European real estate markets 2020 faced with the crisis

The outbreak of Covid-19 quickly translated into a severe shock for the global economy and real estate markets. Near-term indicators of performance have turned sharply downward, and the situation is fast-moving. Notwithstanding those uncertainties, three trends in particular support a more optimistic outlook

European property values are under pressure because of the upcoming severe recession, and there is no doubt that Covid-19 will weigh on the outlook for the rest of this year and beyond. Despite restrictions on activity, the transactions market has held up relatively well compared to the sharp decline seen at the beginning of the global financial crisis in 2008 and 2009, although deal volume in 2020 is set to be down significantly compared to the total recorded last year.

An important factor in assessing how quickly the markets will recover is the level of capital raising in the run-up to the crisis – together with the question of how much contractually committed capital is still available. The volume of capital raised will decline significantly in the middle of this year – not least because of low or negative returns and physical constraints on due diligence reviews. Nevertheless, the positive start to the year indicates that the level of capital raised this year as a whole is likely to remain high, and a return to more-normal levels can be expected in the fourth quarter.

The returns environment is likely to remain subdued in the next cycle – not least because interest rates cannot continue to decrease to support capital growth. Despite the uncertainties outlined here, three trends in particular offer reasons for optimism.

1. Early recovery for office markets with low vacancy

Office is one of the most-cyclical real estate sectors, with headline value swings driven by factors that can vary through the cycle. The factors include, for example, large property sizes that require substantial available financing, delays in the provision of new supply and the structuring of large corporate leases that affect demand for labour.

The encouraging sign for office markets is that most locations are starting with very low vacancy rates, although the nature of the downturn means that demand could pull back sharply in the near term, pushing availability upward. Some persistence to vacancy is possible depending on whether the crisis leads occupiers to realise they can reduce their space footprints without detrimental impacts on output. As in prior cycles, markets that can keep vacancy low are set to have the earliest and most-pronounced recoveries. There is a great deal of uncertainty around future demand, but such markets as Berlin, Munich, Paris and Vienna all started the crisis with very low vacancy and look set to be among the earliest to recover. Liquid central business districts and markets that can keep vacancy rates low throughout the crisis represent potentially rewarding investment opportunities during an office market recovery.

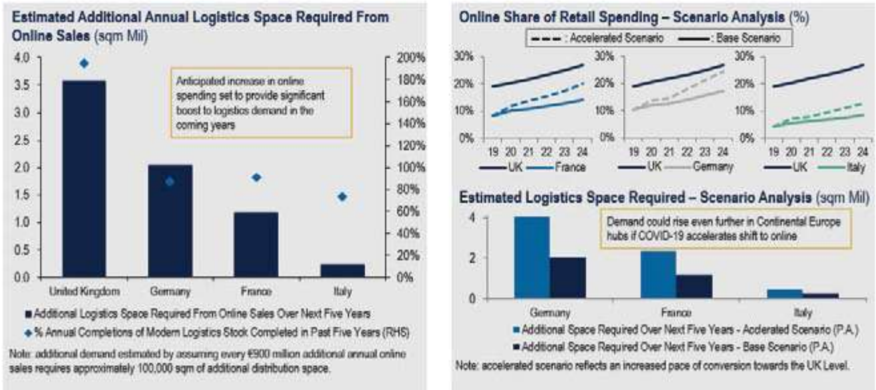
2. Structural trends that favour the logistics and residential sectors

Rising online spending and a growing need for provision of modern residential stock in major cities are set to provide ongoing opportunities for investors. Through the cycle, a further move toward online retail is set to benefit the logistics sector. An increase in online retail activity requires a greater amount of logistics and warehousing space to deliver goods in a timely manner.

Based on an analysis of existing space usage among major international online retailers, additional annual online sales of €900 million will require about 100,000 square metres of logistics space. The following graph shows how that figure translates into potential additional space requirements in the next five years across a number of major European markets.

Based on the analysis, significant additional space is set to be required in major distribution corridors in the United Kingdom, where the share of online sales is above the shares of many countries in Continental Europe. The volume of new space required is elevated compared with the recent pace of completions.

Significant requirements are also set to be forthcoming in other European markets, and they could be further boosted if Covid-19 affects consumer behaviour – not least in the near term because physical shopping is set to remain restricted for some time – and accelerates an already ongoing shift toward a rising share of online retail.



Sources: PMA, Oxford Economics, PGIM Real Estate. As of May 2020. **Figures and information provided are estimates subject to change.**

Logistics demand in the major markets of France, Germany and Italy would grow twice as quickly under an accelerated scenario in which they approach UK levels of online penetration more rapidly.

A potential opportunity for investors relates to housing provision in dense urban areas. Many major European cities have grown rapidly in recent decades, and inevitably, some of the housing stock has been left behind. Combined, London and Paris have about 650,000 households living in overcrowded conditions.

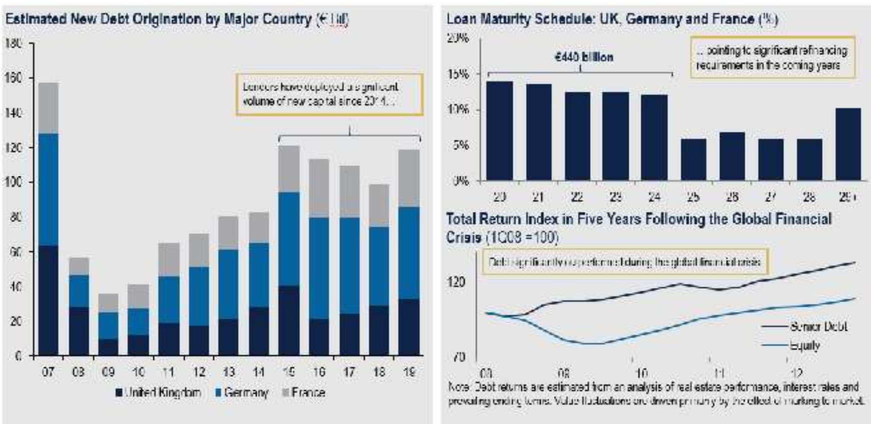
3. A continuously increasing lending volume since 2014

The volume of lending to real estate in Europe's major markets has become elevated in the past few years. In total, a combined €565 billion of new debt has originated in France, Germany and the United Kingdom since 2014, primarily reflecting elevated transactions activity rather than the use of leverage, which has been constrained during the past cycle.

Non-traditional senior lenders might be able to make use of the refinancing of existing loans, whereas for alternative debt, one of options could be to capitalise on market distortions. The latest Cass Business School *UK Commercial Real Estate Lending Report* (April 2020) shows that new business typically accounts for about half of all lending activity when the refinancing of existing loans is considered.

During a downturn, funding gaps can arise as a result of mismatches between lenders' capacities for new business and borrowers' requirements to deal with maturing loans — a situation exacerbated by falling equity transaction liquidity that makes a sale-driven exit difficult. In total, €440 billion of loans is due to mature during the next five years in the United Kingdom, Germany and France combined.

Senior debt tends to outperform in a downturn. Given the risk premium required, we believe there is a strong case for investors to increase exposure to debt in their real estate allocations – at least until uncertainty materially reduces.



Sources: Cass Business School, International Real Estate Business School, Cushman & Wakefield, European Association for Investors in Non-Listed Real Estate Vehicles, PGIM Real Estate. As of May 2020. **Figures and information provided are estimates subject to change.**

Written by PGIM Real Estate head of European investment research, Greg Kane

In association with PGIM REAL ESTATE