Schroders

Crisis polarises European real estate markets further

Schroder Real Estate

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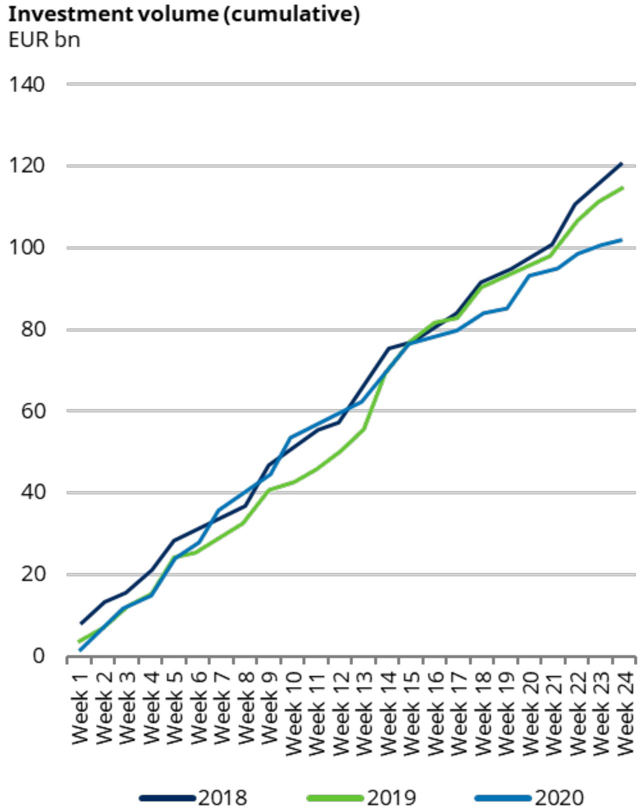
The measures taken by many governments around the world to curb the Covid-19 pandemic have paralyzed many economies, and affected real estate markets and investment activity.

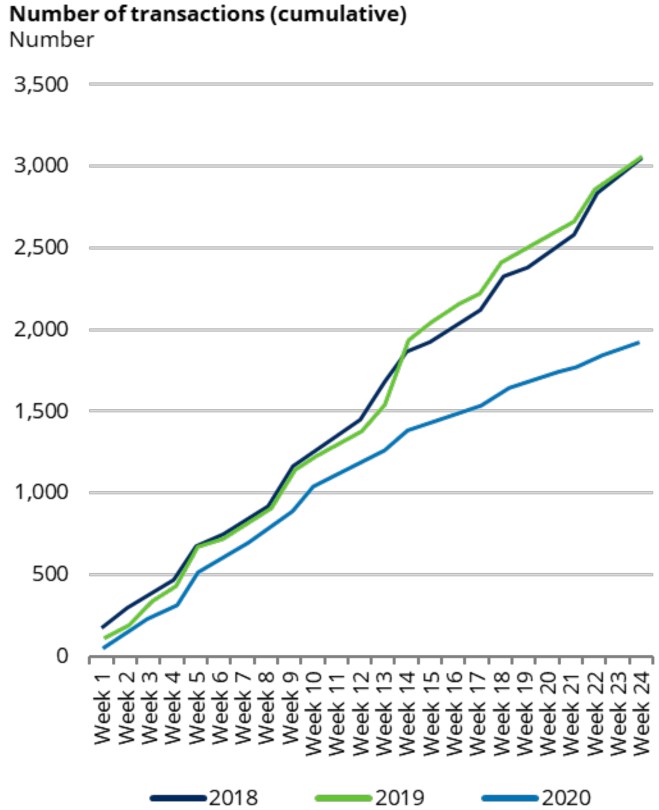
In the Asia-Pacific region, where the virus and consequential lockdowns first appeared, the cumulative investment volume for commercial real estate so far this year was only around $40 billion at the end of May, according to figures from Real Capital Analytics (RCA). In comparison, for the same periods in 2018 and 2019, volumes had already surpassed $70 billion. A similar picture emerges for the Americas region. The total transaction volume here at the end of May was just over $130 billion, where in the two years before, it had already exceeded $160 billion.

As such, the transactional markets in Europe seem relatively robust. The cumulative transaction volume at the end of May stood around $90 billion, which is only slightly below the $100 billion in the same period last year. This is particularly surprising when considering that Europe is the "world's most international region" with cross-border flows at around 50% on a regular basis.

However, Europe benefited from a number of large portfolio and platform transactions since the beginning of the year. In the UK, for example, Blackstone bought student-housing firm 'iQ' for around £4.7 billion. In Germany, Aroundtown took over 'TLG' for around €4.7 billion and in France, Unibail-Rodamco-Westfield sold a portfolio of five French shopping centre worth over €2 billion. A number of larger individual transactions were also successfully completed. In Brussels for example, the 142m high and almost 190,000m^2 'Finance Tower' changed ownership for around €1.2 billion and in London the famous Ritz Hotel changed hands for an estimated £800 million.

European real estate investment





Source: Real Capital Analytics (RCA), Schroders. June 2020.

Just looking at the number of transactions however, at the end of May, Europe had seen ca. 40% decrease year-on-year. Remarkably, it's small transactions – of less than €50 million – where activity has declined significantly since the beginning of the year. Compared to the previous year, around 50% fewer transactions were carried out in this lot size. This seems to indicate that at the moment, it's mostly large, equity-rich investors that are driving activity and large transactions, initiated and negotiated months before the crisis, are now closing.

With regard to the individual markets, looking at the deal count and with the aforementioned 'mega deals' in mind, both Germany and Sweden held up significantly better then some of the other markets for the period of March to May 2020. Both markets are somewhat more inwardly focused and have a broad base of domestic investors. Sweden might have also potentially benefitted from the less harsh measures to control the spread of the virus. For the UK, it was particularly London's performance that was severely impacted by the lockdown and travel restrictions. Typically ~70% of activity is driven by cross-border investors.

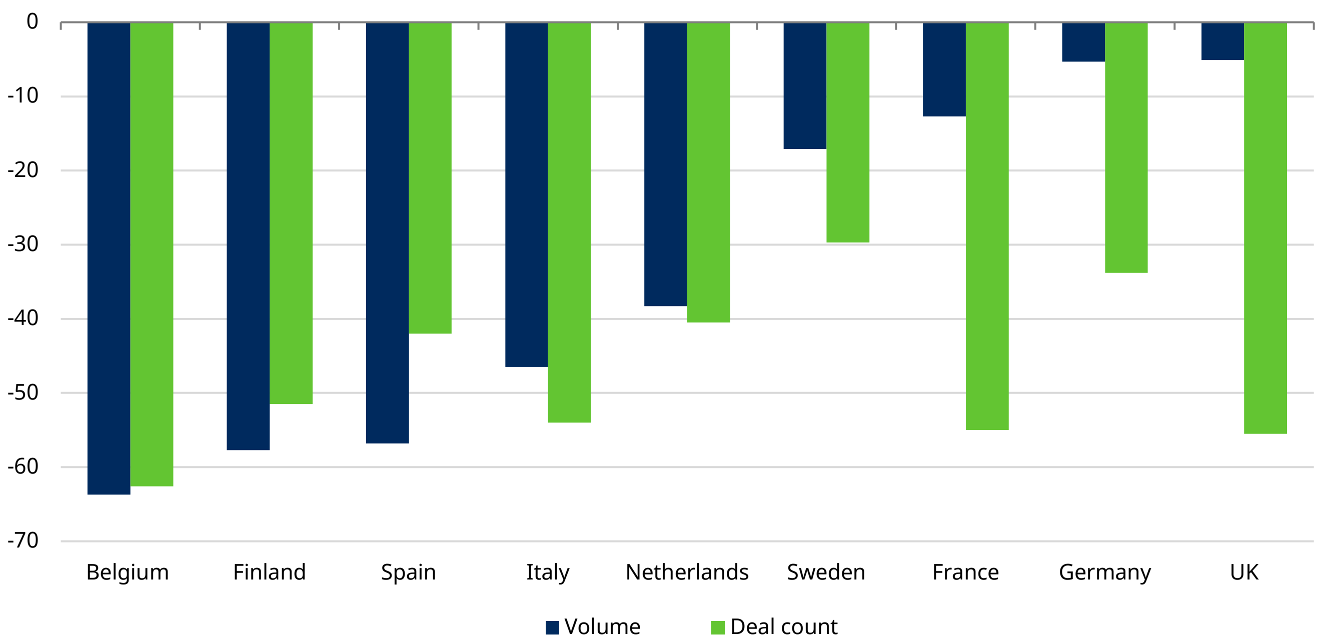
Overall, the investment volume in Europe is likely to decrease in the coming weeks. The restrictions and uncertainties over the world after the lockdowns and the state of the economy meant, that it was not only largely impossible to carry out normal due diligence process during the lockdown phase. It also meant that opportunities were withdrawn or not brought to market. Also, many buyers adopted a wait-and-see approach or were busy managing their current portfolios though the storm. In addition, it became somewhat impossible to produce sound asset valuations, especially where Royal Institute of Chartered Surveyors (RICS) 'red book' valuations are used and even now, where lockdowns are started to being lifted, many investors are still in a price discovery phase.

What is becoming clear though, is that the crisis polarises European markets further. While the yields for extremely secure locations and tenants ('prime') have remained largely stable, there are increasing reports of discounts for less prized locations or locations with higher risks on the tenant side, especially for some retail assets. Financing costs for less secure products have also increased significantly.

Despite the uncertainties currently facing real estate investors in the face of the enormous economic crisis in terms of sectors, markets, tenants and financing, we believe that real estate as an asset class will remain very popular, given low interest rates/bond yields and the high volumes of 'dry powder'. It should also be noted that investors were not idle during the lockdown phases and that there were conversations and that desktop analysis of transactions were conducted. As such, we expect that, after a phase of price discovery, an assessment of the overall economic fallout and the individual risk of investments, activity on the transaction markets should pick up again in late summer.

By then however, issues such as the relationship between the US and China, the US presidential election and a possible 'hard Brexit' will concern many investors.

European investment activity: Period March to May 2020, YoY change %



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