

First half of 2022

Key takeaways

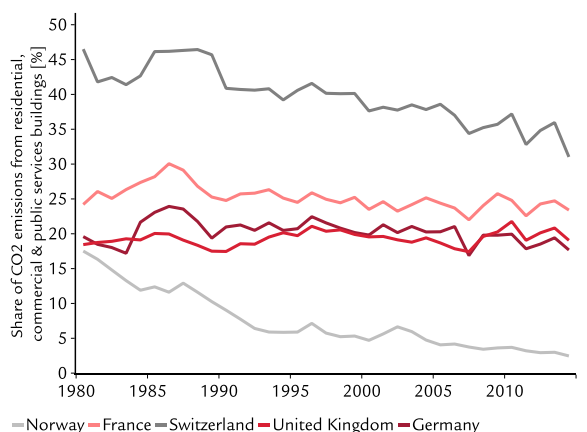
- Talk on the real estate markets in Europe (and globally) is moving away from COVID-19 and back to **affordability, regulation, ESG and digitalisation**. We consider these issues to be the **key challenges** lying ahead of us. We are also concerned about inflation and the interest rate trend.
- **Demand for real estate investments in Europe remains unbroken**, with the price trend becoming increasingly removed from the development of the fundamental data. The growing gap between rental growth and property price trends is due to the limited availability of properties meeting investor criteria. Investors therefore need to closely monitor the reasons for changes in the capital values of their properties.
- The investment markets are also characterised by a **lack of high-quality properties**, as most investors seek high quality. This is also stimulating/accelerating/fuelling the ongoing polarisation between primary and secondary locations, properties and extensions.
- Real estate investments will feature higher **investment and asset management requirements** in view of structural changes, ESG requirements and possible regulations.

Wood – the new real estate sector?

The ongoing demand for real estate has in recent years turned former niche sectors (logistics, healthcare) into pioneers, and we are hearing of new ones such as life science, data centres and self-storage. Another new opportunity has now opened up with rising ESG requirements: investments in woodland.

Wood, which contributes to portfolio modernisation, is therefore now included in investors' own portfolios. Depending on the portfolio, this will require so many trees that it is no longer possible to see the woods.

Chart in focus



“Net zero” (humanity removes the same quantity of greenhouse gases from the atmosphere that it emits into it) is the goal to be reached globally. As buildings account for a significant share of CO2 emissions (Switzerland 31%, France 23%, UK 19%, Germany 18% and Norway 3% in 2015), real estate investors are responsible – to varying degrees – for achieving this goal. However, the conversion of existing old buildings is a costly enterprise that exerts a strong influence on the budget planning of individual assets.

Europe's countries are continuing to benefit from the combined effects of a comparatively swift vaccination campaign and ongoing monetary and fiscal policy support. The payment of EU funds has had a remarkably pro-cyclical effect beyond the current year. Despite the emergence of the new Omicron variant, economic indicators such as the purchasing managers' indices for the manufacturing sectors made significant gains by the end of 2021. Inflation has risen sharply throughout Europe due to base effects and supply chain bottlenecks. The current high inflation rates are expected to prove temporary, and the inflation cycle should peak in the first quarter of 2022. However, inflation is set to level out close to the central bank target values in the medium term, making it higher in future than the average level in the decade prior to the pandemic.

Real estate, real estate, ...

While the variants of coronavirus gradually work their way through the Greek alphabet, life with the virus appears to have become the norm for real estate investors. The focus is very clearly targeted at achieving investment goals, and demand for European real estate is correspondingly high. According to RCA, the volume of investments in 2021 was up 20% year on year at EUR 340 bn. With this, the total volume was only marginally lower than in the record year of 2019 at EUR 349 bn. However, owing to a certain degree of uncertainty (due to structural and economic changes such as inflation towards the end of the year), the focus is placed firmly on Core, and even Supercore properties. Investors are thus seeking the crème de la crème, and as the choice here is limited, prices have increased further and prime yields have fallen (e.g. for office yields in large European cities by an average of at least 20 basis points spread throughout the year). The polarisation between the very good and secondary/peripheral sectors, regions and locations has thus also strengthened again significantly. The most popular sectors at present include residential, healthcare and logistics, the most popular regions the major conurbations of Berlin and London, and for logistics all locations with transport connections.

ESG, politics and inflation

While the legacy of coronavirus is accelerating structural changes in almost every sector (how will we work in the future? In town or in the country thanks to

working from home? Will there still be business trips in the future?) and continues to be observed, other issues are being discussed much more urgently again, with ESG, affordability and potential regulatory measures in the real estate markets leading the way. This was compounded at the end of 2021 by the topic of inflation. The ESG requirements will trigger greater CAPEX requirements in existing portfolios in the next few years and thereby influence the performance of investments, while attention must also be paid in the case of purchases to sustainability standards and possible financial impacts. The topic of regulation comes into play at the latest when refurbishments of housing developments are to be passed on to tenants. The affordability of residential rents in European cities is on the political agenda in many places and will feature in one place or another in 2022. The effects of rising inflation are dependent on the sector and local contractual arrangements. More and more contracts for commercial space tend to be indexed and are also more likely to serve as an "inflation hedge" – if such a term can be used at all. The decisive factor is the simultaneous development of interest rates and which effect then proves to be greater.

Office – a role model?

The office sector recorded an improvement in the second half of 2021 in terms of both investments (Q3 2021 +9% year-on-year) and rental activity. Investors are seeking high-quality properties, and tenants are gaining a better idea of their space requirements. The strong investment demand for high-quality properties led to a further decline in prime yields (20 basis points on average), which we also continue to expect in the short term. The high demand could curb the effects of the interest rate movements in the medium term and result in flat yield movements. Prime office rents rose due to increased tenant demand (Central London 16.8%, Berlin 1.5%, both forecasts for 2021). Only Paris was sending unclear signals up to the third quarter with some prime rents even decreasing, but the fourth quarter of 2021 has brought up strong letting activities with strong rental growth. At the same time the volume of investments is also down 28% on the previous year. This is due to a lack of quality investments and major deals, a picture that could also arise in future in other large cities. As tenants are also seeking high-quality properties, the rental price growth is partly being supported at least in the prime segment (although ad-

ditional incentives such as rent-free periods are not visible in the data). The capital values of prime CBD offices are rising faster than their rental values. At the same time, the prices of properties at secondary locations are under pressure with the exception of those with a long-term rental contract with a low-risk tenant.

Logistics – king with spikes

The logistics hype continued in 2021, with prime yields now partially below those of office buildings (e.g. London 3.3% vs. 3.8% for offices). However, the dependency has also become visible with the supply chain difficulties. For us, this sector is predestined for a “Core pitfall”.

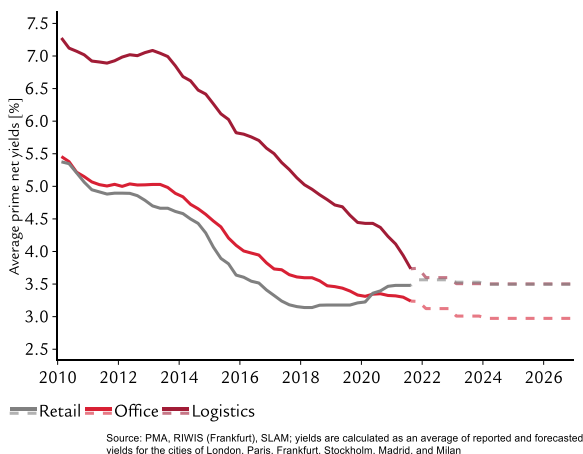
Retail: new strategy

The European retail sector appears to be becoming cheaper with rising initial yields – the potentially positive flip side of structural change. This could offer opportunities for some investors. While overall retail yields are rising, the prime yields of supermarkets and speciality shopping malls are falling. There could be an increase in opportunistic strategies in the retail segments with significant price adjustments in the coming quarters. In view of the market environment, a good understanding and selection of the “right” retail property portfolio is of fundamental importance.

Hotels: extended recovery

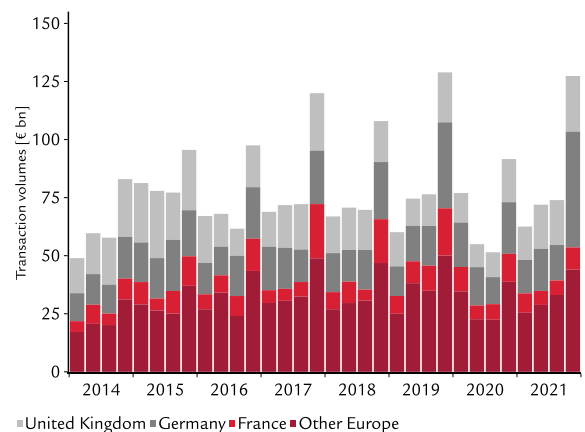
Due to emerging breakthrough infections, ongoing safety measures and technological upgrades, we expect the recovery in travel and thus in the hotel sector to take somewhat longer. Business trips in particular are subject to the prevailing measures, alongside major structural changes in the age of Zoom, Teams and other digital opportunities. However, leisure travel is popular and there could be a more rapid recovery here if inflation does not throw a spanner in the works.

Chart 1: Yield movements



Source: PMA, RIWIS (Frankfurt), SLAM; yields are calculated as an average of reported and forecasted yields for the cities of London, Paris, Frankfurt, Stockholm, Madrid, and Milan

Chart 2: Volume of transactions



Source: RCA

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