

Real Estate Outlook

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COVID-19 weighing on Europe.



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2020 will be a challenging year for European markets as lockdowns and travel restrictions weigh on activity.



The eruption of the COVID-19 pandemic at the end of 2019 has brought about an unprecedented disruption to our daily activities. The virus began in China but quickly moved to Europe and, at time of writing, all major European countries are under lockdown – leading to an unprecedented restriction on our activities and a demonstration of the powers wielded by governments. From a market and economic perspective, this has effectively suspended most business and commercial activities, meaning 2020 will make grim reading. The only relevant question now is how soon can we bounce back?

Real estate fundamentals – A strange new world of uncertainty

Just as with cycles, all economic shocks are different, although most tend to be based on imbalances in either supply or demand. Those which are especially damaging see supply and demand shocks at the same time. The COVID-19 pandemic falls into the latter category as consumers are forced to stay at home while companies are prevented from producing and trading goods.

Needless to say the eurozone has gone into recession, with a decline in GDP of around 5% expected in 2020. This will not be an even correction, rather a sharp downward drop in the first half of the year followed by a recovery towards the end of the year (but not sufficient to make up the losses in 1H). This forecast is consistent with 1Q data, which indicated that the eurozone contracted by 3.8%, with France, Spain and Italy underperforming, and Germany and the Benelux countries proving more resilient.

Sectors of the economy particularly hard hit are the retail and hospitality industries, which will see their revenues fall almost entirely to zero. Manufacturing is also suffering as demand for products flat lines and global supply chains fracture. More defensive sectors will be those focused on the provision of essential goods and services, such as groceries, household goods and pharmaceuticals.

Governments have responded to this crisis on an unprecedented scale. Monetary policy has been relaxed further with, the Bank of England cutting the base rate to around zero and announcing new quantitative easing. The ECB also announced additional quantitative easing and other measures, and is keen to prevent the cost of capital rising for governments, particularly in southern Europe.

However, monetary policy only serves to correct imbalances in the economy; it is fiscal policy that must drive aggregate demand. To this end, many governments have pledged unprecedented support both for loans to businesses, wage subsidy programs for those in work and increased support for those having lost jobs. However, the initial response mirrors the north/south divide, with northern European countries proving far more generous than those in the south (see Figure 1). This raises concerns that the economic recovery will be uneven and not only widen the material gap between the two blocs, but also further add to the growing political tension between EU member states.

Property market data typically lags by at least 4-6 weeks, so most of the data we have currently is largely of historical interest. Take-up of office space had been reasonably strong, with rental growth remaining positive across most markets, despite signs of a slowdown. Indeed, annual rental growth for pan-European prime office rents was around 3%, but quarterly growth was largely flat (see Figure 2).

Since the crisis, most deals have been put on hold, with particular concern about the serviced office sector (as the model assumes long-term liabilities matched against short-term revenues). Up to now most occupiers have remained buoyant; however, although we maintain this is a sector that could be more impacted as the second quarter progresses.

Overall we see the outlook as being very weak in the short term, with a recovery following the initial correction. Positively for landlords, most European office markets are under-supplied and are likely to become even more so as construction halts during the lockdown. This should prove supportive of rents, particularly for new, higher quality stock.

However, thinking on a more long-term basis, the crisis could change working habits. Should home-working become more entrenched, the need for office space could be reduced. Additionally, the CEO of Barclays has speculated that with new social distancing guidelines it may no longer be possible to have thousands of employees in one building. As an alternative, personnel could be distributed around high street branches, most of which are now surplus to requirements following the rise of internet banking. While this would be bad news for office markets, it may be a modicum of good news for the embattled retail sector, to which we now turn our attention.

The retail sector has been under pressure for some time, and as such the timing of COVID-19 could not have been worse. With most European countries in complete lockdown the majority of non-essential retailers have been forced to close, severely impacting their revenues in the process (particularly those such as Primark which chose not to invest in an online platform).

As a result, there have been significant moves by tenants to try and mitigate the impact on their businesses by – in some cases – refusing to pay rent to landlords. While there is no doubt some opportunism at large, this trend really underlines the plight of many operators, many of whom have been looking at ways to unlock liquidity by drawing down available credit lines and turning to sale and leaseback transactions on owned property assets.

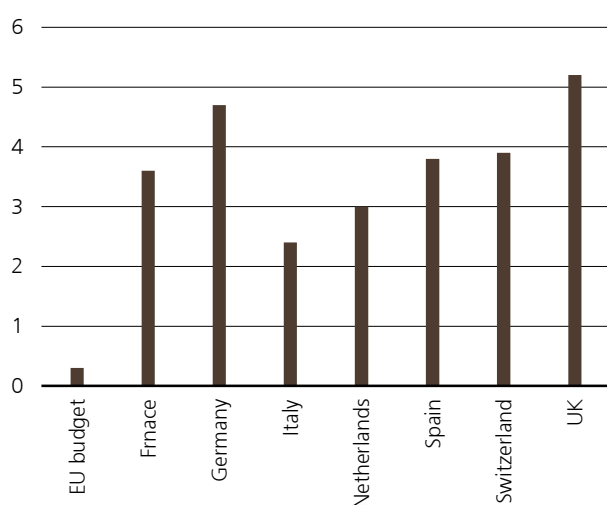
Overall, we expect the outlook for the retail sector to remain weak as we see more administrations and more rationalization of portfolios among the surviving retailers. It is no surprise that prime rents began to fall in 1Q, with further reductions very likely over the course of the year. We are very unlikely to see significant development; however, as vacancy rates across Europe are expected to increase – especially in the shopping center and retail warehouse sectors – and construction activity remains depressed. In terms of regions, we expect the UK and Italy to be most negatively affected, while CEE countries may prove to be more defensive.

The logistics sector is expected to see some benefit from the COVID-19 crisis, as ecommerce rates have increased across Europe, particularly for on-line grocery retailing. This has led to increased demand for logistics space from supermarkets, with several already having leased new space or renewed leases on older warehouses. While there have been boosts to supermarkets' headline sales, operating costs have increased, not least due to the burden of taking on extra staff.

The traditional industrial sector has been more severely impacted, however, as it tends to support sectors such as construction, retail, hospitality and manufacturing. All of these sectors have seen their operations curtailed, and indeed rent collection figures for this part of the market are almost comparable to the retail sector. Quarterly headline rents were also flat in 1Q20, suggesting the occupier market has already begun to slow down; however, on an annual basis rental growth was around 3%.

Industrial supply had been increasing steadily throughout Europe as a result of the pandemic although, as only around 20% of this is speculative, it is likely this is increasing in step with demand rather than indicating an over-development risk. As with other sectors, COVID-19 will likely slow down construction activity as building sites in many countries remain closed; however, industrial assets typically have very short lead times in comparison with other sectors. We remain bullish on European industrial over the medium term, although it will not be immune from the economic shock over the next two years.

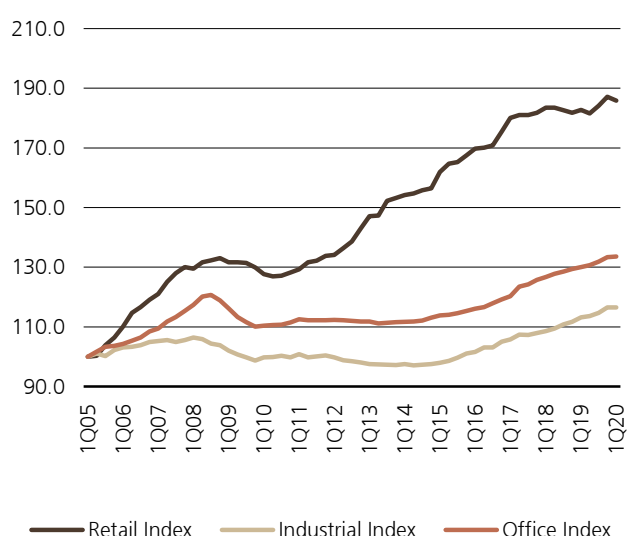
Figure 1: Fiscal stimulus as a % of GDP



Source: UBS IB, April 2020

Figure 2: Prime rents

(index, 1Q05 = 100)



Source: CBRE, 1Q20

Capital markets – the calm before the storm

Investment markets have yet to show symptoms of COVID-19 infection, as the majority of European markets were not placed into lockdown until mid-March. As property is a slow moving asset class, this means the 1Q data is unlikely to show anything revealing. This is very much the case as volumes were shown to rise 7% on a quarterly and 13% on an annual basis, with even the troubled retail sector seeing an uplift. As a result, pricing has largely remained stable, with agents typically citing material uncertainty in their approach to valuations. There has been selective evidence of buyers seeing discounts, but this remains highly anecdotal and is not commonplace.

However, we think these numbers paint too optimistic a picture. Firstly, real estate deals generally take months to complete and as such, 1Q20 numbers are more indicative of year-end activity. Secondly, 1Q19 was reasonably subdued as there were concerns about interest rate rises; this flattered the numbers in 1Q20 somewhat. Third, the numbers were also pushed up by some unusually large deals, with several large shopping centers changing hands in Southern Europe (most notably Intu and CPPIB disposing of the Puerto Venecia scheme in Zaragoza). Aroundtown's acquisition of its rival TLG Immobilien for EUR 4.7 billion is also more indicative of consolidation in the German residential market than investment demand.

Moreover, there are tentative signs that the market is slowing down. Firstly, the number of deals still under contract is unusually high for the first quarter of the year, at nearly EUR 40 billion. This indicates many buyers have adopted a wait-and-see approach before completing on deals. The biggest issue for most deals agreed pre-COVID-19 is that valuations used as the basis for underwriting are almost certainly no longer valid; however, there is no way of telling at present how far the market will fall.

There has also been an uptick in the number of stalled deals (see Figure 3) with a marked increase in buyers beginning to pull out of arrangements. Orion even appear to be contemplating walking away from a deal involving seven retail parks, having exchanged contracts. The fact that they are willing to lose millions in deposit suggests a severely pessimistic outlook for the market.

The number of deals has also dropped off, with the average deal size much higher. This indicates that investors are already starting a flight to quality in which larger, more dominant trophy assets are favored. This is unlikely to be sustained over the coming three months as there is a relatively limited supply of such assets, as well as the fact that cross-border capital flows are likely to dry up as a result of travel restrictions.

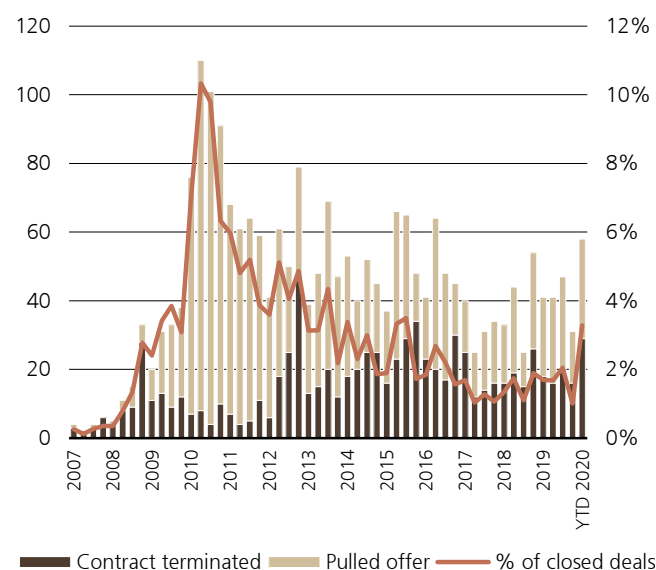
This will likely place upward pressure on yields, particularly for core assets, as cross-border capital is very supportive of this end of the market. By way of example, Manhattan office prices fell by 13% when Chinese buyers exited the market in 2018.

There are certainly examples of investor demand for high quality offices. 90 Bartholomew Place in London is a good example of this. Having initially traded at 20% above the asking price pre-COVID-19, the deal collapsed before being revived by another buyer at a lower price (still ahead of the asking price). There are storm clouds ahead for the office sector longer term, as serviced office providers are likely to be at greater risk. Several corporate occupiers have already stated their intention to reduce office floor space in the long term and make greater use of remote working.

There is also still demand for industrial/logistics in all European countries, which is largely due to the perceived resilience of ecommerce and the logistics companies that service them. However, this enthusiasm is possibly not fully pricing in the risk to income as a result of lockdowns. Retail assets are still very much unloved, except in southern Europe where on-line retail is less established.

All of these factors mean investment is likely to dwindle in 2Q20, although there will still be demand for good quality assets. Overall, the sharp discounts in the public real estate markets suggest we are heading for substantial capital declines over the course of 2020. More damaging though would be the lingering uncertainty over pricing; the sooner we reach the trough the better.

Figure 3: Collapsed deals
(number of deal)



Source: RCA, 1Q20

Strategy viewpoint – Italy the market to watch

Italy was in the front line of the COVID-19 emergency in Europe: the outbreak of the virus and the lockdown started earlier than in other countries. Partly because of this and also because of the severity of the health crisis in some regions, its mobility restrictions were among the strictest in Europe.

Assuming that the magnitude of the recession will be correlated to the length and severity of the lockdown, it is likely the Italian economy will suffer more than its European companions (continuing its period of lower growth vs. peers). Beyond this, it is commonly agreed that an efficient response to the current crisis lies in fiscal policy, although the already high level of Italian government debt poses some questions on further debt expansion and its sustainability in the long term.

Since the outbreak of the crisis, the increase of Italian government bond rates was relatively low (in the region of 50 bps) and this proves that the confidence in the country's economy is not collapsing. It has to be said that this was possible also thanks to expanded quantitative easing measures by the ECB and by the expectation of some form of fiscal aid, which is under discussion among European Union partners. Having said that, the Italian economy – and subsequently the Italian real estate market – needs to be closely monitored.

Compared to the European fundamentals highlighted in the first section of this report, the Italian market shows some peculiarities to consider together with the expected economic downturn. Firstly, international tourism is particularly important in Italy and therefore the short-term impact of mobility restrictions will hit the hospitality sector harder, as well as those retail markets which are more dependent on tourists shopping (eg. fashion stores or stores in tourism driven cities such as Florence and Venice).

However, to define the longer-term impacts we would need more clarity on what tourism will look like after the COVID-19 health crisis is resolved worldwide. Second, the competition between ecommerce and physical shopping was lagging in Italy before the crisis. The market expectations were already pointing towards a gradual alignment of Italian consumption habits to the rest of Europe and market evidence supported such views as prime yields of logistics were, for the first time ever, lower than shopping centers in 2019.

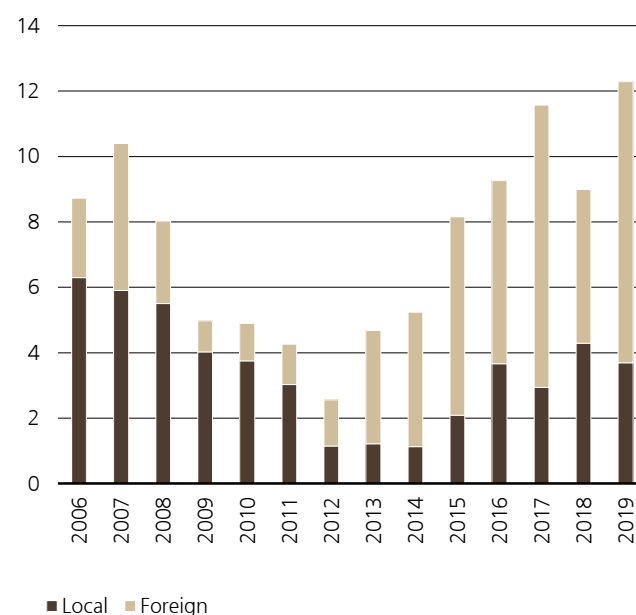
However, the lockdown has made Italian consumers much more used to on-line shopping and this may accelerate ecommerce penetration, to the benefit of the logistics sector. Finally, the performance gap between prime assets and the rest of the market was extremely marked in Italy.

For example, prime office rents in Milan have recorded constant growth since 2014 and were, as of the end of 2019, 10% higher than the pre-GFC peak. Average Italian office rents instead started to grow again only in 2017 and never recovered to pre-GFC levels. This was likely due to the weak economic growth of Italy in recent years, which was not enough for broader rental growth. The COVID-19 recession and vacancy levels being faced by low quality assets suggests the gap between prime assets and the rest of the market will further increase.

On the capital market side, the attention is on the relation between Italian real estate prime yields and government bonds. On the one hand, the spread between the two is still high compared to its long-term average and this provides some comfort. On the other hand, such spread is much lower than in other countries and this, combined with the deterioration of the economic outlook, may represent a threat to real estate pricing in Italy.

Beyond this, it has to be considered that the Italian real estate investment market has dramatically changed in recent years. Foreign investors became the main source of capital and are more likely, in a recession cycle, to maintain their disposal plans (even with lower exit values than originally planned) compared with domestic investors in the previous recession cycle (see Figure 4). As a result, it is likely that investment volumes will not fall as deeply as in 2012, but also that a higher volatility in real estate values will be observed.

Figure 4: Investment volume in Italy
(EUR billion)



Source: CBRE, 1Q20

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