Real Estate House View
Strategy Implications

SwissLife
Asset Managers

Second half-year 2020

Key takeaways

- **Investment environment unchanged**: the low interest rate environment drives investor demand for good-quality assets while the letting environment is dampened by the impacts of COVID-19.
- **Safe haven**: residential and healthcare sectors to remain investors' favoured sectors.
- **Increasing focus on buying assets rather than sectors**: flexibility of use as part of the business plan or also "manage-to-core" strategies.
- **Get to know your customer**: active asset management with a good relationship between the owner/landlord and the tenant is key for current and future investments.
- **Expanding of mobile office and weaker employment growth**: the future of office demand poses the biggest question mark, with decreasing demand over the medium term not to be completely ruled out.

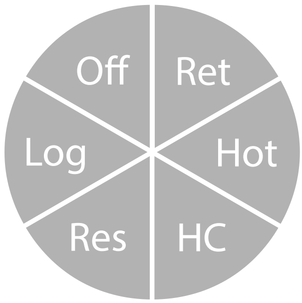
Strategy implications – *type of use and regional focus*

Office	Retail	Light industrial/ Logistics	Residential	Hotel	Healthcare
Central location, good connectivity	Emerging streets, local supply; retail parks	Urban logistics, light industrial	Urban areas; emerging countries with decreasing homeownership rates	Main metropolis with exposure to leisure and local travel	Focus on age care, later living
London, Paris, Berlin, Munich, Zurich	Paris, Munich	Germany, France, UK, Benelux, with focus on metropolitan areas/capitals and regions with superior infrastructure access.	UK, France, Switzerland and Dublin	London, Paris, Munich	Germany, the Netherlands, France, UK

European environment

The global economy has cooled, which will impact tenant demand, especially in the office, retail, light industrial and hotel sectors. Residential is generally less prone to economic cycles. With interest rates remaining low, the relative attractiveness of real estate investments is still intact. Yet we are more cautious and highlight the need for asset scenarios: in an environment where the uncertainty of some sectors is high, change of use should be part of the business plan when purchasing an asset. We favour a well-diversified asset strategy across all sectors with a focus on flexibility. The main risks for investors remain a lack of good-quality assets, increasing transaction prices due to high demand and a growth in regulatory density.

Market Investment – *Overview*



Overweight

Neutral

Underweight

Office sector – *neutral*

Favoured strategy:

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

Given the outbreak of COVID-19, the lockdown measures and the global shift of working from home (WFH), the sector faces a big question about future use and need of office space. We believe that space will still be needed going forward - be it for social interaction or videoconferences - the tenants' opportunistic cost considerations and economic development will have an impact on demand. Tenant demand will be strong for offices located at major transport nodes, there will also be a rising need for cycle storage and end-of-trip facilities for walkers/ runners. Investors should bear these factors in mind.

We expect valuations in core locations to hold up in general, as we see a strong flight to quality and still relatively short supply of good quality floorspace in prime locations. We would rate some individual European office markets as overweight, such as prime offices in French submarkets, Denmark, Sweden and Belgium. In Brussels, the EU recovery plan will imply more political power, i.e. a larger workforce in the EU institutions and related sectors to implement and control the new policies, resulting in a strong subscription of the office market. In Denmark and Sweden our assessment stems from a well sought-after tenant market.

As the situation for investors is unchanged and the flight to quality is as strong as ever, we expect yields for prime assets to decline further. However, given the price levels, the interest rate environment and the (late) cycle, core/core+ assets fulfil investors' long-term income requirements, albeit at low returns. The increasingly demanding nature of occupiers also means that active asset management is needed, and enough capex allowance must be provided for hold periods, especially in the case of unexpected developments.

In summary, we believe in the future of office space, yet focus on prime assets in good locations and buildings that can adapt to the new requirements of companies and their employees. The "neutral" assessment is based on the economic uncertainty.

United Kingdom – *neutral*

The pandemic and lockdown have led to weak office demand. In Greater London and the South East, for example, office take-up fell by 28% in H1 2020 according to Savills. Aggregate office demand in the short term is likely to fall further, requiring a highly selective investment approach. Modern, well specified offices in central, accessible locations serving strong knowledge-based economies, such as Central London and the "Big Six" markets should be resilient. Weaker economic conditions are expected to negatively impact pricing in the short term, so caution is advised. Office quality and amenity is key.

France – *neutral*

Paris will be more resilient given its easy access in a post COVID-19 world: demand is not expected to fall as in La Défense, which is highly dependent on public transport. Given its economic and diversified profile, Paris is less at risk than other more traditional submarkets. Even though rental growth may observe a slight downward adjustment in the short term, the capital city will remain a key anchor of demand and capital. COVID-19 has accelerated a notable trend towards further polarisation of both tenants and investors towards inner-city Paris. Paris is also expected to lead in the recovery phase, paving the way for new rental growth. As of today, the lack of products is limiting transactions.

Germany – *neutral*

The major German cities such as Berlin, Cologne or Munich achieved very low vacancy rates of less than 3% (in Q2 2020), creating a sound basis for stable development in the coming quarters. In the medium term, the different economic patterns of the cities should differentiate the markets. Berlin and Munich are expected to reach the strongest employment growth among the top seven, driven by technology and knowledge-based services. Frankfurt, on the other hand, shows uncertainties in the financial sector and, at least temporarily due to COVID-19, in the event and trade fair businesses, coupled with the completion of several large projects in the coming years. Due to its sectoral structure, Frankfurt may be impacted the most by remote working. In the medium term, we expect a 10-15% decline in the demand for office space due to remote working and weaker economy but in Frankfurt the figure is likely to be a few percentage points higher.

Retail – *underweight*

Favoured strategy:

- Emerging streets, local supply; retail parks
- Paris, Germany

With the obvious influence that the lockdowns have had on the retail sector, there is hardly any need to explain the underweight assessment. The retail transformation from physical to online accelerated significantly during the various lockdowns, even in Southern and Eastern European countries that were lagging previously. This shift is leading to significant capital declines in most retail sectors as occupiers close stores and demand shrinks – especially in the UK, but also in Germany, France, Switzerland, the Nordics and the Netherlands. The developments in the UK are to be closely monitored and taken as a "trend setter" for continental Europe. As economic developments are more uncertain and private consumption is increasing again, although it has not yet reached pre-crisis levels, we advise caution until the extent of the transformation and the economic impacts are clearer.

We still pay attention to "CVE": convenience, value or experience-based demand for physical retail. This means that we believe in shops that are on our way or in vicinity of our home (convenience), a trend that was further fostered during the lockdowns as local shops benefited from people being at home. Furthermore, the rise of value shops is uninterrupted and is further supported by a weaker economic environment. And if clients are going to shops for other reasons than food shopping, we still expect them to look for an experience and social interaction.

Retailers that reinvent their strategy and landlords who offer them the space to implement these strategies will be a strong match in the future. For landlords, this means that they must become closer to occupiers to really understand their business model. Doing so will be necessary to better manage retail precincts so that they align with other uses in any given area. Retailers who successfully build a strong online identity will offer landlords a quick means to create a certain image or brand for office buildings or precincts.

United Kingdom – *underweight*

Retail in all locations is under severe pressure due to cyclical and structural trends, which have been accelerated by the pandemic. Online retail accounted for some 31% of all spending in Q2 2020 according to the ONS, compared to 20% in Q1 2020. Several retailers have collapsed. Data from REMIT Consulting indicates that just 36% of retailers and 22% of leisure occupiers paid their rents on time at the June quarter due date. Underweight positions for all types of retail in all locations is advised for the short term. In the medium term, demand for prime shopping strips will return, but their physical length will shrink. Occupational demand for retail warehousing with a value offering and supermarkets should endure.

France – *underweight*

Most retail formats across the spectrum have been dampened by the lockdown. Many retailers will not recover past losses and a high default rate is expected for high street shop submarkets in secondary cities, while shopping centres will have to face a spike in vacancy rates. Combining convenience stores and high street retailers with a "phygital" strategy should secure returns, more specifically as opportunities might increase in the near term given lower asset prices. Investors specialising in retail are expecting a fall in value in some locations to reposition assets and make the rental profile more affordable for traditional retailers as well as providing good returns.

Germany –*underweight*

Online sales of food products increased by more than 60% in H1 2020, demonstrating that no retail segment will be unaffected by e-commerce. On the other hand, grocery stores and retail parks with anchors in convenience stores have weathered the pandemic well and achieved growth in sales volumes. We therefore maintain our view that supermarkets and retail parks are the better choice in the retail sector. From a regional perspective, greater attention should be paid to where food delivery services are established and thus become a competitor to store-based retail: in the major cities and conurbations. It therefore makes sense to pay more attention to local supply in medium-sized cities, i.e. Stade rather than Hamburg or Landshut instead of Munich.

Industrial/logistics – *overweight*

Favoured strategy:

- Urban logistics, light industrial
- Germany, France, UK, Benelux, with focus on metropolitan areas/capitals and regions with superior infrastructure access.

The logistics and light industrial sector remains a solid investment platform across the main markets in Europe. The pandemic has given investor demand a further upswing, as e-commerce and a reduction in global trade support tenant demand. E-commerce activity in particular captured higher sales volumes during the lockdown in most segments and attracted new customers, who will support demand for large distribution centres and last-mile logistics. At the same time, with the cutback of store-based retail, demand in sectors such as fashion logistics serving high street stores will decrease.

The sector is especially likely to see far higher investment in technology, automation and robotics. Greater demand for tech provision could mean that access to cheap and plentiful power supply becomes a more important locational driver than access to a cheap and plentiful labour supply. Buildings which have superior access to power, or which can generate or store their own energy, will be at a competitive advantage in attracting occupiers. The energy efficiency of buildings will become more important.

Industrial, and especially light industrial, has also seen an upswing over recent years, significantly so in Germany, with growth expected across Europe. By light industrial properties we mean mixed-use commercial properties with a typically medium-sized tenant structure. The types of use include manufacturing, warehouse, office, research and service. Due to the typical multi-tenant structure and the large number of different types of use, risks are spread at property level. The main growth regions are Germany and France, but also the UK and the Benelux region. The top logistics/industrial regions are (by average 5-yr investment volume): Amsterdam/Randstad, Paris, London (Metropolitan area), Rhine-Ruhr and Frankfurt/Rhine-Main.

Although we confident in the investment strategy, we advise careful asset selection. The assessment of "overweight" represents the clear upward trend but the strong correlation to GDP growth needs to be kept in mind.

United Kingdom – *overweight*

The sector has seen significant take-up as it benefits from structural change, high online retail penetration rates and elevated demand for physical storage. Indeed, Q2 logistics take-up was the highest on record according to CBRE, and it was the only main property sector to see rental growth over the period. In our view, sustained logistics take-up will continue, supporting investment prospects for certain types of assets. We favour well specified, well connected units close to major transport nodes and large urban conurbations, which are aligned to the needs of modern occupiers, such as in the UK's big six markets. Access to plentiful power and labour supply is critical. We advise caution on locations with high exposure to traditional manufacturing, for example steel and automotive, as we foresee a significant decline in these types of industries.

France – *overweight*

Although the sector as a whole will continue to perform well, it is at a crossroads: as some industries are facing headwinds, some logistic platforms might feel the chill. Light industrial and last-mile delivery formats should continue to outperform given the need for more flexibility and shifting consumption behaviours. The mitigating factor might come from more regulation in the coming months, notably on assets at the fringes of key cities such as Paris and Lyon. As the sector is one of the most volatile in terms of performance, the stock-picking approach should be favoured.

Germany –*overweight*

There are some strategically well-located logistics hubs spread throughout the country, which are established for large distribution centres, e.g. Kassel/Bad Hersfeld or Eastern Thuringia, however, metropolitan areas and their hinterlands offer investors the best conditions for investing in large-scale logistics. The conurbations, for example, are preferred locations of warehouses for regional or local operations. Germany offers a very high level of manufacturing industry. In the course of structural change, e.g. in the automotive sector, smaller industrial clusters should be avoided, unless they play at the highest technical level (Industry 4.0). The major economic centres, which in addition to the top seven regions also include the Ruhr area, Rhine-Neckar and Middle Franconia, offer a properly diversified economic structure and sufficient number of tenants.

Residential – *overweight*

Favoured strategy:

- Urban areas; emerging countries with decreasing home ownership rates
- UK, France, Switzerland and Ireland

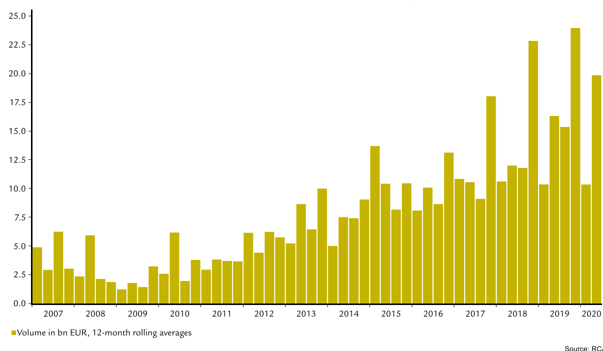
The residential sector is treated as a safe haven by investors, as lockdown measures did not have a direct impact on the cashflow generated from tenants. Although we see sustainable income as one of the main advantages of the sector, economic development will impact tenants' willingness and ability to pay in the medium term.

We expect the increase of teleworking to have an impact on the preferences of tenants (city vs periphery, no commute in small flats vs long commute yet more space), the influx to the cities will still be ongoing and household sizes continue to decrease. This generates more demand for more units and supports rental growth, as availability is low.

We pay special attention to government-imposed regulations, such as rent controls, which will become one of the main investment risks. Moreover, institutional money is mostly looking for investments in core markets, so that the competition as well as the prices increase.

Investor demand is high and has increased markedly over the last couple of months. We favour areas/cities with higher population density and a decreasing homeownership rate.

Residential transaction volumes, Europe



United Kingdom – *overweight*

The Build-To-Rent (BTR) sector has performed well during the pandemic with high rent collection being maintained, although investment volumes were low due to market restrictions. Around 80 000 BTR homes are currently in the pipeline with a further 168 000 planned. Most of these are concentrated in regional locations. The sector's long-term potential appears to be solid due to its reliable, non-discretionary income, low turnover and operational costs. This supports investment opportunities in under-supplied urban areas with a young, growing population, which include most large conurbations. We expect student housing performance to be more selective as UK universities are under severe financial pressure because of the pandemic and due to the expected reduction in overseas students. Student accommodation which provides a high value experiential offer in markets with the country's most reputable universities may be attractive, but selectivity is essential.

France – *overweight*

Rent collection rates have been stable and prices have continued to increase in recent months. Structural trends such as demographics and access to the labour markets are driving housing demand in the largest cities, such as Paris, Lyon, but also Nantes, Toulouse and Montpellier. The private rental sector, the co-living trend and affordable housing are expected to continue to perform well. Both domestic and foreign investors are targeting French residential given the strong stability of cash flows and capital returns. The market is not easy to access as it is highly regulated. On top of that, residential is aligned with investors' commitment to provide sustainable housing.

Germany – *neutral*

Given that the socio-economic fundamentals for the housing market are in place, more attention should be paid to regulations. Berlin has already introduced its rent cap but the idea of a cap has also been discussed in cities like Munich, Frankfurt and Bremen. If no nationwide rent cap is set in place, regulations are less likely to be imposed in the outskirts of the major cities. But it is not only regulation that favours the suburbs (or medium-sized cities), but also the increasing demand due to migration of (evasive) households, higher rental growth prospects due to lower rent levels, and the availability of newly built apartments.

Hotel – *underweight*

Favoured strategy:

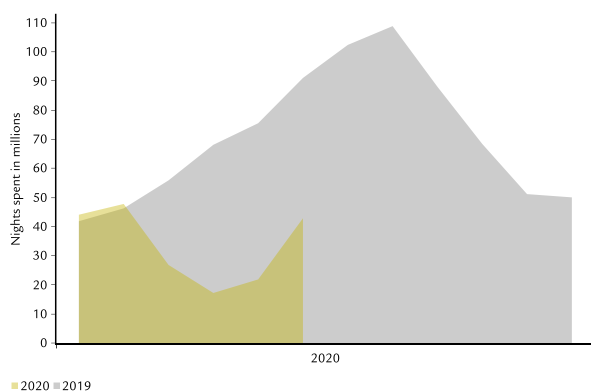
- Main metropolis with exposure to leisure and local travel, average of rooms 100-200
- London, Paris, Munich

The pandemic has sharply changed sentiment for this sector. Whereas only six months ago, hotels were treated as one of the rising stars, border closings and fear of travel have impacted the sector markedly. Not only will the measures for containing the virus have a lasting impact but so will the economic development.

We expect travel to recover relatively slowly and starting locally. Before intercontinental travel reaches a new normal, regional travel will be mainly in focus. Most people try to spend their holiday in their vicinity, which is advantageous for rural hotels. At the same time, business travel will be dampened for a very long time, thus challenging city hotels. In this environment, competition is high and weak operators are likely to drop out of the market.

The challenge is to balance the current situation and long-term prospects. If we assume that the pandemic will lead to certain restrictions in tourism and business travel in the long run, hotels and hotel locations with a strong dependence on international visitors, conferences or events will be negatively affected for a long time. With travel activities recovering, the sector can also recover fast. Yet institutional investors are likely to invest in big hotels from international brands, which are mostly located in main metropolises. As a whole, the selection criteria for this sector has not changed markedly. We advise caution and precise asset selection.

Nights spent at tourist accommodation establishments, Europe



Source: Macrobond, eurostat

United Kingdom – *underweight*

In July 2020 following reopening, UK hotels reported occupancy rates of 33% according to Savills. Despite rising evidence of staycations by domestic tourists and a VAT cut for the hospitality sector, large city-centre hotels are expected to see weaker conditions for some time. The pandemic is expected to lead to fewer inbound tourists and significantly greater domestic tourism in the short to medium term. This is expected to adversely impact consumer demand for larger hotels with higher price points within major cities, but benefit smaller, cheaper accommodation in regional locations. Considering this, we suggest an underweight position in the short term towards the large lot size hotels let to international brands, which are typically most suitable for institutional investors.

France – *underweight*

Hotels have been hurt by a decrease in business and leisure travel: the lack of international travellers has hit Paris hard, driving the occupation rate to a historic low. Notably, upper-end market operators will not reopen until 2021, while mid-market operators are set to benefit from domestic demand. As a whole, the occupation rate is not set to renew to its 2019 level until 2022. In the meantime, investors should remain on the side-lines looking for opportunities from highly leveraged investors. In the long term the sector will remain valuable given the position of France as the country with the largest tourist arrivals in Europe.

Germany – *underweight*

High dependency from US and Asian visitors and a lack of business trips hit Frankfurt in particular, but also Munich and Berlin. The latter two cities attract more domestic (and intra-European) travellers than Frankfurt. Domestic tourism might strengthen to some extent, but this will only be reflected in some regions, e.g. the Baltic Sea coast or the Alps. Nevertheless, the number of investable properties which come into consideration is limited.

Healthcare – *overweight*

Favoured strategy:

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

The pandemic has revealed gaps in the operation of some healthcare institutions – mainly in older buildings, where the crisis revealed structural problems such as double occupancy of rooms. But Europe is ageing, with Germany accounting for the oldest population in Europe and similar patterns are observed in the Czech Republic, Austria, Italy, Spain and Portugal. The fundamentals, such as a relatively low dependency on the economic cycle support the demand for this sector.

We observe a mismatch for care homes in urban areas and the possibility of locating the qualified personnel there, given the high cost of living. In locations considered as good, there is an occupancy stop due to the lack of staff. The development of these regions is therefore hindered.

Regulations vary greatly from region to region and are a key assessment factor, along with a highly regarded operator as well as long-term leases combined with innovative products. In Germany, the ratio of care personnel per patient is the main obstacle whereas the French government regulates the supply of care homes. Operator diversification is considered a must from an investor's perspective and the awareness that healthcare assets mostly do not have third-party use but only third-party operator possibilities.

Investment opportunities are considered in countries with high healthcare spending per capita, i.e. Germany, the Netherlands and France. Furthermore, also in countries with high GDP per capita such as Luxembourg, Ireland, Norway, Switzerland, the Netherlands or countries with full health insurance, i.e. the Nordics.

United Kingdom – *overweight*

This sector includes residential aged-care, later living and primary/ secondary/ tertiary care facilities. The demographic need for additional beds to serve the needs of an ageing society is evident. However, the pandemic may change the specification requirements of aged care facilities. This means that investors should scrutinise specifications carefully when accessing aged care stock. We believe the pandemic will increase demand for UK's nascent later living. Housing with care support is also likely to see growing household and investor interest.

France – *overweight*

Nursing homes have faced tough challenges regarding their operations in the aftermath of the COVID-19 crisis: this means adopting a cautious approach for existing formats. A preference is definitely for new, modular and digitalised assets (from senior housing, nursing homes or medical schemes). As a whole, the healthcare sector offers a large spectrum of opportunities related to an ageing population and a need for more hybrid schemes given tenants' profiles. More importantly, investors need to choose wisely among operators to secure strong performances.

Germany – *overweight*

The ageing population is pushing the demand for nursing homes nearly all over Germany. This need is somewhat dampened by the increasing shift towards self-determined living in old age, thus the trend to assisted living with services. Nevertheless, nursing homes will still have enough customers, and from an investor's point of view, combined facilities for elderly people are a good way of covering the entire healthcare value chain. From a regional perspective, locations on the edge of conurbations are just as suitable as rural areas with solid economies and positive population growth. Regions that are already overaged (rural areas in the east or in the middle mountain regions) may be appealing in the short term, but in the long term they will have too little population.

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