Invesco Real Estate House View
European Summary

H2 2021

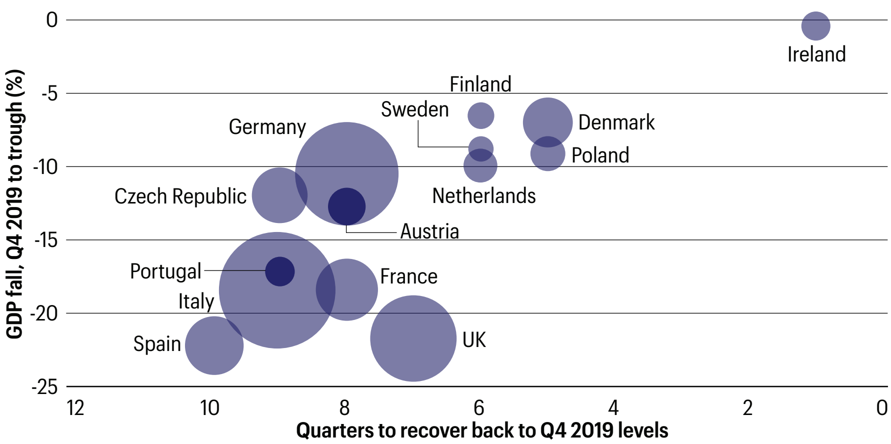
European economies are on a steady recovery path, rebounding from the impact of COVID-19 in 2020 and early 2021. Despite the rise of the Delta variant, European countries continue to reduce remaining COVID restrictions, driving the rebound in economic activity. While our strategic outlook continues to consider the shape of the economic recovery for each market and industry, the fundamental market environment remains supportive for investment in yield assets. We believe that significant volumes of capital waiting to deploy across global real estate markets combines with ongoing confidence in a lower-for-longer economic profile, resulting in an outlook which is likely to remain supportive for European real estate.

H1 2021 has seen European states rolling out COVID-19 vaccines and easing back on lock-down restrictions, leading to a gradual return to economic normality. Forecasts have been brought forward, with key European countries expected to return to 2019 GDP levels between Q2 2021 and Q3 2022.

The global monetary and fiscal stimulus packages injected by central banks and governments, both in response to COVID-19 as well as prior to the pandemic, continue to hold bond yields at low levels versus history. In Europe, the ECB has started slowing bond purchases, but policy is to maintain favourable financing conditions. The result is that the yield curve remains in negative territory for over nine years, and the overall shape of the curve has remained stable since late 2019, showing current market pricing is unconcerned despite media reports of potential inflationary pressures. Thanks to the low leverage in the system and the ongoing low yields from other asset classes, barring an exogenous shock, we continue to see a limited threat of a major correction in prime property values, though we have seen some negative repricing of higher risk real estate assets.

Despite the rebound in economic activity, tenants continue to navigate the uncertainty with caution. The result is that near-term we expect market level rental growth to be limited to certain sectors and sub-sectors and, therefore, for most assets real estate returns will be driven by asset management initiatives and the ability to drive operational improvements. For the long term, we continue to focus on opportunities to meet post-pandemic demand, especially where this demand benefits from structural tailwinds.

GDP recovery versus stimulus package (bubble size is stimulus as % GDP)

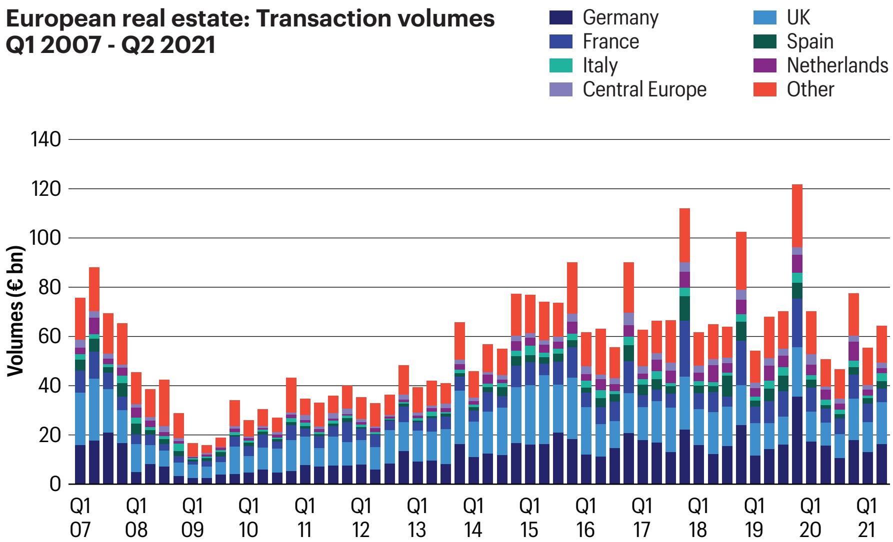


Source: Oxford Economics and IMF, September 2021.

Investor demand

H1 2021 saw European real estate transaction volumes 3% lower than H1 2020, according to data from RCA. Commercial real estate assets were 4% lower year-on-year (y-o-y), while the overall was boosted by a 29% increase in development sites. A clear sectoral variation was seen, with significant investor demand for logistics in particular, where H1 2021 volumes were only just short of the long-term average for full year volumes. Meanwhile office and retail transaction volumes remain down both y-o-y and against long-term averages. Interestingly, hotel transactions rebounded over H1 2021, albeit against a weak comparator from H1 2020. Of the major markets, the UK rebounded 40% in H1 2021 while Germany, down 13% y-o-y, and France, down 19% y-o-y, saw volumes decline largely as a result of limited product being brought to market.

European real estate: Transaction volumes Q1 2007 - Q2 2021



Note: Includes property or portfolio sales US$10 million or greater.
Source: Invesco Real Estate, based on data from Real Capital Analytics, as of August 25, 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 being to seek opportunities to reposition assets for the post-COVID recovery.

ESG+R

Across the European real estate market, Environmental, Social, Governance (ESG) credentials are an increasingly important consideration for both real estate investors and occupiers. ESG+R (ESG and Resilience) investing is a fundamental commitment at Invesco Real Estate. Our ESG+R philosophy is based on our belief that ESG aspects have the potential to deliver both competitive financial returns and opportunities for business growth and innovation. To support this we have set global targets of a 3% annual reduction in energy and emissions by 2030 from a 2018 baseline, net zero carbon emissions by 2050, and 1.0% annual reduction in water consumption and 1% annual increase in waste diversion.

Real estate strategy considerations

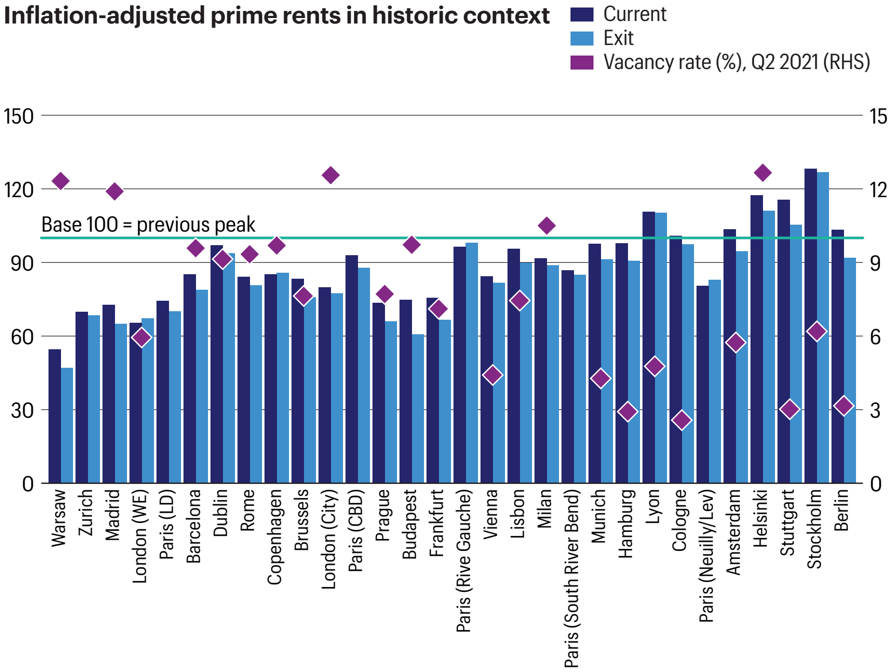
European real estate markets have shown positive momentum in H1 2021, benefitting from confidence stemming out of the global roll-out of COVID vaccines despite the rising concern from the spread of the Delta variant. Barring further economic impacts from significant COVID containment efforts, European GDP growth forecasts show steady recovery, with most markets returning to 2019 output levels late 2021 or early 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 influences on 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 the previous trends as activity normalises.

Office use continues to evolve, even as tenants and employees start to return to European offices. We are clear that these changes have accelerated as a result of the COVID-19 pandemic, though there was already a trend towards greater flexibility in work pre-pandemic. Going forward, there remains a clear need for employers to provide sustainable spaces that attract workforce talent, facilitate collaboration and the curation of corporate culture and enable mentoring. We believe that a result could be that prime office real estate should remain in demand from both occupiers and investors, though patterns of demand are shifting compared to the pre-pandemic market conditions. Furthermore, as we show in the chart below, almost all key European cities are showing prime office rent levels below the prior peak in real terms.

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 organisations optimise 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.

Inflation-adjusted prime rents in historic context



Note: Current & Exit represents 2020, 2025 (5th forecasting year) rent indices respectively.
Indices calculation is done after inflation adjustment of current and exit rents with respect to peak (max of 2000 to 2009).
Source: Invesco Real Estate, H1 2021, based on data from CBRE.

Retail continues to face structural pressures, and these have been exacerbated by COVID. Placing the majority of European consumers in lockdown during 2020 and early 2021 to control the pandemic has accelerated the structural shift towards online shopping. Much of this adoption is expected to remain sticky even as conditions are relaxed, though we expect differential patterns of behaviour between discretionary and non-discretionary items, and also between discount, mass-market, and luxury categories.

In addition, lockdowns placed greater financial pressure on certain retail categories, such as fast fashion, which saw considerable declines in sales in 2020. Post-COVID, we believe some retailers are likely to see further margin pressure as a result of the ongoing shift towards e-commerce, leading many to further rationalise store networks, closing underperforming locations while optimising 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) a lower shopping space per capita in some markets, reducing the likely aggregate adjustment, and (b) the greater tendency to food-anchored centres, leading to a steadier footfall dynamic. However, despite this, there are clear risks which European investors must remain alert to.

Logistics assets have continued to outperform the wider real estate market through the COVID pandemic, seeing both strong occupational and investment demand. Supply chains are reshaping to address challenges of the “just in time” delivery model which emerged and due to changing consumption patterns, not least as retailers have responded to the COVID-driven demand for online retail. Across Western Europe, occupational demand has outstripped the availability of suitable sites to develop warehouses, particularly for edge-of-town distribution assets.

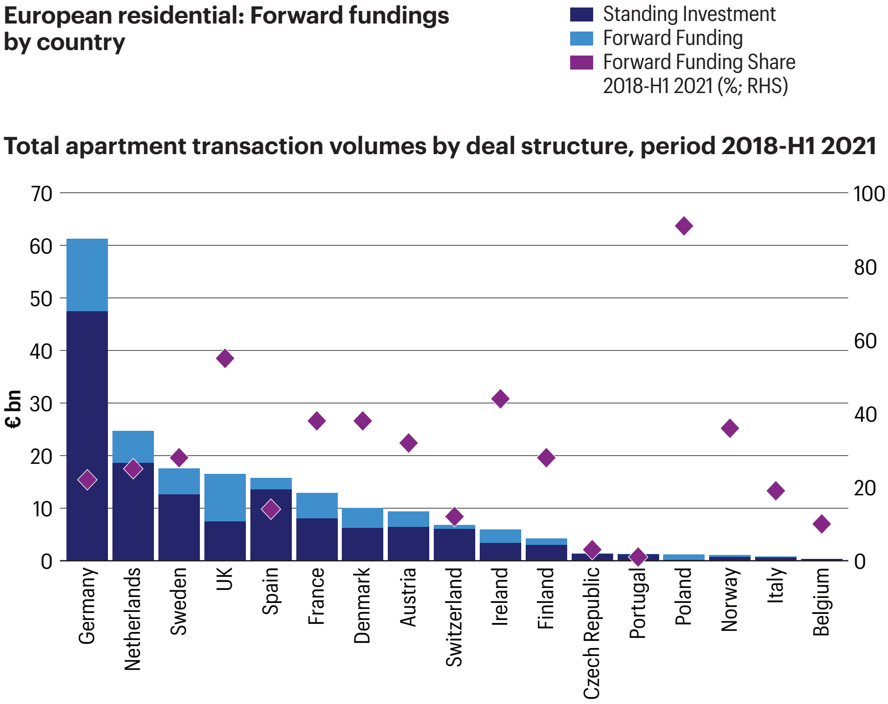
Strong investment demand has resulted in the pricing of logistics assets tightening materially. While we continue to see opportunities in both big box and edge of town logistics across Europe, due to the tight pricing in this sector, we are focussed on assets being underpinned by fundamental land values in strategic locations.

Hotels saw some repricing 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 25-50 basis points, 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.

As travel restrictions gradually ease, we are seeing a post-COVID recovery led by leisure visitors initially. At present, there is limited evidence of business travel resuming, though expectations have consistently been for this market to open up more gradually. Our strategy remains focused on major cities that have balanced demand drivers and constrained supply, and hence should be positioned to capture 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 have continued to 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 urbanisation, has outstripped the supply of new homes. However, certain markets are seeing stretched affordability, and increasing regulatory pressure on residential rental markets needs to be closely monitored.

European residential: Forward fundings by country



Note: "Classic" apartment product includes micro living but not student housing. Minimum deal volume €5 million.
Source: Invesco Real Estate Research, based on data from Real Capital Analytics, August 31 2021.

Our preference is to access the build-to-rent (BTR) market through forward funding developments, taking an incremental return for the development risk, and as we see in the above chart, for certain markets this is an important route to accessing investment stock. The supply of institutional grade assets is seeing increasing occupier interest as enforced WfH has led to tenants prioritising housing with good infrastructure and connectivity, flexibility, and access to outside space. For higher-return strategies, we also target build-to-sell developments in key markets as a means of driving higher short-term returns, especially opportunities which allow repositioning of other existing buildings.

Specialty sectors continue to see strong investor interest. Buyers are concentrating on areas which are influenced by secular trends, such as data centres in key European cities, and life science facilities in the UK and Germany. However, in sectors such as data centres, European transaction volumes remain very low, resulting in stock which is difficult to access and extremely competitively bid. Longer-term, we believe 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 and visitors, and 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, we aim to ensure that stock selection and asset management are expected to drive relative returns over the shorter term. Through H1 2021, uncertainty over the global recovery has subsided, though the clear opportunities for outperformance still need to be balanced with portfolio risk diversification due to the fragile global outlook.

Contact us

Mike Bessell
Managing Director
European Investment Strategist
+44 207 034 3894
mike.bessell@invesco.com

Invesco Real Estate
Portman Square House
43-45 Portman Square
WH1 6LY
London
UK

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