

# Real Estate House View

## Europe

Second half-year 2020

### Key takeaways

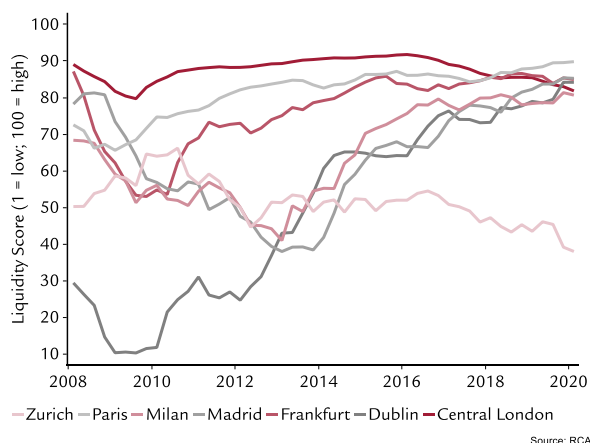
- **The corona crisis has had an unprecedented impact on real estate:** Real estate markets have been confronted by changing behavioural characteristics in the use of physical space by occupiers. Countries and sectors with higher average levels of liquidity have been the first to recover to their pre-crisis pricing levels.
- **Long live the office:** Despite a move towards home working and a rise in flexible working models, we expect demand for office space will remain and likely rise in prime locations. We forecast that office demand to follow the U-shaped economic recovery.
- **Rethink retail:** The pandemic has reinforced structural trends in the retail sector, most notably an increased online penetration. This will negatively impact capital values and income across the sector.
- **Shock for the hotel businesses:** An increase in domestic travel will not cover the lost income from the recent fall in international tourism and business trips. A recovery to pre-crisis levels is not expected before 2022
- **“Safe haven” residential:** Prices and investment volumes have remained firm in 2020. Pre-crisis core drivers within the sector remain, such as a lack of housing, high sales prices, and growing urban populations.

### Cycle-based cities to emerge from COVID-19?

COVID-19 lockdowns led cars being replaced with cyclists traversing back streets from Bogota to Barcelona. Extensive pop-up bike lanes have appeared. The current reopening of economies offers society the opportunity to reimagine city transportation. Reduced traffic and pollution and more cyclist safety measures

should positively influence property values. Cities are expected to walk the talk of environmental discussions. Falling car use as people work from home, walk, and cycle more could herald a permanent trend to create space within cities.

### Chart in focus



Today's crisis is very different to the GFC of 2008 and it remains to be seen whether property pricing will be affected in the same way. According to RCA, markets with higher average liquidity before the GFC tended to be the first to recover to their pre-crisis pricing levels. This should provide a level of comfort to owners and landlords in these markets.

The impact of COVID-19 has varied across European countries. While the magnitude of declining economic activity is highly correlated with the evolving health crisis and the severity of containment measures introduced since March, the timing and pace of the economic recovery depends on country specific fiscal policy strengths and the sector composition of their economies. Southern European countries and the UK have experienced a comparably deeper medical crisis than German speaking countries and their central European neighbours. The EU agreement on a recovery fund is an important move towards supporting the fiscally weak peripheral member states of the Eurozone and to ensure a more sustainable financial union.

## A real shock - depending on where you are

The COVID -19 pandemic and the preventative measures taken in response have impacted real estate markets. Shops, restaurants and offices were temporarily closed. Apartments which are normally almost empty during the day were in full daily use. Compared to the GFC we expect the shock to be deeper and the recovery faster. Although the demand for space will be impacted by the global recession and its long-term consequences, investment conditions have not significantly changed. The low interest rate environment will likely incentivise investors to spend capital to reach their investment goals by the end of the year. Up to mid-year, RCA data indicates slow real estate investment volumes. However, in Q2 2020, European transaction volumes held up better than anticipated in some countries. Investment volumes in Germany were up +5% year-on-year for example, whilst volumes in Spain fell by -69%. In total, European transaction volumes totalled EUR 50.1bn in Q2 2020 which represents a decline of -32% compared to the same period last year. A handful of supersized deals supported this figure. According to RCA, deals priced at EUR 250m and above accounted for 40% of the quarterly total. Deals under EUR 20m dropped by 55%. Data already available for rents and yields in the second quarter does not indicate much change, especially within the office sector. Within some sectors of the UK market, where valuations are carried out more frequently than in Europe, outwards yield movement is evident. In other European countries, the effect of the current crisis on yields is yet to unfold.

## What is the new normal?

The largest experiment of home working in history has clearly demonstrated the ability of staff to maintain output without the necessity to be physically present within an office. The office sector has not been as significantly impacted in the short term as other sectors, but lasting changes and the resulting negative side-effects caused by a declining economy are expected to weigh on demand. Although the pandemic led to a huge step forward in flexible working, solely working from home will not become the new normal and physical offices will still be needed. We expect to see a desire from occupiers for less office space at the aggregate but for better quality, more expensive space. Office space will also be resigned to allow less space for desks and more for social encounters and meetings. We anticipate office demand will track the U-shaped economic recovery path. This means continued low take up in 2020, followed by a recovery in the medium to long term. Corporates are likely to remain cautious, deferring expansion plans, downsizing existing space and seeking more lease flexibility.

## Rethink retail: challenged again

The pandemic has accelerated the ongoing structural changes already seen in the retail sector before the crisis. Retail has been negatively impacted by the forced closure of most shops and supply chain disruption. Retailers that were allowed to continue trading have recorded strong sales performance. Greater online retail penetration is likely to be a lasting change brought forward by the pandemic. Most physical retail outlets that remain in the future will need to form part of the distribution network to fulfil online orders through delivery or click and collect, to return goods or to touch and feel items before ordering them online. Occupier demand for physical retail focused on convenience, value and experience is expected to endure. There is likely to be a growing differentiation between physical retailers within the same sectors. Landlords will need a closer relationship with their occupiers and truly understand their business models. Turnover rents may be more widely adopted. The anticipated increase in unemployment will likely depress consumer spending in the short to medium term. Vacancy rates are likely to rise in prime touristic cities. Luxury high street retail-

ers will continue to suffer until inbound tourism recovers. Overall, retail volumes fell by -37% in the second quarter of 2020 year on year.

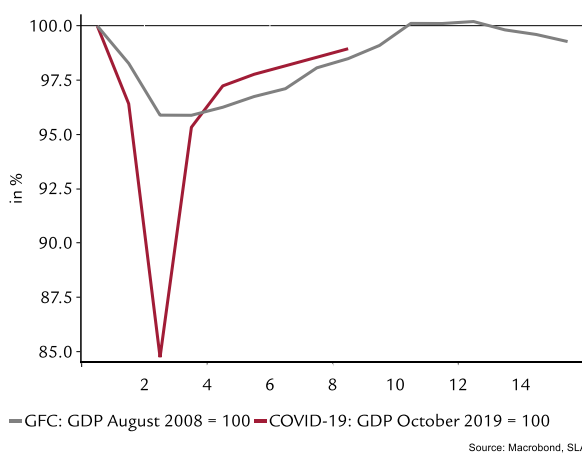
## Logistics a beneficiary

The pandemic has shown the weakness of global supply chains and just-in-time delivery models. Occupiers are likely to reassess these business models in the medium-term as a result, creating stronger demand for storage space and a shift towards the reshoring of some manufacturing activities. E-commerce activity has captured an increased market share across most sectors during the lockdown. This is expected to endure once the pandemic recedes. Attracting new customers will support demand for large distribution centres and last mile logistics. The cutback in demand for store-based retail in sectors such as fashion, could cause logistics serving high street stores to decrease. The sector is especially likely to see a far higher investment in technology, automation, and robotics.

## Hotels: from hero to zero?

European hotel investment decreased by -77% in Q2 2020, the sharpest decrease across all main property sectors. Domestic travel is slowly growing again but many hotels are more dependent on international tourism and business travel, which are expected to remain low. This will put the business models of many operators and their future cash flows in doubt. 5-star hotels are particularly dependent on foreign spending

Chart 1: GFC vs COVID Eurozone

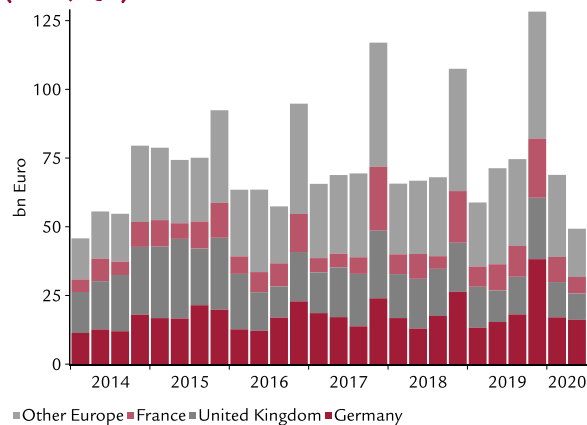


and are expected to suffer the most. We do not expect visitor demand to recover to pre-crisis levels before 2022. Yields are expected to rise, especially for assets let to weak operators or those with a high dependence on inbound tourists. In the short term, domestic demand will remain more important than inbound visitor demand. However, more peripheral destinations will fare better than international cities. Appetite from investors is predicted to remain depressed for some time.

## Apartments as shelter

The residential private rented sector (PRS) is perceived as the “safe haven” for investors as lockdown and economic effects have not led to a reduction in tenant income. Prices and investment volumes are likely to remain robust in 2020, with Germany and Switzerland to be the strongest performing countries. The stable performance across the PRS sector will attract more European investors. We expect net initial yields for PRS developments to compress in 2020. In the medium term, the housing affordability issues already visible before the COVID-19 outbreak will reappear. However, it is likely that weak economic dynamics impacting wealth will dampen demand for rental homes. In the medium-term rental losses could become apparent. Structural changes will lead to increased consolidated in PRS. A greater reluctance to commute could emerge as a consequence of the pandemic which would strengthen the urbanisation trend. However, the willingness of tenants to pay may be reached at some point, increasing demand for more rural apartments offering more plentiful space to work from home.

Chart 2: Commercial property transaction volumes (RCA, Q2)



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