European Commercial – December 2021

SPOTLIGHT
Savills Research

European Investment Outlook 2022

2022 key words ● Secure ● Responsible ● Diverse

Economic horizon strewed with pitfalls

During the third quarter of 2021, GDP grew by 2.1% in the euro area compared to the previous quarter, unexpectedly slightly above the previous quarter (2.0%) on the back of particularly strong household consumption. The economy will remain solid next year, still mainly thanks to unleashed spending, and all European countries are expected to have returned to their pre-pandemic GDP level. Nevertheless, overall the economic growth is forecasted to ease in 2022 as several headwinds are hanging over the dynamism of the economy. According to Oxford Economics, GDP is expected to expand by 4.4% compared to 5.1% last year.

Ripple effects of the supply chain shortages are spreading across all sectors. Furthermore, as the level of global consumption is expected to remain high next year, supply shocks could be prolonged into 2022. Sharp increases in energy prices have fuelled new inflationary pressures, notably under the impact of supply disruptions. But most imminently and possibly damaging for the economy is the rising number of new Covid cases, which have forced some European authorities to impose some circulation restrictions. Although the late information on Omicron suggests that illness may be less severe than its previous variant, this new threatening wave suggests that we are still under the grip of Covid. The longer this thread will last, the more likely the sharp structural changes imposed by the pandemic will become permanent.

2021: the recovery vs 2022: the rebalance

European commercial and residential investment volumes reached approximately €78.9bn in Q3 2021, the highest level recorded in a third quarter over the past five years. This brought the total volume accumulated since the beginning of the year to €201.6bn. This is a 13.5% jump on last year and a 7.7% increase on the past five-year average; some standout figures given the current circumstances. Strong investment activity will continue until the end of the year; we anticipate the end-year volume to be around €288bn (+ 8.5 / 9.0% YoY). 2022 is likely to be pretty much in line with 2021; we expect the European investment volume to range between €290bn and €295bn next year (+2% YoY).

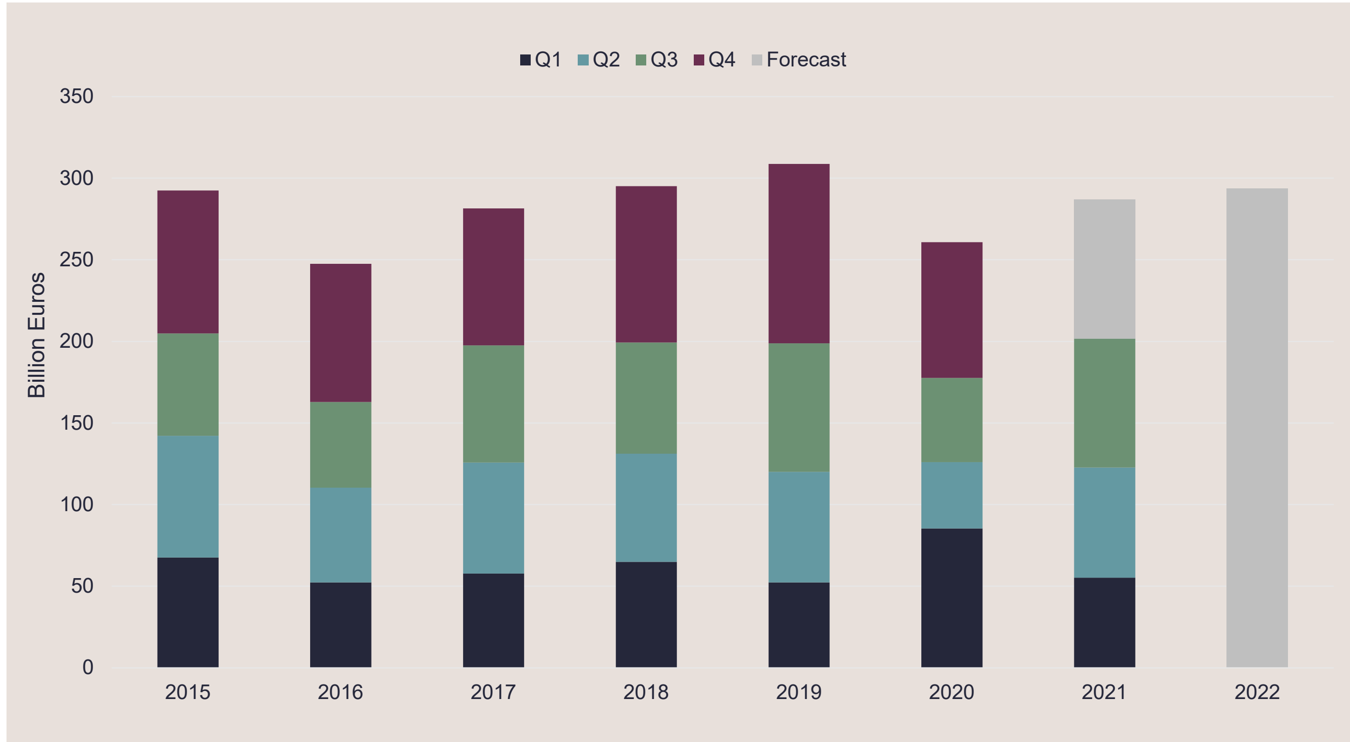
“Flight to quality” will remain the investors’ leitmotif, which will start to heavily weigh on the non-prime stock. With greater ESG imperatives ahead, it will be time to think about renovating some of this stock to achieve greener standards or repurposing some buildings to embrace social values. This will eventually provide some opportunities for value-add investors. Yet, we do not expect a significant return of the value-add investors at least until 2023, after a significant repricing in secondary asset classes. Historically, we have seen value-add investors interest rising in periods when the prime/secondary office yields gap is above 90 pbs (in Q3 2021 it was 88 bps).

It is still too early to determine precisely the extent of the “Covid” factor in the retail, logistics and office markets. Either way, the Covid crisis will have served to highlight the metamorphosis of these markets, which was already in place long before the pandemic. From an investors′ point of view, the adage according to which no one should put all their eggs in one basket will be more prevalent than ever. We expect greater portfolio diversification in the years to come, in terms of assets, locations and strategies.

We expect the logistics and living sectors to remain highly sought after in 2022. In all European countries, the growth of online sales has accelerated during the pandemic, inflicting a sharp rise in occupier demand. Living sectors, on the other hand, offer stable income streams and are driven by rising urban populations, demographic changes and new living arrangements. The common ground of both sectors is clear demand and supply imbalances pressing rental levels up and forcing investors to look into forward-funding strategies. This will carry on into 2022; hence we anticipate solid rental growth for both sectors next year.

2022 could set the start of a new beginning for the retail sectors following years of changes in consumption patterns, retailers attempts to adapt through consolidation strategies, implementation of omnichannel networks and repurposing of retail units. We believe the sector is now more aware and better prepared to adjust to consumers′ changing

Investment volumes - Strong performances given the circumstances



Source: Savills Research

Breakdown per asset class - Toward an even distribution?

Source: Savills Research

behaviour. We expect rental growth to turn positive following several years of decline. Strong retail repricing (+80 bps over the past four years on average across Europe) has turned the sector into one of the most competitive of all. This is already starting to catch investors' attention, and we expect this will start materialising next year through growing retail investment volumes. The best performing supermarkets and retail warehouses will remain the most sought after products, followed by convenience stores, commuting hubs and high street units in strong footfall areas.

There are no doubt that offices will remain commonplace to work for the foreseeable future. Yet, it seems not every office will continue to fit this purpose within the new agile working framework expected by employees. Given the rising residential prices in central locations in all European cities leading to lengthening commuting times and the growing concerns over sustainable mobility, office locations will further be paramount. Hence, based on the very low vacancy rate within European CBDs, notably in core and Nordics countries, we expect solid rental growth for prime CBD offices next year. As such, we expect investors to become increasingly selective seeking exclusively prime offices in key locations. This will support growing rental values and pricing divergences between prime and secondary assets.

In core markets, student housing, senior living and care homes have become mainstream, although still niches by investment volume standards. Strong yield compression for these asset types over the past five years has led to yield levels below 4%. In the very low yield environment, the search for higher returns will push investors further afield within the alternative segment. Hospitals, universities, data centres, life sciences, and urban farming are slowly emerging on investors' radars. We expect these sectors will gradually emerge as an asset class in the next five years. All in all, we believe the investment breakdown per asset class, will be slowly merging toward a more even distribution.

The amount of cross-border capital invested in Europe during the first three quarters of the year totalled €88bn, representing 49% of the total volume invested in Europe. This is 16% up on last year and in line with the previous five-year average for the same period. Gradually over the year, cross-border investment activity has been increasingly led by non-European investors, notably from the US, but also from Canada, Singapore, and the Middle East. We expect long-haul cross-border investment volumes to increase in 2022 unless travel restrictions are enforced due to rising concerns over the spread of the Omicron variant. Nevertheless, we also expect growing intraregional activities from investors, developers and operators. We anticipate Swedish investors to become the most active cross-border investors in Europe.

Core countries (UK, Germany and France) will remain the preferred investment destinations. We notably expect investment activity to increase in France (+20%) and the UK (+10%), whilst it should remain stable in Germany. We also believe the Nordics' share in the total European volume could continue to increase as the region is increasingly attracting foreign capital. During the first three quarters of the year, the Nordics accounted for 21.8% of the total European volume, up from a record level of 15.5% last year.

Over the past few years, the number and the volume of forward-funding deals have been growing significantly, accounting for 7.5% of the total investment volume in 2015 to 16.4% in 2021 (to Q3). We expect forward-funding investment intentions will increase, mainly driven by the living sectors and logistics. However, the overall volume is likely to decrease slightly due to increasing concerns about development delays caused by major disruptions in supply chains, which are unlikely to ease anytime soon.

Another year of prime yield hardening ahead

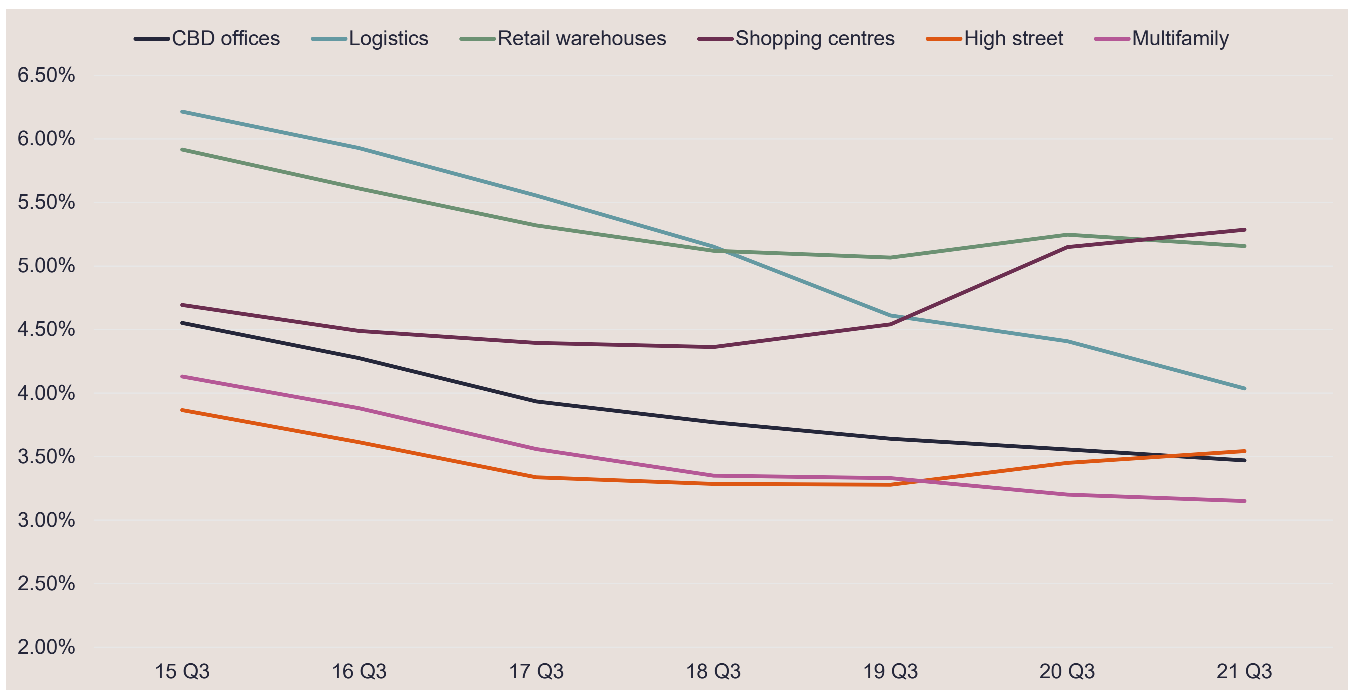
On average, the prime CBD office yield hardened by 9 bps to 3.49% over the past six months, driven by strong compression in core cities. Manchester, London City, and West End compressed by 25 bps, Berlin and Cologne hardened by 20 bps; Paris and Barcelona by 15 bps and Dusseldorf and Hamburg by 10 bps. Rising long-term government bond yields during Q2 and Q3 2021 have not had any impact on record-low office pricing across the main markets, with long-term risk spreads remaining in line with the long-term average. We believe there is still some gap for further yield inward movement for the best CBD offices. We forecast an average annual compression of 3-5 bps by the end of 2022.

The weight of capital targeting European logistics has compressed average prime yields by 28 bps over the last six months - the most significant yield compression of all sectors. Core markets, including London (-25 bps) and Paris (-35 bps) continue to compress, whilst Lisbon (-75 bps), Milan (-50 bps), Madrid (-50 bps) and Amsterdam (-50 bps) observed the strongest compression. For the next 12 months, we expect prime yields to harden further, by 10-15 bps on average in Europe.

Growing investor interest has also put downward pressure on prime yields across the living sectors. During the past six months, the average prime European multifamily yield compressed by 6 bps to 3.2%. The average prime student housing yield has moved in by 14 bps since Q1, standing at 4.1% in Q3 2021. During the same period, prime senior housing and prime care home yields hardened by 14 bps and 17 bps respectively on average across Europe. We expect further yields compression across the living sectors in the next 12 months (5-10 bps on average). This is most particularly true for care homes and student housing, two segments for which we anticipate significant activity in 2022, fuelled by mergers & acquisitions (M&A) between care home operators and disposals of large student housing portfolios.

Within the retail segment, retail warehousing yields have converged further with prime shopping centre yields. Average prime retail warehouse yields compressed by 4 bps in the last two quarters to 5.2% whilst at the same time the average prime shopping centre moved out by 3bps to 5.3%. Average prime high street yields are also edging upwards (+3 bps). We forecast prime retail warehouse yields to compress further by 5-10 bps on average during the next 12 months, whilst shopping centre and high street yields are anticipated to start stabilising during 2022 on the back of renewed investor interest for retail.

Prime yields - Edging downwards



Source: Savills Research

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