European Property Market Update
Q4 2020

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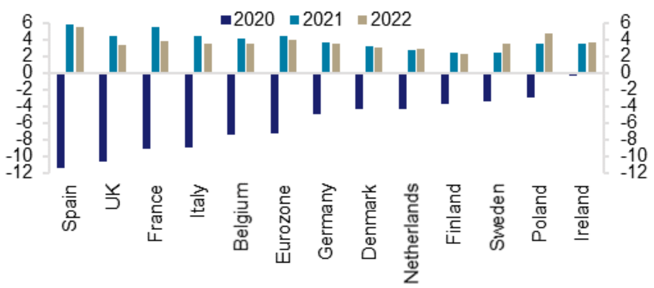
Our investment convictions

- Food retail offers a stable investment income stream that is resilient to e-commerce disruptions.
- The rise in e-commerce is fuelling the need for urban logistics, i.e. last-mile facilities in urban areas.
- There is currently an opportunity for real estate debt to benefit from a gap in bank lending.
- We are warming up to retail warehousing. Working from home has boosted home improvement and DIY.
- The higher education sector is counter-cyclical during economic downturns, underpinning the growth of the PBSA sector.
- We remain positive in regard to the senior care sector long term as the strong demand characteristics associated with an aging population have not changed.
- Despite the fact that there is currently a great deal of uncertainty around offices, a new ‘mixed-working’ approach means physical offices are here to stay.

European politics and economy

- The explosive increase in coronavirus cases across Europe suggests that the epidemic has become much more serious in the past few weeks. There is an additional risk from new strains of the virus that appear to be substantially more transmissible. As a result, the extension of lockdowns has dashed our hopes of an early rebound in economic activity. Instead, the economy is likely to contract in the first quarter of this year, economic forecasters expect. Government crises in the Netherlands and Italy are of little help in this context.
- Consensus Economics expects global GDP and Eurozone GDP to contract by -4.0% and -7.3%, respectively, in 2020 before a pick-up in growth this year to 4.9% and 4.4%, respectively (figure 1).

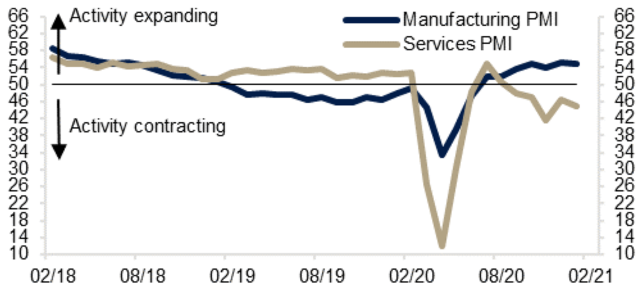
Figure 1: GDP growth (% per annum)



Sources: Consensus Economics, Oxford Economics
Note: Values are estimates and forecasts as of January 2021

- The renewed decline in the Composite PMI to 47.5 (from 49.1) in January confirms that the tighter measures that have been imposed are taking their toll on the economy and that services are bearing the brunt, according to Capital Economics.
- The manufacturing PMI fell slightly to 54.7 from 55.2 in December, the highest level since mid-2018. The recently volatile services PMI decreased to 45.0 in January from 46.4 a month earlier, Macrobond data shows (figure 2).

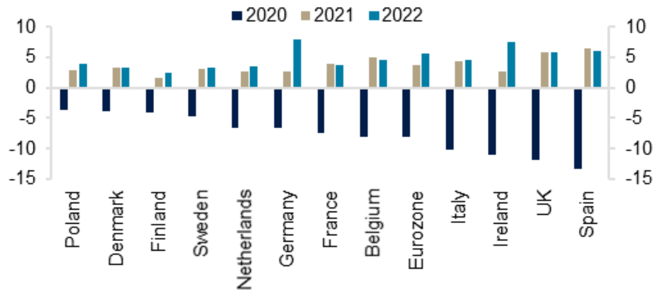
Figure 2: Eurozone manufacturing and services PMIs



Sources: Macrobond (January 2021), Markit (January 2021), Savills IM

- After falling in November, the Eurozone Economic Sentiment Index (ESI) recovered to 90.4 at the end of 2020. Recovery was bolstered by new, more targeted containment measures and the start of vaccination campaigns across Europe, Oxford Economics reports.
- The European Central Bank (ECB) ended 2020 with a surprise by delivering a comprehensive easing package at its policy meeting in December. The ECB's pandemic emergency purchase programme (PEPP) envelope will be increased by EUR 500 billion to a total of EUR 1,850 billion and extended to March 2022. This will keep financing conditions favourable well into 2022, aiding Eurozone growth and inflation recovery, according to Oxford Economics.
- The ECB also made changes to its bank lending tenders, or TLTROs. The central bank extended the period that banks can get paid 1% on their TLTRO loans to June 2022 from June 2021, which should entice banks to lend and will prop up their bottom line on existing loans, Oxford Economics reports.
- Inflation in the Eurozone was only 0.2% in 2020, a four-year low and far below the ECB’s target of just under 2%. The pick-up to 0.9% in 2021 expected by economic forecasters can be attributed to the end of a host of transitory factors rather than an increase in underlying price pressures. On a longer-term horizon, the weak growth and inflation forecasts mean that monetary conditions are likely to remain ultra-loose for an extended period. Economic analysts do not expect to see interest rates start to rise until 2024.
- Considering the ECB’s aim to keep government financing conditions accommodative in order to engineer fiscal policy-backed, sustained inflation recovery means that any rise in bond yields will only be gradual in 2021, Oxford Economics predicts.
- Although retail sales have experienced a strong rebound since May when restrictions were eased, this overemphasises the strength of the consumer sector. Oxford Economics predicts that the latest restrictions are likely to hit consumer spending again in the short-term (figure 3).

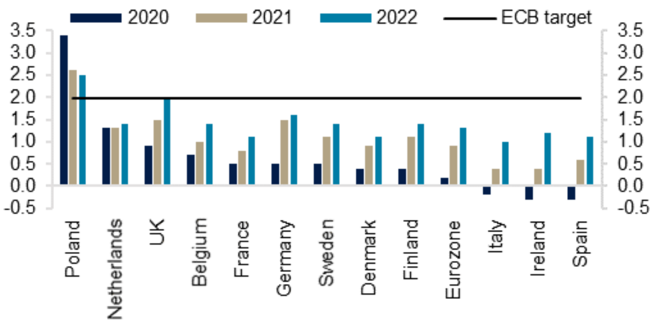
Figure 3: Consumer spending growth (% per annum)



Source: Oxford Economics
Note: Values are estimates and forecasts as of January 2021.

- We maintain our view that longer-term recovery will largely depend on the damage on the labour market caused by pandemic. The various short-time work schemes have to date kept a lid on the unemployment rate across the Eurozone. In November 2020, the unemployment rate did indeed edge down to 8.3% from 8.4% in the previous month. With governments set to provide less support in the future, however, unemployment is likely to rise in the coming quarters. Capital Economics expects the unemployment rate to peak at around 9% in 2021.
- EU Harmonised Index of Consumer Prices (HICP) inflation in the Eurozone was -0.3% y/y in November 2020, according to Eurostat. Consensus forecasts suggest that HICP inflation will remain low at 0.9% y/y in 2021 and 1.3% in 2022 (figure 4).

Figure 4: Inflation (% per annum)



Sources: Consensus Economics, Oxford Economics
Note: Values are estimates and forecasts as of January 2021.

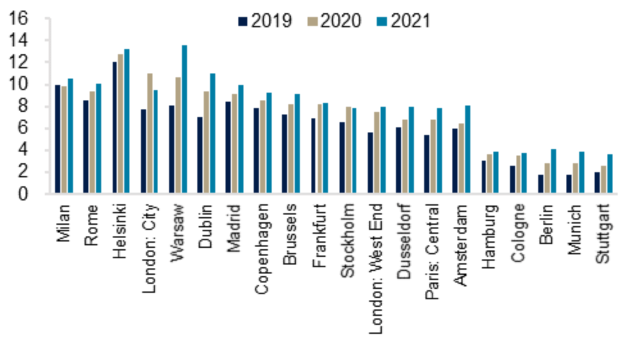
- The trade and cooperation agreement signed by the UK and the EU on 24 December 2020 governs the future trading relationship between the two as of 1 January 2021. The deal reduces uncertainty around the continent's economic outlook and brings clarity for businesses regarding the new trading environment. Importantly, it maintains tariff and quota free access for goods traded between the UK and EU, preventing the potential for large supply chain disruptions. However, it also brings into force new customs procedures, which will add to firms' costs, with some disruption to trade flows already evident.

European commercial real estate market

Offices

- In response to the new wave of coronavirus infections, many countries across Europe imposed further restrictions or lockdowns towards the end of 2020. As a result, weakening market sentiment has impacted office take-up, i.e. many decisions involving leasing transactions postponed were until 2021, JLL reports. Although the final quarter of the year represented the highest quarterly take-up in 2020, the 2.4 million sq m transacted is the weakest Q4 result since 2002, JLL highlights. Annual take-up throughout Europe totalled at circa 8.2 million sq m in 2020, down -41% y/y.
- JLL is cautiously optimistic for 2021. While take-up in the first half of the year is still likely to be affected by the pandemic, JLL expects a recovery from Q2 onwards and predicts an increase of 15%-20% in take-up, i.e. up to 9.8 million sqm.
- Anything else other than increasing availability would have been a surprise against the backdrop of the most lively development activity (a total of 4.4 million sq m) the market has seen since 2014 combined with a drop in office demand. The overall European office vacancy rate increased by 40 basis points (bps) q/q to 6.7% in Q4 2020. Vacancy rates increased in 19 of the 24 cities covered by JLL, with only Utrecht, Frankfurt and Milan recording a minor decrease.
- Given a forecast completion pipeline of 8.2 million sq m, the highest ever recorded, JLL expects to see a steady increase in the vacancy rate to 7.5% by the end of 2021.

Figure 5: Office vacancy rates (%)

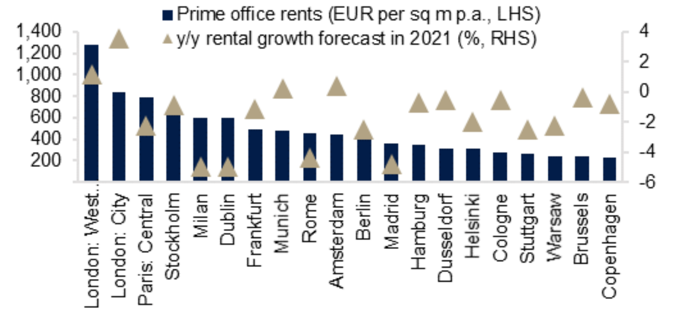


Sources: PMA (Autumn 2020, Recession Scenario), CBRE (Q4 2020), Savills IM

- While JLL's European Office Rental Index decreased (marginally) in Q3 for the first time since 2015, it recovered in Q4. On an annual basis, European prime office rents increased by 1%; however, this represents the lowest growth rate since 2010. JLL recorded an increase in rents in only four of the 24 markets, i.e. Hamburg, Paris, Berlin and Edinburgh, while five markets recorded a decrease in prime rents, i.e. Lyon, London, Stockholm, Barcelona and Madrid.

- Uncertainty in the markets is behind the trend toward more favourable conditions for tenants in some cities. In 2021, JLL anticipates a notable uptick in incentives as landlords look to secure income, particularly on developments still in the pipeline.
- Although JLL does not expect to see a sharp correction in European prime office rents in 2021 ('low single digit decrease') and recovery from 2022 onwards, we are more cautious based on comparable historic events. After the global financial crisis, prime office rents in Europe fell by -12% from peak to trough and by -24% in the UK, according to PMA. After the burst of the dot.com bubble, European prime office rents fell by -17% and by -15% in the UK.
- Concerns about the future of offices in light of the rise in remote working are also reflected in the near 20% discount of the FTSE EPRA/NAREIT Developed Europe Office Index compared to pre-COVID years, Macrobond data shows. However, the need for physical collaboration, mentoring, and innovation are considered by many to support long-term trends for keeping offices alive. Location and quality are still decisive factors with regard to choosing an office building, whereas overall office employment growth remains key for occupation rates in the long-term going forward. In the meantime, new office space requirements will likely be muted, and lease flexibility is set to become more prevalent.

Figure 6: Prime office rents and expectations for 2021 annual rental growth

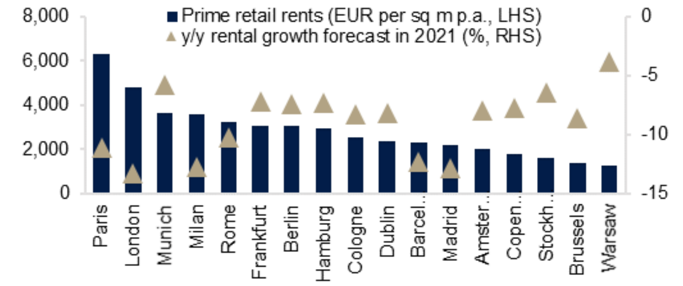


Sources: PMA (Autumn 2020, Recession Scenario), CBRE (Q4 2020) Savills IM

Retail

- A structural change in consumer behaviour and an accelerated shift towards e-commerce in the wake of the pandemic have deepened the issues already being faced by brick-and-mortar retailers prior to the crisis. Lockdowns and other measures (i.e. social distancing and hygiene protocols) introduced to contain the COVID-19 pandemic have also tipped many retail businesses over the edge, particularly those already struggling with structural change, i.e. mainly fashion retailers, PMA reports. Retailer bankruptcies and company administration procedures have been accelerating since the beginning of the pandemic.
- Food retailers, on the other hand, are benefitting from a relatively resilient income stream, as groceries are non-discretionary purchases. Gains have also been noted in DIY, furniture, homeware, sporting goods and electronics, as consumers have had more time to focus on home improvement and hobbies during lockdown, Savills Research reports.
- Since the beginning of the pandemic, out-of-town (i.e. big box) retail formats and destinations seem to have particularly exhibited stronger resilience during the lockdowns than high streets and shopping centres, PMA observes. Consumers currently prefer predominantly open-air destinations with sufficient car parking, which better facilitate measures to contain the pandemic.
- The household savings rate in the Eurozone jumped notably, averaging 19.5% in the first three quarters of 2020 compared to 12.8% in 2019, Capital Economics reports, with the impact of business closures and stay-at-home orders the most important factors. Although Capital Economics expects the savings rate to fall back to its pre-pandemic levels of around 13% by the end of 2022, the boost to retail sales and overall GDP growth is likely to be rather limited.
- Prime high street rents were already experiencing a downward trend prior to the COVID-19 crisis due to the growth in e-commerce. The current crisis is only adding to this trend, which is why PMA expects significant rent adjustments in 2021 (figure 7).

Figure 7: Prime retail rents and expectations for 2021 annual rental growth



Sources: PMA (Autumn 2020, Recession Scenario), Savills IM

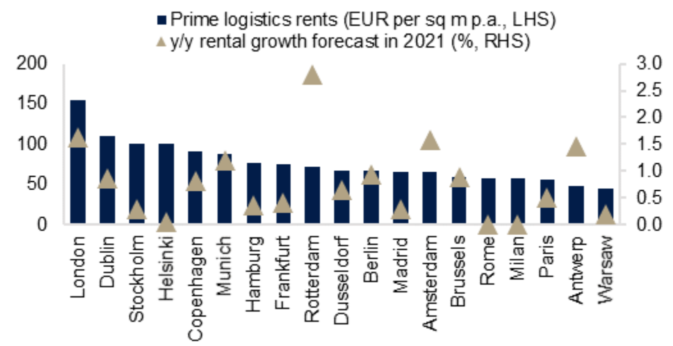
Industrial and Logistics

- The lockdowns have strengthened the strategic role of the European logistics sector as 'essential infrastructure.' E-commerce sales as a percentage of total retail sales accelerated further in 2020, and the trend is expected to continue. Strong occupier demand has driven logistics take-up across Europe and has also partly offset the growing weakness in the manufacturing sector. Savills Research reported a y/y increase of 10% in logistics take-up for the first three quarters of 2020.
- Although the logistics sector is considered an obvious beneficiary of the pandemic, downside risks do remain given the uncertain economic outlook, i.e. demand from manufacturers could be limited for the near future. In addition,

PMA raises the question of how much of current demand will only be short-term in nature. Some occupiers, not only from the manufacturing sector but from traditional retail and even e-commerce as well, will likely not be able to adapt to structural changes, i.e. consolidation trends could become more important in the years ahead.

- Upside risks, on the other hand, include pressure to hold more inventory to ensure supply chain resilience, nearshoring to provide a medium-term boost to demand as manufacturing recovers and innovative mixed-use (re-)development to create new investible product (e.g. urban logistics facilities), PMA reports.
- The European logistics vacancy rate posted 4.5% in Q3 2020, up 16 bps q/q, according to CBRE. Although this is still close to historic lows, particularly those markets with a strong construction pipeline may experience some increases in vacancy in 2021. PMA reports that the share of speculative developments was above 30% across Europe in H1 2020.
- While occupier demand could benefit from further growth in e-commerce in the long term going forward, PMA predicts that prime rents in a handful of markets will take a hit in the short-term due to economic turmoil on the back of the COVID-19 crisis. However, prime logistics rents in the vast majority of markets are expected to remain stable in 2020 (figure 8).

Figure 8: Prime logistics rents and expectations for 2021 annual rental growth

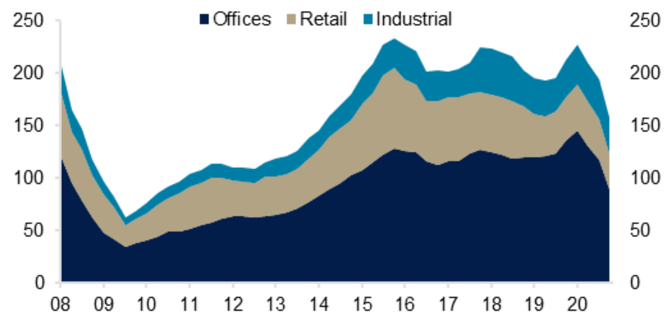


Sources: PMA (Autumn 2020, Recession Scenario), CBRE (Q4 2020), Savills IM

Investment and Capital Markets

- While transaction volumes slightly recovered towards the end of 2020, they remained low in a historic context in Q4. Preliminary data from Real Capital Analytics (RCA) suggest that the aggregate commercial property investment volume for office, retail and industrial transactions in European markets came to EUR 49.5 billion in Q4, a significant drop of -42% y/y and -16% below the long-term average of EUR 59 billion. Annual investment volume for 2020 totalled EUR 158 billion, down -26% y/y and -8% from the long-term average (figure 9).
- Investment volumes particularly dropped in the office and retail sectors in Q4 2020 by -52% y/y and -34% y/y, respectively, whereas logistics investment volumes experienced a more moderate dip of -14% y/y, RCA data shows. On an annual basis, 2020 office investment volumes fell -34% compared with the previous year, while retail investment volumes dropped -18% y/y. Logistics investment volumes remained fairly stable (-1% y/y), signalling a bottleneck supply side rather than in terms of demand.

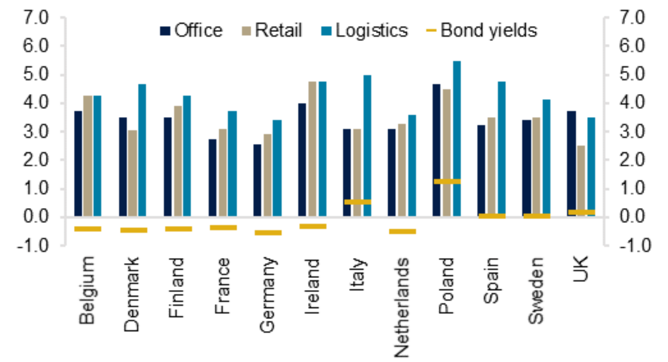
Figure 9: Pan-European CRE investment volume (EUR, billion)



Sources: RCA (January 2021), Savills IM
Notes: The chart represents full-year investment volume as 12-month totals; data are preliminary; assets of USD 10 million and above

- There is no shortage of capital seeking investment in the real estate sector, according to Preqin data. There is still USD 69 billion of dry powder looking to find a home in European real estate markets. That means that the problem is not availability of capital but rather how best to deploy it. That said, the lower-for-longer, or lower-forever, narrative around interest rates will support the commercial property sector amidst very low government bond yields (figure 10).

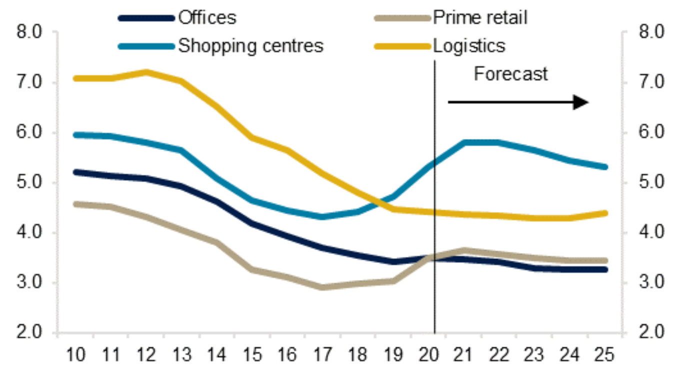
Figure 10: 10-year government bond yields and prime property net yields (Q4 2020, %)



Sources: CBRE, JLL, Macrobond, Savills IM
Notes: Property net yields are for the prime market in each country; government bond yields are as of 31 December 2020.

- PMA forecasts a sustained increase in retail yields compared to the more modest, temporary increase in office and logistics yields under their recession scenario (figure 11). However, with yield levels so low, even a 0.25% increase in yields will have a significant impact on capital values.

Figure 11: European prime yields expectations (%)

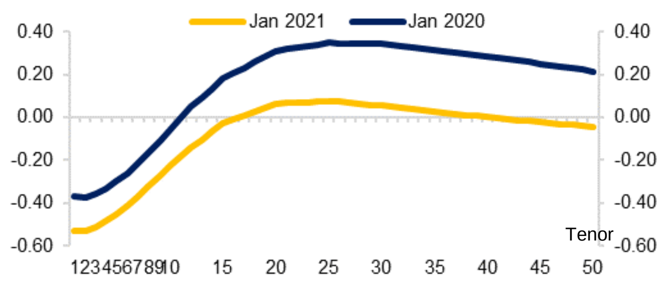


Sources: PMA (Autumn 2020, Recession Scenario), Savills IM
Note: Shopping centre yields are calculated without weighting by market size

Debt, Hedging and Markets Update

- Most lenders continue to seek 50% LTV and below on an interest-only basis. 60% LTV is increasingly difficult to attain due to a catch-22 situation where the best assets are priced too high to support the banks' debt yield hurdles and higher yielding assets don't generally suit the banks' rating models and risk appetite.
- In terms of sectors, retail remains very difficult to finance. Office assets have yet to be seriously impacted by the potential move to a more agile working ethos, though lenders are starting to become more selective, with high importance being placed on asset quality and length of lease term. Logistics remains popular but overexposure and low debt yields are creating issues for some lenders.
- The charts below illustrate the change that we have seen in the interest rate markets over the past year, driven by the COVID-19 pandemic.
- The swaps curve in Europe has uniformly shifted down 15 bps -20 bps, meaning that lower rate expectations will persist further into the future compared to one year ago. The forward-starting 5yr swap has fallen from 0.20% back to 0% in 5 years' time, for example, indicating that negative rates are likely to stick around medium term (figure 12).

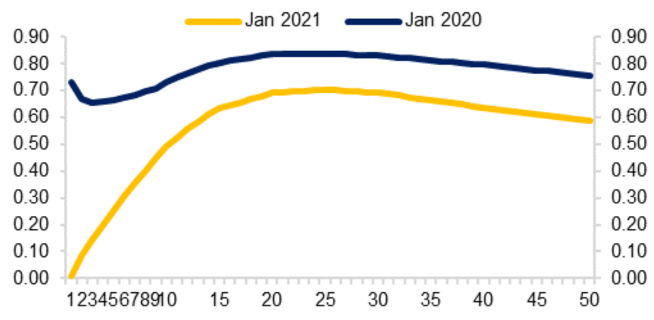
Figure 12: EUR swaps curve: year on year comparison



Sources: Bloomberg (January 2020), Savills IM

- Even more drastic changes have been observed in the GBP market. As of January 2020, the swaps curve was extremely flat and now resembles a more traditional yield curve due to the divergence towards zero at the near end. Longer term expectations have been less impacted than in the EUR market, with the forward-starting 5yr swap only down from 0.80% to 0.75% in 5 years' time (figure 13). Going forward, the chances of negative interest rates becoming prevalent in the UK appear reduced now that no-deal Brexit risks have fallen away.

Figure 13: GBP swaps curve: year on year comparison



Sources: Bloomberg (January 2020), Savills IM

- There has not been any material shift in liquidity costs since the second wave of COVID-19 (as was the case with the first wave), but market flex clauses are being inserted into term sheets to allow for pricing adjustments up to closing.
- All-in financing costs have therefore been relatively stable over the past quarter (table 1).

Table 1: Indicative Debt Rates

	All-in rate incl. fee (5y fixed)	
	Oct-20	**Jan-21**
UK	2.15%	2.15%
Germany	1.25%	1.15%
France	1.40%	1.30%
Netherlands	1.70%	1.60%
Belgium	1.80%	1.70%
Italy	2.50%	2.40%
Spain	1.95%	1.90%
Poland (EUR)	2.09%	2.05%
Sweden	1.80%	1.75%
Denmark	1.10%	0.90%
Norway	3.10%	3.20%
Finland	1.70%	1.60%
Ireland	2.25%	1.90%

Source: Savills IM (January 2021)
Assumptions: 5-year loan, zero floor applied on EUR interest rates, 50% LTV, prime office/logistics assets, long lease, strong tenants. Note, retail/hospitality assets will attract considerably wider margins.

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