Real Estate

European real estate: Searching for opportunity in a new era

It's difficult to think of a scenario more impactful to real estate markets than COVID-19. The pandemic has been a direct hit on European real estate, and much uncertainty remains regarding the ultimate long-term effect. But even as a second COVID wave sweeps across Europe and lockdowns continue, there are things investors should consider that may help provide some clarity around what to expect in the coming months and beyond. Members of our European real estate team recently discussed the dramatically changing real estate landscape and strategies for investors to consider moving forward.

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The end of a Goldilocks era

The European real estate landscape has seen a dramatic shift from 12 months ago to today. Andrew Thornton, CEO - Principal Real Estate Europe, highlighted that at this point last year, Europe was roughly five years into an economic recovery and experiencing widespread growth and falling unemployment. Strong performance, low interest rates, and broad investor demand in the capital markets—along with robust demand and growth in the occupier markets—had created a "Goldilocks" period for European real estate. Mid-cycle in the recovery, the consensus was that much runway remained for continued economic growth. There were, of course, ongoing risks posed by factors such as Brexit, the rise of online retail, and trade wars, but the outlook was generally very favorable.

This positive outlook changed dramatically with the arrival of COVID-19, as European real estate markets suffered from a confluence of factors. Health risks, the economic downturn, and structural changes in retail and offices were the primary challenges, all of which were complicated by frozen markets and cautious banks. Making matters worse, many tenants stopped paying rent altogether, often under the protection of legislation.

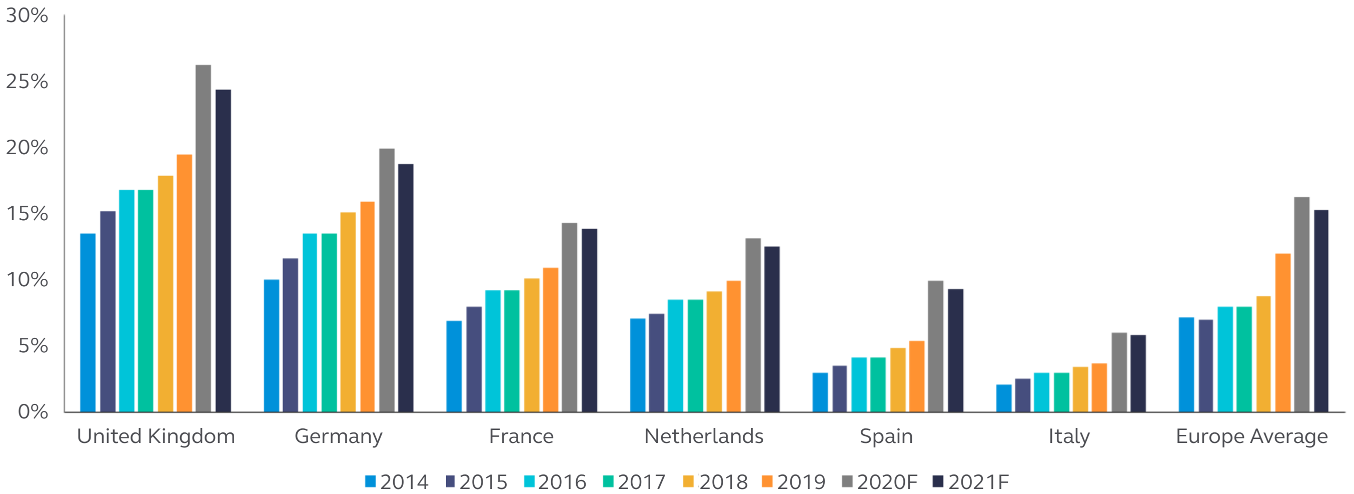
Where we stand today

The challenges created in the wake of COVID-19 are significant and have only added to pre-COVID risks (for example, the shadow of Brexit remains). COVID-related lockdown and containment measures will negatively impact fourth quarter GDP, even as the recent vaccine news gives hope there may be less damage than expected. The forceful policy response throughout Europe has been aimed at keeping people employed, and while ECB policy remains supportive, public and private finances are stretched. However, governments will continue to believe that printing money is the only choice and take the associated inflation risk.

Real estate values have bifurcated similar to other markets, but not all sectors have been hit the same. Retail sales were hurt by the lockdowns but differ depending on the country and category of retail (food sales have been flat, for example). With e-commerce surging, retail returns are diminishing across Europe as savings rates rise due to the continued uncertainty. As shops reopen, consumers' willingness to spend their savings will be critical.

European e-commerce has surged since COVID-19

E-commerce as share of total retail



Source: Edge by Ascential Retail Insight, September 2020

Office values have remained virtually unchanged, while industrial values have actually increased, reflecting the flipside of the move online. Within capital markets, there's been some price discovery but overall transaction levels are down. Private markets remain on hold and transaction volumes have slowed as spreads for retail, hospitality, and secondary offices have widened. In this environment, it's been difficult for non-domestic investors to deploy capital, even with an abundance of uncalled capital waiting to be put to use.

Regarding retail rent abatements in Europe, most of the requests from the first COVID-19 wave have been addressed, and while no new requests have been received recently, we're anticipating more as the second wave takes hold. It's important to note geographical differences with rent abatement requests. For example, German shopping centers have performed better than Spanish shopping centers because assets in Spain have taken longer to recover as a result of longer closed periods.

The death of the office?

Guillaume Masset, Head of Transactions & Asset Management, spoke about the dramatic shifts in office space resulting from the pandemic. While the outlook might seem bleak, this may be one area poised for more recovery in Europe than in other regions. Technology companies expanding offices in the UK include Google, Netflix, and TikTok, even as they prepare for further months of remote work. And, compared to the United States and Asia, European employees aren't as positive about working from home. A recent survey found that European workers have less of a sense of wellbeing when working remotely.[1] Perhaps counterintuitively, the younger generations are the least eager to work from home, citing the importance of being in the office for social interaction and career advancement. Moreover, within Europe, there are cultural differences that play a big role in views of the office. For example, presenteeism is more common in southern countries, and in some countries organizational status is linked to office size .

[1] Source: Cushman & Wakefield, Center for Real Estate Urban Analysts, George Washington University School of Business, History and Future of the Office, October 2020

The office paradox

The office needs to raise its game, the definition of core will change

Impact of technology

- **First retail, now offices—** technology and COVID are changing our relationship with real estate
- **Transformed attitudes** to working from home
- Global **businesses feel closer**
- **ESG/D&I** benefits
- Access to talent expanded
- **No commute!**

Offices have benefits

- **Companionship, training**, and mentoring—per style
- **Creativity and innovative thinking**
- Building a business and team **culture**
- Better separation of **work and home life**
- Workers **less likely to quit** due to loneliness and low engagement

Hybrid model

- Majority of workers prefer a **combination** of WFH (1-2 days a week) and office, while under 10% prefer WFH only

Searching for opportunities

Giles Smith, Head of Fund Management, noted in the discussion that in the wake of the Global Financial Crisis (GFC), many investors waited for the dust to settle before committing to future investments. While this “wait and see” approach may be tempting in times of great uncertainty, the reality is this type of strategy leaves investors exposed to portfolios that are likely to be sub-optimal, preventing them from capitalizing on current opportunities. As changes in work and leisure trends take shape, we believe there are currently COVID-resistant opportunities in three specific areas with solid fundamentals: the “eds” sectors, durable income, and data centers.

The “eds” sectors include logistics (“sheds”), residential (“beds”), education (“eds”), and medical (“meds”) properties. Logistics has been one of the strongest performing real estate sectors in the last 10 years, with MSCI reporting an average total return of just over 10%. Logistics, whether regional distribution hubs or last mile delivery centers, has benefited from the continued growth of e-commerce, further accelerated by the pandemic. On the whole, demand drivers remain favorable for logistics, even as concerns of potential oversupply and obsolescence of stock are surfacing in some markets.

A limited supply of housing across many European markets underpins demand and investment performance for the residential sector, as high prices will continue to act as a barrier to homeownership for younger generations, supporting the increase in supply of rental properties. Additionally, time will tell if urban locations lose their appeal and more people move to suburban locations as they’re working remotely and desire more space.

Student housing demand has held up well, and demand for UK university housing remained solid in the third quarter, including a 9% increase in non-European Union students and a 27% rise in students from China. We’ve seen a slowdown in short- to medium-term supply, however, GFC showed us that education can provide a countercyclical investment opportunity as graduates face an increasingly challenging employment market, making higher education a direct beneficiary.

Demand for health care assets has remained robust, especially in Germany, which has favorable demographics, particularly for the assisted living sector. Investing in these specialty assets can provide exposure to long-term income streams, particularly where there’s an element of government funding.

Beyond these "eds" opportunities, durable income strategies can provide secure income with a hedge against inflation at an appropriate risk premium to bonds. Data centers are particularly attractive, given the increasing reliance on technology and the dramatic growth of data consumption. These centers aren't only part of a secular demand shift, they also present significant barriers to entry given the financing constraints, difficulty of finding ideal locations, and necessary product knowledge. Moreover, data centers provide a compelling return profile and growing demand from foreign, private, and institutional capital.

It's also worth considering contrarian strategies in retail and offices. Not all retail is equally susceptible to the growth of e-commerce (e.g., southern Europeans more likely to continue in-store shopping), and it's quite possible in the wake of the pandemic that employers and employees may decide that being together in an office is better than working from home.

Regardless, the opportunity here is in the details. With this (or any other potential opportunity in this environment for that matter) the most important thing is to focus on underlying fundamentals.

Now is the time to plan for the future

As noted above, we believe investors may be disadvantaged if they choose to sit back and wait. Regardless of risk appetites and objectives, investors can benefit from a proactive approach to their real estate exposure, either by targeting COVID-resistant strategies, or manufacturing assets to provide transformational capital. In this environment, investors should also consider preparing for value investing and explore the benefits of contrarian approaches, particularly in the depressed office and retail markets.

Finally, Economic, Social and Governance (ESG) strategies and other forms of impact investing remain as important now as they were pre-COVID, and investment strategies going forward should include ESG considerations.

Ultimately, our goal as investors should be to collectively think through the unique challenges posed by this pandemic and develop long-term and sustainable strategies. We'll continue to maintain a dynamic approach to risk management and proactively seek opportunities in the European real estate markets as this unprecedented time unfolds.

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