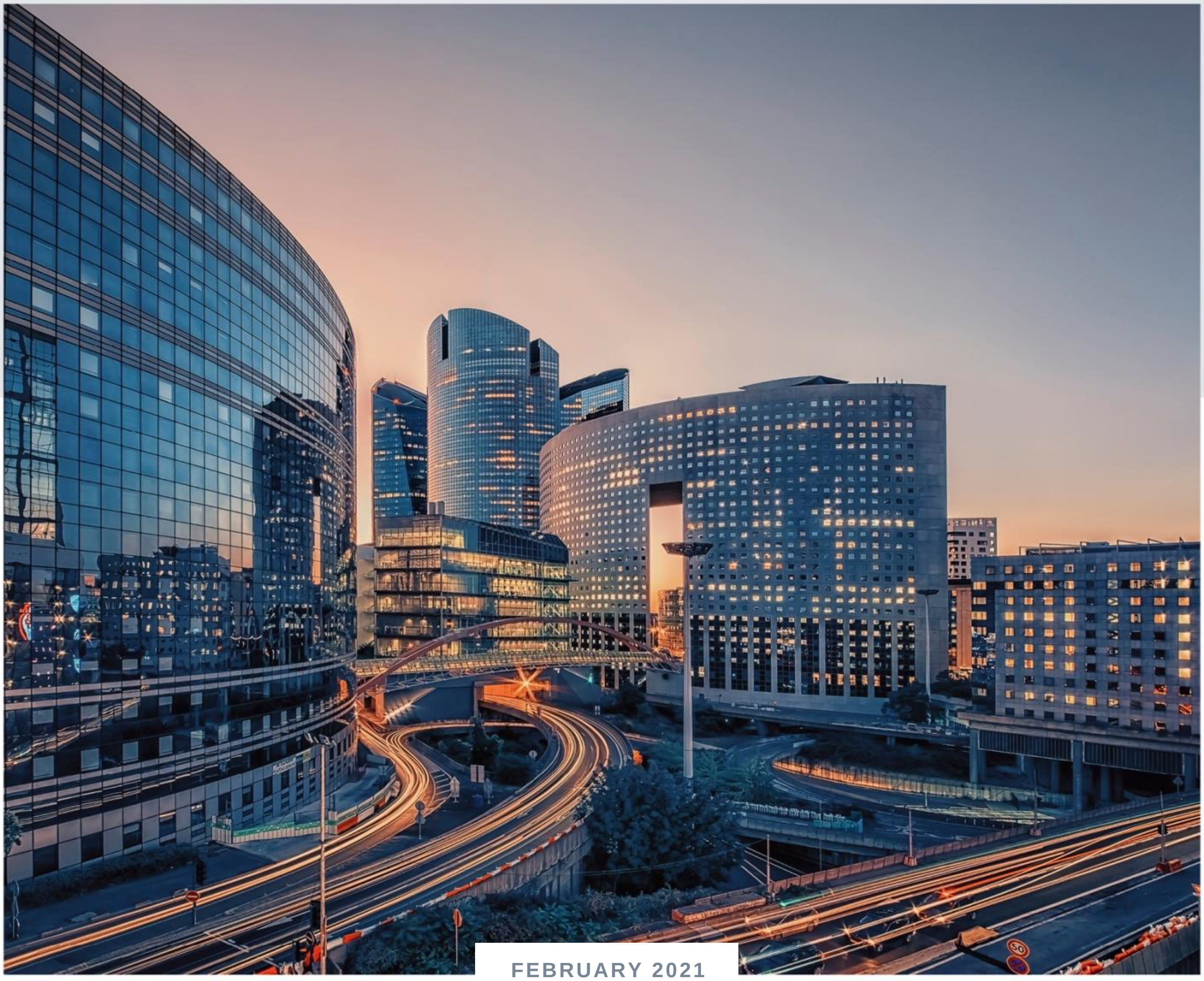
BARINGS

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

European Real Estate Research Quarterly



FEBRUARY 2021

21-1500587

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.

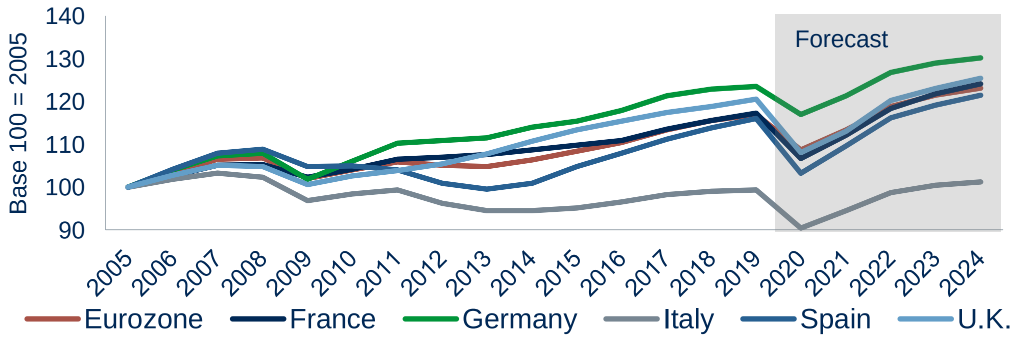
Economic Outlook

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.

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.

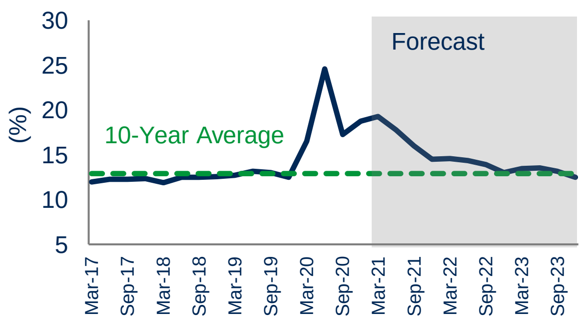
For 2020, Oxford Economics is forecasting Eurozone GDP will contract by -7.1%, accelerating to 4.2% in 2021, with the economy expected to return back to it pre-pandemic level by early 2022. Inflation expectations are well below target, which provides headroom for European Central Bank policy to remain 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%

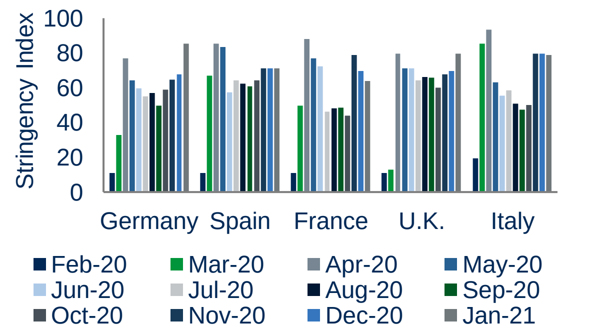
Source: Oxford Economics. As of January 2021. (NB: 2020 = forecast)

HOUSEHOLD SAVINGS RATE



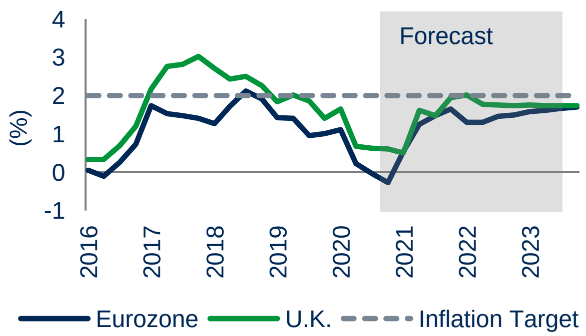
Source: Oxford Economics. As of January 2021.

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.

Capital Markets

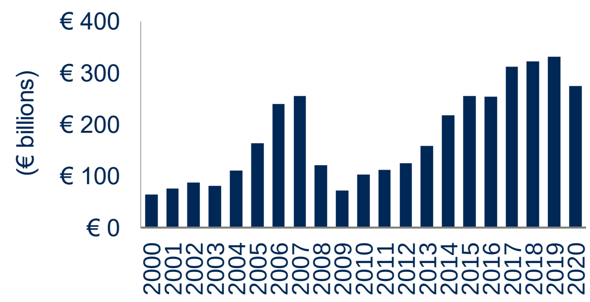
European commercial real estate (CRE) capital flows surprised to the upside in 2020, with CBRE reporting the total annual investment volume at €275 billlion, a decline of just -17% on the 2019 level. At an individual country level, Germany was the most liquid market, with total annual investment reaching €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.

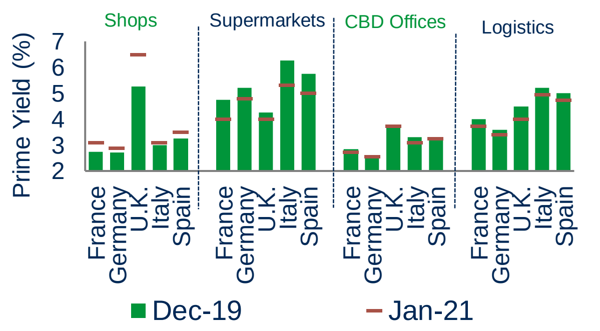
COVID’s impact on CRE does not seem to have damaged the asset class appeal. There is still plenty of capital ready to deploy, with the latest INREV 2021 Investment Survey estimating that a minimum of €64.6 billion will be invested in global real estate this year. Offices, industrial and residential, 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



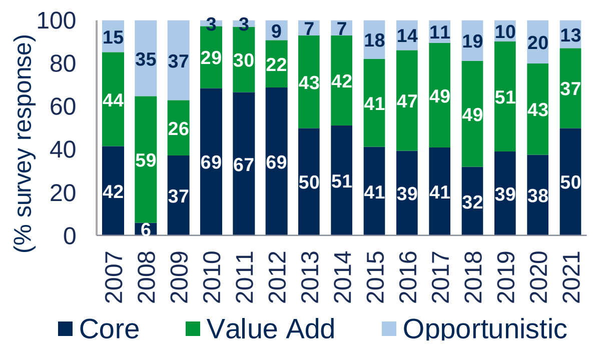
Source: CBRE. As of January 2021.

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.

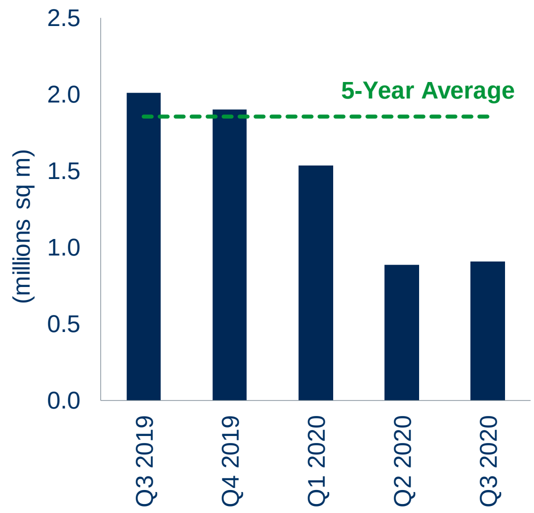
Despite physical occupancy being just a fraction of typical occpuancy levels, market vacancy has only ticked up slightly to just over 6% (Q3 2020), well below the 10-year average (roughly 8.5%). Weaker demand and a rise in completions will put upward pressure on the vacancy rate.

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.

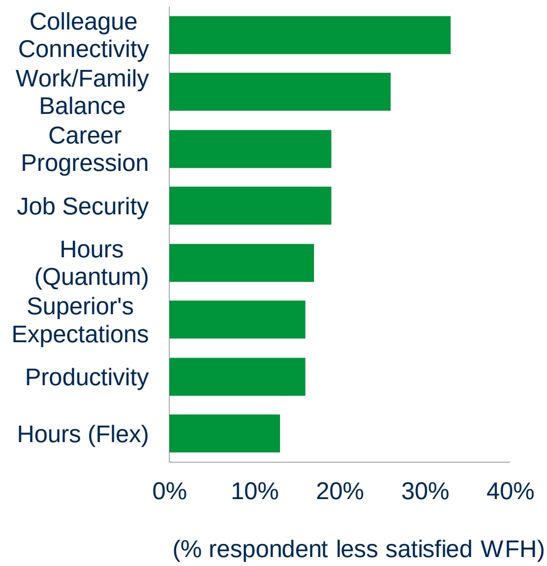
With bank lending largely focused on the wider corporate sector recovery, the current part regulatory-driven (e.g. Basel III) post-GFC dearth of new construction will continue. That suggests that the already acute low supply of modern office accommodation, in most European cities, is likely to become 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

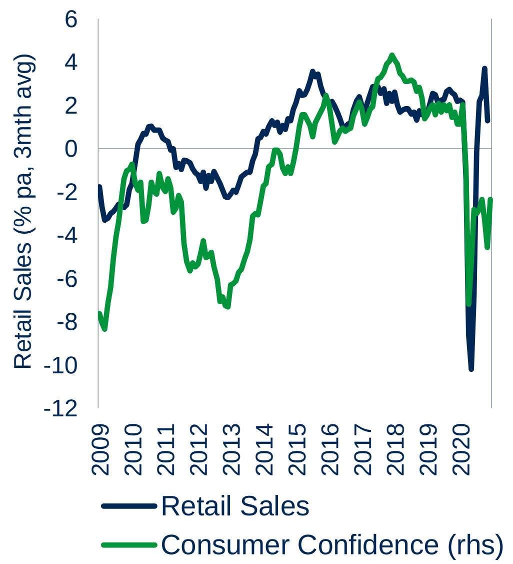
RETAIL SECTOR

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

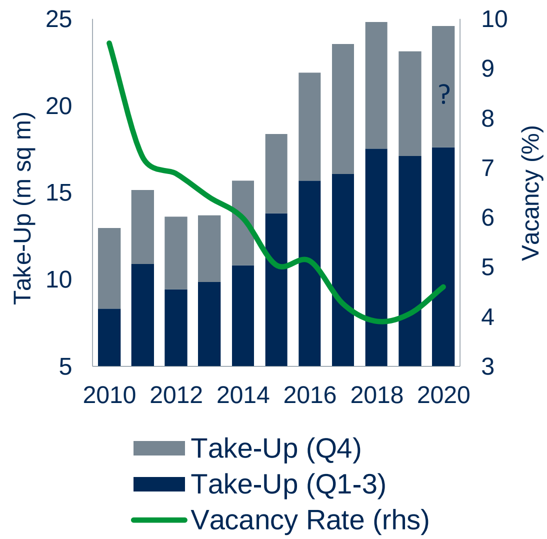
Contracting GDP implies a reduced velocity of goods flowing around the economy, and thus a reduction in occupier demand for storage space might typically be expected. This has not transpired through the pandemic, as current cyclical weakness has been more than compensated by structural boosts, which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

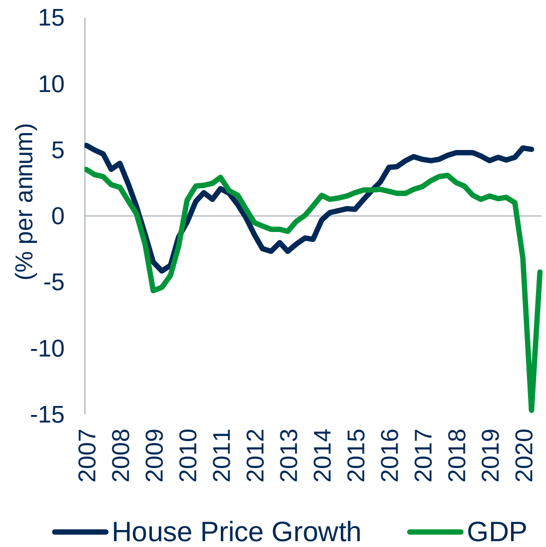
RESIDENTIAL SECTOR

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

Important Information

Any forecasts in this document are based upon Barings opinion of the market at the date of preparation and are subject to change without notice, dependent upon many factors. Any prediction, projection or forecast is not necessarily indicative of the future or likely performance. Investment involves risk. The value of any investments and any income generated may go down as well as up and is not guaranteed. Past performance is no indication of current or future performance. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. Any investment results, portfolio compositions and or examples set forth in this document are provided for illustrative purposes only and are not indicative of any future investment results, future portfolio composition or investments. The composition, size of, and risks associated with an investment may differ substantially from any examples set forth in this document. No representation is made that an investment will be profitable or will not incur losses. Where appropriate, changes in the currency exchange rates may affect the value of investments. Prospective investors should read the offering documents, if applicable, for the details and specific risk factors of any Fund/Strategy discussed in this document. For Professional Investors / Institutional Investors only. This document should not be distributed to or relied on by Retail / Individual Investors. Barings LLC, Barings Securities LLC, Barings (U.K.) Limited, Barings Global Advisers Limited, Barings Australia Pty Ltd, Barings Japan Limited, Barings Real Estate Advisers Europe Finance LLP, BREAE AIFM LLP, Baring Asset Management Limited, Baring International Investment Limited, Baring Fund Managers Limited, Baring International Fund Managers (Ireland) Limited, Baring Asset Management (Asia) Limited, Baring SICE (Taiwan) Limited, Baring Asset Management Switzerland Sarl, and Baring Asset Management Korea Limited each are affiliated financial service companies owned by Barings LLC (each, individually, an "Affiliate"), together known as "Barings." Some Affiliates may act as an introducer or distributor of the products and services of some others and may be paid a fee for doing so.

NO OFFER: solicitation for the purchase or sale of any financial instrument or service in any jurisdiction. The material herein was prepared without any consideration of the investment objectives, financial situation or particular needs of anyone who may receive it. This document is not, and must not be treated as, investment advice, an investment recommendation, investment research, or a recommendation about the suitability or appropriateness of any security, commodity, investment, or particular investment strategy, and must not be construed as a projection or prediction.
In making an investment decision, prospective investors must rely on their own examination of the merits and risks involved and before making any investment decision, it is recommended that prospective investors seek independent investment, legal, tax, accounting or other professional advice as appropriate.
Unless otherwise mentioned, the views contained in this document are those of Barings.

These views are made in good faith in relation to the facts known at the time of preparation and are subject to change without notice. Individual portfolio management teams may hold different views than the views expressed herein and may make different investment decisions for different clients. Parts of this document may be based on information received from sources we believe to be reliable. Although every effort is taken to ensure that the information contained in this document is accurate, Barings makes no representation or warranty, express or implied, regarding the accuracy, completeness or adequacy of the information.

These materials are being provided on the express basis that they and any related communications (whether written or oral) will not cause Barings to become an investment advice fiduciary under ERISA or the Internal Revenue Code with respect to any retirement plan, IRA investor, individual retirement account or individual retirement annuity as the recipients are fully aware that Barings (i) is not undertaking to provide impartial investment advice, make a recommendation regarding the acquisition, holding or disposal of an investment, act as an impartial adviser, or give advice in a fiduciary capacity, and (ii) has a financial interest in the offering and sale of one or more products and services, which may depend on a number of factors relating to Barings' business objectives, and which has been disclosed to the recipient.

OTHER RESTRICTIONS: The distribution of this document is restricted by law. No action has been or will be taken by Barings to permit the possession or distribution of the document in any jurisdiction, where action for that purpose may be required.
Accordingly, the document may not be used in any jurisdiction except under circumstances that will result in compliance with all applicable laws and regulations.
Any service, security, investment or product outlined in this document may not be suitable for a prospective investor or available in their jurisdiction. Any information with respect to UCITS Funds is not intended for U.S. Persons, as defined in Regulation S under the U.S. Securities Act of 1933, or persons in any other jurisdictions where such use or distribution would be contrary to law or local regulation.
INFORMATION: Barings is the brand name for the worldwide asset management or associated businesses of Barings. This document is issued by one or more of the following entities:
Barings LLC, which is a registered investment adviser with the Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940, as amended (Barings LLC also relies on section 8.26 of NI 31-103 (international adviser exemption) and has filed the Form 31-103F2 in Ontario, Quebec, British Columbia, Alberta, Nova Scotia, Manitoba, New Brunswick, Newfoundland and Labrador, Prince Edward Island and Saskatchewan); Barings Securities LLC, which is a registered limited purpose broker-dealer with the Financial Industry Regulatory Authority (Barings Securities LLC also relies on section 8.18 of NI 31-103 (international dealer exemption) and has filed the Form 31-103F2 in Ontario, Quebec, British Columbia, Alberta, Nova Scotia, Manitoba, New Brunswick, Newfoundland and Labrador, Prince Edward Island and Saskatchewan);
Barings (U.K.) Limited, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 194662) and is a Company registered in England and Wales (No. 03005774) whose registered address is 20 Old Bailey, London, EC4M 7BF.

The document is for informational purposes only and is not an offer or Barings Global Advisers Limited, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 552931) and is a Company registered in England and Wales (No. 07622519) whose registered address is 20 Old Bailey, London, EC4M 7BF and is a registered investment adviser with the SEC; Baring Asset Management Limited, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 170601) and is a Company registered in England and Wales (No. 02915887) whose registered address is 20 Old Bailey, London, EC4M 7BF; Baring International Investment Limited, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 122628), and is a Company registered in England and Wales (No. 01426546) whose registered address is 20 Old Bailey, London, EC4M 7BF, is a registered investment adviser with the SEC (Baring International Investment Limited also relies on section 8.26 of NI 31-103 (international adviser exemption) and has filed the Form 31-103F2 in Quebec and Manitoba;
Barings Real Estate Advisers Europe Finance LLP, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 401543); or
BREAE AIFM LLP, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 709904);

Baring Fund Managers Limited, which is authorized as a manager of collective investment schemes with the Financial Conduct Authority in the United Kingdom and is authorized as an Alternative Investment Fund Manager in several European Union jurisdictions under the Alternative Investment Fund Managers Directive (AIFMD) passport regime;

Baring International Fund Managers (Ireland) Limited), which is authorized as an Alternative Investment Fund Manager in several European Union jurisdictions under the Alternative Investment Fund Managers Directive (AIFMD) passport regime and, since April 28, 2006, as a UCITS management company with the Central Bank of Ireland;
Baring Asset Management Switzerland Sàrl, which is authorized by the Switzerland Financial Market Supervisory Authority to offer and/or distribute collective capital investments;

Barings Australia Pty Ltd (ACN 140 045 656), which is authorized to offer financial services in Australia under its Australian Financial Services License (No: 342787) issued by the Australian Securities and Investments Commission;

Baring Asset Management (Asia) Limited, which is licensed by the Securities and Futures Commission of Hong Kong to carry on regulated activities Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities), Type 5 (advising on futures contracts) and Type 9 (asset management) in Hong Kong in accordance with the requirements set out in the Securities and Futures Ordinance (Cap 571);

Barings Japan Limited, which is registered as a Financial Business Operator (Registration No. 396-KLFB) for Type II Financial Instruments Business, Investment Advisory and Agency Business, and Investment Management Business with the Financial Services Agency in Japan under the Financial Instruments and Exchange Act (Act No. 25 of 1948);Baring SICE (Taiwan) Limited, an independently operated business (Business license number: 2008 FSC- SICE- Xin- 030; Address: 21 F, No.333, Sec. 1 Keelung Road, Taipei 11012; Taiwan Contact telephone number: 0800 062 068); or
Baring Asset Management Korea Limited, which is authorized by the Korean Financial Services Commission to engage in collective investment business and is registered with the Korean Financial Services Commission to engage in privately placed collective investment business for professional investors, discretionary investment business and advisory business.