

# Real Estate Outlook

Europe – Edition 3, 2020



Europe feeling the effects of COVID-19.



European real estate is struggling right now but **the outlook for 2021 is brighter.**

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The first estimate of GDP data confirmed that Europe has been plunged into a deep recession as a result of the COVID-19 virus. While occupier markets have remained somewhat resilient, investment activity has been impacted, particularly in less sought after sectors. Overall, we expect negative performance in 2020, with a recovery from 2021 onwards, although this is likely to vary by sector and geography.

# Real estate fundamentals

## – The eye of the storm

At the time of writing the 1Q20 outlook there was still some uncertainty about the impact of COVID-19 but the second quarter really saw the storm break over Europe. There are now over 700,000 deaths globally, with European countries UK, Italy and Spain seeing particularly adverse effects. These last three months have seen the most drastic state intervention in the economy since the Second World War, as most European countries initiated near-comprehensive lockdowns to try and contain the spread of the virus. As a result, government spending has increased drastically as most have been required to supplement the income of workers and provide a crutch for businesses.

Nevertheless, the intervention was not enough to prevent Europe from entering a deep recession in the second quarter. The 12% QoQ fall in eurozone GDP was by far its worst quarter since inception and in one fell swoop set GDP levels back to the mid-2000s. By sector, the pain was felt mostly in the industries directly affected by lockdown, namely trade, transport, accommodation and dining, which fell by around 40% QoQ. However, industries which are better positioned to allow homeworking fared better, with financial and insurance output growing 3.4% QoQ<sup>1</sup>

The recovery going forward depends very much on the success of efforts to contain the virus and the level of certainty that can be provided to consumers. Most countries have come out of quarantine but remain in a cat and mouse game where localized lockdowns are being applied at the discretion of local health officials. This means the expected mechanical snap back in growth may be more intermittent and patchy than many assume, although this should be the nadir of the COVID-19 crisis. However, on balance we are anticipating the core European countries to have a slower recovery when compared with the global outlook (see Figure 1).

Taking Oxford Economics's forecast as our base case, we expect some of the losses to be made up in 2H20. This amounts to an annual GDP decline of around 7.9% for 2020 with growth recovering to 6.1% in 2021, though this varies by country and sector. We are also expecting all property rental decline of -3.7% in 2020, followed by a flat year in 2021. However, like the economy this will vary by sector as the virus has exacerbated pre-existing issues.

Turning to the office sector first, there has been a marked decline in office take-up as occupiers have looked to reappraise deals in light of the market uncertainty (see Figure 2). However, there have not been increased surrenders of active leases, which has resulted in just a marginal uptick in vacancy.

This has meant that for the time being there have been very few centers where we have observed rental declines, with the exception of London, where rents fell in both the West End and City markets as Brexit uncertainty continued to weigh on demand. Paris, on the other hand actually managed to see rental growth of around 2.2% QoQ, possibly related to companies wanting a European rather than a London base.

However, the office sector is facing a further headwind as apart from the cyclical issues of falling occupier demand there is a further secular trend of an acceleration of the switch to home working. This throws into doubt the willingness of even successful companies to expand their footprint after the virus has been and gone. Several high profile companies – most notably Twitter – have announced that they will give their staff the option of working from home full-time going forward.

That being said, we do still expect there to be demand for well-located high quality office space, although offices which are largely functional in nature may see demand dry up. However, high frequency indicators show that employees have been returning to work in locations where the government is perceived to be effectively containing the virus. On the supply side, there has been a slowdown in construction activity in most European centers, which is likely at least to ensure that there will not be a supply shock.

The retail sector was experiencing unprecedented challenges even before the onset of the pandemic, and has since been further hit by the decision to close shops in many European countries. The majority of retailers rely on their stores for the lion's share of trading, despite the growth of online. It is noteworthy that even retailers considered strong performers in their sectors have announced store closures, such as John Lewis in the UK. Going forward, we expect further rental declines across Europe.

Further to this, the high levels of non-rental payment during the pandemic have already prompted several large landlords to offer rents on a turnover basis, such as Hammerson and Legal and General in the UK. This is a trend that was observable pre-COVID-19 and we feel that following the pandemic risk sharing on the part of retail landlords will become much more commonplace. While this makes sense from a fairness perspective, it raises many difficult questions about how retail property should be valued, particularly as it forms an integral part of many managed funds.

There has been resilient demand from foodstores and DIY traders, both of which saw an increase in trading during lockdown as consumers were confined to their homes. However, the next few years will be tough for the vast majority of retailers and their landlords. We are forecasting negative rental growth in 2020 and 2021 of -5% p.a.. The plus side for retail is that supply moving online has reached an all-time low. In fact, landlords in many locations have started to explore conversions to alternative uses.

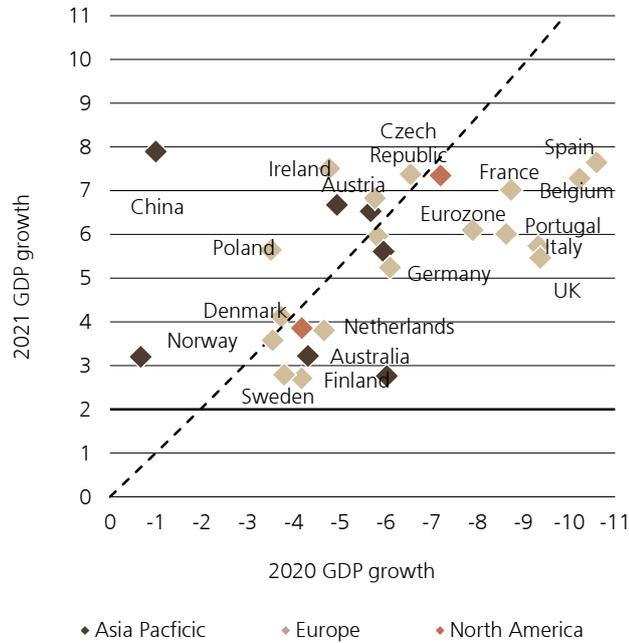
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<sup>1</sup> Oxford Economics, July 2020

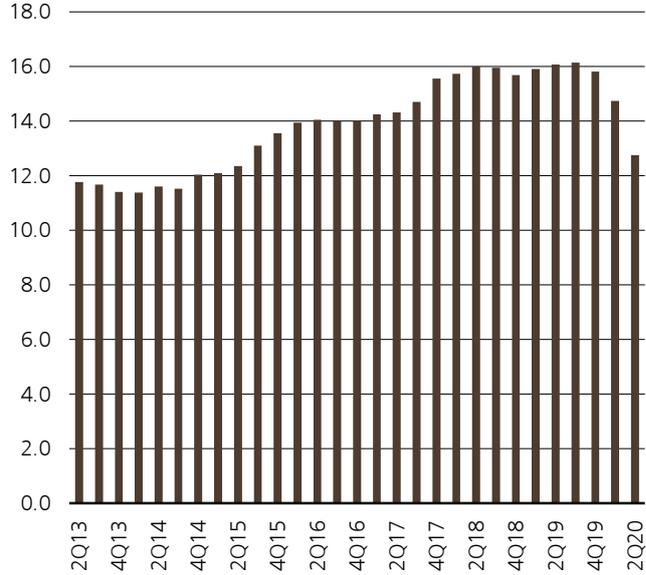
The industrial and logistics sector has seen a renewal in demand since the COVID-19 pandemic as consumers have shifted to online shopping, especially in the online grocery space. According to ONS data, a third of UK transactions are now completed online, while food purchases have doubled. It has been a busy first half of the year in terms of existing online retailers looking to boost their capacity, and supermarkets and other retailers ensuring they have sufficient warehouse space to preserve their market share. The fact that Amazon's share price has increased 70% since the start of the year illustrates this point well.

However, the industrial sector is not immune to COVID-19. While it is likely to be one of the 'beneficiaries' of the pandemic, there are certain downside risks investors need to bear in mind. The majority of its tenants are still more traditional operators servicing the 'real' economy, i.e. sectors such as construction, production and aviation. Additionally, many of these operators are small and medium-size enterprises that run on thin margins and tend to have low capital reserves. Such occupiers have struggled during quarantine, with some unable to pay rents on time. As a result, we are anticipating eurozone industrial rents to fall by around -2% in 2020, before returning to growth from 2021 onwards.

**Figure 1: GDP growth (%)**



**Figure 2: Pan-European office take-up**  
(rolling annual, million sqm)



Source: Oxford Economics; UBS Investment Bank, 2Q20

Source: JLL, 2Q20

## Capital markets – European markets in a static phase

The second quarter of 2020 has been a slow one as buyers and sellers have been holding back in the face of uncertainty and the restrictions on travel and social distancing have been preventing the necessary due diligence required to progress deals. Nevertheless, Europe has fared better than the rest of the world, with volumes down around 32% compared with the same time last year (see Figure 3), which contrasts to nearly 50% globally. Indeed, 1H20 was only down by around 9% when compared with the same six-month period the previous year.

However, these headline numbers mask the weakness in the market. The numbers were bolstered by some very large entity deals which do not tend to feature often; entity volumes were up over 200% HoH, driven by IQ's student accommodation portfolio in the UK (EUR 5.3 billion), URW's disposition of a 50% stake in six shopping centers (EUR 1.1 billion) and German residential landlord ADO's acquisition of its rival, Adler Real Estate (EUR 5 billion). This shows the continued popularity of the student accommodation and residential sectors with investors, but when you look at the numbers in terms of deal count the decline was much steeper at around 46%.<sup>2</sup>

There is a greater number of more 'normal' commercial property transactions in the EUR 5-50 million mark where volumes declined by more than 50% (see Figure 3). The quiet nature of this market segment is of particular concern as it is generally these deals which account for a larger share of transactions and as such provide more sustainable liquidity to the market than one-off 'mega deals'.

However, there were some bright spots. Germany managed to actually see a slight increase in volumes YoY. While some of this is explained by large platform deals, the resilience of domestic investment was important too. Around 85% of deals were done by German institutions in 2Q20, which is highly significant as cross-border capital flows declined substantially. Going forward, we would expect markets which are less dependent on international investors and have a solid investor base to prove more defensive on pricing. This is a concern for more 'peripheral' markets where much of the capital flows from overseas; examples of these more at risk markets are Warsaw, Lisbon and Helsinki where more than 80% of capital flow comes from overseas sources.<sup>3</sup>

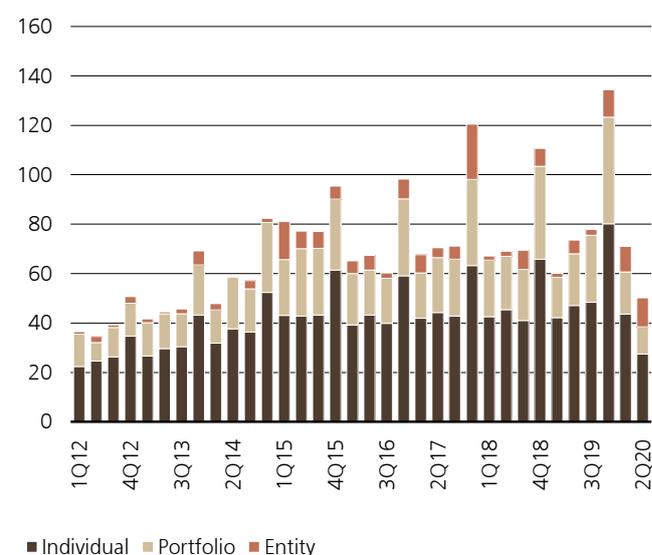
The other bright spot was Denmark, which saw a 110% increase on the same quarter the previous year. Scandinavian countries were generally more defensive, which was no doubt due to their 'light touch' approach to quarantine and operational continuity in the early quarter months.

Overall there is evidence that investors are adopting a 'wait and see' approach to the market. Forward sales have increased significantly over the quarter, many of which involve some kind of development or major value-add component. This indicates investors are taking the view that the COVID-19 disruption should not prove to be long-term and thus taking on projects with J-curve return profiles is proving more attractive.

Disagreements over pricing levels are also playing a role, as many markets and sectors still have situations where valuation houses are evoking a 'material uncertainty' clause. This has meant there is very little basis for negotiations, which has caused a growing disparity between buyer and seller expectations. This reflects the market uncertainty relating to COVID-19 and disagreements over what (if any) discount should be applied. There are signs that yields are starting to move out, however, a good example is Amsterdam where yields moved in 10 basis points YoY, but out 10 basis points QoQ<sup>4</sup>.

The direction the market takes in the third quarter will be interesting to observe. A recent PERE survey showed that 70% of raised capital in 2Q20 was opportunistic. There has also been an uptick in distressed debt strategies, as CMBS default rates have been climbing, evoking memories of the global financial crisis. However, with central banks remaining committed to supporting markets with ultra-low interest rates such investors may end up being disappointed.

**Figure 3: Investment volumes** (EUR, billion)



Source: RCA, 2Q20

<sup>2</sup> RCA, August 2020

<sup>3</sup> Ibid

<sup>4</sup> Ibid

## Strategy viewpoint – Office markets and the pandemic

### **What impact do we see from COVID-19?**

We do not envisage a world anytime soon where a significant proportion of office-based work is done fully remotely. Many of the recent statements by CEOs on the future of the office are largely overdone in this regard, although we do acknowledge that COVID-19 is likely to act as an accelerator of some trends.

### **Changing focus of office space**

In general terms, most office-based businesses have been able to achieve a reasonable level of business continuity through home working. What is far more challenging however, is implementing any new initiatives to grow businesses, without being able to meet either colleagues or clients in person. The post-COVID-19 office is going to become increasingly focused towards supporting the latter. In essence, if day-to-day functional desk based work can be done remotely, making a journey into an office needs to add value. So the focus of the space provided will need to shift away from physical workspace, and more towards interactive and collaborative spaces, meeting rooms and company branding.

This will accelerate the polarization to better quality buildings which have value-add attributes. The attraction of leasing bland and functional desk-based office units will have a decreasing relevance going forward. And although we are uncertain on the future direction of the virus, we expect that even if a vaccine or treatment is found, the memory of the pandemic will maintain a focus on wellbeing features.

### **Central locations will be more defensive**

On a similar theme, we expect that office locations which offer very limited value-add will struggle to maintain occupancy. Again it is the issue that functional office locations, typically business parks or weaker secondary city locations, will offer very little to enhance the experience of coming into the office. Without that added value, in terms of both amenities but also proximity to other companies and clients, the value of the workspace element of the office building will diminish.

It is not just proximity to amenities and clients that we think will polarize performance between central and suburban office space. The expected increase in flexible working could actually have more profound impacts on the residential market, particularly in the larger European cities. The length of commute which an employee may be prepared to make if they are only required to be in the office on a few days of the week, rather than five, could increase significantly.

So the radius that employees live away from the city center should increase over time. But the office needs to remain accessible for the days which staff do commute into the office. Essentially this means being located close to the main central public transport hubs to enable the office to be accessible from the widest commutable locations. This gives the company the largest pool of talent to recruit from, and higher rates of retention. The challenge of non-central suburban locations is that whilst they are extremely convenient for staff living in that part of the city, it is the opposite for employees living elsewhere, and limits the capacity for further decentralized living to make the most of less frequent trips into the office.

### **Could offices become the new retail?**

In our view, no. Office buildings have proved to be far more adaptable to changing demand trends in the past than retail. When office markets become structurally oversupplied, conversion to alternative uses is often viable, particularly in undersupplied residential markets, which most major European cities are. Much of the oversupply built during the dot com boom was never fully utilized as office space, but has since been converted into alternative uses.

Even with rents falling, retail floorspace remains by some distance the highest capital value real estate. And this makes conversion of large scale retail parks and shopping centers economically unviable in the vast majority of situations. As e-commerce has eroded the volume of floorspace required, the oversupply has built up and it is going to be much harder for that structural vacancy to come down.

So even if we are too bullish on future office occupancy trends, and the growth in working from home accelerates a decline in net absorption of office space faster than we anticipate, with a city center strategy we remain comfortable as the residual land value of office buildings gives us a strong degree of assurance as we enter an uncertain environment.

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