Executive Summary

The outbreak of COVID-19 has quickly translated into a severe shock for the global economy and real estate markets. Near-term indicators of performance have turned sharply downward, and the situation is fast-moving.

Real estate values are under pressure in Europe owing to the severe nature of the recession, although significant capital is waiting on the sidelines and interest rate expectations are falling — so there are some reasons for optimism.

In Europe, attractive investment themes can be grouped as follows:

- **Early Recovery Office Markets**: Liquid CBDs and markets that can keep vacancy down through the crisis are set to offer a significant opportunity set during an office recovery.

- **Accelerated Structural Trends**: Rising online spending and a growing need for provision of modern residential stock in major cities are set to provide ongoing opportunities for investors.

- **Debt-Funding Requirements**: Elevated lending to real estate in recent years points to refinancing opportunities for nontraditional lenders, while alternative debt providers can look to capitalize on any distress in the market.
EUROPE

Sharp Recession, But Fiscal and Monetary Support Is Extensive

The outlook for real estate markets in Europe has altered significantly since the start of 2020. Economic growth was already running below trend, but real estate performance was supported by several tailwinds, including low supply boosting occupier markets, ample liquidity and low interest rates supporting capital values.

The rapid spread of COVID-19 throughout Europe in March triggered the imposition of highly restrictive measures in almost all major countries in the form of lockdowns, movement restrictions and travel bans that aim to limit transmission of the virus.

Sentiment indicators and timely economic data are pointing to an unprecedented, sharp contraction in economic output through the second and third quarters of 2020. Sharp downward movements in equity indexes — and elevated volatility — demonstrate that asset values are under severe pressure. Real estate valuations lag but will not be immune to wider market trends, as demonstrated by significant falls in REIT valuations through March and April.

It is not yet clear how deep or how long the recession will be, but there is some cause for optimism. Unlike during the global financial crisis, when policy response was slow off the mark, fiscal and monetary policy action to cushion the impact of COVID-19 has been swift, synchronized and sizable across Europe.

Policy action should help limit losses in output and employment provided that restrictive measures can be lifted before too long. Central bank credit lines are supporting liquidity among key real estate lenders, and along with emergency business loan and employee retention schemes, the health of major corporate occupiers.

Undoubtedly, recent events are set to weigh heavily on the outlook for the remainder of 2020 and beyond. A return to what was considered normality only a few months ago looks some way off. While some of the supportive factors for real estate opportunities remain in place — notably, contained supply growth and low interest rates — pricing adjustments and alterations in the way society interacts with the built environment mean that the landscape for investment opportunities is shifting rapidly.

Deal Volume Set to Decline

European real estate transaction volume remained at high levels throughout 2019, picking up toward the end of the year, when receding Brexit uncertainty boosted activity in the United Kingdom. Transaction volume during the fourth quarter of 2019 was the second highest on record, and this momentum carried into early 2020.

Deals continued to be completed at the same pace as those last year until early March, when COVID-19 restrictions were imposed and activity quickly ground to a halt, reflecting the sharp decline in economic and financial sentiment. With lockdowns restricting the ability of purchasers, lenders and appraisers to physically visit sites, there was an immediate effect on the completion of transactions in the second quarter.

With the impact to economic activity set to be at least as severe as during the global financial crisis, it is not unreasonable to assume that transaction volume will decline in a fashion similar to 2009, if not more significantly. The highly synchronized nature of the COVID-19-related downturn means the adjustment is set to occur over an even shorter time frame.
A simple projection based on the decline in volume recorded in 2008 and 2009 but adapted to reflect current restrictions on activity shows that deal volume in 2020 may eventually be as little as one-third of the total recorded last year (exhibit EU1).

When a recovery does come, some recent and past trends are set to be repeated. By sector, investors are likely to continue to favor investment in industrial and residential assets over retail, although challenges in the hospitality sector are set to persist, dampening appetite for hotels. Markets that offer a combination of scale and significant domestic capital sources — which are set to prove more resilient initially than overseas flows due to travel restrictions — are likely to hold up better and recover more swiftly.

**Investors Waiting on the Sidelines**

Beyond the inevitable period of disruption in the short term, an important factor in determining how quickly investment markets will recover relates to capital raising in the run-up to the crisis and, more specifically, how much dry powder — contractually committed capital yet to be drawn — is waiting on the sidelines.

Over the past few years, the aggregate volume of capital raised has remained at high levels, broadly tracking the pattern of investment volume (exhibit EU2), reflecting the growing investor appetite for real estate motivated by elevated returns, diversification benefits and a growing opportunity set. As a result, the volume of dry powder waiting to be deployed in European real estate markets reached a record level of just below €80 billion in 2018 and remained close to that level throughout 2019.

The actions of investors during the global financial crisis can provide some clues as to what investors might do with their available capital in the face of a downturn. While transaction volume declined through 2008 and 2009 — and capital raising didn’t start to recover until 2011, three years after the crisis began — dry powder remained effectively unchanged.
Similar trends can be expected this time around. Capital raising is set to decline significantly in the middle part of this year, reflecting a range of factors, including the prospect of weak or negative returns, physical constraints in visiting managers and conducting due diligence, and pressures to rebalance portfolios owing to value declines in liquid asset classes such as equities and corporate bonds. However, a strong start to the year means that overall capital raised in 2020 should remain substantial, assuming a return to more-normal levels in the fourth quarter.

Dry powder rose slightly in the first quarter and, given limited potential to complete transactions in the near term, is set to rise in line with the €15 billion of capital raised so far this year. As in 2009 and 2010, many investors with available capital are set to be patient until there is greater clarity on the impact of the crisis. At the same time, the presence of a large volume of capital that is on the lookout for opportunities points toward a floor to potential value declines and the prospect of a swift value recovery following a correction, once uncertainty recedes.

**Capital Values Under Pressure, But Will Low Interest Rates Help?**

While capital availability and low interest rates have helped support elevated real estate valuations in the early part of 2020, the capital value upswing that has been a feature of the market since 2012 is ending. Occupier distress is apparent — weighing on short- and medium-term cash flow potential — while the risk premium is rising.

Alongside movements in REIT markets, which can lead private market values — albeit sometimes with mixed signals — history can act as a guide to what is to come. Causes and effects differ across downturns, but value movements recorded over the past 40 years provide some clues into typical durations and magnitude of typical capital value downturns.
On a very simple level, European real estate capital values have tended to oscillate around a linear, gently upward-sloping trend. In the last four downturns, the average correction, in real terms, was down to 13% below that trend, with a range of 6 to 19% (exhibit EU3).

Exhibit EU3: Assessing the Magnitude of Value Declines

Boosted by low interest rates and a weight of capital that has chased core real estate assets in recent years, prime capital values come into this crisis at relatively high levels. If capital values fall in a typical fashion — to 13% below trend — the total peak-to-trough capital value correction would be around minus 28%, taking just under three years to return to the trend path from the trough.

As always, several factors are different going into this crisis compared with past downturns. In the near term, the economic impact is set to be more severe than even the global financial crisis, yet the contraction is highly synchronized and playing out quickly, so natural valuation lags may provide a cushion against the worst of the impact if conditions start to improve.

Extensive policy measures have already been deployed to try to cut the recession short and support economic activity as restrictions are lifted. Unlike past crises, the current downturn has not followed a period of rising interest rates, meaning that policy support has been more or less immediate.

In addition to cutting rates, central banks across Europe have restarted quantitative easing and asset purchase programs — much as the Federal Reserve has done in the United States — acquiring significant quantities of government and corporate debt (exhibit EU4). Broadly speaking, the aim is to provide liquidity and to divert capital away from safe-haven assets toward other investments, with low bond yields driving down required returns on risk assets. In real estate terms, this means yields being lower than they otherwise would be.
**Exhibit EU4: Central Bank Policy Response**

*Central Bank Interest Rates (%)*

![Central Bank Interest Rates Graph]

*Sources: Bloomberg, Oxford Economics, PGIM Real Estate. As of May 2020.*

*Forecast*

**Cumulative Asset Purchase Estimates by Major Central Banks ($ Tr)**

![Cumulative Asset Purchase Graph]

*Projection*

*Shaded bars show periods when real estate values are below trend*

*Interest rates are set to stay very low for the foreseeable future…*

*…and central banks are set to buy trillions of dollars of government and corporate debt*

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**Low Supply to Soften Impact on Rental Growth**

The severity of the near-term economic impact of COVID-19 is having an impact on occupier markets. Most visibly, some tenants are not legally required to pay rents in many major markets during the second quarter. While such measures will not last forever, the risk that cash flow disruption could happen again in the future — especially while the virus is not totally eradicated and further lockdowns may be required — will now have to be explicitly factored into cash flow expectations.

On the back of a sharp increase in unemployment and stress in the small business sector, vacancy is set to rise — especially as demand coming out of the lockdown restrictions is set to remain tentative across all sectors and markets.

In the office sector, an adverse impact on demand is inevitable, but there should be some support from low supply coming into the crisis. Demand for space has dropped significantly and is putting downward pressure on rents, but limited space availability in many European markets should help contain rental falls.

In general, vacancy starts from a low base across most major office markets, owing to a combination of above-average demand — driven by significant gains in employment in recent years — and below-average additions to space through much of the past cycle (exhibit EU5).
In the run-up to the global financial crisis, supply growth was higher than in recent years, and demand dropped sharply, pushing vacancy rates upward. To make matters worse, several major markets, including Amsterdam and Frankfurt, came into the crisis with legacies of excess supply that dated back to rapid development in the late 1990s. In such circumstances, rents dropped significantly.

A stressed near-term vacancy scenario is proxied in exhibit EU5 by (1) taking existing vacancy, which is very low in most markets; (2) adding on all space due to be added to the market in the next two years; and (3) assuming the release of flexible office space. The reason to include flexible office is twofold: first is the short-term challenge to its operational model posed by the nature of COVID-19 and associated policy measures, and second is that its tenant base includes corporate overflow space and small businesses, both of which tend to be disproportionately affected in a downturn.

While overall office demand is certain to be impacted in the coming months, this analysis demonstrates that there is some headroom before reaching the peak vacancy reported in the aftermath of the global financial crisis.

The already struggling retail sector — in which vacancy has been rising for some time, even in the strongest locations — is set to be further affected as occupiers fail and prospects for the releasing of vacated space look weak, unless significant concessions are made. Similarly, prospects for hotel occupancy, which is now running at historical lows, are highly uncertain, even once travel restrictions are eased.

In contrast, the logistics sector comes into the crisis on the back of a significant increase in supply in recent years, with additions to stock in major markets running three times higher than in the early part of the cycle. There is some overhang of speculative space to work off, although vacancy remains low in a historical context, and further shifts toward online retail point to demand remaining more resilient than in other sectors.
Investment Opportunities

Current conditions point toward a sense of caution in the near term. While the outlook could improve swiftly if progress is made to contain or treat COVID-19, the reality is that the whole of 2020 looks set to be characterized by occupier and investment market uncertainty and distress.

Looking ahead, the returns environment is likely to remain subdued through the next cycle — not least as interest rates are effectively unable to fall further to support capital growth. The ability to maintain income receipts and deploy effective asset management strategies to grow cash flow and asset values is increasingly important.

Despite the uncertainty, several trends support the outlook and give some indication as to what the investment opportunity landscape is going to look like.

The relatively low-supply environment means that major core office markets that offer liquidity are well positioned to record a swift recovery. In addition, the crisis is exacerbating structural trends that were already gathering momentum. Supply chain expansion is boosting demand for logistics and there is set to be a growing need for higher-quality, affordable residential units in major cities.

In the near term, debt investments offer an attractive entry route into the market, providing defensive cash flow and capitalizing on an opportunity set that is growing as regulation constrains traditional bank lenders.

1. Early Recovery Office Markets

Liquid CBDs and markets that can keep vacancy down through the crisis are set to offer a significant opportunity set during an office recovery.

Office is one of the most cyclical real estate sectors, with headline value swings driven by factors that can vary through the cycle, such as large lot sizes that require significant available finance, lags in providing new supply and the lumpy nature of large, corporate leases that drive occupational demand.

The experience of past cycles points toward two important factors determining the nature of the opportunity set during an office recovery cycle: liquidity and vacancy.

Liquidity is important not only for buyers that need to be able to transact through the cycle but also in terms of there being an opportunity set in the form of stock available to bid on.

During a downturn and into the early recovery phase of a cycle, investors are typically still cautious, and finance may not be so readily available if the occupier story isn't solid. A good example is CBDs, which tend to report stronger leasing fundamentals in weaker market conditions, owing to factors that drive location preferences such as density, agglomeration effects and connectivity.

Investors typically follow occupier trends and CBDs constituted 50 to 55% of total office investment volume in Europe’s major markets in the years following the global financial crisis. In more recent years, as occupier demand broadened, the CBD share dropped to about 40% (exhibit EU6).
Similarly, one clear lesson from past crises has been that elevated vacancy — whether due to an existing legacy, a mistimed spike in new additions or simply demand dropping sharply — holds back any recovery. In the third quarter of 2009 — the year following the trough of the global financial crisis — values in markets with below-average vacancy rose by 16% compared with a rebound of only 4% in higher-vacancy markets.

The encouraging sign for office markets is that most locations are starting with very low vacancy rates, although the nature of the downturn means that demand could pull back sharply in the near term, pushing availability upward. Some persistence to vacancy is possible depending on whether the crisis leads occupiers to realize they can reduce their space footprint without a detrimental impact on output.

As in prior cycles, markets that can keep vacancy low are set to have the earliest and most-pronounced recovery. While there is a great deal of uncertainty around future demand, markets such as Berlin, Paris CBD, Munich and Vienna all started the crisis with very low vacancy and look set to be among the earliest to recover.

**2. Accelerated Structural Trends**

Rising online spending and a growing need for provision of modern residential stock in major cities are set to provide ongoing opportunities for investors.

Given the severity of the economic impact of COVID-19, logistics markets are set to face some near-term disruption — notably relating to a period of weaker retail spending across Europe. However, looking through the cycle, a further move toward online retail is set to benefit the logistics sector.

An increase in online retail activity requires a greater amount of logistics and warehousing space to deliver goods in a timely manner. Based on an analysis of existing space usage among major international online retailers, it is estimated that additional annual online sales
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of €900 million (about $1 billion) require about 100,000 square meters (1 million square feet) of logistics space. Exhibit EU7 shows how this figure translates into potential additional space requirements in the next five years across a number of major European markets.

Exhibit EU7: Estimating Logistics Space Requirements

Estimated Additional Annual Logistics Space Required From Online Sales (sqm Mil)

<table>
<thead>
<tr>
<th>Country</th>
<th>Additional Logistics Space Required From Online Sales Over Next Five Years</th>
<th>% Annual Completions of Modern Logistics Stock Completed in Past Five Years (RHS)</th>
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</thead>
<tbody>
<tr>
<td>United Kingdom</td>
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<tr>
<td>Germany</td>
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<td>Italy</td>
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Note: Additional demand estimated by assuming every €900 million additional annual online sales requires approximately 100,000 sqm additional distribution space.

Sources: PMA, Oxford Economics, PGIM Real Estate. As of May 2020.

Based on the analysis, significant additional space is set to be required in major distribution corridors in the United Kingdom, where the share of online sales is above many countries in Continental Europe. The volume of new space required is elevated compared with the recent pace of completions.

Significant requirements are also set to be forthcoming in other European markets, and these could be further boosted if COVID-19 affects consumer behavior — not least in the near term as physical shopping is set to remain restricted for some time — and accelerates an already ongoing shift toward a rising share of online retail. Logistics demand in the major markets of France, Italy and Germany would grow twice as quickly under an accelerated scenario in which they approach UK levels of online penetration more rapidly.

Another structural trend in recent years has been an increased interest in residential assets among institutional investors that are attracted by their defensive granular cash flows, a relatively favorable mix of demand driven by household formation in major urban areas and relatively constrained supply through much of the cycle.

Over time, part of the story — especially for investors that are interested in impact investments that target socially beneficial projects — is linked to urban regeneration, enabling cities to repurpose existing sites to cater to the changing living and working needs of their populations.

While the effects of the COVID-19 crisis are yet to be fully borne out, a potential opportunity for investors relates to housing provision in dense urban areas. Many major European cities have grown rapidly in recent decades, and inevitably, some of the housing stock has been left behind. Combined, London and Paris have 650,000 households living in overcrowded conditions (exhibit EU8).
At the same time, most major cities are expected to record population growth in the coming years, pointing toward an ongoing need for provision of living spaces. The popularity of the residential sector is benefiting from its relatively stable rental growth profile, which outperformed commercial markets for much of the past cycle.

Refurbishing existing buildings, providing new accommodation to gradually replace older stock and creating living spaces that cater to growing urban populations continue to be important parts of the investment landscape. The public health implications of COVID-19 can only accelerate a need to improve the mix of residential stock as well as provide in-town living spaces for employees who have proved crucial during the crisis, notably those working in health sectors.

**3. Debt-Funding Requirements**

Elevated lending to real estate in recent years points to refinancing opportunities for nontraditional lenders, while alternative debt providers can look to capitalize on any distress in the market.

The volume of lending to real estate in Europe’s major markets has been elevated in the past few years. In total, a combined €565 billion of new debt has been originated in France, Germany and the United Kingdom since 2014 (exhibit EU9), primarily reflecting elevated transactions activity rather than the use of leverage, which has been constrained during the past cycle.

Evidence from a Cass Business School study of the UK market suggests that new business is typically around 50% of total lending activity once refinancing of existing loans is taken into account.
The volume of lending that has taken place in recent years looks set to give rise to significant opportunities. During a downturn, funding gaps can arise as a result of a mismatch between lender capacity for new business and borrower requirements to deal with maturing loans — a situation exacerbated by falling equity transaction liquidity that makes a sale-driven exit difficult. In total, €440 billion of loans are due to mature over the next five years in the United Kingdom, Germany and France combined.

Given the potential for values to decline in the short term, there are two broad groups of opportunities. The first, relating to non-distressed assets, is for non-traditional senior lenders to participate in financing new deals and refinancing existing loans given the regulatory constraints that continue to constrain bank lenders.

The second, relating to stressed capital structures, is for alternative debt and capital solutions providers to inject capital, which is an appealing prospect for senior lenders that could face a deluge of defaults if the COVID-19-related downturn is severe.

More generally, senior debt tends to outperform in a downturn. During the global financial crisis, the estimated value of debt positions barely fell, and it was almost a year before equity started seeing prospects of outperforming on a longer-term basis. Given the risk premium required, there is a strong case for investors to increase exposure to debt in their real estate allocations — at least until uncertainty materially reduces.
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