Alternatives Research
Real Estate

February 2022

IBERIA REAL ESTATE STRATEGIC OUTLOOK

First Quarter 2022

IN A NUTSHELL

_ Accelerated structural change and continued economic growth are likely to support an acceleration in logistics rental growth this year, particularly in supply-constrained urban locations in Barcelona and Madrid.

_ In the absence of further regulation, residential rents should continue to grow, and we are expanding our focus to commuter locations and key regional markets.

_ Risks remain in the office sector, where occupier demand is taking time to recover, and availability is still above pre-pandemic levels. There may be opportunities to develop next generation offices in Madrid where there is less of a surge in office supply expected.

_ Senior housing will be a key strategy in the coming year as the ageing population in Spain fuels demand for new product.

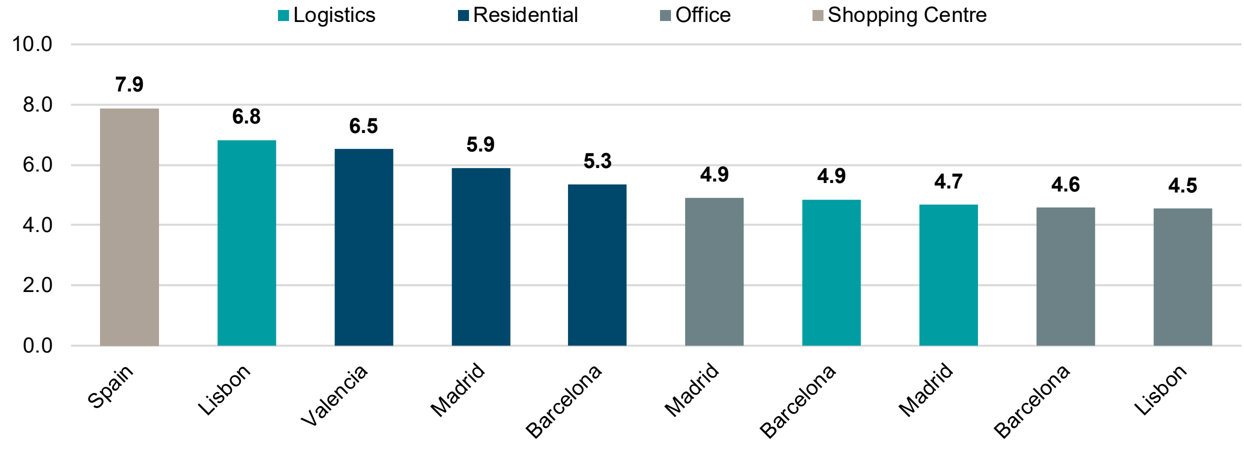
Economic outlook improving

Like other European economies, the short-term economic outlook is clouded by the surge of Omicron infections. In the medium term, we anticipate an improving labour market, although structural unemployment in Spain is likely to remain elevated. Spain and Portugal will together receive up to €144bn as part of the EU Recovery Fund, which should boost GDP growth over the next five years. However, while we expect Spain to grow faster than the European average over a ten-year horizon, Portugal is set to lag.

Real estate investment volumes recovered well in the second half of 2021. Volumes were behind the very strong levels recorded before the pandemic but were still ahead of the ten-year average. We expect further recovery in the investment market this year, driving yield compression across all commercial real estate sectors except retail.

Continuing strong economic growth over the next year should support improved rates of rental growth, particularly for the logistics and residential sectors. Risks to the office market remain, as a rise in remote working could permanently dampen demand and take-up is still below the long-term average. Strong yield compression in the logistics sector over the past six months has reduced our total return outlook, as more of the potential upside has already been taken. Retail remains an expected outperformer on a gross total return basis, but the outlook for income growth is weak and the risks within the sector are high. We now see the most attractive opportunities within residential, particularly within larger regional cities.

Prime Total Returns, 2022-31F (% p.a.)



Source: DWS, December 2021.
Note: F= forecast. Forecasts are not a reliable indicator of future returns. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

The logistics market has moved fast

Logistics remains a strong performer within our forecasts, although much of the yield compression we anticipated has already materialised, reducing achievable total returns over the next ten years. In 2021, expectations of strong rental growth and record levels of investor sentiment towards the sector boosted investment volumes to almost double those of 2019,[1] causing prime yields to decline by around 70 basis points for both Madrid and Barcelona.[2]

Strong supply growth in Madrid is likely to constrain short-term rental growth, despite high levels of occupier demand. We expect rental growth in Barcelona to outperform Madrid in the near term based on lower availability and higher barriers to supply. However, urban logistics locations in both cities should see stronger-than-average levels of rental growth, as building new stock is difficult in urban areas where logistics must compete with other land uses. There may also be an ESG angle to an urban logistics strategy, as occupiers in urban areas in Spain are increasingly turning to solar energy to power delivery fleets as a way to reduce air pollution.

Residential key focus but regulation a concern

The draft Housing Bill announced in the fourth quarter of 2021, which seeks to improve housing affordability by introducing forms of rental control and penalising landlords with multiple properties, has introduced an additional element of regulatory risk for the Spanish residential sector. However, for the main markets of Madrid and Barcelona, the impact of the Bill may be limited. Barcelona has already rolled out rent controls and the regional government of Madrid, which has control over whether to implement the Bill or not, has opposed the proposed measures.

Madrid residential is currently our top-performing sector in Spain but in the absence of certainty regarding the future of regulation, we would underwrite rental growth with caution. There are investment opportunities in larger regional markets – such as Malaga and Valencia – where the rental offering is still in an early stage of development and good economic and demographic fundamentals support new developments.

In addition to multi-family residential, we are likely to explore opportunities in the senior living sector. Strong growth in the 70–84-year-old age cohort and a relatively wealthy foreign retirement population will be key demand drivers for

[1] RCA, January 2022
[2] DWS, PMA, December 2021

assisted and retirement living in Spain. Our focus will be on coastal markets such as Alicante, Barcelona and Malaga, based on lifestyle preferences of domestic and foreign retirees.

Boom time is over for offices, and retail at risk

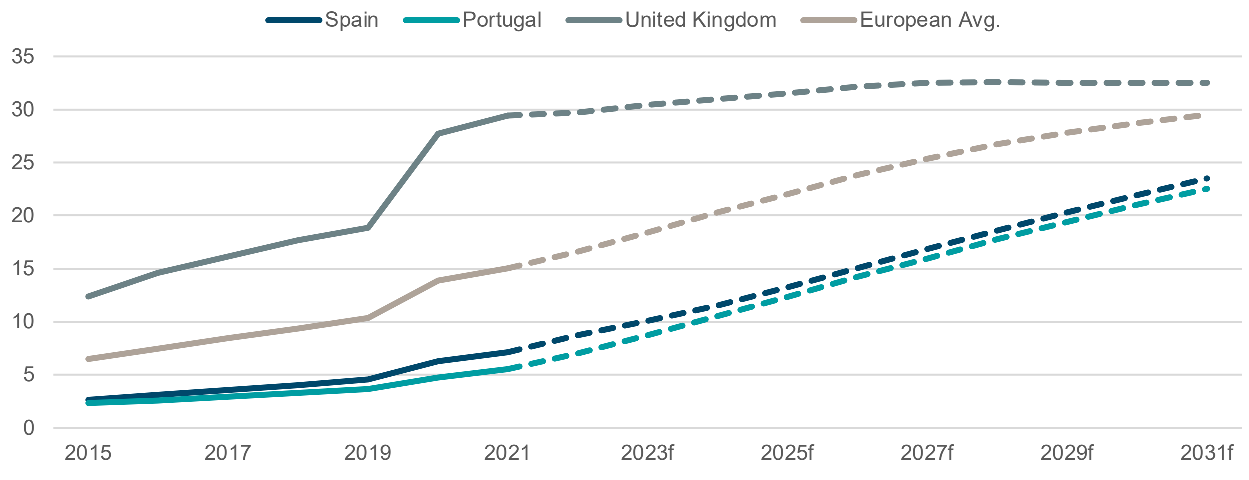
After five years of record rental growth leading up to the pandemic, driven by a deficit of supply and strong economic growth, the office market in Spain has seen a modest rental correction over the past two years. Vacancy rates are now in double digits as both Barcelona and Madrid experienced an uptick in net completions in 2021 just as occupiers were exercising greater caution in taking up new space due to the Covid-19 pandemic.

However, after 2024, net completions are likely to fall, and we expect that strong growth in the tech sector in Iberia will help the market absorb space. There may even be scope to unlock rental uplift in redeveloping outdated office assets in CBD locations in Spain and the historic centre of Lisbon to the latest occupier standards in terms of amenities, energy efficiency and technological capability.

For the retail sector, our forecasts for rental growth over the next ten years in Spain, and to a lesser extent Portugal, are more positive than the European average. While the pandemic has brought about a swift acceleration in e-commerce spending, online retail penetration rates in Iberia remain considerably lower than in other parts of Europe, allowing for greater recovery of in-store spending in 2022 and 2023. As a result, we are not seeing the same downward pressure on rents as in other markets, with shopping centres performing relatively well in terms of total returns over the next ten years.

However, there are strong downside risks, particularly for non-prime retail, which has seen values fall considerably more than the prime segment in markets such as the United Kingdom, where online retail is considerably further along its evolution. The current improvement in investor sentiment may permit a reduction in exposure to these weaker assets.

Retail Spending, Online Share (%)



Sources: DWS, PMA, December 2021.
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