SPOTLIGHT
Savills Research

European Themes 2022

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● Office recovery ● Omnichannel strategies ● Operational assets ● ESG ● Investment picks

Introduction: Real estate prospects in a recovering European economy

As Europe battles with rising coronavirus cases, the Euro Area's economy will continue its recovery in 2022. Capital Economics forecast GDP growth will fall from 5.3% to 4.0% between 2021 and 2022, with all of Europe's major economies expected to have recovered above pre-pandemic levels of GDP by the end of 2022. CEE markets have recovered among the fastest of Europe's economies, led by Romania, Poland and Hungary, whilst southern Europe is recovering at a slower pace, due to lower levels of international tourism and higher levels of unemployment.

Supply chains will continue to adjust to both disruption to supply and a resurgence in demand. Port closures, labour scarcity and rising fuel costs have all impacted the price and availability of goods, particularly semiconductors, which have created shortages of new vehicles and smartphones. We have since seen some companies seek to near-shore their supply chains in order to mitigate future operational risks.

The main theme for investors will remain to what extent inflation will impact real estate returns. Eurozone inflation rose to 5.0% in December 2021, the highest reading since September 2008. However, looking more closely at the figures, the core level of Eurozone inflation remains at 2.6%, close to the ECB's target rate of 2.0%, and below other advanced economies, indicating that any policy change is unlikely for the forecast period. The 26% yoy increase in energy costs is expected to normalise, reducing the headline rate.

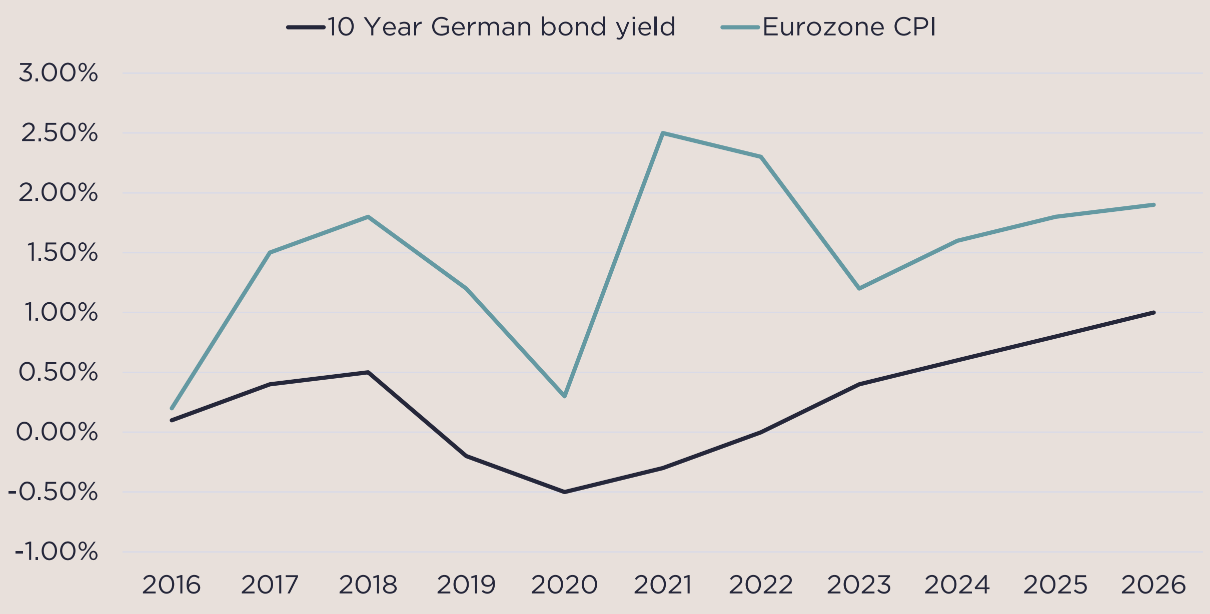
A scarcity of labour remains an additional price pressure in the Eurozone, although not as severe as those in the US, for example. Conversely, on the demand side, the Eurozone consumer bounceback has been weaker than other global markets, such as the US, which will reduce price pressures. As such, Capital Economics do not expect the Eurozone base rate to rise before 2024.

European real estate will remain an attractive asset class given the majority of leases are index linked, providing a hedge against inflation. The yield spread between prime CBD offices and government bonds also remains above the long term average.

The other consideration is the impact of rising construction input costs, increasing overall development costs, which may, in turn, support rental growth opportunities for existing stock.

One of the main downside risks for world economies in 2022 is the

Chart 1: German bond yield and Eurozone inflation forecasts



Source: Capital Economics

possibility of the pandemic dragging on longer than we anticipate. The proportion of unvaccinated people remains high, especially in developing countries and the emergence of Omicron is a proof of the ongoing threat of new variants. Rising cases and new lockdowns will lead to new economic shocks, further disruptions on supply chains and upwards price pressures.

Despite the disruption and uncertainty caused by the pandemic, investor confidence in European real estate is stronger than ever. Savills data show that property investment volumes were 13% higher yoy and 8% above the five-year average during the first three quarters of 2021. We anticipate 2022 transactional activity to be at similar levels to 2021 (€290bn-€295bn).

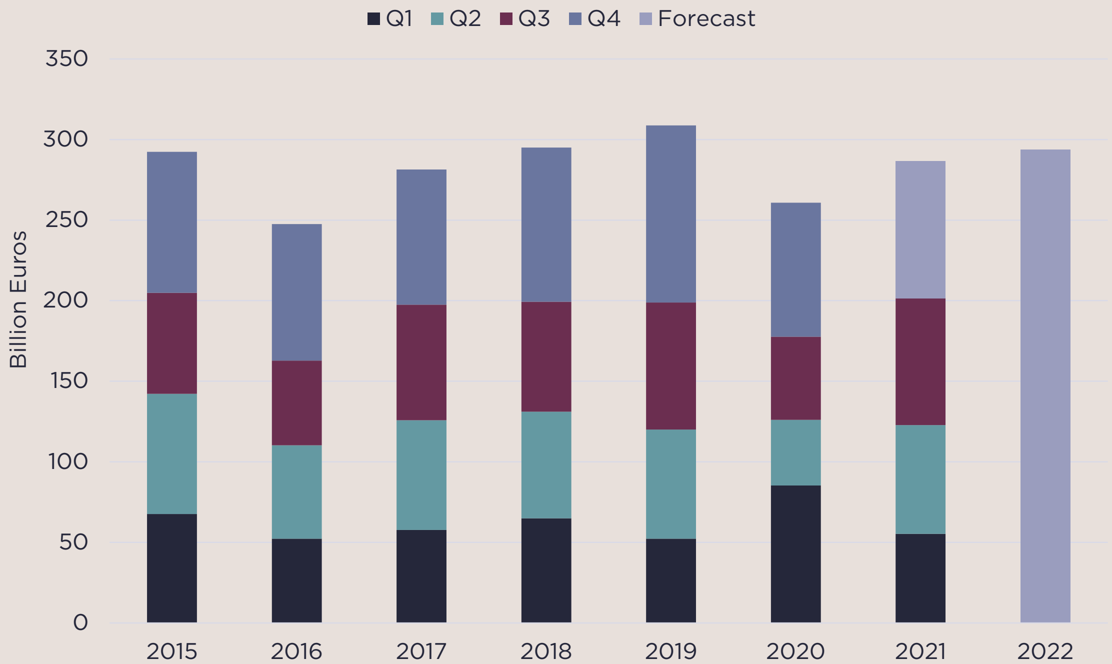
The risk of stranded assets has risen driven by occupier demand for buildings with high environmental credentials.

This creates new development and investment opportunities for market players that are prepared to undertake retrofitting and refurbishment works in the medium term and benefit from the upside rental potential.

Low development activity is expected to cause a supply gap in the market in the medium term (2022-2023), which coupled with higher land and construction costs are expected to lead to above inflation rental growth.

Throughout this report, we examine the major themes we expect to impact European real estate, focussing on; adopting omnichannel strategies, the prospects for office occupational markets, operational real estate opportunities and development in an ESG focussed environment and provide our top investment picks for core, core-plus, value-add and opportunistic investors.

Chart 2: European investment transactions volumes forecast



Source: Savills

Theme 1) Embracing retail and logistics as part of omnichannel strategies

The implementation of further restrictions and potential for further lockdowns will continue to support online retail spending in 2022, creating new occupier demand for logistics space. Since the pandemic, UK online retail sales rose from 21% of total retail sales in Q1 2020 to reach 36% in Q1 2021 and mainland Europe has observed a similar upwards trend over the same period (Forrester data indicates circa 18% of total retail sales will be made online during 2021, up from 15% in 2020).

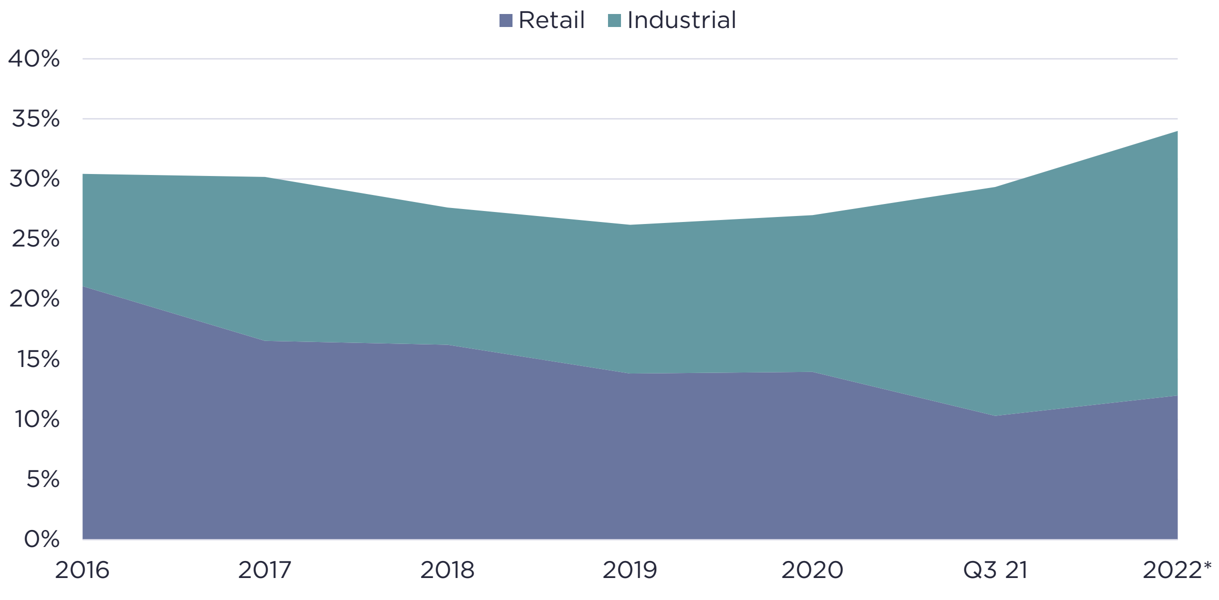
The sprawling occupier demand has been particularly visible across online retailers and 3PLs. According to Savills European Logistics Census of industry experts, 58% of 3PLs and 46% of retailers expect to increase their warehouse occupancy over the next three years. 41% of manufacturers, who have been particularly disrupted by supply chain challenges and rising input costs anticipate an increase in warehouse demand. However, building affordability and expansion capacity remain the most significant warehouse challenges for occupiers over the next 12 months as speculative development and zoning of new logistics space fail to meet record levels of demand. This is beginning to apply upwards pressure on rents (an average 3% increase over the 12 months to end Q3 2021) and we anticipate similar rental increases in 2022.

These same trends have had the opposite effect on the retail sector. Investor allocations in physical stores and malls have been falling along with the rise of online consumption. Over the past decade the share of retail investment has dropped from over 25% of the total activity to 13% in 2021. Prime shopping centre yields have been moving out over the past five years to reach 5.35% on average in the end of 2021, across Europe. This compares to a peak of 4.45% in Q1 2018 and a trough of 6.6% in Q2 2009.

The pandemic has accelerated the transition forcing retailers to adapt to a new reality, where the consumer makes one out of five purchases online. Winners and losers have emerged and certain retail formats in certain locations have proven more resilient than others. In 2021, the share of the convenience sector, including retail parks, retail warehouses, hypermarkets, and supermarkets, increased from a ten-year average of 20% to 50% of total retail investment in 2021. Investors looking to meet higher return thresholds while managing income risk have discerned that retail parks and grocery stores are often located close to population centres and are generally less exposed to changes in discretionary spending due to downturns or public health restrictions. Moreover, retail warehouses and parks are increasingly seen as a hybrid operation providing in-store retailing with last mile delivery fulfilment options.

We expect investor focus on these market segments to continue in 2022. Supply of prime assets will be scarce, but value-add opportunities will come-up, especially in Western European markets where a significant share of retail stock was built over 15 years ago and is becoming dated. Repriced retail centres, in strong catchment areas with good accessibility will offer refurbishment and redevelopment potential. Depending on the profile of the scheme and the local planning regime, retail can be complemented with leisure, housing, co-working, healthcare, and other community services, offering more diversified income. Moreover, new and refurbished retail assets should aim to minimise their environmental impact through energy and water efficiency methods, use of sustainable materials and landscaping.

Chart 3: European omnichannel investment allocation as a % of total investment



Source: Savills (* indicates forecast)

Theme 2) Will office vacancy rates recover in 2022?

The World Health Organisation's stark reminder that Europe is "once again at the epicentre of the pandemic" is likely to have a more modest impact on occupier demand than during 2020/21, as occupiers have already had their first taste of work-life post pandemic and begin to plan longer term. The recent re-introduction of curfews and work from home advice across several countries following the outbreak of the Omicron variant will continue to cloud the outlook for European office occupier demand in 2022.

Historical data shows a strong relationship between GDP growth and demand for office space as companies hire employees at a faster rate during recovery periods. Malaga, Toulouse, Bratislava, Seville and Valencia are expected to observe the strongest office based employment growth over the next five years according to Oxford Economics. We may begin to see some companies seek to expand across secondary cities where talent availability remains strong and cost of living is lower, and city-based employment growth will continue to outstrip national averages.

Workers have shown encouraging signs of returning to the workplace and occupiers are now removing some of their previously marketed "grey space" from the market. In Prague, for example, space available for sublease fell by 25% to 48,700 sq m during Q3 2021 which will feed into vacancy rates levelling out in 2022.

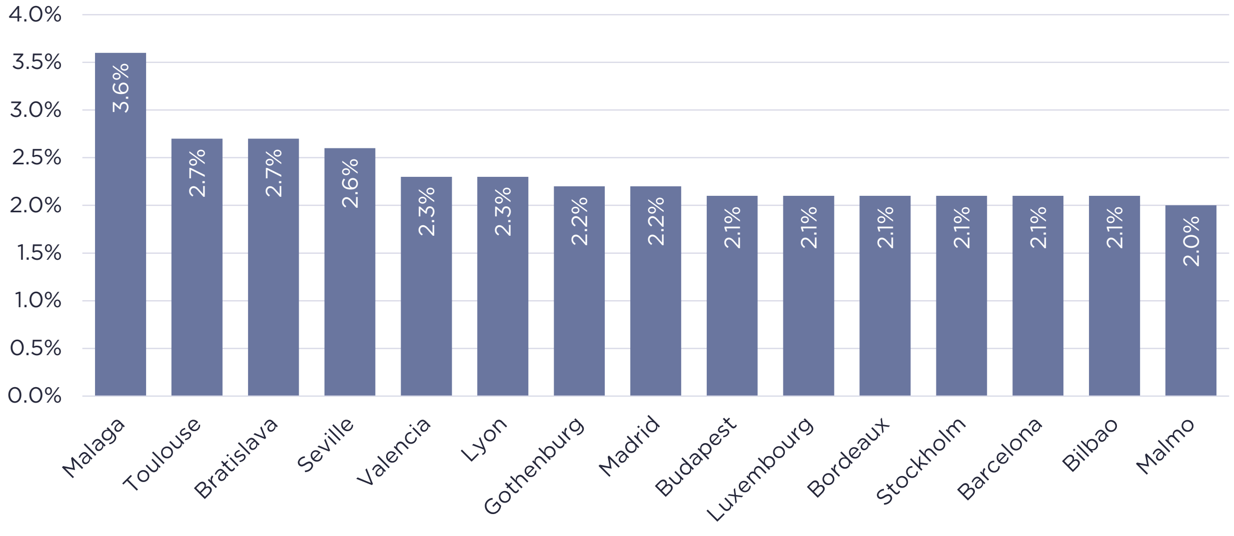
Countries may also begin to introduce new laws to attract talent intending to work remotely. New Portuguese work from home laws have banned employers from contacting staff outside working hours and the legislation is also aimed at attracting inflows of skilled 'digital nomads' to Portugal. We anticipate this will boost occupier demand in these locations on the basis that office-based workers expect a return of 2/3 days per week as employers factor remote working into their operations.

Offices in prime locations with good transport links and strong EPC ratings will be essential to attract and retain workers, where we will see the strongest occupier demand. Although some tenants may look to downsize their footprint, demand for high quality space will remain strong and we may begin to see office densities reduce as employers increase their focus on the social aspect of the workplace, which will keep prime vacancy rates low. For older office buildings in fringe locations, we expect landlords to spend more on refurbishments to avoid obsolescence, although an increase in secondary vacancy rates is to be expected in 2022 as prime/secondary rents will begin to diverge.

Flexibility will become more essential for occupiers' return to work strategies, centred around collaboration, creativity, and engagement. Many companies will remain unable to plan for longer lease periods and we expect more larger corporates to be increasing their exposure to the flex office market. Flex accounted for a record 9% of Europe's office demand in 2019, falling to 2-3% during 20/21 and we anticipate a recovery towards the pre-pandemic level in 2022.

A shortage of new supply will help to stabilise vacancy rates and rents. Germany's development pipeline appears majority pre-let in 2022, whilst only 260,000 sq m of new space is expected to be delivered in Madrid in 2022, of which 33% is committed. Indexation and rising construction costs will maintain modest rental growth across the core markets in 2022, although we expect incentives to remain generous, at least during the first half of the year. Developers have absorbed much of the increase in construction costs thus far, which we anticipate may begin to be reversed once occupier markets stabilise.

Chart 4: European office based employment growth forecasts (five year, % pa, top 15)



Source: Oxford Economics

Theme 3) Surging operational real estate opportunities

The definition of core assets has been challenged during the pandemic. Although offices will continue to prevail investment strategies, as it is the largest and most liquid commercial sector, investor interest has shifted towards the residential sector, as an alternative core asset class. In 2021 (up to Q3) investment in European multifamily only was 21% up yoy, with several new players entering the field. The average prime European yield reached record low levels at 3.15%. The sector is supported by strong demand and supply fundamentals; rising urban populations seeking rental accommodation in cities with structural undersupply of housing. According to our analysis housing completions lag new household creation not only in most European capitals, but also in dynamic secondary cities in Germany, Netherlands, and Spain. Additionally demand for rental is rising also in markets with traditionally high home ownership ratios, such as Southern and Eastern European cities.

Another benefit of multifamily investments is that income streams are typically linked to inflation, offering a hedge against rising prices. One of the emerging risks of the sector is the more stringent regulatory environment, which aims to protect households from rising rents. We believe that while these measures limit rental growth prospects, they provide security to tenants and suit core investment strategies. We anticipate local governments to start focusing more on the increase of housing supply rather than regulation in the coming years, which should limit the upward pressure on rents. We also expect more collaboration with the private sector in the production of affordable housing. The challenge for core investors in 2022 will be to identify stabilised assets, while more opportunities will be available for new developments and forward funding agreements.

An additional challenge for residential investors is the increasing operational intensity of the assets. Post pandemic, occupiers are spending more time at home, and focus on wellness and convenience. The design of residential space needs to adapt to the rise of 'working from home' with additional or separate work/office space essential for some tenants. Following the lockdown experience, outdoor spaces and better access to larger and operable windows have become a prerequisite. Heightened interest in safety and sanitation is likely to continue after Covid-19. As a result, touch-free technologies are incorporated as well as design of more spacious communal areas. Additional amenities depend on the location of the property and the demographic profile of the residents. Overall, this points to greater operational complexity and required expertise.

PBSA (Purpose Built Student Accommodation) and care homes have also been performing strongly in 2021 and are expected to continue growing rapidly in 2022. The two sectors have proven their resilience as overall, their activity levels quickly bounced back to pre-pandemic standards. Both sectors benefited from reduced investment allocation in the traditional asset classes such as retail and offices, yet they also make an increasingly strong investment case. The fundamentals of these two aged-restricted residential sectors are solid, based on long-term demographic changes. Both asset types provide a long-term secured rental income stream, which in many cases can be supplemented by additional revenues from a-la-carte services. Additionally, with ESG taking higher stakes in investors' strategy, the intrinsic nature of student and care home residences benefits from natural leverage over the social aspect of ESG policies. In 2022, we anticipate care home investment will be driven by further M&A (Mergers & Acquisition) activity. Regarding the student housing sector, we expect further consolidation and expansion movements from the major European market players. Additionally, towards the end of 2022, we expect the next wave of PBSA portfolio transactions, as the first generation of developers and operators will be ready to sell their assets and exit.

“The design of residential space needs to adapt to the rise of 'working from home' with additional or separate work/office space essential for some tenants,” Savills Research

Theme 4) ESG strategies: developing vs redeveloping

Net zero is going to be the main priority next year and in the coming years for real estate stakeholders. Our industry is responsible for about 40% of the world's carbon emissions, so it is no surprise that there is an urgency to act. Investment managers and investors are setting ambitious targets for the reduction of their emissions over the coming years across the entire lifecycle of their real estate assets. Decarbonisation of real estate portfolios needs to accelerate under the threat of a warming climate and the pressure of new regulations. In order to achieve this investors and asset managers need to measure the energy footprint of their existing portfolios and to assess future climate adaptation risks of newly acquired assets.

In this context we expect to see more investment into climate tech and retrofitting, in an effort to address climate risks and improve the energy performance of the buildings. With regards to new acquisitions, initially investors are likely to focus on newly built assets with high energy performance credentials and future developments. Over the past 10 years, the share of forward funding deals across sectors went from for 3.7% to 16.4%. During the same time, the share of acquisitions of development land went from 6.1% to 8.9%. Most of these forward funding and land development deals involved logistics and residential projects; two sectors currently in a strong supply and demand imbalance situation. The weight of capital and competition for the best assets is likely to lead to some further prime yield compression. We project prime achievable yields to compress by up to 5bps for offices, 10-5bps for logistics and 5-10bps for living sectors on average across Europe. Retail yields should gradually stabilise or correct further in some markets.

The need for energy efficiency is also driven by major corporate tenants from a variety of sectors. Major companies, such as Microsoft, Amazon and Google have stated significant carbon reduction commitments for the future decades, meaning that they will require corporate space that meets these prerequisites.

Tenant demand for green buildings has led to an increase in office development activity with the development pipeline in 2021 having increased by 24% yoy. However, new construction is responsible for significant amounts of carbon emissions, which are commonly referred to as embodied carbon. It is argued that renovation and reuse projects typically save between 50% and 75% of the embodied carbon emissions compared to constructing a new building. Regulations and planning are likely to force the shift from new construction to renovations and repurposing of assets in the coming years. The polarisation of occupier and investor demand is expected to lead the repricing of secondary assets, which will make their redevelopment financially viable.

The yield gap between prime and secondary office assets tends to narrow in periods of high investment turnover and to widen in periods of uncertainty. Post GFC the gap peaked at 90bps in 2014 and started moving in until 2017 at 59bps. This year it is closing at 77bps, with secondary yields moving out in some of the markets, where new environmental regulations are being introduced (UK, Netherlands). We expect this trend to spread across most markets in Europe offering value-add opportunities to investors with higher risk tolerance.

Building decarbonization is being pushed by more property owners, real estate investors, and corporations not simply to help cool a warming planet, but also because their own success depends on it.

Top European investment picks

Core / Core plus

For core investors income stability and low risk are key prerequisites. They should be looking for the best-in-class assets, in terms of location, tenant strength, and ESG credentials, notably in relation to their energy footprint. We recommend:

- **Prime offices with high EPC ratings** in cities with dynamic economies, low vacancy rates and solid occupier demand such as London, Paris, Berlin, Munich, Stockholm, Madrid and Amsterdam.
- **State of the art logistics facilities** in markets with high ecommerce penetration and established 3PL operators and online retailers such as UK, Netherlands and France.
- **Stabilised, newly built multifamily assets in major cities** with large and rising populations such as London, Paris, Berlin, Frankfurt, Amsterdam, Stockholm and Copenhagen.
- **Large supermarkets** in accessible locations with strong catchment areas let to established, strong performing food retailers across all European capital cities.

Value-Add

Net zero is going to be the main priority next year and in the coming years for real estate stakeholders. Investors will focus on measuring their assets' carbon footprint, to identify underperforming buildings and to improve their energy performance. This can bring value-add opportunities in the market with good rental uplift potential. Other value-add opportunities may emerge from the need to improve the performance of operational real estate, with more focus on meeting the expectations of the occupiers and successful branding. We recommend:

- **Well-located offices** with energy performance upgrade potential in cities with demand and supply imbalances such as German cities, Amsterdam, Paris, London, Stockholm.
- **Life science facilities** in research and development hubs such as UK Golden Triangle, Randstad and Paris-Saclay.
- **Student housing in large university cities** with low supply of professionally managed student accommodation in Spain, Italy, Poland, and Germany.
- **Healthcare in countries with ageing populations** or with low level of bed per inhabitants (Care homes and Hospitals) such as Germany, UK, France, Spain, Italy, Ireland.
- **Datacentres** in all large urban centres with solid manufacturing, healthcare and financial services GVA prospects or with major digital infrastructure network to be delivered soon.
- **Prime retail parks** in well-connected locations with strong catchment areas across capital and regional cities in Europe.
- **Hospitality in established tourist destinations** where visitor flows are expected to rebound strongly post-covid such as Southern Europe and key city break destinations (Italian cities, Prague, Amsterdam, Paris).

Opportunistic

Demand and supply imbalances caused by slow construction activity across several sectors, the need of refurbishment and structural changes are creating a lot of opportunities for investors that are prepared to take on development risk.

- **Multifamily development** in partnership with local developers in secondary cities in countries with strong regional urban centres such UK, Germany, France and Poland.
- **Logistics development** in countries with low but fast-growing ecommerce penetration in Southern and Eastern Europe.
- **Corporate warehouses for manufacturing and storage** as a result of nearshoring trends in Eastern European and Balkan countries.
- **Retail centres in need of active asset management** in well-connected locations with strong catchment areas and high disposable incomes in the UK, Germany, France, Spain and the Nordics.
- **Eco-friendly hospitality developments** with focus on wellbeing, in distinctive locations which benefit from high-speed train connectivity for environmentally cautious travellers such as France, Spain, Germany, Benelux and Italy.
- **Retrofitting and repurposing** of assets across sectors and geographies.

> "Investors will focus on measuring their assets' carbon footprint, to identify underperforming buildings and to improve their energy performance," Savills Research

Savills Commercial Research
We provide bespoke services for landowners, developers, occupiers and investors across the lifecycle of residential, commercial or mixed-use projects. We add value by providing our clients with research-backed advice and consultancy through our market-leading global research team.

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