Amundi ASSET MANAGEMENT | Alternative & Real Assets

Real Estate Trends Q4 2020

***by* Amundi Immobilier**

Confidence must be earned

Amundi ASSET MANAGEMENT

Real Estate

A slowdown in leasing activity and selective but not inactive investors in a context of reduced visibility

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Economy

In the euro zone, after a drop of -3.7% in the first quarter and -11.8% in the second, GDP growth in the third quarter was close to +12.7%. However, the introduction of business restrictions at the end of the quarter at local level slowed the recovery.

Pressure on the labour market remains high, even though job protection measures are slowing the rise in the unemployment rate (8.3% in September compared with 7.4% in January).

Inflation remains very moderate, with preliminary figures for October showing -0.3% over 12 months, unchanged from September.

National governments are preparing reform programmes with a view to obtaining support from the European Recovery Fund. However, disagreements between some EU countries and the European parliament over the conditions for accessing the funding remain unresolved and could delay payments. Negotiations on Brexit are continuing.

The pandemic continued to spread in October, leading several European countries to take measures to restrict movement.

Real GDP growth (%)

	2019	2020 (bracket, forecast)
World	3.0	-4.5/-3.8
Eurozone	1.2	-8.1/-7.5
Germany	0.6	-6.3/-5.7
France	1.2	-10.0/-9.4
Italy	0.3	-10.0/-9.4
Spain	2.0	-12.4/-11.7
United Kingdom	1.4	-11.5/-10.5

Source: Amundi Research (October 27, 2020)

Leasing markets

On average, office take-up remained very slow in the third quarter of 2020 in Europe's main markets.

The hoped-for upturn did not really take place at the aggregate level. This is explained in particular by the wait-and-see attitude of companies in the face of economic and pandemic uncertainty, with in particular at the end of the quarter the (well-founded) fear of a new pandemic wave. This context is not conducive to making real estate decisions and encourages some companies to opt for the status quo. It should be noted that lease renegotiations are an option that is more closely watched and used by companies than before Covid-19. There is also an increased appetite for flexible solutions.

Finally, in the first nine months of 2020, office take-up is down sharply over one year, and remain well below the ten-year average. This is the case in a number of major European markets, such as the Greater Paris region and Barcelona, for example, where take-up is more than 40% below the ten-year average, or even Frankfurt. Cities such as Lyon, Berlin or Amsterdam have fared better.

As a result of deliveries in a context of slower leasing activity, the average vacancy rate increased. For example, the average vacancy rate in the EU15 increased by almost 60 bps in 3 months, to 7.1% at the end of Q3 2020 according to CBRE. Although it is 90 bps higher than the rate observed at the end of 2019, the vacancy rate has returned to the level observed in Q3 2018.

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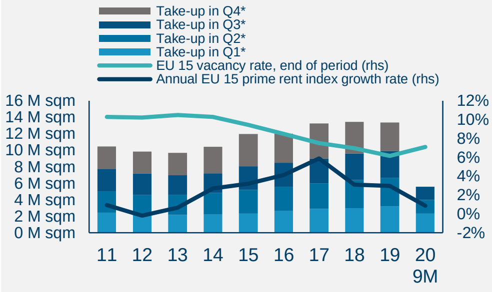
The vacancy rate in Q3 2020 is very close to that observed just before the reversal in leasing markets during the 2008 financial crisis.

Beyond the disparities between cities, which remain marked, vacancies still appear to be limited in central business districts, particularly for modern surfaces. For example, the vacancy rate is less than 3% in the central business district of Paris, a low level. These elements are at this stage noticeable, even if we need to remain attentive to demand and future deliveries.

Prime headline rents have been broadly stable over 3 months in Q3 2020. The relatively low number of transactions does not facilitate visibility on rents. Some upward pressure from commercial benefits granted to tenants has been observed, for example in the Greater Paris region and Milan.

European office market



*Take-up in 28 European markets
Source: Amundi Immobilier on CBRE Research (Q3 2020)

Investment market

After several particularly active years and a record Q1 2020, the European investment market slowed significantly in the following two quarters.

Over 9 months, commercial property investment volumes were down year-on-year and generally close to the ten-year average at the European level, helped in particular by a record first quarter. The investment market is thus showing some resilience in the current context. Germany, Europe's leading market in terms of volumes invested, has held up well and volumes invested in France are down by around 20%.

In connection with Covid, investor interest in residential and logistics seems to have increased. Over 9 months, offices remain the main asset class. Retail, which is still the subject of some investor caution, accounted for around 20% of volumes invested. Covid has also led to a decrease in the share of foreign investors due to reduced travel.

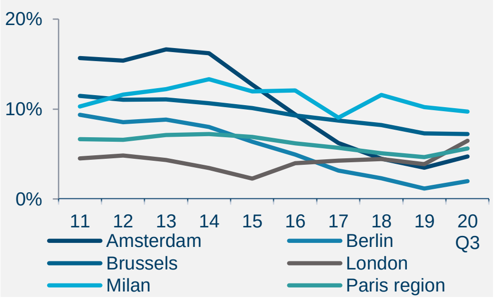
Q3 2020 confirmed the trends observed in Q2 in reaction to Covid-19 and its economic consequences, with many investors maintaining a high degree of selectivity, and yield divergences between asset classes and between assets.

Since the start of the pandemic, hotels and non-food retail appear at this stage to be the asset classes most vulnerable to Covid-19 and are the ones whose prime yields have increased the most, particularly in light of increased uncertainty about short-term financial flows.

Investors have generally shown some confidence in office and logistics prime assets, with their prime yields broadly stable over 3 months in Q3 2020, with even slight yield drops observed in several markets including Germany. Investors remain very attentive to the quality of the assets under review and in particular to the security of cash flows, with an appetite for long leases and tenants deemed to be financially strong.

Assets considered to be less secure in terms of rental income or location are subject to sometimes significant price reductions, particularly as financing is more restrictive on these assets, even if buyers continue to position themselves. Despite uncertainties in the leasing market, demand remains fuelled in particular by negative 10-year government bond interest rates in several European countries.

Office vacancy rates*



*at period end
Source: Amundi Immobilier on CBRE Research (Q3 2020)

Key takeaways

- On average, office take-up remained very slow in Q3 2020 in Europe's main markets.
- Vacancy rates for office space have increased, but remain relatively contained, particularly in central business districts
- Prime headline rents were stable overall in Q3 2020 over 3 months
- After several particularly active years and a record Q1 2020, the European investment market slowed significantly in the following two quarters
- Over 9 months, commercial property investment volumes were down year-on-year and generally close to the ten-year average in Europe
- Hotels and non-food retail appear at this stage as the most vulnerable asset classes to Covid-19

Outlook for Q4 2020 – 2021

In the central economic scenario - potential but not certain - the economic recovery is expected to take several years to return to the GDP level of 2019, at different speeds in different countries. In 2021, a technical upturn is expected due to the base effect in Q2 (sharp drop in GDP in Q2 2020 due to Covid-19). The outlook for 2021 will be linked to the date of vaccine availability and the implementation of vaccination campaigns, and phases of economic crisis, outbreaks, localised lockdowns and stimulus measures could occur. "Unconventional" monetary policies should be maintained and 10-year interest rates should remain low with, for example, the forecast at the end of October 2020 of the German 10-year interest rate one year later situated between -0.5% and -0.3%.

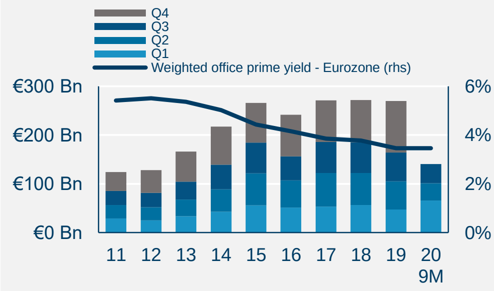
Property markets are not immune to this environment and we maintain our scenario of lower volumes let in 2020 in Europe, both in the leasing and investment markets. However, we believe that the second wave of the epidemic is likely to affect activity in Q4 2020, particularly in the leasing markets, whereas a certain recovery was expected after HY1. On the other hand, changes in uncertainty, confidence and the economic and health context will be key factors that could impact the upturn in activity in 2021.

In the office market, the wait-and-see attitude of companies, which was confirmed in Q3 2020, should continue as long as uncertainty remains high. The deterioration of the labour market should also affect demand for commercial office space: after a drop in 2020 (mitigated by public policies), employment in Europe should increase in 2021 depending on the environment but should not return to its 2019 level in the short term. In this context, extensions, renegotiations or sub-leasing could be a solution appreciated by companies, some of which looking for flexibility. In terms of market rents, we expect greater incentive measures in the coming months, particularly in oversupplied sectors. These sectors appear to us to be more exposed to reductions in headline rents in the coming quarters. The relatively moderate average vacancy rate is a comforting factor in the short term, particularly in central business districts, which may therefore see their rents less impacted than other sectors. Nevertheless, we should remain attentive to changes in demand and the rate of business effort in a degraded environment. One of the issues to be monitored will be the behaviour of companies with regard to controlling real estate costs.

The hotel and non-food retail markets should continue to be highly dependent on the economic and health situation, with a potentially long convalescence for the segments dependent on travel and air traffic in particular. Logistics should continue to be driven by e-commerce. It should nevertheless continue to be affected, particularly the side related to industry and physical retail.

Regarding the investment market in Europe, we expect investors to continue to be cautious with regard to the assets deemed most vulnerable and the less secure assets, as long as uncertainty remains high about economic and pandemic developments. Despite historically low prime rental yields, investor interest in property is expected to remain strong in an environment of low financial rates and a spread between rental yields and 10-year rates that is higher than the historical average in many property markets. Long-term buyers should continue to favour visibility of cash flows, favouring long leases with tenants deemed financially strong, which should keep yields at low levels for prime assets in the coming quarters. Re-segmentation with yields of less secure assets is expected to continue in the coming months until there is greater visibility in the leasing markets.

Real estate investment* in Europe



*commercial real estate
Source: Amundi Immobilier on CBRE Research data (Q3 2020)

Estimate of office prime yield at Q3 2020*		
		q-o-q change
Amsterdam	3,00%	→
Berlin	2,65%	↓
Dublin	4,00%	→
Düsseldorf	3,00%	→
Frankfurt	2,80%	→
Hamburg	2,75%	↓
London (West End)	3,75%	→
Madrid	3,25%	→
Milan	3,20%	↓
Munich	2,60%	→
Paris region	2,75%	→
Prague	4,25%	→
Vienna	3,30%	→
Warsaw	4,50%	→

Source : Amundi Immobilier (Q3 2020), brokers
*indicative data, for prime assets let at market rent (Q3 2020)

Key takeaways

- Investors have generally showed some confidence in prime office and logistics assets, with prime yields broadly stable over 3 months in Q3 2020
- In the office leasing market, the wait-and-see attitude of companies, which was confirmed in Q3 2020, should continue as long as uncertainty remains high
- The investment market is expected to remain highly segmented and the value of prime office and logistics assets is expected to show some resilience in the coming months
- Covid-19 should play a role as a trend accelerator

On the value side, prime office and logistics assets have shown some resilience at this stage and this may continue over the coming months, with the value of less secure or more vulnerable assets being more affected and creating opportunities. We should remain attentive to the change in financing conditions and the way investors integrate the change in leasing markets into their asset prices.

More generally we believe that Covid-19 should play a role in accelerating trends, affecting the various property asset classes, with for example a more widespread use of e-commerce or remote working. We consider that the latter could continue to develop in the coming years, and that offices should remain essential for companies in terms of collaboration, cohesion and team spirit, but also in terms of circulating information, which could lead offices to evolve towards more collaborative spaces[1].

Lexicon

Take-up

Spaces leased or acquired for own use. This does not include lease renewals.

EU-15

Germany, Belgium, France, Italy, Luxembourg, the Netherlands, Denmark, Ireland, United Kingdom, Greece, Spain, Portugal, Austria, Finland and Sweden.

Prime rent

Rent of the most sought-after assets relative to available supply. This is the highest rent for a given asset class and geographical area.

Office vacancy rate

Proportion of unoccupied office space immediately available relative to all existing office space.

Prime yield

Yield provided by leasing under the market conditions of the assets - sometimes few in number - most sought-after by investors relative to available supply. This was the lowest yield for a given asset class and geographic area.

[1]For more details, see in particular the document published by Amundi Immobilier: "Remote working: a trend accelerated by Covid-19 and the complex consequences for offices" (September 2020)

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SOURCES

Amundi Immobilier, Amundi Recherche, ECB, brokers, Insee … (Q3 2020, October 2020)

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