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Aberdeen Standard Investments

European Property Market Outlook

Q2 2020

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European Real Estate Market Outlook in the context of Covid-19

28 April 2020

- **Please note:** the Covid-19 pandemic is having a significant impact on the economy and on the real estate market. The outlook is changing frequently and the volatility in liquid assets such as equities and bonds has been unprecedented. We lack full clarity on the evolution of the virus and the potential for vaccination. We also do not have a full picture of how governments will respond with fiscal and monetary support. Therefore, investors should treat our forecasts, and the market commentary below, with caution. The levels of uncertainty are likely to result in unknown impacts beyond those described below. We are tracking events closely and will be updating our views frequently.

Economic outlook

- The Eurozone economy is mired in an enormous recession. The depth of this downturn is hard to quantify, but our best guess is that GDP will contract by 25% over the first half of 2020. Moreover, the recovery over the second half of the year and beyond is likely to be slow, relative to the size of the initial shock. Member states that have been able to control the virus more rapidly, such as Germany, should experience shallower recessions and quicker recoveries. Those with larger outbreaks, such as Italy and Spain, are facing even deeper recessions and slower recoveries.
- The incoming economic data are certainly consistent with a very large negative shock. The Eurozone composite purchasing managers’ index fell to 29.7 in March, an all-time low, and is likely to drop further over the next few months. At the same, labour market data show a dramatic increase in applications to the bloc’s various short-time work schemes. This is consistent with a big fall in hours worked, although the schemes should cushion the actual rise in unemployment. Finally, inflation has started to drop. The Harmonised Index of Consumer Prices was 0.7% in March, and is likely to weaken further.
- Gauging the actual decline in GDP is difficult. However, we think that the data, plausible estimates of hours lost in the economy and sectors of activity which are effectively shut, point to a 25% drop in GDP in the first half of 2020. This is enormous relative to the size of historical shocks (see chart). While some member states are turning their attention to the exit from lockdown, the lifting of suppression measures will be slow, partial, and subject to re-imposition.
- Both monetary and fiscal policy have been deployed in considerable size to keep the Eurozone economy on life support. The European Central Bank’s Pandemic Emergency Purchase Programme lifts asset purchases to around €115 billion per month for the rest of the year. This allows the central bank to deviate from its capital key if necessary. This should be enough to prevent an even more damaging spiral into sovereign debt crisis.
- Meanwhile, fiscal stimulus across the bloc worth around 3% of GDP has already been announced. This is twice as large as the stimulus during the global financial crisis (GFC). But fiscal measures have largely been announced at the level of individual member states. The failure of the Eurozone to put together a meaningful, mutualised fiscal response increases long-term fragmentation risk.

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Occupier market trends

- Occupier markets are starting to show signs of a demand shock. It is impossible to tell how long this will last and how deep the decline in demand will be. However, we expect different geographies and sectors to respond differently and we are focused on relativities at this point. Requests to defer or cancel rent payments are increasing, with retail, hospitality and leisure assets clearly more affected so far.
- In addition to stores closed by governments, many retailers have chosen to close their stores as they are unprofitable. Depending on the type of retailer (discretionary or non-discretionary), at the market level we estimate between 25% and 75% of rent to be collected over the next six months, with only a modest share of it likely to be recouped by landlords thereafter.
- Demonstrating the real distress in the discretionary retail sector, century-old French shoe brand Andre filed for bankruptcy last week. While sales had been improving before the crisis, it took just over two weeks of lockdown to generate losses of €4 million (€250,000 per day). Vivarte is also attempting to restructure its debt and has sought court protection for its La Halle brand. Vivarte estimates it will lose €106 million in sales between 15 March and 11 May, when the lockdown in France is due to be lifted.
- Exceptions to the retail pain include supermarkets and other forms of food-retail. For the most part, these are reporting stable or even increasing turnover. We believe this segment will continue to deliver resilient operational performance.
- On the basis of the current economic forecasts, office markets are likely to be less affected in the short term, but it depends significantly on the industry the tenant is in. Most financial and business services companies are still functioning, albeit at a reduced level of output. Our best estimate is that over 75% of the market rent will be received over the next six months in this sector.
- Industrial supply chains have clearly been disrupted in the near term. However, like offices, these should remain more resilient unless we head into a prolonged economic downturn. In the longer term, the sector could get a boost from inventory rebuilding, greater stock retention levels, reshoring of production to Europe and the rapid rise of e-commerce.
- We see evidence that residential real estate is less affected so far. Operational data recently published by listed residential companies supports our own experience that termination of leases in apartments has dropped compared to previous months, reducing fluctuation and costs.
- Other residential types, such as care homes and purpose-built student accommodation, are expected to be hit quite hard, judging by the repricing of real estate investment trusts in these sectors. Student accommodation is reliant on international students as well as domestic applicants. Both sets of students face challenges in sitting entrance exams this spring/summer and universities are likely to see much lower levels of undergraduates arriving in August and September 2020.
- Overall, for real estate markets, we obviously expect weaker rental growth than previously projected. This is particularly the case for retail and hotels, which may see a notable decline in rents. For offices and logistics, where we previously expected sound rental growth in 2020, we expect rents to be flat or to fall. Effects on core residential rents are expected to be limited in the base-case scenario, but lower consumer price inflation leads to fewer rental uplifts through indexation for the short term.
- There are long-term implications across sectors. Development pipelines are expected to grind to a complete halt in Europe while the lockdowns are in place. This will help protect to the downside, rather than provide a boost to rents in the medium term.

Investment market trends

- It should be noted that, at present, due to such unprecedented circumstances, valuers are placing uncertainty clauses in valuations. Physical barriers to trading assets only act as a further constraint on the market and on pricing mechanisms returning to normality.
- Capital flows were strong until mid-March, recording an increase versus Q1 2019, but we have noted a marked slowdown in activity since then. Investors are extending exclusivity periods on live transactions, placing their acquisition activities on hold to take a wait-and-see approach. Additionally, travel bans are making any ongoing processes challenging, as due diligence and site visits become very difficult to perform.
- Overall we expect to start to see sharp falls in capital values in the coming months, particularly where tenant revenues are more at risk or where bank finance conditions tighten sharply. This implies more pain for hotels, retail, leisure, student accommodation and senior living.
- There are early signs that bank margins have increased by roughly 30-50 basis points so far, with good-quality assets less affected and lenders starting to price risk assets more cautiously. However, with swap rates remaining negative, the all-in cost of debt has not risen dramatically at this point. Loan-to-value (LTV) is reducing and investors and banks are generally looking to trim loan portfolios and reduce financial risks. At this point, LTV ratios are less at risk of breach, compared to income cover ratios. Banks have so far demonstrated forbearance on assets where cash flows have temporarily dried up, but this could change in a more severe crisis.

“We believe that new cohorts of society will have tried e-commerce who might not have otherwise done so and the trend to shop online could accelerate”

Performance outlook and risk tolerance

- It should be noted that any forecast in the current environment is highly uncertain. Looking ahead, our base case suggests a decline in European real estate values of approximately 10% in 2020, resulting in a total return of roughly -5.8% once income returns are taken into account. For the short term, most of our forecast decline in capital value is caused by rising yields, but also the capitalisation of the risk of temporary and permanent loss of rental income from a combination of lower rental levels, lower inflation indexation and higher voids.
- The biggest decline in values in 2020 is expected for the retail sector (-16%). We do not forecast performance for the hotel sector, but we expect the value decline could be similar to retail. Residential, logistics and offices are expected to demonstrate stronger fundamentals under the current base case.
- Geographically, we are more concerned about markets which experienced more pain in the GFC and Eurozone crisis as a result of stress in debt markets and sharp falls in liquidity resulted. This would include Spain, Italy, Portugal and Ireland, while there are concerns around corporate debt levels in other markets such as France.
- Taking into account the highly uncertain market environment and potential for capital value decline, we suggest an extremely risk-averse approach in all aspects of our investments.

Medium to long-term investment themes

As stated above, in light of the uncertainty, we are revising our overall outlook down. However, we still believe there will be core principles to consider on a sector basis. These support long-term trends in the market that should hold true through the pandemic and once it has stabilised.

- **Offices:** this sector is not immune from the risks from Covid-19. While other sectors are more exposed in the immediate future, a more protracted and damaging lockdown could lead to sharp repricing in the sector. Core long-leased offices are preferred for now and leasing risk should only be taken once a recovery is clearly under way. We anticipate an abrupt halt in almost all construction projects in the near future and this will limit new supply in 2020 and 2021 at least. Flexible offices could carry additional risk given the pain expected for small companies and their untested financial strength, and should be avoided.
- **Industrial and logistics:** this was the best sector to allocate to in the last two years. However, the pandemic has abruptly halted and potentially damaged supply chains for some time. There could be quite a lot of pain from some parts of the sector as logistics companies can be running notoriously tight profit margins. However, longer term, we believe that new cohorts of society will have tried e-commerce who might not have otherwise done so and the trend to shop online could accelerate.

European performance signals, Q2 2020

	Performance Signals	Current Signal	Outlook	Comment
Macro	Economic fundamentals		↘	Demand shock to create a peak-to-trough contraction in Eurozone GDP in H1 of nearly 2.5%, with a partial rebound over H2. Downside risks.
	Margin over bonds		↗	Long govt bond yields fell by 20-30 bps in Q1, might give support to secure income assets but weaker/uncertain rental outlook offset effect
	Monetary policy		→	Monetary policy is being deployed in response, will not be able to fully offset the shock, but rather help recovery
Real Estate	Supply		↗	Development relatively modest, but supply likely to be higher than demand as economies slow down
	Flows of capital		↘	Healthy activity in the beginning of 2020, but expected to slow rapidly due to market uncertainty related to COVID-19
	Lending		↘	Until now very favourable, but lending expected to be much more selective going forwards, with large spreads on riskier assets
	Fund flows		↘	Fundraising expected to slow rapidly, as investors holding back on investment decisions
	360° view		→	General stock market sell-off and volatility. Low liquidity for secondaries. Many companies cutting dividend, and funds suspending trading.

Source: Aberdeen Asset Management, April 2020.
Views reflect our view on Europe excluding the UK. MSCI/IPD; Thomson Reuters Eikon; PMA; RCA; CBRE, Investment Association; Aberdeen Standard Investments, March 2019. 360° view encompasses direct, indirect, lending and multi-manager views and market signals. Key: Supportive / Neutral / Unsupportive.

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Furthermore, there could be a growing reticence towards shopping in store after the difficulties experienced in the last few weeks. This would support our long-term view that there is stronger performance to come from urban logistics assets.

- **Residential:** private rented residential should display some resilience in the context of current market conditions. However, cash flows will in part be damaged by higher unemployment and potentially by rent holidays. We may even see government legislation try to remove pain from tenants during this downturn, asking landlords to take some of the burden. However, we still believe that this sector should provide investors with long-term cash flows. Investors must be wary of lease convention, legislation and potential changes to the outlook for cash flows. The best policy is to be highly focused on good amenities, accessibility and affordability within the local market.
- **Long-leased residential:** there are strong long-term demographic drivers underpinning some types of long-leased residential. This is mainly in the form of senior living and student accommodation. However, the outlook has severely affected the outlook for more temporary types of accommodation, such as hotels and serviced apartments. These should be treated with caution. Risks around the operators should be the focus of the underwriting, given the yield premium between operational assets and leased assets in this space. But, with leases longer than 20 years often available, these segments can offer diversification and income duration, albeit investors should wait until we know more about the immediate outlook before investing.
- **Retail:** while we are increasingly cautious of the outlook for almost all retail formats, particularly in view of the pandemic, the long-term drivers are different across retail segments. Our preference is for supermarkets and convenience retail, where spending should be less vulnerable and where rental levels remain modest. Shopping centres are most vulnerable to emerging trends in consumption and have sustained serious pressure following the Covid-19 pandemic, with large-lot sizes also creating a liquidity issue for the sector. Very low-yielding prime high-street retail is also highly vulnerable to a reduction in tourist travel and looks overstretched at yields close to 2%, with rental levels likely to take a hit.
- **Long income:** as mentioned, no asset types will escape the virus unscathed. However, in the long term, the current situation reinforces the appeal of defensive assets with durable long-term cash flows. In light of the significant policy response we are seeing and the renewed expectation of ultra-lower-for-longer interest rates, the growing appetite for longer-duration income from real estate is a notable theme. While conventional leases in Europe tend to be shorter than 12 years in duration, there is a considerable number of longer-term leases available. These can be accessed through sale and leasebacks, forward fundings and through sectors such as leased hotels, government offices and other long-term commitments. We believe funds targeting these types of inflation-linked cash flow will offer lower volatility and attractive risk-adjusted returns for some pools of investors.

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