GRE News and Reports

GRI Club

THE FUTURE OF THE EUROPEAN REAL ESTATE & CAPITAL MARKETS

Gearing up Capital & Distress

July, 2020

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Introduction

The European real estate and capital markets are slowly seeing transactions and investments return while lockdown easings sweep across the continent. With some countries affected less by the pandemic, Europe is seen as a safe haven for many foreign investors looking for equity opportunities or core investments at the moment. But many investors remain cautious and continue their wait and see approach. Most agree, however, that the next few months will show in which direction the markets are headed and draw potential recovery lines for 2021.

This GRI Report will discuss the immediate impact of COVID-19 on the European real estate and capital markets from the point of view of GRI Club members during the GRI Opportunity eSeries Europe. It will also explore the challenges and opportunities investors, lenders and developers will face in the medium and long term as activity revamps and the rules of the game change.

1. Is the Eurozone still a safe haven?

Guest Contribution by
Prakash Loungani, Assistant Director, IMF

Recovery in various segments of the real estate market of course depends on many developments specific to each segment, but also on economy-wide ("macro") developments such as the extent of economic recovery and the prospects for interest rates. For the Euro Area, the macro prospects appear supportive of recovery in real estate markets. The IMF's latest forecasts for the Euro Area predict that incomes will grow 6 percent next year, after an admittedly deep decline of about 10 percent this year due to the impacts of the stringent lock-downs that many countries put in place to flatten the curve of the epidemic. Meanwhile, interest rates are low and expected to remain so, in part due to stimulative actions by central banks.

The combination of expected recovery in their incomes and low interest rates should boost demand from consumers and companies for the real estate sector as a whole, though of course the extent of the boost will differ across market segments. The Euro Area would appear to be positioned somewhat better than the United States, where there is at the moment greater uncertainty about the course of the recovery. (Nevertheless, even in the United States, the low interest rates are triggering a boom in the residential sector in many cities.) The Euro Area should also benefit from the nature of the support provided to their labor markets over the course of this year: countries in the Euro Area were much more likely to use programs that kept workers attached to their companies than in the United States and the United Kingdom, where there was greater recourse to layoffs that could turn permanent. Unemployment rates are likely to remain much more stable in the Euro Area as a result, providing greater certainty to people about the expected course of their incomes.

In short, each segment and asset class in the real estate faces its own headwinds, but the macro developments in the Euro Area -- expected recovery in incomes and, despite that, continued low interest rates -- provide powerful tailwinds.

Photo: Mauro Sbicego / Unsplash

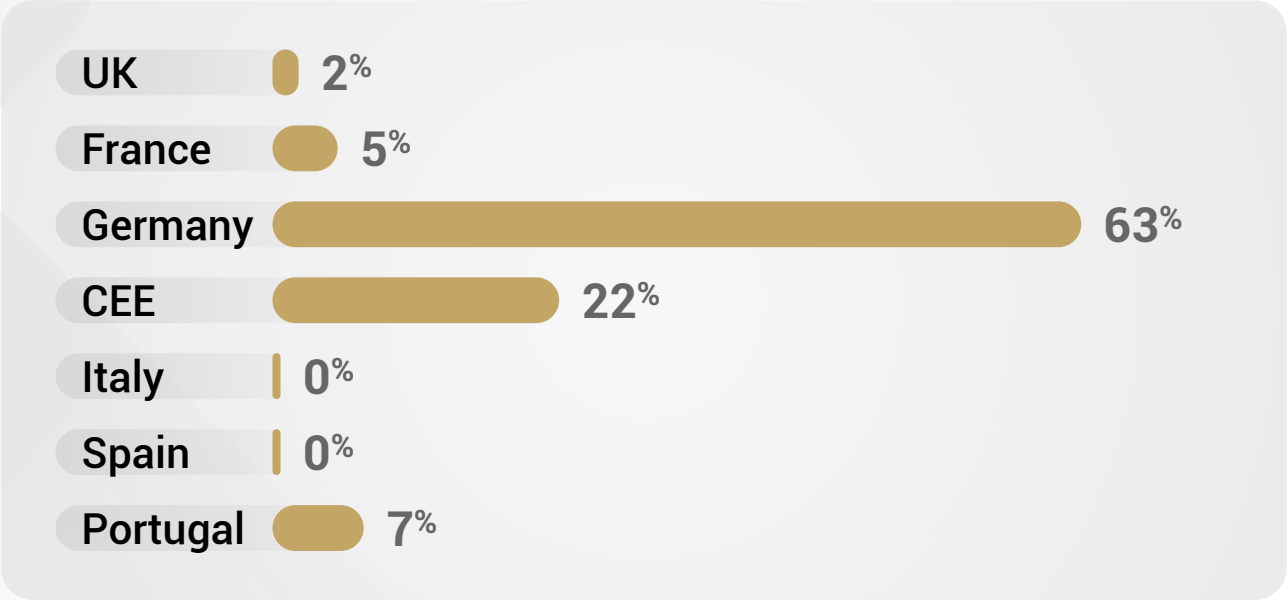
1.2 Winners & Losers

While the Eurozone as a whole is seen as one of the main investment destinations in the short to medium term, it is worth drilling down further and looking at the specific countries that will attract the most and least interest from domestic and foreign investors.

Germany is seen by the members as the overwhelming winner of the crisis. Not many were surprised, as Germany's monetary and fiscal actions to support its own economy were nearly unmatched across the world, while there was almost no debt build up due to long term fiscal surplus. Similarly, the country was praised for its quick and strict lockdown measures that softened the blow of the pandemic impact. Close behind Germany followed CEE and especially Poland, which was keened as a stable country by a majority of real estate executives. Surprising was the fact that France was looked upon quite negatively, raising questions about the stability and future of the French real estate markets. A possible explanation for the negative outlook might have been the more severe lockdown scenario compared to other European countries. In general the view towards winners and losers was very much characterised by the longevity and severity of lockdowns, as well as infection and deaths rates.

Another factor is also the treatment of employees. The group sentiment saw countries with more governmental regulations in place to support workers and lessen the increasing amount of unemployment rates, as better equipped after the crisis. In general the uncertainties that clouded economic forecasting are slowly dwindling, offering a more positive view on the short and medium term real estate prognosis.

WHICH EUROPEAN COUNTRY WILL BE LEAST ECONOMICALLY IMPACTED BY THE PANDEMIC?



* Surveyed GRI Club members as part of GRI Opportunity eSeries Europe (20 July 2020)

2. Dry Powder Spend & Interest Rates

Investors are expected to move up the risk curve especially towards value add and opportunistic deals with the expectations of some important changes in the transaction landscape in 2021. Especially, since many are expecting a real correction to hit the markets this time around, since we are facing a crisis that started in the real economy opposed to 2008's financial crash. Nevertheless, investors are confident in their fundraising and hitting their targets.

This might also be a consequence of many assuming that investment volumes will increase in the first half of 2021. Funds at the moment need to prove that they can transact in difficult situations and those with a proven track record will be more favourable in fundraising stages with investors. Despite such positive views, COVID has indeed disrupted fundraising capital and pricing of risk, reducing capital offering opportunities for debt funds. Due to unprecedented reposenses from the ECB we see record level low interest rates, however, this will be leveled out by higher coupons based on prolonged due diligence. The right credit risk and reward balance will be key.

Looking at interest rates, 48% of the group thought that we will see an increase of rates within the next 5 years. While the risk of inflation was touched upon, few saw concrete signs of rising levels within the next 12 to 18 months, due to unconventional monetary actions from the ECB and the steady increase of unemployment rates. Most agreed that inflation rates will stay around 0%. However, some raised concerns around potential bubbles that might be surfacing in pockets of the markets.

2.1 Foreign Capital into Europe & Cross Border Activity

Guest Contribution by **Tim Graham, Executive Director, JLL APAC**
JLL cross-border investment: Asia Pacific sentiment

Global investment volumes (direct, non-listed) declined 29%, to US$320 bn at half year point. Performance varied across the three regions, with capital flows broadly tracking the evolution of the pandemic. Globally, JLL advised our clients on $1.2 bn of capital markets deals every working day last year. This gives us great insight into active capital sources and the ability to track market liquidity.

Asia Pacific remains the largest source of outbound capital

Cross border investment has grown significantly over the last 10 years, consistently making up 25% of global volumes and representing closer to 40% over the last few years.

Asia Pacific remains the largest source of outbound capital over the last 12 months, with US$31.6 bn invested outside the region during this period. For context, this is 30% more than the US. Europe remains the most attractive investment destination for cross border buyers, with US$170 bn flowing from Asia Pacific to EMEA over the last decade.

Investor sentiment and strategic areas of focus

How to effectively price risk is a key consideration for investors. Our conversations with large regional investors have shifted focus towards identifying new opportunities as deal flow globally starts to increase.

Since the onset of COVID-19, investors have remained calm and measured, with few signs of distress across Asia Pacific. We expect that as markets reopen, it will have a direct positive impact on deal flow and volumes. The markets that have been most resilient are those with deep pools of domestic capital.

Our clients invest in real estate to generate income and capital returns – this is fundamental. Asset management will remain key to the creation & preservation of value and having defensive portfolios that generate strong underlying rental income is key.

Photo: Envato / Elements

As investors watch for signs of green shoots to appearing across the markets, country-by-country and sector-by-sector, there will be a focus on underwriting growth. In the current environment of ultra-low global interest rates, negative bond yields, volatile equity markets, real estate looks set to at benefit. As investors look for income producing assets, the relative stability of the asset class is attractive.

Whilst some investors will adopt a wait and see approach, the majority of the large regional investors in Asia Pacific are already on the front foot in terms of either deploying capital or actively monitoring markets. Investors are seeking core, defensive assets. There are a few bright spots in the region – we have seen clear focus on industrial, logistics, core offices, multi-family and other alternative asset classes.

Traditionally a lot of capital deployment has flowed through as investment sales. This will still be the case but, we have seen growth in the number of opportunities in corporate finance, fund raising, debt and joint ventures. We also expect more sale and leaseback transactions to occur in the second half of the year. Corporates in Asia Pacific, are looking at ways to monetise assets held on balance sheets and shore up liquidity.

Photo: Envato / Elements

What's next?

COVID-19 is accelerating trends that were already gaining momentum. Long term – the large demographic trends will continue to play out in Asia Pacific – rising urbanisation, growing populations, an expanded middle class – all have important impacts on our industry.

Technology and growth of e-commerce traffic is one example, as is the status of data centres and logistics that are part of an expanded defensive asset class in the eyes of investors. Given the acceleration of these trends, we believe it likely that investors will look to increase weighting of these sectors within their portfolios as deployment becomes more viable.

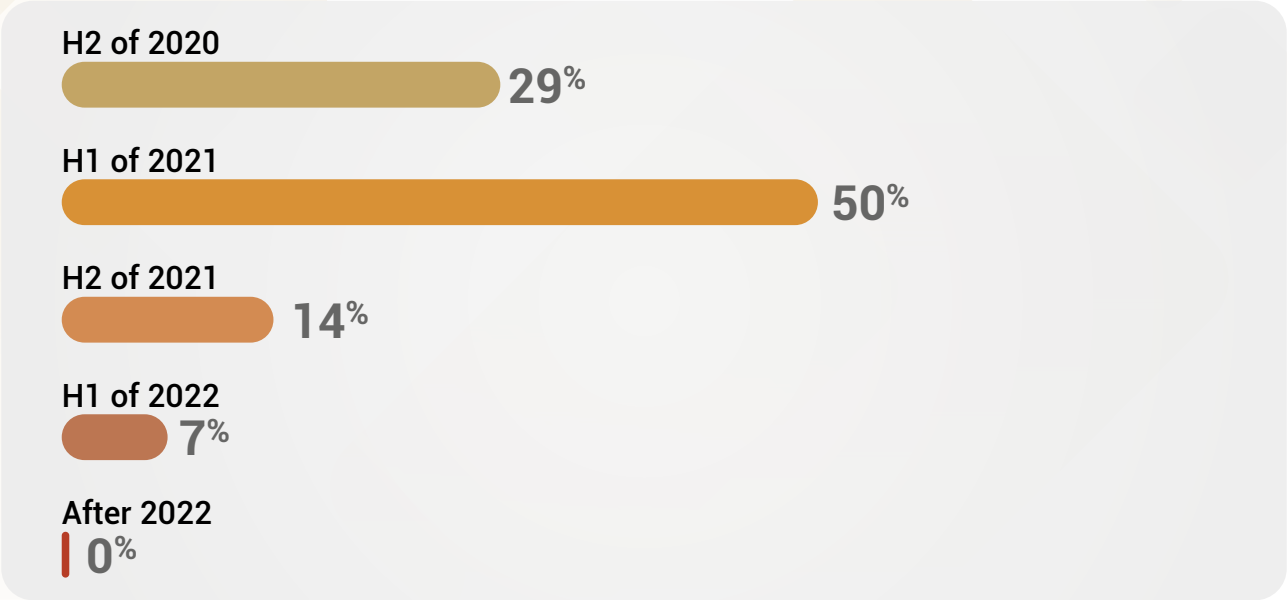
Investment in global commercial real estate has to an extent been underpinned by rising allocations. Cross-border investment has grown in prominence and scale in the current cycle and these themes will continue. The strength and resilience of cities will continue to be a central theme for investors. We have certainly seen lots of encouraging signs from investors who on the whole continue to be patient and long-term in nature.

2.2 Pan European Transaction & Investment Markets

The current transaction market has stagnated drastically compared to the strong start into 2020 beginning of the year. However, with lockdown easings transaction volumes have slowly picked up again and requests for fundraising and financing for development schemes have been ongoing. Higher levels of uncertainties are still surrounding retail and hospitality. While non-food retail was already in the midst of shifting business concepts and real estate structures, which COVID now further accelerated, during the GFC hospitality has shown that the sector takes longer to recover on a global scale (2 - 3 years). Distressed assets are most likely to emerge from these two sectors, however, at the same time lenders will be least likely to finance these two asset classes.

Currently, most deals can be found in the PRS and logistics sector, as well as some student accommodation and to some extent offices. While logistics and light industrial have seen an upswing due to increased e-commerce penetration and potential near-shoring trends, finding suitable products has become harder. Residential as a whole is also still seen as an attractive investment asset class. Overall, a main focus is on Core products in a 'flight to quality', where investors are trying to secure assets that will bring long term income and have more resilience in a downturn. However, despite many assumptions there has yet to be a shift between value add, core and opportunistic strategies, which some expect to show a return to "normal".

ACROSS EUROPE, WHEN MIGHT TOTAL INVESTMENT VOLUMES START TO INCREASE?



* Surveyed GRI Club members as part of GRI Opportunity eSeries Europe (21 July 2020)

2.3 Repurposing of Assets & Portfolio Diversification

A main topic for the members was understanding how to diversify their portfolios to be more resilient, as well as repurpose assets to match emerging demand drivers.

One such sector where members saw chances to repurpose and reposition was in retail. As this is one sector that has been hit the most by COVID, however, the motions for distress had been set in motion long before by a structural shift driven by the disruption of e-commerce. The virus has accelerated this trend and with e-commerce being in major demand, retailers and landlords are looking very carefully at their current assets. Whether landlords are gearing up to reposition their assets with more experienced based consumption, e-commerce and food-anchored retail, or trying to repurpose them into more resilient assets like urban multifamily and BTR, it seems as though the landscape of retail and many other asset classes is trying to adjust to the new normal.

Others are trying to diversify their portfolio by moving to secondary cities. This trend as well started pre COVID with yield compressions in prime locations. Working from home and remote working seem to benefit this strategy, as in some countries we saw a reversal of the urbanisation trends with people moving into suburbs during the lockdowns. Asset classes like offices, residential and retail might benefit the most from suburban revivals. However, at the same time members were cautious about diversifying for the sake of diversification itself, as in fact it proves to offer risk adjusted returns on assets and the process can be a real benefit on overall strategies.

3. Distress, Opportunistic & Value Add

Guest Contribution by **Peter Plaut, Executive Director, Wimmer Family Office**

On July 22nd, I had the pleasure and honour to moderate the last day of the GRI Opportunity eSeries Europe titled "Distressed Deals & Opportunistic, Value Add -Bottom hit, ready for risk?" My distinguished group of co-chairs included: Anas Halabi (3S Capital), James Piper (TPG), Joseph De Leo (BENSON ELLIOT CAPITAL MANAGEMENT LLP), Karim Habra (Ivanhoé Cambridge), Laurian Douin (BC Partners), and Tavis Cannell (Goldman Sachs).

Over the past 3 months, COVID-19 has triggered the worst economic crisis since the Great Depression. I published a detailed article on this on the GRI website in late March titled "The Super Economic and Social Depression of 2020". In the developed world, GDP declines in Q1 have not been seen since the Global Financial Crisis of 2008-09. Q2 declines in GDP likely were in the mid teens to well over 20%+ for some developed countries and unemployment rates have skyrocketed throughout the developed world.

This crisis is much different than the 2008 financial crisis as it is not contained to the housing and financial markets but the broader real economy. Aggregate demand collapsed in the 2Q 2020. The rally in equity and debt markets is due to unprecedented liquidity measures implemented by the Fed and ECB resulting in overvalued securities prices and a bubble that will likely crash over the next 3 to 6 months, especially if spikes in Covid cause another lock down of the global economy. Thus there is no V-shape recovery!

COVID-19 has changed the current real estate and investing environment creating opportunities not seen since the 2008 financial crisis. Over the next 24 months these buying opportunities will come from: (1) Forced Liquidations, (2) Companies and Developers requiring liquidity and capital injections including rescue financing and first lien loans and creative financing structures including securitizations and opportunistic sale leasebacks; and (3) Consolidation between the strong and weak.

The panel was asked many questions, but the primary ones focused on:

1. How the pandemic is affecting investment strategy in terms of risk profile, geographies and sectors?
2. Are there opportunities right now and if so, which sectors?
3. When shall we expect to hit bottom and where are the distressed opportunities?
4. Pricing of debt and equity risk pre and post Covid
5. In what ways is the debt landscape influencing the amount or lack of distress in the market and how do we think this will play out over time?
6. How should we think about what is the right discount (if any) for assets across different use classes, post-COVID?
7. What kind of distressed/opportunistic deals could we expect from the current crisis?
8. Are all asset classes equal with regards to the real estate cycle ahead of us?
9. How many distressed deal opportunities have there been thus far? Why haven't we seen more?
10. In the absence of demand and rental growth, what are the (return) expectations for value-add deals?
11. Will the lack of debt for value add or development opportunities result in more distressed situations?

3.1 Capital risks, Distress & Opportunities

The current mindset of investors remains on the cautiously optimistic side, with continued fundraising, expected returns at near pre COVID levels and opportunities on the horizon for cash buyers.

Drilling down on these themes, we can see that for those still active in the market, the situation is relatively positive. While significant repricing has yet to set in (especially looking at logistics), there is less competition in the markets, creating a healthier environment than 3 to 4 months ago. Cash buyers especially see now opportunities emerging, however, many are still holding off major investments as they see values being affected in the short to medium term with price drops, vacancies going up and decreases in yields. Most opportunities currently are in the value add realm and office sector where equity investors have their pick due to lenders shying away from financing anything with more risk attached than core+ assets.

With the markets picking up activity again, the interest of many lies on risk return. Many are looking for distressed deals, but they have yet to be seen. Some are saying that the current environment is a "false economy" created through the continued stimulus packages on a European and national level. The next months will show the hotspots for distress.

Most members agreed that the current focus should be on going back to investment fundamentals, understanding demand changes and macro trends in order to choose the right deals. Thus, many have been busy re-assessing their strategies within the last months to adapt to the accelerating trends. This also translates into developing assets, as it is becoming a lot more expensive to buy new products. However, equity investors again see the positive side of things, as through less competition some see up to 4 - 6 percentage points increase in returns.

Lastly, looking at debt, senior debt has increased 300-400bps for construction financing post COVID and equity IRRs at least 15%+. Some also do not see a return to "normal" or pre COVID levels in risk assumption for debt. However, there might be a chance for other lenders to emerge on a broader scale, as Commercial Banks are repricing a lot less than traditional banks and some even suggest that investors will have a different base of lenders every month. It seems that mezzanine is also keen to fill the gap that lenders are leaving in the markets.

4. Conclusion

Despite uncertainties and a potential second wave looming on the horizon, investors are gearing up their capital to be prepared when distressed assets will hit the market. With foreign capital streaming into Europe, a low interest rate environment and a more diversified financing landscape, investors remain cautiously optimistic for the future of the European markets.

Where the real opportunities will emerge can only be said in the next couple of months when we get a better sense on recovery lines and pandemic rates. However, obsolete space is likely to emerge in many asset classes like retail, hospitality and offices giving way to new opportunities in repurposing, repositioning and transforming the asset classes themselves.

GRI Club
REAL ESTATE

GRI Club is a global club bringing together key players in the real estate and infrastructure sectors. Founded in 1998 in London, it is present in more than 20 strategic countries.

The mission of GRI is to connect leaders from these markets and contribute to the building of privileged relationships and real business opportunities. In this context, more than six thousand businessmen, senior executives and investors participate annually in the club's programming in the world.

Contact

Diego Tavares
Managing Director
diego.tavares@griclub.org

Julia Haugg
Production Executive
julia.haugg@griclub.org

Our Offices

USA - New York

Ave of the Americas
Suite 4100
New York NY 10011

+1 866 399-1210

Europe - London

Suite 01-103
5 Merchant Square
London, W2 1AS

+44 20 7121-5060

Brazil - São Paulo

Alameda Santos, 415,
14º andar, Paraíso,
São Paulo - SP

+55 11 4810-5698

Mexico - Mexico City

Blvd. Miguel de Cervantes
Saavedra, 301 - Miguel Hidalgo
Ciudad de México

+52 55 1555-6710

India - Mumbai

C - 20, G Block Rd, G Block BKC,
Bandra Kurla Complex, Bandra East,
Mumbai

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