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BlackBee Commercial Real Estate Sector

Insights / November 2021

No Signs of Pandemic Trauma

Recent commercial real estate returns have remained positive - the industrial and office sectors have seen gains while retail capital values have fallen.

Little evidence of pandemic in headline commercial real estate returns

As with many of the other asset classes, recent commercial real estate returns show little sign of the trauma that investors and society as a whole has gone through over the past 18 months or so. The second quarter results from both the MSCI/SCSI and JLL Irish Property Indices confirmed this. The MSCI/SCSI Ireland Property Index (an index of unlevered returns covering assets in the office, retail and industrial sectors comprising €8.4Bn) showed that commercial property inched higher by 1.2% in Q2 meaning that returns for the past twelve months were 1.5%.

The JLL Irish Property Index (with a mix of 55% office, 20% retail and 12% industrial) also put in a similar performance to the MSCI/SCSI Index with a gain of 1% in Q2 and 3.5% over the past year. Although recent performances have been positive, these returns have masked a wide divergence of performances across the various commercial real estate sectors.

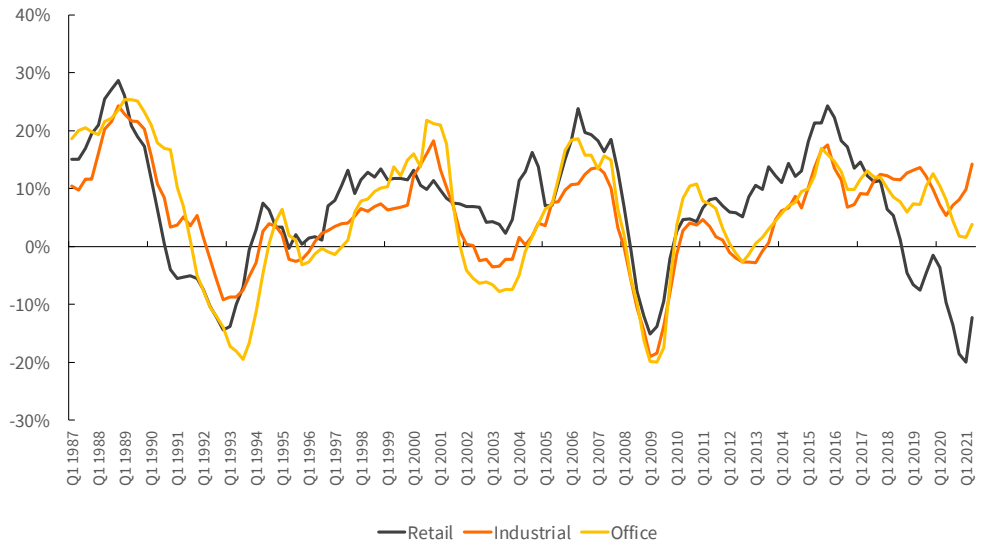
Generally, the industrial sector has been by far the outperformer in recent times, the retail sector the underperformer and the office sector in the middle. JLL data for Q2 as an example showed that capital values for the industrial, office and retail sectors moved by +3.2%, -0.6% and -3.5% respectively.

The COVID 19 pandemic has had a major impact on both the retail and industrial sectors. For the retail sector, the closure of bricks and mortar retail stores further compounded a secular online challenge for retailers which has already forced many to radically alter their business models. However, while the pandemic and ecommerce more generally has cast a long shadow over retail, it has buoyed the industrial sector.

The performance divergence in these sectors has also been visible across the US and Europe – for example between Q1 2020 and Q1 2021 the capital values of retail properties in the CBRE Prime EU 15 Index fell by 20% while those of industrial properties rose by 10% (chart 1). Thankfully retail capital values stabilised somewhat during Q2 (up 2.2% in the period) while the industrial and office sectors rose by 4.8% and 1.6% respectively.

In the office market the lack of significant volatility in index returns indicate that fundamentals for prime assets have been largely sheltered through the pandemic. However, we have seen tougher conditions outside prime markets with more pressure visible in vacancy rates and rents, ultimately culminating in somewhat higher yields from mid-2020 onwards.

Chart 1: Annual change in CBRE EU-15 Capital Value Indices



Source: CBRE. October 2021

Solid long-term value on offer for prime assets, particularly in the office space

Solid Long Term Value

As long term investors a key consideration for us is valuation and the belief that if you buy good quality assets at valuations that are cheaper versus long term averages, you stand a better chance of outperforming and vice versa.

When assessing the current value in Irish commercial real estate, we look at the issue through two lenses

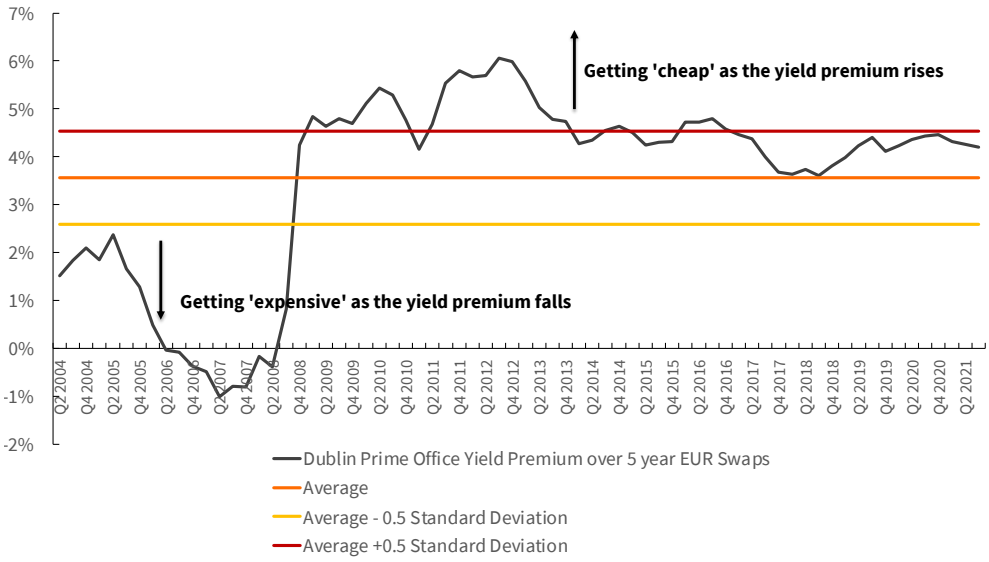
1. Current yields on prime assets, less some proxy for financing costs (here we've assumed five-year swap rates in the Euro area) given that most commercial property investments use some amount of leverage. An added advantage of this approach is that it also implicitly takes into account the prevailing stance of monetary policies in the Euro zone, which we well know are exceptionally loose at present. The general rule with this valuation tool is that higher yields and yield premia versus long term averages tend to point to cheaper valuations and vice versa

2. The relative value in Irish commercial real estate yields versus other EU locations - the simplistic rule here is that if Irish prime yields are higher than EU peers that this tends to indicate cheaper valuations and vice versa

Irish commercial real estate offers solid value when viewed through the lenses of yield premia versus long term averages and yield levels versus European markets.

When we examine Irish yields and yield premia versus long term averages, our main conclusion is that there is solid value on offer for investors at present. As an example, charts 2-4 show prime Irish yields (less financing costs) for the office, retail and industrial sectors over time. For the office and retail sectors in particular yield premia (yields minus 5-year swaps) are above long-term averages. In fact, both sectors are approaching one standard deviation above long term averages which suggests there is solid value here from a long-term perspective. On this metric chart 4 suggests that the industrial sector is becoming more expensive. However, we would caveat this as the secular moves towards ecommerce and towards more efficient supply chains justifies a more attractive valuation for the industrial sector as a whole.

Chart 2: Dublin Prime Office Yield Premium over 5 year EUR Swaps

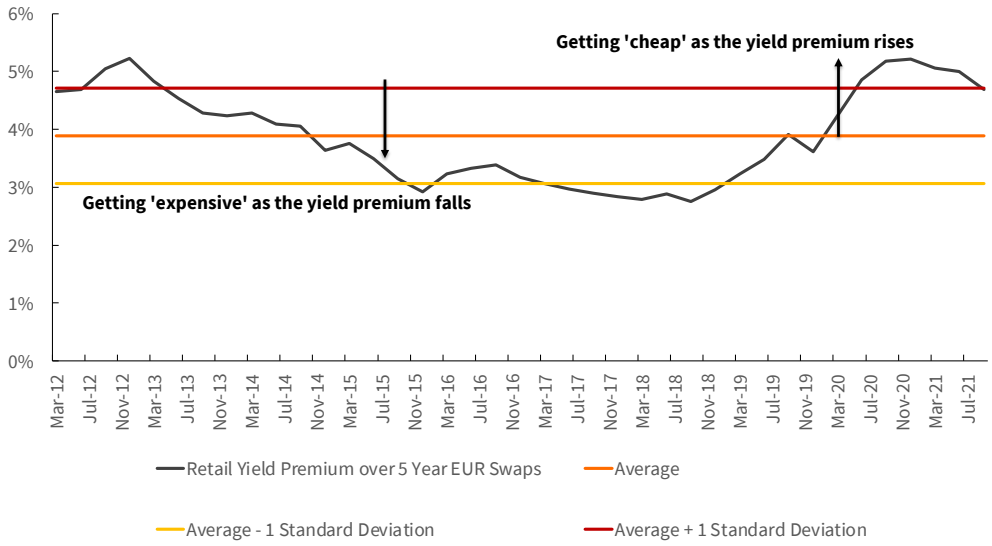


Source: CBRE, BlackBee, Bloomberg, October 2021

5 Year Yields

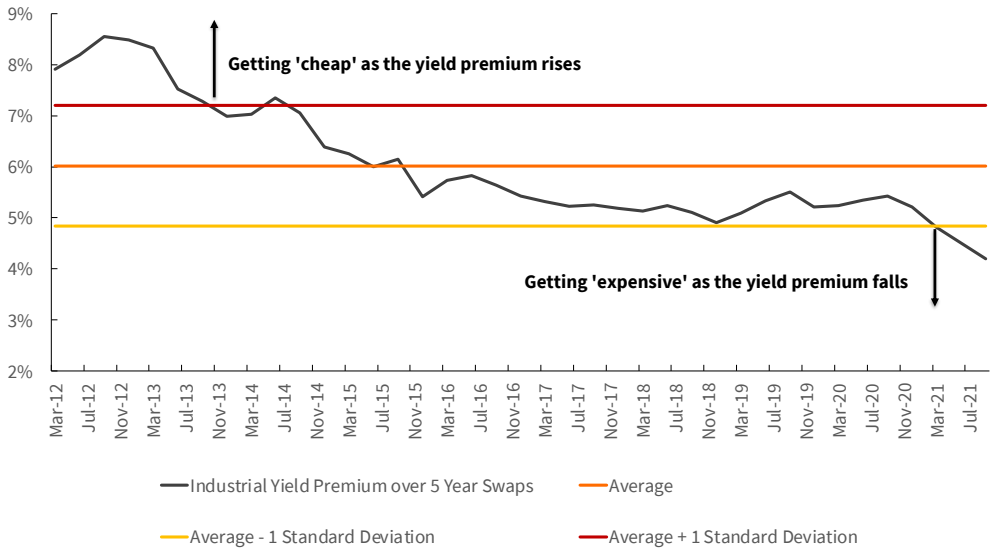
Irish commercial real estate yields offer a premium of 30-100 basis points over comparative markets in Europe.

Chart 3: Dublin Prime Retail Yield Premium over 5 Year Euro zone Swaps



Source: CBRE, BlackBee, Bloomberg, October 2021

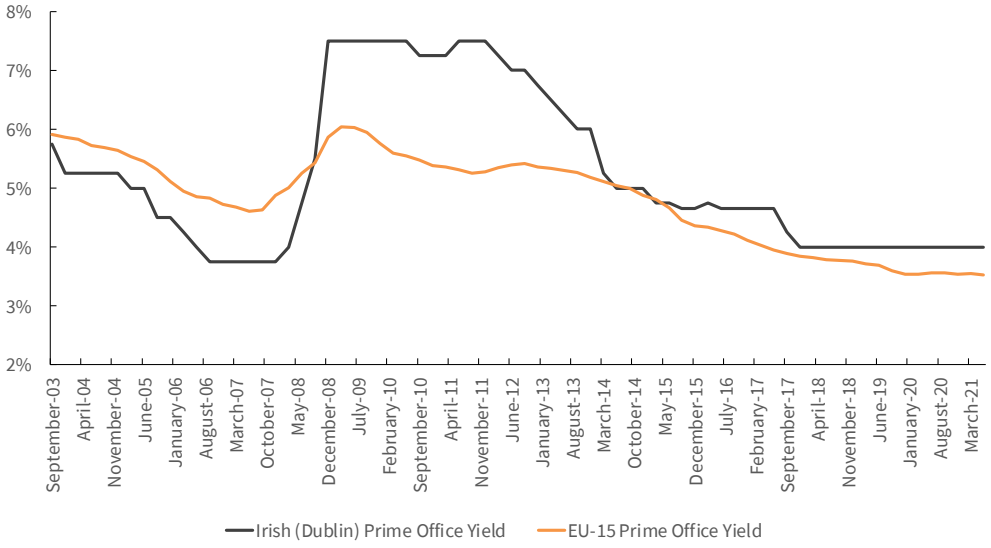
Chart 4: Industrial Yield Premium over 5 Year Euro zone Swaps



Source: CBRE, BlackBee, Bloomberg, October 2021

When we examine the relative value proposition for Irish commercial real estate versus other EU locations, this also validates our view that Irish commercial real estate offers value for long term investors. On the whole prime Irish assets in the office, retail and industrial sectors offered premiums ranging from 30 basis points to 100 basis points (0.3% to 1%) over EU locations based on the data for Q2 this year. We can see this specifically in the case of the office market in chart 5.

Chart 5: Irish Prime Office Yields versus EU Peers



Source: CBRE, October 2021

Irish prime office yields are currently above those for comparable EU peer markets.

Cyclical outlook for the Irish economy and commercial real estate is favourable

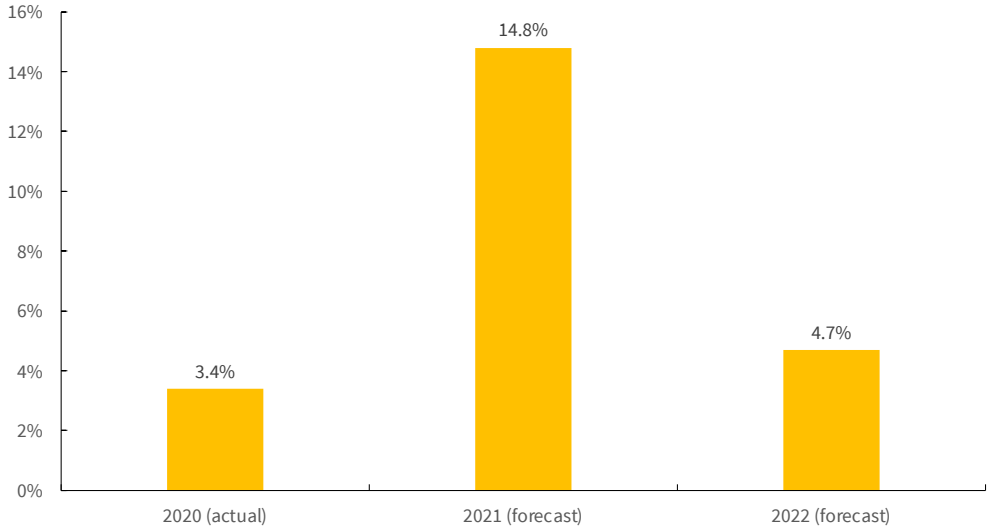
As we mentioned earlier, for any successful investment it is important that the long-term valuation 'case' stacks up. However, so too must the cyclical outlook. In a commercial real estate context a positive economic outlook is crucial as it will be a key driver of things like employment growth, consumer spending, investment and trade – all factors that will ultimately feed into the outlook for occupier demand and rental and capital values for each of the main real estate sectors.

From a purely economic perspective the good news is that momentum across the Irish economy appears to be building as we approach the end of 2021. The shield provided by the export sector last year from the worst of the COVID 19 pandemic is now giving way to an improving outlook for the domestic economy through increased consumer spending, investment and employment. This should help bolster the medium-term prospects for the economy and for the real estate sector. As evidence of this, chart 6 shows that the strong growth forecast for this year is set to continue in 2022. Below we've included our current views on the specific outlook for the main commercial real estate sectors.

The cyclical economic outlook for Ireland should provide a positive tailwind for commercial real estate over the medium term.

Positive Economic Outlook

Chart 6: Medium term Irish GDP growth forecasts



Source: Bloomberg, October 2021

All else equal, a stronger economy points to an improving outlook for the office sector.

Office - Economic outlook a positive, concerns about the future of the office easing somewhat

Key office metrics like occupier demand, vacancy rates, rents and ultimately yields tend to correlate strongly with growth in the economy. All else equal, a stronger economy tends to point to an improving outlook for the office sector. Therefore, at a high level the economic projections we see in chart 6 should translate into a good outcome for the office market over the medium term.

From a wider economic perspective, the sharp rise and persistence of inflation creates some uncertainties around the future for monetary policy in the Euro zone. While we are of the view that inflation rates may be higher going forward than we're used to, we don't think it will automatically translate into regular interest rate rises (and therefore financing costs) over the medium term. The uneven nature of the Euro zone economic recovery, lower long-term potential growth rates from the region and high debt levels should constrain how aggressive the ECB can be with respect to rate hikes.

In an Irish context the recent decision to increase corporate tax rates to 15% from 12.5% is disappointing for multinational entrants but we're reluctant to attach too much emphasis to this development given the plethora of other advantages offered by 'Ireland Inc' including a young, well educated English speaking workforce (the only one following the UK's departure from the EU) and access to the largest economic bloc in the world. Furthermore, the UK's departure from the EU has also led many financial firms to establish new offices in the EU in order to continue to access this market. Ireland has already benefited from this and could continue to do so in the future, a factor that could ease concerns about the corporation tax hike.

Longer term, one key issue that the COVID 19 pandemic also exposed was that of the role for the traditional office – particularly given the rapid and largely successful adoption of remote working. From investors' point of view the most taxing question was whether office footprints would decline significantly over the medium term, increasing vacancy rates and resulting in a weaker picture for rents and capital values.

Positive Economic Outlook

Occupier sentiment around this crucial issue initially pointed to much lower office footprints but this view has shifted over the past year and now appears to point to a more modest impact on office markets around the world. Two surveys conducted over the course of the pandemic by CBRE and Savills illustrate this point.

- CBRE's June 2021 EMEA (Europe, Asia and Middle East) survey of occupier sentiment found that 40% of respondents said that they would reduce their office footprint over the next three years, only slightly above the 33% that said they would increase their footprint. Crucially, of those looking to reduce their office footprint, only 5% said they would shrink it significantly.

- In Savills' EMEA survey it found that 87% of respondents believed the office remained essential for successful business operations post pandemic, only slightly lower than the 89% response a year earlier. Interestingly, around 70% of Irish respondents still saw a city centre location as the preferred one for an office.

At an aggregate level we're not hugely surprised at the possibility that any aggregate post pandemic shift in office footprint could be modest. We are sympathetic to the notion that employee mentoring, training and interaction and even corporate culture could be negatively impacted by a future working environment which was heavily tilted towards full time remote working. However, the future of the office will still change in a number of ways in our view – more flexible office space, more use of suburban campus style offices (versus city centre ones) and an emphasis on enhanced office technology are changes that appear likely over the medium term.

Occupier sentiment around office footprint has shifted during the pandemic - survey responses now indicate COVID 19 could have a more modest impact on office occupier demand.

Retail – spending outlook is good but traditional approach to retail needs to evolve

As with the office sector, the overall macro outlook is a positive for retail on the whole. The restoration of employment on foot of the reopening of the economy, rising levels of consumer confidence and the prospect of attractive economic growth rates should translate into consumer spending. In addition, the household savings buffers built up during the course of the pandemic – now amounting to over €130 Billion also represent a big plus for the sector.

While the overall outlook is positive, the big challenge for the sector is how to capitalise on it. 'Bricks and mortar' only retailing will continue to be challenged by ecommerce and consequently need to provide a compelling experience to counter the growth of internet shopping. As a result, many retailers are adopting a multi-channel combination of online and physical offerings and we may see even more of this over the medium term.

The Irish retail market has already seen a number of high-profile departures over the past couple of years. This, together with the structural shifts in retailing may well result in more existing space available and a hold being put on new projects, particularly given the impact COVID 19 has had on the sector.

Industrial – ecommerce boom added to by pandemic

We noted earlier that the secular trend towards online spending has boosted demand for high quality industrial and logistics space as businesses realign their supply chains. If anything, this trend has accelerated thanks to the coronavirus pandemic. Brexit is another factor causing suppliers to also re-evaluate their supply chains. So the overall outlook for the sector is strong and this is reflected in low vacancy rates in Ireland and strengthening rents and as a result we feel it is likely we will see further development in the sector over the medium term.

Activity is starting to build following economic reopening

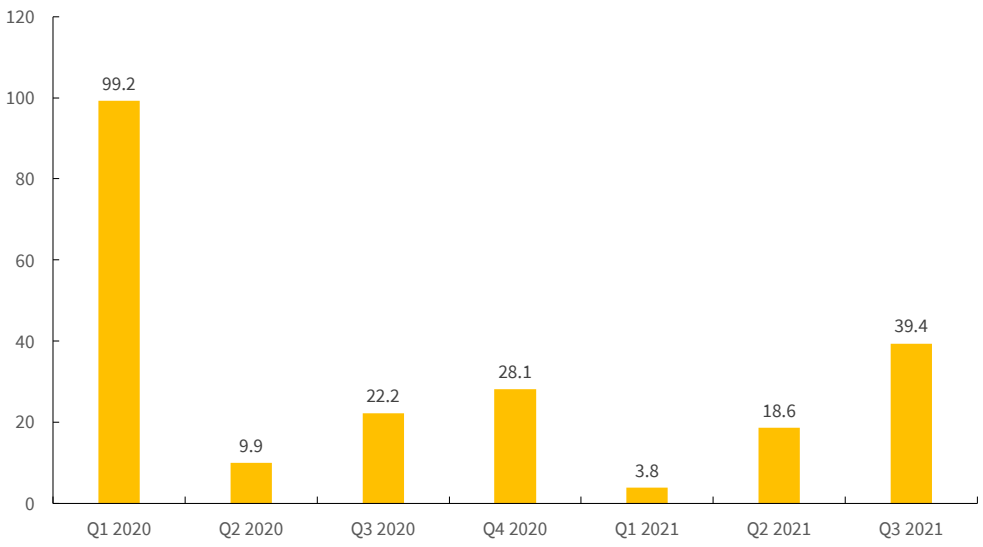
Activity Accelerating

Following the economic reopening in May, the good news for investors is that we see firm evidence that activity levels in the Irish commercial property market are now beginning to accelerate, albeit from depressed levels.

In the office market Dublin take-up amounted to almost 40,000 square metres in the third quarter of the year based on CBRE data. While this is still low in a longer-term context, it represented a doubling of take-up compared to Q2 (chart 7). In addition, demand for space has also increased significantly and was estimated at 407,000 square metres at the end of Q3, almost back to pre-pandemic levels. Finally, €211 million was spent on offices in the overall Irish market in the third quarter meaning €911 million has been spent on the market by investors this year. With a positive outlook for Q4 on the horizon the total spend on office properties could outpace that of 2020.

Activity in the industrial sector has also similarly begun to recover with 70,000 square metres of transactions taking place nationally in the third quarter, up compared with the previous quarters this year and almost on a par with Q3 2020.

Chart 7: Dublin office takeup (000 square metres)



Source: CBRE, October 2021

Transaction activity is now building following the reopening of the economy.

Summary

Overall - Valuations and economic outlook combine to offer good long-term value for investors

The last 18 months has been a turbulent period on the ground for commercial property markets. However, at a headline level thankfully commercial real estate returns in Ireland haven't suffered much negative fallout as a result of the COVID 19 pandemic. Looking forward, the COVID 19 pandemic has altered many aspects of household and business life which we feel will shape the evolution of the commercial property market over the medium term.

To our mind good quality commercial real estate in Ireland continues to offer compelling long-term value. Valuations still look attractive when judged against long term averages and also peer markets in the EU. In addition, commercial property fundamentals are generally very correlated to economic improvement. To this end the cyclical economic outlook for Ireland remains very strong, another crucial tailwind for commercial real estate returns over the medium term.

The combination of solid valuations and a strong cyclical economic outlook for Ireland point to positive medium term returns for Irish commercial real estate.

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