Real Estate House View
Europe

Second half-year 2021

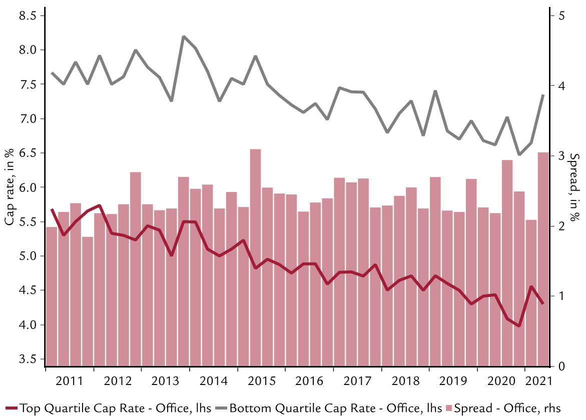
Key takeaways

- **Safe havens in demand:** The current environment, shaped by uncertainty, is driving investors to safe haven sectors and core properties. Fast increases in capital values should be assessed to avoid the core trap.
- **Office – all eyes on core:** While companies are still re-evaluating their workplace strategies, demand for office space will remain, though the requirements will adjust to new forms of working (from home) and interacting in the office. Core properties in prime locations are likely to benefit from changes in demand.
- **Retail – e-grocery next?** Grocery-anchored stores exhibit momentum, though there is evidence of a growing request for e-groceries. The entire sector – including the shaken high street and shopping centres – still needs to establish how it will respond to structural changes and shifts in consumer preferences.
- **Logistics and residential – king and queen**: Both sectors possess healthy occupier markets that are in demand, and both sectors feature a shortage of supply, pushing rents and capital values.
- **Hotels – the worst is over:** The sector is recovering very slowly. Support originates from domestic tourism.
- **Healthcare – small but mighty:** A niche sector with a strong economic foundation – an aging society – that is also characterised by a shortage of supply meeting increasing investor demand.

A sustainable shift?

It's no big news anymore that consumer behaviour has undergone significant changes during the pandemic. However, the expected stickiness of behaviour and digital adoption post-Covid-19 varies across sectors. A recent survey by McKinsey finds that especially e-grocery shopping, virtual healthcare and home nesting are likely to remain after the pandemic; while remote education, the reduction in leisure air travel, and the dip in live entertainment are likely to revert to pre-pandemic patterns. Another effect of the crisis is an accelerated awareness of sustainability. A recent survey by Accenture finds that 60% of respondents report that they have been making more environmentally friendly, sustainable or ethical purchases since the start of the pandemic.

Chart in focus



Source: RCA

The shift towards risk-off positions leads to a polarisation among assets. This polarisation towards prime properties is becoming apparent in the office sector, where investors seek assets in easily accessible, amenity-rich city centres that offer high quality, specified space and possess ESG conformity, while there is subdued demand for secondary, low-quality stock with inferior accessibility/infrastructure. The polarisation is causing a widening of the cap rate spread. As of Q2 2021, the spread amounts to 300 bps. That marks the highest difference within the last five years.

Europe's economies are benefiting strongly from the combined effects of a comparably fast vaccination campaign and the ongoing support from monetary and fiscal policy. The roll-out of the EU recovery funds has a noteworthy procyclical impact and is likely to contribute around 0.8% worth of GDP to economic growth in the Euro area this year and in 2022. As of June 2021, business sentiment indicators like the Purchasing Managers' Indices are positive in expansion territory in all countries and all sectors. Due to base effects and supply chain bottlenecks in the aftermath of the pandemic, inflation has risen sharply across Europe. In our view, the currently elevated levels of inflation will prove transitory, and the peak in the inflation cycle is likely to occur in Q4 2021. Nevertheless, we expect inflation to settle in close to central banks' target levels over the medium term, which means that inflation is likely to be higher going forward than on average over the decade preceding the pandemic.

The price of safety

Despite economic recovery and progress in vaccination campaigns, investors are operating under uncertainty. Given enduring low interest rates, real estate remains an attractive option, but investors have shifted towards a risk-off position. This causes two trends: first, a focus on sectors that are perceived as resilient due to intact occupier markets. These sectors are logistics (driven by e-commerce and reshoring trends), residential (driven by a housing shortage), and healthcare (driven by demographics). Second, in sectors that inherit higher uncertainty, like office, a flight towards core is looming. Due to the homogeneity of investors' risk-aversion preferences, prices increase, and prime yields compress. In addition, the likelihood of the core trap emerges in some markets – this is the case where capital growth is not fundamentally justified anymore by the magnitude of the expected income stream. As a result of too much capital flowing into core properties, yields compress while the risk of mispricing kicks in.

Office: the core the better

The occupier market has not yet recovered from the effects of the pandemic and corporate decisions on post-Covid-19 workplace strategies are still pending, both because uncertainty prevails on ultimately required office floorspace and because most corporations are still bound in lease contracts. The current hesitance is leading to subdued take-up volumes and rising vacancy rates. The reluctance among market participants has triggered an increase in rent incentives. However, in dense markets with low vacancies, such as Munich, rent incentives are lower than in markets with high vacancies and high construction activity, such as Paris La Défense. Besides incentives, occupiers favour shorter, flexible lease terms and earlier break options. Subletting space is on the rise, too. As flexible office space is becoming part of the overall package from a landlord or within a building, flex office/coworking space providers will become increasingly challenged. All factors combined lead to a decline in prime rents in most markets, though in some core markets, such as the German top seven, prime rents remained stable. Prevailing uncertainty will weigh further on rents in 2021. Thus, a light decline is expected before rental growth sets in again. In the investment market, investors are opting toward risk-reduced core properties. Therefore, prime yields ought to remain mostly stable to slightly decreasing across Europe in 2021.

Retail: a divided sector

High street retail and shopping centres have been hit hard by the pandemic and the lockdowns, resulting in steep rent declines that have spilled into the current year. In 2020, rent dropped significantly – up to 20-30%. Although reopenings and pent-up demand are supporting in-store spending in the very short term, i.e. H2 2021, the turmoil is not over. The sector still owes an answer on how to successfully respond to structural changes and online competition. Thus, further rent corrections are likely in 2021, and investors will continue to demand risk premia. A further increase of prime yields of 30 bps in 2021 is expected – after they already decompressed by roughly 30 bps in 2020. Grocery-anchored and convenience stores, on the contrary, are blooming: allowed to remain open given the short-term and daily need character of their sold goods, these stores attract consumer spending and offer stable cash flows. As a result, investment volumes in grocery-anchored and convenience stores are rising, just like capital values. The rise in prices is compressing yields. From 2019 to Q1 2021, the average prime yield for supermarkets in Europe dropped by 30 bps. However, the hype about grocery investments ought to soften a bit in the medium term, given the growing demand for e-grocery – a trend that grocery retailers should not miss.

Logistics: king of safe havens

Logistics is considered a safe haven within the commercial real estate sector. This is reasonable, given that the occupier market shows strong demand for floorspace, and rents remained stable in most European markets as of Q1 2021 y-o-y. Key logistics markets, like Amsterdam, or markets with low availability of stock, like Dublin, even reported positive rental changes. The shortage in stock and land ought to support future rental prospects. As the occupier market is intact, investors are pushing investment volumes to new heights: the rolling 4-quarter investment volume of EUR 49.8 bn as of Q2 2021 marks a new record. Investor demand is pushing capital values, too, leading to compressing prime yields. As of Q2 2021, prime yields in the European market stood at 4.1% and thus 20 bps lower than six months ago. For 2021, all signs point to a continuation of logistics' momentum.

Residential: queen of safe havens

With a rolling 4-quarter investment volume of EUR 83 bn as of Q2 2021, residential constitutes the largest of the safe haven sectors. The shift towards safer sectors is leading to a rising share of residential in the total investment market. As of Q2 2021, residential's share is 28%, compared to 19% in 2019. Given that existing stock is not able to meet demand, the share of forward sales is increasing as well, from below 5% in 2011 to currently approximately 30%. Reasons why investors are flooding the market: safe to increasing cash flows and increases in capital value. Residential is the only sector that exhibited positive rental growth rates during the pandemic. Ongoing fundamentals – a shortage of supply and an increase in rental rates in Europe – are supportive of a continuation of this trend in the short term. In the medium term, affordability issues and rent regulation should not be overlooked.

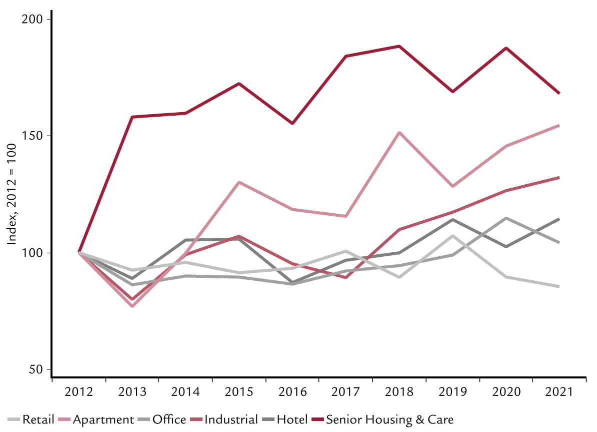
Healthcare: a tiny safe haven

An aging society in demand of accommodation types that cater towards the needs of the elderly is a strong fundament for healthcare real estate. The sector has performed well during the pandemic and investor demand is growing, although there is an undersupply of properties. The supply shortage positions healthcare as a niche market, although the rolling 4-quarter investment volume (EUR 9.3 bn) as of Q2 2021 constitutes a new record. Investor demand is also reflected in compressing prime yields across Europe.

Hotels: a slow recovery

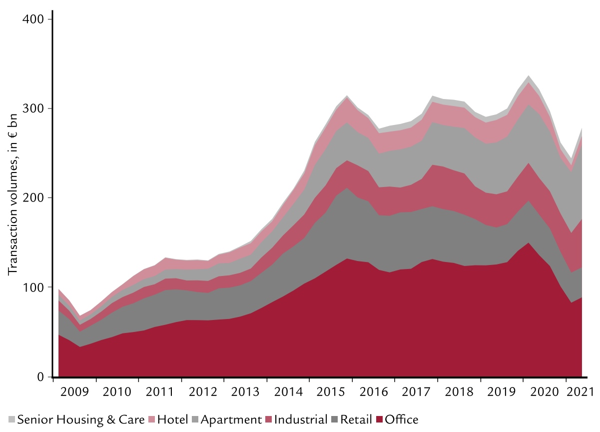
With increasing vaccination rates, a pick-up in travelling is being observed. A recovery to pre-crisis levels is possible in selected markets in 2022 – such as Spain – though most markets will not recover before 2023/24. A faster recovery will happen in markets/hotels that rely on domestic demand and tourism, whereas hotels that depend on business and international travel will recover at a slower pace. Though investment volumes are down significantly, no fire sales occurred, and prices have already recovered to pre-crisis levels.

Chart 1: Top quartile price, until Q2 2021, indexed



Source: RCA, 2021 data as of H1 2021

Chart 2: rolling 4-quarter transaction volumes until Q2 2021



Source: RCA

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