Real Estate House View
Strategy implications

SwissLife Asset Managers

Second half of 2022

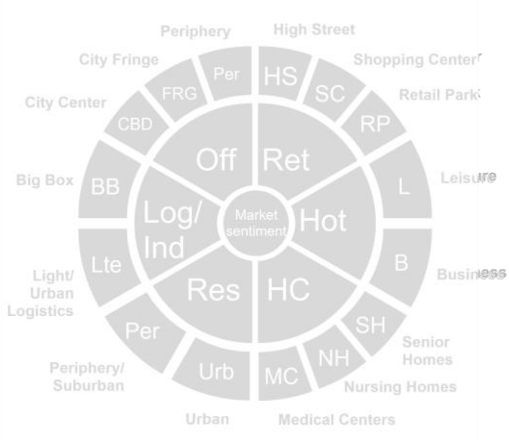
Key takeaways

- **Introduction of "market sentiment" element in the strategy map:** highlighting overall attitude of investors across European real estate markets.
- **No change in strategy:** we are taking a more selective stance and advising investors to take the opportunity to invest in the existing stock (e.g. to comply with ESG requirements).
- **There is still a lot of money to be deployed**, which will be invested in prime assets to diminish risks. Hence, we expect a significant continuation in the diversion between prime and secondary assets.
- **Inflation indexation** differs across countries and sectors, takes time to take effect and must be considered with a view to the economic power of the tenants.

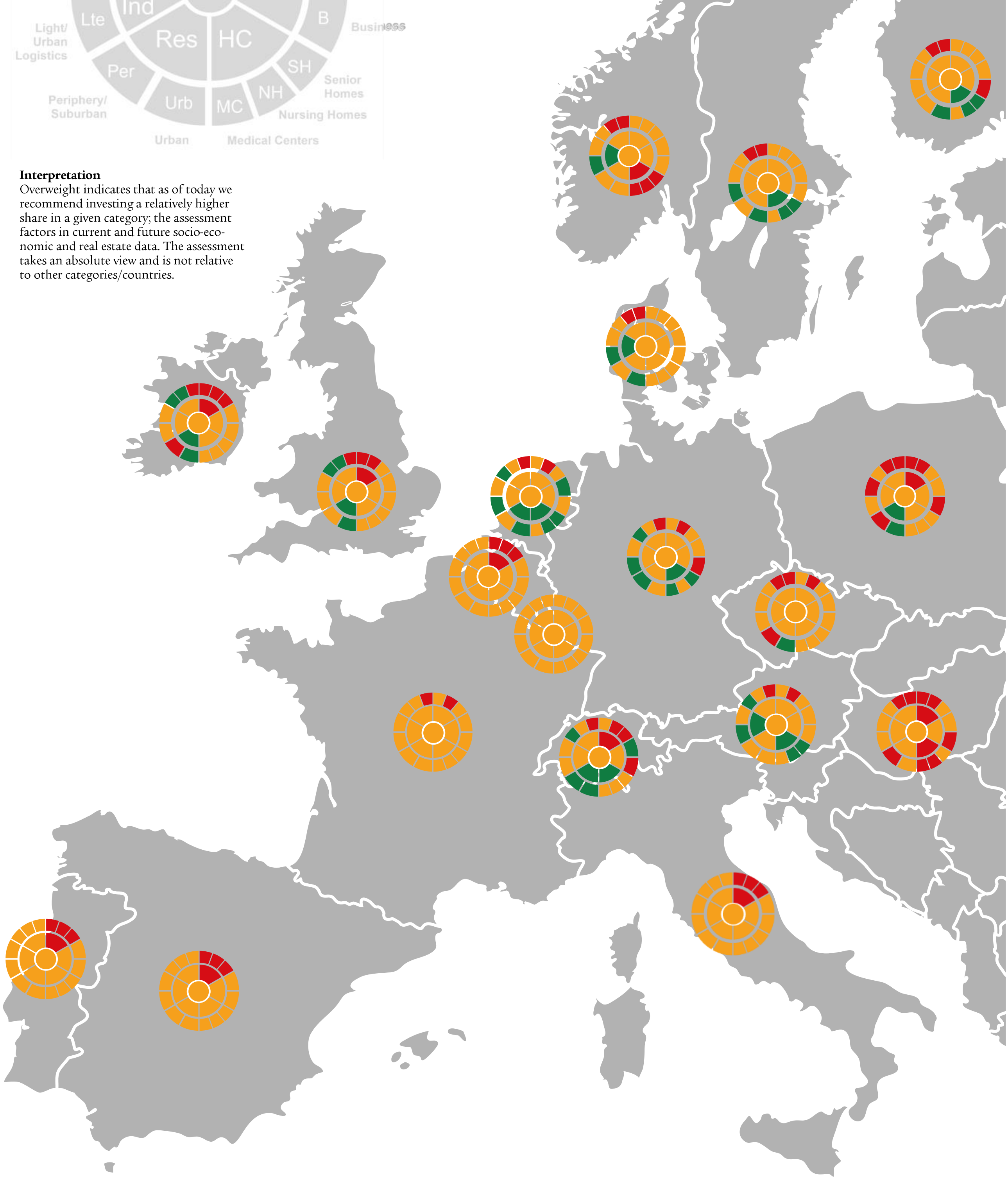
Strategy implications – *type of use and regional focus*

	Office	Retail	Industrial/ logistics	Residential	Hotel	Healthcare
What	Well-connected location, "new work" standard, ESG-aligned	Convenience shops, local supply, develop to Grade A	Urban logistics, 'big box' logistics in relevant logistics regions with access to traffic infrastructure, light industrial, self-storage	Metropolitan areas with favourable socio-economic fundamentals, overweight in multi-family properties	Main metropolis with exposure to leisure and domestic travel	Focus on care in old age, later living, strong operators
Where	European capitals, peripheral locations only with excellent connections	Selected cities across Europe	Metropolitan areas/regions with good traffic infrastructure in Germany, France, UK, Benelux, Nordics	Germany, Switzerland, France, UK and Netherlands	Selected cities such as Barcelona, Vienna, Berlin, Amsterdam, and Paris	Around wealthy populations in Germany, Netherlands, France, UK

Market investment – *overview*



Interpretation
Overweight indicates that as of today we recommend investing a relatively higher share in a given category; the assessment factors in current and future socio-economic and real estate data. The assessment takes an absolute view and is not relative to other categories/countries.

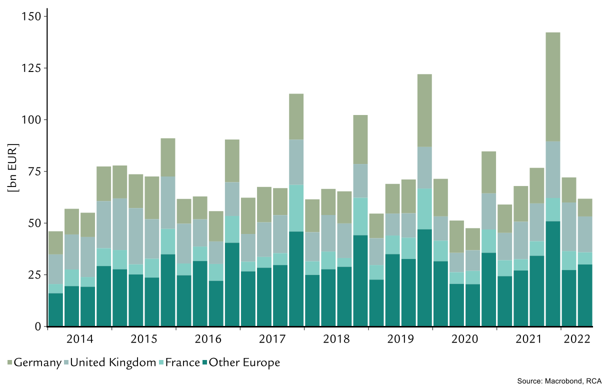


Strategy implications

Now they are here, the higher interest rates. For years we have talked about the possibility of rising interest rates. With the start of the war in Ukraine and the (resulting manifestation of) rising inflation, central banks reacted by raising interest rates. These higher interest rates have an impact on property valuations, but with significant differences in prime and secondary assets and sector, country, and quality. In our House View publication, we have described our observations and assumptions by country and sector.

The uncertainty about the "right" price and how to invest in the current environment is high. We illustrate this in our map (p. 2) by adding "market sentiment" and setting it to "neutral" for all countries accordingly. The combination of higher interest rates with a weakening economy (depending on the country, we are expecting a mild recession, as in Germany or the UK) has caused investors to pause and reassess their expectation. The indexation of rental contracts can partially counteract the change in the discount rates. But it can take some time for indexations to take effect, rent increases might be capped or may be rare to non-existent, as for example in the UK. This makes it even more important to be aware of local peculiarities when it comes to contracts, regulations and actual implementation of rental growth. The next mandatory question to ask is whether tenants can afford a higher rent at all.

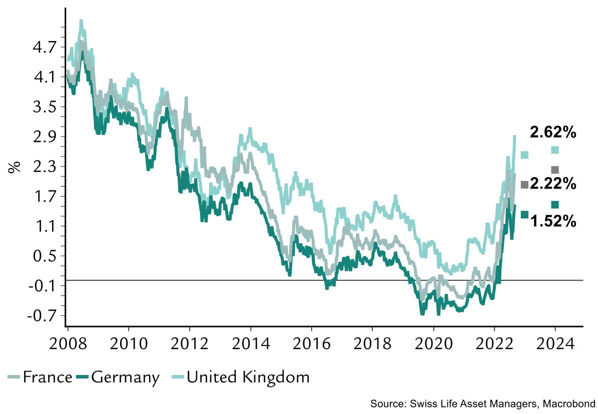
Total transaction volumes (all property types)



Despite the changed market conditions, we want to highlight that we are not changing our strategy recommendation. We continue to recommend long-term investments in good-quality assets and in good locations. Therefore, we also assume that prime yields will see smaller changes, as many investors will continue to follow the Core/Core+ strategy. We have to keep in mind that Grade A is only the tip of the iceberg, as property markets comprise different qualities of assets. Secondary assets that are already suffering are likely to see greater price reductions. A possible spill over to the top quality must be monitored across countries.

Investing in existing stock can be a short term tactics for some investors. Especially when it comes to ESG requirements, refurbishment should not be forgotten despite initial costs and the simultaneous pressure of decontamination – on the contrary, this offers opportunities. Project developments are an additional investment alternative, even if the higher construction costs naturally have an impact.

10-year government bond yields incl. forecasts by Swiss Life



When investing in direct real estate, we advise paying close attention to the flexibility of the space and evaluating the business case for all investments. This is because the risks of persistent inflation and increased interest rate volatility remain. For asset managers, the focus is on management.

Investors' focus should now be on diversification and understanding the portfolio's underlying drivers of return and sources of risk. The short-term tactic is about balancing higher inflation and the probability of a mild recession. The latter has to be incorporated in business case scenarios, especially so in office, retail and logistic investments. For long-term investors, market movements are part of the business. A highly diversified portfolio keeps performance stable.

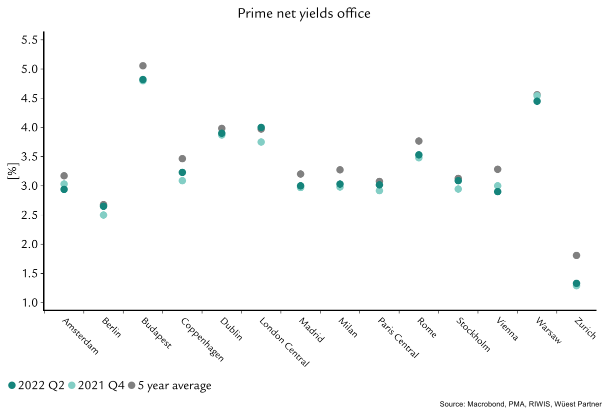
Strategy implications

Office – *neutral*

Office remains on the shopping list. Yet it is a particularly good case when it comes to polarisation: demand towards top-quality objects in prime locations is expected to continue. When investing in office, prime location is still a must. This also offers opportunities to develop the quality of an asset to an A which is currently a B. So, our assessment “neutral” is the balance between overweight for prime locations and underweight for secondary assets and locations.

Buildings with weaker ESG credentials will have significant capital expenditure requirements, which could impact returns, or will face increased obsolescence. The supply of top-quality assets in top locations is still limited, which is why steady or increasing rental growth is to be expected.

The impact of changing working practices creates the greatest uncertainties in the UK, where structural changes tend to take effect faster than in the rest of Europe. Well-connected, amenity-rich locations such as London and the “big six” markets are expected to perform well. A subdued development pipeline due to rising building costs should support rental growth and pricing for the best assets. The same holds true for Paris and the city centres of regional French cities. In Germany, the polycentric economic environment allows people to focus on fundamentally strong alternative markets such as Dresden, Leipzig, Bonn, or Karlsruhe. They exhibit positive office employer growth and yields above 3%. Again, this strategy only works if the asset is in a top location. We are more cautious in metropolises where office vacancies are increasing. Furthermore, the rent for prime locations must be monitored. In some cities, such as Amsterdam, some tenants are moving out to other cities where rents are lower.



Retail – *underweight*

Overall, we are still cautious when it comes to retail. With higher inflation rates, the retail sector once again faces some headwind given the squeeze in disposal income. The polarisation across the retail segments is forecast to continue in the short to medium term. But we acknowledge the differences between countries. For example, shopping centres in the city outskirts of the Nordic countries still seem to work. This is where inhabitants meet and go shopping.

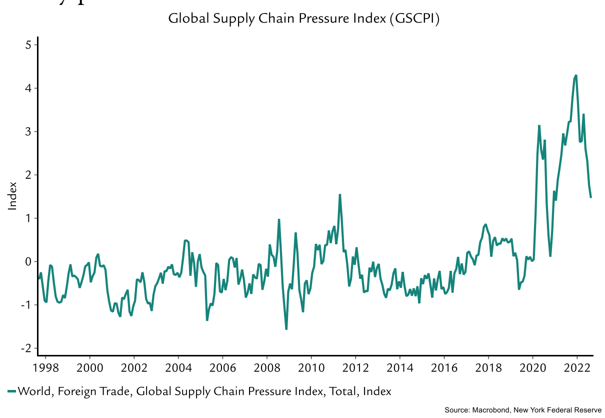
Right at the beginning of the year, investor sentiment towards retail improved somewhat. They seemed to have more confidence in the new retail formats establishing or combining bricks-and-mortar and online retail or spotted opportunities to develop assets in high street locations into top-quality properties. These locations are increasingly favourable for office and residential use as well, so it becomes a mixed use of the three sectors.

In the UK, retail parks anchored by food or value retailers are expected to be pockets of resilience, as occupational demand remains robust. At parks where rental values have already been rebased, there may be potential for modest rental growth. High street assets are expected to continue to underperform as the market is oversupplied, and more repurposing of units including conversion of “stranded” assets is needed before the sector stabilises. Similar developments can be observed in Germany. However, there are signs that prices for supermarkets are starting to decrease (due to inflation, construction costs and increasing interest rates). For Europe as a whole, we are focusing on top metropolitan areas for high street and neighbourhood "shopping streets" where the locals buy, retail parks in suburban areas (a large enough catchment area is needed) and high streets in A-cities for opportunities. We would not recommend investing in high streets in B and C cities.

Strategy implications

Logistics– *neutral*

The underlying fundamentals – given the increase in e-commerce and possible deglobalisation and reshoring across Europe – still support the sector. However, industrial and logistics operators are also being impacted by higher inflation (especially higher energy prices). Although occupier demand still seems to be healthy, we expect rental growth to be lower than anticipated one year ago. That said, we continue to focus on established locations. Supply of grade A assets remains low, and the best specified assets in highly connected locations close to large conurbations will still offer attractive opportunities although pricing should be scrutinised. Strong connectivity to major distribution nodes should support demand from both national and international occupiers. Further, the lack of available land in almost all of Europe (excpect in the central European markets) supports maintaining the land value. ESG requirements must be analysed very carefully, also when it comes to regulations. For instance, in the Netherlands, all city centres will be zero-emission zones by 2030, so last-mile delivery is only possible with electric vehicles.



We are focusing on inner city locations in London and the "Big Six" markets that can service last-mile logistics; edge/out-of-centre locations with good accessibility to large conurbations; sites adjacent to an infrastructure hub, such as major UK airports, seaports, and railway links. In France, for large logistics assets, we are focusing on the main axis: Lille-Paris-Lyon-Marseille and main regional cities outside of the axis: Bordeaux, Nantes, Toulouse, Strasbourg, etc. In Germany too we are focusing on conurbations such as RheinRuhr, RheinMain, RheinNeckar and the region around Hamburg and Berlin.

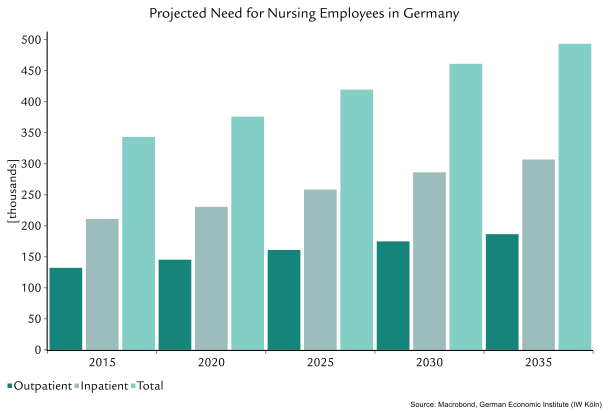
Residential– *neutral*

We see investment conviction for residential, given an increase in rental demand due to higher home ownership prices, a steady migration (in some countries temporarily also driven by Ukrainian refugees) and the relative independence of the economic environment. However, in well-established countries such as Germany and Switzerland, the overallocation in residential combined with the change in asset allocation across all assets can lead to an urge to sell residential property. Moreover, adjustment to higher inflation takes longer, as it is not a clear "inflation indexation" (e.g. in Switzerland it follows the mortgage benchmark rate). Also, most "innovations" occur in the residential sector, meaning changes in regulations, whether with regard to rents, construction permits, ESG requirements or other political regulations. Although supply is still lower than demand in the main markets, our advice is to analyse each residential investment in close detail, especially when it comes to rent development and ESG requirements. When it comes to locations: there is more room for rental growth outside well-established metropolises while tenant security is higher in well-established cities. In Germany, there is still uncertainty about the path of the "new" government (e.g. public transport flat-fee ticket etc.). Throughout Europe, the location must be "commutable" to the main cities in light of the increase of flexible working. In the UK, with a significant amount of new supply being developed combined with an increasing cost of living, the previous rates of rental growth in core UK cities may not be sustained. London has been underperforming the regional markets as there is more rental stock available. There are signs that demand is improving, and the outlook is strengthening. Opportunities are likely to be greatest in the regional markets, particularly given the yield discount, as the supply in London is relatively high, dampening overall performance. Locations with strong socio-demographic characteristics and an under-supply of good-quality assets, such as the "Big Six", and M25 affluent towns are expected to be most attractive. Same developments are observable in France, with a focus on the main cities yet more rental growth possible in peripheral areas.

Strategy implications

Healthcare – *overweight*

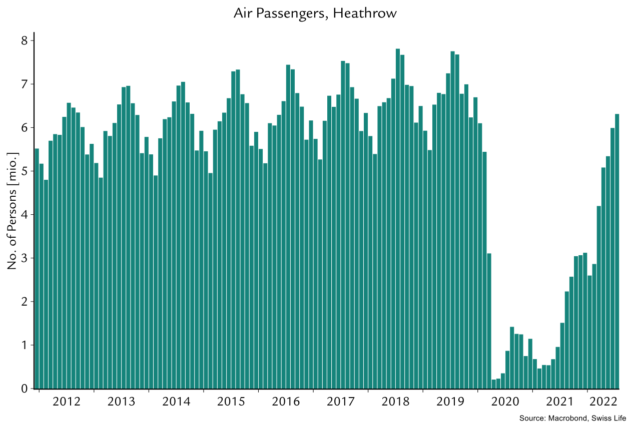
The healthcare sector's foundations seem unshakable: aging of the population, relatively independent of GDP changes and the growth of the middle class in Europe, all mean that there is more money available for health expenses (we also monitor the future financing of the health system). Additionally, demand in Europe is on average higher than supply. Yet we want to highlight that investing in healthcare needs expertise. The operators must be analysed carefully. The offering is crucial – 70-year-olds have other needs than 90-year-olds, where combined facilities of both elderly living and care in close proximity are interesting concepts. It is also a sector that is significantly driven by regulations. The availability of caretakers (attracting and keeping staff) must be part of the investment analysis. The location (cities versus urban or suburban areas) does not matter that much if socio-economic factors (such as purchasing power, positive demographics, catchment area, availability of care takers) are intact.



There is a compelling investment case for good-quality and well-located elderly care and later living stock throughout Europe. This reflects the chronic undersupply and ageing demographic. Therefore, the strongest prospects are likely to be focused on affluent catchment areas that are under-supplied with good-quality properties. Elderly care acquisition must involve careful stock selection based on location specification and covenant, as cost pressures are increasing for operators. Later living is an emerging sub-sector which has limited provision at present. It is expected to see rising demand as an alternative to elderly care and will be viewed more favourably given its successful handling of the pandemic. In view of the lack of provision, accessing investment-grade stock will be challenging, and forward funding is likely to be needed.

Hotel –*neutral*

After a glimmer of hope due to increased travel activities following the pandemic, inflation has dampened the joy again. Also, the difficulties airlines and airports are currently facing has hindered some travellers in taking a plane trip. Lower disposable incomes are expected to have some impact on travel activities and hence the recovery to pre-pandemic levels is again postponed to 2024 at the earliest.



However, this offers opportunities for repricing and then repositioning of assets to fulfil travellers' needs. When investing, the operator must be analysed, and we would avoid locations with a tendency to hotel oversupply, such as Frankfurt. Core, city-centre locations in markets that offer a diverse clientele such as business, leisure and university-driven demand are expected to offer the best prospects.

In the UK, the hotel sector is one of the few with an inflation indexation that may offer an inflation hedge given the current economic backdrop. In Germany, domestic demand in B and C cities is strong and might offer opportunities.

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