

Real Estate Outlook

Europe – Edition 2, 2022



Cost pressures warming up.



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European outlook

Balance of negotiating power is key.



For many years, the main argument in defense of ever-lower property yields was that the spread over fixed income yields remained comfortably above historic levels. This is no longer the case, with the spread between government bond yields and prime office yields now below their long-term average in every major market. We expect performance to become polarized between the select few sectors and micro-locations where there is a genuine supply-demand imbalance and landlords can pass on some of the inflationary pressure to tenants. For the rest of the market, the record low property yields now look exposed to rising rates.

Market overview and outlook

Relative value of real estate rapidly eroding.

Economy

As inflation continues to exceed expectations, hitting 7.5% in the eurozone in April and 9% in the UK, the outlook for economic growth has weakened. Under the base case scenario, we are still not in recessionary territory although the risks of a persistent war in Ukraine driving a stagflationary scenario have risen over the last three months. Central banks are treading a precarious path in attempting to ease demand without contributing to a recession. Base effects mean that if wholesale energy prices stabilize or start to fall back, this will have a neutral or negative contribution to the consumer price index in twelve months' time. This would provide a major contribution to bringing inflation back down to target levels. But the biggest concern is that higher wage settlements agreed in 2022, in-light of the current levels of energy-driven inflation, is resulting in second-round inflation effects. This could push high inflation well into 2023.

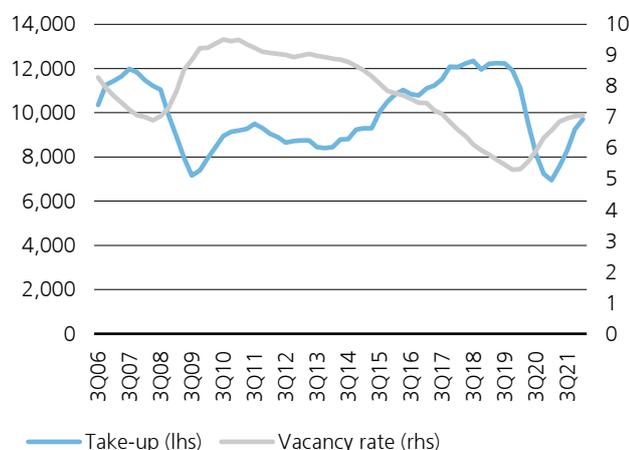
Although the full picture is not yet available, there have been some early signs of higher inflation feeding through into higher wages. In response to this, UBS IB is now forecasting a further two hikes from the Bank of England to bring the base rate to 1.5% by the end of 2022. The ECB is expected to end its asset purchase program in July and hike rates three times in 2022, followed by four further hikes in 2023 to bring the base rate to 1.25% by year-end.

Occupier markets

With the pandemic starting to fade, we appear to be seeing a leveling off in the office supply and demand data (see Figure 1). The vacancy rate continues to edge up, but now at a very marginal rate. And the level of take-up continues to improve on activity recorded during the pandemic, but remains 15-20% below pre-pandemic levels for the first quarter. Demand at these levels would be consistent with calculations for occupiers assessing their real estate requirements for a hybrid working environment, resulting in a net loss of demand for office space. It is too early to see any impact of the Ukraine war on the data, although with weakening business sentiment and heightened uncertainty we may see some occupiers delaying requirements in 2Q22.

Prime retail markets were again largely stable in 1Q22, with just a couple of UK regional markets reporting negative rental movements. With a slimmed down network, the outlook for in-store retail in 2022 was actually reasonably positive, particularly at the prime-end of the market with overseas tourism set to resume. But the squeeze on disposable incomes is likely to delay any recovery in rents that may have come through. Logistics rents continued to increase, but there are now clear signs of pressure building on the occupier side, particularly for high energy consumers. Key logistics occupiers have seen sharp declines in their share prices, as future growth assumptions now look too optimistic against the challenging backdrop.

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



Source: JLL, 2Q22

Capital markets

Despite the headwinds, investor demand for European real estate continued to strengthen, with data from RCA showing a record level of transactions for the first quarter of the year at EUR 71.4 billion. Based on the valuation data, real estate returns are looking very attractive in a multi-asset portfolio as liquid markets have corrected. With large volumes of capital already earmarked for European real estate, it is unlikely we will see this correction filtering through to the market in the next six months. But it's difficult to see how in an environment of weakening economic growth, cost-push inflation, rising interest rates, geopolitical uncertainties and higher debt costs, yields will be able to maintain their record low levels for the foreseeable future. Higher inflationary costs are only going to be transferrable to tenants in the markets and sectors where supply is tight, elsewhere the record low real estate yields are starting to look exposed.

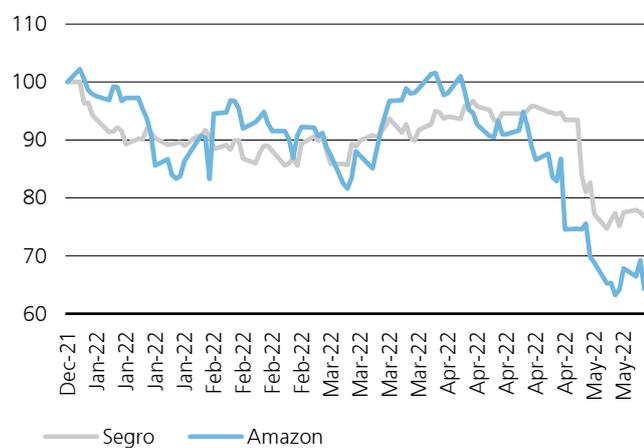
Strategy viewpoint

Has the logistics market overheated?

Early warning signs

On 28 April, Amazon announced its first quarterly loss since 2015 with a warning that it had over-leased and over-hired during the pandemic triggering a sharp correction in its share price. Soon after, the share price of Segro and other industrial focused REITs followed a similar decline (see Figure 2).

Figure 2: Equity prices indexed to 31 Dec 2021



Source: Refinitiv Eikon Datastream, 19 May 2022

There seemed to be a strange misconception within some real estate circles that the logistics sector was bulletproof after several years of huge outperformance. But the reality is that logistics occupiers in Europe are facing the same, and in some cases stronger, headwinds than other sectors due to the rise in energy costs and the squeeze in consumer spending. Add to that higher interest rates and an economy rebalancing from consumer spending on durable goods (that can be delivered), to services (which cannot) and you can start to get quite concerned about the health of the occupational market.

The counterargument

Since the correction in the listed market, some commentators (usually employed by companies with a vested interest in the logistics sector), have sought to quash concerns of a spillover into the direct market. The gist of the argument goes, that the logistics market was so hot that a company like Amazon pulling back will make very little difference. And as Amazon was far more aggressive in its expansion than other logistics occupiers, the rest of the market is still playing catch-up. Against a backdrop of low supply, they expect the market to still see plenty of rental growth and there's no need to worry.

Reality

However, there are some quite significant flaws to this argument. The biggest being that logistics real estate was priced based on extremely strong occupier demand continuing into the future. Even if we accept that demand will stay strong, albeit slightly weaker than anticipated, then slightly weaker demand will feed into slightly weaker rental growth. With prime yields dropping below 4% across all major Western European markets, if you're not getting stellar rental growth off these yields you've overpaid. And taking Amazon aside, the assumption that demand will remain strong is also questionable. As noted before, there are many cost-pressured logistics operators across Europe that have been affected, and some of the pure-play e-commerce companies had been operating on wafer thin profit margins even during the pandemic. The idea that these companies are still going to be aggressively acquiring more logistics space against the current economic backdrop seems optimistic at best.

And lastly, the supply-side argument has been oversimplified. What is correct, is that for the past several years demand has significantly outweighed new supply coming through which has driven strong rental growth. And vacancy rates are still generally still very low. But construction has been increasing year-on-year to try and keep up with demand, and based on key market data from PMA there was nearly 19 million square meters completed in 2021, a 25% increase on the previous year. During the COVID-19 impacted years, the vast majority of new supply was

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