% quarter-on-quarter in the second quarter, 7% per annum. At a country level, the strongest annual growth through the same period was experienced in Denmark (16%), Czech Republic (15%) and Germany (11%). More subdued conditions exist in Spain (3%) and Italy (0.4%).

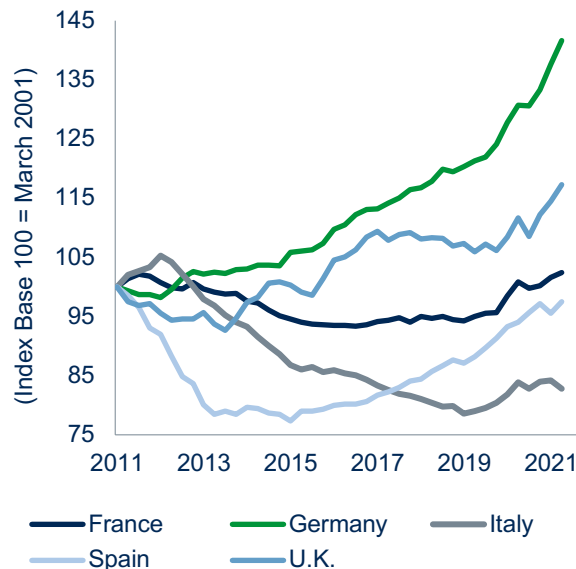
Surging pandemic house price growth reflects public sector support via labor furloughs, stamp duty and mortgage holidays, as well as ultra-loose monetary policy. Lockdowns have also meant a reappraisal of housing needs in terms of size and amenities, such as outdoor spaces. Near-term prospects for house prices are largely contingent on interest rates remaining low and labor market volatility remaining minimal.

Where the household formation rate has been strongest, prices have tended to rise faster than incomes over the past decade. This is reflected in rising house price-to-income-ratios, and a corresponding deterioration in buyer affordability of 30-40% in Germany and Sweden, and around 20% in the Netherlands and U.K. Where the local supply of good quality housing is lowest, affordability will be significantly more stretched than the national data.

Poor buyer affordability not only generates rising demand for rentals, but it is also sustained by increasing the average age of the typical first-time-buyer (FTB). Against a rental affordability threshold, set at roughly one-third of average household disposable income, the rent of a typical two-bedroom apartment in the Dutch cities and Madrid looks the most 'stretched' against incomes.

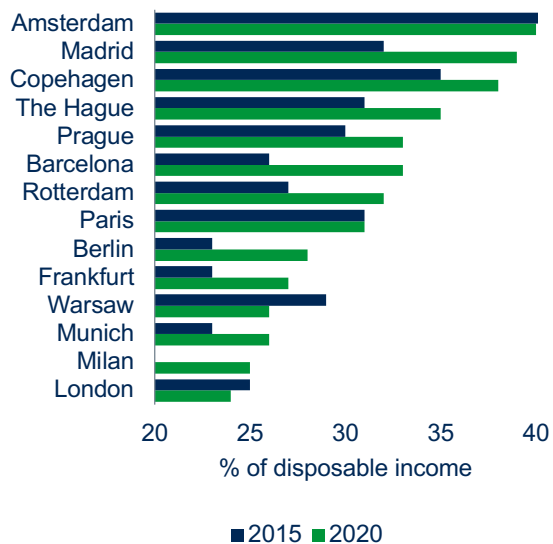
Partly a long-term consequence of WWII rebuilding, more than half of Europe's residential stock was built before 1970. The potential to extract an enhanced rental level for modern top quality residential accommodation thus exists. This premium will likely be easier to unlock where demographic growth is strongest, and in modern stock with a strong sustainability rating—in other words, where renewable energy sources reduce emissions, and sustainable materials such as laminated timber structural frames are used in construction.

### EUROPEAN HOUSE PRICE INCOME RATIO



Source: OECD. As of Q2 2021.

### EUROPEAN RESIDENTIAL RENTAL AFFORDABILITY



Source: Savills. As of September 2021.

## *About the Team*

Barings Real Estate's research team is structured by sector and geographic expertise, with efforts led by Philip Conner in the U.S. and Paul Stewart in Europe. The team has a diverse background covering various industries, asset classes and countries, which is complemented by an analytics function enhancing the team's ability to collect, augment and analyze data to inform better decision making.



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