Real Estate House View
Strategy implications

SwissLife
Asset Managers

First half of 2021

Key takeaways

- **K-shaped development:** the polarisation of locations and sub-sectors has once again increased markedly, particularly in retail
- **Overcome short-term view**: current developments should not obscure the long-term view of real estate investors
- **Action rather than reaction:** after experiencing rapid changes, focusing on long-term scenarios is a key requirement for long-term investments such as core real estate
- **Shift of returns:** the strong focus of investors on core assets offers opportunities for other investment strategies
- **Partnership**: investors should now be seeking strong relationships with their current and future tenants in order to be part of the solution

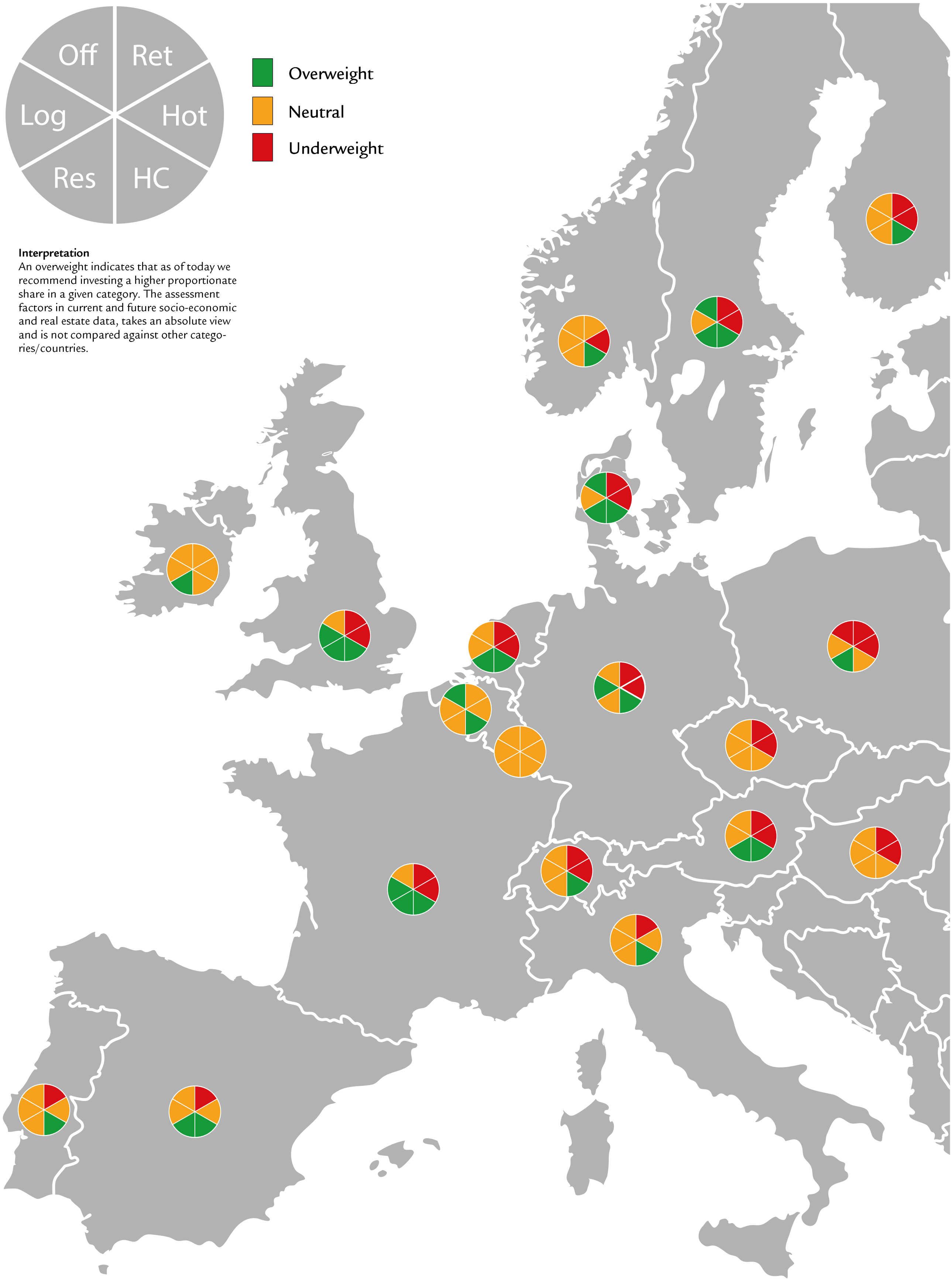
Strategy implications – *type of use and regional focus*

	Office	Retail	Industrial/ Logistics	Residential	Hotel	Healthcare
What	Central location, good connectivity	Convenience shops, local supply	Urban logistics, light industrial	Metro areas with favourable socio-economic fundamentals, overweight in multi-family	Main cities with exposure to leisure and local travel	Focus on age care, later living, good operators
Where	London, Paris, Berlin, Munich, Zurich	Selective cities across Europe	Metro areas in Germany, France, UK, Benelux	Germany, Switzerland, France, UK, the Netherlands	London, Paris, Munich	Germany, the Netherlands, France, UK

European environment

In 2021, investors will aim to get back on track regarding their investment targets and make some adjustments to their strategy. Due to the current uncertainty, they will tend to focus on core assets in prime locations, thereby reducing their return. In this environment, it could pay off for some to consider value-adding or opportunistic strategies in order to maintain their return targets. However, and apart from any short-term events or style drift considerations, pure core investors' key focus will be on the long-term orientation of their real estate allocation. We therefore continue to monitor lockdown impacts while also focusing on long-term changes that could influence the income stream of an asset, such as home-working and online shopping trends, as well as a recovery of travel.

Market investment – *overview*



Interpretation
An overweight indicates that as of today we recommend investing a higher proportionate share in a given category. The assessment factors in current and future socio-economic and real estate data, takes an absolute view and is not compared against other categories/countries.

Office sector – *neutral*

Favoured strategy:

- Central location, good connectivity
- London, Paris, Berlin, Munich, Zurich

As the new year gets underway, for many companies the economic future is still tainted with uncertainty. Take-up consequently remains subdued. At the same time, the long-term effects on the demand for space due to an increased share of employees working from home are adding to the uncertainty. Investor demand is therefore very selective – a strategy we support as we believe that 1) not all work that needs floor space can be done at home, and 2) even if work can be done at home, people still have a need to meet, socialise and innovate together while also seeking an experience of affiliation to the company.

The strategy for a core/core+ investor remains the same: focusing on good quality assets (i.e. with flexible floor space and a high technical standard) in the well-connected environments of larger metropolitan areas is a safe way to go. In any event, 2021 will be a year of transition characterised by weak demand for new space, as companies are likely to hold back on location and staffing decisions until the pandemic is over.

As the supply of these kinds of assets is low and demand high, we expect yields to decrease further. In order to pursue a given return target, now is therefore a good time to rethink strategies and invest in urban-outskirt still to be developed. However, more specialised know-how is needed for such investment strategies.

While we wish to highlight the need for accurate asset selection with our "neutral" weighting, some European office markets can be categorised as "overweight", especially urban areas such as London, Paris, Munich and Zurich.

United Kingdom – *neutral*

H2 2020 take-up was weak as renewed government restrictions prevented office reoccupation. Thus, take-up for 2020 remained 40% below the five-year average. There were also concerns about a no-deal exit from the EU. With a trade deal now struck and the vaccine rollout underway, we expect take-up to improve throughout H2 2021. The pandemic has prompted occupiers to reassess their preferences. In future much more space will be devoted to collaboration rather than to desks. More emphasis will be placed on quality and service. Well connected, amenity-rich locations such as Central London and the "Big Six" markets should be resilient as they are easily accessible and provide the vibrancy occupiers desire. Stock selection will be crucial.

France – *neutral*

Take-up in France has decreased by 50% since the start of 2020. In addition, last year's 30% drop in the Paris investment market can be explained by the lack of investable stock. Corporates will continue to reduce floor area in the short term. Reduced developments suggest a structural downward shift in take-up. Apparently commercial incentives are back at their 2008 levels in the Paris region, with strong divergences across submarkets. Inner Paris is experiencing polarising trends in letting and investment demand. Following recent transactions, prime rents and capitalisation rates in the CBD are stable. The outer submarkets are vulnerable, with a stronger outward yield shift in locations with higher vacancies such as La Défense (9.7% at the end of 2020) and Paris CBD (3.4%). We recommend stock-picking assets in new emerging tech markets. Paris remains our preferred market, as it is set to lead in the recovery phase.

Germany – *neutral*

Berlin and Munich showed their resilience in 2020 with ongoing low vacancies of around 2% and moderate declines in take-up, thereby remaining our favourites. The other top seven markets and economically strong regional markets provide additional opportunities for core properties. Owing to the shift towards flexible working, location is becoming more crucial: modern, customisable buildings in central locations are on the list to buy. Properties in less attractive decentralised locations with problematic transport connections and service infrastructures should be avoided or sold out of portfolios.

Retail – *underweight*

Favoured strategy:

- Convenience shops, local supply
- Selective urban areas across Europe

Retail sales altogether held up surprisingly well in 2020 given the slump in GDP witnessed. However, they were significantly supported by the shift to online shopping, which forms part of total retail sales. With another sharp rise in online sales in 2020 of 36% in the UK, 20% in Germany and 14% in France (up from 19%, 16% and 11% respectively in the previous year), this trend will further reduce the demand for retail space in the medium to long term. It has become increasingly difficult again to talk in general terms about retail; instead we need to distinguish between convenience shopping, supermarkets, high streets, shopping centres, services, catering and so on.

The pandemic has not only accelerated structural changes but also revealed some structural failings: the "no brainer" sector has for a very long time faced challenges leading to an oversupply, mismanagement and underinvestment in existing assets.

As an investor, it is now time to be part of the retailer's business story, which in turn must take consumers' needs into consideration. While focusing on the desire for convenience, we believe the combination of stationary and online is set to be the future (e.g. click & collect). This is very likely to lead to less space demand, while at the same time operators become more prudent in their space selection, with changing requirements in terms of configuration. In our view this will lead to a retail landscape with less but enhanced floorspace and fewer but fitter operators. At the same time, all services that cannot be provided online such as hairdressers and restaurant meals will also need to be considered as these are also services people wish to experience.

Going forward, retail will be a capital-intensive sector that requires readiness to invest. The fall in value of specific locations is an opportunity to reposition assets, change the tenant mix (or use) and make rental profiles more affordable for traditional retailers (tenants) and good returns. Furthermore, locations with strong alternative uses may also offer interesting conversion opportunities to attract value-add investors.

United Kingdom – *underweight*

The retail sector is at the epicentre of structural and cyclical trends. Renewed lockdowns in H2 2020 compounded issues for retailers already contending with strong online retail competition. The online retail penetration rate reached an all-time high of 36% of all spending in November 2020, according to the Office for National Statistics. Food and discount retailers have remained open and traded strongly. Other retailers which lack an online presence are under extreme pressure. Rent collection in the retail and leisure sectors has been low and vacancies are rising. In the short term we expect high street retail and shopping centres to see further capital erosion. Retail warehousing and supermarkets will remain resilient for the time being.

France – *underweight*

We maintain our baseline scenario implying a high rate of defaults at high street shops and a spike in vacancies at shopping centres. Retailers will continue to face headwinds of potential new lockdowns and e-competition. One positive outcome of the COVID-19 crisis is the acceleration of the multichannel retail strategy benefiting both retailers and consumers. Nevertheless, vacancy and capitalisation rates are increasing. They will start to decrease again at some locations as soon as tourists return and the vaccines display an effect. Elsewhere, however, retailers are set to keep rationalising their portfolios and closing shops.

Germany –*underweight*

Inner-city areas will remain the preferred location in the long term, not only for retail, but also for restaurants, services and leisure. For investors, the key question concerns pricing and timing. There is major uncertainty about rent levels and therefore prices and valuations. Following the downward adjustments of rents and prices, high streets will revive – assuming people are keen to reconnect in public places with commercial service offerings. Strong attention must also be paid to the trend in supermarkets, currently the strongest retail segment. Online trading is quietly knocking at this door too. However, due to the high costs of packaging and delivery this is not yet a breakthrough story. Retail parks and supermarkets in medium-sized and smaller towns seem to offer better prospects than locations in metropolitan areas, where the strong competition from delivery services may arise first.

Industrial/logistics – *overweight*

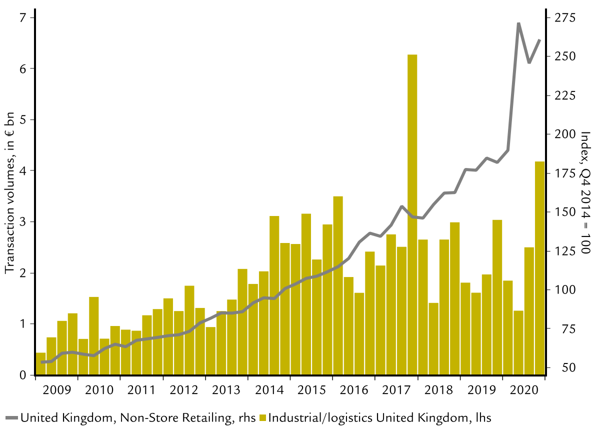
Favoured strategy:

- Urban logistics, light industrial
- Metro areas in Germany, France, UK, Benelux

The recent surge in e-commerce has boosted demand for logistics space, but in urban areas in particular the availability of space and land is severely limited. This makes the revitalisation of (brownfield) commercial sites a promising strategy for investors who can afford and handle such project developments. These sites close to city centres offer potential for both city logistics and commercial uses for manufacturing and trade.

The sector is at a crossroads due to the disruption of some supply chains, notably in the manufacturing sector, that is affecting logistics platforms. Light industrial and last mile delivery formats are set to continue outperforming thanks to new flexibility needs and consumer behaviours. The downside risks for the overall sector, particularly light industrial, stem from the increased regulation expected in urban areas (retail protection and minimisation of carbon footprint).

Although we are fairly confident about investing in this sector, we recommend careful asset selection. While our "overweight" assessment reflects the clear upward trend, the sector's cyclicality due to its strong correlation to GDP growth needs to be closely monitored.



Source: Macrobond, RCA

United Kingdom – *overweight*

The second half of 2020 saw record logistics investment volumes fuelled by online retail sales growth and pre-Brexit stockpiling. Occupational activity in 2020 was the highest ever at over 4.6m sqm (50m sq ft) for "big box" (>9290 sqm or 100 000 sq ft) warehouses, according to an industry study. We expect online penetration to retract from its current peaks in the short term but to settle at a level far higher than prior to the pandemic. This will support demand for high-quality and well-connected assets within or adjacent to major conurbations. According to agents, supply of grade A big box assets is at its lowest in three years, which may support further yield compression. We advise caution regarding secondary assets as we expect modern occupiers to become increasingly uncompromising in terms of specifications.

France – *overweight*

Investment demand remains strong around large cities such as Paris, Lyon and Lille. However, capitalisation rates are following different paths depending on asset types (size, vintage, use) and accordingly reflecting uncertainties regarding economic cycles and fundamental changes. As the industrial/logistics sector is one of the most volatile in terms of performance, we favour a stock-picking strategy. Landlords with strong ties to flagship European specialists should be better placed to secure long-term leases.

Germany – *overweight*

From a regional perspective, not only the popular top seven cities should be considered, but also regions with a diversified economic structure and spread of tenants such as the Ruhr or Rhine-Neckar areas and urban areas such as Nuremberg. Both the effects of the pandemic on individual business models and the general structural change in the manufacturing industry underline the need for a well-thought-out tenant mix. While the heartland of car manufacturing around Stuttgart remains open for investment due to its diversification and size, smaller, monostructural regions such as Salzgitter/Brunswick should be avoided. New acquisitions should focus on multi-tenant properties and the favourable market situation should be used to sell single-tenant properties.

Residential – *overweight*

Favoured strategy:

- Metropolitan areas with favourable socio-economic fundamentals, overweight in multi-family
- Germany, Switzerland, France, the UK and the Netherlands

Residential remains the top investor target of the COVID-19 era. However, we wish to raise some concerns for the long term due to the short-term effects of the expected rise in unemployment. Altogether residential remains a sector favoured by both domestic and international investors. This will bring yields under pressure, with well-established markets such as Germany, the Netherlands and Switzerland taking the lead.

Increased home-working could also have an impact on the residential sector. As workers spend less time commuting and increasingly work from home, they may consider living further away from their workplace. Closer to nature and open countryside, suburban residential areas offer more affordable and spacious housing opportunities. Interesting investment opportunities are likely to emerge from these changing living and work habits.

A more conservative approach is recommended for flexible living as long as future occupant patterns remain uncertain. Assuming students wish to remain close to universities, selective investments in student housing in established university cities with low supply rates are attractive. However, as it is more difficult to predict how businesspeople will act in future, we are cautious about micro/serviced apartments with (young) professionals as a target group.

We also continue to pay special attention to regulations in the residential sector, although we would not dismiss a country or region solely due to regulatory constraints. The call for public rent control measures largely stems from a sharp increase in rents in the past, which is why affordable housing has come to the fore of investors' attention. Affordable housing is particularly needed in metropolitan areas, which are a key focus of investors. Despite the intense competition in this segment, investments here offer secure long-term income while also scoring well in terms of ESG criteria.

United Kingdom – *overweight*

Recent events have led to renewed interest in the residential sector due to its strong pandemic performance and long-term potential. This reflects the significant need for modern accommodation across the aged care, later living and build-to-rent (BTR) markets combined with its reliable, non-discretionary income, low turnover and operating costs. BTR transaction volumes in 2020 are expected to be 44% higher than in 2019, according to recent market studies. We expect investor appetite for living products to remain strong.

France – *overweight*

Seen as a safe haven, private, affordable and social housing generated average rent collection of more than 95%. Owing to the imbalance of supply and demand, prices in the top five largest cities in France are not expected to fall. The current crisis has opened strategies up to the build-to-rent sector due to the shift in preferences. Interestingly, as in the UK and Scandinavian markets, demand for co-living is also on the rise in Paris in anticipation of increasing worker mobility with the opportunity for tenants to share costs. Structural trends such as demographics and access to the labour markets will maintain demand in Paris and Lyon.

Germany – *neutral*

Owing to strong fundamentals, the focus on risks is particularly important for investment strategies in German residential. A strict regulation such as Berlin's rent cap puts the city on investors' waiting lists until court decisions finally provide regulatory clarity for long-term planning. Other large cities in Germany are likely to follow suit if this intervention is approved. We therefore prefer medium-sized and small towns in suburban areas with good transport connections and infrastructure. This, combined with fewer regulatory uncertainties and the availability of newly built apartments, makes them promising candidates. Suburban districts of larger urban areas, such as Dachau, Erding and Fürstenfeldbruck in the Munich region or Hochtaunuskreis and Darmstadt in the Rhine-Main area rank at the top of our residential scorings from a socio-economic and housing market perspective.

Hotel – *underweight*

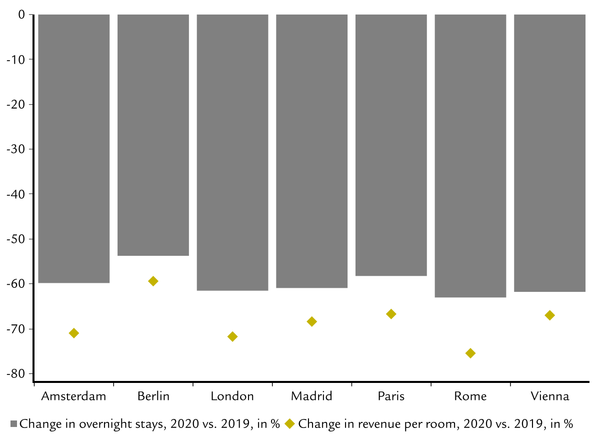
Favoured strategy:

- Major cities with exposure to leisure and local travel, average of 100-200 rooms
- London, Paris, Munich

Hotels continue to be impacted by the decline in business and leisure travel activity. Investors' hopes of being able to stay on the sidelines and "bottom fish" are diminishing.

Although we rate the sector as underweight, this is merely intended to underline our short-term caution and recommendation that investors conduct very profound due diligence on possible investments. In the medium to long term, we expect travel, including business trips, to recover and thus to stabilise the sector.

For now, the question remains as to how the relative share of leisure and business travel will develop in the future. While we expect leisure travel to recover fairly fast once vaccination rates are sufficiently high, the recovery of business travel is less predictable. With most business meetings taking place online, companies may see advantages here in terms of time and cost efficiency. Although face-to-face meetings will remain necessary in some cases, we expect the number of online meetings to hold up. This will further impact the hotel sector and challenge operators, while also opening up opportunities for investors.



Source: PMA

United Kingdom – *underweight*

Travel restrictions and the loss of inbound tourism have had a significantly adverse impact on hotels. Occupancy rates have been extremely low. We do not expect a strong recovery in inbound tourism or business travel in the short term and therefore advocate a cautious approach when allocating new capital towards Central London hotels. In the medium term we see sound prospects as tourism recovers to pre-pandemic levels. During H2 2021, domestic tourism is likely to bounce back strongly, with demand directed towards boutique and niche hotel offerings in regional locations.

France – *underweight*

Paris has the lowest occupancy rate due to a lack of international travellers. Notably, upper-end market operators reopened after the lifting of the first lockdown, but occupancy rates remained below 20%. By contrast, mid-market operators are in better shape and have benefited from domestic demand by digitalising their overall offering (in- and out-of-hotel services). The digitalisation effect seems to be boosting profitability per sqm through a shift from fixed to variable costs. Finally, the impact of the vaccines is set to reshape the market by mid-2021: on the downside, the metrics are not expected to recover from their average levels until 2022, which should be a key consideration when pricing a deal. In the long run, the sector remains highly valuable with France the largest country in Europe for tourist arrivals.

Germany – *underweight*

2021 at the very least is set to be a very difficult time for the hospitality sector, with insolvencies and consolidations of hotel chains likely. From an investor's point of view, the formation of larger, financially robust hotel chains is not such a bad thing and will cast a positive light on the hotel sector in the medium to long term. The selection of investment opportunities and locations largely depends on the demand side: tourists will return quickly to the hot spots such as Berlin and Munich once the pandemic is over, although international guests are likely to return more gradually. However, there is more doubt about locations with higher dependencies on business travel, trade fairs and congresses. In Germany, this applies to Frankfurt and Düsseldorf, which were both already experiencing hotel oversupply before the crisis.

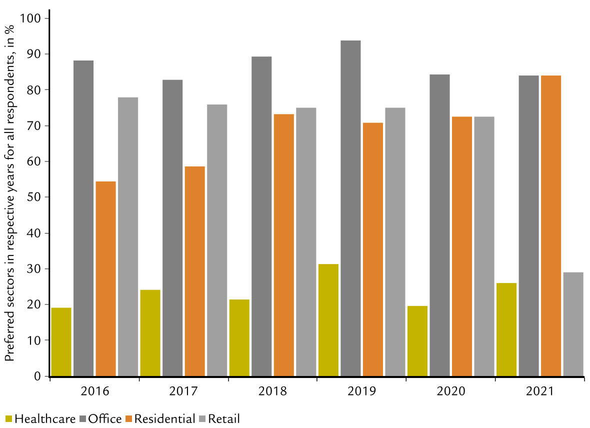
Healthcare – *overweight*

Favoured strategy:

- Focus on age care, later living, good operators
- Germany, the Netherlands, France and UK

Health is a buzz word for investors in the same way as residential products. The health sector is also considered a "sweet spot" for incorporating ESG aspects. However, nursing homes are facing tough challenges during the COVID-19 crisis. This is prompting investors to be all the more diligent when selecting operators and schemes. Nevertheless, for specialists the sector offers diverse allocations to medical offices, life science formats, nursing homes and senior housing. Based on the variety of tenant profiles, we believe that health will continue to provide opportunities related to an ageing population and the need for more hybrid schemes (e.g. assisted living and specific care institutions).

Overall, the sector has been a focal point throughout the pandemic, as the crisis has highlighted the importance of adequate healthcare facilities to respond to major public health challenges. As such, demand for assets such as life science facilities and medical offices has been increasing. Moreover, some existing trends, such as the aging of the population, continue to generate a high demand for senior housing. This in turn is reinforcing overall demand for the healthcare sector, which is a trend that investors should follow as it is likely to persist.



Source: Investment Intentions Survey (2016-2021)

United Kingdom – *overweight*

An ageing population and an acute shortage of supply underpins the thematic case for UK healthcare investment. As we expect age care services to evolve as a result of the pandemic, investors should focus on best-in-class stock serving affluent catchments which is likely to be most resilient. We believe the pandemic may support stronger demand for aspirational later living products as an alternative to age care. Later living supply is highly constrained, creating strong investment prospects for the right type of product, particularly in affluent metropolitan areas.

France – *overweight*

On average the sector has displayed strong resilience recently despite the COVID-19 crisis. Most operators have coped well with the crisis and learnt to become more flexible by implementing new services. By 2035, senior citizens will represent 25% of the overall population and 230 new developments are therefore underway and due for completion by 2024. The pipeline is very diversified both geographically and in terms of services (medical, semi-medical and senior housing). We continue to prefer new, modular and digitalised assets across France.

Germany – *overweight*

Our recent unprecedented experiences during the pandemic underline the importance of operators at nursing homes, not only regarding their organisation and expertise in protecting residents, but also in terms of financial strength. We therefore feel comfortable buying properties that are run by well-known, larger operators, especially if we already have ongoing partnerships with them. Regional aspects tend to be less important in view of the overall need for care throughout the country. However, a more critical view is taken towards regions with weak carer demographics, which may result in an oversupply in the long term. At the same time, a lack of professional staff owing to inadequate salaries could limit the occupancy and operation of facilities in major cities and metropolitan regions. Stronger regional differentiation is required in the assisted living segment. Since the cost of living is not borne by residents' social insurance funds, investments in regions with above-average purchasing power are the preferred option, thereby placing attention on metropolitan regions but without excluding economically strong rural areas.

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