

Real Estate House View

Europe

First half year 2020

Key takeaways

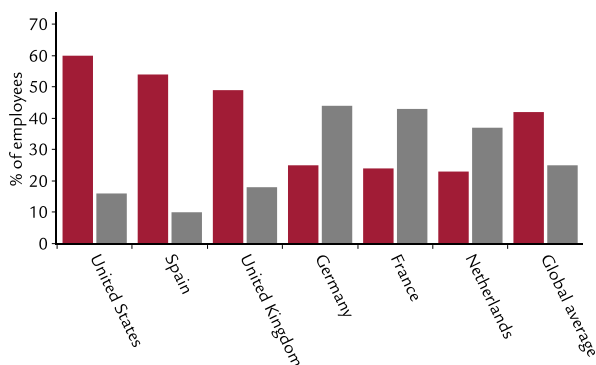
- **Ongoing investors' demand:** transaction volumes capped by lack of supply, yield compression ongoing in the short term.
- **Economic cooling to impact income:** weaker occupier demand influences the performance of assets and portfolios.
- **Possibility of yield increase in medium term:** uncertainty about structural changes and the late state of the cycle can lead to higher yields in the medium to long term.
- **Regulations as main risk:** the increase of regulations, not only in the residential sector, impacts investment activity.

Food delivery delivering more vacant space?

While currently gastronomy is claimed to be the solution for vacant retail space (although at lower rents due to lower margins!) the food delivery business will become a space disruptor in the near future. While companies like Uber Eats, Deliveroo and takeaway.com are already visible in public, popular new formats such as shadow kitchens or home delivery of groceries are on

the rise. Across Europe, online grocery shops are still in their infancy, yet growing fast. Supermarkets are improving technologies when it comes to warehousing and fulfilling of orders. Changing consumer behaviour such as increasing orders of readymade meals or their ingredients to your doorstep will impact the space needs of traditional supermarkets.

Chart in focus



■ Willing to adapt to a more innovative office environment
■ Not willing to adapt to a more innovative office environment

Source: JLL, survey Workplace (2018)

Changes take time. While we believe that structural change is a given in the future, cultural differences are visible. Flexible working models and the willingness of employees to adapt to new working environments varies widely across countries. While in Germany and France, employees are more reluctant to accept innovative environments, the flexibility to adapt is far higher in the UK. According to the world average, 42% of employees are open to give up the cellular office for a more innovative office environment.

Throughout 2019, Europe's industrial sector was particularly hit by global headwinds with the Sino American trade dispute and Brexit-related uncertainties. At the end of 2019, purchasing managers' indices (PMI) in most European economies stood below the 50-points expansion line. For 2020, risks of spill-overs into more domestically oriented service sectors remain on an elevated level. The multi-year healing of Europe's labour market is likely coming to an end, as unemployment is expected to stop falling further in 2020. Meanwhile, prospects of ongoing monetary policy support and a stronger fiscal impulse in the Eurozone compared with 2019 should prevent Europe from falling into recession.

And it goes on...

Contrary to the sentiment from six months ago, the decrease in the economic dynamic doesn't seem to have been the reason for a decreasing transaction volume in the first half of 2019. Or to be more precise: the cooling seems to be less of an issue in an environment of lower interest rates, offsetting weakness caused by external headwinds and therefore pulling more money into the markets. Yet, the volume of commercial real estate was 5% lower compared to the prior year by Q3 2019. This can be explained by a still existing – or at least felt – lack of good quality assets. The high investor demand also compressed yields in 2019 more than originally anticipated. With investor demand remaining elevated, we expect yields to decrease on average again in 2020 before levelling out. In the medium term, as headwinds stemming mainly from the economic environment persist, yields can increase while representing a higher risk. Having said that, investors should not be overly high-spirited but well aware of existing risks.

...yet proof of resistance needed

While investor demand undoubtedly remains, we expect an impact of the economic dynamics in combination with structural changes and a tendency for more regulations. Weaker occupier demand in the commercial sector influences the performance of assets and portfolios. The performance gap between desirable and undesirable sectors, locations and building types continues across Europe. The retail sector in its segments is the best example. Within a high street, a couple of

metres can decide if the location is attractive or not. Furthermore, outer skirt locations of big office metropolises (e.g. illustrated by high vacancies in peripheral submarkets like in Amsterdam, Brussels or Stockholm) struggle more than before. In the residential sector, the situation is somewhat bizarre: many investors are moving out of large cities - not due to poor fundamentals, but because yields are insufficient. With investors taking more risks to fulfil their demand, various scenarios and different outcomes should be discussed.

Office as safe haven

The office sector continues to be the largest investment sector in Europe while the lack of supply is decreasing absolute investment volumes. The office sector is also the one in which yield compression was most visible in 2019 and the one where we expect an observable yield decrease in 2020. With space supply still limited, we expect rents to further grow in the short term. Yet new supply may come in "too late": while net additions are picking up slowly, lower employment growth may lead to regional oversupply with the related downward pressure on rents. In the medium term, we therefore expect rents to be flat on average across Europe. On a country level, main cities still seem to be attractive. Paris overtook London marginally in 2019 as the most active investment market and offices were the largest sector in Paris by Q3 2019. Berlin has seen high occupier demand, mainly driven by tech companies and a flourishing start-up community. This rather "young" economy needs to prove resilience by implication in a less favourable economic environment. In comparison, London is proving its resilience in times of Brexit uncertainty. Occupier demand has held up well in London this year, with activity running at around 14% ahead of the ten-year average. In Paris, demand was high, leading to a falling vacancy rate in Paris CBD of 1.7%, down 20 basis points (bps) in one year. The same for Zurich, where space is scarce with a vacancy rate of 1.4%.

Ongoing monitoring

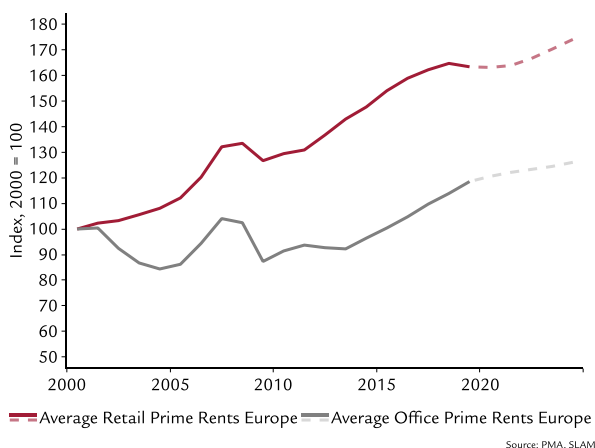
We are still in the monitoring mode when it comes to the retail sector. While we have already reported repeatedly about the ongoing structural change, the outcome is yet unclear. Despite new formats, vacant retail space

is filled with pop-ups and gastronomy is still treated as the saviour in need - the situation has not yet improved since lower margins with impact on future rent growth must be considered. The decline in investor confidence and therefore in investment volumes is a sign of the times. The volume was down by 32% y-o-y by September 2019 with a clear effect on pricing. The performance gap between desirable and undesirable cities, locations and buildings is visible in this sector. Demand for super-prime retail does exist, but trades are few and opportunities are rare. The UK still feels the hardest hit, where retail values fell 7.7% over the first nine months of 2019, due to a combination of rental declines (-2.9%) and pricing movements. Values have fallen across the sector, but the loss has been most acute in shopping centres (-11.7%) and retail warehouses (-9.6%). The UK can be considered as a forerunner, as for instance in Germany demand for retail warehouses is high and yields are under pressure. London serves as an example of why yields can be increasing in the short to medium term indicating the state in the cycle and the effects of structural changes on rents. On average, we expect rents and yields to be flat in Europe this year, with downward trends in rents and upward ones in yields – trends which are visible in many regional markets related to high streets only for instance.

Rents in logistics less affected

Major geographical cluster and location structures developed in the logistics sector. Yet, the network of logistics facilities for the various operations is becoming denser, especially through e-commerce. Its growth is

Chart 1: Average prime rents in the top markets in Europe

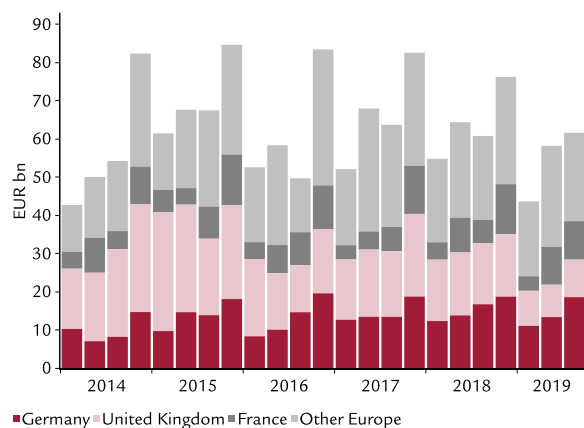


increasingly spilling over to peripheral European countries, where e-commerce has had a below-average penetration rate. This applies to Central Europe, where this region has a double function in logistics: regional demand is growing due to the growth of online trade; at the same time the region serves numerous online retailers as a delivery and returns hub for the dispatch of goods to Western and Northern Europe. The influence on rents remains relatively limited. A large amount of land and development sites is available, so that the potential for increasing rents is focused on central locations in the metropolitan regions - the situation is similar in other European regions, however the availability of land is more complicated.

Regulations spoiling demand?

The residential sector saw the highest increase in transaction volumes by September 2019: apartments went up 7% y-o-y and senior housing and care even 14% y-o-y. Yet it is also the sector most in focus, more regulations are expected, mainly driven by affordability issues. Rent caps are being discussed in Berlin, and also in Paris there is talk of a reintroduction. In Switzerland, a national initiative for “more affordable rental apartments” was launched. This has impacts on developments (currently mostly stopped in Berlin) and investors’ desire to invest in a market where growth is hindered. After location, regulations are increasingly becoming the main risks for investors, raising the question of how to price these in when buying.

Chart 2: Commercial property transaction volumes



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