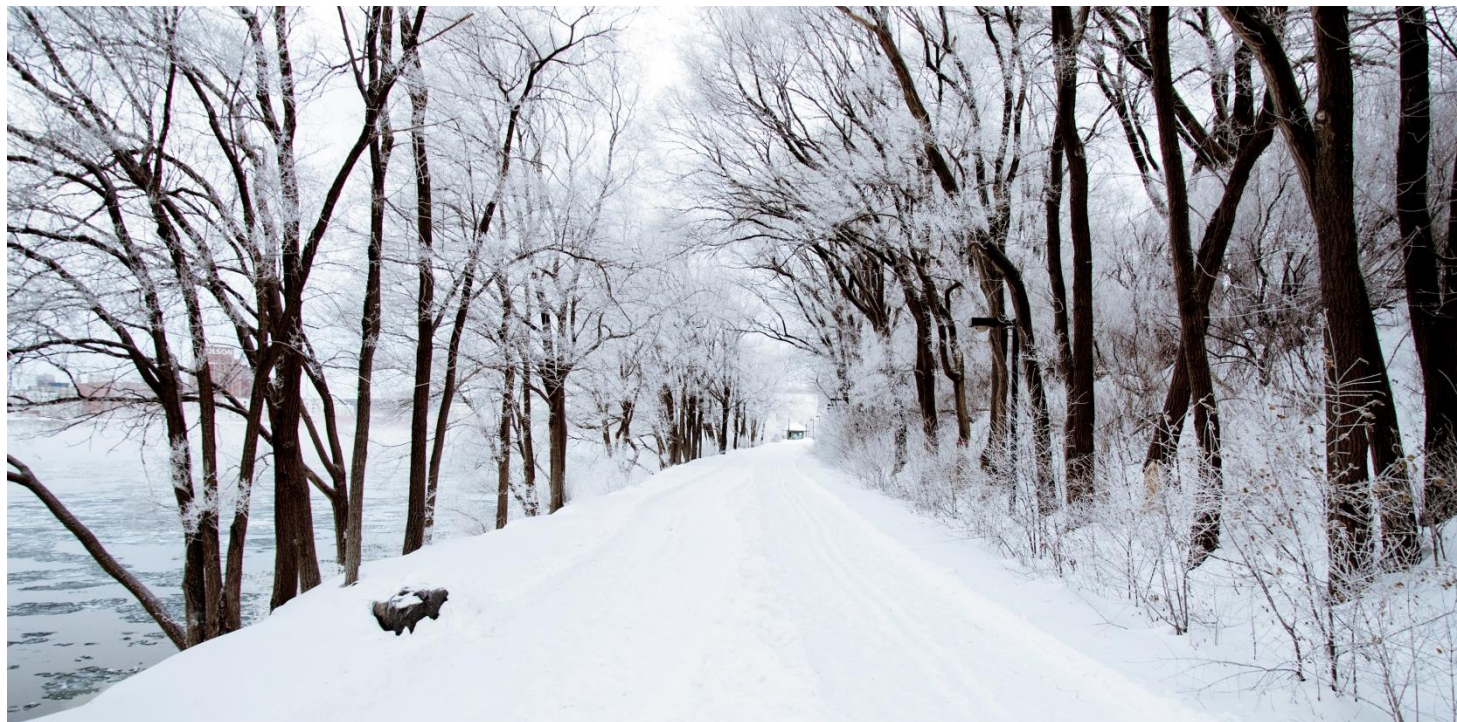


Real Estate Outlook

Edition 1, 2021



Cautious optimism.

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Global overview

Changing mainstream spurs **specialist sectors.**



The rollout of vaccines gives rise to cautious optimism that the economy will improve in the second half of the year as lockdowns can be lifted. Real estate investment activity has shown some pick-up but remains below pre-pandemic levels. Logistics property remains the focus for the main commercial sectors, with interest in niche and specialist real estate types being driven higher.

Macroeconomic overview

Cautious optimism for strengthening economy.

The COVID-19 pandemic continues to grip the world and weigh on activity. According to the World Health Organization, the total number of virus cases globally passed 100 million in January and the death toll exceeded two million. Extended lockdowns have been enforced across most European countries during the winter months and restrictions are also in place in the US. Asia Pacific is further ahead in the recovery and returning to more normal life in many parts, although some localized lockdowns have been needed to combat the virus, such as in Sydney, Australia.

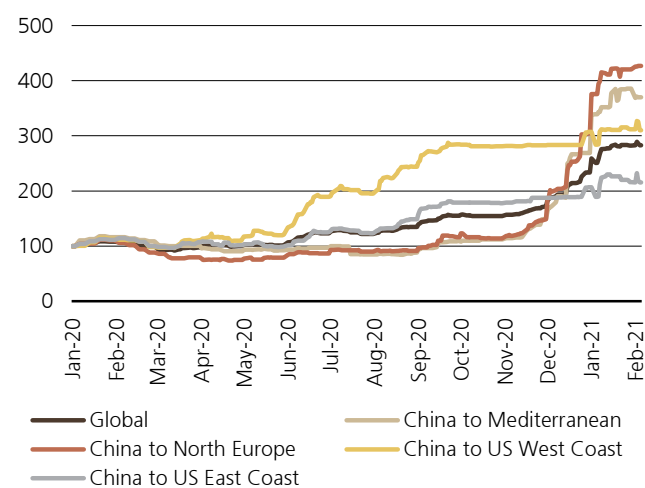
The rollout of vaccines began in late 2020, with three vaccines being used for the initial immunizations in western countries. The pace of the rollout has varied, with the UK and Israel leading the way, followed by the US. Other European countries have lagged due to delays in placing orders for vaccines last summer. There have also been some supply bottlenecks in the vaccine production chain, such as facilities being re-configured to ramp up production. These delays are not unexpected, but have stoked political tensions around the vaccine rollout.

Economies weakened in 4Q20 as new lockdowns hit activity and business surveys show many remained weak moving into 2021. Government statistics agencies reported that US GDP expanded 1.0% QoQ in 4Q20, eurozone GDP fell 0.7% QoQ while, according to estimates by Oxford Economics, Chinese GDP rose 2.9% QoQ. Arguably, the position of economies versus their pre-pandemic levels of activity is a better gauge of their underlying health. On this basis, US GDP was down 2.5% in 4Q20 from 4Q19, eurozone GDP was 5.1% lower while the Chinese economy was 6.5% larger. For the advanced economies, Oxford Economics estimates that GDP was 3.4% lower.

Weak economies and the precipitous drop in demand saw inflation tumble in 2020. Indeed, it turned negative in Australia and the eurozone, with a strong euro compounding downward pressure on prices in the single currency bloc. More recently though, some pockets of price pressure have been evident in the world economy. For example, global shipping costs have surged. According to media reports, shipping agents have said that the cost of transporting a 40-foot container unit from Asia to northern Europe has risen from around USD 2,000 in November to USD 9,000 in January. This has been mirrored in shipping cost indices (see Figure 1).

The sharp increases in shipping costs are due to stronger demand and a shortage of capacity on routes from Asia to Europe and North America. Empty containers were not returned to Asia once the pandemic struck and are scarce there now. Ports and shipping lines have also had their operations impacted by workers being unable to work due to the virus. The surge in prices looks unlikely to recede until later in the year when the industry has had a chance to normalize and clear the backlog. Prior to the crisis, shipping lines reported excess capacity in the industry.

Figure 1: Freightos Baltic index of shipping costs
(1 Jan 2020 = 100, USD)



Source: Thomson Reuters Datastream; UBS Asset Management, Real Estate & Private Markets (REPM), February 2021

The rise in shipping costs serves as a reminder of potential inflationary pressures. Energy and commodity price inflation will also likely move higher as prices rebound from crisis lows. However, inflation prints remain below target. Statistical agencies report that eurozone inflation rose to 0.9% in January, ending five months of deflation, and US inflation was 1.4%. Japan remained mired in a mild deflation of -1.2% in December. If the economy improves as expected, rising demand will likely exert some upward pressure on prices. Hence some increase in inflation is likely, but not the kind of spike or sustained rise which might prompt central banks to unwind their QE programs and raise interest rates aggressively. Such a scenario is a risk for real estate investors.

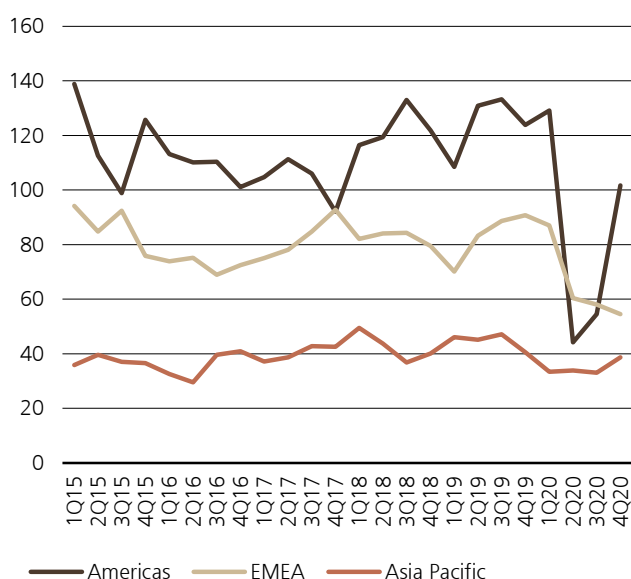
Capital markets

Some recovery in transaction activity.

Real estate investment activity varied by region in the second half of 2020. Having fallen sharply as the pandemic hit, transaction activity has started to recover in the Americas and Asia Pacific, while remaining weak in EMEA. This broadly reflects trends seen in the economies and the level of restrictions being imposed. According to Real Capital Analytics total global investment activity was USD 726 billion for 2020, down 28% from 2019. Despite the pandemic, all regions saw the usual sharp seasonal pick-up in activity in the last quarter of the year as investors completed deals before year-end.

After allowing for seasonal effects, the Americas showed a sharp pick-up in underlying activity in 4Q20 and Asia Pacific also rose, albeit by less. However, transactions in EMEA fell again, reflecting tougher lockdown restrictions in the region which impinged on activity (see Figure 2). Compared to 4Q19 pre-pandemic levels of activity, 4Q20 investment volumes were just 5% lower in Asia Pacific, 17% lower in the Americas, while EMEA lagged, where activity remained down by 40%.

Figure 2: Real estate transaction volumes (ex-land sales)
(USD billion, seasonally adjusted)



Source: Real Capital Analytics; UBS Asset Management, Real Estate & Private Markets (REPM), February 2021

There were significant differences by sectors. Other than hotels, at the global level all the main sectors showed a rise in activity in 4Q20, after allowing for seasonal effects. Compared to 4Q19, office investment volumes were down 34%, retail volumes down 30% while industrial volumes were little changed with a 3% drop. The resilience of industrial reflects strong investor interest in the sector. Apartment volumes were 6% lower while hotels remained very subdued, down 76% from their pre-pandemic level. The fall will have been exacerbated by declines in asset values too.

On the basis of valuations data released so far by MSCI and NCREIF, for Canada, Ireland, the US and the UK, office capital values showed single-digit falls for 2020 overall. In addition, retail values showed larger, double-digit falls, while industrial capital values showed single-digit increases. At the global all property level, we estimate that real estate values fell 2-3% in 2020 on a valuation basis. This would give a small positive total return on global real estate for the year. Capital values have held up well in the context of the Global Financial Crisis (GFC) when, according to our series based on MSCI and NCREIF data, they dropped 9% in 2008, the first year of the downturn. We attribute the current resilience to the swift and sizeable support from governments and central banks in 2020.

Large sector differences remained in pricing in the last quarter of the year. According to cap rate and yield data from CBRE, NCREIF and PMA office yields were generally flat, with slightly more markets reporting falls than rises. Retail yields continued to increase, up in 42% of markets and flat in nearly all of the remainder, while industrial and logistics yields fell en-masse, dropping in 54% of markets, and remained flat in the bulk of the rest. Pricing adjustment to the pandemic will take time to feed through the market and further price adjustment is likely in 2021.

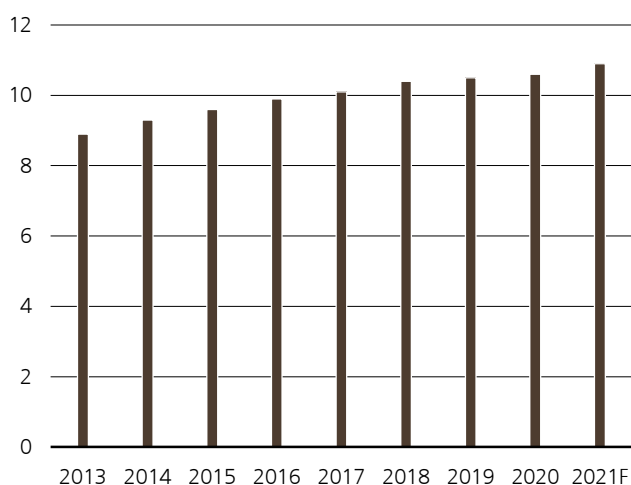
The listed market continues to reflect the sector differences seen in private real estate markets. According to FTSE EPRA NAREIT listed market data, by the end of January global industrial prices were 14% above end-2019 levels in USD terms, residential down 5%, offices down 20% and retail down 27%. At the country level there was less variation, with falls of around 15% in the markets of the US, Europe excluding the UK, Japan and Switzerland. Prices in the UK showed a slightly sharper fall, down 20% since end-2019, but having recovered from the lows hit when the pandemic struck last spring. The bigger fall in UK values reflects a relatively high exposure to the badly hit retail sector.

Strategy viewpoint

Focus on niche and specialist real estate.

The rotation to interest rates near zero around the world has been supportive of all risk assets. Indeed, investors also continue to be attracted to real estate because of its ability to generate income. For example, the 2021 ANREV/INREV/NCREIF Investment Intentions Survey reports that globally investors are targeting an allocation to real estate of 10.0% versus their current average allocation of 9.3%. Similarly, Hodes Weill & Associates's 2020 Institutional Real Estate Allocations Monitor report states that globally investors targeted a 10.6% allocation to real estate in 2020, which is expected to rise to 10.9% in 2021. The target has risen steadily from 8.9% in 2013 (see Figure 3). The rise reflects a gradual adjustment of investor portfolios to the low interest rate environment, and the improved accessibility of real estate as an asset class as new investment routes into it have become available.

Figure 3: Target allocations to real estate (%)



Source: Hodes Weill & Associates, December 2020

Investors looking to increase their real estate allocations must carefully consider their strategy. In the mainstream traditional sectors of office, retail and industrial very different trends are playing out now. There is significant uncertainty over offices. First, it is unknown how long the pandemic will last and keep large swathes of workers from using the offices that their employers are paying rent for.

Moreover, there is significant uncertainty over the impact that more flexible working arrangements will have on offices in the medium-term once the pandemic has passed. In retail, we expect further falls in capital values as structural change and the rotation to online drastically alter the retail landscape. Hence, for offices and retail the investment opportunities which exist will likely be asset specific. By contrast, at the market level we expect industrial and logistics to perform well, fueled by strong occupier demand pushing rents higher and heightened investor demand compressing yields. Multifamily also presents an option in markets where it is an institutional asset class.

Outside of the mainstream, investors will need to focus on niche and specialist sectors which have the potential to grow and deliver good investment performance. This includes areas such as data centers, lab space, medical offices and affordable housing. When investing in these more specialist areas investors will need to carefully consider their entry route and ensure that they are partnering with an advisor or manager who has the specialist knowledge and skills required to be successful when operating in these sectors.

Another potential area for investors to look at is pockets of distress in the market which lead to properties becoming available at discounted prices. So far though, we have not seen high levels of distress in the market resulting from the pandemic. However, typically it can take two years or so for distressed assets to work their way through the system, and given that retail values only really started to decline in earnest in some markets last year, distressed opportunities may not appear until 2022. Distressed sales typically occur when loan covenants are breached or investors need to sell rapidly for liquidity reasons.

Along with deploying capital to increase their allocations to real estate, investors will also be mindful of what will happen if inflation does pick up. We believe that real estate offers a partial hedge against inflation since in many cases rents within leases are indexed to an inflation measure and in the longer-term open market rents have tended to keep pace with inflation. Hence on the income side real estate is attractive, particularly assets with long, inflation-linked leases. The other aspect of higher inflation is its potential to prompt central banks to reduce liquidity, scale back QE programs and increase interest rates. This would likely push discount rates higher and weigh on all risk assets, real estate included. However, for central banks to move they would need to see a sustained and enduring pick-up inflation rather than a transitory increase which is partly driven by base effects.

Real estate investment performance outlook

2020 forecast and 2021-23 outlook are measured against the country-sector's long-term average total return, with a margin of 100bps around the average described as *in line with long-term average*. The long-term average refers to the period 2002-19. The red underperformance quadrant refers to negative absolute total returns, either in 2020 forecast or the 2021-23 outlook.

		LTA	Office	LTA	Retail	LTA	Industrial	LTA	Multifamily
North America	Canada	9.5		10.3		10.1		n/a	
	United States	7.9		9.9		9.9		8.3	
Europe	France	8.0		10.1		9.1		n/a	
	Germany	4.5		5.5		7.3		n/a	
	Switzerland	5.6		6.3		n/a		6.3	
	UK	7.5		5.9		9.5		n/a	
Asia Pacific	Australia	10.3		10.1		10.8		n/a	
	Japan	5.3		5.5		5.9		5.2	

: Forecast 2020 : Outlook 2021-2023

: Underperformance (negative absolute returns)
 : Underperformance vs. long-term average
 : In line with long-term average
 : Outperformance vs. long-term average

Source: UBS Asset Management, Real Estate & Private Markets (REPM), February 2021. Note: Abbreviation LTA: long-term average. Past/Expected performance is not a guarantee for future results.



Toh Shaowei
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APAC outlook

Still under **the weather.**



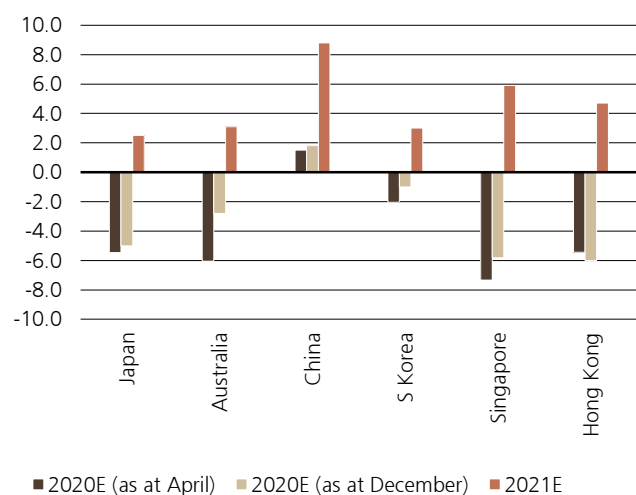
Most major APAC economies will bottom and reverse the growth decline by year-end. The general prognosis for 2021 is less negative but occupier performance will continue to face pressure. Real estate investors into APAC should not get carried away by expectations that the vaccine is a silver bullet and relax underwriting standards. Remain on the lookout for tactical opportunities arising from the pandemic.

Real estate fundamentals

The sun peeks through the clouds.

The encouraging news of the vaccine roll-out brought much optimism to Asia Pacific (APAC) markets towards the last few weeks of 2020. It could not have been timelier, as several economies such as Japan and South Korea are now grappling with a resurgence in COVID-19 cases that threatens to undo all the good work done in containing the virus. In other markets, there have been sporadic waves of community infections, but it can be argued that APAC governments are becoming adept at nipping the spread in the bud, preventing major clusters from forming. This level of diligence has been the hallmark of the APAC battle against the coronavirus, and it provides much needed confidence to investors who are watching very closely.

Figure 4: GDP growth by market (annual, real, %)



Source: Oxford Economics, January 2021

The fluid nature of the situation manifests itself in the growth prospects for various markets. In a way, forecasters have been revising the outlook for APAC economies regularly, taking into account high frequency data such as trade, investment and consumption figures. We have seen many iterations of GDP growth within APAC. In general, the adjustments have been mostly positive as markets display their resilience, supported by massive fiscal and monetary programs.

Amongst the major economies globally, China is looking to be the only one to record positive growth in 2020, followed by a strong rebound in the region of 8.8% in 2021 (see Figure 4). This is of much importance to the region, as a resurgent China will carry the APAC economy, particularly given the tight trade and supply chain linkages. Oxford Economics expects that most major APAC economies will bottom and reverse the decline by the end of 2021. The Purchasing Managers' Index (PMI) for Asia is a good leading indicator of business conditions and sentiments. We have seen a consistent recovery in the PMI since the trough in April 2020 when it was touching a low of 38. As at December 2020, Asia's PMI has reached a three-year high of 53.6. Part of that had to do with the restart of China's economy. However, it is too early to cheer. A concerted recovery in the US and Europe is needed to truly pull APAC out of the trenches.

Real estate investors should take heed not to get carried away by expectations that the vaccine is a silver bullet, and henceforth relax their underwriting standards. The underlying assumption is that inoculation programs are rolled out over the course of the next two years, and economic activity will normalize gradually. This process is bound to be uneven. In a downside scenario, bouts of fresh infections may lead to some markets having to undertake lockdown measures again. Most APAC governments have proven to be resolute in that regard, even if it brings about near-term economic pain. In short, the sun is hiding behind the clouds. We advise investors to stay circumspect while keeping an eye out for pockets of opportunities in key APAC markets.

Office

It is fair to say that APAC office markets are happy to put 2020 behind them, as the pandemic led to declines in rents across the Grade A segment. Data from CBRE suggests that net absorption in 2020 in the Grade A office segment was the lowest seen in the last 10 years across APAC, coming in at approximately 2.9 million sqm. Clearly, renewals and expansions were not forthcoming in 2020, as existing occupiers looked to reassess their office requirements while taking the pulse of the economic environment. That was a major drag on overall market rent performance (see Figure 5). The general prognosis for 2021 is less negative but key APAC markets will continue to face pressure on occupier performance, albeit in a less drastic manner.

Across the region, office completions in 2021 are expected to be on par with that in 2020. We saw some delays last year due to interruptions to work sites as well as the postponement of construction starts, and that helped to spread out the supply pipeline slightly. Some markets will feel the impact more than others. In Shanghai and Beijing, sustained construction activity suggests that CBD office vacancy rates will stay elevated and above 15% in the next few years. The bulk of the new supply will come through the competing decentralized areas.

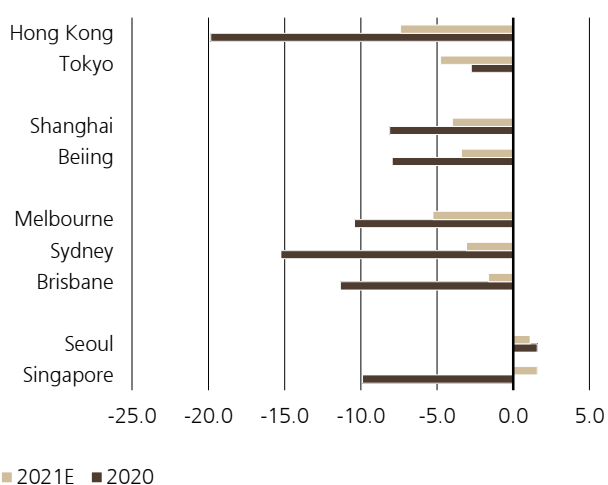
In Beijing, the diversion of demand has been acute, as we saw more than half of new leases in 2020 being committed in decentralized locations, partly also a flight to safety response due to lower occupancy costs. In Shanghai, more than three quarters of leasing activities took place in decentralized areas in 2020. To be sure, decentralized office locations are increasingly accessible, making them better substitutes nowadays, and this will continue to be a trend in the Chinese office markets.

In Sydney and Melbourne, the increased adoption of telecommuting has led to some firms putting their office space up for sub-lease. In these markets, vacancy rates are expected to rise to levels last seen in the Global Financial Crisis (GFC), at more than 8% conservatively. Tokyo and Seoul are two markets where the impetus for telecommuting has been somewhat muted. That helped to support office market occupancy throughout the pandemic. Together with Singapore, these markets will not see major supply in the next two years at least, which is supportive of rents.

Logistics

While high quality industrial space continues to be desired by tenants, especially those operating in the e-commerce area, elevated levels of supply have kept the lid on rent growth in the prior years before 2020. The immediate and sharp surge in demand due to the pandemic led to an outperformance in rent growth that will persist into 2021, albeit on a moderated basis. Data from PMA points to rent growth between 2% and 3% in 2021 for key prime logistics markets in APAC (see Figure 6).

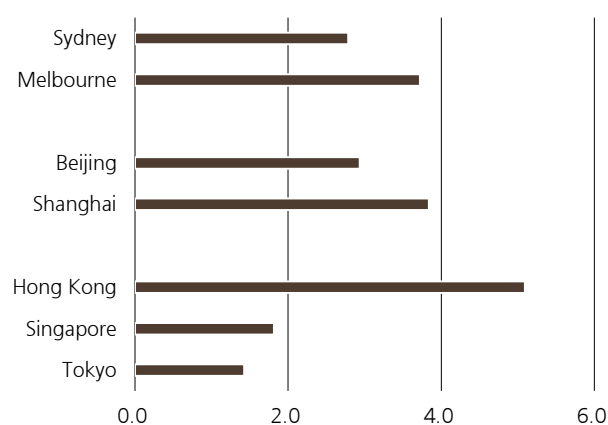
Figure 5: Grade A office rent growth (% , annual)



Source: CBRE, January 2021

Even as the macro outlook improves, we note that professional firms and financial institutions are starting to return some space and rationalize their office footprint. That will inadvertently add to secondary and shadow space. Will technology firms come to the rescue this time? In the last cycle, as recently as 2018, co-working firms picked up the slack from a softening office market. In this cycle, we have been seeing some relentless expansion by technology firms which have been relatively unscathed by the pandemic. That will offer some support, but will not plug the gap entirely.

Figure 6: Prime logistics rent growth 2021 (% , annual)



Source: PMA, November 2020

Prospects for China's logistics sector are underpinned by structural changes in the economy. Chief of this is the rise of the consumer class, partly driven by growing urbanization and rising income levels. The story has been playing out for many years and is expected to continue. China's logistics sector, however, is not just driven by domestic consumption and e-commerce. According to PMA, the retail sector accounts for 41% of China's logistics demand and third-party logistics (3PL) players make up 24%, while the manufacturing sector is also a major contributor with a 28% share. China's dominance as a global manufacturing center will thus be a key factor for the logistics sector. To that end, the government is pushing for an upgrade of the industrial sector through national strategies such as the Dual Circulation strategy.

In Sydney and Melbourne, demand from grocery operators and 3PLs spiked in 2020, but tenants highly dependent on international trade basically had little cashflow in the past few months as global ports and airports remained shut. That partly led to incentive levels reaching a decade high. On a blended basis, there is some weakness in the overall leasing market, as rent growth moderates in 2021. The winners and losers will be more defined, with high quality assets set to be more resilient during and after the pandemic.

Over at Greater Tokyo, despite the high volume of upcoming supply in the pipeline, oversupply risk is considerably lower than what it appears to be on paper. The pre-commitment rate for upcoming schemes stands at approximately 80%, with at least half of the upcoming completions being fully pre-leased already. With continued investor interest focused on Tokyo logistics development, vacancies are set to steadily rise to around 5% by 2024. However, overall supply-demand dynamics should remain generally balanced.

Retail

In the retail sector, leasing demand in key APAC cities of Japan will remain focused on prime high streets, essential retail formats and locations that will see returning demand from tourists. In the near-term, the lack of inbound tourists and weak retailer sentiments will cancel out the relaxation of social restrictions as domestic consumers continue to tighten their purse strings. After falling by approximately 10% in 2020, we expect a decline in prime retail rents in the range of 2-5% in most APAC markets in 2021, with Hong Kong being a key outlier (5-10%). Markets such as Hong Kong and Singapore are reliant on inbound tourism because of their limited domestic consumer base, and they will continue to see weak retail performance.

The Spring Festival holidays in China will boost retail sales, but in a slightly different manner this year. As the pandemic rages on, the authorities are discouraging the annual travel rush in which typically more than 400 million people will make approximately 1.5 billion commuting trips in total, over this 40-day period. Stricter measures around domestic travel are being imposed by local governments and that will likely divert the retail spending back to key cities as many migrant workers remain in place.

In Japan, there have been casualties from the pandemic, as some major domestic retailers are downsizing or even ceasing operations. That said, many international retailers are still looking towards the Japanese markets. Luxury brands such as Hublot, Chopard and Louis Vuitton, to name a few, have opened flagship stores in Osaka and Tokyo in the past few months. CBRE expects prime retail rents to drop by 4.3% over the next two years.

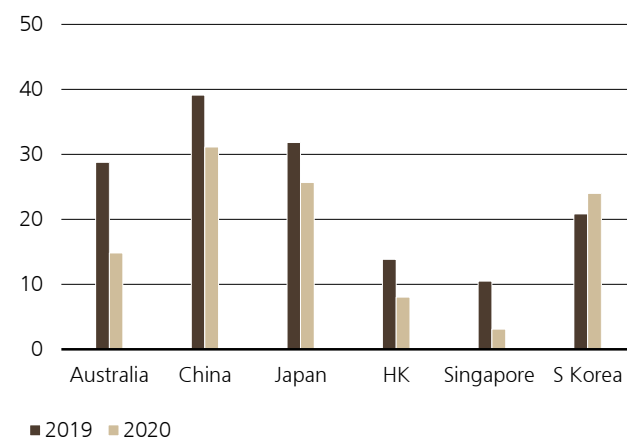
National retail sales have held up better than expected in Australia with a forecast full year decline of just -1.4% over 2020 as strong government and central bank support measures have largely sustained jobs and spending. However, spending has been very much directed towards essential items (food and pharmacy) and household goods, and away from discretionary items. On the supply side there is very little new space coming through, with a high possibility of delays, and some schemes being scrapped altogether. Over the longer-term, Australia's high population growth (once borders are re-opened) and low retail supply should support some rental recovery in Sydney and Melbourne, although we expect rents to stay below 2019 levels.

Capital markets

Pockets of rain.

According to preliminary data from Real Capital Analytics (RCA), total transaction volumes of APAC commercial property fell by approximately 23% YoY in 2020 (see Figure 7). On a sectoral basis, it does not come as a surprise that retail and hotel transaction volumes plunged by around 41% YoY and 53% YoY, respectively.

Figure 7: Commercial real estate volumes (USD, billion)



Source: RCA, as at 29 January 2021

The uncertainty around the outlook for the retail and hotel sectors will not dissipate immediately even with the positive news on the global rollout of vaccination programs. There is capital sniffing around for distressed opportunities where the market dislocation might offer a good entry point.

We have did not see much distressed selling in 2020, as government support measures helped to buy some time for cash-strapped asset owners. The experience from the GFC tells us that the window for distressed sales typically happens in the next two years from the peak of the crisis. As governments start to taper down on support schemes, a fiscal cliff scenario looks increasingly probable, and that is likely going to separate the chaff from the wheat, leading to more distressed opportunities.

South Korea was the standout performer in the APAC region in 2020, as commercial real estate volumes jumped by 15% YoY, reaching a historical high of USD 24 billion. Both cross-border and domestic investors were active, with the latter's appetite for core office assets increasing due to limited opportunities offshore. CBD office cap rates compressed by almost 50bps in 2020, touching a low of 3.9%. Even so, 2021 is looking to be a strong extension of the previous year, with some transactions already undergoing due diligence. Investment volumes in both China and Japan contracted by 20% last year. Domestic buyers and end-users dominated the scene in Shanghai making up more than 80% of the transaction volumes.

Over in Beijing, local technology companies flexed their muscles, taking advantage of softer pricing to expand their office footprints. It is likely that 2021 will see a pivot towards domestic-led investments as the external geo-political environment continues to simmer. In Japan, we saw greater investment interest from cross-border capital, mainly due to how well Japan handled the pandemic in the first three quarters of 2020, coupled with an attractive yield spread across sectors such as office and multifamily. In contrast, a depressed stock market saw J-REIT activity subsiding but that is gradually reversing track.

The Hong Kong government abolished the double stamp duty on commercial property in late November 2020, effectively reducing stamp duties by almost half. That is likely to jumpstart the commercial property investment market. We expect the industrial sector to see the most action, as the Industrial Revitalization Scheme goes hand in hand with the cut in stamp duty.

Singapore saw the steepest drop in investment volumes in 2020, by almost 70% YoY. Let's not be misguided by that figure. The closure of borders had a disproportionate impact on investment activity, more so in a small market such as Singapore. In the latest joint report by the Urban Land Institute and PwC, Singapore was ranked first in APAC for investment prospects in 2021. What happened on the ground was a temporary shift from institutional activity in the commercial space towards high net worth individuals and family offices, focused on prime residential and shophouses. This is a true testament of Singapore's effective response in the fight against COVID-19.

Strategy viewpoint

The end of the rainbow.

Investors are searching for that pot of gold at the end of the rainbow, for when the pandemic is behind us. It feels simple enough for most investors who are piling into sectors where there is conviction around structural changes arising from the crisis. We have seen a surge in interest in data centers, last-mile logistics, and cold storage, amongst others. These are sectors that have emerged strong and are likely to endure. However, it is often a case of too little too late for recent entrants into these segments where returns have already been compromised to some extent. We believe there are also opportunities that are related to the pandemic but not direct plays, which could also lead to that elusive pot of gold.

Australia's multifamily sector: COVID-19 might have disrupted Australia's population growth story as net migration took a backseat. However, we strongly believe that the population growth momentum will resume. The pandemic has further exposed the weakness in the housing system where a chronic undersupply of housing threatens the socio-economic fabric, leading to a generation of renters in Australia. Various states have become more open to the idea of a private sector led multifamily initiative to solve the housing crisis, and that throws up tremendous opportunities for investors into this nascent sector.

Prime retail in Japan: A counter-cyclical play on prime retail in the key cities of Tokyo and Osaka may appear reckless today, but is likely to be astute. The underlying premise is that tourism has taken a beating but once the pandemic is brought under control, the situation will normalize. More prime retail assets are being re-priced in Japan as the current situation remains uncertain. At the right entry price, investors with longer holding periods may be able to undertake value-add work on retail assets and ride the structural rebound in tourist numbers.

Distressed acquisition in China: In August 2020, the People's Bank of China and the Ministry of Housing announced new financing regulations, assessing real estate developers against thresholds called the *three red lines*, which include the liability-asset ratio, net gearing, and cash to short-term debt metrics. The pressure on Chinese developers to ease up on leverage is intense and there is an urgent impetus to secure financing in a market ravaged by the pandemic. Many developers are now open to disposing of their non-core commercial property assets, and we believe it creates a tactical window for investors to gain access to a market that is traditionally tight on asset availability.



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European outlook

Nearly out of **the woods?**



The European economy ends 2020 fairly battered and bruised as the second wave of the COVID-19 pandemic hit hard, both in terms of infections and the wider economy. Offices are showing some weakness on the occupier side, while retail continues to struggle. Logistics has been going from strength to strength, however, as have alternative sectors such as residential. Overall, capital markets remain buoyant as there is significant dry powder targeting real assets.

Real estate fundamentals

Uncertainty remains high.

Economy

The eurozone endured an especially torrid 2020, with an outbreak in 4Q necessitating the reimposition of quarantine measures across the bloc. This derailed the mechanical bounce back from 3Q, meaning GDP shrank by 0.7% in the fourth quarter, with an expectation that the first quarter of 2021 will see further falls. Overall, European countries are faring worse than other locations in terms of restrictions, especially Asia which appears to have largely contained the virus.

The recovery in 2021 is likely to be more muted than initially projected due to issues with vaccine distribution. The only exception to this is the UK, which at the time of writing has dispensed over 9 million doses of the vaccine. This briefly caused a spat between the newly separated UK and its former spouse the EU, which was quickly resolved. As a result, we are expecting a GDP recovery of around 4.6% this year, which will mean the economy is still smaller at end-21 than it was at end-19.

The silver lining at this stage is that governments, companies and consumers appear to have adapted somewhat to the challenging conditions as GDP is not falling by anything like the double-digit figures seen in the first lockdown. Manufacturing PMIs were reasonably robust in January and indeed industrial production has been far more robust this time round.

There has actually been signs of a capacity shortage in global shipping as companies which sold off old container stock were hit by a surge of demand in the run-up to Christmas, causing prices to increase significantly. Indeed, retail sales were only around 1% down for the year, as consumers found ways to rotate spending away from areas such as hospitality and travel into things like DIY and groceries.

However, the economic damage of the various lockdowns is starting to become apparent with unemployment ticking up in the official figures, and surging in various other alternative measures such as hours worked. This suggests that the actual level of inactivity may be greater than the headline figures suggest, which are nonetheless expected to exceed 10% this year according to Oxford Economics.

Offices

In terms of real estate occupier markets, offices have understandably taken a hit in leasing demand. Anecdotal evidence suggests letting markets had been quiet for most of the fourth quarter, as renewed lockdown measures forced companies to be more cautious about taking on new leases. There has also been a significant amount of lease breaks exercised in the City and West End of London, as occupiers have taken the opportunity to re-evaluate their office needs. In terms of rental performance, growth for the year was still fractionally positive at 0.2%.

However, the only growth was recorded in the first half of the year, with 3Q and 4Q seeing rental declines, though it is a fairly mixed picture across Europe. Central London has seen a YoY decline of around -8% as home working has been especially widespread in the UK capital, whilst values saw growth of around 6% over the course of 2020, possibly receiving a boost from pan-European occupiers selecting a new HQ after Brexit. The major German markets were broadly flat with only previous fast-growers, Berlin and Hamburg, seeing rental declines.

Elsewhere, Milan and Rome saw rents unchanged while Barcelona and Madrid both saw declines of around -1% YoY. We would expect rents to stay largely flat over the next couple of years, due to the impact of the pandemic on work/life habits. We anticipate there will still be a place for the office, but major occupiers will most likely require fewer and better-quality spaces, which will lead to a polarization in performance between prime and secondary.

Retail

Retail continues to suffer in the wake of ongoing structural changes and the impact of the pandemic on trading operations. Up to this point the retail apocalypse has been regarded as a predominantly Anglo-Saxon phenomenon, with the biggest impacts seen in the UK and the US. There are now signs that the continent is catching up, with pan-European prime rents down by around 8% YoY. Another former narrative has been that prime will most likely outperform secondary. This appears to no longer to be the case, with multiple prime schemes in Europe seeing asking rents fall away.

According to CBRE, the UK continued to bear the brunt of falls with most major centers seeing declines of between 20-30% YoY. What was different this quarter, is that London also took its share of the pain, with the ballast of high tourist flow taken away. Rents in the City and West End both fell by 24% YoY. Other European cities were not exempt, however, as prime high street rents in the major German markets fell by 15-20% YoY, Paris by 15% and Madrid and Barcelona by 13% and 17% respectively. The only major centers to hold firm were Milan and Rome, where rents remained stable.

Shopping centers were similarly impacted with rental declines of between 10-20% YoY in the major French cities, ~20% in Germany and 25-30% in the UK and Spain. The Netherlands saw slightly more moderate falls of 5-10%, while Italy once more managed to hold the line, with prime rents stable in Milan and Rome.

We would expect rental declines to continue into 2021, especially in mainland Europe which has further to go than the UK. The one silver lining of the pandemic is that it will most likely force retail landlords to confront their problems head on and focus on repositioning and repurposing assets so that they are better suited to the new normal.

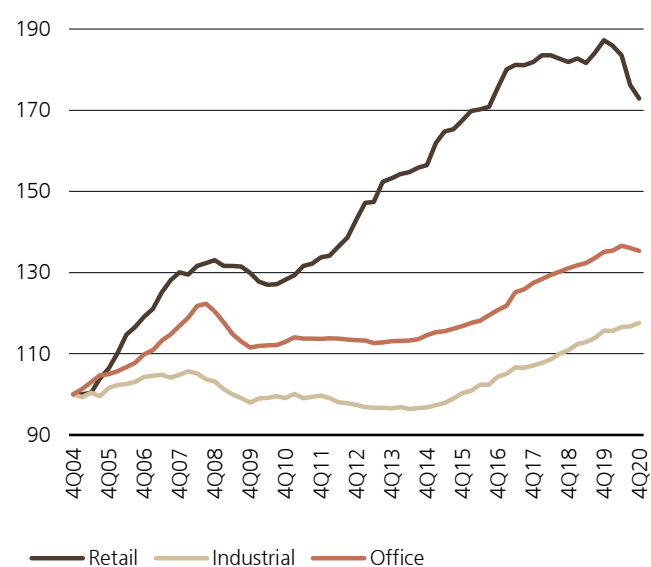
Industrial

Industrial and logistics has very much received a second wind in the wake of the COVID-19 pandemic, as e-commerce occupiers have been stretching to deal with a surge in demand from homebound shoppers and manufacturers keen to de-risk their supply chains by keeping more inventory closer to their home markets. As a result, rent have continued to grow at a brisk, if unspectacular, pace of 1.6% YoY (see Figure 8). The UK has seen particularly strong growth with rents increasing by around 4.8% in the South East and 4.3% in the North West. Germany also saw relatively strong performance with Dusseldorf achieving growth of 5.2%, while Paris (4.5%) and Marseille (6.4%) in France also enjoyed a good year.

In terms of supply, European markets are still seeing relatively low levels of vacancy, particularly in and around urban areas where rental has been especially strong. The exception to this is Polish centers, where logistics stock has grown very rapidly in the past two years and Madrid which has also seen high levels of building construction.

Going forward, we would expect industrial and logistics to still be a strong performer with the supply and demand imbalance in the market likely to drive further expansion in rental values.

Figure 8: Eurozone rental index (4Q04 = 100)



Source: CBRE, 4Q20

Capital markets

Still healthy activity despite fundamentals.

While investment volumes have understandably taken a hit in the wake of the COVID-19 pandemic, the impact has been less pronounced than in the occupier markets especially for well-located, good-quality assets. European investment volumes were down by around 27% when compared with the previous year (see Figure 9), however, December showed a year-end boost to deal flow. Single asset and portfolio deals were down considerably when compared with the previous year, however, the 10% upturn in entity level deals demonstrates the resilience in the industrial sector, as investors became frustrated with the lack of individual buying opportunities in the most prized sector.

As a result, it's hardly surprising that industrial fared the best, with volumes showing a very moderate 6% decline on the previous year. The other favored sector – apartments saw just a 15% decrease – while development sites were also fairly resilient at -8%. At the other end of the spectrum, offices saw volumes tail off by around 35% as the largest asset class became mired in uncertainty over the future direction of homeworking.

At the same time, hotels saw volumes collapse by 65% as lockdowns posed an almost existential threat to some operators. Retail surprisingly only saw volumes decline by around 21%, but that must be taken in the context of precipitous declines in recent years meaning retail is now the smallest of the three main commercial sectors in terms of trading volumes.

Ironically, the fall in volume has yet to really impact pricing. While the effects of the pandemic have actually injected more liquidity into financial markets due to central banks keeping rates at near-0 levels, governments are planning fiscal stimulus and increased savings have given rise to a new army of retail stock investors. The GameStop saga in which an organized band of Reddit users successfully instigated a short squeeze on an established US hedge fund demonstrates the power of this trend.

However, it is unclear if this will become a permanent feature as with retail investors' loss aversion tends to be high and patience low. Nonetheless, this demonstrates the potential of new low-cost trading apps, disposable income and internet organization.

As a result, yield movements have been relatively minimal with most European office markets still seeing prime yields compress over the year, despite the likelihood of rental declines over the next few years. Prime office yields ended the year at 3.45%, largely consistent with where they were at end-2019. Most remarkably, yields actually compressed in 3Q and 4Q, having edged out in the first half of the year despite the ongoing concerns about the pandemic and home working.

There have been a number of high-profile transactions for core, long leased assets in major cities. The sale of the Finance tower in Brussels was the largest deal of the year at EUR 1.2 billion, while several large office towers exchanged in Frankfurt and Paris, including an acquisition of a largely vacant scheme by Allianz.

Retail investment remains highly restricted with liquidity disappearing from the market for all but the best in class assets. However, the decline was less pronounced than for other sectors, as the year saw several disposals by high profile shopping center Intu properties, including Intu Puerto Venecia in Zaragoza, Spain for EUR 475 million. Nonetheless, prime yields moved out by around 50bps on average, with non-core markets and secondary assets thought to have suffered more.

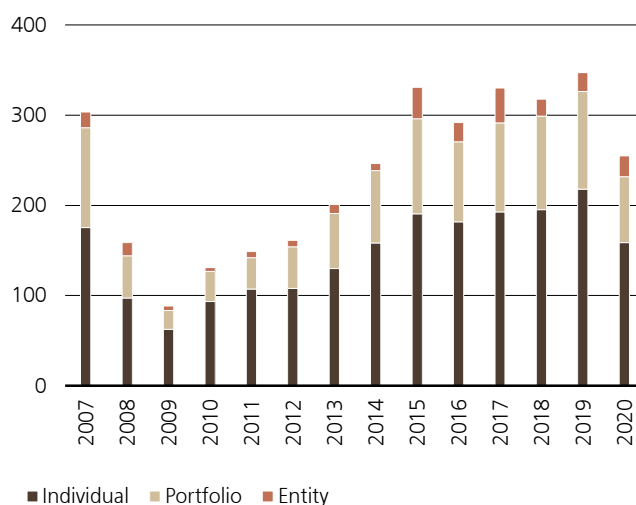
By way of example, the biggest outward movers were the UK regional cities, as Glasgow, Birmingham, Leeds and Liverpool all saw yields expand by 125bps. Prime London, conversely, saw yields expand by just 50bps, and this was from an exceptionally low level of 2.25%.

Industrial and logistics saw very resilient volumes, and considering sentiment in the market, it is likely the -8% decline on 2019 was more due to a scarcity of product than a fall in momentum. Indeed, yields compressed by 30bps on a pan-European basis, with much sharper declines for assets located close to major cities and key distribution areas. An urban logistics opportunity in London, for instance, traded for an initial yield of 2.9%.

The key indicator of demand surpassing supply was the high volume of entity level and portfolio deals in 2020, which were largely focused on the industrial sector. Goodman's acquisition by GLP and GIC's purchase of a JV created by Palmira and Apollo are a couple of examples of this trend as investors tried to efficiently scale their exposure to the industrial sector.

The alternative sectors remained popular, with apartment volumes only marginally down (-15%), although students and hotels have been hit by lockdowns across Europe. We would expect momentum to increase in these sectors as question marks remain over the viability of retail and office properties and industrial becomes increasingly keenly priced.

Figure 9: European investment volumes (EUR billion)



Source: RCA, 4Q20

Strategy viewpoint

A sleeping giant? The UK Build-to-Rent sector.

Despite being the largest commercial real estate investment market in Europe, until very recently the UK did not have an established institutional build to rent (BTR) sector. This is starting to change – in 2020 investment volumes in the sector reached a record high at GBP 10 billion, accounting for 10% of total volumes. But even at this record level it remains well behind established BTR markets such as the US and Germany, where it accounted for 33% and 27% respectively.

This relative immaturity is a key attraction of entering the UK market now. Development to date has been focused in London, and although there are a few schemes emerging in the main regional markets the proportion of genuine purpose-built rental space across much of the UK is very small compared to the non-institutional market. The UK is a fundamentally undersupplied residential market – the government has a target of building 300,000 new homes per year yet since the Global Financial Crisis (GFC) completion levels have rarely exceeded 200,000 homes per year.

The demand side is also strong. Although the UK has a strong culture of home ownership, there are signs that renting for longer periods is becoming more acceptable and, in some cases, preferable. Part of the issue has been a very negative conception of the rental market, which has been dominated by small scale *Mom and Pop* investors.

But with institutional schemes following in the models of the US and other parts of Europe the benefits, particularly to young professionals renting in high quality, fully managed accommodation with a strong range of amenities on site are starting to be appreciated. Renters may still aspire to home ownership, but with the average age of a first-time buyer now standing at 35 in London and 32 in the rest of the UK, there are many years of accommodation which still need to be provided.

And for some, the ease of having rental accommodation rather than some of the restrictions and challenges which come with home ownership, may support further demand for rental space beyond the point they could afford to step onto the housing ladder.

Part of the challenge for investors has been accessing the sector. There are relatively few stabilized schemes in the UK, and as most of these have been developed in the past few years, they are not available to trade. And when stabilized schemes do start to come to the market, they are going to be very expensive. To build diversified exposure to the UK market, a development partner with pan-UK coverage is essential. Without a skilled partner in place with local expertise in the key markets, navigating the UK's convoluted planning system and delivering the right quality of product could prove challenging.



Tiffany Gherlone
Head of Real Estate Research
and Strategy – US



US outlook

Real estate **careful recovery.**



Increased transaction activity late last year reflects pent-up investor demand for real estate assets, with a clear preference for industrial and apartments as 2021 begins. We expect retail and office to continue to face headwinds even as the economy improves.

Real estate fundamentals

Fortitude required.

The US economy is recovering from the depths of distress realized in 2Q20, even as political disputes and surging COVID-19 infections impede progress. We expect vaccine distribution and economic recovery to accelerate by mid-2021. QE supports persistent wide spreads, which positions real estate well relative to other asset classes.

Downturns are rare in private commercial real estate, but when they happen, the disruption brings new and unique opportunities for investors. Some weakness should persist into 2021 as effects from the pandemic and 2020 recession ripple through society and the economy.

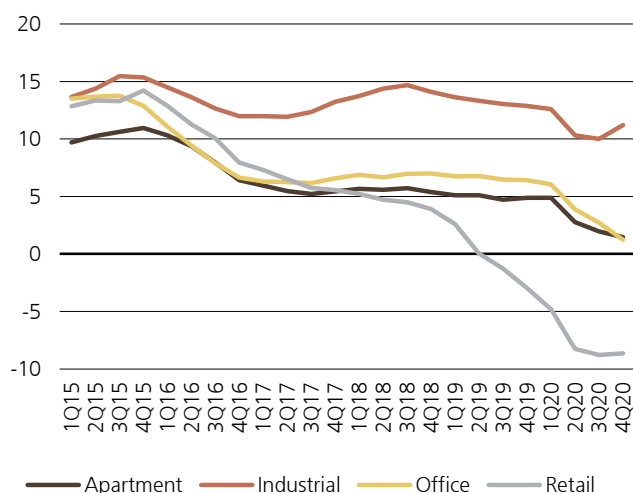
The NCREIF-ODCE Fund Index, shown in Figure 13, illustrates how income return offset depreciation in private commercial real estate resulting in a positive total return of 1.3% QoQ in 4Q20 and 1.2% for the full year of 2020. The hotel and retail sectors continued to be the most directly impacted by lingering effects of the pandemic.

Office performance has been protected by contractual lease agreements, however, the outlook for office demand and future performance is uncertain. The short lease cycle and necessity of apartments keep the sector poised for steady recovery. Fundamental evolution of the industrial sector has kept performance steady in this increasingly agile sector.

Divergent sector return performance remained exaggerated over the quarter. Retail posted a negative total return after nearly three years of negative returns. Apartments and office returns slowed in 2020 (see Figure 10). Industrial returns held in the double-digits. In 2021, we forecast positive returns for industrial and apartments but negative performance in office and retail.

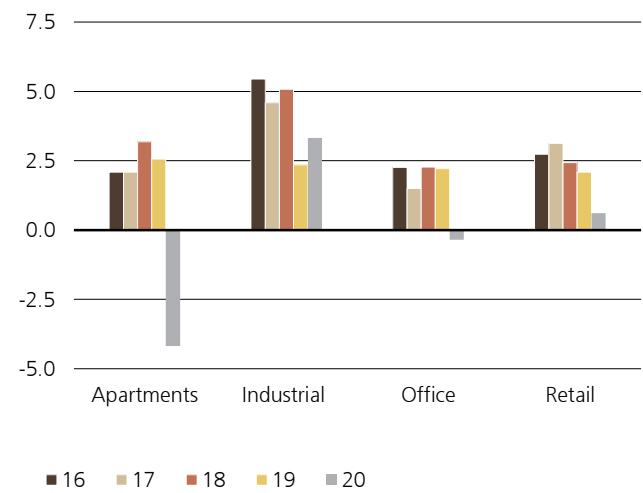
As the year progresses, positive news on vaccine distribution, competitive lending markets, and fiscal stimulus should support a meaningful rebound in economic growth and a turnaround in aggregate real estate performance. In this low interest rate environment, real estate should continue to be viewed as a good portfolio diversifier and a pathway to sustainable and impact investing.

Figure 10: US real estate total returns by property type
(rolling four-quarter total return, %)



Source: Data show unlevered NCREIF Property Index total returns filtered for only ODCE managers. Past performance is not indicative of future result, December 2020.

Figure 11: Property sector rent growth
(YoY change, in quarters ended 4Q20, %)



Source: CBRE-Econometric Advisors, 4Q20. Note: retail rent growth only reflects Neighborhood, Community and Strip Shopping Centers, thus excluding Malls, Lifestyle and Power Centers.

Apartments

Apartments vacancy is up 30bps from one year ago (see Figure 12), a modest increase under the circumstances, according to CBRE-EA. Average asking rents are down 4.2% YoY (Figure 11); indicating that landlords are allowing rent to slip in favor of filling vacancies. The apartment sector's ability to monetize changes in the economy quickly, coupled with low capex burdens, position the sector well in 2021.

Find opportunity

Apartment returns held up overall in 2020, but it was a year of mixed results. Housing is a necessity, and consumers prioritized paying rent. Buildings actively leasing-up typically faced elevated concessions. Metros with large downtown clusters or high construction levels suffered most. Inner-ring suburbs with proximity to employment, transit connections and moderate rents appear attractive, abrupt employment recovery could drive short lived demand surges. Disruption to transactions, permitting, and construction could lead to reduced supply in some markets over the coming years.

Industrial

The 2020 holiday season was dominated by online shopping and consumer direct shipping. Maintaining a position as the least volatile sector, 4Q20 industrial availability was just 10bps higher than one year ago. 2020 YoY rent growth remained healthy at 3.3%, as tracked by CBRE-EA.

Challenge old trends

Supply chain disruptions and logistics challenges were no match for sustained customer demand in 2020. Growing investor appetite should reinforce good performance while tenant demand is supported by accelerating online ordering and increasing inventory build-up. Industrial's low capex requirements supports flexibility. High-tech firms may begin to require a changing skill set with more expertise in automation and digitalization. Warehouse and distribution still dominate, but opportunities are growing to seek further diversification within modern industrial portfolios through emerging concepts in ESG, technology, in-fill, cold and self-storage.

Office

Total office vacancy surged 280bps over the year to 15.0% in the fourth quarter. According to CBRE-EA, 2020 saw nearly 40 million sqft of new supply delivered into a market with rising availability. Downtown vacancy has risen to 13.8%, 350bps; while suburban vacancy, at 15.6%, is 240bps above last year. Asking rent declines are expected to continue through mid-2022, with downtown declines more dramatic than suburban.

What isn't priced in?

A drop-off in office rents is not priced in right now, but there is downward pressure. Values will likely adjust downward when more leases are signed and allow comparisons to current assumptions. Firms will still need office space, even if the rise of flexible ways of working lowers demand potential somewhat over the long-term. We are more optimistic about the urban edge than the traditional urban core. Despite the need for space and fresh air, locations closer to more densely populated areas remain more attractive. As for Downtown office, as the pandemic eases, urbanization should return, albeit at a diminished pace.

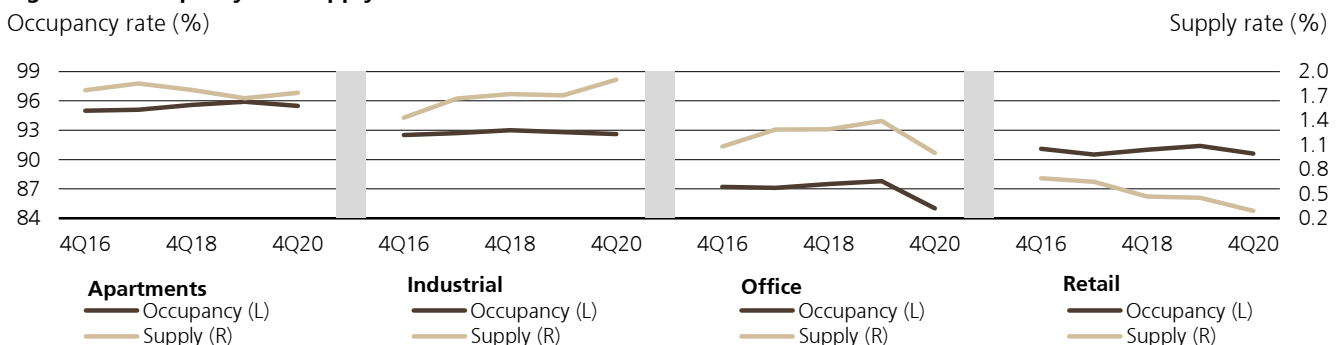
Retail

Reactivation of pandemic restrictions have hurt independent brick and mortar stores and restaurants, particularly businesses unable to adapt to flexible and online strategies. Malls continue to bear the brunt; NCREIF indicates 4Q20 annualized mall returns were -12.6% while non-mall returns were -5.5%. Research indicates an average of two years to fill vacated mall anchor space.

Nothing lasts forever

The situation looks dire, but don't count retail out forever. As recovery begins to take hold, retail should benefit from pent-up consumer demand for goods, entertainment and food. Smaller shopping centers should offer less risk than malls with a faster payoff. Retail industry transformation will likely come from increased mergers and acquisitions, tech-oriented innovations and integration of more advanced logistics capabilities. Traditional thinking needs to change, and change quickly including deeper partnerships with operators and tenants as well as cooperation with municipalities.

Figure 12: Occupancy and supply trends



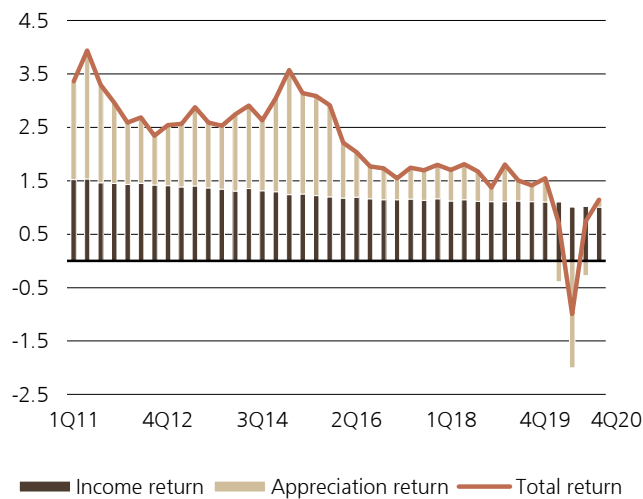
Source: CBRE Econometric Advisors, 4Q20. Note: Supply is shown as a completion rate (i.e. completions as a percent of existing inventory). Note: retail occupancy and supply rates only reflect Neighborhood, Community & Strip Shopping Centers, thus excluding Malls, Lifestyle and Power Centers.

Capital markets

Recovery bottleneck.

Property-level returns improved during the fourth quarter. Only the industrial sector produced positive appreciation, but it was enough to balance the other sector declines and close the quarter with a net value increase (see Figure 13). Although down slightly from a year ago, income returns remain steady.

Figure 13: US property returns (QoQ, %)

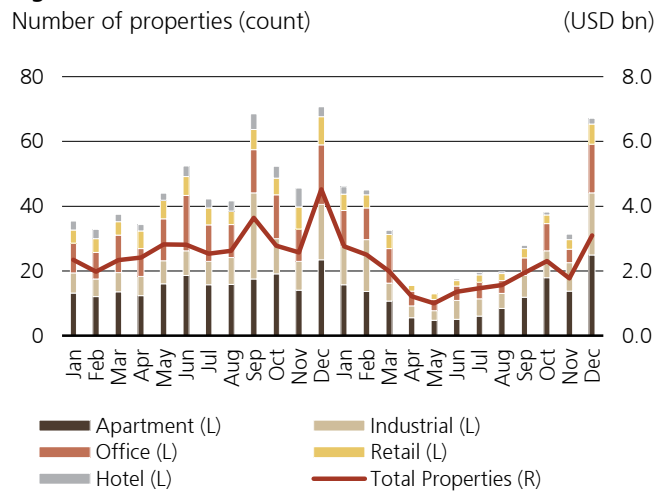


Source: NCREIF Property Index, 4Q20. Past performance is not a guarantee for future results.

Interest rates are expected to remain low for years. Stimulative measures from the US Federal Reserve moved short-term interest rates to zero in March 2020. On the long-end of the curve, the US 10-year Treasury rate, reported by Moody's Analytics, is below 1.0%, maintaining real estate spreads above-average (see Figure 15). The higher risk premium implied by wide spreads reflects uncertainty around future occupancy rates, leasing velocity and income growth expectations.

While all downturns bring uncertainty to capital markets, the 2020 pandemic-led downturn brings several challenges unique to real assets: travel restrictions, site closures and backlogs in municipal permitting processes. These challenges continue to stall investment volumes and tenant leasing as returns are repeatedly reassessed. Investors and appraisers are waiting for more comparable lease and sales transactions to support or refute the magnitude of adjustment. Low interest rates support increasing transactions. Spreads available in private real estate remain well-above long-term averages (see Figure 15). Debt markets are loosening with lenders favoring high-quality credit, long-term leases, multifamily and industrial properties.

Figure 14: US transactions

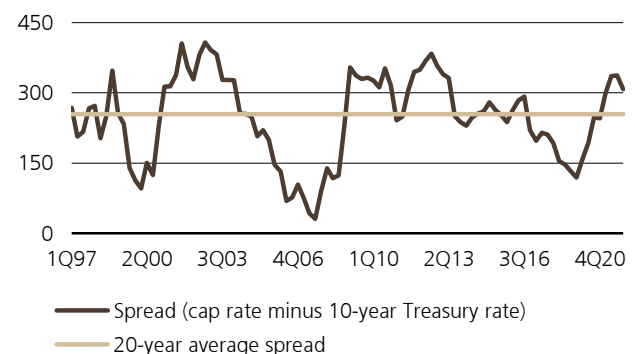


Source: Real Capital Analytics, 4Q20. Includes entity-level transactions.

December 2020 showed a fairly normal surge in transactions, as tracked by Real Capital analytics (see Figure 14). However, total volume during the second half of 2020 was 37% below the second half of 2019. Apartments and industrial trades continue to lead the way. Increased transaction volume should give investors more clarity and confidence in values for these properties during 2021. Although transaction volume during the first half of 2021 is likely to soften from the December spike, optimism in the transaction market and cross-border investment should improve throughout the year.

With limited sales restricting the availability of current pricing data, investors remain cautious. Although many lenders are open and able to lend, the near-term focus will be on managing portfolio stress and working out terms for existing loans, while extending new debt to the highest-quality deals.

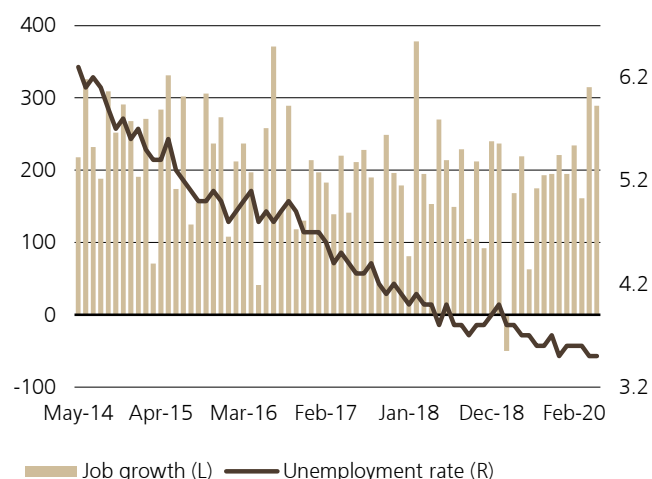
Figure 15: Commercial real estate spread (basis points)



Source: NCREIF Fund Index – Open-end Diversified Core Equity, Moody's Analytics, 4Q20

The unemployment rate, tracked by Moody's Analytics, shot to 14.7% in April (see Figure 16) and almost immediately began to decline as Payroll Protection Program loans were approved. The US unemployment rate was 6.7% by December, which translates to 10 million Americans out of work (see Figure 18), depressing consumer demand, particularly for services. Regional differences should play an important role in determining the trajectory for metro level downturns and recoveries.

Figure 16: US job growth and unemployment rate
Historic – Change in employment (thousands of jobs)



Source: Moody's Analytics, as of December 2020

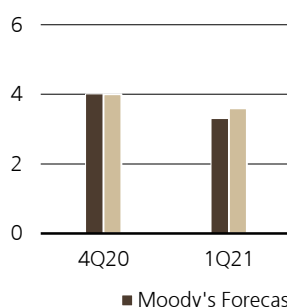
Direct financial support helped establish a floor on the severity of short-term decline and help communities, tenants and customers. Additional stimulus, approved and distributed in the last week of December 2020, came too late to have much impact on the fourth quarter but could be supportive of early 1Q21 recovery.

Strategy viewpoint

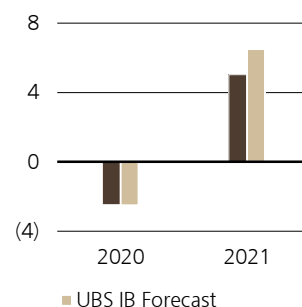
Near-term dichotomy.

The momentum of future job growth is dependent on vaccine distribution – which has not proceeded as efficiently as anticipated – and the confidence business and consumers have in the security provided by vaccination. State and metro variations in public health procedures may have widened the gaps around near-term economic potential.

Figure 17: US GDP quarterly annualized forecast (%)



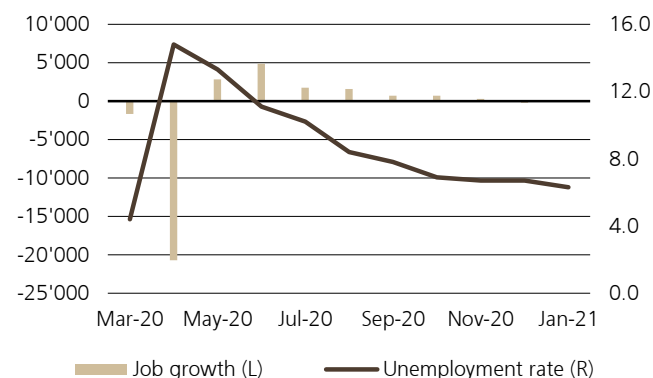
US GDP calendar year forecast (%)



Source: Moody's Analytics forecast as of 12 January 2021; UBS Investment Bank forecast, as of 29 January 2021

While the third quarter GDP recovery of 33.4% annualized growth erased the bulk of 2020's economic decline (see Figure 17), in the fourth quarter the economy remained 2.5% smaller than a year earlier. Progress toward full recovery will remain measured, given virus flair-ups, challenging vaccine distribution logistics, and stalled stimulus negotiations. Moody's Analytics expects GDP to reach the 4Q19 level by the end of 2021. Recovery will be slow given virus flair-ups and stalled stimulus negotiations.

Figure 18: US job growth and unemployment rate
Recent – Change in employment (thousands of jobs)



Source: Moody's Analytics as of December 2020.

Investor confidence is higher in the industrial and apartments sectors given the persistent, necessity-driven tenant demand. In retail, office and hotels, limited transactions and higher capital expenditure (capex) burdens make it difficult to assess whether current risk premiums compensate adequately for the risk. We expect industrial and apartments to continue to diverge and outperform retail and office in 2021.

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