European Real Estate

QUARTERLY RESEARCH

THIRD QUARTER 2020

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Executive Summary

ECONOMY

- While Q3 GDP rapidly rebounded, rising infections mean restrictions on activity are tightening again, pushing the economic recovery backward.
- Despite ultra-accommodative monetary and fiscal policy responses, the strength of COVID's impact on demand means prices and thus interest rate expectations should remain anchored for the foreseeable future.
- The IMF are now encouraging governments, which have access to capital markets, to ramp up public spending and support to limit permanent economic scarring.

PROPERTY MARKETS

- COVID has cyclically weakened all of the major real estate sectors but to varying degrees. Retail and hotels are most negatively impacted, whereas the logistics and residential sectors, where longer-term structural trends are more supportive, have been much less affected.
- Low rates are a huge support for core pricing, but only where the structural drivers (demographics and technology) are favorable.
- Investor and lender uncertainty is currently greatest around the outlook for offices. Reduced corporate office footprints look likely, but an occupier flight to quality will occur during the recovery—initially driven by fears and health and safety concerns, then to maximize productivity benefits, of the already in chronic short supply, top quality offices. This will be a significant opportunity for value add investors.

Economic Outlook

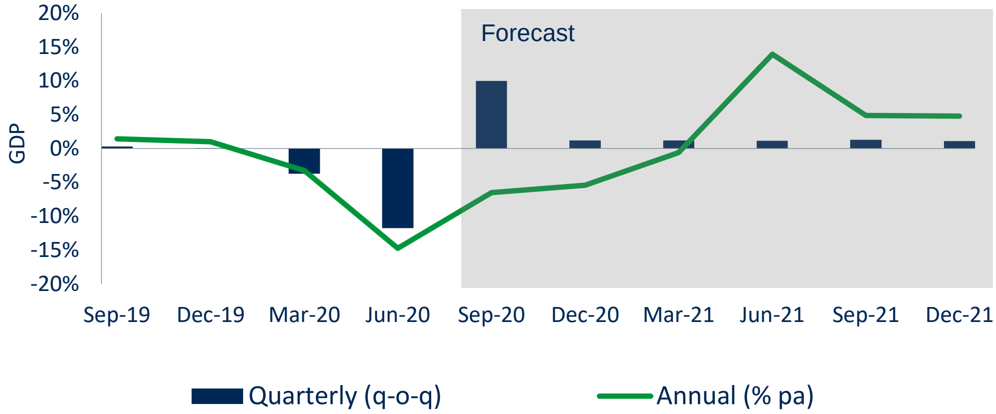
As medical scientists predicted during the initial stages of the outbreak, the virus is resurgent again this autumn. The initial optimism of a “V-shaped” recovery for the Western world has thus vanished. Governments will want to avoid the re-introduction of national lockdowns, but more stringent containment policies look inevitable, with infections rising once more—pushing back the eventual economic recovery.

A historically strong rise in Q3 GDP is forecast for the Eurozone (c.+10%), underpinned by favorable base effects and an initial surge in activity levels following the reopening of economies. Even before the most recent surge in infection rates, activity showed signs of losing steam—particularly the services sector, which has borne the brunt of mobility and social distancing restrictions. Following a very brief summer revival, September’s services PMI (Purchasing Managers’ Index) slipped below the +50 growth threshold to 48.0 (versus 50.5 in August). The manufacturing sector seems to be faring better, with the manufacturing PMI in September at 53.7 (versus 51.7 in August), the third consecutive month above 50. The favorable PMI print was welcome news, but is slightly at odds with industrial production data, which showed signs of slowing in August.

While Eurozone unemployment has been steadily rising month-on-month since April, in contrast to the U.S., European government job retention schemes have prevented a sharp rate spike so far. The pace that these policies are wound down over the coming months will dictate the degree of the increase in joblessness, and thus household incomes and the sustainability of the economic recovery.

Despite the European Central Bank’s ultra-accommodative monetary policy (which includes an enormous increase in the monetary base) and strong fiscal response from governments, inflation remains very weak (-0.3% in September). Given the strength of COVID’s impact, the shock to demand means prices are expected to remain anchored for the foreseeable future. Current ultra-low debt servicing costs mean the International Monetary Fund (IMF) are now encouraging governments, which have access to capital markets, to ramp up public spending. This temporary support of the private sector through the crisis is seen as vital to limiting any permanent economic scarring. If governments embrace IMF guidance, public sector debt ratios look set to surge. Fixed income investors’ focus will then shift to governments’ abilities to service public debt, rather than just its quantum.

FIGURE 1: EUROZONE ECONOMIC EXPANSION



Source: Oxford Economics. As of October 2020

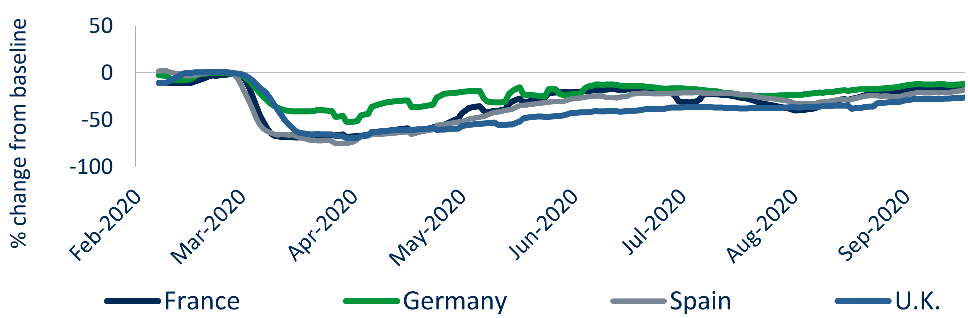
For 2020, Oxford Economics is forecasting a GDP decline of -7.5%, followed by an acceleration to +5.5% in 2021. Forecasts are subject to downward revision, and subject to the medical facts. The outlook for 2021 will be determined by the fiscal response of individual governments through the winter season. Ultimately, the pace and strength of the economic recovery is dependent on how quickly the world can get the virus under control and begin re-opening economies once again.

FIGURE 2: GDP COUNTRY FORECASTS (% PA)

	2019	2020	2021	2022	2023	2024	2020–2024
Eurozone	1.3%	-7.5%	5.5%	3.7%	2.2%	1.5%	1.0%
France	1.5%	-9.0%	6.9%	3.8%	2.9%	1.9%	1.1%
Germany	0.6%	-5.3%	4.8%	3.3%	1.5%	1.0%	1.0%
Italy	0.3%	-9.5%	5.9%	3.8%	1.6%	0.7%	0.3%
Spain	2.0%	-11.9%	6.4%	4.6%	3.3%	2.7%	0.8%
U.K.	1.5%	-7.9%	9.4%	4.5%	2.0%	1.7%	1.8%

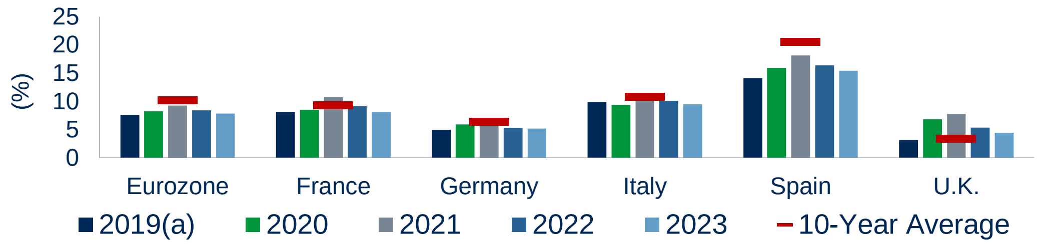
Source: Oxford Economics. As of October 2020.

FIGURE 3: WORKPLACE MOBILITY



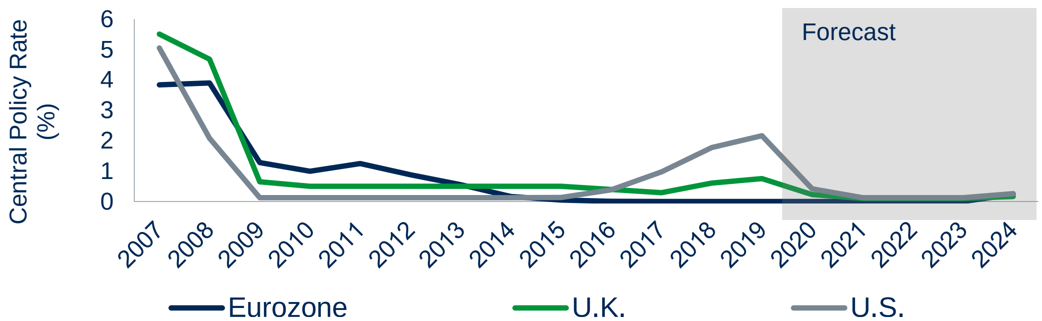
Source: Google Mobility Data. As of 9 October 2020. (N.B: 7-day moving average)

FIGURE 4: UNEMPLOYMENT PROJECTIONS



Source: Oxford Economics. As of October 2020.

FIGURE 5: INTEREST RATE OUTLOOK



Source: Oxford Economics. As of October 2020.

Capital Markets

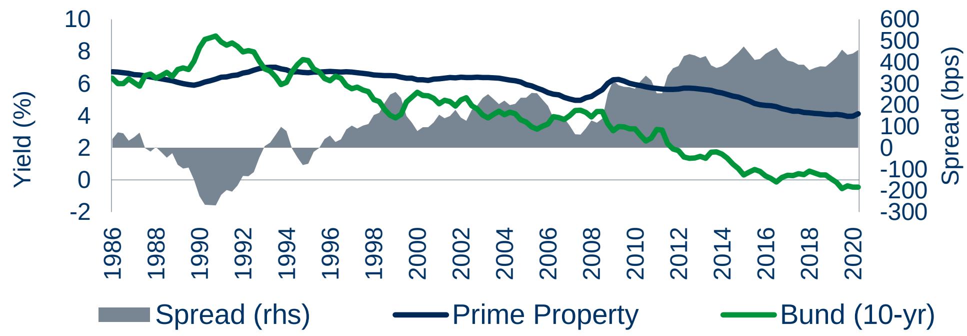
CBRE estimated Q3 2020 European real estate investment totalled €48 billion, down 37% in the same period a year ago. Over the nine month period to September, investment was down by only 11% (€183 billion), boosted by a record first quarter. CBRE further note, *"Some markets have performed better than others amid the pandemic, with volumes correlating strongly to the extent countries have kept the virus under control."* Nonetheless, liquidity will remain challenging, tempered by the deteriorating medical situation and tightening of a variety of restrictions.

Ultra-low interest rates will be a huge support for core real estate pricing. Where the structural drivers (demographics and technology) are still favorable, long-term asset appreciation is almost certain. This also explains why a highly divergent pricing outlook across the property sub-sectors has already emerged.

Retail, which was already in the midst of a deep structural decline, now faces accelerated price corrections. This decline will be pronounced in large lot size shopping centers, but marginal for the super resilient grocery sector. Despite huge uncertainty about the future role of the office, prime office yields have managed to remain broadly stable so far, while industrial yields continue to harden in many markets.

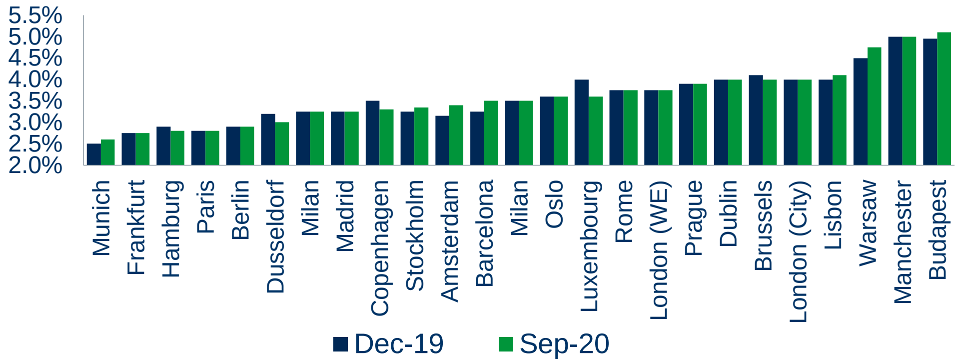
Commercial property lenders are becoming more conservative. Loan-to-value ratios (LTVs) could potentially fall below the 50% level this year. Timely Bank of England lending survey data shows commercial property debt availability has fallen markedly in the U.K., as banks are focusing on supporting other sectors of the economy and managing existing real estate relationships and loan books. This trend will most likely also become apparent across Europe as banks limit their exposure to the retail and hotel sectors, secondary quality assets/locations and new developments. The withdrawal by traditional lenders should create opportunities for alternative lenders to fill the gap.

FIGURE 6: PRIME EUROPEAN PROPERTY VS. RISK-FREE RATE



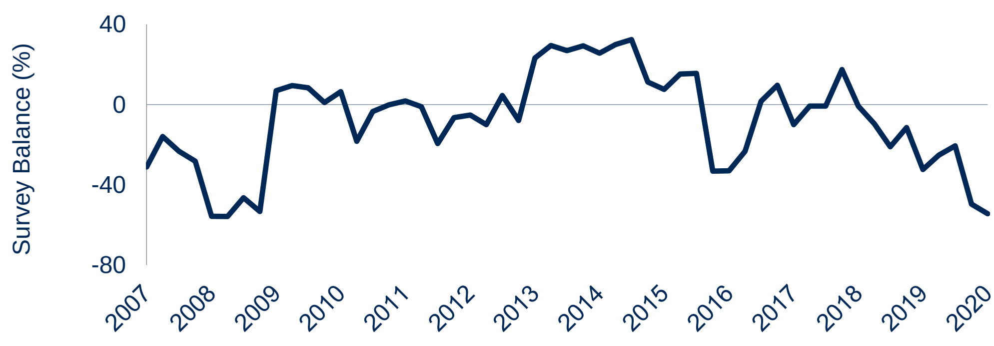
Sources: CBRE, Cushman & Wakefield, OECD. As of Q2 2020.

FIGURE 7: PRIME EUROPEAN CBD OFFICE YIELDS



Source: Cushman & Wakefield. As of Q3 2020.

FIGURE 8: U.K. CRE LENDING CONDITIONS



Source: Bank of England, Credit Conditions Survey. As of October 2020.

Occupier Market

OFFICES

Occupier demand was already softening last year, but the pandemic has accelerated this into a slump as take-up fell c.50% in Q2 compared to the same period a year ago. While vacancy saw a marginal uplift through June 2020, supply levels still remain very low and shortages of Grade A space are even more pronounced.

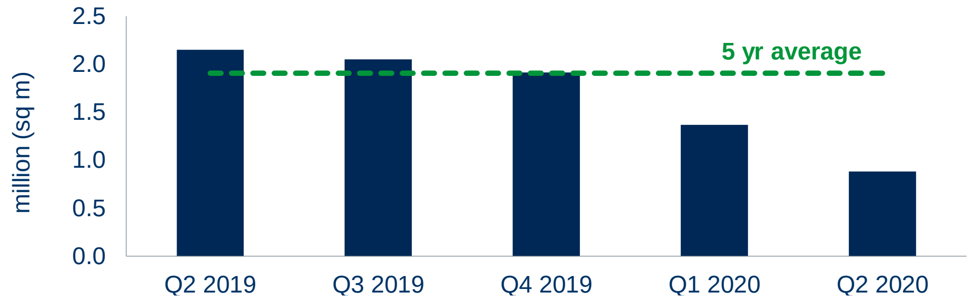
Vacancy is expected to increase, as occupiers delay non-urgent property decisions and the number of insolvencies inevitably rise as restrictions emerge once again this winter. We envisage sharper rises for secondary quality space, often occupied by weaker corporates, and a two tier rental market should rapidly develop.

The future of the office is currently heavily debated, but cities remain the pinnacle of human development—and to believe otherwise is to take a grim outlook for society. The agglomeration, knowledge sharing and social benefits will endure, and be more appreciated than ever as the virus impact inevitably fades. A highly specified office building in an amenity rich vibrant city center will remain a powerful weapon for building corporate culture, training and in the “war for young talent”.

Post pandemic “working-from-home” is almost certainly here to stay. Corporates are already reassessing footprints, but given that current lease commitments need to be unwound, that rent is a much smaller proportion of corporate operating costs than in the past, and with the unknown long-term productivity impact, space reductions could be less than some assume today. We envisage that future occupier demand will be reduced, but focused on the very best quality, fully flexible space. Further, initially based on virus fears and health and safety grounds, the legal requirements to de-densify will morph into a permanent need for more collaborative training and client meeting spaces in an effort to truly maximize “in-the-office-days” productivity. Central urban locations will also be more appreciated than ever, as the most convenient places to meet face-to-face in the future.

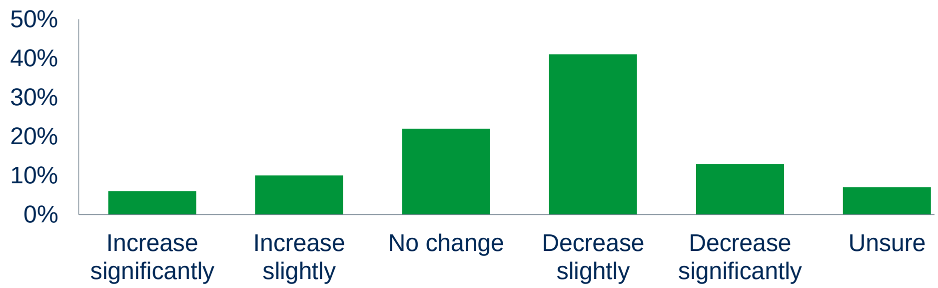
Following a lack of new development for much of the post Global Financial Crisis period, the best Grade A space is already in short supply across Europe’s capital cities. With occupier demand highly likely to focus on modern space during the recovery and developers and lenders freezing new construction, upward pressure on Grade A rents over the mid to longer term could be considerable. Perhaps paradoxically (to some), despite current anxieties about the investibility of the office sector, the widening rental and therefore yield gap between the best quality space and ‘the rest’ also implies that the best real estate return prospects will soon reside in “value-add” office projects.

FIGURE 9: EUROPEAN DEMAND (TAKE-UP)



Source: Cushman & Wakefield. As of Q2 2020.

FIGURE 10: FUTURE IMPORTANCE OF THE PHYSICAL OFFICE



*Assumes a stable environment.

Source: 2020 CBRE Global Occupier Sentiment Survey, The Future of the Office. As of June 2020.

RETAIL

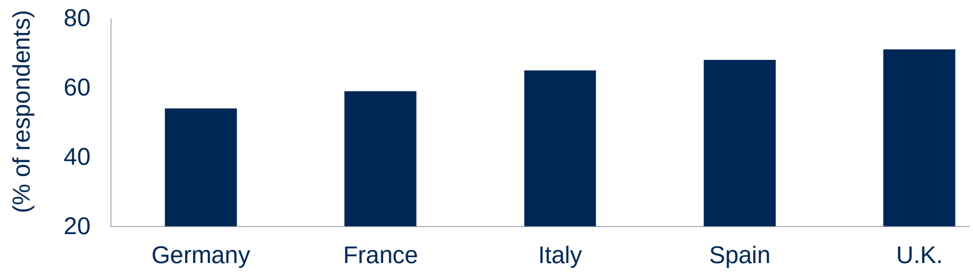
Retail has been heavily impacted by the pandemic, with forced store closures and social distancing measures discouraging physical store visits. Enclosed shopping centers have proven most vulnerable, with footfall generating amenities often closed (e.g. food courts, cinemas) and virus concerns deterring shoppers.

Retail sales volumes have improved from the lows seen in spring, but high street conditions still remain extremely challenging, with many retailers continuing to face cash-flow difficulties. While weak near-term low inflation and reduced commuting costs have propped up purchasing power, deteriorating labor market conditions and the tapering of fiscal support could derail the recovery.

Store vacancy rates will rise, as insolvencies increase depending on the national government, and surviving retailers will restructure store portfolios and offload surplus space. In time, some redundant out of town/edge of town retail warehouse schemes could suit repurposing as 'final mile' logistics sites.

Longer term, the acceleration of e-commerce adoption means retailers with robust omni-channel offerings will survive and prosper. Although not entirely immune to the march of automation and technology, there also seems to be considerable internet resilience in mass market food stores, where low margins and high online delivery costs still erode grocers' profits.

FIGURE 11: CUSTOMERS WHO TRIED NEW SHOPPING BEHAVIORS SINCE COVID



Source: McKinsey and Company, COVID-19 Consumer Pulse Survey data. As of July 2020.

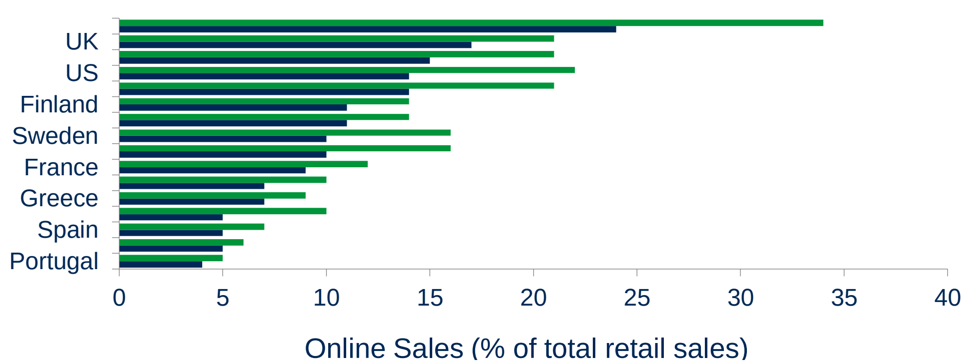
INDUSTRIAL

The European logistics sector has been one of the stronger performing sectors, with e-commerce expansion a key source of demand both before and during the pandemic. This sector is certainly not fully 'COVID immune', with a high exposure to beleaguered 'traditional' retailers and sharp GDP contractions negatively impacting the velocity of goods flowing through economies. Take-up data suggests a performance divergence, with big-box demand seeming more resilient than smaller multi-let space, where there are some tentative signs of occupier market weakness, probably via their higher exposure to small and medium-sized enterprises.

Supply pressures are intensifying, with strong demand for pre-lets and ready-to-occupy units reducing the already tight supply of new warehouses. Over the coming months, heightened competition for speculative space is anticipated, given c.70% of the 2020 development pipeline is pre-let or build-to-suit.

Industrial is expected to be a long-term pandemic beneficiary, with e-commerce growth projections suggesting sustained future logistics demand. Pandemic supply chain disruptions could also lead to increased inventory levels being stored closer to home, and perhaps even the reshoring of some production.

FIGURE 12: FORECAST E-COMMERCE GROWTH



Source: Euromonitor. As of July 2020.

RESIDENTIAL

The European housing market has continued to see capital appreciation this year, up 5% per annum or 1.2% quarter-on-quarter through June 2020. It is clearly unusual to see house prices rise during a recession. The explanation is largely due to a combination of rapid and massive accommodative monetary policy driving interest rates lower, job retention schemes limiting the rise in unemployment, other government support via transfer tax cuts, mortgage holidays and landlord eviction bans, and buyers' reappraisal of housing needs with mass working from home likely to persist in part.

With rising infections, which imply increasing activity restrictions, the wider economic recovery has been pushed back. That means the outlook for house prices over the next six months or so now depends on the degree of ongoing temporary government support. Nonetheless, the longer-term case for allocating to this sector relies on identifying markets where shortages of housing stock is endemic—a structural support that varies significantly at a local level across Europe.

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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