Real Estate House View
Strategy Implications

SwissLife
Asset Managers

Second half-year 2021

Key takeaways

- **Economic foundation remains promising:** for the time being, the economic environment – i.e. low interest rates – still favours real estate investments and supports their "there is no alternative" (TINA) status.
- **Sector preferences and structural winners and losers:** the shift towards resilient sectors – i.e. residential, logistics and healthcare – continues as does the polarisation in location and sub-sector sentiment, especially in retail but also in office.
- **Returns under pressure:** investors' strong and uniform focus on prime assets offers opportunities for other investment strategies, especially in terms of "how low can you go" for returns in the prime segment. Ultimately, the homogeneous focus on core assets might trigger asset pricing bubbles.

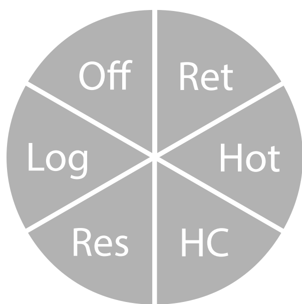
Strategy implications – *type of use and regional focus*

	Office	Retail	Industrial/ Logistics	Residential	Hotel	Healthcare
What	Central location, modern and high-quality assets, good connectivity	Convenience shops, discount retailers, grocery as well as omni-channel retailers	Urban logistics, light industrial	Metropolitan areas, medium-sized cities with favourable socio-economic fundamentals	European top destinations with exposure to leisure and domestic travel	Focus on later, longer, and more self-determined living, good operators
Where	London, Bristol, Paris, Berlin, Munich, Zurich, decentral locations with excellent connectivity	Metropolitan areas; high street in high footfall locations such as Bahnhofstrasse in Zurich	Metro areas in Germany, France, UK, Benelux, Nordics	Germany, Switzerland, France, UK, the Netherlands and Denmark	Selected metropolises, such as Paris, Munich, Berlin, Vienna, Copenhagen, Barcelona	Germany, the Netherlands, Belgium, France, UK, Nordics, and Southern Europe

European environment

Though the economy is recovering from the pandemic, certain uncertainties remain. For example, how will COVID-19 and its variants impact the autumn/winter season? Are inflation hikes really temporary? Will interest rates increase again? Consequently, investors remain risk averse and continue to focus on sectors that guarantee stable cash flows, such as residential, and core assets in prime locations. The run on core is leading to a polarisation within – not only across – sectors, dampening returns in the prime segment. When investors flock to core assets, the risk of a so-called "core trap" emerges. The influx of capital compresses yields. The influx of too much capital could potentially create pricing bubbles, where capital appreciation and rental growth no longer align. Thus, real estate investors in the core trap may receive lower returns for higher risks. Either investors weigh their perceived risk of the core trap against the risk of structural vacancy, which non-core properties feature, or they look for value-add or opportunistic strategies to maintain return targets in search of trying to balance out their risk-return profile. Long-term investors should not overreact towards short-term market developments, unless it is for strategic opportunity reasons, such as portfolio optimisations to benefit from current pricing in certain sectors.

Market investment – *overview updated*



Overweight
Neutral
Underweight

Interpretation
An overweight indicates that, as of today, we recommend investing a relatively higher share in a given sector; the assessment considers current and future socio-economic and real estate data. The assessment takes an absolute view and is not relative towards other sectors/countries.

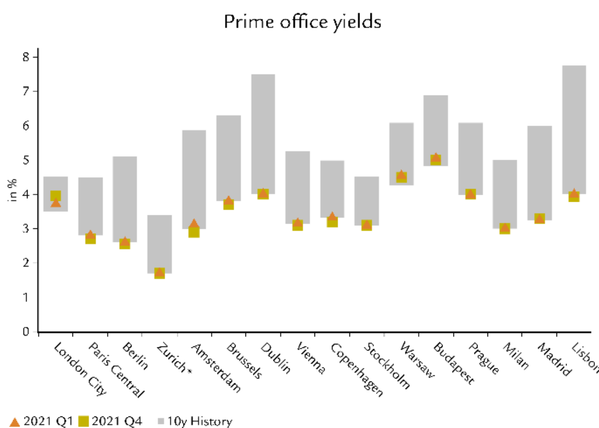
Office sector – *neutral*

Favoured strategy:

- Central location, modern and high-quality assets, good connectivity
- London, Bristol, Paris, Berlin, Munich, Zurich, selected decentral locations with excellent connectivity

Most companies are maintaining their wait-and-see approach and have not yet decided on their final post-COVID, office space strategies as uncertainties prevail. Thus, take-up volumes are subdued and vacancy rates up. In the medium term, we forecast a bounce back to the office, but with adjusted occupier requirements. Ultimately, the occupier market will be shaped by offering a mixture of the amenity of home office and the possibility to interact and meet in the office. Offices with long-term resilience must possess essential features, such as superior location and/or transport connectivity, easy adaptability, multi-functionality, a human-oriented design/feel-good atmosphere, smart technology, and ESG conformity. We see less demand in secondary locations or for lower quality objects.

Consequently, the investment market focuses on core/core+ assets that remain in demand from the letting market, stabilising prime yields in the short term. In the medium term, when uncertainty has lifted, competition for scarce core/core+ assets will further pressure prime yields. Already low prime yields in key markets, such as Berlin or Paris will touch yield levels that potentially collide with return targets. Thus, it might be reasonable to add yet to be developed high-quality assets in more decentral but well-connected locations.



United Kingdom – *neutral*

Take-up demand is still subdued and below the long-term average. For example, in Q1 2021, the volume (72 000 sqm) in central London was 64% below the five-year average. Vacancies and the availability of sublet space are rising – in the City, vacancies (Q1 2021: 11.8%) increased by 460 bps within a year. Post-pandemic, the polarisation between and within office markets based on office specification will become more pronounced. Investors will drive capital into the strongest markets, like Central London and the “Big Six”, such as Bristol, at the expense of weaker, less attractive locations. Transaction volumes will recover as travel restrictions ease and investors look to capitalise on the change in trends that will have taken place.

France – *neutral*

Prime rents in core/central locations in Paris and main regional cities, such as Lille and Marseille, remained mostly stable during the pandemic. In secondary markets, rents already started to decrease in 2020 – a trajectory we believe will continue. Paris La Défense is likely to be challenging in the short term given a large amount of speculative space underway and low level of take-up volume (Q1 2021: 21 000 sqm, -65% to 5-year average): the vacancy rate (11.2%, +590 bps to Q1 2020) is likely to increase. Paris CBD performed better, helped by a buoyant ‘super-prime’ segment. Paris City remains our preferred market, as it is set to lead in the recovery phase, but we see some acquisition opportunities for the best assets in challenged markets such as La Défense, to benefit even more from the current yield decompression.

Germany – *neutral*

Occupiers’ uncertainty results in subdued take-up demand – with Berlin marking an exception (Q1 2021: 180 000 sqm, +1% to 5-year average) – and the trend of leasing smaller spaces. Currently, the public sector is stabilising the market, whereas other occupiers remain reluctant to rent new space. As in other countries, vacancies are up, albeit at modest levels in markets such as Munich (3.1%) or Berlin (3.2%, both +130 BP y-o-y), and subletting offers are rising. Demand for core assets is stabilising prime rents. The relative stability of Berlin and Munich attracts investors. However, given their prime yield levels (2.6% and 2.7%), they are prone to the core trap.

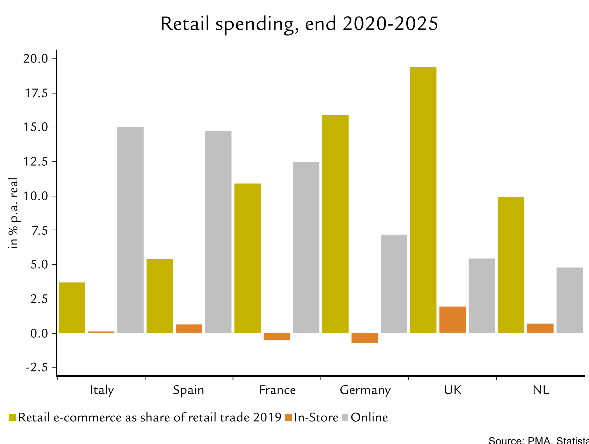
Retail – *underweight*

Favoured strategy:

- Convenience shops, discount retailers, grocery as well as omni-channel retailers
- Metropolitan areas; high street in high footfall locations such as Bahnhofstrasse in Zurich

Increasing vacancies and decreasing rents – these are the characteristics shaping high street retail and shopping centres during the pandemic and into 2021. Grocery stores, on the contrary, benefited from the crisis as they are not directly affected by the lockdown measures, and e-commerce retail profited directly from changes in consumer behaviour. The convenience aspect is going to play a key role in the future of retail.

In the short term, the combination of reopenings and high savings ratios ought to boost retail in-store spending, though it is questionable if pre-crisis levels will be reached again. In the medium term, clients' spending behaviour continues to shift towards e-commerce. Successful retailers will offer hybrid models that bridge physical retail space offering experience, with online channels offering convenience, including in-between schemes, such as click and collect. In some markets, new schemes have already emerged, such as new grocery tenants. These new players are increasing their footprint, potentially changing the retail mix, and consequently the market rents. Despite their current momentum, supermarkets are expected to be challenged in the medium term by clients' increasing demand for online options, especially for bulky products. Overall, a tenant's business model becomes crucial and landlords should carefully review their expectations on the level of rents, including the necessity of incentives.



United Kingdom – *underweight*

The retail sector remains weak, with shopping centres most affected – nationwide, prime rents lost 21% in 2020. Further, though less dramatic, rent declines are expected in 2021. We remain underweight across the UK for shopping centres and high street retail, apart from properties that would be well located for conversion. These would be found within or close to large cities, such as London and the "Big Six" and would be well positioned for conversion into urban logistics locations. In contrast, retail warehouse performance has been robust throughout the pandemic and is expected to continue to remain so due to the resilience of those discount retailers. As retail reopens, pent-up demand should support a trading boost in H2 2021.

France – *underweight*

The lockdowns severely affected the retail sector. Government measures, such as tax payment deferrals or rent-free periods, were not enough to avoid bankruptcies. Rents declined significantly – e.g., prime rent on Champs-Elysées decreased by 15% between March 2020 and March 2021. It will take time for the sector to recover and we are still careful on locations that are highly dependent on tourism, like Central Paris or the French Riviera. We are neutral towards retail parks as their local customer base and value-oriented shopping experience should generate satisfying footfall. The move in cap rates is not yet over due to remaining uncertainties. And although investors may think about repositioning some retail assets, it is probably too early to deploy such a strategy yet.

Germany – *neutral*

The struggles of retail are underscored in high street prime rent declines of -14% across the top five markets in 2020 – excluding incentives. Investors are currently focusing on grocery-anchored or convenience stores – respective investment volumes (EUR 3.2 bn) were up by 32% in 2020 (y-o-y). Despite the current attractiveness of supermarkets, occupiers' low profit margins should be factored in when making rental expectations and investments. In the long run – after the downward adjustments of rents and prices – we are slightly optimistic for high street retail in prime locations and assets that offer service components – however, it is still a long way ahead but the timing might be right to acquire core properties that offer flexibility at discounts.

Industrial/logistics – *neutral*

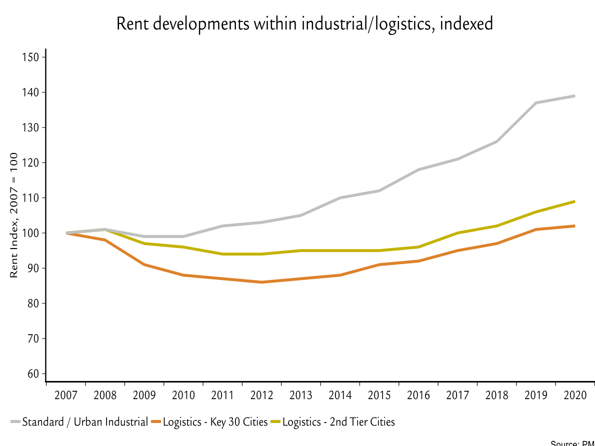
Favoured strategy:

- Urban logistics, light industrial
- Metro areas in Germany, France, UK, Benelux, Nordics

European industrial/logistics benefited from fast-growing e-commerce and higher inventory levels during the pandemic, and supply chains that remained intact during the second and third lockdowns. Furthermore, occupational demand from manufacturers is a driving factor. Within the sector, urban logistics/light industrial are gaining relevance. City distribution centres, for example, allow for last-mile delivery that caters towards consumer preferences for shorter delivery times. Therefore, rents for urban logistics properties have grown steeper than rents for logistics properties in the last couple of years.

The sound occupier market is attracting (new) investors. As demand faces a shortage of land and good quality supply, prices are being pushed up. In certain cases, e.g. Paris, we see the potential risk of an overheating investment market. However, we remain positive that the momentum will continue in the short term. We advise using this momentum to offload weaker assets at attractive prices. For investments, we recommend carefully assessing the quality and level of modernisation, including a building's access to power and energy efficiency, and the (micro-)location of a property. As certain tenants in the occupier market, such as third-party players, have low profit margins, we advise caution towards future rental expectations versus realisations. Due to the potential risk of the core trap in this sector we assess it as "neutral", though opportunities exist and the occupier market is sound.

Rent developments within industrial/logistics, indexed



Source: PMA

United Kingdom – *neutral*

The logistics sector continues to outperform the rest of the market – in Q1 2021, the rolling 4-quarter investment volume (EUR 9.5 bn) was up by 68% over the comparison period. Q1 2021 (EUR 3.1 bn) and Q4 2020 (EUR 3.9 bn) mark the second and third highest investment volumes in history. Take-up in 2020 (43m sq ft) increased by 69% compared to 2019. The market is driven by the acceleration of structural changes and shift towards e-commerce triggered by the pandemic. In the short term, occupiers will likely continue to adjust their supply chains and expand their facilities to service the e-commerce trend. The supply of grade A assets remains low, underpinning rental growth in the best specified assets in highly connected locations close to large conurbations. Assets with fast access to major freight hubs including ports and international airports should attract occupier demand. Poorly configured assets in primary and secondary markets will underperform.

France – *neutral*

Occupiers are identifying their real estate strategies for 2021 in the midst of many uncertainties, leading to volatile take-up volumes. Occupiers are also increasing their focus on efficiency and buildings that offer reversibility and superior energy performance. As a result, digital tech is becoming a key criterion of operational priorities. For large logistic assets, we focus on the main axis: Lille-Paris-Lyon-Marseille and main regional cities outside the axis: Bordeaux, Nantes, Toulouse, Strasbourg. Based on the large capital inflows, logistics prime yields are now below 4%. We expect the compression to continue in the short term. For Paris (3.7%), we see a potential risk of overheating, and thus predict a light increase in prime yields in the medium term.

Germany – *neutral*

With 1.77m sqm in Q1 2021 (+19% to Q1 2020) a new first quarter take-up volume record was achieved. While ongoing occupier demand pushes rents up, continued investor demand pushes yields down (Q1 2021: 3.4%, -40 BP to Q1 2020). We advise using the current run on logistics to sell single-tenant properties and invest in multi-tenant properties to diversify rental income. Besides the key regions, such as Berlin or the Ruhr, we favour locations with a diversified economic structure, such as the Rhine-Neckar area. Smaller and more monostructural regions should be avoided.

Residential – *overweight*

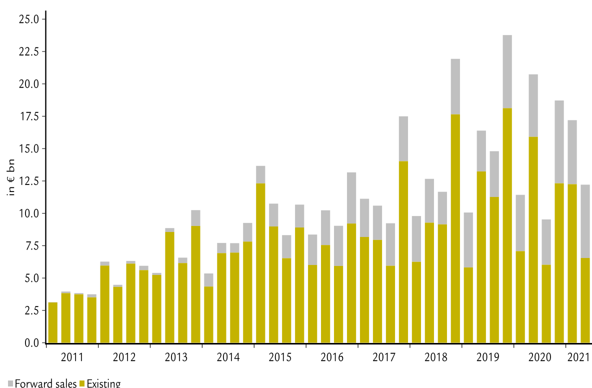
Favoured strategy:

- Metropolitan areas, medium-sized cities with favourable socio-economic fundamentals
- Germany, Switzerland, France, UK, the Netherlands and Denmark

The European residential sector has exhibited strong occupation levels and rent increases during the crisis. The sound occupier market led to a further influx of capital – the rolling 4-quarter investment volume as of Q2 2021 totalled EUR 58 bn, while a lack of stock is causing an increase of forward deals. Properties in the UK, Denmark, France, Switzerland and the Netherlands are especially in demand. The relative stability of the sector will further push investor demand. Thus, prime yields will continue to decline. In some markets with already low prime yields, such as Paris (Q1 2021: 2.5%) or Zurich (1.4%), a further compression, which is likely, might raise the question of whether investments in these markets are still in line with return targets or just serve to avoid penalty interest while being invested in a comparatively resilient sector.

The occupier market faces a shortage of housing supply, especially in metropolitan areas. These areas are also expensive. Thus, occupiers are moving into the suburban areas. This trend already existed before 2020 and has been further accelerated by the pandemic. The possibility of remote working increases the relative attractiveness of suburban living, i.e. more space at lower rent levels. As occupier demand grows, rents will increase both in urban and suburban areas. In the medium term, debates on the affordability of rents and regulation are potential obstacles. The regulation aspect in particular requires domestic expertise.

Residential transaction volumes Europe, quarterly



Source: RCA

United Kingdom – *overweight*

The market is characterised by a shortage of housing supply – an additional 300k homes p.a. are needed to meet demand, although delivery is currently falling short. Furthermore, the need for affordable housing is also rising. Government actions have reflected this issue. London, its commuter belt, and the major cities, e.g., Manchester, Birmingham, Bristol, Edinburgh, Glasgow and Leeds, where economic activity and output is concentrated, are affected the most by the shortage of living space. The UK is also an established market for student housing. Despite uncertainties about the effect of Brexit on international students, investor demand for student housing is strong. As of Q1 2021, the rolling 4-quarter investment volume (EUR 6.6 bn) is up by 19% to the comparison period.

France – *overweight*

Roughly 500k new dwellings p.a. are needed to meet housing demand in France. The shortage is most pronounced in Île-de-France and the coastal region of Provence-Alpes-Côte d'Azur. As most rental units are in Île-de-France and due to the Grand Paris project, which aims to confirm Paris as an international megacity, we advise focusing on this region. The rental market is shaped by affordability issues. In Paris, rent regulation schemes are already in place and expected to spill over to other cities in the coming years. Thus, social housing is on the rise. By law, French cities with more than 3500 inhabitants must reach 25% of social housing units before 2025. Paris is aiming at 30% by 2030. Given that social housing is extending and shielded from foreign investors, local players should assess opportunities in this sector, especially in the Paris region.

Germany – *neutral*

Germany's rental sector was unaffected by the pandemic – between Q1 2020 and Q1 2021, average rents in the top seven increased by 2% for existing units and by 4% for new units. However, affordability and thus regulation is becoming a heated social and political issue, especially in large cities. Small to medium-sized towns exhibit less regulatory uncertainty, while they also offer positive rental growth potential. Moreover, these cities allow for investments in newly built apartments that offer yields above the top seven markets. Thus, we favour cities in the proximity of, and with good transport connections to, metropolises.

Hotel – *neutral*

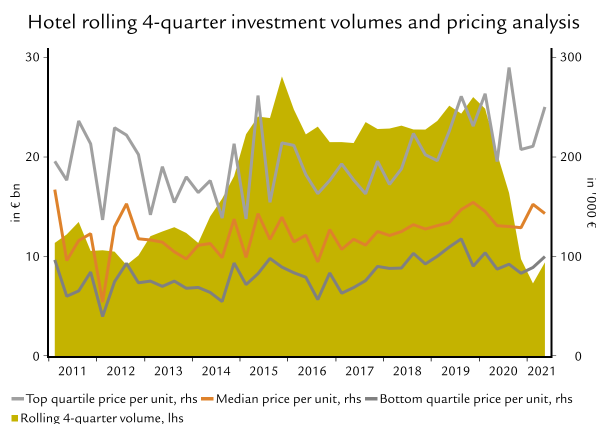
Favoured strategy:

- European top destinations with exposure to leisure and domestic travel, average of 100-200 rooms
- Selected metropolises, such as Paris, Munich, Berlin, Vienna, Copenhagen, Barcelona

After the sector was severely hit by multiple lockdowns and travel restrictions, it is gradually improving. A pick-up in travelling is evident as vaccination rates increase. As the recovery seems more a question of when as opposed to if, we assess the sector as neutral. However, the "when" differs for business and leisure travel as well as for domestic and international travel, but can generally be expected for 2023 and/or 2024. While domestic demand is expected to act as a stabiliser in the short term, the level of international travel ought to remain subdued as the lasting effects from the pandemic may keep holding back global travel. Leisure travel is benefiting from pent-up demand and accumulated savings rates, currently resulting in increased average hotel rates across Europe in August 2021 of 34% over August 2019. For business travel, the recovery uncertainty is higher as corporations not only reassess their travel demand with respect to cost aspects but also from an ESG footprint perspective. As a result, it is possible that business travel will not fully recover to pre-crisis levels.

Investors should consider the heterogeneity in recovery and assess deals case by case. Important aspects are the targeted clientele, number of rooms (ideally medium-sized), competition from surrounding hotels and level of technology (e.g. self-check-in/-out). While the investment market remains restrained, it might offer investment chances for properties at discounts.

Hotel rolling 4-quarter investment volumes and pricing analysis



Source: RCA

United Kingdom – *underweight*

International travel restrictions continue to hold back the market in the short term, although the recent relaxation of border rules for inbound EU and US tourists should boost hotel demand, particularly in London, in H2 2021. As the UK is typically a net exporter of tourism, short-term pent-up demand for holiday travel over the summer should drive an increase in domestic travel. However, greater domestic tourism is likely to be focused on non-investment grade hotel stock outside city centres. Budget hotel operators have delayed and foregone rent payments during the pandemic, meaning we remain cautious on investments in the hotel segment.

France – *neutral*

A rebound in tourism is expected in line with the vaccine rollout. The absence of international visitors is impacting Paris and the French Riviera regions the most, even though domestic summertime demand has sustained the sector overall. Unsurprisingly, the largest differences have been observed across operators and categories: the luxury segment has been more vulnerable given the absence of high net worth foreign tourists. On the contrary, 3-to-4 star operators have done far better. As one of the world's most attractive destinations, Paris remains the top investment market, which is mirrored in its share (45%) of the total hotel investment volumes of the French market and relative capital value stability during the crisis. As the French sector is well balanced between local and foreign demand, the green pass for vaccinated guests is likely to sustain the recovery by 2023 with pre-pandemic occupation rates to be reached in 2024.

Germany – *neutral*

The German hotel sector typically exhibits a high share (>75%) of domestic travellers. Coupled with the staycation trend, the sector possesses relatively positive short-term prospects, especially in vacation regions. City tourism magnets, like Berlin and Munich, should also experience a rebound soon and remain investors' favourites. Occupancy data for Berlin as of May 2021 already indicates pick-up activity, and investment data is supportive to signal a slow recovery: in both markets, H1 2021 investment volumes are above the 5-year average. We are also positive for Cologne, given its high share of domestic tourists and historic stability. We are more hesitant for locations that rely mostly on business travel, such as Düsseldorf, Frankfurt and Stuttgart.

Healthcare – *overweight*

Favoured strategy:

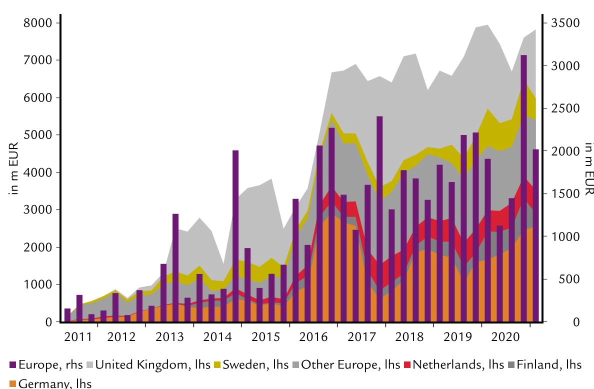
- Focus on later, longer, and more self-determined living, good operators
- Germany, the Netherlands, Belgium, France, UK, Nordics, and Southern Europe

The sector performed well during the pandemic: rents were stable and offered recurring cash flows. The fundamentals remain strong across Europe: according to the European Commission, the quota of people aged 65 and above will increase from 20% in 2019 to 30% in 2070, and the number of people potentially in need of long-term care will rise from 19.5 million in 2016 to 23.6 million in 2030 and to 30.5 million in 2050.

Given that the sector offers a promising and sustainable outlook, investor demand is growing. This is reflected in increasing investment volumes and a harmonisation of prime yields. Across European top markets, yields are between 4% to 4.75%. Despite demand from occupiers and investors, challenges exist in the long-term undersupply of good quality stock and qualified personnel, especially in regions where care properties are most in demand (catchment areas). Besides, some countries regulate the supply of care homes (France) or care personnel per patient (Germany). Another peculiarity is the possibility of changing operator options.

We favour later living as it is less regulated and viewed among care-dependent seniors as a popular alternative to nursing homes, as costs are more modest. We also stress the necessity of picking a financially stable operator and locations within attractive catchment areas.

Investment volumes in the European senior housing and care sector



Source: RCA

United Kingdom – *overweight*

There is a compelling investment case for good quality and well-located aged care and later living stock in the UK. This reflects its structural undersupply and ageing population. However, micro-location is important. The strongest prospects are likely in affluent catchments with increasing demographic challenges that are undersupplied by good quality stock. Both elderly care and later living offer promising investment opportunities. However, aged-care acquisition depends on deep and local market insights and careful stock selection based on covenant, location and specification. Later living is an emerging subsector and is expected to see rising demand as an alternative to aged care. Therefore, it will be viewed more favourably given its successful handling of the pandemic. Given the lack of investment grade stock, forward funding is likely to increase.

France – *overweight*

Most of the French healthcare facilities are public and the sector is heavily regulated. Operators have provided new services and leveraged digitalisation to increase efficiency since the pandemic. Both nursing homes and senior housing benefit from strong investor appetite, pushing yields downward. The prime yield of senior residences in the Paris region was 3.5% in Q1 2021; in regional cities, senior residences generate 4%. We favour investments in all bigger cities, such as Paris (region), Lyon, Marseille, Nice, Bordeaux, Lille, Toulouse, Nantes or Strasbourg where there are still imbalances between supply and demand given an increasing elderly population.

Germany – *overweight*

Demand exists from potential residents and investors who face a shortage of stock, insufficient completions, and the challenge of finding financially strong occupiers. Nonetheless, yield levels – despite compression – remain attractive. In Q1 2021, the prime yield for care homes was 4%. For later/senior living, we favour regions where the elderly population is sufficiently large, growing and endowed with high purchasing power. Recent positive rental growth and a projected increase of employees in the healthcare sector are a plus, too. Thus, Frankfurt (Main), Heilbronn, Munich (region), Heidelberg, Mainz or Regensburg are attractive regions.

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