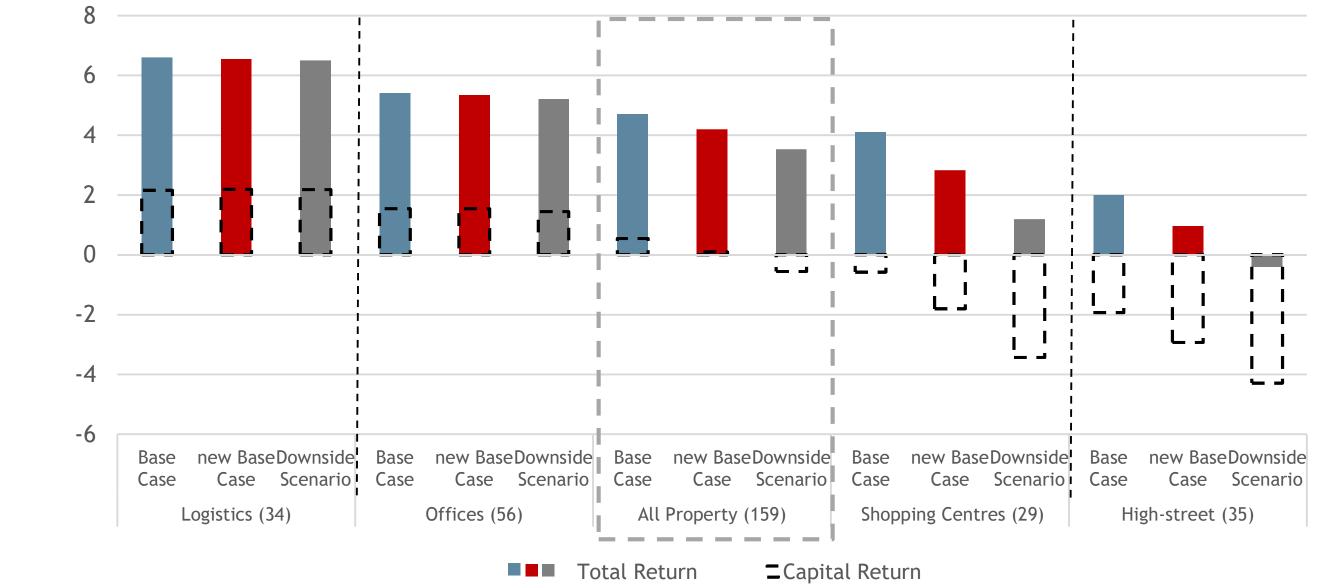
European Research Flash Report

08 April 2020

COVID-19 SPECIAL UPDATE: LOGISTICS & OFFICES RESILIENT

- As economists adjusted their economic growth forecasts down, it seems inevitable that most leading European economies will enter recession in 2020. To place the current uncertain situation in a relative context, we present three different scenarios:
  - ✓ Base case scenario which is based on the Jan-20 economic assumptions before Covid-19;
  - ✓ New base case which applies the Mar-20 consensus forecast of a V-shape recovery;
  - ✓ Downside scenario at -8% Eurozone 2020 GDP growth, +5% in 2021 and a convergence towards the long term average after 2021.
- As Covid-19 forced stock markets down and pushed out both corporate and government bond yields, central banks announced significant interest rate cuts and bond purchasing programmes, which have stabilised financial markets to some degree. To reflect these policies and their increased long term necessity, we use swap-implied government bond yields in the downside scenario.
- Significant declines in prime rental growth rates for all sectors are expected, which move down from 1.6% p.a. in our January base case to only 0.5% p.a. in the new base case and -0.8% p.a. in the downside scenario based on our simplified approach. Prime retail rent growth gets hit significantly more than office and logistics as it has proven to be more than double as sensitive to past GDP growth changes.
- Our prime property yields in the downside scenario are based on swap-implied 10-year government bond yields. Given the current high excess yield and historical delay in which prime property yields adjust to bond yield changes this means that in the downside scenario property yields are, on average, holding steady. In fact, office and logistics yields are projected to remain more robust.
- Our new base case and downside scenarios show all property total returns of 4.2% and 3.5% p.a. respectively. Prime retail is more impacted due to the low yields and larger market rental declines. In contrast, total returns for prime logistics (6.5%) and offices (5.2%) stay much more resilient in the downside scenario as lower rental growth is offset by yield tightening.

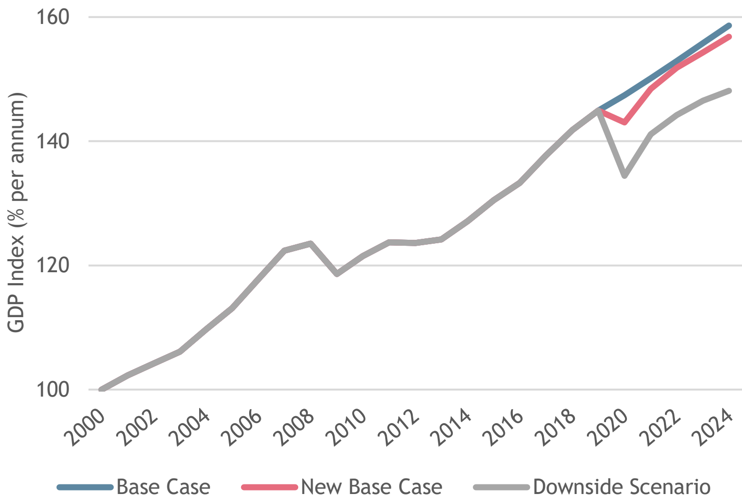
ALL PROPERTY RETURNS SHOW RESILIENCE IN NEW BASE CASE & DOWNSIDE SCENARIOS OVER 5 YEARS



Sources: CBRE, Natixis, Bloomberg & AEW

COVID-19 LOCKDOWNS & ECONOMIC SLOWDOWN DRIVE NEW GDP GROWTH SCENARIOS

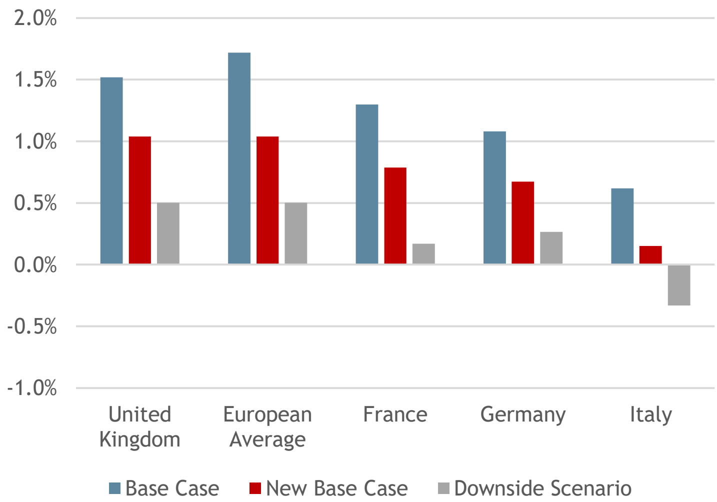
- Given the fluid and volatile economic outlook, we highlight the current uncertainty with 3 scenarios:
- Base case scenario which is based on the Jan-20 economic assumptions before Covid-19:
  - New base case which applies the Mar-20 consensus forecast of a V-shape recovery;
  - Downside scenario at -8% for 2020 Eurozone GDP growth, +5% in 2021 and convergence towards long term averages beyond 2021.
- Our downside scenario is based on our review of relevant sell side research and consultant reports over the last 2-3 weeks and represents our interpretation of a reasonable course of events based on the situation as of 08-Apr-20.
- The cumulative difference in GDP growth over the 2020-24 period between the new base case and the downside scenario is 4.5%. This is the equivalent of less than 0.5% GDP growth p.a.



Sources: CBRE, Natixis, Bloomberg & AEW

NEW BASE CASE AT 1% P.A, WHILE DOWNSIDE RECOVERS TO 0.5% P.A. GDP GROWTH OVER NEXT 5 YEARS

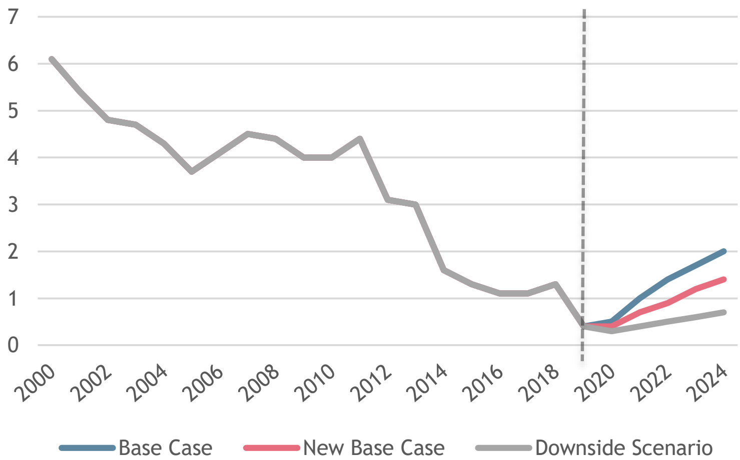
- European GDP growth is estimated at 1% p.a. for the next five years in our new base case scenario, down from 1.7% p.a. in our old base case. The downside scenario is half of this new base case, based on most recent external research.
- With already weak growth forecast in the old base case, Italian GDP growth gets hit particularly hard in the new base case and downside. Please note that this does not directly link with the number of covid-19 cases and casualties.
- Germany and France both show GDP growth below the European average in the new base case and downside, consistent with the old base case.
- UK GDP growth comes in at the European average for the new base case and downside scenarios, which is due to its flexible labour market. However, this assumes that Brexit arrangements can be negotiated and set in place before year-end.



Sources: CBRE, Natixis, Bloomberg & AEW

COVID-RELATED MONETARY POLICIES TO KEEP BOND YIELDS LOWER-FOR-MUCH-LONGER, IF NOT FOR EVER

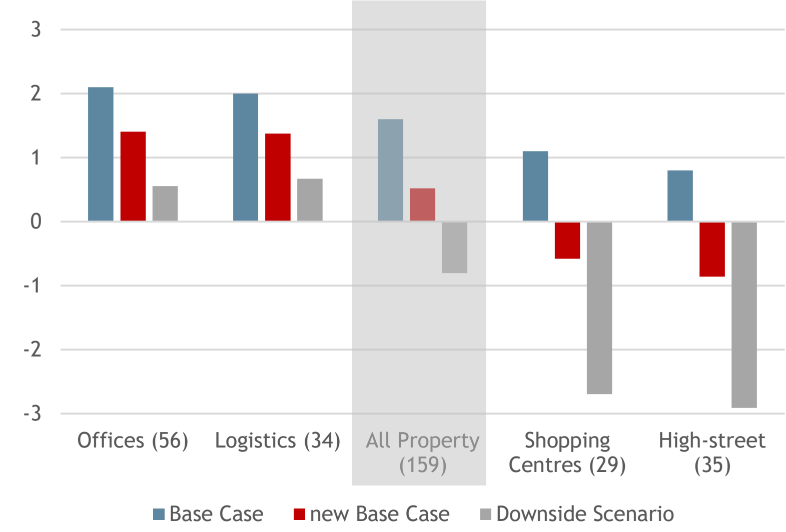
- As the Covid-19 related economic outlook forced stock markets down and pushed out corporate and government bond yields, central banks announced significant interest rate cuts and bond purchasing programmes, which has stabilised financial markets.
- To reflect this, we use swap-implied government bond yields in the downside scenario.
- In fact, many commentators are starting to ask whether government bond yields might need to be held lower-for-ever, given the longer term repercussions from the increased Covid-19 related government funding needs.
- The virus is also forcing already highly indebted corporations and consumers into more debt. They will also find it difficult to deal with increased borrowing costs, leaving central banks little room to normalise yields.



Sources: CBRE, Natixis, Bloomberg & AEW

LOWER GDP GROWTH HITS RENTAL GROWTH EXPECTATIONS, ESPECIALLY IN RETAIL

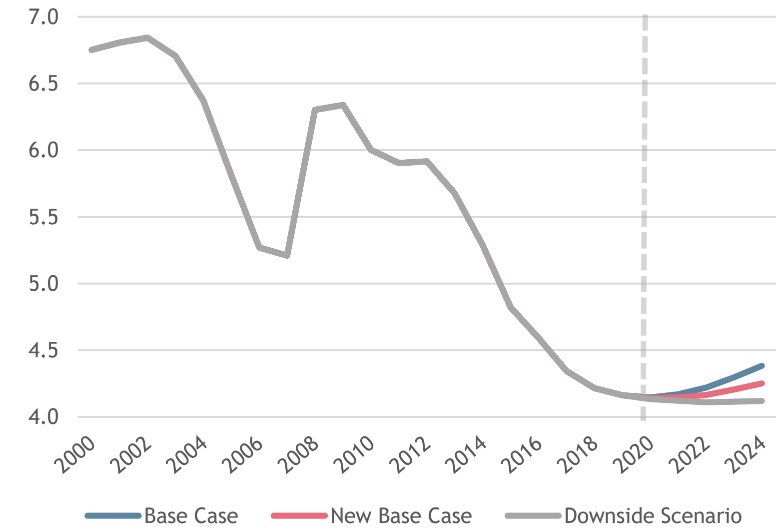
- We estimate downside scenario prime market rental growth rates across our 159 European segment market universe, based on the change in national GDP growth and the average historical regression coefficient between GDP and prime rent growth for each property type on a European level back to 1986.
- Based on this simplified approach, we estimate significant declines in rental growth rates for all sectors from 1.6% p.a. in our old base case to only 0.5% p.a. in the new base case and -0.8% p.a. for the downside scenario.
- Retail gets hit more than offices and logistics as it has proven to be more than twice as sensitive to past GDP growth changes as the other sectors.
- This higher GDP sensitivity for retail has been amplified by the lockdown and the impact of continued e-commerce penetration as reflected by the already lower rental growth in our old base case.



Sources: CBRE, Natixis, Bloomberg & AEW

LOWER-FOR-LONGER BOND YIELDS SUPPORT INITIAL YIELDS IN DOWNSIDE, KEEPING CAPITAL VALUES STABLE

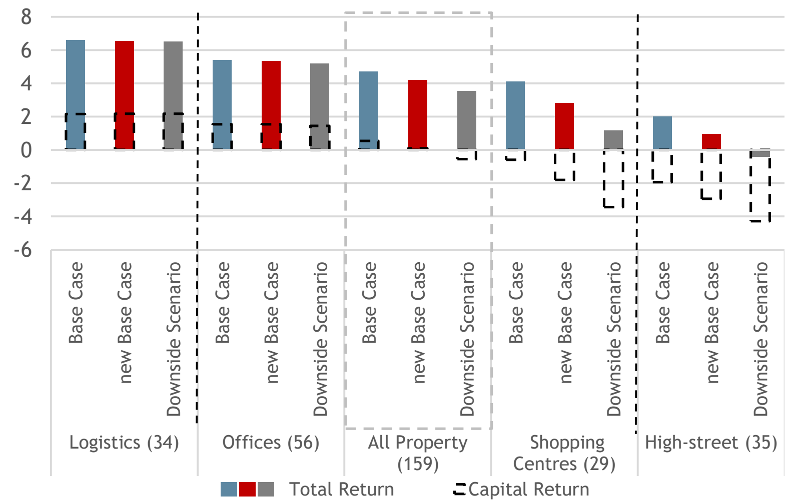
- Similar to previous lower-for-longer scenarios, we have modelled our prime property yields based on swap-implied 10-year government bond yields.
- Data on corporate bonds are not widely available for each country in Europe and can therefore not directly be linked to property yields as easily as government bond yields.
- Given the current high excess yield and historical delay in which prime property yields adjust to bond yield changes this means that in the downside scenario property yields are holding steady. However, yields in offices and logistics are projected to be more robust than retail yields during the forecast period.
- The new base case is based on the difference between government bond yields in the old base case and those in the downside scenario.



Sources: CBRE, Natixis, Bloomberg & AEW

ALL PROPERTY RETURNS PROVING TO BE RESILIENT IN DOWNSIDE SCENARIO OVER NEXT 5 YEARS

- Our new base case scenario shows 4.2% p.a. total returns across all 159 prime property segments. This is 50bp lower than our old base case and 70bps better than the 3.5% p.a. in our downside scenario.
- However, high street and shopping centres are impacted much more as they are lower yielding and suffer from bigger market rental declines.
- Despite a significant negative impact on capital values over the 5-year forecast period, we do still estimate total returns between -0.3% and +1.0% for retail sectors.
- In contrast, total returns for prime logistics and office markets stay much more resilient as lower rental growth is offset by yield tightening keeping capital value growth constant across the different scenarios.



Sources: CBRE, Natixis, Bloomberg & AEW

ABOUT AEW

AEW is one of the world's largest real estate asset managers, with €69.5bn of assets under management as at 31 December 2019. AEW has over 700 employees, with its main offices located in Boston, London, Paris and Hong Kong and offers a wide range of real estate investment products including comingled funds, separate accounts and securities mandates across the full spectrum of investment strategies. AEW represents the real estate asset management platform of Natixis Investment Managers, one of the largest asset managers in the world.

As at 31 December 2019, AEW managed €33.0bn of real estate assets in Europe on behalf of a number of funds and separate accounts. AEW has over 400 employees based in 9 offices across Europe and has a long track record of successfully implementing core, value-add and opportunistic investment strategies on behalf of its clients. In the last five years, AEW has invested and divested a total volume of over €20bn of real estate across European markets.

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