European Commercial 2021

SPOTLIGHT

Savills Research

European Property Themes 2021

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Key themes • Investment tips • Predictions

> "Economic growth should bounce back strongly in 2021, thanks to sustained EU funding, supportive monetary and fiscal policies and the gradual reopening of the global economy"

2021 OUTLOOK - Q&A

When will the economy bounce back?
The European economy is set to return to growth in 2021, although concerns remain around the trajectory of the health crisis.

Who is going to drive property investment activity?
The market will continue to be driven by European investors. Non-European capital will access product through European-based platforms.
Core money will be targeting the best in class product. Core yields should further move in, while secondary will soften. In the second half of 2021, some investors may start moving up the risk curve.

What are the non-core opportunities?
Repriced secondary offices and retail. Development of offices, logistics and multifamily in locations with strong fundamentals. Retrofitting buildings to achieve green status.

What is the outlook for office vacancy rates?
Vacancy rates are not expected to rise significantly in core markets. Secondary, older stock in need of refurbishment will suffer more, and we may see more repurposing.

How far can prime logistics yields go?
Availability in most core markets is limited and supply is controlled by a few large players. This can lead to positive rental growth and we expect further yield compression for prime logistics assets.

Retail – will disruption be the catalyst for change?
2021 could be the year when repricing reaches a point where it could begin to look interesting for buyers, whether for the current use or repurposing.

Are the living sectors becoming core?
2021 will favour sectors with defensive characteristics such as multifamily, senior living and even student housing, which benefit from macro factors such as demographic shifts.

Eurozone economic outlook Economy set to return to growth in 2021

Source Focus Economics

Key themes for 2021

The pandemic has raised a lot of questions on the short and long term implications of the health crisis on real estate. We attempt to answer some of them in this publication

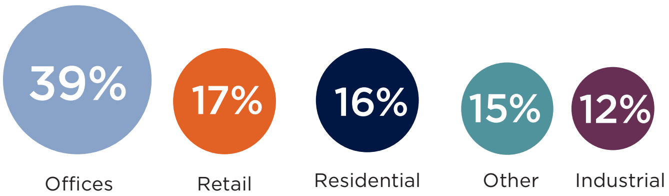
When will the economy bounce back?

The European economy has responded more strongly than some had anticipated to the economic turmoil brought about from the coronavirus pandemic. Policy support from the European Central Bank (ECB) has boosted the Pandemic Emergency Purchase Programme (PEPP) further from €1.35tr to €1.85tr to stimulate growth. However, Focus Economics forecasts inflation will remain below the target 2% until at least 2025, suggesting further policy action may be required and the ECB is unlikely to rule out lowering interest rates below zero if inflation expectations weaken further.

Rising public and private debt levels are likely to weigh in on GDP growth rates across the euro area as a result of government furlough schemes. Debt will remain serviceable due to low risk-free rates and sovereign defaults will remain relatively unlikely, with overall euro area public debt stabilising at circa 95% of GDP by 2024, according to Focus Economics. Unemployment is forecast to rise to 9.3% in 2021 before recovering to 8.7% in 2022 as furloughs are wound up. We anticipate lending rates to standing real estate to remain low, albeit loan to value ratios will remain in the circa 55-60% range, around five percentage points below the equivalent end-2019 levels.

The euro remains at its strongest level relative to the US dollar since H1 2018, which may limit the rebound of extra-European investment in 2021. Joe Biden's US election victory could point to increased trade between Europe and the US which will act as a boost to European exporters.

Questions around the UK's relationship with the European Union will remain into 2021, with mass disruption for haulage companies regardless of whether a Brexit deal is agreed. Financial passporting remains the large concern for Europe's financial institutions which has led several investment banks to announce relocations of assets to mainland Europe. London's share of total European investment has reduced since the Brexit vote, although we anticipate this will recover as England's capital becomes increasingly under-priced relative to mainland Europe. Relatively higher cost of UK sovereign debt will dictate higher office yields relative to the rest of core European markets.



Investment shares by sector in 2020 (Q1-Q3)

European property sectors' risk and return profile

Source Savills

Source Savills

Who is going to drive market activity in 2021?

According to Preqin, even though the number of real estate funds closing in 2020 is set to be the lowest in the decade globally, the percentage of vehicles targeting Europe has increased from about 18% (of $183.3) last year to more than 25% (of $115.8) this year. This indicates investor confidence that the European real estate market offers stability and healthy fundamentals.

Overall European investment activity remained fairly robust in the Covid-19 context compared to other continents. Paradoxically, lesser competition from the US and Asian investors left more room for European funds to deploy capital in their continent. For the first time in 10 years, the balance of cross border money transacting across the region's real estate market is weighted towards European funds rather than the previously dominant internationals.

We believe in 2021, the European investment market will continue to be predominantly driven by European investors as travel restrictions continue. There is still availability of debt for cross border investments and with limited core assets available in one single market this capital is willing to look further afield to offset their income flows and liabilities.

Some non-European capital will continue to hit the European property investment ground through equity deals, international funds with a good network of European offices or fund managers. We also anticipate a resurgence of appetite from the Asia Pacific during the second half of the year, when the vaccine will slowly normalise the health situation.

We expect investment volumes in 2021 to increase by approximately 20%, a modest rebound. Indeed, investor appetite will be there but the lack of adequate product will constrain the market. During the first half of the year, investors will remain cautious still focusing on the core segment of the market. Towards the end of the year, some investors may slowly start moving up the risk curve to be able to find more competitive assets.

We expect core money to continue to be very much at the forefront of transactional activity targeting the best product in each asset class in 2021. With still so much equity available to deploy, competition amongst these players will be fierce, meaning we are likely to see new records set for core across Europe's key markets.

Prime yields will further move in when the competition is strong, especially in logistics located in key distribution hubs and offices in the major European districts where the vacancy rate is low. We could also witness some surprising hardening yield movement in the retail sector, due to further strong activity expected in the food industry. The common thread will be strong location-covenant-fundamental regardless of assets type. At the other end of the spectrum, secondary yields will continue moving out throughout 2021.

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2021 EUROPEAN HOTSPOTS

Top picks for Core / Core+

1 High specification office buildings in core CBD locations with low vacancy rates such as Berlin, Munich, Paris CBD, Stockholm, London

2 High specification logistics warehouses in markets with high or rising e-commerce penetration such as UK, Germany, France, Netherlands, Spain, Nordics

3 Convenience retail such as supermarkets, retail warehouses and convenience stores in or around densely populated areas

4 Multifamily in cities/regions with supply shortages such as Randstad, Stockholm, Paris, London, German cities

5 Last-mile logistics in densely populated areas

Top picks for Value-add

1 Logistics development in undersupplied markets such as Nordics and Spain

2 Short term income sectors such as flexible offices and student housing, which are likely to recover in the second half of next year

3 Multifamily development in markets with rising demand for rental such as Southern and Eastern Europe

4 Repositioning of buildings to green standards

Top picks for Opportunistic

1 Repurposing of secondary offices into residential

2 Distressed hospitality assets in tourist destinations

What are the non-core opportunities?

Most investors are expected to focus on core / core plus product at least during the first half of next year. Besides, we also expect to witness a new wave of capital, targeting opportunities occurring off the back of any signs of distress. However, the ‘middle ground’, which is the value-add segment, has already seen some stagnation. Over the next months we should start to see owners gradually becoming more realistic about their holdings. As pricing becomes more transparent, this should encourage more sellers to bring product on the market, unlocking liquidity. We believe that most value-add opportunities will be found in the retail and office segments.

Some investors who are ready to take some development risk, may choose to commit to new developments, aiming to catch the cycle at its recovery phase. Developers are already seeking alternative funding, as financing conditions remain tight. Fundamentals for new developments are healthy as supply remains tight and development activity below trend. Office vacancy rate is still at record lows, at 6.3% for offices and 5.3% for logistics. As far as the residential sector is concerned, it has been constrained by rising labour and construction costs, with the share of dwellings built after 2010 at only 3.7% across Europe.

In our Spotlight: EU Property Themes 2020+ report, we had already highlighted the structural changes that are boosting demand for more logistics and residential accommodation. This year, as the pandemic is leaving its mark on people’s habits and priorities, these changes have been accelerated. Regarding offices, green credentials and health and wellness at the workplace are becoming primary issues for occupiers, which should boost further demand for high specification space. Construction activity, on the other hand, has slowed down this year and supply of high-quality space is lagging.

Opportunities may also arise through repurposing and redevelopment projects, as long as pricing and planning make them viable. Retail warehouses can be converted to local fulfilment centres or vaccine storage spaces. Secondary offices could be converted to residential. City-centre retail units can be used for healthcare or lab facilities. Department stores can become food stores or leisure centres and malls can also include wellness, co-working, community space and residential.

Investing in a (re)development opportunity that will deliver the product when the economy is recovering, can capture the rental market cycle at an early upswing phase. We expect prime CBD rents to stagnate on average in 2020 and drop only slightly in 2021, while the next five-year outlook is modestly positive, albeit below inflation levels. As a result of undersupply, we anticipate logistics rental growth to be positive, especially for prime last-mile facilities. Residential rental growth will be muted, due to the economic conditions, but index linked-rents provide a hedge to inflation. On the other hand, retail rents will experience further corrections.

What is the outlook for office vacancy rates?

Office occupier decision-making remains cautious as we head into 2021. Most companies have not made any drastic changes to their occupational footprint yet; however, they are reviewing how they occupy their office space, revisiting their fitout and layout plans.

As business failures inevitably come to the fold in 2021 as is expected in economic downturns, we anticipate a rise in vacancy rates- only this time around Europe’s vacancy rates are around their historic lows and well below the historical equilibrium of 9% for stable office rents. Limited development pipelines are as equally constrained across the core markets which will maintain stock levels across CBDs.

News of a vaccine has improved sentiment among occupiers regarding their business continuity plans. The European Union has already ordered 300 million Pfizer vaccines and as the drug becomes more widely distributed across Europe, we will observe the lifting of restrictions and government-led return to work campaigns. In many respects, corporates are waiting for the ‘green light’ to encourage staff back to the workplace.

In the second half of 2020, work-from-home fatigue and rising anxiety levels among younger workers have begun to weigh in on productivity levels, despite a surprisingly smooth transition to the initial home-working experiment. Human resources directors within the TAMI (Technology, Advertising, Media and Information) sector are increasingly reporting of lagging levels of creativity as a result of limited workplace interaction.

After a period of ‘wait and see’ occupiers will begin to review their real estate strategies. The role of the office remains essential for collaboration, with 89% of workers considering the office to be of high importance after the pandemic, according to Savills Office FiT survey. We anticipate demand for high quality, well designed centrally located offices to be most resilient, potentially complemented with some renewed interest for flexible office space in peripheral locations. Location and connectivity remain important workplace factors for employees, who may choose from now on to work once or twice a week from home.

Particularly given an ageing population across

4.6% The average prime logistics yield in Europe has reached record low levels

Europe, office landlords will be paying additional focus to demographic shifts in the wake of the pandemic. Barcelona (2.0% pa), Madrid (1.8% pa), Stockholm (0.9% pa), Dublin (0.9% pa) and Milan (0.7% pa) are anticipated to observe the strongest population growth between ages of 20-35 years old over the next 10 years, according to Oxford Economics and we anticipate office-based employment to be most resilient among these cities as a result of this urbanisation.

However, the core cities of London, Paris and Berlin will continue to attract the most venture capital investment across Europe. €42bn of venture capital funding has been raised as of December 2020; €14bn in the UK, €7.4bn in Germany and €5.4bn in France, although we are now observing non-core markets attracting a higher proportion of investment. Overall, this marks an 11% increase on the full year 2019, driven in part by the fintech, mobility tech and life sciences sectors, where we anticipate future occupational requirements in 2021.

We anticipate that in the second half of the year we will see most of the occupational activity resume, after the rollout of vaccines and the gradual return to the office. It is likely that H2 2021 could be the right time for occupiers to strike a deal, as we expect rents to adjust and incentives to rise in the meantime. However, this period could be short-lived as vacancy rates are not expected to rise significantly in core markets. The office space that will suffer the most will be secondary, older stock in need of refurbishment, and we may see some of this stock being repurposed to other uses, including residential.

When occupiers are ready to review their space requirements, they are likely to prioritise the location and quality of the building in order to attract and retain talent, as corporate headquarters reflect companies' identity and values. In this context, the current undersupply of newly built offices in the major European markets mean that renovated buildings will still attract occupier demand at competitive rental levels.

Offices traditionally dominate the weight of European investment stock, usually around 40% of annual volumes. We expect investor demand for high quality, BREEAM-certified office stock to be most resilient and the vaccine news during the closing weeks of 2020 has also kickstarted activity in the lending community following a brief hiatus during mid-2020. It is likely that the Brexit outcome will redirect some capital flows back to London, which now appears underpriced compared to mainland European markets.

How far can core logistics yields go?

The sheer volume of money targeting the logistics sector has compressed prime yields across Europe in 2020 and we believe that competition for the best logistics assets will continue next year.

Big box facilities, urban logistics and dark stores- landlords are fighting to increase their exposure to the sector, which has traditionally accounted for only circa 11-12% of total investment volumes.

The fundamentals of the sector support this trend. The accelerated consumer shift towards online shopping during the pandemic has created a swift rise in warehousing requirements from retailers, pure players and parcel companies. Alibaba's planned expansion into the European market is likely to act as a further boost to demand over the next 2-3 years too, whilst rising numbers of returns from online retail are spurring demand.

Warehouse availability in most core markets is limited and supply is controlled by a few large players. These conditions can lead to positive rental growth, depending on the type of retailer and location. Average vacancy rates remain low, at 5.3% due to a dearth of spec development starts since the virus outbreak. It is likely that the current level of new active requirements will roll into 2021, restricting occupier options. The level of second-hand space returning to the market from business failures next year is likely to be snapped up quickly by expanding e-commerce operators. Last-mile logistics are likely to experience stronger rental growth than large scale facilities as consumers opt for a flight to convenience.

Therefore, we expect further yield compression, albeit more limited than in 2020. The lack of product will force investors to commit to forward funding of new developments and to core plus and value add opportunities. Although the differential in retail/logistics capital values makes the conversion of underperforming retail warehouses unfeasible in today's market, landlords may look for ways to add urban logistics components to existing retail schemes.

We anticipate portfolios to continue to attract a premium of circa 5-10% for prime assets and even in excess of this into next year. Landlords are aware of the keen pricing on offer for prime assets and many landlords will have to develop in order to gain exposure to the market. Target logistics allocations have doubled in some instances to 30-35% of portfolio weightings over the course of 2020. The lending environment remains particularly favourable to the logistics sector, which should facilitate transactions into 2021.

Investors should focus on vacancy rates hot spots, which should deliver the best rental growth prospects. Capital Economics predict the Nordics and Benelux markets will observe among the strongest logistics rental growth over the next five years.

2021 EUROPEAN HOTSPOTS

Top picks for Alternatives

1 Science parks in core European university clusters in Germany, Switzerland, France, Denmark and Sweden

2 Health care, senior housing and care homes in countries with ageing population trends and availability of product, such as Germany, Sweden, Netherlands, Finland, France and Belgium.

3 Datacentres in markets with strong fundamentals and infrastructure, such as the Nordics, Frankfurt, London, Amsterdam and Paris

The share of investment in the living sectors increased by a third in 2020

Retail – will disruption be the catalyst for change?

Retail has been hit hard by the health crisis. Retailer turnovers have come under immense pressure due to the lockdowns and the strict hygienic protocols. Consumer experience has been restricted and the shift towards online shopping has accelerated. Post-Covid, e=commerce will increase significantly across Europe (from 12% in 2019 to over 16% in 2020), albeit stabilising at lower levels than the ones observed during the lockdown periods.

As a result, retailers have been seeking some relief to their fixed costs, to survive. Across Europe, we have observed rent holidays or rent discounts and a rising number of short- to mid-term lease agreements that are on a turnover rent basis only. With regards to new leases, retailers can achieve rent- free periods, or lower rents for longer leases. Agreements vary depending on covenant strength, location, and affordability ratios per product category.

Although footfall is recovering, shopping trips are dictated by need and convenience. Moreover, uncertainty about future employment is likely to contribute to higher savings ratios and less impulsive purchases, therefore having a further negative impact on retail sales. The Christmas period will be critical for the survival of some retailers, so we expect more clarity in Q1-Q2 2021 on vacancy and rental trends.

Vacancies will rise due to retailer failures and rents will be under downward pressure. Less severe has been the impact on retail parks and supermarkets, while central high street locations and shopping centre suffer more. Food, Athleisure, Toys, Pharmacies and Furniture retailers are performing better. Also, luxury streets show more resilience, while the middle range of the market is seeing most failures. Some retailers who have already committed to expand in certain markets, take advantage of their negotiation power and the vacancies that emerge in good locations, to position themselves at favourable terms.

Inevitably this situation has brought to the fore the discussion between landlords and tenants about lease structures. Although we expect the fixed element of rental income to return to retail leases, we may also see the turnover element becoming more established, as it is becoming a retailer's market. The big challenge for the future landlord and tenant relationship will remain measuring the halo effect of physical stores on online sales and how to account for this in turnover leases. Technology will be used more widely to facilitate the sharing of data between landlords and tenants.

Prior to the onset of Covid-19 investors had shifted their portfolio allocation away from retail. Funding a retail strategy requires significant repricing, as well as clarity in terms of security of income and performance. Supermarkets have been one of the few retail segments to make a comeback during the pandemic. We expect them to remain one of investors' favourites and market activity to be led by sales and leasebacks. We believe that 2021 will finally be the year when rental levels and pricing expectations start to reach a point where it could begin to look interesting for buyers whether for the current use or alternative concepts.

Are the living sectors becoming part of core strategies?

This year, investment strategies will favour sectors with defensive characteristics, which benefit from macro factors such as demographic shifts. The living sectors, including multifamily, senior living and even student housing (PBSA) fall into this category. An ageing population and the increase in demand for rental during times of economic uncertainty, will support the fundamentals. The pandemic had a heavier impact on the PBSA sector with students postponing their plans to study abroad. Nevertheless, studying has countercyclical characteristics with admissions rising in recessionary environments.

Residential has already become a core segment of investment strategies. Its share has increased by one-third this year and in some markets, it captured between a quarter and one third of the activity in 2020. In 2021, investor demand is expected to further intensify, but finding income-producing investments will be challenging. In some cases, forward funding new developments may be the only way to get exposure in the sector.

Intense competition has been pushing yields down rapidly in 2020, with prime yields at record low levels (European average at 3.4%). We believe that prices can rise further, especially in markets where rental housing supply lags demand. In the short-term rental growth will be muted, in line with inflation, but income streams from residential are characterised by stability and resilience. This will also support development activity, as banks are expected to remain an active capital source for the sector. Interest in locations and types of products may widen, including both centrally located assets, as well as housing in suburban areas. Prime city-centre locations as we move into 2021 should regain their attractiveness as younger population will still choose to live in locations that offer density and access to amenities, culture and leisure. On the other hand, some demographic groups may choose larger homes in suburban areas with good connectivity to business and cultural hubs.

In our Spotlight: European Property Themes 2020+ report last year, we had addressed the issue of affordability. There are concerns that the rise of corporate investment in urban residential properties has a negative impact on housing affordability. This has led some local governments to impose stricter regulations in order to control prices. However, we do not expect this to affect investor appetite significantly. On the contrary, it may create opportunities for collaborative partnerships between public and private sector for the supply of affordable housing. During the current health crisis, it has become even more clear that the fundamental right to live in an affordable, adequate and healthy home with access to services, shops and outdoor space should be guaranteed to everybody.


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