AEW Research Flash Report

EUROPE | 25 JUNE 2020

SOME MARKETS WILL PROVE MORE IMMUNE TO COVID-19 THAN OTHERS

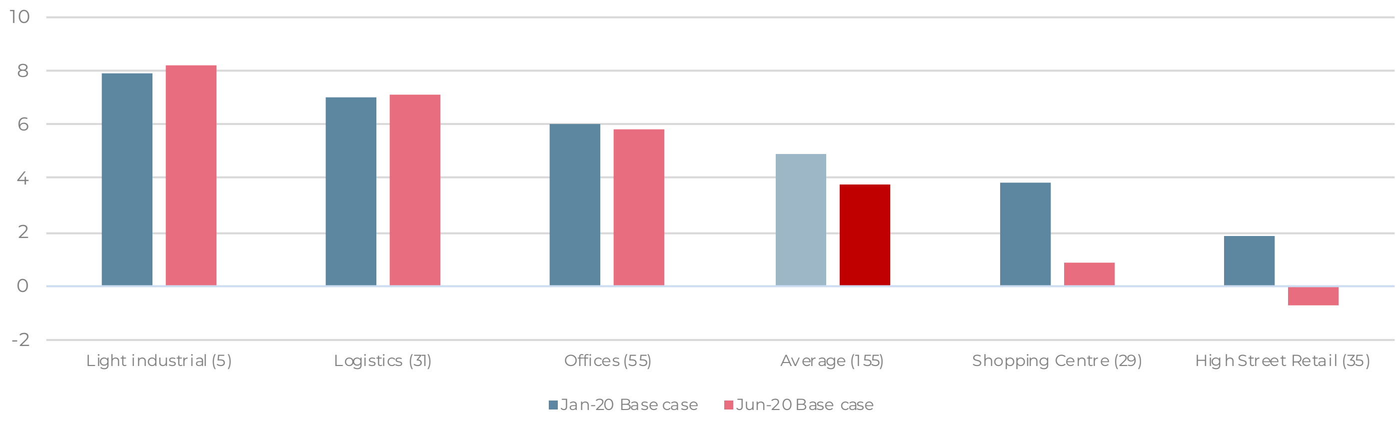
- In this fifth update since the onset of the Covid-19 pandemic, we define a new base case scenario by being more precise about our cash shortfall and yield widening assumptions for individual markets and quantify both short and long-term return implications across more individual markets.

- Our Jun-20 base case scenario replaces our previous scenarios and has the following key assumptions:
  - Cash rent shortfall are adjusted on a country and sector level based on Covid-19 resilience;
  - Short term yield impact for individual markets are based on year-to-date investment market liquidity and yield convexity;
  - We update our total return calculation to reflect that changes in markets rents only affect future rental income for each market when existing leases roll over. We assume a WALT of 5 years, so 20% of in-place leases roll to the new market rent each year.

- The results from our latest Jun-20 base case are in line with our previous Covid-19 flash reports, as follows:
  - Average all-sector income growth turns negative for the next five years at -0.7% p.a., down by 2.5% from our Jan-20 base. This is mostly driven by the cash rent shortfall and market rent declines in retail showing income growth at -3.2% p.a. while offices and logistics post +1.0% p.a. rental growth;
  - Despite our assumed 2020-21 widening, yields are forecast to remain flat over the next 5-years, down from the 20bps widening in our Jan-20 base case. Sector specific yield moves differ much, with retail showing 20bps widening to 2024, while logistics and offices tighten by 30bps and 15bps, from current levels.

- In the long term, lower-for-longer yields offset both Covid-19 related short-term cash shortfall and yield widening as well as market rent declines in light industrial, logistics and offices. Total returns for these sectors over the next five years are anticipated to remain stable at 6-8% p.a. in line with our pre-Covid-Jan-20 base case. However, retail returns are expected to be hit significantly as returns are projected between -1% to +1% p.a. over the same period.

PRIME TOTAL RETURNS BY SECTOR (%, P.A. FOR 2020-24)



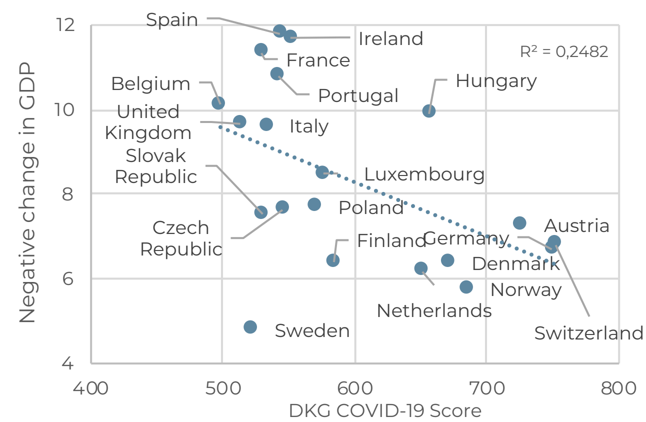
Sources: Oxford Economics, RCA, CBRE & AEW Research

METHODOLOGY ON RENT COLLECTION ASSUMPTIONS

COVID-19 RESILIENCE LINKED TO GDP GROWTH AND USED AS NATIONAL PROXY FOR INCOME SHORTFALL

- To reflect the uneven national impact of Covid-19 across Europe and refine our original assumption of the possible income shortfalls for landlords in our fourth flash report, we consider additional country level data.
- New (big) data on national resilience to Covid-19 from DKG shows a significant correlation to the predicted change in GDP growth between 2019 and 2020. Based on that demonstrated correlation, we estimate national income shortfall proxies based on this change in GDP growth forecasts.
- It is reasonable to expect Covid-19 resilient countries to have a less steep decline in economic activity and therefore a substantially higher probability to have less impact on the income shortfall, ceteris paribus.
- In fact, our graph shows a significant correlation between the change in economic activity and Covid-19 regional safety score of around 50%. Countries such as Germany, Switzerland and Austria are expected to see a less steep decline in economic activity as Covid-19 measures have been in general more sufficient than in other countries.

Change in Economic activity (2019-2020 %) and Covid-19 national resilience (score)

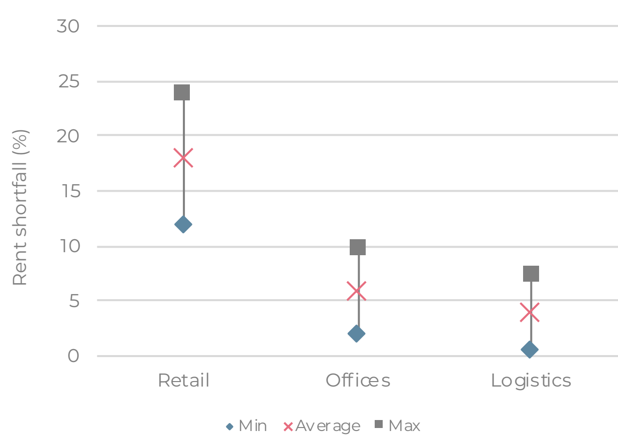


Sources: DKG, Oxford Economics & AEW Research

WIDEST NATIONAL RANGE OF COVID-19 RELATED RENT CONCESSIONS EXPECTED IN RETAIL

- As highlighted in our previous Covid-19 flash report, we estimate cash shortfalls (the percentage of income that will remain unpaid in 2020) by sector (Retail: 18%, Offices: 6% and Logistics: 4%) on an European level based on discussion with brokers, fund managers and desk-based research based on second quarter rent collection. Our estimates in May 2020 were 18% for Retail, 6% for Offices and 4% for Logistics.
- To further precise our income shortfall expectations, we apply the aforementioned proxy based on economic activity changes to estimate country-sector specific income shortfalls for 2020.
- As shown in our chart, retail (a combination of high-street and shopping centre markets) is expected to have the highest income shortfall at an average of 18% with a range of 12% to 24%. In contrast, offices and logistics income shortfalls are much lower and range between 2% and 10% for offices and between 0.5% and 7.5% for logistics.
- As before, as the Covid-19 lockdowns get lifted the impact of these estimated income shortfalls in the last six months of 2020 are expected to decrease and none are assumed for 2021.

Assumed range of national shortfall of rental income by sector (as % of income)

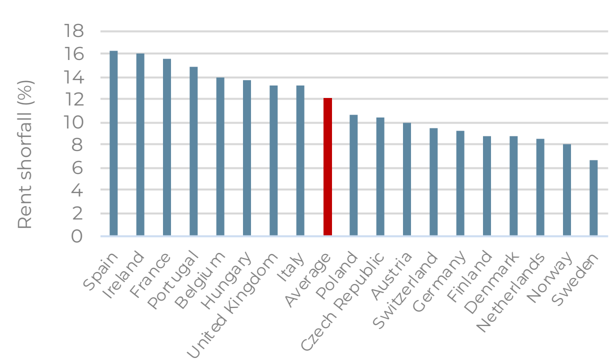


Sources: Oxford Economics & AEW Research

NOTHERN EUROPEAN COUNTRIES ANTICIPATED TO SUFFER LOWEST INCOME SHORTFALLS

- Average all sector income shortfalls between countries provide a relevant comparison, as national economies have been unevenly affected and are in different stages in terms of easing lockdown measures.
- As highlighted by the graph, we expect the highest income shortfall to be in Spain while, in contrast, Sweden is expected to have the lowest income shortfall. The latter is due to the relatively low impact on the expected economic activity, as Sweden did not impose a lockdown.
- Other European countries such as France, Italy and the United Kingdom have an above average expected income shortfall as economic activity dropped significantly during the lockdown.
- Finally, countries such as the Nordics, Germany and the Netherlands see relatively low cash shortfalls as their economies have proven more resilient over the first six months of the year.

Income shortfall as % of 2020 income (average all sectors)



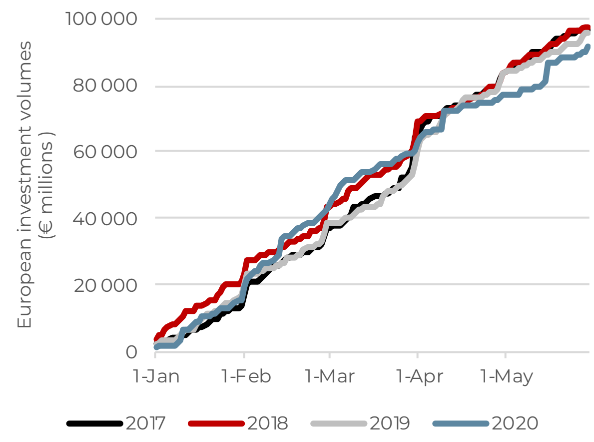
Sources: Oxford Economics & AEW Research

METHODOLOGY ON SHORT-TERM YIELD SHIFT ASSUMPTIONS

REFINING OUR YIELD WIDENING ASSUMPTION BASED ON YEAR-TO-DATE LIQUIDITY

- To further refine our original post-Covid-19 property yield assumptions, we built further on our previously introduced risk-premia framework by considering individual market investment volumes for 2020 year-to-date.
- In the graph, we show the European investment volumes up until the end of May for the current year versus the previous years (until the end of May). Interestingly, we observe that the 2020 volumes are only trailing 5% behind the previous years as the Covid-19 impact became only apparent in April.
- The starting point for our yield shift approach is country level investment volumes which we adjust by sector. In the next step, we also adjust the yield shift to take into account the different yield levels across property markets as a small shift in a low yielding assets impacts the valuation much more than a small shift in a high yielding asset (this is known as yield-convexity).
- By doing so, we assume that real estate markets where investment volumes are holding up have a tighter bid-ask spread and are more supportive of current yield levels compared to markets where volumes have declined.

Investment volumes until end of May by Year (€ millions)

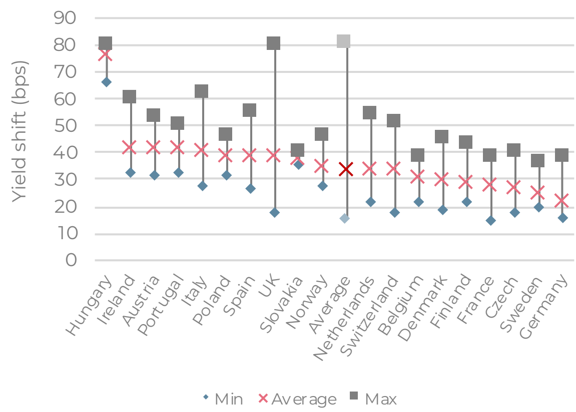


Sources: RCA & AEW Research

GERMANY AND FRANCE ANTICIPATED TO HAVE LIMITED 2020-21 YIELD DECOMPRESSION

- The impact of Covid-19 on property yields is clearly unevenly distributed across Europe as investors remain active in core investment markets and refrain from investing in more peripheral markets where the share of domestic investors is lower than in core markets. Therefore, countries such as Germany and France are expected to be among the markets with the lowest expected yield widening.
- Indeed, the lowest average yield decompression is expected in Germany which is largely driven by robust investor appetite and relatively strong Covid-19 policy response. However, within Germany yield widening expectations are uneven and range from approximately 15bps to 40bps.
- In contrast, the United Kingdom is expected to experience an above-average yield widening over the next two years amid some high-yielding regional markets, a particularly badly-hit retail sector and the on-going Brexit uncertainty.

Expected yield widening by country (bps, until end 2021)

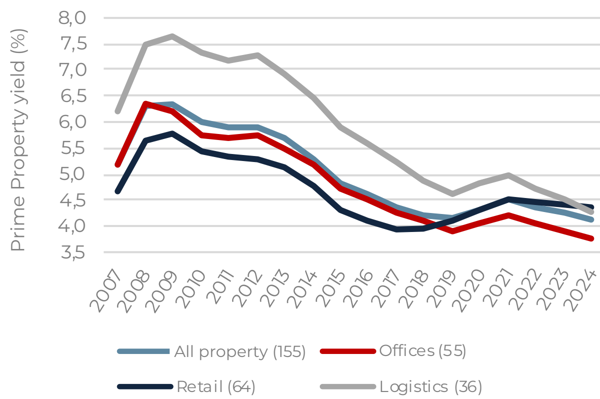


Sources: RCA & AEW Research

RETAIL ONLY SECTOR TO NOT BENEFIT FROM LOWER-FOR-LONGER BOND YIELDS

- Retail yields are expected to decompress by 40bps by the end of 2021. This is more than expected for offices and logistics which are expected to decompress by 30bps and 33bps, respectively.
- Despite this short-term yield movements, prime property yields are expected to remain close to historic lows particularly in the offices and logistics sectors in 2020 and 2021.
- Retail includes broadest range of yield widening, driven by some of the very low yielding prime high street retail markets, such as Paris and London. Of course, yield convexity implies that a small shift in a low–yielding market implies a relative large decline in value.
- In the long term, we retain our lower-for-longer yield assumptions based on government bond and swap-implied pricing. This means that both prime offices and logisitcs yields are expected to compress again after 2021 and reach all-time lows in 2024. While in retail, there is some yield tightening from 2022 onwards. However, it will not be sufficient to completely offset the anticipated 2020-21 widening.

Expected yield widening by sector (%)



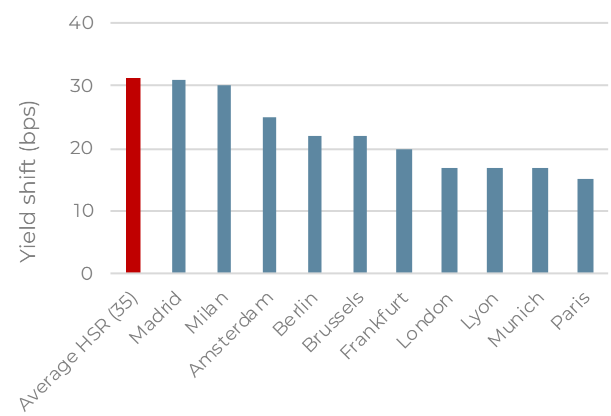
Sources: RCA & AEW Research

JUN-20 BASE CASE RESULTS FOR HIGH STREET RETAIL

PARIS HIGH STREET RETAIL EXPECTED TO HAVE LOWEST 2020-21 YIELD WIDENING

- As expected, Paris and other core high street retail markets have retained their investment liquidity year-to-date and are therefore projected to have below average yield widening over the next two years.
- On the other hand, high yielding regional UK and CEE markets have seen a significant reduction in transaction volumes. In the UK, this is mostly explained by the pre-existing difficulties of the retail sector (CVAs leading to cashflow uncertainty, rising ecommerce penetration, business rates increase etc.). As a consequence, we anticipate significantly more yield widening in our new Jun-20 base case scenario.
- These adjustments are reflective of our quantitative approach, but are also consistent with feedback from investors in the market. During periods of increased uncertainty, investors have traditionally preferred more liquid markets.

Projected 2020-21 yield widening for selected prime high street retail markets

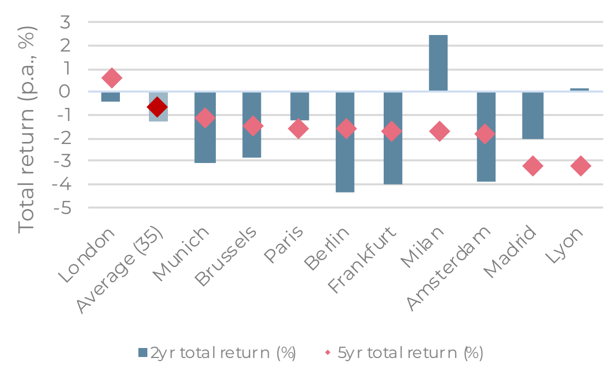


Sources: RCA, CBRE & AEW Research

NEAR-ZERO HIGH STREET RETAIL RETURNS PROJECTED FOR THE NEXT FIVE YEARS

- In the long term, high street retail returns are expected to struggle with the well documented challenge of e-commerce on traditional retail formats. Our forecasts across the 35 markets shows a -0.7% p.a. return, with Edinburgh and other UK regional markets showing above average returns, reflecting higher entry yields.
- On the other hand, Dublin, regional French and Spanish markets are expected to underperform due to weaker rental growth prospects and limited yield tightening over the full five year period.
- Based on this, investors' short term preference for more liquid markets during more troubled times does not seem directly tied with total returns in the long term. However, pro-active diversification should protect against this potential bias.

2020-24 forecasts of total returns (% p.a.) for selected prime high street retail markets

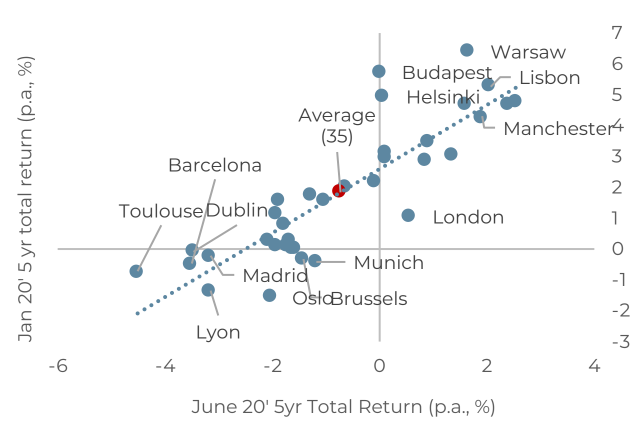


Sources: Oxford Economics, RCA, CBRE & AEW Research

COVID-19 FORCES HIGH-STREET RETAIL RETURNS DOWN TO NEGATIVE TERRITORY

- The impact of Covid-19 is highlighted by a comparison of our projected high street retail returns for our latest Jun-20 base case relative to our original pre-Covid Jan-20 base case in the adjacent scatter plot.
- Our 35 markets average prime return for high street retail over the period shifted down significantly from +1.8% into negative territory at -0.7% p.a. The diagonal best fitted line shows a consistent worsening across markets.
- No clear trend can (yet) be seen in the country or market type from this, perhaps confirming the need for pro-active asset management and portfolio diversification to protect against downside risk.

2020-24 prime total returns (% p.a.) for Jan-20 and Jun-20 base cases



Sources: Oxford Economics, RCA, CBRE & AEW Research

JUN-20 BASE CASE RESULTS FOR LOGISTICS AND LIGHT INDUSTRIAL

MOST 2020-21 YIELD WIDENING EXPECTED FOR CEE AND SOUTHERN EUROPEAN MARKETS

- Yield widening across the logistic & light industrial market is mostly limited outside of CEE and southern European markets as these markets face higher illiquidity in the short-term as investors remain cautious putting pressure on pricing.
- On the other hand, low yielding core markets (Germany and France) experienced limited declines in transaction volumes year-to-date, partly due to strong market fundamentals and investor appetite. As a result, these markets are forecast to have less yield widening in our latest Jun-20 base case scenario.
- As before, these yield adjustments are reflective of our approach and volumes year-to-date. With a near historic high risk premium (difference between government bond yield and property yields) and a robust, domestic investor base, core markets should see only limited yield decompression over the next two years.

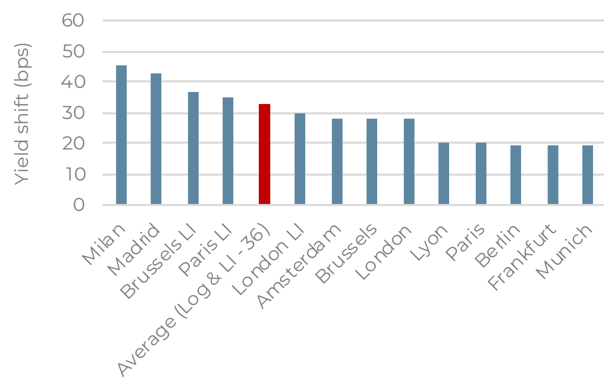
LOGISTICS RETURNS EXPECTED TO POST STRONG COME-BACK FROM SLOWDOWN IN THE SHORT TERM

- In line with office markets, logistics and light industrial returns are expected to post a strong rebound over the full five year period from an expected 2020-21 slowdown. For our 36 market universe we forecast a +7.3% p.a. return over the full 5-year period, nearly triple the level of +2.5% expected over the first two years.
- This highlights the resilience and strong demand for this sector going forward with leading markets, like London and Paris light industrial expected to have above average returns over the full 5-year horizon.
- Despite having negative total returns in the short-run, Amsterdam and Zurich post positive returns per annum of 4.8% and 3.0%, respectively. Even at these levels, they are among the lowest in our universe.

LONG TERM RETURNS UNAFFECTED FROM COVID-19 IMPACT

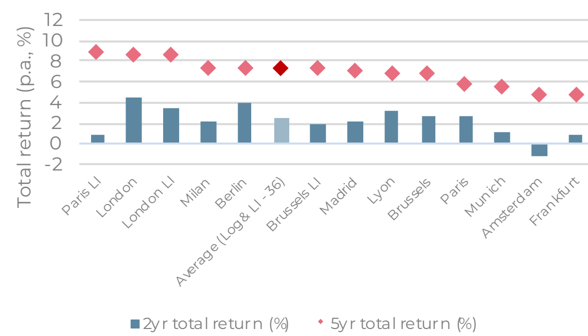
- Our chart illustrates the impact from Covid-19 by comparing returns for our latest Jun-20 base case relative to our original pre-Covid Jan-20 base case.
- In contrast with the other sectors, the average projected return actually increased to 7.3% p.a. from 7.1% previously as long-term yield compression offsets the milder initial income and yield decompression shocks. Despite remaining a solid outperformer, Budapest is the only outlier according to the best fitted-line in the graph.
- Our data also shows markets such as Zurich, Frankfurt and Amsterdam as underperformers while Stockholm, Budapest and the Manchester and Paris light industrial markets are among the outperformers over the next five years.
- On balance, we expect that the current surge in online sales penetration will be beneficial for the sector going forward and should support demand while only limited supply is expected over the near future for most markets.

Forecasted 2020-21 yield widening for selected prime Logistics & Light Industrial markets



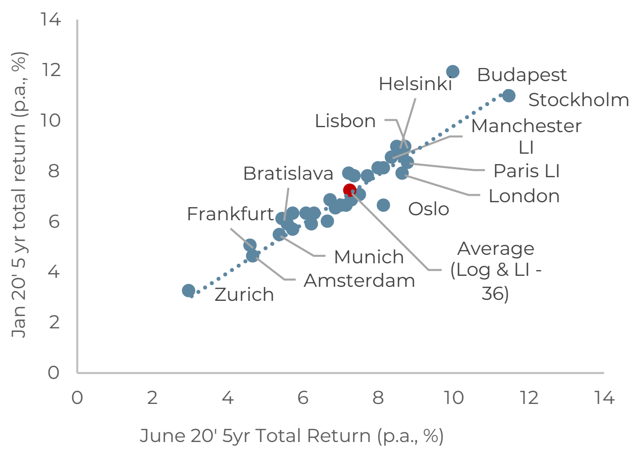
Sources: RCA, CBRE & AEW Research

2020-24 forecasts of total returns (% p.a.) for selected prime Logistics & Light Industrial markets



Sources: Oxford Economics, RCA, CBRE & AEW Research

2020-24 prime total returns (% p.a.) for Jan-20 and Jun-20 base cases



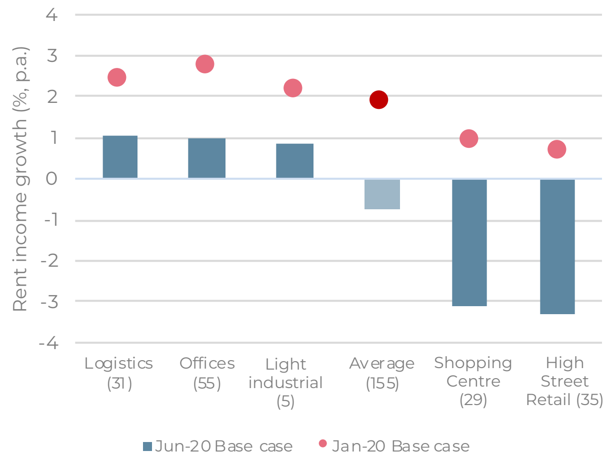
Sources: Oxford Economics, RCA, CBRE & AEW Research

JUN-20 BASE CASE RESULTS FOR ALL SECTORS

COVID-19 SLOWS INCOME GROWTH SIGNIFICANTLY

- All property rental income growth takes into account in place leases based on market rents over the last four years and is expected to turn negative across Europe at -0.7% per annum over the next 5 years. This is down from 1.9% p.a. expected in January 2020, based on income shortfalls and market rental declines.
- Our graph confirms that the decline in income growth is larger in the retail sector, as retail is hit by an above average expected cash shortfall from the Covid-19 impact.
- In contrast, income growth in the office, logistics and light industrial sectors remain positive, albeit at a lower rate than previously anticipated. This make sense as, despite the short term Covid-19 impact, supply-demand imbalances remain very limited and broadly supportive of income growth.
- We update our total return calculation to reflect that changes in markets rents only affect future rental income for each market when existing leases roll over. We assume a WALT of 5 years, so 20% of in-place leases roll to the new market rent each year.

Prime income return growth per sector (5yr annualised, %)

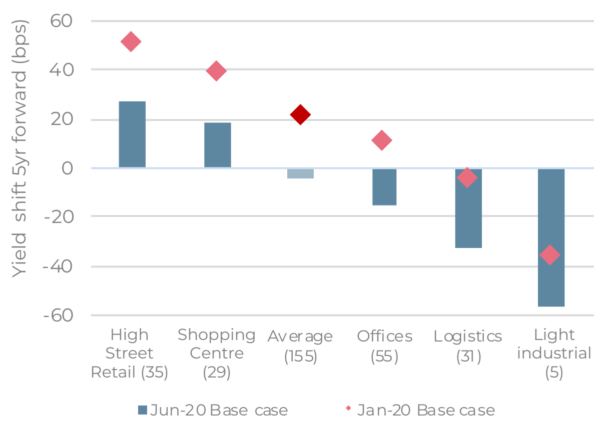


Sources: Oxford Economics, CBRE & AEW Research

COVID-19 SHORT-TERM YIELD WIDENING OFFSET BY LOWER-FOR-LONGER BOND YIELDS IN LONG-TERM

- Yields are forecast to remain flat until the end of 2024 in our latest Jun-20 forecasts (down from 20bps decompression expected in Jan-20 forecasts) after an initial short-term period of decompression amid Covid-19.
- This change in our long-term yield widening expectations is driven by the lower for longer government bond yield environment that is now broadly anticipated based on further Covid-19 related central bank policy announcements.
- However, in both our Jan-20 and Jun-20 base cases logistic and light industrial yields are projected to compress further over the 5-year forecast period amid strong investor appetite and a relatively limited supply pipeline in Europe.
- In contrast, retail yields are expected to decompress despite lower for longer bond yields as e-commerce, investor appetite and pricing put pressure on yields outside of the most sought-after locations.

Expected prime yield widening by sector (bps, until end 2024)

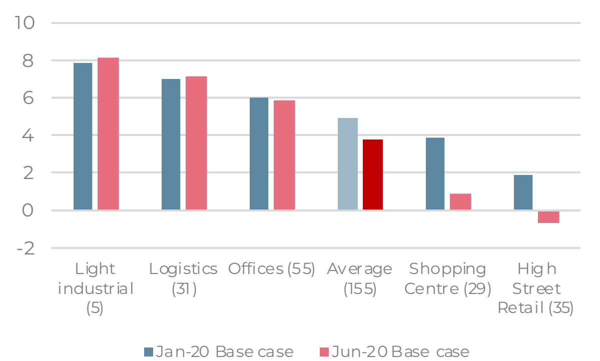


Sources: RCA, CBRE & AEW Research

DESPITE NEGATIVE IMPACT, LOGISTICS AND LIGHT INDUSTRIAL TO OUTPERFORM

- Despite the short-term Covid-19 impact, total returns over the next five years imply resilience in both the light industrial, logistics and office sectors. We expect prime returns for these sectors to be broadly in-line with our pre-Covid-19 forecasts (Jan-20) as demand shocks via lower income growth are offset by lower for longer yields and a robust investor appetite for these property types.
- To highlight this, prime total returns for the next five years are 6% for offices, 7% for logistics and around 8% for light industrial.
- On the other hand, prime total returns for the retail sector are hit by both Covid-19 and longer term structural changes. These are expected to be at 1% and -1% over the next five years for shopping centres and high-street retail, respectively.

Prime total returns by sector (%, p.a. for 2020-24)



Sources: Oxford Economics, RCA, CBRE & AEW Research

ABOUT AEW

AEW is one of the world's largest real estate asset managers, with €71.2bn of assets under management as at 31 March 2020. 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 March 2020, AEW managed €33.5bn 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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