

Real Estate Outlook

Europe – Edition 4, 2020



Europe heads into the second wave



Subdued fundamentals persist as the second wave breaks around Europe.

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Europe remains in a somewhat gloomy situation despite strong 3Q GDP growth numbers. Occupier demand has been very subdued for all asset classes apart from logistics, while investment volumes have been down as investors struggle to visit assets and become more nervous about the market outlook. As a result, we are not expecting strong momentum going into 4Q causing most countries to have a weak 2020.

Real estate fundamentals – Underwhelming recovery thus far

The third quarter saw record GDP growth in most European countries as lockdowns eased and a majority of more normal life functions could resume over the summer. This led to a record increase in Eurozone GDP (+12.7% QoQ)¹. However, as this metric is usually measured on a quarterly basis, this says more about the dismal performance in 2Q20 than any real form of recovery. Following a peak to trough contraction of 15%, the Eurozone has still only recouped two thirds of the lost output.

Moreover, as autumn bites most countries have been struggling with resurgent case numbers and most major markets have introduced more restrictions over the last month. At the time of writing, France had just reimposed a nationwide lockdown, although there are more exemptions this time round. Most forecasters are expecting a gloomy winter as consumers have mostly exhausted their savings from the first lockdown and unemployment is expected to creep up, particularly in countries where work support schemes have expired.

In terms of real estate markets, the pandemic has radically reconfigured the nature of occupier demand. Offices had been benefitting from relatively low construction rates and robust demand, particularly for grade A floorplates. However, the pandemic has put most expansion plans on hold and led many to speculate that many companies will no longer need an office due to the now established practice of mass homeworking. Additionally, serviced office occupiers such as WeWork and IWG have seen significant falls in revenue as their customers have taken full advantage of the flexibility of the model and cancelled memberships. As a result, take-up has fallen by around 33% on a rolling annual basis while vacancy has begun to tick up in several major markets, most notably London which saw vacancy rise to 6.5% from a level of 3.9% at end-2019².

It is difficult to gauge the effect of this on the total market as most available data sources focus on prime assets only. These have been the most resilient throughout the crisis and have seen rents maintained despite a rumored increase in incentives. Availability of prime stock remains fairly low as well, with leasing levels remaining fairly robust. However, it is surely only a matter of time before we see rental falls. It is worth noting that Eurozone rents increased by 1.9% YoY but fell by -0.4% QoQ, indicating there has been a marked momentum shift.

There is also likely to be a divergence between prime and secondary assets. Companies will most likely still need a head office, but various back and middle offices can be surrendered and the employees either integrated into the head office or told to work from home. We expect this to put downward pressure on landlord's net operating income (NOI) in the next few years, and we have already observed instances of companies maintaining offices but significantly downsizing their footprint.

The retail sector is still struggling as the crisis continues. While certain categories of retail sales have benefitted – such as DIY and grocery – the overall reduction in mobility has still not been reversed as infections rise and governments reintroduce restriction measures. Store closures are increasing as a result of both administrations and reduction in the number of stores by viable retailers. Inditex for instance, the owner of Zara, announced the closure of 1,200 of its 7,200 stores around the world by the end of 2021. This will most severely impact the high street and shopping center markets. While on the other end of the spectrum, retail warehouses should be more defensive due to a lower exposure to shoes and apparel, sectors which have suffered the worst drop in sales over the lockdown period. As a result prime rents tumbled, falling by 4% in just one quarter.

This has put more pressure on retail landlords at a time when many were struggling with defending occupancy and rental tones. We have seen prime high street rents decline by around -9% YoY, with UK centers suffering more than continental Europe². London for instance, saw rents in the West End fall by around -25% YoY, as the impact of COVID-19 kept the summer tourist trade away, while other major UK cities saw comparable declines of around 25-30% YoY². A silver lining of the pandemic is that it is accelerating structural changes and forcing landlords to really start thinking about how to make the best of struggling retail assets. There has been a significant increase in change of use applications, with the most favored target sectors for converting retail premises to being last mile logistics, student accommodation and residential.

The industrial and logistics sector on the other hand has benefitted massively from the pandemic as e-commerce rates have surged and many companies have begun looking to repatriate various elements of their production. Take-up has risen strongly across Europe as demand has surged from a variety of occupiers. Amazon has been particularly acquisitive, having acquired over 600,000 sqm of warehouse space to date in the UK alone. On the back of this strong demand, there has been strong rental growth of around 2.5% YoY³ across the Eurozone with most forecasters expecting this positive momentum to continue despite the pandemic².

¹ Oxford Economics, 3Q20

² CBRE, 3Q20

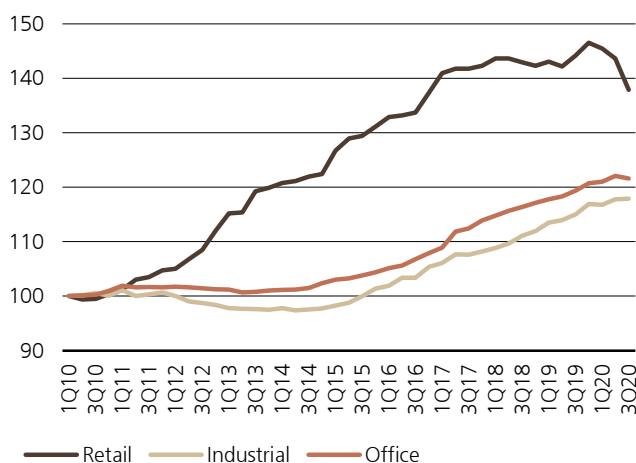
³ UBS Evidence Lab, 3Q20

An interesting growth area has been online grocery retail, which was previously a very niche area of e-commerce. Penetration rates in the US have increased from 7-8% pre-pandemic to 23% at the most recent reading. This is likely to be mirrored across Europe as consumers have grown to trust online grocery ordering, and occupiers are becoming increasingly innovative and data-driven in their solutions to meet the increased demand.

Added to this has been the rising emphasis on the concept of resilience following the disruption of the pandemic. While production centers in Asia have now largely returned to their former levels of functioning, the experience of COVID-19 has convinced many CEOs to emphasize de-risking their supply chains, even at the price of greater overhead costs.

As a result, we have seen rental growth for prime industrial assets of around 1.5% YoY, with vacancy remaining at very low levels in most centers (see Figure 1). This is most pronounced in the urban logistics segment, where there continues to be issues with unlocking land for development. Most operators are still reporting difficulties accessing warehouse space of sufficient quality in the right locations. However, we expect rental growth to remain moderate going forward due to the very modest profit margins of most companies in the logistics sector. This begs the question of whether fairly modest increases are enough to compensate on tenant risk arising due to the relatively bespoke nature of modern logistics warehouses.

Figure 1: Eurozone prime rental indices (1Q10 = 100)



Source: CBRE, 3Q20

Capital markets – Markets quiet but pricing largely firm

The pandemic has naturally put a strain on real estate capital markets as a combination of travel national restrictions, uncertainty about valuations and weaker economic fundamentals has caused many real estate investors to put their plans on hold. 3Q20 rolling annual volumes were down 43% at quarter end, while the YTD figures were down by around 20%. Of the main sectors, offices were down around 50%, retail around 40% (but from an already low level) and industrial down around 10%⁴.

A key feature of the market now is a shrinking investment universe. Many major commercial sectors have been severely impacted by the crisis, with the more niche sectors either remaining resilient or benefitting. Offices, for example, are by far the biggest and most liquid sector in most jurisdictions and currently there are serious doubts about how much and what type of office space companies will require in the future. Hotels have seen the most dramatic fall from grace, having been one of the favored alternatives pre-COVID-19. Investment in the sector is down roughly 70% YoY as the tourist industry remains in severe distress, with little hope of an immediate bounce back. Even retail had been attracting a few investors sniffing out countercyclical opportunities⁴. However, this interest evaporated following the lockdowns and requirements for most shops to close.

The sector which has benefitted on the other hand is logistics. This has been the clear winner due to even more rapid e-commerce growth than before the crisis. However, industrial does not make up more than 25% of the investment universe in any European market. This sector has seen rapid yield compression as investors have been focusing on a very small sample of assets, with yields now standing at 3.5-4% in the core Western European markets. We will discuss this sector more in our strategy viewpoint.

Similarly, investors have shown keen interest in the private-rented sector, though it remains a very niche market in most locations and as such assets have been trading at high valuations. Finally, food stores have seen pricing tighten as supermarkets have a much lower trading frequency than other types of retail assets. The fact that they have remained open during the pandemic has proved attractive to investors.

⁴ RCA, 3Q20

What has emerged is a discrepancy between volumes and pricing (see Figure 2). There has been little evidence of yields moving out for core office assets, while logistics has compressed even further and retail nudged out only slightly (+10bps). This has likely led to the mismatch between buyers' and sellers' expectations, which is likely to further restrict deal flow. This does of course vary by sector; most major logistics markets saw prime yield compression of 10-25bps over the quarter and even more compression seen on an annual basis. Meanwhile, multiple retail markets saw outward movement of 25-50bps.

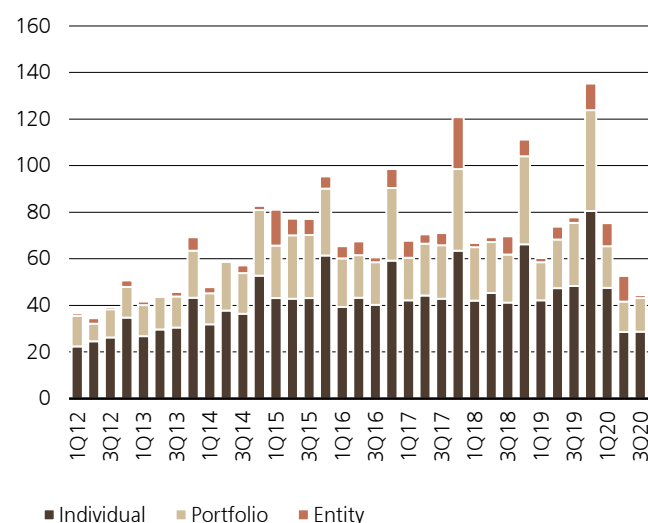
Offices remain one of the most gripping sectors, with the majority of prime yields remaining stable and some even compressing further QoQ. This is in spite of mounting evidence of very weak net absorption and rising tenant incentives, which indicate rental falls must surely follow.

The only market to see outward movement was Liverpool in the UK (hardly a big market), while several other markets such as Milan and Luxembourg City actually saw yields compress further. There is an argument that these are prime yields being quoted and there has certainly been far more resilient demand for grade-A office stock (both in occupier and capital markets) during the pandemic. However, we would expect even the more resilient assets to take a hit eventually, particularly if economic activity does not recover in 4Q20.

Another interesting feature of the market has been the growing tendency of operators to engage in sale and leaseback transactions. Amazon has long been a pioneer of this approach through developing bespoke warehouses, bringing them to market with a rentalized mezzanine floor and as a result achieving a higher price than is standard. Retailers have begun doing this in earnest as well, particularly with respect to their warehouse network. This has provided these operators with more liquidity as activity has fallen, while giving investors access to more sought-after assets. As a result, sale and leaseback transactions have risen from 7% of the market in 2015 to 13% in 2020. We have previously forecast this would happen over the medium-term, however, COVID-19 appears to have brought this process forward.

The outlook for the investment market is highly uncertain but appears to be propped up by excess liquidity. Fundraising has fallen back and there is still a significant amount of dry powder targeting commercial real estate. Added to this, the ECB has provided stronger than expected support to the market in the form of an additional EUR 300 billion in its pandemic emergency purchase programme (PEPP). This is likely to sustain the low real returns of sovereign and high-quality corporate bonds at least until end-2021. While this form of policy measure will not save investors from deteriorating fundamentals forever, it certainly provides valuable time to ride out the worst of the pandemic's impact.

Figure 2: European investment volumes (EUR billion)



Source: RCA, 3Q20

Strategy viewpoint – Logistics: from flavor of the month to the only game in town

A very well-known story over the past decade has been the transformation of the logistics sector from its perception as a grubby, uninteresting sector to being the apple of investors' eyes. The Amazon effect and all the other associated drivers have been discussed ad nauseam and matched with eye-watering amounts of capital.

Just before the pandemic broke, we were starting to take the view that logistics was becoming too highly priced, particularly in the core Northern markets of the UK, Germany, Netherlands and most recently France. This view has now shifted again. Despite appearing to be nearing the end of its bull run, the pandemic has injected yet more vigor into the golden sector. If you include deals in contract, investment volumes for the first 10 months of the year are almost equivalent to those in the same period in the previous years, a stellar performance considering the malaise hanging over the general market (see Figure 3). Volumes have moderated by just 2%, compared with market-wide declines of 30-70%.

As discussed above, this has come at a price; it is now barely possible to find a yield above 5% for a sector which has traditionally had a high-income return. Indeed, such is the ferocity of bidding processes where very often assets brought to market are selling at higher than the initially quoted yield.

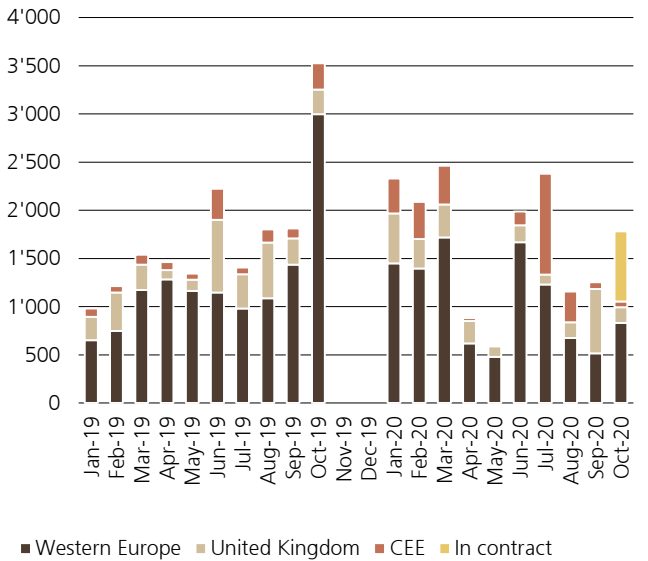
The obvious question here is: *Are investors overpaying?* On the one hand, there are good reasons for this re-surge in pricing. In 2020, e-commerce growth rates reached levels not previously expected until around 2030. The growth has been broad-based, however, niche sectors such as online grocery retail have seen volumes more than double. This has led to record high levels of take-up as online retailers and the supporting third-party logistics (3PL) companies clamor to secure enough space. The constant recurring theme we have heard from agents, investors and academic commentators alike, is that there is not enough logistics space. This appears to be reflected in the investment market as well, as sales of development sites have been very high in 2020, most of it aimed at logistics. In addition to this, there have been various schemes to repurpose retail warehousing and shopping sites to provide last mile logistics facilities.

Added to this is the theme of nearshoring. This has been on investors' radars for a while but has really come to the fore following the experiences during the pandemic. Increasingly, de-risking of operations and full end-to-end visibility have been pushed up the agenda at the expense of cost control. In a recent McKinsey survey, 43% of directors said they would actually trade higher costs for greater resilience. This could drive further demand for warehouse stock within Europe.

However, there are risks for investing into the sector at such low yields. Logistics operators have seen a decline in gross profit margins over the past five years, despite rising revenues from e-commerce (see Figure 3). This is due to various factors, most notably a shortage of drivers, rising construction costs and the far greater granularity of e-commerce distribution. Added to this, many traditional logistics operators have exposure to operational industries affected by the pandemic and as such there have been instances of rental non-payment among certain tenants.

Whatever your view, the key to understanding a logistics real estate investment at these prices is thinking hard about how future-proofed the asset and the location are. If you are buying at sub-5% it will take more than 20 years to recoup the investment (assuming flat rents and capital values). As many of these mega sheds are typically quite bespoke and single let, this provides a real risk that investors need to become comfortable with. Good understanding of the local market and careful underwriting of the tenant covenant are key to delivering positive outcomes for clients in this sector.

Figure 3: Logistics investment volumes (EUR million)



Source: RCA, 3Q20

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