Real Estate Outlook

Edition 2, 2021

Seeing an uneven recovery.

UBS

UBS Asset Management

Content

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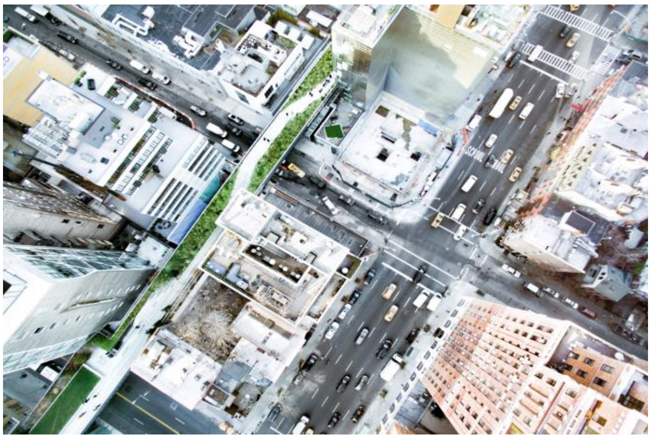

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Global overview

Strong performance in first quarter.

Economic performance varied by country in the first quarter, affected by different paces of progress against the virus. Real estate investment activity slipped slightly, but remained significantly above its nadir in 2020. Real estate markets showed a strong performance, led by further strong capital value growth for industrial real estate.

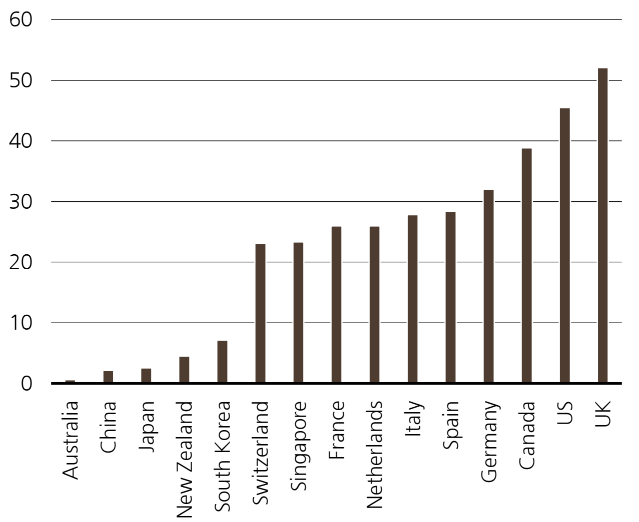
Macroeconomic overview

Uneven recovery, driven by virus progress.

According to the World Health Organization, the number of COVID-19 cases reached 150 million globally in April 2021 and the death toll passed three million. India, ravaged by a second wave of the virus, has been a significant contributor to the increase in cases, with its total number rising from 12 million to 19 million in April alone. However, good progress has been made on the vaccine rollout in some countries, fueling expectations that the economic recovery will gather pace as the year progresses. This will be very much dependent on whether new, vaccine-resistant forms of the virus emerge though, which could trigger further waves of lockdowns.

The rollout of vaccines has varied by country, with the US and UK now well-advanced. Indeed, in early May 52% of the UK population had received at least one dose of a vaccine and 45% in the US (see Figure 1). By contrast, the vaccine rollout in the rest of Europe has been more problematic, due to a lack of vaccines from manufacturers and more vaccine hesitancy in the population. By early May vaccination rates in France, Italy, Germany and Spain were in the range of 26-32%, though European governments are confident they can catch up over the summer. Vaccination rates in Asia Pacific remain low, generally less than 10%, and leave the region exposed to further outbreaks of the virus.

Figure 1: Share of population vaccinated at least once
(% of total, 10 May 2021)



Source: Our World in Data; UBS Asset Management, Real Estate & Private Markets (REPM), May 2021

The varied progress in combatting the virus was reflected in most recent GDP data. The US economy showed strong growth in 1Q21 of 1.6% QoQ while eurozone GDP fell 0.6% QoQ, reflecting the impact of widespread winter lockdowns there. Oxford Economics estimates that in China, the economy contracted 0.7% QoQ as caution held back Chinese New Year celebrations. The US economy is now within a whisker of its pre-pandemic level of output, just 0.9% below it, while bigger shortfalls persist in Europe.

The US, Canada and the main Asia Pacific economies are expected to regain their pre-crisis levels of output by the end of the year, with strong fiscal support driving the US. By contrast, Europe is lagging, with smaller and less timely fiscal stimulus in place. The Next Generation EU package, worth EUR 750 billion over five years, is still being finalized. The eurozone as a whole is not expected to regain its pre-pandemic level of output until 1Q22, with recovery in Italy and Spain delayed until the second half of 2022.

In line with the wider economy, the consumer sector is improving too. The rotation to online shopping supported retail spending during lockdown periods, though pent-up demand will likely fuel an initial bout of consumption as restrictions ease. Moreover, according to Oxford Economics consumers have built up excess savings worth USD 4.7 trillion globally. Whether consumers view these extra savings as wealth or income will be key in determining how they treat them. If viewed as wealth, the base case assumption, around 5% of these savings should be spent annually according to Oxford Economics, while if these savings are treated as income a much higher share, of around 45%, may be spent, creating an upside risk.

The recovery in demand is filtering through to rising inflation, also pushed higher by base effects as prices rebound from the lows hit last year. We expect that the rise in inflation will be transitory rather than sustained, which is also the view of the central banks. However, we cannot rule out the possibility that the sharp pick-up in inflation will push up price expectations and cause higher inflation to be sustained. Moreover, with elevated public debt levels, now above 100% in more countries than pre-crisis, higher inflation would be a convenient way for governments to reduce their debt burdens. We also cannot rule out a policy error by central banks as they navigate the uncertain path out of the pandemic. Hence investors need to be vigilant and ready to successfully navigate these factors as they evolve.

Capital markets

Strong performance in the first quarter.

Real estate investment activity slipped back in the first quarter as renewed lockdowns impinged on activity. After adjusting for seasonal effects, data from Real Capital Analytics showed global investment activity down 11% QoQ in USD terms. However, the market still showed a substantial improvement from its nadir in 2Q20, with volumes up 36% from their low. On a seasonally adjusted basis, global investment activity in 1Q21 remained 25% below its pre-pandemic level of 4Q19, with no significant differences between regions. We expect investment activity to mirror the economy, with a further easing of restrictions likely to boost investment volumes in the second half of the year. Moreover, a gradual return of international travel should aid cross-border purchase activity.

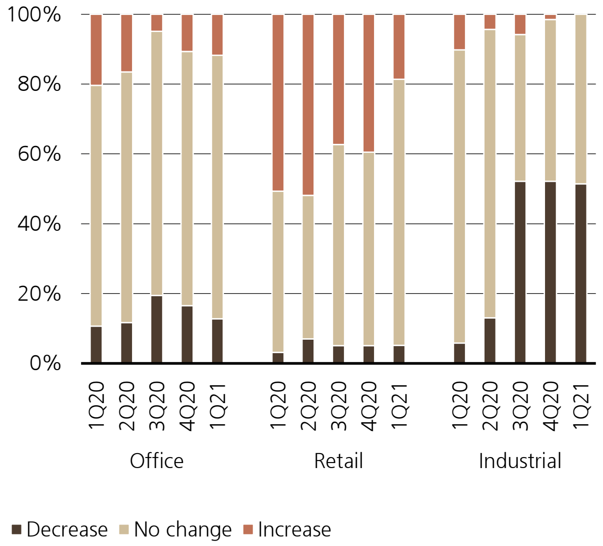
The sector trends which were already evident continue to play out. Global industrial investment volumes in 1Q21 were 3% above their pre-pandemic level, boosted by both strong investor demand for the sector and price rises across most industrial markets in 2020. By contrast office volumes were down 39%, while retail volumes were 49% below their pre-pandemic level, pushed down by both weak investor sentiment and widespread price falls in the sector. Residential activity was little-changed, 1% above pre-pandemic levels, while hotels remained down 52%, also impacted by falling prices as well as reduced transaction numbers.

MSCI reported a global all property return of 2.1% for 2020, with a capital value decline of 2.0%. Hence the market held up well compared to the Global Financial Crisis (GFC), when capital values fell 22% over two years. Unsurprisingly, the retail sector reported the weakest performance, with a global total return of -6.6% for 2020, driven lower by capital values falling 10.5%. Offices showed a single-digit positive return of 2.6% as income offset a modest capital value decline of 1.6%. Finally, industrial recorded a 10.4% total return, fueled by capital values rising by 5.5%. Income returns trended lower across sectors, to 4.1% at the all property level.

Initial results for 1Q21 suggest that the market showed a strong performance, driven by the prospect of economic recovery, and ongoing support from central banks and fiscal stimulus. Industrial capital values showed very sharp rises of 2-4% QoQ in Canada, Ireland, the UK and the US, according to data from MSCI and NCREIF. If sustained, this pace of increase would lead to double-digit growth for 2021 as a whole. By contrast, office capital values showed small falls of up to 1% QoQ across these four markets, while retail weakness continued, with capital values declining by up to 2% QoQ. In the US apartment sector capital values rose by 1%.

These trends in performance were mirrored in pricing and yield movements. According to CBRE and NCREIF data, office yields were generally flat. Within the office sector a bifurcation exists, with pricing for assets which have good location, accessibility and positive ESG credentials holding up better. Nearly 20% of retail markets monitored reported a rise in yields, down from 39% which reported an increase in 4Q20. In industrial, a majority of markets reported a fall in yields and cap rates for the third quarter in a row, with the remainder reporting them as flat (see Figure 2). Strength in the industrial sector looks set to continue, with further yield declines likely.

Figure 2: Global prime yield / cap rate movements
(QoQ, share of markets)



Note: From a sample of 103 office markets, 158 retail and 69 industrial
Source: CBRE, NCREIF; UBS Asset Management, Real Estate & Private Markets (REPM), May 2021. Past / expected performance is not a guarantee for future results.

In terms of fundraising, Preqin reported that globally there was USD 368 billion of capital targeting real estate as at May 2021, the same as at the end-2019. Capital targeting core and core plus real estate rose, while capital which was focused on opportunistic and value-added real estate fell slightly. Core is the dominant strategy in institutional portfolios and comprises 83% of the average portfolio, according to the ANREV/INREV/NCREIF 2021 Investment Intentions Survey, with value-added accounting for 11% and opportunistic 6%.

Strategy viewpoint

How to mitigate against inflation risk.

With inflation rising and a risk that price pressures may be prolonged rather than transitory, real estate investors must consider what this means for their strategy. How can they mitigate against inflation risk? In general, we think that real estate offers good inflation protection, but adjustments can be made to portfolios to maximize protection. Inflation affects real estate performance via two main channels. First, its impact on within-lease rental income and whether it keeps up with inflation; and second due to its impact on market rents and capital values via its influence on interest rates and the broader economy.

With regard to rental income, investors can follow several strategies to protect against inflation. The first is to look to leases which have rents indexed to an inflation measure. Such leases tend to be more common in Europe than in Asia Pacific or the US. A lease with rents linked to inflation will provide protection, as rents get uplifted automatically should a bout of inflation occur. By contrast, rents under leases which are not indexed to inflation can get eroded over time in real terms if unexpected inflation occurs, and will likely be less than those underwritten. An alternative to indexation is focusing on shorter leases, which provide the opportunity to reset rents more quickly if inflation does take off.

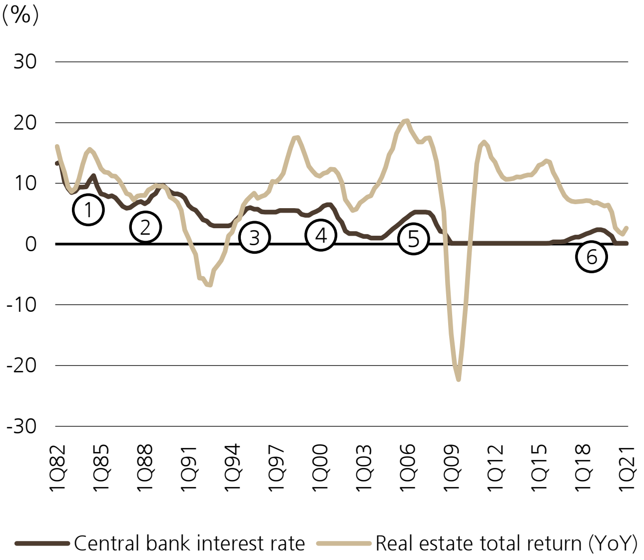
The impact of inflation on market rents, capital values and real estate investment performance is more complex. Ultimately, the impact depends upon what the inflation means for the broader macro economy and interest rates. Typically, we identify three variables as key in determining real estate performance. They are the level of development activity, what's happening in the broader economy and interest rates, with the latter two being particularly interlinked.

Excessive development can result in a glut of supply and put downward pressure on market rents. Economic growth normally coincides with rising occupier demand from businesses and pushes rents and capital values higher. Finally, across all asset classes falling interest rates push down discount rates which result in a given flow of expected income being valued more highly. Indeed, for real estate the adjustment to lower interest rates over the past decade has boosted returns via its impact on capital values.

Hence investors looking to protect against higher inflation must understand what impact inflation might have on the drivers of real estate performance. At the current juncture, central banks have said they will look through the temporary overshoot in inflation.

However, if there is a regime change and higher inflation turns out to be more permanent, it would likely jolt central banks into action, unwinding their QE programs and raising interest rates more aggressively than expected. Moreover, dealing with such a situation exposes the risk of policy error on the part of central banks.

Figure 3: US real estate total returns and interest rates



Source: NCREIF; Oxford Economics, 1Q21. Past / expected performance is not a guarantee for future results.

Historically, rising interest rate rises have not necessarily been bad for real estate returns. Indeed, in five out of six periods of interest rate rises in the US, real estate returns accelerated as interest rates were lifted (see Figure 3). On two of these occasions – the late 1980s and the GFC – real estate returns subsequently turned negative following the rate rises as the economy went into recession. Hence, if central banks are able to effectively manage a bout of higher inflation by cooling the economy without pushing it into recession, real estate performance is unlikely to see a significant hit.

The bigger risk for investors is that the economy overheats and central banks raise interest rates sharply to cool it, prompting a recession which then hits the wider economy and occupier demand. A diversified portfolio across countries should help protect against this risk since inflation dynamics vary by country. Investors should closely monitor how inflation evolves over the coming months and ensure that their portfolios are as resilient as possible to this emerging risk.

Real estate investment performance outlook

2020 actual and 2021-23 outlook are measured against the country-sector's long-term average total return, with the average +/- 100bps described as "in line with long-term average". The long-term average refers to the period 2002-20. The red underperformance quadrant refers to negative absolute total returns, either in the 2020 actual or the 2021-23 outlook.

		LTA	Office	LTA	Retail	LTA	Industrial	LTA	Multifamily
North America	Canada	8.9		8.8		10.2		n/a	
	United States	7.5		8.9		10.0		7.9	
Europe	France	7.7		9.4		9.4		n/a	
	Germany	4.7		5.3		7.7		n/a	
	Switzerland	5.6		6.2		n/a		6.3	
	UK	7.0		4.8		9.5		n/a	
Asia Pacific	Australia	10.0		9.0		11.0		n/a	
	Japan	5.2		5.4		6.0		5.6	

: Actual 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), May 2021. Note: Abbreviation LTA: long-term average. Past / expected performance is not a guarantee for future results.

Shaowei Toh
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APAC outlook

Still getting mixed signals.

Asia's growth prospects have been largely based on the resumption of global demand. The key downside risk remains the rate of inoculation vis-à-vis sporadic infection waves. Occupier markets are adjusting and taking stock of the carnage. Cap rates will likely remain low, at least in the near-term, even as investment volumes look lackluster. Emerging asset classes in APAC such as healthcare and multifamily are garnering institutional attention.

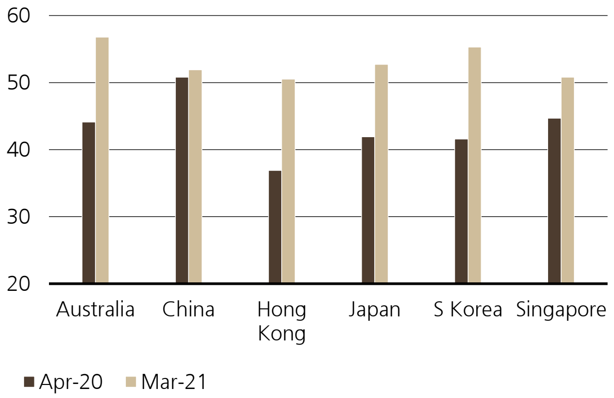
Real estate fundamentals

Occupier markets trailing economic recovery.

The recovery theme from our last edition extends into this quarter. The initial exuberance from the rollout of vaccination programs has largely settled, replaced now by real confidence that regional and global demand are improving as seen in a slew of positive economic data releases. The Purchasing Managers' Index (PMI) for Asia is a good leading indicator of business conditions and sentiments. We have seen a consistent recovery in Asia's aggregate PMI since the trough in April 2020 when it touched a low of 38. The latest PMI readings across the region (see Figure 4) inform us that business conditions are indeed looking up, as all major markets are now in expansionary territories.

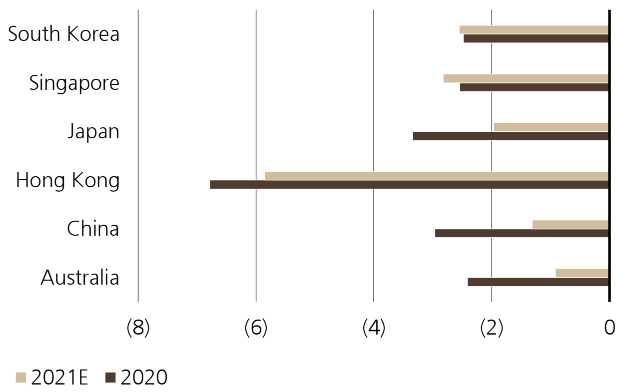
That gave rise to fears that higher interest rates could be a premature dampener on the nascent recovery story in the real economy. All said, inflation is a double-edged sword for commercial real estate. On one hand, inflation is generally correlated with rent growth which bodes well for the NOI performance of real estate in general. On the other hand, excessive inflationary expectations will lead to an increase in borrowing costs as nominal interest rates rise in tandem. That often puts pressure on existing asset owners who are looking to refinance their property holdings, as well as investors tapping into investment and construction loans.

Figure 4: Manufacturing PMI by market



Source: Oxford Economics, April 2021

Figure 5: Output gap (% of GDP)



Source: Oxford Economics, April 2021

At the point of writing, China recorded an 18.3% YoY surge in GDP growth in 1Q21, relative to the same period last year. Japan's nominal goods exports rose by 16.1% YoY in March 2021. Singapore's trade surplus reached an all-time high in 1Q21, largely due to an outstanding 21% YoY increase in exports in the month of March. In Australia, the unemployment rate dropped to a one-year low of 5.6%, with the number of employed persons surpassing pre-pandemic levels. That means the Australian economy has more than recovered the approximately 870,000 jobs lost due to the lockdowns last year. The list of positive news runs long.

Overall demand in the private and public segment will support household and business expenditure, which further feeds into improving labor markets across the region. Strong growth prospects underpin the reflationary expectations which have been building up over the past few months. We experienced recent episodes in which the fixed income markets reacted in expectations of an inflationary environment, as long-term bond yields spiked in some economies.

The output gap measures the degree of inflationary pressure within the economy. Looking ahead, we are not expecting run-away inflation as the output gap in most APAC economies remains in negative territory (see Figure 5). This implies that APAC economies are nowhere close to full capacity which makes it unlikely that inflation will run ahead of itself.

Not departing from our usual tone, we are offering words of prudence here, even as the regional economy looks to be in better shape. Some market observers are already moving away from the *recovery narrative* and jumping onto the *expansion* bandwagon. We prefer to err on the side of caution. Asia's growth prospects have been largely based on the resumption of global demand, but the key downside risk remains the speed of inoculation in APAC markets such as Japan, South Korea and Australia. There are bound to be subsequent waves of lockdowns, and while Asia has proven adept at managing that, the temporary shocks to the wider economy could still be significant.

Office
While most office markets in APAC held firm in the early part of 2020, the lagged effect of the macroeconomic downturn is manifesting itself in a soft occupier outlook going into early 2021. To that end, the leasing market was relatively quiet in the first quarter of 2021.

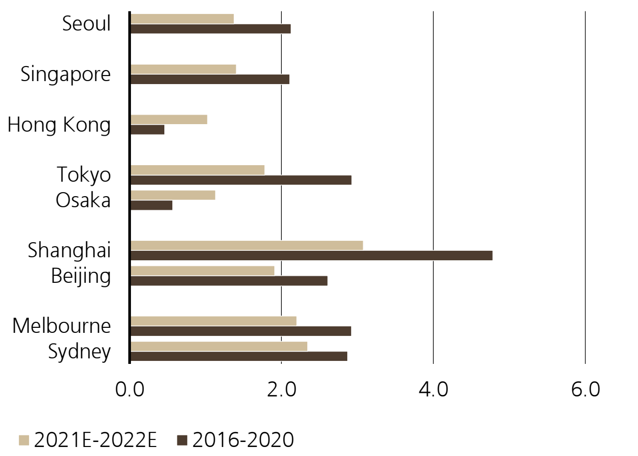
Even as the global economic recovery is underway, office tenants are still taking stock of the carnage from the past year. The fact of the matter is, most office markets in APAC benefitted from the rent support measures and rebates that governments handed out last year. Some governments have since extended the timeline for such support measures (for example, Japan), while others such as Australia are sending out clear signals that stimulus programs will be tapered off. Regardless, accommodative fiscal measures were never meant to be perpetual. That consideration has been a key drag on the renewal and expansion plans of many tenants, as most wait out for indications of sustained improvement in the business environment.

Moreover, the full impact of telecommuting is not yet clear. Some head honchos of firms that are major office occupiers have called for a return to the office, yet we are hearing of banks reducing their office footprint. For instance, Citigroup and Mizuho Financial group have trimmed their real estate requirements in Singapore, while Standard Chartered and BNP Paribas have done the same in Hong Kong. According to the Japan Productivity Center, the telecommuting rate of companies in Tokyo peaked at around 60% in June 2020, before normalizing to roughly 36% in January 2021, which lends itself to a baseline level of office occupancy. The same situation can be said for South Korea, which is less susceptible to remote working's impact.

One sector that has fared well is the technology sector, in which we are seeing strong levels of leasing demand. In China, domestic technology firms led the way in leasing activity in Beijing. CBRE reported that net absorption was up by more than 13% QoQ in 1Q21, marking the third consecutive quarter of growth in net demand. In the case of China, it is worth noting that the 14th Five Year Plan (2021 - 2025) emphasizes the development of technology driven industries as well as the digitalization of the economy. In the mid to longer-term, this bodes well for business parks and office demand in key Chinese cities.

Across the region, future office completions are expected to be below their recent historical average (see Figure 6). The events of 2020 resulted in a disruption in construction activity which inadvertently delayed some completions to this year and the next year. However, some development schemes were also postponed. Put together, most markets will see a supply pipeline that is less aggressive than the period before the pandemic, and this is supportive of occupier performance even as demand wavers in the face of lingering uncertainty.

Figure 6: Office completions (% of stock, period average)



Source: PMA, March 2021

In Shanghai and Beijing, competition from decentralized completions suggests that CBD office vacancy rates will stay elevated at around 15% in the next few years. In Tokyo, we expect the vacancy rate to inch up towards 3% by the end of 2021, although there are huge disparities among the various wards. Chuo ward is supported by larger tenants and is likely to stay resilient while Shinjuku ward will come under pressure due to an aging office profile. Down under, Melbourne entered 2019 with record low vacancies, but that is now driving a short-term supply boost in 2021.

Although the pipeline of supply is largely pre-committed, we still expect some backfill and sub-lease vacancies to emerge. Sydney has seen rents more than double over the six years to 2019, with affordability constraints and COVID-19 impacting on current office demand. The strong supply response, with sizeable completions lasting until 2023, will result in the vacancy rate rising to 9.9% in 2021, according to PMA.

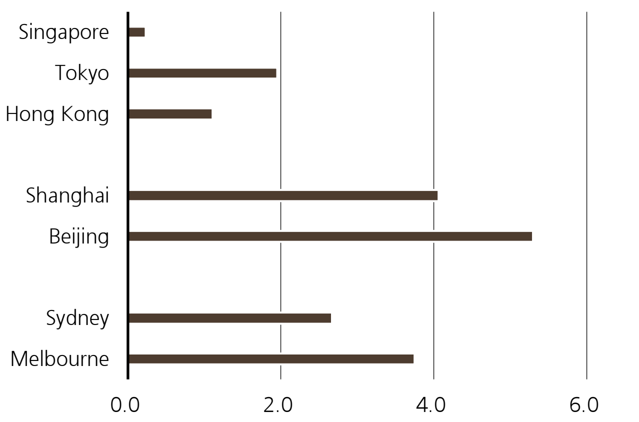
Logistics
In the APAC region, modern industrial real estate continues to be supported by secular trends such as increasing e-commerce penetration, supply chain efficiency and labor shortages. These trends have been accentuated by the COVID-19 outbreak. The unprecedented surge in logistics demand arising from the pandemic resulted in significant rent growth in 2020 in most key markets. However, we expect that will become less uniform in 2021 (see Figure 7).

Large modern logistics facilities in key distribution hubs and smaller units in infill submarkets that are positioned to serve urban locations will continue to see healthy demand from retailers and third-party logistics providers (3PLs). This is on account of new growth in the e-commerce space and increasing demand for efficiency in the transportation and warehousing of goods.

2020 was a standout year in which Tokyo prime logistics rents rose by more than 2.5% YoY, while vacancies tightened to less than 1%. CBRE noted that approximately half of completed logistics facilities in the Greater Tokyo area were inhabited by single tenants, which is a clear sign that large operators have been a steady source of occupier demand.

With continued investor interest focused on Tokyo logistics development, overall vacancy is set to steadily rise to around 5% by 2024, according to PMA. However, there will be discrepancies between areas. The Route 16 and Ken-o-do submarkets will see a persistent delivery of new supply, which will exert downward pressure on rents and occupancy. On the contrary, the Gaikando area's strength as a logistics precinct is being bolstered by its connectivity and easy access to labor. The supply response is likely to come only in 2023, which implies that the vacancy rate will stay at below 1% until end-2022.

Figure 7: Prime logistics rent growth 2021 (%, annual)



Source: PMA, March 2021

In Sydney and Melbourne, pre-lettings by major retailers and end-users were on the rise last year, which should continue into 2021. Affordability concerns are real in Sydney, as prime logistics rents are expected to stay at a premium of more than 50% to Melbourne logistics rents. That should cap Sydney's rent growth at close to inflation rates over the next few years. Greater Sydney industrial land values have grown by more than 10% annually over the past five years. To that end, returns in the Australian logistics space will be largely driven by capital growth.

Retail

Regional retail sales have held up better than expected 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 eating out and discretionary items. On the supply side there is very little new space coming through, with a possibility of further delays and some schemes being scrapped altogether.

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. In contrast, major Chinese cities experienced the resumption of normal consumer activities as early as in the middle of 2020. The key drag on occupier performance is the indigestion of retail inventory that had accumulated over time. We believe there could be a shift in the highest and best use of retail assets in China, as repositioning and re-purposing appear to be viable strategies considered by investors.

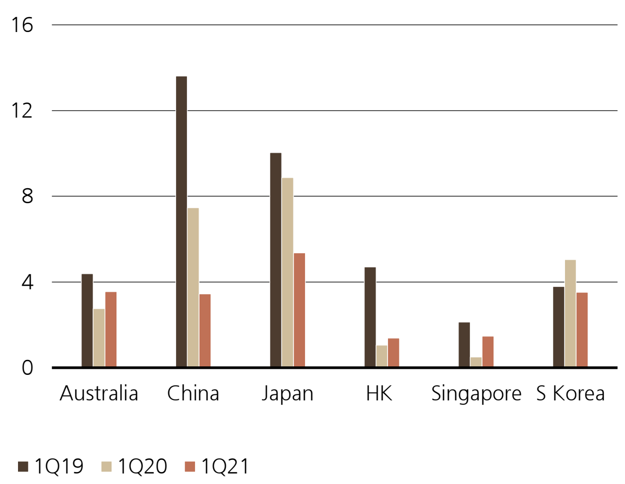
The 2021 Olympic Games in Japan will be held without foreign spectators given the pandemic, and that will be a lost opportunity for Japan to showcase its retail offerings to the world. Leaving aside the immediate impact on retail sales, what is more significant is that it presents a setback towards Japan's tourist arrivals ambition of 60 million visitors by 2030. All said, the expectations are that tourists and footfall will return to Japan over time and tenant demand for prime retail in Tokyo and Osaka will recover gradually.

Capital markets

Waiting at the gates.

According to preliminary data from Real Capital Analytics (RCA), total transaction volumes of APAC commercial property fell 25% YoY in 1Q21 (see Figure 8). On a sector basis, office and retail transaction volumes plunged by around 34% YoY and 23% YoY, respectively. Separately, the regional hotel sector saw volumes fall by 64% YoY in 1Q21, following on from the 70% YoY plunge in the last quarter.

Figure 8: Commercial real estate volumes (USD, billion)



Source: RCA, as at 22 April 2021

Investment activity was focused on Australia, China and Japan, which made up more than two thirds of total transactions. Notably, South Korea extended its solid run into the first part of 2021, clocking up approximately USD 3.5 billion in transaction activity. According to CBRE, domestic investors accounted for more than 80% of this turnover in Seoul alone. In addition, insurance firms focused on capital and liquidity management in line with new accounting standards, which led to the disposal of core property assets.

There is also a shift towards alternative segments. Going beyond data centers and cold storage, asset classes such as healthcare real estate are increasingly garnering attention from institutional investors. Traditionally, healthcare real estate has been a very resilient asset class and that has been further cemented by the COVID-19 pandemic. Healthcare is essentially non-discretionary in nature. While medical offices and non-critical medical services such as aesthetics are likely more susceptible to the ebbs and flows of the wider economic environment, hospitals and primary medical services are not as sensitive.

The sector is underpinned by a track record of resilience, having performed admirably throughout the previous economic downturn in 2008, and during the peak of the coronavirus in 2020.

With most APAC central banks committed to an accommodative monetary stance, interest in real estate is likely to remain strong. The question is, are transaction volumes low due to risk aversion, or are sellers not being realistic enough? We think it is a combination of both. There is definitely greater caution around some asset classes such as retail, and to a lesser extent, the office segment. However, we also observe that some sellers are pricing their assets at pre-pandemic levels (in view of improving sentiment), while most buyers are underwriting transactions based on post-pandemic financial assumptions. While it will take longer for deals to close, it is not for lack of interest. After almost a year of inactivity, there is a wall of capital waiting at the gates. The corollary is that cap rates are likely to remain low, at least in the near-term, even as volumes look to be lackluster.

Strategy viewpoint

Australia multifamily.

We can all agree that having a roof over our head is a necessity, pandemic or otherwise. What COVID-19 really did was highlight the resilience and non-discretionary nature of the residential rental sector globally, underscored by generally stable rent collections and relatively limited delinquency. Casting our horizons across APAC, we believe the Australia multifamily sector is poised to emerge next. The trajectory in other markets suggests that this process will not be linear, but the headroom for growth could potentially reap strong dividends for early movers.

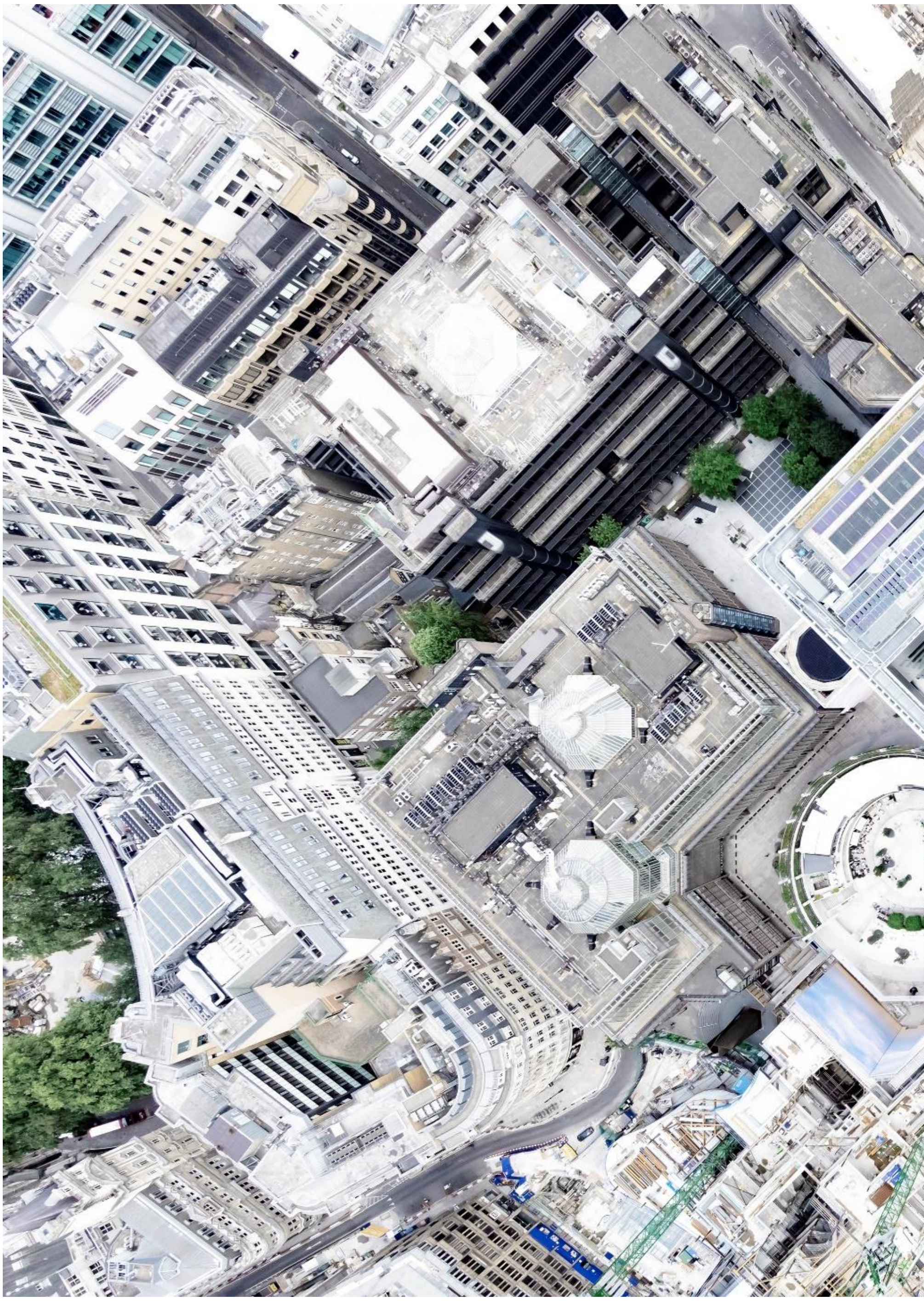
Australia ranks among the few developed economies globally that will experience positive population growth over the next decade at least. Its resident population is expected to breach the 30 million mark by the year 2030, an increase of approximately 65% from 1995 levels. The ongoing increase in the number of residents brings about a structural rise in the demand for accommodation. Specifically, new residents aged 15-44 years will comprise almost 40% of the incremental population in Australia by 2030. This is the age bracket in which working adults start to embark on family formation.

The rise in home prices has exceeded income growth in many key Australian cities, and this worsening affordability has indirectly steered potential homebuyers into the private rental market.

To that end, the multifamily sector can provide an interim and scalable solution for many who are unable to cross the total home affordability hurdle. It need not necessarily displace home ownership aspirations totally. In fact, the Australian multifamily sector can potentially allow future homebuyers to set up their family units while accumulating their financial resources in a more cost-rational manner.

While the demand for housing grew in tandem with the increase in population, the supply of accommodation in Australia did not manage to keep pace over the years. This pent-up demand for accommodation was layered on over many years, of which the construction of new housing is now struggling to close the gap. In December 2020, the National Housing and Investment Corporation suggested that nationwide housebuilding output would need to be maintained at similar levels for many years before the previously accumulated supply deficit can be balanced out.

This provision of multifamily housing in Australia expands the list of options for people based on their financial situations and personal aspirations. It complements the broader effort to boost housing supply in the nation, albeit in a scalable and more efficient manner. To that end, a mature Australian multifamily market will ultimately offer sufficient depth and liquidity to the investor, on top of a very stable income profile.



Zachary Gauge
European Research Analyst

European outlook

Opportunities for contrarian investors.

After a tough start to the year there are some causes for optimism for the European economy and real estate markets. The vaccine rollout is finally gathering steam, giving hope that some degree of normalization can be achieved in the second half of the year. Capital markets remain healthy, although in-demand sectors and assets are seeing heavy price inflation. Sourcing value will be a key challenge for the rest of 2021.

Real estate fundamentals

Varied performance driven by virus progress.

Economy
The anticipated rate of economic recovery in 2021 is highly correlated with the pace of the easing of lockdowns, which is itself essentially driven by the relative speed of vaccination roll-outs. In this regard, we have seen a complete two speed outlook emerge between the UK and Continental Europe. Based on data from Our World in Data as at the 8 May, the UK has vaccinated 52.1% of its total population with at least one dose, compared to 27.8% in the EU. Whilst the UK economy is starting to open up, many European countries are still facing some degree of lockdown measures to combat the third wave of the virus which has emerged since the winter.

This has had a significant impact on the short-term economic outlook for the two areas. The UK has seen significant upgrades to its short-term outlook, with Oxford Economics now forecasting GDP growth to come in at 7.2% in 2021 and 5.7% in 2022. The EU by contrast won't see the bulk of its' recovery coming through until 2022, with GDP growth anticipated to hit 4.7% after 4.0% in 2021.

However, there are some causes for optimism across Europe. Anecdotal evidence from the UK and other countries which have started to ease economic restrictions, strongly suggests that consumers are eager to go out and spend on both leisure and retail. This gives weight to the argument that there will be a strong consumer led bounceback in economic growth when the pent-up forced savings from lockdowns are released.

Unemployment has also remained much lower than originally feared, supported by the extensive government support schemes. Unemployment rates in both the UK and EU are forecast to peak in 2H21, at 5.7% and 7.7% respectively, before easing back in 2022. And after a slow start, European countries have picked up the pace of vaccinations, with Germany and France hitting a daily vaccination rate of 0.81% and 0.64% of their population respectively (based on data from 7th May).

There are still significant downside risks, largely associated with the virus itself. The emergence of a new strain which demonstrates immunity to any of the main vaccines which have been rolled-out could set the recovery back considerably. And although issues around vaccine supply have eased in recent months, the threat of a drop in supply and protectionist policies remains a background threat.

Offices
There was no significant change in direction for European office markets in 1Q21. Aggregate take-up from JLL was around 25% above the trough recorded in 2Q and 3Q20, but remained 40% below pre-pandemic levels for the first quarter. And, also according to JLL, the aggregate vacancy rate continued to move up, although the quarterly pace of increase slowed to 0.21pps from 0.4pps in 4Q20 and 0.33pps in 3Q20. The aggregate vacancy rate for Europe stood at 6.3% in 1Q21, which is comfortably below its long- term trend and significantly lower than other regions.

The very low levels of supply are the main reason that prime office rents have remained stable, despite the collapse in occupier demand. No market reported a decline in prime rents in 1Q21 according to CBRE, whilst Paris CBD, Luxembourg, Leeds and Manchester all recorded small increases. However, as is common during economic downturns, we are hearing anecdotally that incentives are increasing in many markets, which helps support a *stable* headline rent profile.

For secondary offices, the situation is certainly more challenged. Office buildings which only provide functional workspaces, and particularly those in non-central locations which are not easily accessible by public transport, are likely to face increasing obsolescence as occupiers prioritize buildings which add value to the working day experience as we move out of the pandemic. Sustainability credentials are going to become of ever greater importance to both occupiers and investors, and assets with a heavy reliance on cars for accessibility will struggle against stricter criteria.

Retail
Although retail valuations in mainland Europe have finally started to move down, the numbers still appear to have a significant lag. MSCI data suggested that retail rents in France only dropped by 2.3% in 2020, and by just 0.9% in Germany. To put this in context, retail rents in the UK have fallen by 18% since the shift towards e-commerce started to be reflected in the valuation numbers. Unfortunately, it may be some years until realistic rental values are applied to retail assets across Europe, which makes it more challenging for investors to underwrite deals.

CBRE's prime data perhaps give a more accurate reflection of the market. Across the main European high street markets, rents have declined by at least 5% in the past twelve months, and by double digits in many markets. Shopping centers have fared even worse and have the added challenge of requiring significant capex to remain operational and relevant to retailers and consumers against a drop in operational income.

Going forward, we believe there may be very selective opportunities in the UK market this year as valuations for certain assets have reached a point where the entry yield is extremely attractive. However, in Europe valuations remain completely out of sync with market reality, and it may be some time before values bottom out and sensible risk-adjusted opportunities emerge.

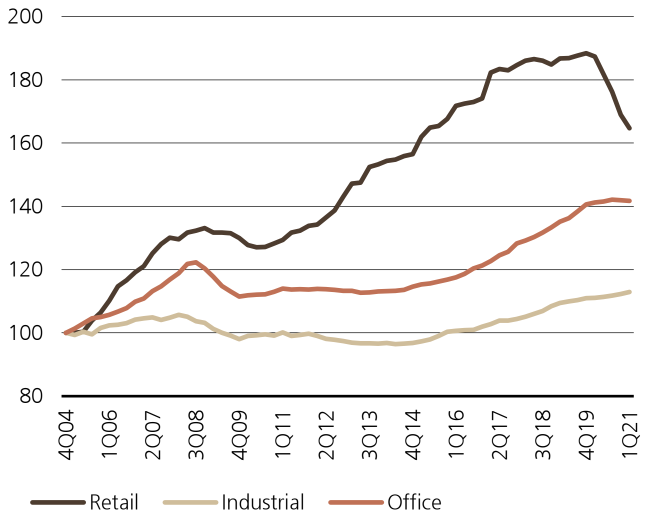
Industrial
Despite all the furor around the European logistics sector since COVID-19 accelerated the structural shifts towards e-commerce, the prime rent index for the eurozone continues to only gradually edge up (see Figure 9). Based on data from CBRE, prime rents were flat in most markets. However, some significant growth QoQ was recorded; in Brussels (+5.5%), Amsterdam (+4.3%), Tilburg (+4.5%), Yorkshire, UK (+4.2%) and Berlin (+3.3%). More moderate increases of between 1-2% were also recorded in the UK Midlands region, Munich and Hamburg.

Industrial demand is in a strong position and in certain locations is benefitting from increased e-commerce related demand. But there are caveats to this which explain why rental growth has not accelerated in the manner that may have been anticipated. Logistics occupiers operate on notoriously thin margins, and significant increases in rental growth can have a noticeable impact on their bottom-line and place affordability constraints on the market.

The sector is also continuously evolving, with requirements for the type and location of unit changing significantly in a relatively short space of time. The largest operators typically sign for new pre-let units, as opposed to renting existing stock.

Thus, it is land supply rather than existing warehouse supply, that is the key driver of rental growth. With a tendency to pre-let, the supply constraint on rental growth we have seen in other sectors historically is less common with logistics space. Sharper increases in rents are generally found in urban logistics hot spots, where new-build opportunities are scarce and land constraints do create that intense pressure on available space.

Figure 9: Eurozone prime rental indices (4Q04 =100, to 1Q21)



Source: CBRE, 1Q21

Capital markets

Robust sentiment in capital markets.

Despite the clear challenges in occupational markets, sentiment surrounding commercial real estate capital markets has proven to be very robust during the pandemic. Data from Real Capital Analytics shows that European annual investment volumes declined by 15% in 2020 to around EUR 250 billion (see Figure 10). But taking into account the physical constraints on transacting real estate due to the lockdown restrictions and the limited capacity for overseas travel, a 15% decline can be seen as relatively modest.

With strict lockdown measures implemented again in 1Q21, quarterly volumes fell by -30% YoY. But there are optimistic signs for the second half of 2021 assuming restrictions are eased over the summer. Investor sentiment surveys continue to show positive indications for further exposure to European real estate, largely supported by the ultra-low interest rate environment and the attractive yield spread of property to fixed income holdings.

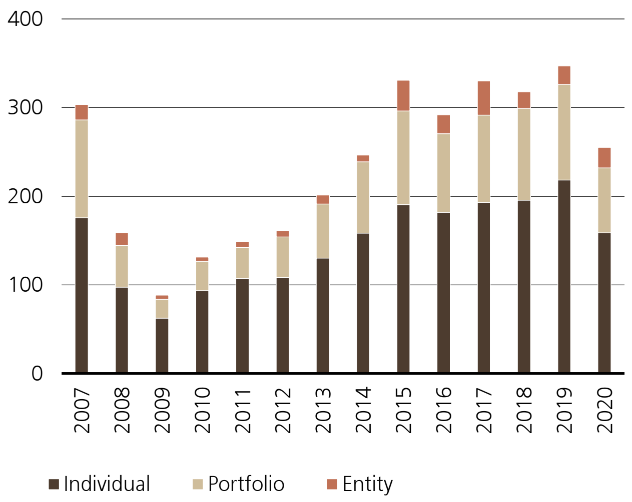
However, there is significant variation in sentiment on a sector, and asset quality basis. Office investment volumes declined by 30% in 2020 YoY. The situation has not improved in 1Q21, when quarterly volumes fell to the lowest level since 2012 and undergoing a 56% decline YoY. Investors are evidently cautious on buying office buildings which are currently largely unoccupied, and the future structural patterns of home working remain uncertain. Having said that, demand for core offices appears to be holding up well, provided that income and lease lengths are robust.

Perhaps surprisingly, the majority of core markets in Europe have actually seen prime office yields compress in the last 12 months, with none of the major markets recording outward movements. The availability of cheap finance at the very core end of the market has certainly helped justify yields which are now extremely low. Outside the core segment, however, pricing appears to be softening although valuations continue to be conservative in factoring in declining values.

Retail transaction volumes actually recorded a smaller decline in YoY activity in 2020, of 15%. But with volumes already in decline, this is largely because activity was coming off a low base, rather than any resilience within the sector. In 1Q21 volumes dropped to just EUR 3.9 billion, equaling the record low level recorded in 2Q09. We expect activity to remain very weak until there is further price discovery and values reach a level that could tempt more opportunistic buyers could back into the market. Valuations in Europe remain way off the mark, but in the UK there are indications that a trough in values have been reached, particularly for the retail warehouse segment. This has resulted in a mini-surge of investment activity from a range of investors, recognizing the attraction of the now very high yields for some relatively strong performing parks.

Unsurprisingly, the much touted *beds and sheds* have seen the strongest relative levels of investment activity. Industrial volumes actually increased in 2020 YoY by 10%, with a further increase in 1Q21 despite the lockdowns. This has driven yields down across the board, particularly given the relatively limited volume of institutional stock in Europe. Core markets in the Netherlands, France and Germany now have yields below 3.5%, with many markets in Europe seeing between 50-100bps of compression in the past 12 months.

Figure 10: European investment volumes (EUR billion)



Source: RCA, 4Q20

Despite a rapid increase in demand for residential assets, the sector reported a decline of 8% in volumes in 2020 YoY. As with the logistics sector, there is a finite amount of available standing stock in the sector and the increase in sentiment towards the sector in various surveys suggests volumes would be much higher if more stabilized schemes were available to trade. That sentiment has followed through into 1Q21, which was actually the strongest first quarter for apartment sales in Europe ever recorded. As would be expected, yields have compressed and are as low as 2.2% for a prime PRS scheme in a market like Munich or Berlin.

Although the drivers behind these sectors are undeniably strong, we are becoming slightly cautious over the herd mentality of investors in Europe. With so many investors chasing a relatively small proportion of the market, inevitably the prices paid are becoming hugely inflated. When there are downturns and market challenges, often the best returns are achieved by thinking in a slightly contrarian manner, rather than simply following the crowd to the most obvious sectors and assets.

Strategy viewpoint

Multifamily strategies based on market maturity.

Real estate investor interest in European multifamily assets has been growing continuously in the last decade. In our view, resilient income-driven performance, supported by strong occupier market fundamentals and long-term socio-demographic trends, will continue to fuel the rise of this asset class in the coming years. In terms of implementation, investment strategies for building direct exposure to the European multifamily sector vary depending on the maturity level of the targeted markets (see Figure 11).

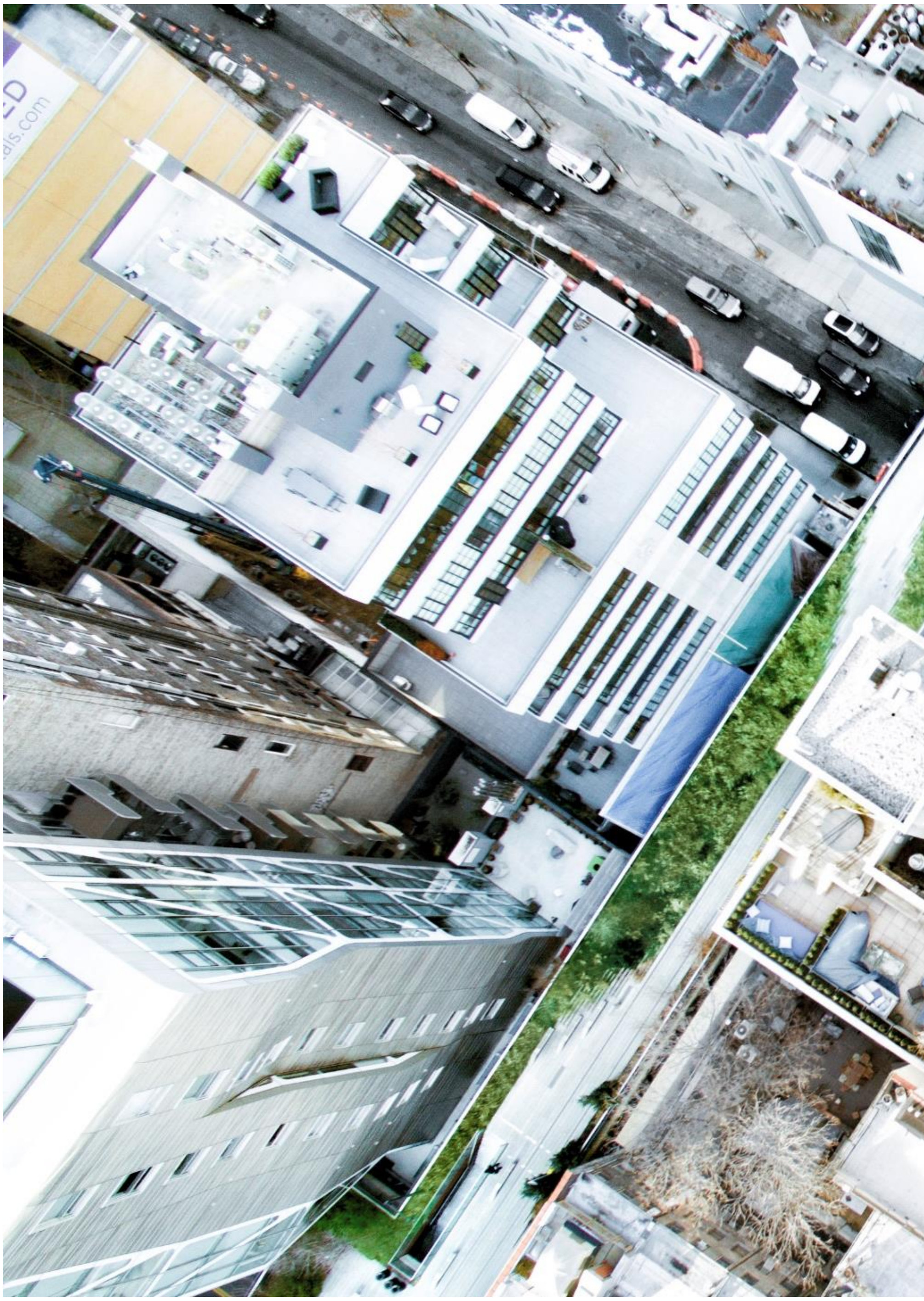
Thanks to their depth, established European multifamily markets typically offer a wide investment spectrum in terms of investable macro-locations. Given the actual investment pressure in prime locations and the potential effects of increasing home and near-office activities, attractive micro-locations in the agglomeration areas and well-connected secondary cities are likely to be preferred over large city locations, both in terms of initial yield level and rental growth prospects. Thanks to the high level of institutionalization of these markets, sizeable direct exposure can be efficiently achieved through the acquisition of an existing professionally managed portfolio. Single assets should also be considered as these are likely to offer some extra-yield compared to large portfolio deals. Once the initial exposure has been achieved, active asset management strategies can be applied in order to create value within the existing stock in the long run.

The investment approach in frontier markets is set to be somewhat different given that institutional-grade products are likely to be either not available, or so scarce that pricing and availability of quality multifamily assets will probably be inadequate in the existing stock. Also, the geographical scope of frontier multifamily markets tends to be focused on a few gateway cities and locations in close proximity. Therefore, partnering with local residential developers who have access to building plots in these targeted areas and can deliver the expected building quality, is an interesting strategy for core residential investors seeking multifamily exposure in frontier markets.

Figure 11: Level of multifamily market maturity and proposed strategic approach

	Countries	Strategic focus
Established markets 	Austria Denmark Finland Germany Sweden The Netherlands	– Target robust micro-locations in metropolitan areas (outside of core urban centers) and attractive secondary cities – Build up exposure by acquiring portfolio of established properties and consider selected single asset deals offering an extra yield – Apply active asset management strategies to unlock untapped potential of existing properties in the portfolio
Frontier markets 	Belgium France Ireland Italy Luxembourg Norway Poland Spain United Kingdom	– Use a geographically focused strategy on a limited number of gateway cities and surrounding municipalities – Partner with established local players to access desired product quality through forward-purchased deals – Selectively reposition existing properties lacking professional management using a manage-to-core approach

Source: UBS Asset Management, Real Estate & Private Markets (REPM), May 2021
Notes: Switzerland is not considered in this analysis due to legal constraints (Lex Koller) on foreign investments in the Swiss multifamily market.



Tiffany Gherlone
Head of Real Estate Research
and Strategy – US

US outlook

Bifurcated recovery.

As summer approaches, we expect the US will make progress in the slow process of reopening. With that renewal, markets are starting to move again as well. By autumn, real estate investors should gain insight from increasing comparable leases and sales.

Real estate fundamentals

Healing.

The US economy is recovering from the depths of distress realized in 2Q20. Political disruptions have not dissolved, even as the incoming administration advances goals and messaging. Additional stimulus and legislation designed to seed expansion have supported stronger economics and inflation.

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 through 2021 as effects from the pandemic and 2020 recession ripple through society and the economy.

The NCREIF-ODCE Fund Index shows income return offsetting capital depreciation in private commercial real estate resulting in a positive total return of 2.1% QoQ for 1Q21, and 2.3% YoY. The hotel and retail sectors continued to be the most directly impacted by lingering effects of the pandemic.

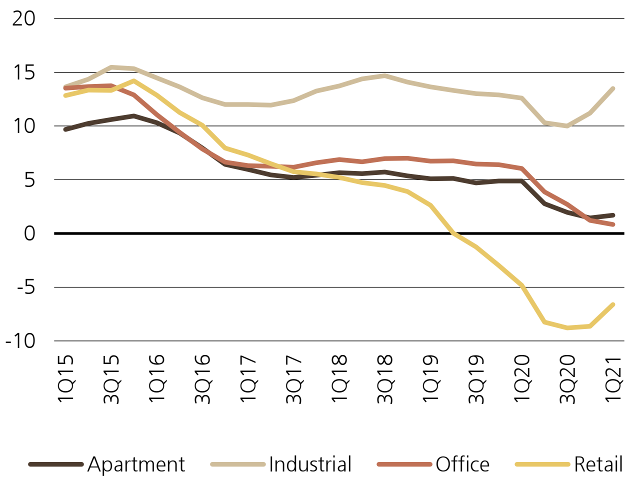
According to the CDC, nearly half of the US adult population was fully vaccinated by mid-May which, combined with spring weather, has led most states to pull back on gathering and travel restrictions.

The most recent legislation, approved in March, provided additional stimulus, extended unemployment benefits, and provided funding support for small businesses. However, direct stimulus is expected to fade by the end of summer.

Divergent sector return performance persists, as industrial returns surge (see Figure 12). Retail continued to post negative returns, albeit at a diminishing pace. Office returns slipped closer to zero. Apartment returns saw a minor increase, leading to optimism for this agile sector. At the market levels, we forecast positive total returns for industrial and apartments, but negative performance for office and retail during 2021.

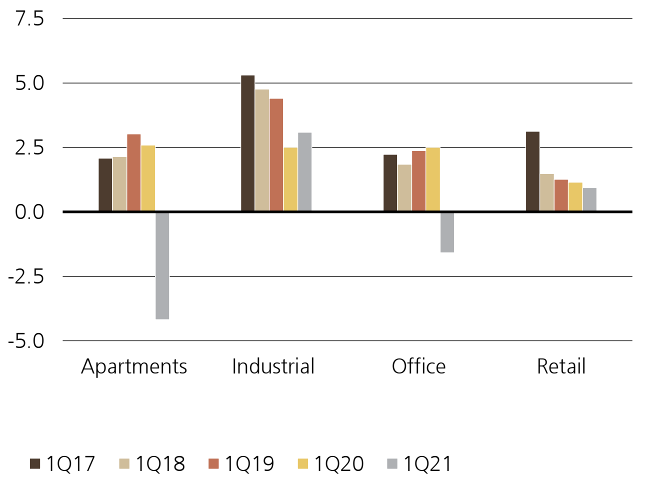
Office performance has been protected by contractual lease agreements, however, the outlook for office demand and future performance is uncertain as occupancy and rents are anticipated to decline into 2022. The short lease cycle and necessity nature of apartments keep the sector poised for recovery and rent declines appear to be ending. A fundamental evolution of the industrial sector has kept performance steady in this increasingly agile sector, consequently occupancy (see Figure 14) and rent (see Figure 13) are both on the rise.

Figure 12: US real estate returns across property types
(rolling four-quarter total return, %)



Source: Data show unlevered NCREIF Property Index total returns filtered for only ODCE managers, March 2021. Past performance is not indicative of future result.

Figure 13: Property sector rent growth
(year-over-year change, in quarters ended 1Q21, %)



Source: CBRE-Econometric Advisors, 1Q21. Note: retail rent growth only reflects Neighborhood, Community and Strip Shopping Centers, thus excluding Malls, Lifestyle and Power Centers.

Apartments
Over the past year, apartments vacancy rose 50bps to 4.7% (see Figure 14), according to CBRE-EA. A comparatively modest rise, to a rate in line with the 10-year average. Average asking rents are down 4.2% YoY (see Figure 13); in 2020, landlords sacrificed rent to fill vacancies. However, 1Q21 marked the first increase in the average US rent in a year. The apartment sector's agility comes from short leases with ability to monetize changes in the economy quickly, coupled with low capex burdens, which position the sector for a recovery in 2021.

Poised for summer
Apartment returns continued to hold steady into 1Q21. Buildings actively leasing-up 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. With pandemic restrictions easing in time for the summer holiday season, increasing employment should lead to an uptick in leasing, although competitive concessions are likely to remain. Rental rates hint the beginning of growth.

Industrial
Industrial remains the strongest sector, with rising returns driven by robust fundamentals. With a 1Q21 growth rate in completions of 1.9% YoY, industrial supply remains above average. However, demand has accelerated and 1Q21 availability, at 7.0%, is 30bps below one year ago. Sector rent growth is in line with the 10-year average at 3.1% YoY, as tracked by CBRE-EA.

The more the merrier
Continued e-commerce growth kept sector fundamentals growing, readily supporting increased investor demand and rising income returns. Industrial's low capex requirements supports flexibility. Higher-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 sustainability, technology, in-fill, cold and self-storage.

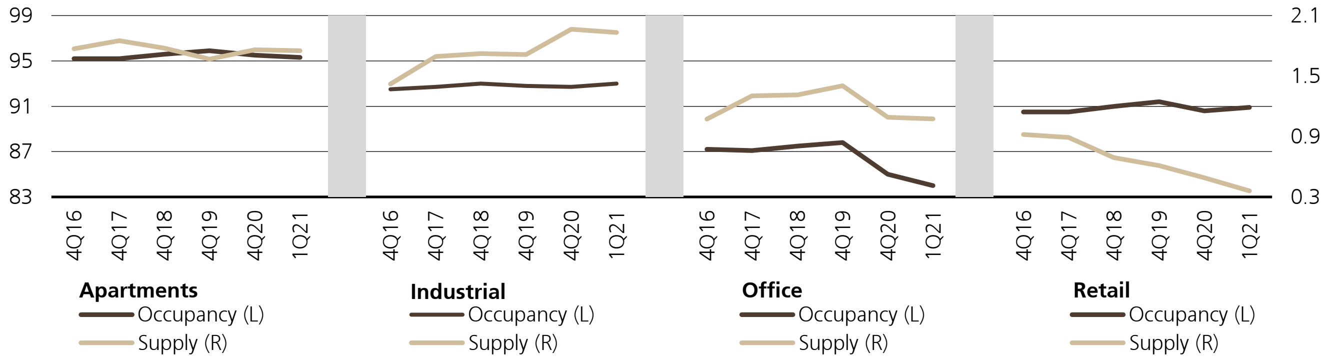
Office
Office completions have remained in line with the historical average, with over 40 million sqft delivered in the year ending 1Q21. In the same period, net absorption was negative 100 million sqft, causing vacancy to surge to 16.0%. According to CBRE-EA, this supply imbalance is expected to continue through this year; office vacancy could approach 20% by mid-2022. First quarter rents were down by 1.6% YoY, under pressure from lingering effects of the pandemic, and could continue to decline through year-end 2022.

Long road ahead
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 density remain more attractive. As for downtown office, urbanization should return, albeit at a diminished pace as the pandemic eases.

Retail
Neighborhood, community & strip (NCS) retail availability is up 50bps YoY, to 9.1%. The pace of supply has been declining for a decade and inventory grew by just 0.3% YoY. NCS asking rent growth, of 0.9% YoY in 1Q21 (as tracked by CBRE-EA), remains positive. However, a lack of new, comparable leases and offsetting effects of past rent deferrals cast doubt on the observable rental rate data.

Thriving or just surviving?
As recovery begins to take hold, retailers 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. Long-term retail industry transformation will likely come from 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 to reimagine existing sites.

Figure 14: Occupancy and supply trends



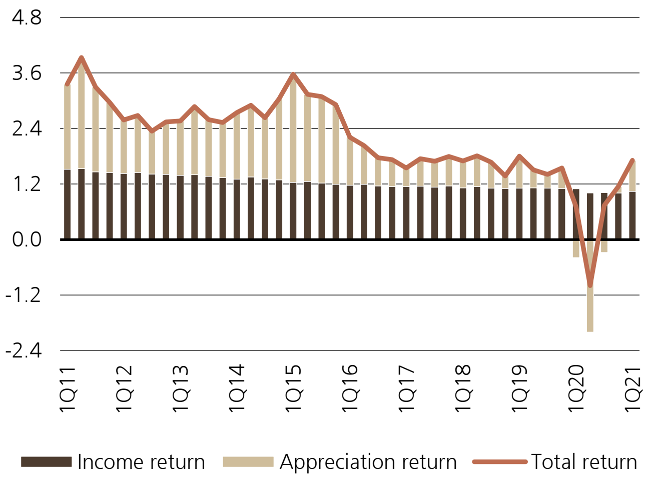
Source: CBRE Econometric Advisors, 1Q21. Note: Supply is shown as a completion rate (i.e. completions as a percent of existing inventory). Note: retail occupancy and supply rates only reflect Neighborhood, Community & Strip Shopping Centers, thus excluding Malls, Lifestyle and Power Centers.

Capital markets

Measured momentum.

Property-level returns improved during each of the last three quarters, with 1Q21 total return approaching recent averages (see Figure 15). Once again the industrial sector carried the bulk of the quarter's improvement, with retail slowly becoming less of an anchor. Although down slightly from a year ago, income returns remain steady.

Figure 15: US property returns (QoQ, %)



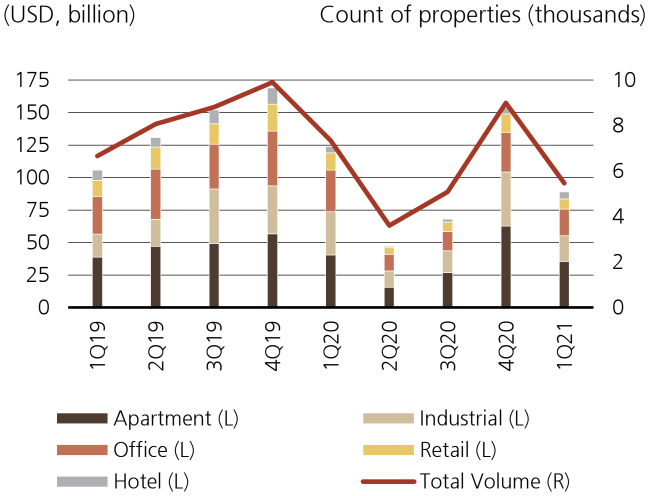
Source: NCREIF Property Index, 1Q21. Past performance is not indicative of future result.

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, remains below 2.0%. However, the specter of higher inflation has pushed rates up, which pushed real estate spreads down toward the long-term average (see Figure 17).

While all downturns bring uncertainty to capital markets, the 2020 pandemic-led downturn brought several challenges unique to real assets: travel restrictions, site closures and backlogs in municipal permitting processes. These challenges continue to hinder 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 above long-term averages (see Figure 17). Debt markets are growing more competitive, with lenders favoring high-quality credit, long-term leases, multifamily, industrial and niche-sector properties.

Figure 16: US transactions

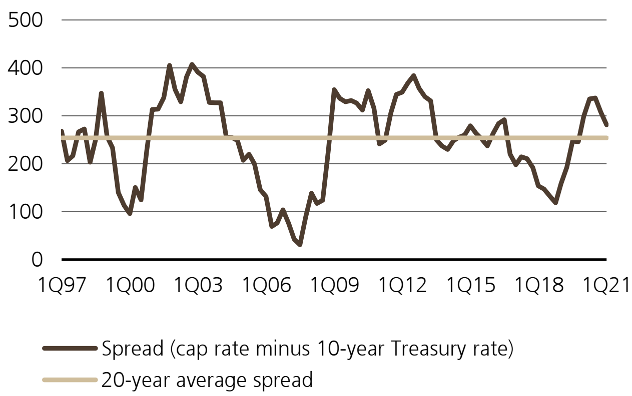


Source: Real Capital Analytics, 1Q21. Includes entity-level transactions.

Fourth quarter 2020 showed a fairly normal surge in transactions (see Figure 16). Early 2021 volume exhibited seasonality but remains well above mid-2020 volume. Apartments and industrial continue to lead the way. Increased transaction volume should give investors more clarity and confidence in values as 2021 progresses. Although transaction volume during the first half of 2021 is trending softer than 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. We expect sales and leasing comps will increase throughout 2021, bringing a new wave price discovery to private real estate.

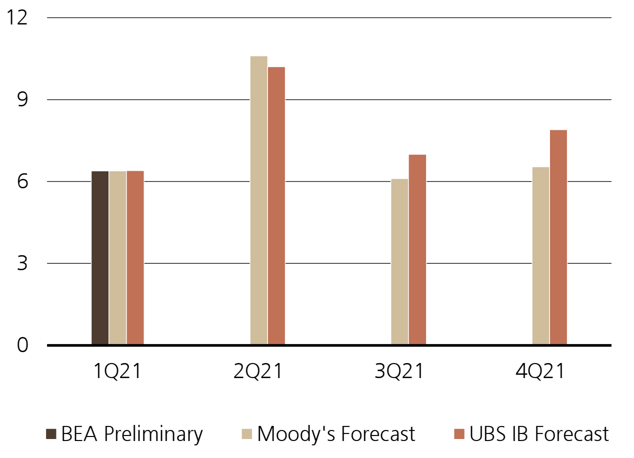
Figure 17: Commercial real estate spread (basis points)



Source: NCREIF Fund Index – Open-end Diversified Core Equity; Moody's Analytics, 1Q21

Despite a year-to-date increase of about 65bps in the 10-year US Treasury rate, interest rates are low and support increasing transactions. Spreads available in private real estate remain near long-term averages (see Figure 17). Borrowers have options as lenders become more competitive, especially for high-quality properties.

Figure 18: US GDP quarterly annualized forecast (%)



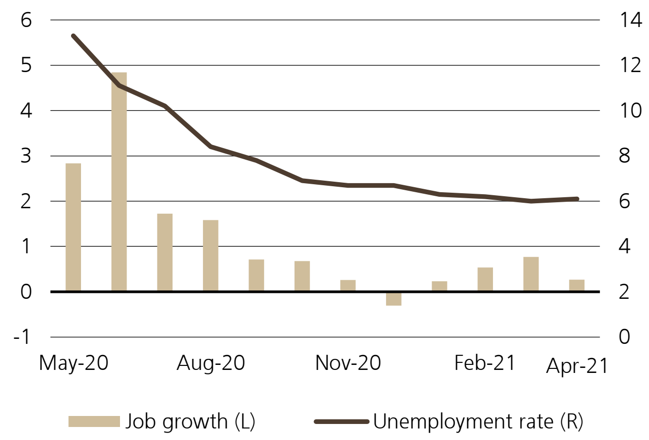
Source: Moody's Analytics forecast, as of 10 May 2021; UBS Investment Bank forecast, as of 7 May 2021

Total 1Q21 GDP has exceeded the 2Q19 level. If the rate of growth remains strong (see Figure 18), US GDP could exceed pre-pandemic levels by this summer. Moody's Analytics expects GDP to reach the 4Q19 level before the end of 2021.

Monthly unemployment has temporarily plateaued near 6% (see Figure 19). Higher virus exposure associated with customer service jobs is keeping candidates away. Additionally, restaurant employees that rely on tips may prefer the steady income from weekly unemployment bonuses, rather than return to an industry restricted to 50% capacity.

Some states are opting out of the federally funded USD 300 weekly unemployment bonus to encourage service employees to return to work. Although most employment sectors are experiencing modest growth, full employment recovery is not anticipated in 2021.

Figure 19: US job growth and unemployment rate
(change in employment, thousands of jobs)



Source: Moody's Analytics, as of March 2021

Strategy viewpoint

Drawing focus.

Progress toward full recovery will remain measured. Current uncertainty is centered on the strength and speed of recovery. Previously shuttered or restricted businesses are reopening and seeking employees. However, many businesses are slow to fill open positions – particularly service jobs. Positive news on vaccine distribution, reopening of schools, and fiscal stimulus should continue to support a meaningful rebound in economic growth and a turnaround in aggregate real estate performance.

Investor confidence remains higher in the industrial and apartments sectors, given the persistent, necessity-driven tenant demand. Confidence is growing in the leisure and travel sector, supporting optimism for hotels. For retail and office investors, 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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