Invesco Real Estate House View
European Summary

H1 2021

European economies are on a steady recovery path over 2021-22, rebounding from the impact of COVID-19 in 2020. The pace and scale of the recovery from this impact varies, and from a real estate perspective we have to factor the shape of the economic recovery into our considerations for each market, both in terms of our thinking about the strategic merit of current holdings, as well as where potential opportunities may lie going forward. However, the fundamental outlook remains supportive for investment in yield assets, and with significant volumes of capital waiting to deploy across global real estate markets, the outlook remains supportive for the sector.

With the roll-out of multiple COVID-19 vaccines globally providing confidence in a gradual return to economic normality, forecasts are for most European countries to return to 2019 GDP levels in Q2 or Q3 2022, with the recovery outlook supported by recent comments from the IMF that COVID-19 will do little lasting damage to most advanced economies.

The global monetary and fiscal stimulus packages injected by governments and central banks, both before COVID 19 and in response to the pandemic, have resulted in further downward pressure on bond yields. In Europe, the yield curve has dropped further into negative territory at the short end of the curve, though the long end has remained reasonably fixed as markets price in concerns of potential inflationary pressures. Thanks to low leverage in the system and the ongoing dearth of yield from other asset classes, barring an exogenous shock, we continue to see a limited threat of a major correction in prime property values, though there has been some negative repricing of higher risk real estate assets.

Near-term, we expect limited market-level growth, if at all, and therefore real estate returns will be driven/drive by asset management initiatives and the ability to introduce operational improvements. We therefore focus on those strong opportunities to meet post-pandemic demand, or to use the current uncertainty to acquire assets that would not otherwise trade.

European real estate market signals

		France & Benelux	Germany & Austria	UK & Ireland	Central Europe	Nordics	Southern Europe
Macro	2020-22 GDP recovery	→	↗	→	↗	↗	→
	Monetary policy outlook	→	→	→	→	→	→
	Demographic change	↗	→	→	↘	↗	→
	Urbanization	↗	→	→	→	↗	→
Real Estate	CRE yield margin	↘	↘	→	→	→	↘
	Capital demand	↗	↗	→	→	↗	↘
	2020 RE volumes	↘	↘	↘	→	→	↘
Debt Markets	Covenant package	→	→	→	→	→	→
	Security/enforcement	→	→	→	→	→	→
	Debt supply	→	→	↘	→	↗	↘

Macro trend	↗ Growth	→ Stable	↘ Declining
Real estate impact	Positive	Neutral	Negative

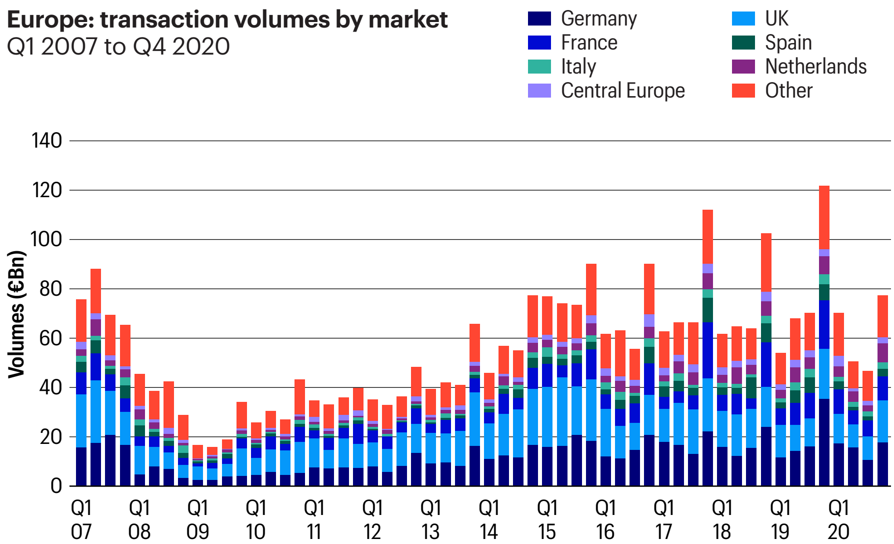
Source: Invesco Real Estate using data from Oxford Economics, CBRE, and Real Capital Analytics.
Notes: Demographics = total population growth 2019-25; Urbanization per Oxford Economics 2019-25; CRE yield margin = capital city CBD offices over 10 year Government bond (movement over 12 months). For GDP change: Positive >2.0%, Neutral 0%-2%, Negative <0%.

Investor demand

European real estate transaction volumes were 22% lower in 2020 versus 2019, in a large part due to travel restrictions limiting investors' ability to undertake site visits and due diligence assessments. 2020 saw a classic response to an exogenous shock, with high-quality, long-income assets remaining seeing strong investment demand. Meanwhile risk assets with near-term lease events or capex requirements have been repriced, though by less than many commentators had expected. This was mainly due to lenders continuing to support assets, rather than forcing sales.

Within overall volumes, European logistics investment volumes increased 10% in 2020 versus the previous year, while hotel transactions fell 66% reflecting the uncertainty around the travel sector. These sector variances combined with the flight to core in the transaction volumes by country, with the Netherlands and Central Europe showing smaller decreases of 12% and 13% respectively, as a result of ongoing strong logistics activity, while Spain saw activity fall 52% and Italy 33%.

Europe: transaction volumes by market
Q1 2007 to Q4 2020



Note: Includes property or portfolio sales US$10 million or greater.
Source: Invesco Real Estate, based on data from Real Capital Analytics, as of March 18, 2021.

Europe: transaction volumes by sector

Market	Transaction volume (€bn) 2019	2020	Change (%) '19-'20	10-year average (€ bn)
Office	136.3	93.8	-31	102.3
Industrial/Logistics	35.3	38.8	10	28.1
Retail	41.2	35.0	-15	48.8
Apartments	62.1	55.6	-11	38.9
Hotel	25.0	8.5	-66	17.4
Others	14.1	13.3	-6	10.9
Europe "All Properties"	314.1	245.0	-22	246.4

Note: Includes property or portfolio sales US$10 million or greater.
Source: Invesco Real Estate, based on data from Real Capital Analytics, as of March 18, 2021.

Preqin data on closed-ended funds estimates $118bn was raised by real estate funds globally in 2020, and while this was down on 2019 volumes, $314bn is targeted for 2021. These strong flows continue to add to the $324bn of global private real estate dry powder that was still waiting to be deployed at the start of 2021.

With market expectations of limited scope for yield compression from this point, we see two polarised focal points for real estate investors at present: the first is a focus on quality, income and security; the second, a search for opportunities to reposition assets for the post-COVID recovery.

Real estate strategy considerations

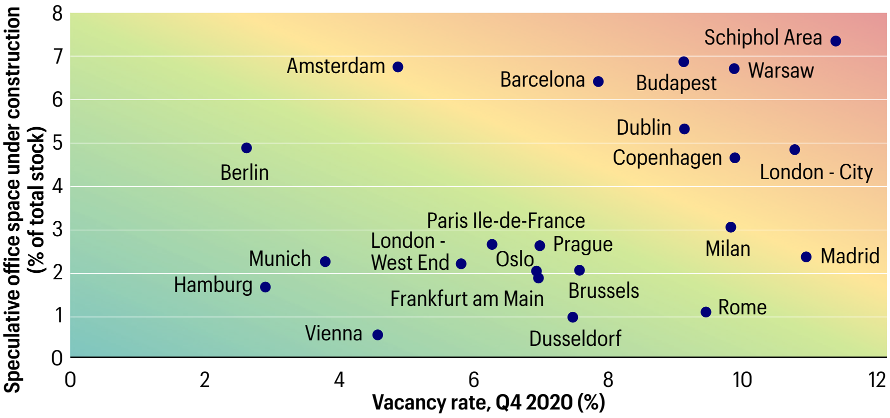
European real estate markets have shown good momentum coming into 2021, benefitting from the confidence stemming out of the global roll-out of COVID vaccines. Indirect property returns recovered in H2 2020, with the MSCI European index showing a 96bps return for 2020 overall, ahead of the global index return of 30bps, and with positive returns through H2 2020 offsetting the weakness in H1. Global listed real estate showed a strong return of 5.97% in Q1 2021. Barring further economic impact from COVID containment efforts, European markets' GDP growth is forecast to steadily recover through 2021-22, with most markets returning to 2019 output levels around mid-2022.

For European real estate markets, the investment considerations at present focus on the medium-term outlook for sectors, and the extent to which these may have changed as a result of COVID-19. We remain clear in our view that the current global pandemic caused a significant short-term disruption without directly changing any of the longer-term structural changes that were influencing real estate. However, for certain sectors, the reaction to COVID-19 accelerated structural changes which were already occurring, such as the increase in online retailing. At the same time, other sectors have seen a short-term disruption, such as global travel patterns, but we reasonably expect to return to previous trends as activity normalizes.

Office usage is evolving, and these changes have accelerated as a result of the COVID-19 pandemic. However, looking forward to the normalisation of activity post-COVID, there remains a need for employers to provide sustainable spaces that attract workforce talent, facilitate collaboration and the curation of corporate culture and enable mentoring. The result is that prime office real estate will remain in demand from both occupiers and investors, though patterns of demand should be expected to shift compared to the pre-pandemic market conditions.

Our conviction on the sustained long-term demand for high-quality offices results in no small part from detailed conversations with market participants, including both those who directly advise on real estate, as well as strategy consultants helping organizations optimize their operational requirements. These discussions confirm that while many occupiers are examining their existing office exposures, almost all are increasingly focussed on location, quality, and efficiency of the space they use. As such, contrary to certain headlines suggesting that the work-from-home (WfH) experiment will result in major long-term reductions in office usage, we find that occupier and investor demand for core assets in central locations is set to remain strong. Further, we believe that the longer that lockdowns force WfH for office employees, the stronger the desire by both employees and employers to return to the interactive environment offered by the office.

Vacancy rate (Q4 2020) and speculative office construction (2021f-2023f)
% of total stock



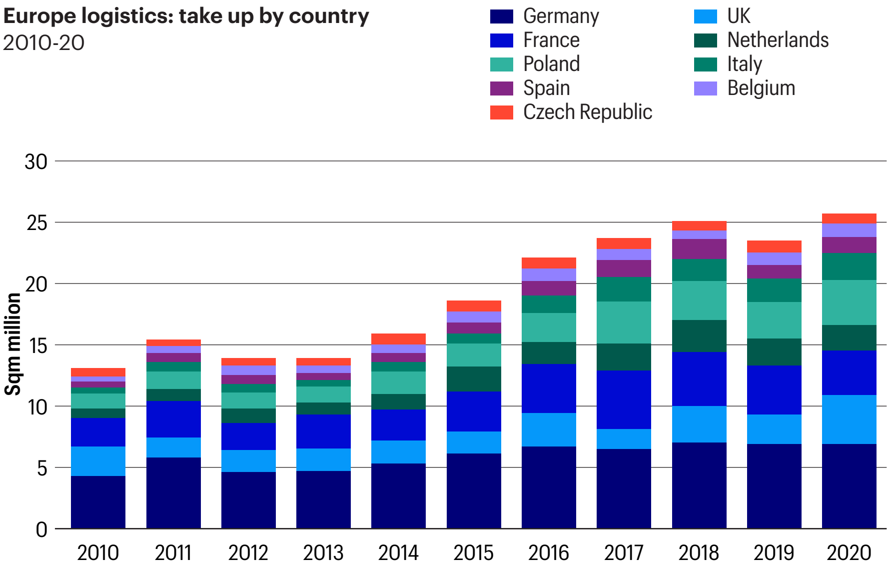
Note: Only the speculative share of the office pipeline is shown on the y axis, not the total pipeline which would include pre-let spaces and office projects where construction has not started yet.
Source: Invesco Real Estate, based on data from CBRE, February 2021 (f=Forecast).

Retail continues to face structural pressures, and these have been exacerbated by COVID. Placing the majority of European consumers in lockdown to control the pandemic has accelerated the structural shift towards online shopping, much of which is expected to remain. In addition, lockdowns placed greater financial pressure on certain retail categories, such as fast fashion, which have seen considerable declines in sales in 2020. Post-COVID, we believe many retailers are likely to see further margin pressure as a result of the ongoing shift towards e-commerce, leading many to further rationalize store networks, closing underperforming locations while optimizing and often expanding in "flagship" locations. The result is that enclosed, multi-storey mass-market orientated assets without a strong local catchment are most vulnerable.

Notwithstanding these concerns, UK retail real estate has already repriced materially, leading to some attractively priced opportunities starting to arise for well-located assets where leases can be repriced to appropriate levels and still result in an attractive running yield. In Continental Europe we believe that there is a degree of protection offered by (a) the lower shopping space per capita, reducing the likely aggregate adjustment, and (b) the greater tendency towards food-anchored centers, leading to a steadier footfall dynamic. However, despite this, there are clear risks which European investors must be alert to.

Logistics assets remain in strong occupational and investment demand. Supply chains are reshaping to address changing consumption patterns, not least as retailers have responded to the COVID-driven demand for online retail. Across Western Europe, demand outstrips the availability of suitable sites to develop warehouses, particularly for edge-of-town distribution assets. However, pricing has tightened materially, so while we continue to see opportunities in both big box and edge-of-town logistics across Europe, we remain extremely focussed on assets being underpinned by fundamental land values in strategic locations.

Europe logistics: take up by country
2010-20



Source: Invesco Real Estate, based on data from CBRE February 2021.

Hotels have repriced in 2020, offering opportunities to acquire either core hotels for a long-term hold or value-add projects following a manage to core strategy. Valuations are down 10-15% and prime yields have shifted out by 25-50bps, in contrast to the office and logistics sectors, further increasing the relative yields from hotels. Although the sector has been hit hard by the Covid-19 pandemic, we believe this is a short-term shock rather than a reversal of long-term positive trends where revenues historically grew by approximately 1% p.a. above CPI.

We expect the post-COVID recovery to be led by leisure visitors initially with business travel following. Our strategy remains focused on major cities that have balanced demand drivers and constrained supply, and hence are positioned to capture an early rebound in travel. Within those markets, we like hotels with a clear consumer proposition run by trusted operating partners, avoiding the undifferentiated midmarket.

Residential investments benefit from ongoing demand pressures, as most key European cities have had a long period where growth in household numbers, in part driven by ongoing urbanization, has outstripped the supply of new homes. The result has been continuing upward pressure on rental levels in many European cities, though certain markets are seeing stretched affordability, and increasing regulatory pressure on residential rental markets needs to be closely monitored.

Our preference is to access the build-to-rent (BTR) market through forward funding developments, taking an incremental return for the development risk. This supply of institutional grade assets is seeing increasing occupier interest as enforced WFH has led to tenants prioritizing housing with good infrastructure and connectivity, flexibility, and access to outside space.

Specialty sectors continue to see strong investor interest. Buyers are concentrating on areas which are influenced by secular trends, such as data centers and life science facilities in the UK and Germany. The income stability of student housing and micro living is attractive to core mandates, but pricing is already strong in many markets such as the UK, and we note that significant demand is driven by foreign students, therefore resumption of travel is key to these sectors' recoveries.

Overall, real estate performance is seeing asset-specific divergence within markets and sectors. By focusing on sectors supported by secular tailwinds, stock selection and asset management are expected to drive relative returns over the shorter term. Through Q1 2021, uncertainty over the global recovery has subsided, though opportunities for outperformance still need to be balanced with portfolio risk diversification due to the fragile global outlook.

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