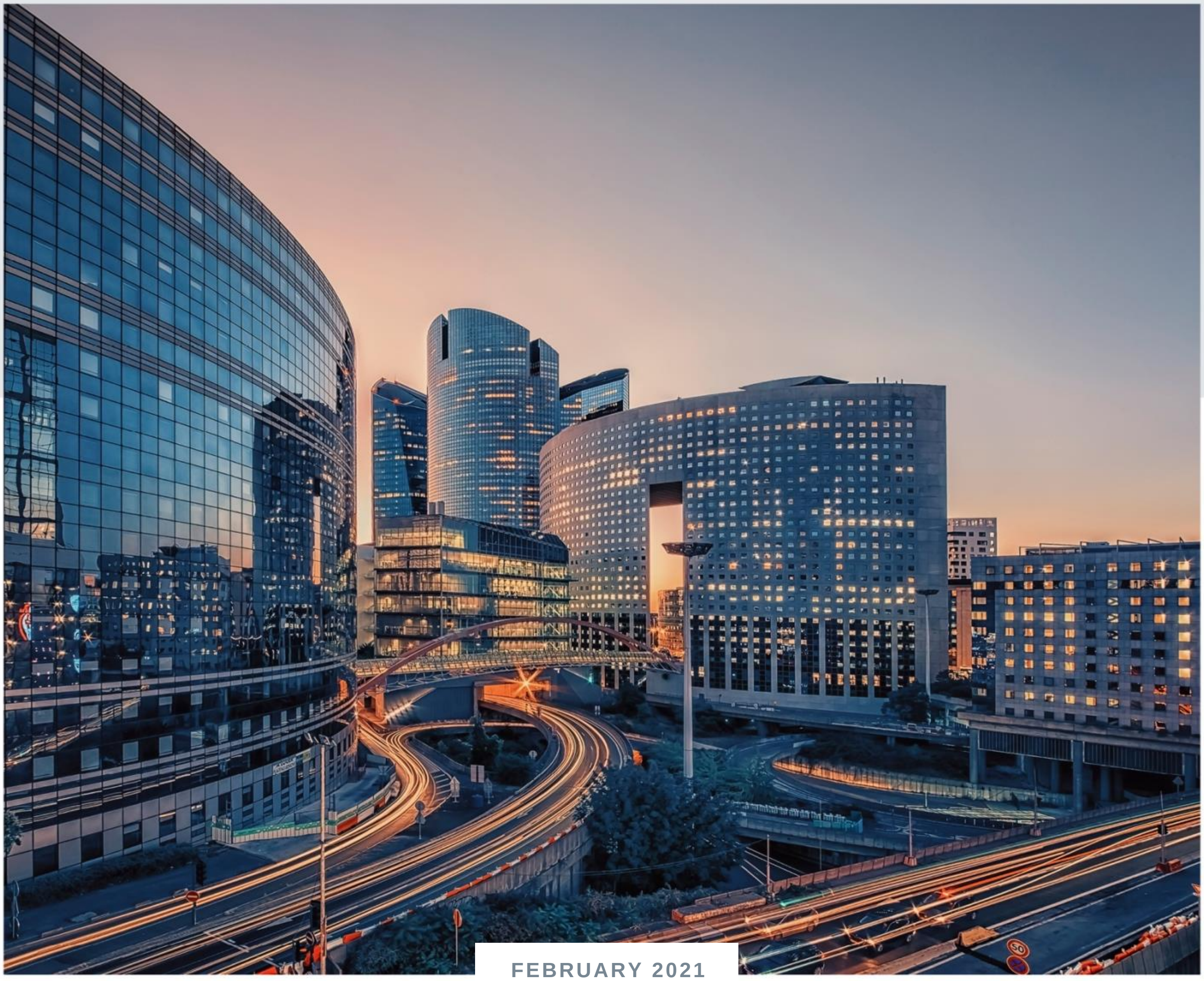
Are Offices Where the Most Compelling Post-COVID Opportunities Reside?

European Real Estate Research Quarterly



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Executive Summary

ECONOMY

- The latest lockdown restrictions will have likely pushed back the recovery, but at least this time around, there is reason for optimism with the COVID vaccine rollout underway.
- The H2 2021 outlook is now much improved, although there is the downside risk that the virus mutates, increasing the rate of new infections or that it affects vaccine efficacy.
- Highly accommodative monetary policy and fiscal stimulus will help to sustain the recovery, with additional support from the European recovery funds for those countries hit hardest by the pandemic.

PROPERTY MARKETS

- The pandemic has accelerated many pre-existing real estate trends, with logistics and residential the most resilient sectors and retail and hotels the most challenged. Mass working-from-home probably makes the outlook for offices the least certain.
- Property investors and their lenders are shifting down the risk curve and becoming highly selective about property sector exposures and asset quality. It will be these trends that will drive sector-pricing prospects through 2021 and beyond.
- Core real estate pricing has held firm through the pandemic, underpinned by the enormous support provided by ultra-low interest rates and the unprecedented fiscal support efforts; but only where structural drivers (demographic and technology trends) remain favorable.

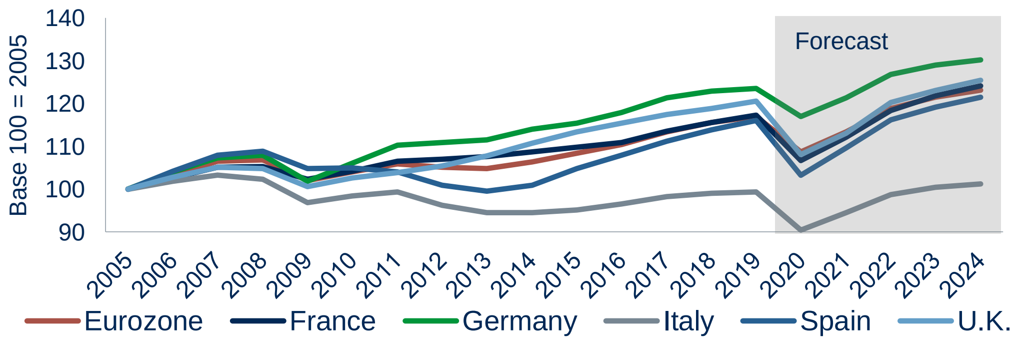
Economic Outlook

Early autumn optimism—which followed the easing of lockdown restrictions—faded fast with governments again forced to introduce tighter lockdown restrictions through Q4, to try and combat soaring infection rates and prevent health services from becoming overwhelmed. With case numbers still high and health services remaining under extreme pressure, these restrictions now look here to stay well into Q1 2021, which will likely push back the recovery. Although crucially, the big differentiator this time around is the availability of vaccines, which assuming a successful rollout program and uptake, should mean economic conditions start to normalize sooner, with local economies and property markets hopefully on the path to recovery by mid-2021.

With businesses learning from the first lockdown, economic contractions are expected to be smaller this winter, with corporates generally better prepared, greater supply chain resilience and base effects at play. The manufacturing sector is once again expected to be more resilient, with the services sector, particularly the already heavily weakened retail and hospitality sectors, again bearing the brunt of the latest measures. Over the near term, economies with a large manufacturing base and headroom for fiscal support, should perform better. The longer-term recovery will depend on the scale of the impact of the pandemic, with the European recovery funds providing additional support to those economies worst affected.

Over the past year, labor market trends have not reflected the incredibly challenging economic conditions, with government job retention schemes (so far) preventing the rate of joblessness spiking—with Eurozone unemployment estimated at 8.3% in November, against 7.3% in early 2020. As government support schemes are wound down and the number of corporate failures grows, a temporary rise in the unemployment rate is expected through 2021. Some of this upward pressure should, however, be mitigated, where fundamentally sound businesses are prevented from failing, through access to targeted fiscal support.

FORECAST ECONOMIC GROWTH



Source: Oxford Economics. As of January 2021.

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Economic Outlook

Near-term downside risks focus on further viral mutation that will increase the pace of infections, or affect vaccine effectiveness, alongside concerns around the extent of permanent economic scarring. While a low probability scenario, upside risks also exist, should the release of pent-up demand and running down of currently high household saving levels spark a strong consumer revival. This could potentially kick-start a self-reinforcing cycle of employment growth and stoke an investment boom—that would be amplified by the ongoing ultra-low interest rate climate and plenty of government stimulus still in the system.

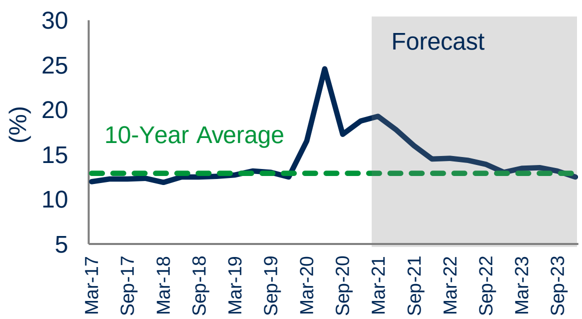
For 2020, Oxford Economics is forecasting Eurozone GDP will contract by -7.1%, accelerating to 4.2% in 2021, with the economy expected to return back to it pre-pandemic level by early 2022. Inflation expectations are well below target, which provides headroom for European Central Bank policy to remain ultra-accommodative for the foreseeable future. Fiscal policy stimulus should also remain supportive, although there is the downside risk that governments taper support before the recovery has taken hold.

GDP COUNTRY FORECASTS (% PA)

	2019	2020	2021	2022	2023	2024	2020-24
Eurozone	1.3%	-7.1%	4.2%	4.9%	2.2%	1.4%	1.0%
France	1.5%	-9.1%	5.1%	5.6%	2.8%	2.0%	1.1%
Germany	0.6%	-5.3%	3.8%	4.5%	1.6%	1.0%	1.0%
Italy	0.3%	-9.0%	4.5%	4.5%	1.8%	0.7%	0.4%
Spain	2.0%	-11.1%	6.3%	5.9%	2.6%	1.9%	0.9%
UK	1.4%	-10.3%	4.5%	6.4%	2.3%	2.0%	0.8%

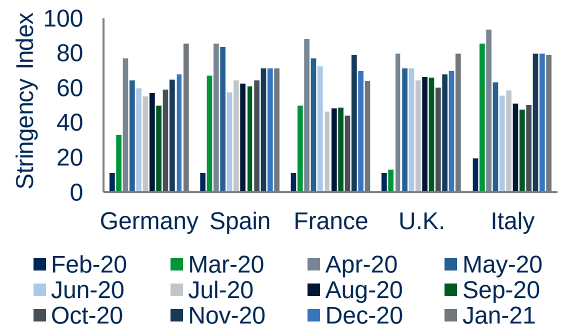
Source: Oxford Economics. As of January 2021. (NB: 2020 = forecast)

HOUSEHOLD SAVINGS RATE



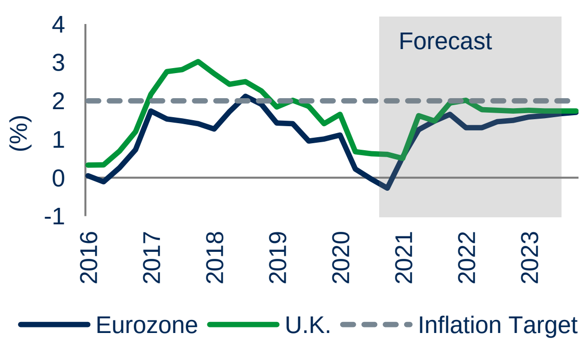
Source: Oxford Economics. As of January 2021.

GOVERNMENT CV19 RESPONSE: STRINGENCY INDEX



Source: Oxford COVID-19 Government Response Tracker, Blavatnik School of Government. As of January 19, 2021.

INFLATION OUTLOOK



Source: Oxford Economics. As of January 2021.

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Capital Markets

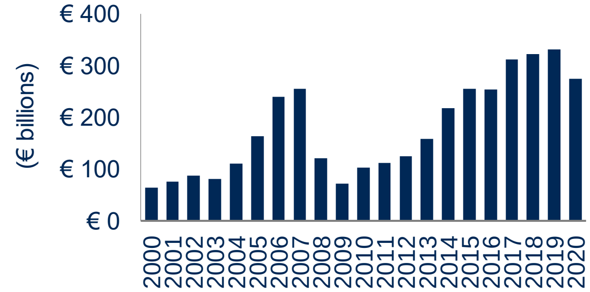
European commercial real estate (CRE) capital flows surprised to the upside in 2020, with CBRE reporting the total annual investment volume at €275 billlion, a decline of just -17% on the 2019 level. At an individual country level, Germany was the most liquid market, with total annual investment reaching €79.3 billion, down just -5% on 2019. This contrasted with the U.K. and France, where annual investment volumes fell by -25% (€45.8 billion) and -39% (€29 billion), respectively.

Despite the severe economic weakness and deteriorating rental growth outlook, core real estate pricing has held firm through the pandemic, underpinned by the enormous support provided by ultra-low interest rates and the unprecedented fiscal measures. However, this only applies where the structural drivers (demographic and technology trends) remain favorable. What has become evident from CRE relative sector capital flows, REIT pricing and thus shifts in property yields in 2020, is that the virus has accelerated existing, pre-pandemic trends in different ways across property sectors and local markets. These longer-term value drivers will continue to determine pricing prospects and relative performance during 2021 and beyond.

A shift down the risk curve for property investors and their lenders means they are becoming highly discerning about property sector exposures and asset quality. Access to debt in the sought after logistics sector has generally remained stable. Elevated retail sector risks likely mean that debt is no longer available for a lot of retail assets that were previously considered as “prime”. For offices, where the outlook is more uncertain, lender appetite is focused on top tier locations such as London, Paris, Milan, Frankfurt and the Nordic cities, but declined elsewhere due to working-from-home (WFH) concerns.

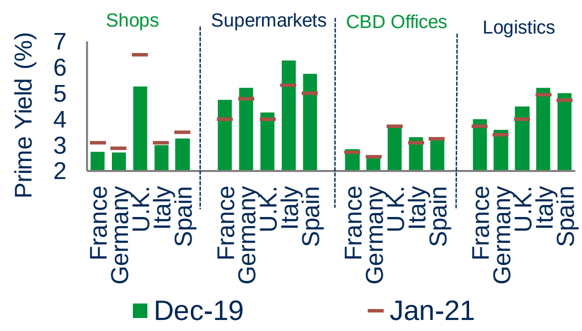
COVID’s impact on CRE does not seem to have damaged the asset class appeal. There is still plenty of capital ready to deploy, with the latest INREV 2021 Investment Survey estimating that a minimum of €64.6 billion will be invested in global real estate this year. Offices, industrial and residential, continue to top the preferred sector investor ranking by a long way, while retail has slipped back to fifth place, behind development. What has however changed this year is attitude to risk, which has shifted toward risk-off approaches, with core strategies currently favored.

EUROPEAN CRE INVESTMENT VOLUMES



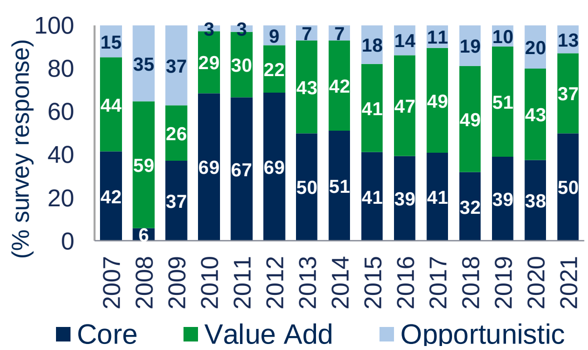
Source: CBRE. As of January 2021.

PRIME REAL ESTATE YIELDS



Source: CBRE. As of January 2021.

EUROPEAN CRE INVESTOR INTENTIONS



Source: ANREV/INREV/PREA Investment Intentions Survey 2021. As of January 2021.

Occupier Market

OFFICE SECTOR

Last year was challenging for the office market. Employees were required to WFH for much of 2020, which has led corporates to reassess their current and future office space needs. Active requirements were placed on hold and lettings activity slumped, with Q3 take-up down roughly -55% on the same quarter a year ago.

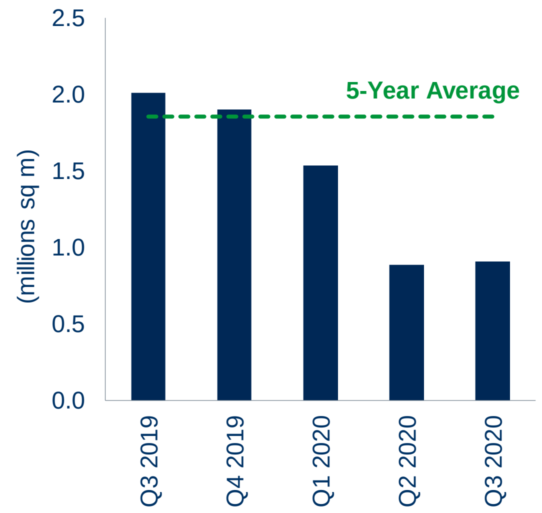
Despite physical occupancy being just a fraction of typical occpuancy levels, market vacancy has only ticked up slightly to just over 6% (Q3 2020), well below the 10-year average (roughly 8.5%). Weaker demand and a rise in completions will put upward pressure on the vacancy rate.

We expect WFH to persist, but only in part, with enthusiastic corporate downsizing likely subject to pushback. For employees, recent surveys suggest almost half do not want to WFH with lower job satisfaction, flagging motivation, other home interruptions and health concerns shifting center stage. For employers, the erosion of a carefully crafted corporate image and culture, and problems recruiting and training staff, are already becoming apparent. Companies will have to decide whether the relatively marginal cost saving on office space, on the corporate bottom line, is worth it.

Upon the return to the office, we expect occupiers to shift up the accommodation quality spectrum, partly driven by health and safety concerns, then favoring less dense layouts to harness productivity and collaboration gains for "in the office days". A flight to quality will accelerate the pace of obsolescence in secondary office assets, increasing hurdle returns in this sector over the longer term.

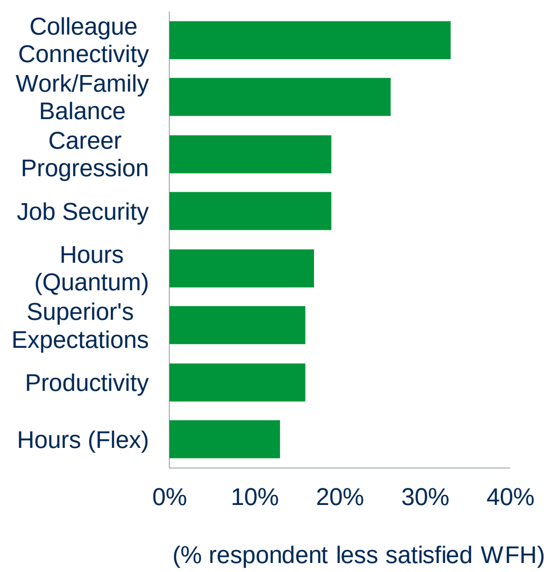
With bank lending largely focused on the wider corporate sector recovery, the current part regulatory-driven (e.g. Basel III) post-GFC dearth of new construction will continue. That suggests that the already acute low supply of modern office accommodation, in most European cities, is likely to become chronic. The case for strong performance of European grade A office rents over the mid- to longer-term is therefore already building.

EUROPEAN OFFICE TAKE-UP



Source: Cushman & Wakefield. As of September 30, 2020.

WORKING FROM HOME JOB SATISFACTION



Source: Pew Research Center. As of December 9, 2020.

Occupier Market

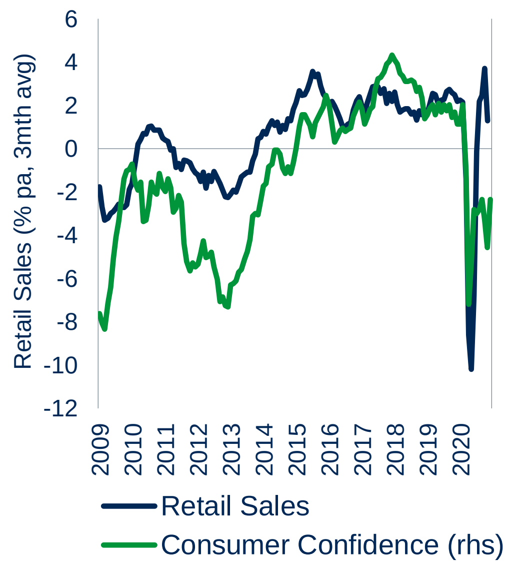
RETAIL SECTOR

Conditions remain extremely challenging for bricks-and-mortar retail. While Eurozone retail sales initially rebounded (4.3% p.a. August 2020), following the easing of the first lockdown restrictions, the recent re-introduction of tougher measures means softer activity once again (-2.9% p.a. November 2020). Heavy disruption to the vitally important Christmas trading period means that retail failures will be focused where government support and bank forbearance—for those with over-extended lines of credit—is not readily forthcoming.

One outlier to current negative retail sector trends is the grocery sector. Food retail has been a beneficiary from the crisis, as lockdowns have spurred a spending boom on essentials, with stores allowed to remain open. It has also become more widely appreciated that food retail offers a decent degree of internet resilience due to low margins and high delivery costs. The paradox of rising turnover but falling grocery profits will remain an operational headache for the future. Even the heavily automated delivery-only, online grocery retailer Ocado has made losses over the past 3-4 years.

Near-term conditions will inevitably remain tough, with the temporary closure of non-essential retail stores, which are exacerbating the cash-flow pressures that retailers were already facing—and making rental collection extremely difficult for landlords. Weak consumer confidence and softer labor markets will also dampen discretionary spending levels. Once lockdown restrictions ease and consumer confidence is restored, a huge potential for a consumer spending boom exists—should households who accumulated lockdown savings choose to start spending their wealth.

EUROPEAN RETAIL SALES VS CONSUMER CONFIDENCE



Source: Eurostat. As of January 2021.

Occupier Market

INDUSTRIAL SECTOR

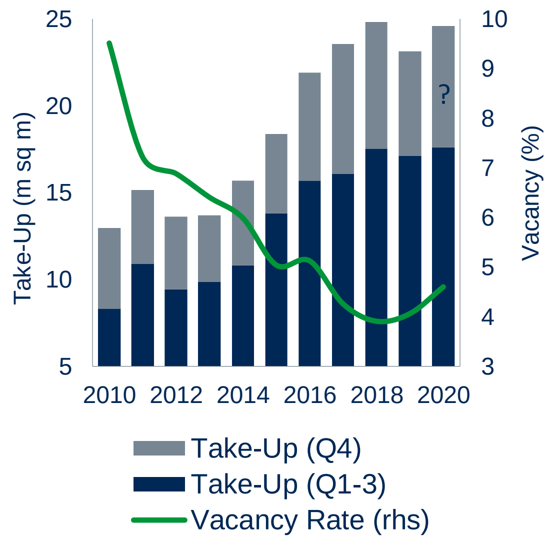
Contracting GDP implies a reduced velocity of goods flowing around the economy, and thus a reduction in occupier demand for storage space might typically be expected. This has not transpired through the pandemic, as current cyclical weakness has been more than compensated by structural boosts, which include the acceleration of online retail.

Lettings activity has been robust, with BNP Paribas Real Estate recording a 7% increase in total take-up for the first nine months of 2020 for Europe's six key markets, on the 2019 level. The U.K. and Poland were standout markets, with take-up rising by 57% and 48%, respectively. Supply levels are tight, with BNPPRE noting that new development is still insufficient to meet occupier demand.

The disconnect between the economy and the strength of the underlying market fundamentals is apparent in positive rental growth performance, with prime industrial rents rising by just over 3% p.a. (Q3 2020).

The outlook for the sector remains extremely positive. If household spending ramps up, when individuals feel confident to start spending their accrued lockdown savings, this could boost urban logistics demand. Longer term, the sector looks set to remain a pandemic beneficiary, with the prospect of increasing global trade frictions, supply chain fragility concerns, and perhaps even some re-shoring of production back from the East to the West, underpinning future demand.

EUROPEAN LOGISTICS SUPPLY & DEMAND



Source: CBRE. As of November 2020.

Occupier Market

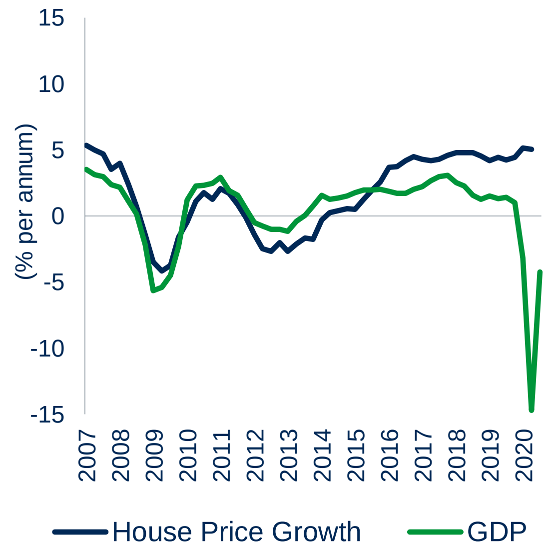
RESIDENTIAL SECTOR

It is perhaps surprising, on the face of it, that house prices appreciated during the crisis—albeit modestly in the low to mid single digits. This disconnect between the direction of the economy and the housing market speaks in part to a pandemic reappraisal of housing needs, but probably says more about the pace and magnitude of fiscal (including job retention schemes, mortgage holidays and transfer tax cuts) and monetary policy support (ultra-low interest rates).

Moving into 2021, the pace and efficacy of vaccines will be critical to near-term market prospects. However, policy error risk will be elevated should housing market support measures (tax cuts) and the unwinding of job support occur concurrently. Where governments are fully mindful of secondary economic impacts of a big house price slide, large price corrections are not anticipated.

There is even an upside housing market scenario, with some now arguing that the pandemic surge in household savings is mainly accumulated in more affluent households. This implies that “lockdown wealth” is more likely to work its way into asset prices (including housing), than be squandered to fuel a consumer boom.

EUROZONE HOUSE PRICE GROWTH VS GDP



Sources: Eurostat, Oxford Economics. As of January 2021.

About the Team

Barings Real Estate's research team is structured by sector and geographic expertise, with efforts led by Philip Conner in the U.S. and Paul Stewart in Europe. The team has a diverse background covering various industries, asset classes and countries, which is complemented by an analytics function enhancing the team's ability to collect, augment and analyze data to inform better decision making.

Paul Stewart

Head of Real Estate Research & Strategy—Europe

Ben Thatcher

Associate Director

Jo Warren

Associate Director

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