BARINGS

European Real Estate

QUARTERLY RESEARCH

2Q 2020

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Executive Summary

ECONOMY

- A sharp GDP contraction is forecast for the second quarter of 2020, but a strong third quarter bounce back may already be in progress.
- Improving medical data and the ongoing easing of lockdown restrictions will be key in dictating the recovery rate; a second wave of infections is a downside risk.
- The rapid and coordinated fiscal and monetary policy response to the pandemic should help accelerate individual country recovery rates.
- The European Union (EU) now has the ability to tap global bond markets, mutualise national debts, and thus address a systemic weakness in the Euro currency.

PROPERTY MARKETS

- The best retail will survive and may eventually emerge stronger, but the path is uncertain, and pricing does not yet appear to reflect huge stock selection risks.
- Businesses will still retain an office presence despite a rise in employees working from home. Offices could be redesigned to include more collaborative space.
- E-commerce acceleration, increased inventory levels held in supply chains, and on-shoring are all potential COVID-19 impacts which will boost logistics demand.
- Economic uncertainty and physical difficulties to inspect mean the property investment market has slumped, with the second quarter activity (deal count) down 50% for the same period a year ago.
- Listed pricing suggests large price corrections in retail and hotel valuations through the remainder of the year, but only very modest declines (if any) in residential and industrial.

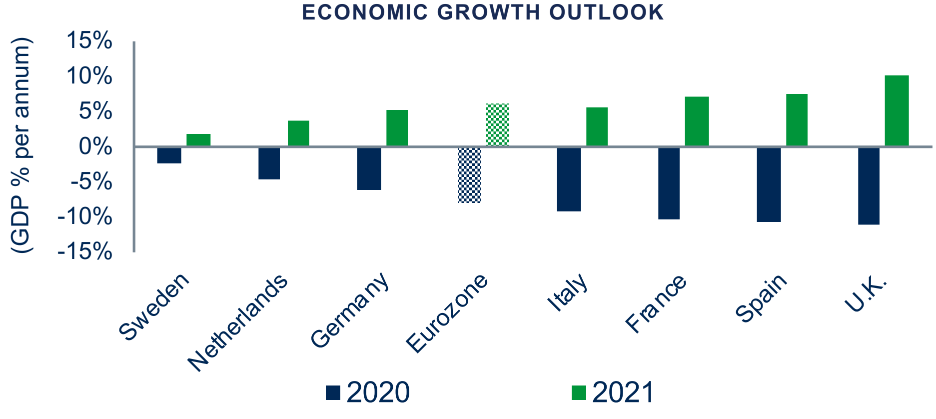
Economic Outlook

The Eurozone economy contracted by -3.6% quarter-over-quarter (0.1% for the fourth quarter of 2019) through the first quarter of 2020. With lockdown restrictions only beginning to act as a drag performance in late March, an even steeper decline is forecast for the second quarter of 2020. Stringent mobility restrictions mean industrial production and business sectors focused on consumer services (e.g. retail, leisure, travel/tourism) will have been heavily impacted. These are also areas of the economy where commercial property investors typically have considerable exposures. As lockdown restrictions began to ease in June, real-time data (e.g. Google, Apple mobility indexes) started to show a rebound in activity. The nascent recovery has subsequently spread into business sentiment surveys, with the Eurozone Composite PMI (Purchasing Managers' Index) in expansionary (+50) territory in late July. However, the medical facts will continue to dictate the pace that economic activity can recover.

Variations between countries will reflect different economic structures, success in containing the virus, and headroom for national fiscal policy responses. While retail sales are expected to see a strong initial rebound from pent-up demand, longer term consumer spending growth will be dependent on supportive labour market conditions vis-à-vis fiscal support. Travel restrictions and a lower propensity for foreign travel, will weigh on the tourist sector, leaving southern European economies struggling to recover as quickly.

There is currently little risk of inflation, with aggregate demand expected to recover at a slower pace than aggregate supply. With upward pricing pressures absent, it suggests that interest rates will now likely remain lower for even longer. This should provide comfort to governments who have had to significantly increase public debt levels to tackle the crisis fallout.

ECONOMIC GROWTH OUTLOOK



Source: Oxford Economics. As of July 2020.

Economic Outlook

Unlike the global financial crisis (GFC), the monetary and fiscal response to COVID-19 has been more rapid and coordinated. The European Central Bank (ECB) has increased and extended asset purchases to €1.35 trillion of bonds until at least June 2021. In July, the European Commission signed an agreement with all 27 EU states to launch a €750 billion Next Generation EU/Recovery Fund, instantly making the EU one of Europe's largest bond issuers. The Fund will distribute €390 billion in grants, with the remainder in loans. This funding will be in addition to the fiscal stimulus that individual national governments have already put in place.

This will not only support financially weaker countries that have been hit hard by the virus impacts, but also moves the EU toward closer integration, addressing a systemic weakness in the Euro currency by potentially allowing debt to be mutualised.

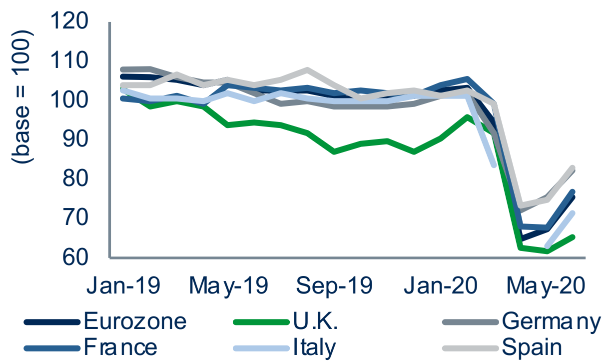
Looking ahead, Oxford Economics is forecasting Eurozone 2020 GDP to fall by -7.9% (compared to 1.2% for 2019), with a strong rebound in 2021 with growth of 6.1%. The recovery pace is expected to be gradual, and subject to ongoing medical data improvements. A second wave of infections is the key downside risk.

EUROPEAN GDP FORECAST (% PA)

	2019	2020	2021	2022	2023	2024	2020–2024
Eurozone	1.2%	-7.9%	6.1%	3.2%	1.9%	1.4%	0.8%
France	1.5%	-10.2%	7.3%	3.5%	3.0%	2.2%	1.0%
Germany	0.6%	-6.1%	5.2%	3.2%	1.2%	1.0%	0.8%
Italy	0.3%	-9.3%	5.7%	2.8%	1.4%	0.6%	0.1%
Spain	2.0%	-10.6%	7.6%	3.7%	2.5%	1.8%	0.8%
U.K.	1.5%	-10.9%	10.3%	3.5%	1.9%	1.8%	1.1%

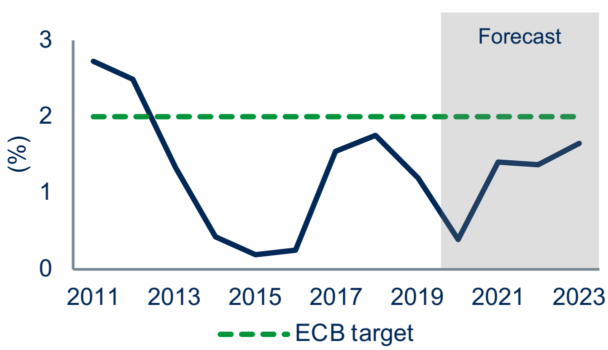
Source: Oxford Economics. As of July 2020.

ECONOMIC SENTIMENT



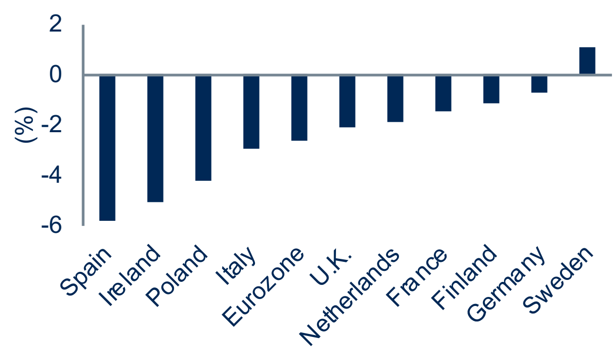
Source: Eurostat. As of July 2020.

EUROZONE INFLATION



Source: Oxford Economics. As of July 2020.

UNEMPLOYMENT TO TREND



Source: Eurostat. As of July 2020.

Capital Markets

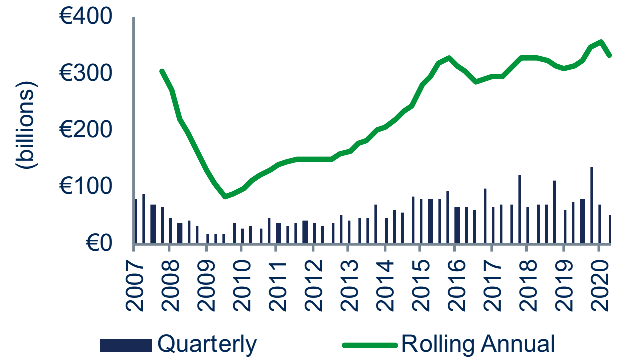
According to Real Capital Analytics, European investment volumes totalled just c.€50 billion in the second quarter of 2020, down around one-third versus the same period one year ago. This is a shallower decline than the U.S. (c.-70%) and APAC region (c.-50%). Some European countries and sectors even managed to post an increase on the second quarter of 2019 (e.g. Germany (c.+5%) and apartments (c.+22%)). However, activity (deal count) fell 50% in Europe over the same period. Closer scrutiny reveals that a number of 'mega' apartment transactions flattered investment volumes (c.€20 billion).

COVID-19 has negatively impacted listed property company (REIT) share prices. Residential and industrial REIT share prices have proved to be most resilient, helped by the recent e-commerce boost, while lockdowns and travel bans have, understandably, negatively impacted retail and hotels heavily. We expect this to be relativity reflected in pricing, if not the magnitude, as REIT prices have company balance sheet leverage and wider stock market volatility inherent in them.

For property sectors, locations and assets with long-term demographic and technological tailwinds will continue to maintain CRE cash flows and thus retain bond-like characteristics. The current substantial 450+ basis points (bps) prime property yield spread to 'risk-free' rates means that the right real estate is still highly attractive.

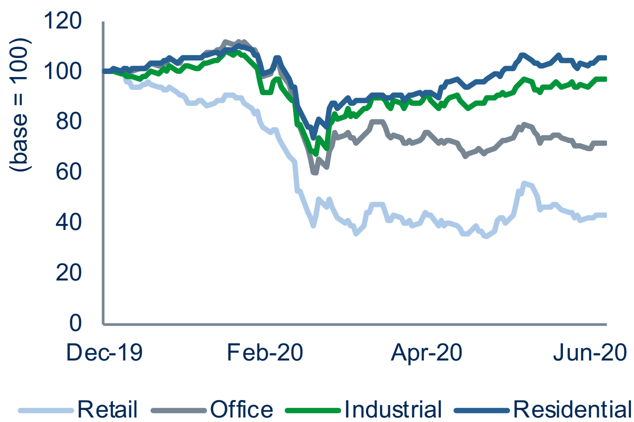
With banks focused on supporting the wider corporate sector and their existing real estate loans, less fresh capital for new property loan origination exists. Early in the second quarter, corporate bond yields initially spiked, driving the average senior property margin up to over 250 bps, before narrowing back to c.200 bps by the quarter end. Rent collection difficulties, and a rise in tenant defaults over the coming months, could put interest cover under pressure. A more collaborative banking approach, perhaps allowing missed interest to be rolled into the loan principal, means added headroom can exist.

EUROPEAN CRE CAPITAL FLOWS



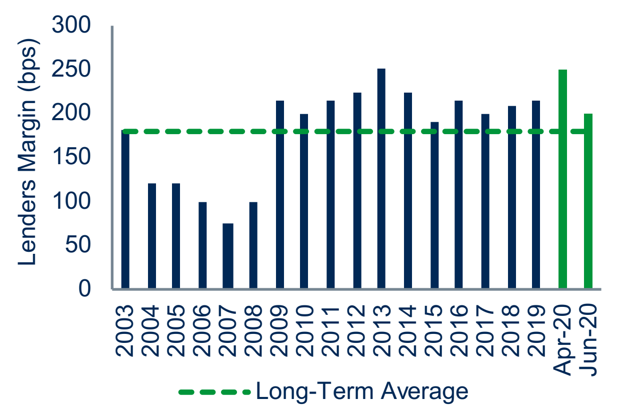
Source: RCA. As of July 2020.

EUROPEAN REIT PRICING



Source: EPRA. As of July 2020.

EUROPEAN CRE DEBT: SENIOR



Sources: AEW, Barings, CBRE. As of July 2020.

Occupier Market

OFFICE SECTOR

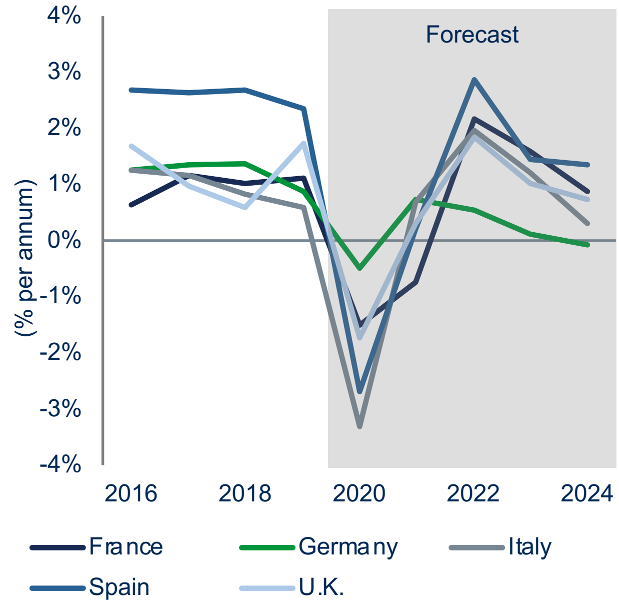
Pre-COVID-19, European office demand was already slowing, with rolling annual take-up to the first quarter of 2020 back in line with the 10-year average. The weak near-term employment outlook suggests lettings activity will be temporarily subdued, as companies put requirements on hold while they wait to see how the 'new normal' unfolds.

Falling demand and rising insolvencies will put upward pressure on vacancy over the coming months, but this will be from a position of strength, with vacancy currently well below long-term trends at sub-6%. Development pipeline delays and the potential indefinite postponement of some schemes, should also help keep supply under control while demand is softer.

The recent success of the 'Great Working from Home' experiment, is generating much debate about the future of offices. Businesses have remained operational because technology has stepped in and acted as a substitute host for many activities that previously took place face-to-face. With home working seeming to have gained much greater acceptance, there is potential for some more permanent behavioural shifts, with more employees spending a greater proportion of time working from home. This may change how employers think about their business models and real estate footprint.

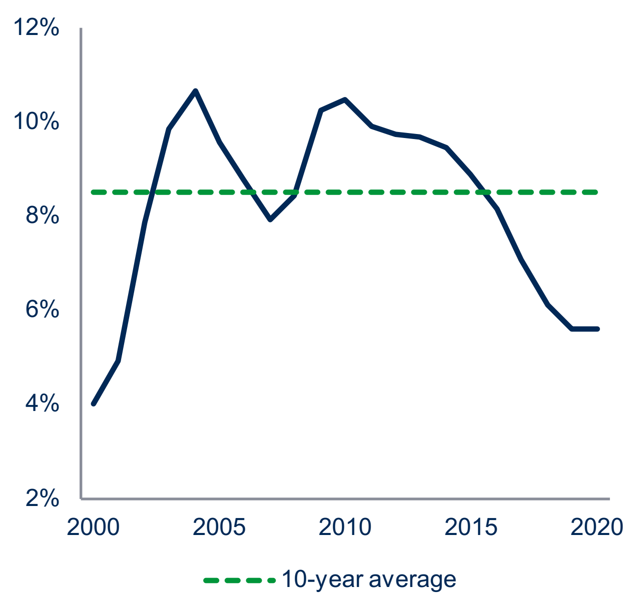
Longer-term, our central case is that the majority of businesses will continue to maintain an office presence. This reflects that offices not only provide a workspace, but contribute an important role in defining and nurturing corporate culture, training and mentoring new employees, recruiting talent, team building, and other intangibles that would be hard to replicate on a sustained basis in a virtual world. With demand for newer, sustainable, flexible offices likely to rise, high quality offices will become even more valuable in the future. The quid pro-quo is that more emphasis on high quality space could also imply an acceleration in the pace of obsolescence, and thus higher 'CapEx' requirements in the sector.

FUTURE DEMAND: FORECAST EMPLOYMENT GROWTH



Source: Oxford Economics. As of July 2020.

EUROPEAN OFFICE VACANCY RATE



Source: Cushman & Wakefield. As of April 2020.

Occupier Market

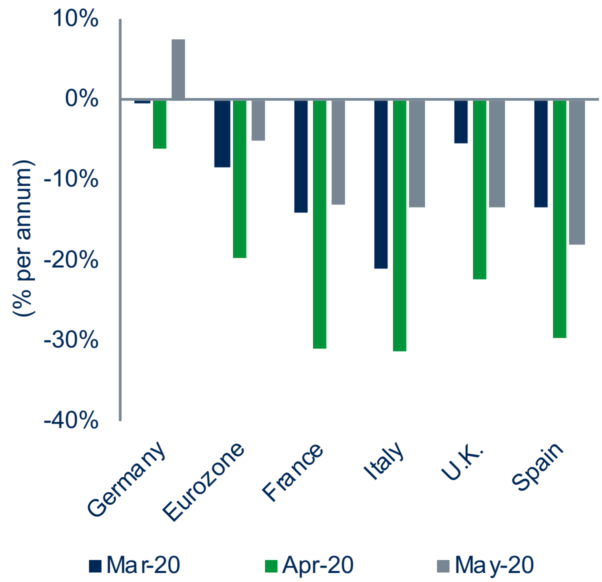
RETAIL SECTOR

Non-essential store closures and social distancing left the retail sector in the 'cross-hairs' of the virus. Government fiscal support, like the Furlough scheme in the U.K., has helped prop up household finances, but as things re-open, support will be wound down and unemployment is expected to rise.

Retail sales volumes have improved from April lows, with physical stores re-opening. A weaker labour market and soft consumer confidence will likely weigh on discretionary spending over the near term. This may be partially offset by spending from households that increased their savings rates through lockdowns.

Over the coming months, retail rent collection is expected to remain highly challenging. Store closures and bankruptcies will increase tenant defaults, putting upward pressure on vacancy and further eroding local retail 'critical mass'. Accelerating e-commerce will lead to a flight to quality, with obsolete secondary retail schemes repurposed. The best retail will survive, and may even emerge stronger, but the path is highly uncertain and pricing does not yet reflect huge stock selection risks.

RETAIL SALES VOLUMES



Source: Eurostat. As of July 2020.

Occupier Market

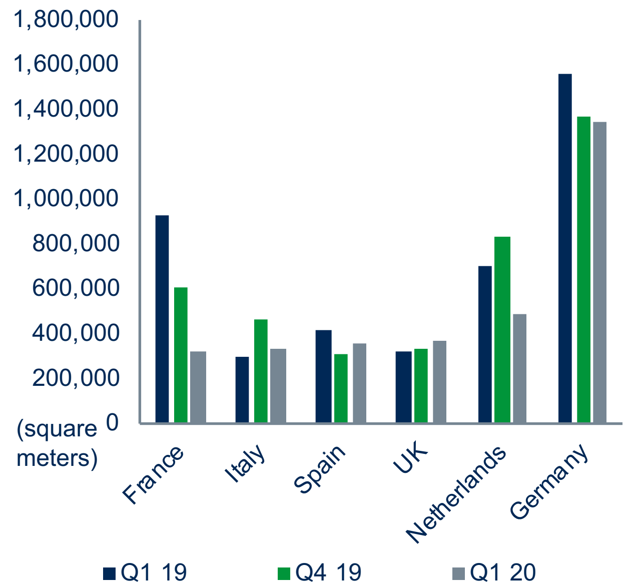
INDUSTRIAL SECTOR

Industrial demand was mixed through the first quarter of 2020, with the virus impact not fully reflected in the data (e.g. U.K. and Spanish letting activity exceeding levels seen in the fourth quarter of 2019). While the sector has benefitted from rising short-term demand from firms stockpiling inventory, emergency health provisions and the grocery sector, unprecedented near-term economic weakness, especially amongst retailers (a key logistics sector user) mean we expect lettings to slow in 2020.

Pan-European logistics vacancy remains low, at sub-5% at the end of the first quarter of 2020. Over the coming months, vacancy could rise (albeit from a low level), with demand weak and rising insolvency rates particularly in sectors hit hardest by the virus (i.e. retail). However, with just under 30% of pipeline space in core markets speculative, this should help prevent a sharp spike in supply.

Longer term, e-commerce acceleration, increased inventory levels held in supply chains, and on-shoring are all potential COVID-19 impacts, which will significantly boost demand for distribution and logistics assets.

EUROPEAN LOGISTICS DEMAND



Source: JLL. As of April 2020.

About the Team

BAI Research & Analytics is led by Colin Gordon and consists of 12 members that sit alongside the investment team globally. BRE's research team efforts are led by Philip Conner in the U.S. and Paul Stewart in Europe. The research team is structured by sector and geographic expertise. The team's diverse background includes appraisal, legal, technological and academic applications, across multiple asset-classes, across buy and sell-side shops in markets around the globe. The real estate research team is complemented by an analytics function enhancing the team's ability to collect, augment and analyze data to inform better decision making.

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