BARINGS

How is Omicron Impacting European Commercial Real Estate?

European Real Estate Research Quarterly

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Executive Summary

ECONOMY

- Omicron's rapid spread slowed growth early this year, but the direction of travel could likely improve again from the second quarter.
- The current stubborn bout of inflation is expected to linger into 2022, but its 'cost-push' nature, absence of solid wage growth and passing base effects, suggest it should still eventually pass.
- The ECB is facing pressure to follow other central banks, but has ruled out raising interest rates this year.

PROPERTY MARKETS

- Real estate capital market activity has recovered well, with 2021 European investment reaching a record high.
- REIT share prices suggest industrial assets will remain popular through 2022, putting sector capital values under further upward pressure.
- There will be no shortage of capital to deploy in 2022 according to INREV's latest Investor Intentions Survey, but sourcing product in sought after sectors could prove challenging!
- Until there is a significant pick-up in development pace, Grade A landlords will hold the balance of negotiating power.
- Retail market conditions improved last year, but structural challenges driven by changing shopping patterns remain.
- Industrial take-up for 2021 is forecast to hit a record high, with sector rental growth prospects exceedingly bright.
- Positive (but slower) house price growth is forecast for 2022, with interest rate hikes minimal in Europe.

Economic Outlook

High frequency data indicates growth is slowing, with January's Eurozone Purchasing Managers' Composite Index declining to 52.4 (versus 53.3 in December), with the Omicron variant weighing heaviest on the services sector—while manufacturing activity improved with signs of supply chain pressures easing. Oxford Economics project a marked slowdown, with Q4 2021 and Q1 2022 GDP at around 0.3% quarter-on-quarter (versus 2.2% in Q3 2021). Assuming hard lockdowns are avoided, the direction of travel is likely to improve again from the second quarter.

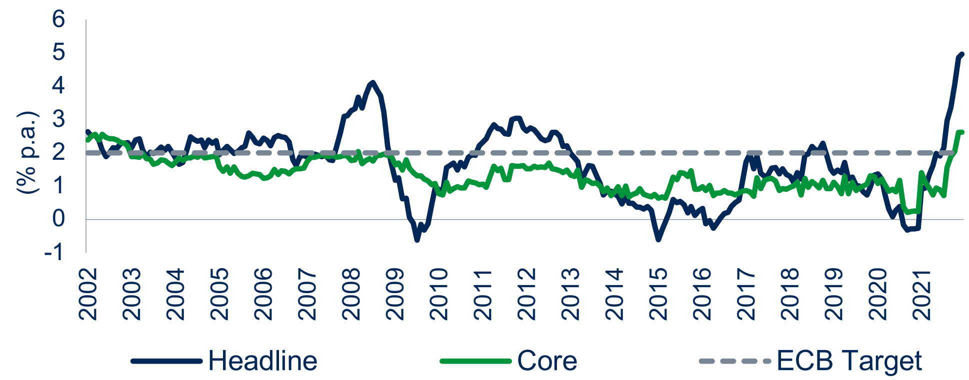
Eurozone inflation continues to rise, edging up to 5.0% in December 2021, from 4.9% the previous month. Energy remains the key inflationary driver, but other prices are now rising as well. This recent stubborn bout of inflation is expected to linger into 2022, but its 'cost-push' nature, absence of solid wage growth (discussed below) and passing base effects, suggest it should still eventually pass.

Labor market conditions are healthy, with Eurozone unemployment declining to 7.2% (November), its lowest level since March 2020, and strong worker demand reflected in elevated job vacancy rates. While these buoyant conditions might feed through to wage negotiations this year, a higher labor market slack than official statistics suggest means wage increases will likely be modest, and thus the risk of ramping up inflation expectations remain low.

Over the mid-term, consumption is expected to be a key growth driver. While consumer spending will likely have softened of late, a quick bounce back is anticipated once conditions normalize, as Omicron restrictions ease and households can again spend freely. The strong capital spending cycle will also support the recovery, with the EU Next Generation recovery plan playing an important role.

With the Eurozone economy forecast to be back to its pre-pandemic size in early 2022, the European Central Bank (ECB) is facing pressure to start winding back its pandemic support measures, and follow other central banks like the U.S. Federal Reserve and Bank of England and start tightening its monetary policy. At the ECB's December 2021 meeting, it did make a move in this direction, agreeing to end the emergency bond buying program (PEPP) in March 2022. To ease this transition, the longer-running Asset Purchase Program will be temporarily expanded, with monthly purchases doubling from €20 to €40 billion in Q2 2022, then €30 billion in Q3 2022, back to €20 billion thereafter, for 'as long is necessary'. It also ruled out raising interest rates this year.

EUROZONE: HEADLINE VS. CORE INFLATION



Source: Eurostat. As of January 2022.

Economic Outlook

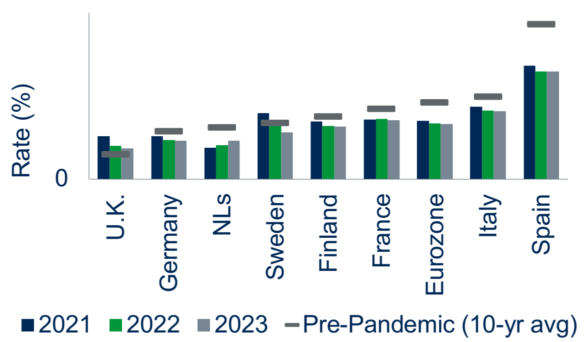
Oxford Economics estimate that the Eurozone economy expanded by 5.1% in 2021, with growth forecast to moderate to just under 4.0% in 2022. Widespread vaccine availability means the medical situation is far less bleak today compared to a year ago, with the recovery expected to quickly regain traction. Despite the Omicron outlook appearing to be heading in a fairly favorable direction, it highlights future variant concerns and thus, risks remain elevated around the forecasts.

GDP COUNTRY FORECASTS (% P.A.)

Country	2021	2022	2023	2024	2025	2026	2022–2026
France	**6.7%**	3.7%	2.2%	1.5%	1.4%	1.4%	2.0%
Germany	**2.5%**	3.9%	2.9%	1.3%	0.9%	0.9%	2.0%
Italy	**6.3%**	4.4%	2.5%	0.8%	0.2%	0.1%	1.6%
Netherlands	**4.6%**	3.5%	2.1%	1.2%	1.1%	1.0%	1.8%
Spain	**4.9%**	5.5%	4.3%	2.6%	1.5%	1.1%	3.0%
Sweden	**4.7%**	3.2%	2.1%	1.7%	1.7%	1.7%	2.1%
United Kingdom	**7.2%**	4.4%	2.8%	1.5%	1.7%	1.7%	2.4%

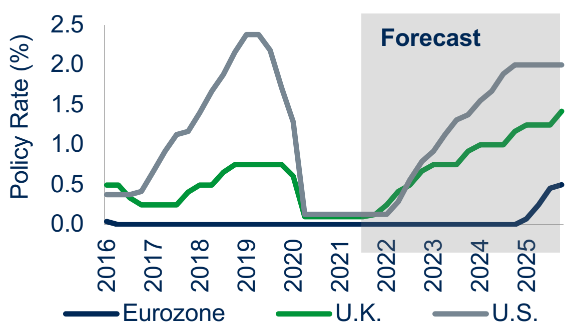
Source: Oxford Economics. As of January 2022.
(NB: 2021 = Forecast)

FORECAST UNEMPLOYMENT RATE



Source: Oxford Economics. As of January 2022.

INTEREST RATES



Source: Oxford Economics. As of January 2022.

Capital Markets

CBRE report that European investment reached a record high in 2021, totalling €359 billion, up 25% on 2020 and 8% on 2019 (the previous record year). At a country level, Germany was the top market, attracting €110 billion of investment last year. While volumes exceeded 2020 levels in many major markets (e.g. U.K., Italy, Spain and Ireland), activity remained subdued in several markets (e.g. France, Portugal and Netherlands) with 2021 investment volumes down on the previous year.

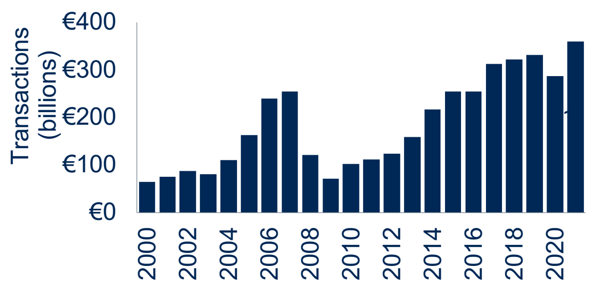
Listed property companies and REIT share prices reveal the most popular sectors through 2021, with industrial (55% pa) and self-storage (75% pa) outperforming. Residential was very slightly negative (-3% pa), although pricing was still 10% higher than its pre-COVID level. Office pricing increased (9% pa), perhaps reflecting the more positive outlook for prime offices, driven by a 'flight to quality'. Retail pricing rose 6% pa, albeit from a very low base, with prices still almost -50% below December 2019. Hotels continued to struggle (-2% pa), reflecting ongoing poor REIT investor sentiment.

CBRE report little change in debt terms for prime assets (with maximum LTVs and margins) in late 2021. Over the longer-term, as has already occurred in the U.K. over the past decade with the introduction of bank slotting[1], regulatory changes driven by Basel III will lead to growth in non-bank lending across Europe. Attracted by lower risk-adjusted returns, these 'alternative lenders' are pension funds, insurance companies and specialist property debt funds—many of whom are already highly active in Anglo-Saxon jurisdictions with decades of experience. In our view, the prospect of a more diverse, deeper lender base, often with a longer-term perspective, can only increase the sector's resilience to future property cycles.

According to the latest INREV Investment Intentions Survey, capital to deploy into global real estate has increased to €76.7 billion in 2022 (versus €64.6 billion 2021). There has been a marked upward shift in investor risk appetite in Europe, with value-added strategies now preferred over core. This is likely attributable to the better economic outlook, lack of suitable product (particularly industrial and residential assets) and search for yield.

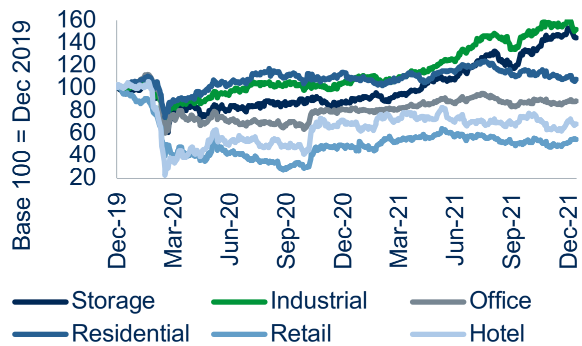
Highly competitive market conditions continue to put downward pressure on prime logistics yields, which now range between 3-4% in key markets, according to CBRE. In the U.K., retail warehouses seem to be attracting investor interest—possibly for their 'final mile' potential, in some cases—with yields declining -150 basis points (bps) in the year to January 2022. There has also been downward pressure on prime CBD office yields, with the biggest movements in the West End and Helsinki, which moved -50 bps over the past year.

EUROPEAN CRE: TRANSACTION VOLUMES



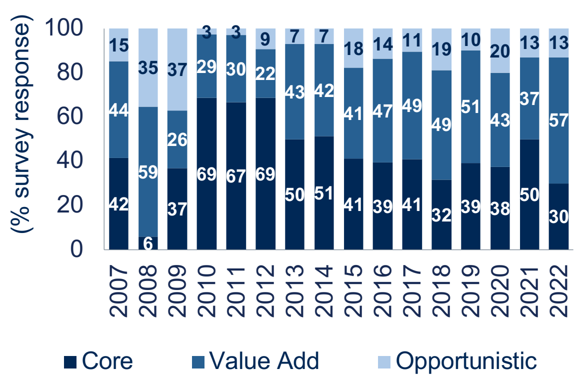
Source : CBRE. As of January 2022.

EUROPEAN REIT: LISTED SHARE PRICE



Source: Bloomberg. As of January 13, 2022.

EUROPEAN CRE: INVESTOR INTENTIONS



Source: INREV. As of January 2022.

[1] This refers to a procedure where U.K. banks assign a credit risk category—and a corresponding capital charge requirement—to specialized lending exposures.

Occupier Market

OFFICE SECTOR

Lettings activity steadily rose through 2021, with Q3 2021 take-up totalling 2.5 million sq m, up almost 50% on the same quarter a year earlier, but down -10% on the long-run average. The recovery in European office markets will gain further traction during 2022, but mainly at the prime end.

Office vacancy has steadily risen, and is now at around 7.1% (Q3 2021), up from 5.5% pre-pandemic. Total vacancy will likely fall back in 2022, with Grade A shortages intensifying. The increase in pre-letting activity of late confirms the dearth of quality space, and also highlights corporate desires to build both their brand and capitalize on face-to-face contact benefits (i.e. social, collaborative, training, etc.).

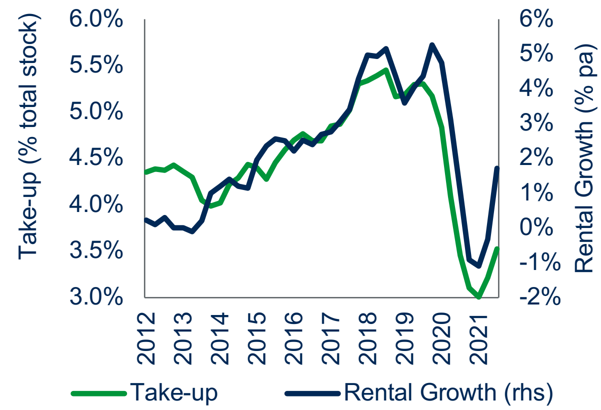
Occupier requirements have ratcheted up. For instance, a resultant 'flight to quality' is occurring driven by health and safety concerns over variant fears, there is a desire to maximize productivity and collaboration, and a need to satisfy environmental sustainability standards. Only the most modern, flexible, 'green' offices can accommodate the rise in occupier requirements. Investors recognize this—and demand is following suit, with the focus shifting to Grade A product with the strongest sustainability ratings.

Chronic shortages of top quality space were endemic across most major Western European cities prior to the pandemic. The commodity price driven surge in construction costs, resultant scheme delays and pressures on developer viability/profits will only exacerbate this scarcity.

At the top end of the market, the balance of negotiating power will reside with landlords of Grade A space, until the pace of development significantly picks up. This contrasts with the plight of owners of older, poorer quality office space, where the increase in occupier needs have accelerated the pace of stock obsolescence, and required capital expenditure has risen higher.

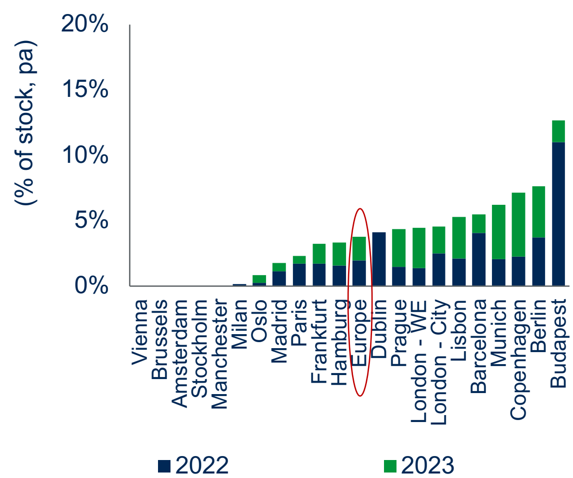
We estimate the average prime European office yield stood at roughly 3.7% per annum, a fall of around -12 bps over the year to Q3 2021, and about -10 bps below pre-pandemic December 2019 levels.

EUROPEAN OFFICE: DEMAND VS. RENTAL GROWTH



Source: CBRE, Cushman & Wakefield. As of Q3 2021.

EUROPEAN OFFICE: DEVELOPMENT COMPLETIONS



Source: Cushman & Wakefield. As of Q3 2021.

Occupier Market

RETAIL SECTOR

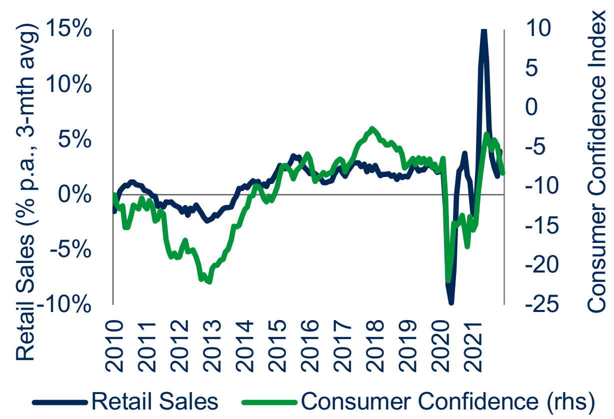
Retail trading conditions improved through 2021, following a very difficult 2020 when many of Europe's shops were shuttered for months at a time. Easing restrictions, positive consumer sentiment and spending of accumulated lockdown wealth all coalesced to support the resuscitation of retail in 2021. The latest Eurozone retail sales volumes remain well above the long-term trend at 3.9% pa (3-month average) through November. Restrictions in response to the Omicron variant will likely lead to some temporary softening in sales volumes over the winter months, but these should quickly revive as conditions normalize.

Physical store visits have yet to return to pre-pandemic levels. In autumn 2021, retail expert Locatus undertook an extensive footfall study of 96 shopping areas across Europe. It found that in the majority of locations, footfall was down markedly on pre-COVID levels. While German and Scandinavian cities have been more resilient recording smaller footfall declines, cities with a high dependency on international tourists, such as Paris, Rome and Amsterdam, were impacted the most.

The pandemic has led to a step change toward shopping patterns online. For many European countries, this trend is still in its infancy, with a decade or more to run. These long-term structural changes are putting upward pressure on yields, with the average European high street yield estimated at roughly 4.1% (Q3 2021), a rise of about 50 bps on pre-pandemic December 2019 levels. We do not expect these negative sector pricing pressures to ease in the foreseeable future.

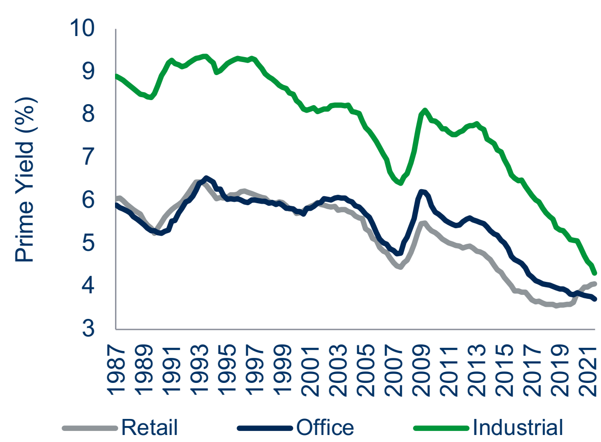
Over the long term, we continue to assert the view that there is a future for the best retail assets in dominant locations. For now, stock selection risks are elevated, and the reservation for opportunistic investors. However, for investors looking to maintain a sector exposure, food and neighborhood convenience will likely be most resilient. Selective retail warehousing schemes that are optimally sited for final mile logistics and/or with multi-use repurposing potential, are also worthy of consideration.

EUROZONE: CONSUMER CONFIDENCE & RETAIL SALES



Source: Eurostat. As of January 2022.

EUROPE: PRIME PROPERTY YIELDS



Source: CBRE, C&W, Barings. As of Q3 2021.

Occupier Market

INDUSTRIAL SECTOR

Occupier demand for the logistics space remains robust, with CBRE data suggesting that 2021 could be another record year for take-up. Lettings activity for the nine months to September 2021 totalled 23 million sq m, up more than 20% on the same period a year ago. Third-party logistics providers (3PLs) and e-commerce remain the key demand drivers, although activity from other traditional sectors is rising as corporates seek to reinforce their supply chains and hold more inventory closer to market. Supply pressures are intensifying, with aggregate vacancy tight at just over 3%, and even tighter in a number of key markets such as Germany, U.K. and Belgium.

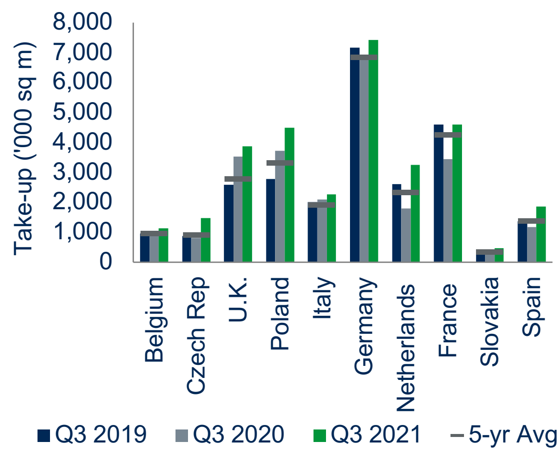
Strong underlying fundamentals have boosted developer activity levels. According to JLL, total development completions (build-to-suit and speculative) reached a quarterly high in Q3 2021, as did total space under construction, which exceeded 23 million sq m. Build-to-suit schemes continue to make up the bulk of construction activity. While speculative development is rising, it still only accounts for one-third of total space under construction—which is unlikely to significantly alleviate the excess of demand over supply.

Going forward, sustained logistics demand is anticipated, with the shift in shopping patterns online continuing to drive warehouse demand. As noted above, an additional demand boost will also come from corporates building in greater supply chains contingency, shifting from ultra-lean 'just-in-time' to 'just-in-case' inventory levels.

Highly supportive fundamentals continue to put upward pressure on rents, with prime European logistics rents rising 4.1% p.a. (Q3 2021), outperforming both offices (1.7% p.a.) and retail (-5.5% p.a.). In our view, future industrial rental growth prospects are exceedingly bright, with ongoing supply / demand imbalances, a lack of suitable logistics development sites in key markets, rising land values and a surge in commodity prices and thus building costs, all providing support.

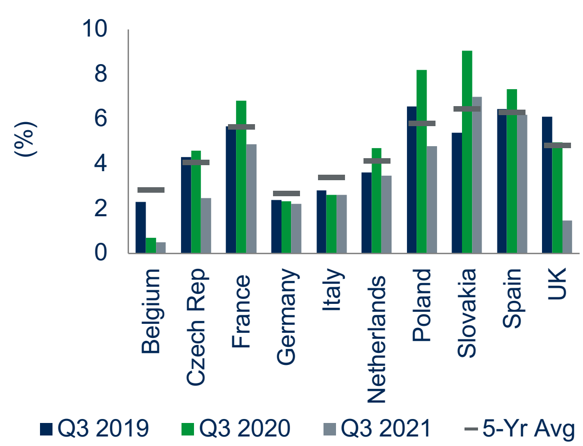
The weight of capital into the sector continues to drive down yields, with prime logistics yields in Nordic and northern and southern European markets now typically ranging between 3-4%, according to CBRE. Further widespread yield compression is anticipated, as institutional investors continue to seek sector exposure, and 'tap into' positive rental growth prospects.

EUROPEAN LOGISTICS TAKE-UP (ROLLING ANNUAL)



Source: CBRE. As of December 2021.

EUROPEAN LOGISTICS: VACANCY RATES



Source: CBRE. As of December 2021.

Occupier Market

ACCOMMODATION SECTOR

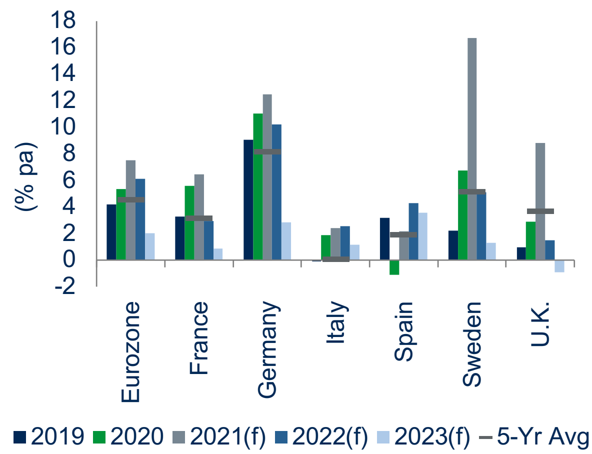
There is no sign of momentum slowing, with robust house price growth—close to 10% p.a. on average—recorded across Europe's housing markets in Q3 2021. Of the major economies, the pace of appreciation was strongest in the Netherlands (17% p.a.) and Germany (12% p.a.), up around 10% p.a. in Sweden and the U.K., followed by France (7% p.a.), and more modest price appreciation in Spain and Italy (4% p.a.).

Further house price growth is anticipated in 2022, albeit at a reduced pace. Despite upward pressures on interest rates, supportive monetary policy is likely to continue to sustain some positive capital growth, but the recent boost from pandemic fiscal support packages will fade. Oxford Economics house price forecasts are generally ahead or in-line with the five-year average for most countries.

The rise of Europe's residential sector is catapulting it into a mainstream asset class, as institutional investors search for a viable retail alternative and access to stable income streams. However, sector maturity does vary widely across Europe, with the largest institutional markets tending to be in the north (e.g. Netherlands, Denmark, and Sweden). This suggests that a lot of investment opportunities exist across Europe, to suit different investment strategies / risk appetite. For long-term holds (i.e. core investors), careful consideration should be given to local long-term demographic trends, existing housing provision levels, the affordability of rents versus buying, and sustainability credentials, to ensure positive rental growth potential and reduce obsolescence risk.

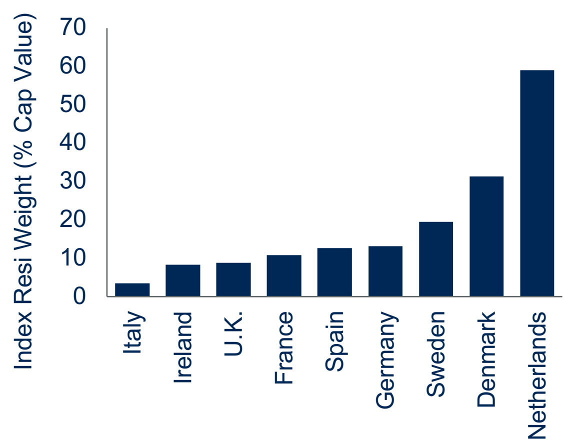
The imbalance between investor demand and suitable product means pricing pressures are intense. During 2021, CBRE report that prime residential (multi-family) yields fell in most northern EU capital cities, especially in Copenhagen (-60 bps) and Stockholm (-75 bps); meanwhile, yields in Madrid and Milan were flat. Paris and Berlin are the lowest yielding markets at 2.1%, followed by Amsterdam at 2.7%, 3.0% in Madrid and 3.25% in London.

EUROPEAN HOUSE PRICE GROWTH



Source: Oxford Economics. As of December 2021.

EUROPE: INSTITUTIONAL MARKET MATURITY



Source: MSCI. As of December 2020.

About the Team

Barings Real Estate's research team is structured by sector and geographic expertise, with efforts led by Dags Chen 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.

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