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European Commercial Real Estate Markets: 2021 & Beyond

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OVERVIEW

- With the success of vaccination programmes to date, there is the growing expectation of an incremental return to normality starting in 2022, with a potential worldwide new normal from 2024 onwards. COVID-19 is likely to move from a pandemic to being endemic – in that it remains with us but is managed through treatments and annual vaccinations.
- It is well understood that the short-term impact of the pandemic has been most pronounced on the leisure and retail sectors.
- Below we share our views on the longer-term trends in how we use real estate. Budding trends that have been burgeoning – but which have now been accelerated and are here to stay.
- These trends surround the key aspects of:
  - How we work
  - How we live
  - Healthcare
  - Social inclusion
  - Our impact on the environment and our surroundings
- These have profound effect on the long-term occupational use (demand) of real estate and hence its income potential and income sustainability.
- Real assets that can demonstrate a long-term demand and stability of income will be valued up according to the risk premia above base reference rates for that income duration. In this regard, the debate over reflation versus long-term inflation, what drives inflation and the response of central banks to it is highly relevant. Our view is that the rapid reflation we are seeing today is a mid-term effect (brought about by the unwinding of demand and the deployment of significant fiscal support that has been provided over the last year) and not a long-term one. And hence we believe that long-term rates revert to a base level which, whilst higher than in 2019, is still relatively muted.
- We favour lending on assets where long-term structurally in-demand rents are of a shorter duration and where demand is more closely linked to economic activity, hence allowing a closer reset of rents to inflation driven by growth.

The table below provides a brief summary of our view on the key long-term occupational performance of the key asset classes:

Asset Class	Long-term structural view
Offices	We believe that there are two key factors in the long-term trend for offices: 1. Work from home. Here, we do believe that, for business functions that can, employees will be permitted to work from home for a number of days in the week. This move is here to stay. 2. Quality of accommodation. Even before COVID-19, there has been a rejection of cramped, sub-standard working conditions. The move to comfortable, spacious, green working environments with a focus on well-being is a good one and is permanent. These factors are unfavourable towards city centre "dense" offices that are dated. They do, however, favour the new generation of green spacious offices centred around the well-being and working environment of the individual. The availability of amenities and proximity to open spaces is likely to benefit these new office types. As an example of this, we see London city centre rents for tall towers declining for the long term, whilst low-rise, well connected offices, outside the core city centre benefitting.

Hotels	Unsurprisingly, we are seeing a significant resurgence in demand for leisure hotels. The resumption of travel and holidays outside of the local area will almost certainly benefit the leisure hotel – especially those classed as "sea and sand" and city centre leisure. We support this thesis, as do the growing number of large borrowers who reach out to us for finance. The typical underwrite we see is for a reversion to 2019 trading in 2024 / 2025. We are less constructive on business travel hotels – due to the obvious reason of increased use of online video conferencing. Just like the business class seat on an airline is likely to be in permanent decline, the business class hotel will need to adapt to a markedly lower demand. One theme on which we are also less constructive is that of staycation assets. Here we are at odds with the significant PE demand for the asset class. We simply believe that as international travel resumes, the preference for a beach holiday abroad will cause a reversion to the mean in the demand for a local holiday park.
Retail	We have long been negative on shopping centres. Brexit and the continued move to online retail causes us to hold to that view. There is an increasing view of buying in shopping centres for a change of use play. Whilst possible in the long run, we see that a lot of sponsors underestimate the viability of such schemes – especially so in tight town centres. We are neutral on other forms of retail such as "big box" out of town and high-end retail.
Logistics	The asset class is all the rage today, with an abundance of capital chasing various strategies linked to logistics. Whilst we are broadly supportive of the long-term thesis for logistics (continued growth of e-commerce in virtually every product offering), we are mindful of the growing indiscrimination in the asset class. Some of what passes for "last mile" logistics today has nothing to do with e-commerce at all, but is linked to industries such as building materials and fast-moving consumer goods (FMCG) headed for the shopping centre. These buildings do not lend themselves to conversion to an e-commerce purpose and hence are tied to the retail economy, which is the very sector being curtailed by e-commerce.
Rental Apartments	Rental apartments that are truly affordable continue to offer a defensive and in-demand asset profile which we support, especially those that promote the building of inclusive communities in city centres. However, we are concerned on the path for the higher rent PRS industry – especially so in London – where the double hit of declining affordability and Brexit has seen demand (potentially permanently) impaired.
Single Family Homes	After an initial six month period of deep uncertainty on the suburban single family home (for sale or rent) asset, the migration to partial work from home, coupled with the simple need for a better quality of life, has seen the significant demand for this asset class. That demand is deeply undersupplied in suburbs of the key cities across the UK and Europe. As with apartments, the affordable end of suburban homes is a thesis we believe is set for significant growth.
Healthcare	This sector covers a large range of asset classes – all of which are largely underserved. The main asset types are: ▪ Care homes (where the affordable home is in high demand with little supply) ▪ Specialist care accommodation ▪ Retirement villages and communities ▪ Specialist hospitals Whilst a mature and consolidated industry in the US, these are fragmented and underserved markets in the UK and Europe. The operational challenges here are immense and barriers to entry high, but for the capable operator, these are compelling markets.
Other Residential Themes	We believe there is a broad base of other forms of residential assets that will see a supportive level of long-term demand and with an undersupply in the current level of stock. These include: ▪ Student housing (PBSA) ▪ "Co-living" – affordable, amenity rich, city-centre living promoting social inclusion and fostering a closer community

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