Invesco Real Estate House View

European Summary

H1 2022

At Invesco Real Estate, we continue to recognize the plight of the Ukrainian people in their time of national crisis. The conflict has created significant short-term uncertainty in financial markets, and could potentially have a significant medium-term impact on the European and global economies which we monitor closely. While our strategic outlook continues to consider the shape of the economic recovery for each market and industry, as well as local inflation pressures, the fundamental market environment remains supportive for investment in yield assets which can offer inflation hedging.

Many nations have reacted to the crisis by issuing sanctions against the Russian state, key Russian institutions, and a number of politically-connected individuals. Those sanctions can also have a negative impact on those markets issuing them, and therefore on global economic growth. Looking forward, the scale of these impacts depends fundamentally on how long the conflict lasts. We believe this can be broken down into two broad scenarios:

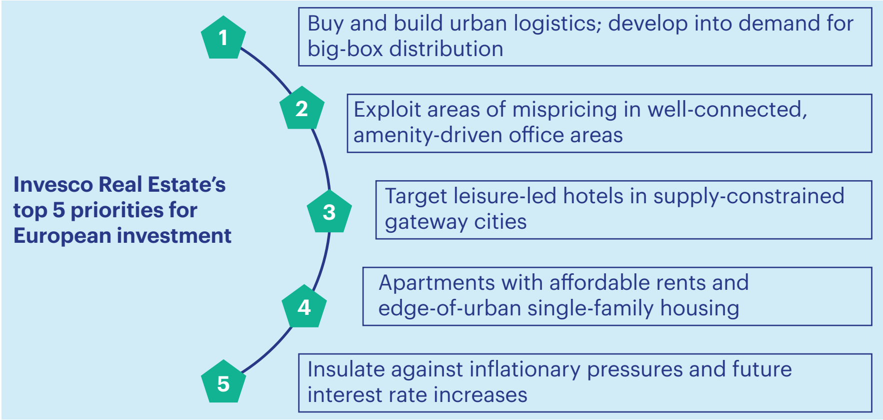
1 There is a rapid resolution to the current conflict. In this situation, we believe that transitory inflationary pressures will stay elevated for a longer period than was expected pre-crisis, particularly those driven by energy costs. Global economic growth in 2022-23 will reduce marginally from the recovery forecast at the start of the year, and proximity to the crisis means that this is likely to impact Europe more than the US and APAC.

2 Alternatively, the current situation could turn into a lengthy conflict. In this situation, global inflation is likely to continue for a more prolonged period. A protracted crisis will result in a longer and deeper drop in economic activity, with the result that certain key European markets are likely to at least come close to recession.

Our investment strategies seek to find a path which works for either scenario. While lower growth may weaken demand for some real estate sectors, we believe that certain areas may experience robust or even increased demand. We therefore focus on those real estate sectors where demand is supported by long-term secular growth drivers. In addition, these sectors will offer the strongest inflation hedges, as will assets with a clear business plan to drive rental growth without relying entirely on underlying market movements. We also continue to monitor for opportunities to capture deep value in markets created by the uncertain market conditions.

Five things to do in 2022

Focusing resources on priority activites



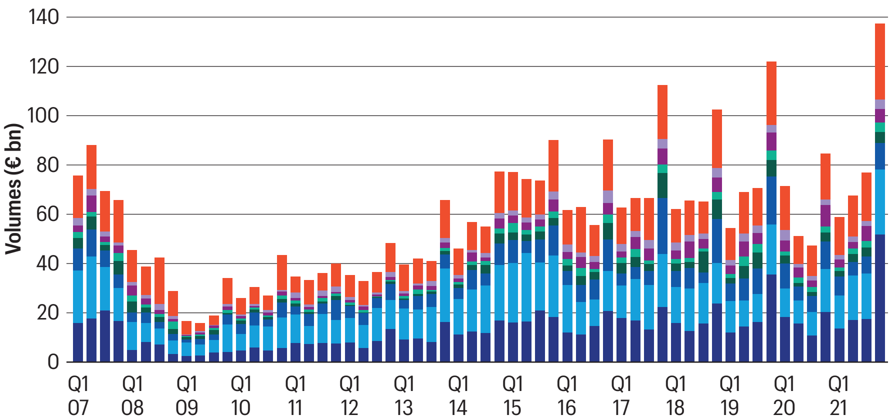
Source: Invesco Real Estate as of April 2022; for illustrative purposes only.

Investor demand

2021 saw European real estate transaction volumes 34% higher than 2020. Clear sectoral variations continue to be seen, with significant investor demand for logistics and apartments. Office and retail remain subdued, though hotel transactions rebounded strongly in 2021.

Of the major markets, the UK rebounded 46% in 2021 and Germany 33%, boosted by one large apartment transaction. Due in part to a lack of product coming to market, France saw a decline of 15% and the Netherlands a drop of 30%, despite the strong increase in logistics demand there.

European real estate: transaction volumes 2007 – 2021



Note: Includes property or portfolio sales US$10 million or greater.
Source: Invesco Real Estate, based on data from MSCI Real Capital Analytics as of March 22, 2022.

European real estate: transaction volumes 2007-2021

	Transaction volume (€bn)		Change (%)	10-year
Market	**2020**	**2021**	**'20- '21**	**average (€bn)**
Office	96.0	**104.9**	9%	**107.0**
Industrial/Logistics	39.3	**66.8**	70%	**33.6**
Retail	35.7	**36.0**	1%	**48.7**
Apartments	59.2	**98.9**	67%	**47.8**
Hotel	9.5	**15.1**	58%	**18.1**
Others	14.6	**19.2**	31%	**12.4**
Europe "All Properties"	**254.4**	**340.8**	**34%**	**267.6**

Note: Includes property or portfolio sales US$10 million or greater.
Source: Invesco Real Estate, based on data from MSCI Real Capital Analytics as of March 22, 2022.

Market expectations are for limited prime yield compression from this point, and with interest rate increases foreseen for the next 12-24 months, certain sectors may see a minimal spread for a period of time. We believe that the result will be a significant bifurcation of performance between different assets within the same sector, based on location, quality, and asset opportunities. As such, 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 an economic 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 can 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% annual reduction in water consumption and 1% annual increase in waste diversion.

Real estate strategy considerations

European real estate markets showed positive momentum in 2021, benefitting from confidence stemming out of the global roll-out of COVID vaccines. Coming into 2022, most restrictions are being eased, and markets are returning to far greater normality. European GDP growth forecasts suggest steady recovery through 2022-23, even after a strong 2021. However, the current situation in Ukraine has created significant short-term uncertainty in financial markets and is likely to have a significant medium-term impact on both the European and the global economy. The impact on the global economic recovery is compounded by the effect of further inflationary pressures for energy and key raw commodities. Looking forward, the scale of these impacts depends fundamentally on how long the conflict lasts.

Construction costs have increased further as result of the **Ukraine crisis**. In assessing the impact of the current uncertainty on development projects, we consider three factors:

1. **Materials cost** increases which affect the final development cost
2. **Labor cost** increases, which affect the final development cost
3. **Availability of materials**, which result in a delay to delivery times

For European real estate markets, the investment considerations at present focus on the medium-term outlook for sectors. 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. For certain sectors, the reaction to COVID-19 accelerated structural changes which were already occurring, while other sectors saw a shorter-term disruption.

However, coming through 2022, the Ukraine crisis is exacerbating supply chain costs, and driving inflation concerns through increases in the cost of energy and raw materials. Furthermore, reductions in monetary support is resulting in rising bond yields. Monetary policy going forward will need to strike a balance between countering inflation and supporting growth, which could influence real estate yield pricing.

The relative impact on labor and material cost increases will be different across European markets. Low availability and high costs of construction land in many markets will also limit activity.

Office use continues to evolve as tenants and employees return to European offices. Market evidence through 2021 shows that office leasing was more concentrated on the highest quality space, and there were examples of tenants moving to better-connected locations, even if this required taking less space. We believe there remains a clear need for employers to provide sustainable spaces that attract workforce talent, facilitate collaboration and the nurturing of corporate culture and mentoring. The result is that prime office real estate will likely remain in demand from both occupiers and investors.

Retail continues to face structural pressures, which were further exacerbated by COVID. The increase in European inflation, which is unlikely to be fully matched by wage growth, will place consumer spending under further pressure, with corresponding negative impacts for the retail sector, especially in the non-food mass market segments.

Notwithstanding these concerns, some areas of European retail real estate, particularly the UK, have already repriced materially, leading to some attractively valued 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 throughout the COVID pandemic, seeing both strong occupier and investor demand. Across Western Europe, occupier demand has outstripped the availability of suitable sites to develop warehouses, particularly for edge-of-town distribution assets. With further pressure on global supply chains as a result of the Ukraine crisis, many firms are reshaping operations to address challenges of the "just-in-time" delivery model which had underpinned manufacturing. Warehouse demand has further increased by changing consumption patterns, not least as retailers have responded to the COVID-driven demand for online retail.

Strong investment demand has resulted in the tightening of logistics asset pricing in a material way. 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 had been hit hard by the COVID-19 pandemic, but 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 ease, we are seeing a post-COVID recovery, led by leisure visitors initially, though with early evidence of business travel resuming as well. 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 continue 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.

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 above, 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.

We are also looking for opportunities to develop single family housing (SFH) schemes, supplying high-quality rental units in the commuter catchments for key cities. As the millennial generation, so-called 'generation rent', increasingly have families, demand is growing rapidly for the provision of rental homes.

Specialty sectors continue to attract strong investor interest. Buyers are concentrating on areas which are influenced by secular trends, such as data centers in key European cities, and life science facilities in the UK and Germany. However, in sectors such as data centers, European transaction volumes remain very low, resulting in stock which is difficult to access and extremely competitively bid. Longer-term, 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 recovery in these sectors.

European sector performance

	10-Year
12.79	Industrial
9.34	Residential
8.54	All
7.96	Office
7.38	Hotel
6.44	Other
4.06	Retail

Ranking of global sector total returns in the MSCI European Property Index (%)

2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Other	Hotel	Hotel	Hotel	Residential	Residential	Industrial	Industrial	Industrial	Industrial
Industrial	Industrial	Industrial	Industrial	Office	Industrial	Residential	Residential	Residential	All
Retail	Office	Office	Office	Industrial	Office	All	Other	Office	Other
All	All	Other	All	All	All	Office	Office	All	Residential
Hotel	Retail	All	Other	Retail	Other	Other	Hotel	Hotel	Hotel
Residential	Other	Retail	Residential	Hotel	Retail	Hotel	All	Other	Office
Office	Residential	Residential	Retail	Other	Hotel	Retail	Retail	Retail	Retail

MSCI European Quarterly Index (unfrozen, EUR).
Source: Invesco Real Estate using data from MSCI as of April 2022.

Overall, we believe real estate returns will continue to exhibit increasing asset-specific divergence within markets and sectors. In such periods of uncertainty, our strategies focus on themes which are expected to hold through the macro scenarios we envisage. As we head through 2022, this leaves us with a strong focus on assets which are insulated against inflationary pressures, and protecting against future interest rate increases. We continue to see ESG credentials and energy self-sufficiency as a growing focus for occupiers and investors.

We look to invest in line with our conviction themes including:
- well-connected Grade A office space which remains in strong demand but relatively short supply;
- logistics, supported by strong demand from e-commerce and near-shoring;
- hotel markets where both tourism and business demand will likely experience healthy recovery;
- and residential, with a focus on mid-priced private market apartments, as well as SFH, student and senior living for greater diversification.

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