

# IBERIA REAL ESTATE STRATEGIC OUTLOOK

Mid-Year 2021

IN A NUTSHELL

- \_ As the vaccination campaign continues in Southern Europe, we expect economic growth to resume. However, risks remain on the downside as Covid-19 infections continue across the continent.
- \_ Our focus remains on the logistics and residential sectors, where we see room for further yield compression and stronger rental growth over the next five years.
- \_ The office sector is likely to recover more slowly as vacancy rates are elevated and occupier demand may be tentative given the accelerated trend in remote working.

Following several years of economic and real estate outperformance, many sectors in Iberia are starting to look fully priced. Yields in the logistics sector, which has been a main area of focus, continue to tighten and we believe that only urban assets in Barcelona are likely to see strong enough rental growth to offset current pricing levels. The residential sector has weathered the pandemic well and we expect that future supply will not be sufficient to meet demand, setting the scene for rental outperformance. With the outlook for office demand looking increasingly uncertain, and pricing at record highs, we see relatively few opportunities in this sector at present. However, there may be prospects to acquire leisure hotels, particularly in Barcelona where development is highly constrained, after some repricing of the sector in 2020.

## Economic outlook improving

Both the Spanish and Portuguese economies were hit particularly hard by the pandemic in 2020 and early in 2021, but there are now signs of a recovery emerging. Recent PMI data shows a marked improvement in economic confidence and there is evidence of growing ease of mobility, which suggests a potential resumption of more normal levels of activity in the retail and hospitality sectors during the all-important summer season.

The main risk to the short-term outlook is that the summer tourist season is weaker than expected, resulting in a permanent rise in unemployment as government support measures are eased. There are currently 450,000 people registered under the furlough scheme in Spain and while we expect most of this number to be absorbed back into the workforce as economic activity normalises, underperformance in the tourist sector could cause a further rise to the already high level of structural unemployment in the Spanish economy.

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In the longer term, the Next Generation EU plan will deliver up to a total of €39.7bn to support the Spanish and Portuguese governments following the pandemic. This is likely to lift GDP growth over the next five years. In Spain, we expect Madrid's economy to outperform Barcelona, and this translates into our forecasts for growth over the next 10 years, with Madrid extending a small advantage.

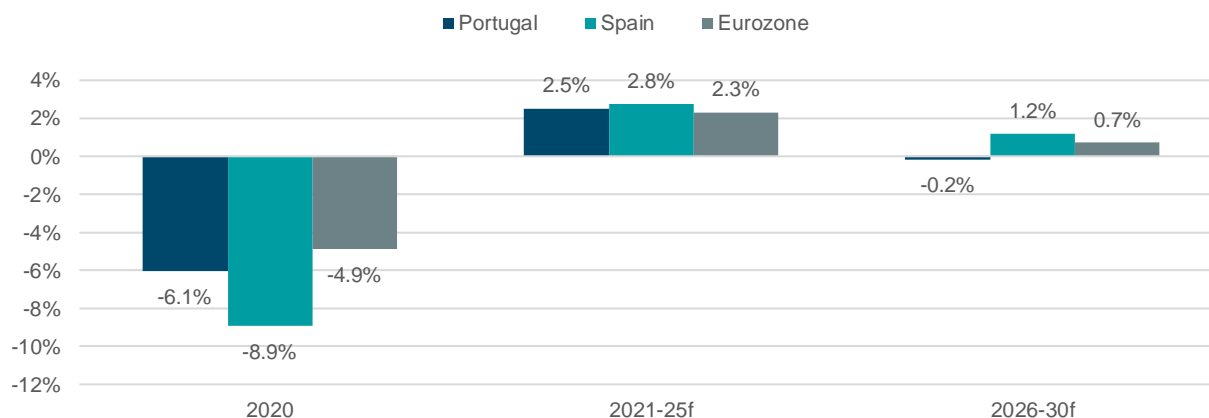
In the office market, we expect all three Iberian markets to marginally outperform the European average in terms of rental growth, although further yield compression may be limited given existing high pricing levels.

In Madrid, despite a better economic outlook, office availability is higher at present. However, a more limited supply pipeline in the Spanish capital should allow vacancy to decline over the next five years. In Barcelona, a significant influx of new development in the New Business Areas is expected to result in occupiers releasing second-hand space back into the market, pushing vacancy rates up into the low double digits for the foreseeable future. We therefore expect rental performance to diverge between high quality, recently developed or refurbished assets, and older stock where availability is greater.

Nevertheless, we do not see the Spanish office market as a key focus at present. Spanish office investment volumes over the last four quarters are down by almost 70% year-on-year,<sup>1</sup> in part reflecting investor caution towards offices in general, but also uncertainty about the economic resilience of Spain coming out of the pandemic.

We also expect Lisbon to be an underperforming office market in terms of risk-adjusted returns over the next 10 years. The limited supply of modern office stock and strong demand protected the market from rental decline in 2020, and Lisbon's economy didn't contract to quite the same extent as Madrid or Barcelona last year. But the recovery is also likely to be more moderate, slightly dampening the outlook for occupier demand. That said, we anticipate a resumption of moderate rental growth in 2022.

#### GDP GROWTH (% P.A.)



Source: DWS, July 2021. F = Forecast. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect. Past performance is not indicative of future returns.

## Opportunity narrowing in logistics

Driven by the growing market share of e-commerce during the pandemic, logistics is a popular sector for investors at present. In Iberia, the picture is no different. In 2015, e-commerce was virtually non-existent in Spain, but by 2020, internet sales comprised almost 10% of total retail sales.<sup>2</sup> By 2025, we believe that internet sales could exceed 15% of the total – still a

<sup>1</sup> RCA, July 2021

<sup>2</sup> Euromonitor, June 2021

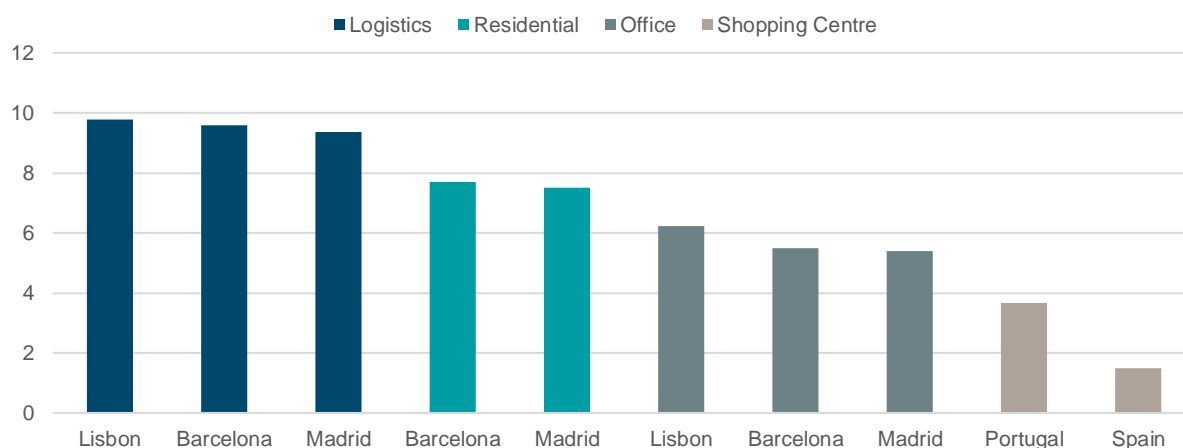
low level relative to the European average, but a significant increase nonetheless. We also see further e-commerce growth in Portugal, with a similar expected growth trajectory, albeit from a slightly lower base.

In anticipation of future rental growth, logistics yields in Spain compressed by around 25 basis points in 2020 – the height of the pandemic – and we expect significant further compression to take prime yields below 4.00% this year.<sup>3</sup>

That said, high pricing is now limiting the opportunity to acquire outperforming logistics assets and we advocate a focus on urban logistics in Barcelona, where rental growth is still likely to be high enough to justify present yield levels. Overall, Barcelona is a relatively supply constrained logistics market with a lower vacancy rate and a more limited development pipeline than Madrid. Therefore, we believe that there is greater scope for rental growth here, averaging 2.2% p.a. over the next 10 years. Yet assets closer into the city are likely to experience even stronger rental growth, being more protected from oversupply.

Our outlook for Lisbon is slightly less positive. The market demonstrated no rental growth from 2000 until 2018 and rents are still 15% below 2007 values. This is partly because the market can be served by other logistics hubs such as Seville in Spain. However, there could still be opportunities for well-located assets to deliver goods direct to the Lisbon urban population.

#### TOTAL RETURN, 2021-25F (% P.A.)



Source: DWS, July 2021. F = Forecast. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect. Past performance is not indicative of future returns.

## Opportunity remains in residential and hotels

The residential sector in Madrid remains a key area of opportunity, despite seeing some rental decline in 2020. The city continues to gain population at almost double the rate of the national average. While we saw an uptick in development activity in 2019, last year was a slower year, partly due to constraints in the construction industry as a result of the pandemic. Our strategy continues to be focused on commuter locations such as Vallecas and Getafe where affordability is greater, allowing for high occupancy levels to be sustained. An increasingly restrictive regulatory regime in Barcelona has reduced the attractiveness of this market, although we do expect strong rental growth to resume in 2022.

Demand for hotel space in Barcelona and Madrid is likely to recover gradually. Both cities rely heavily on international travellers, and Spain has been one of the more affected markets by Covid-19. Current forecasts suggest that demand from international travellers could take three years to return to 2019 levels. Even so, we expect strong performance for the hotel sector in Barcelona once international travel recovers, due in part to regulatory constraints on new hotel development.

<sup>3</sup> DWS, July 2021

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# Research & Strategy—Alternatives

## OFFICE LOCATIONS:

### Chicago

222 South Riverside Plaza  
34<sup>th</sup> Floor  
Chicago  
IL 60606-1901  
United States  
Tel: +1 312 537 7000

### Frankfurt

Mainzer Landstrasse 11-17  
60329 Frankfurt am Main  
Germany  
Tel: +49 69 71909 0

### London

Winchester House  
1 Great Winchester Street  
London EC2N 2DB  
United Kingdom  
Tel: +44 20 754 58000

### New York

875 Third Avenue  
26<sup>th</sup> Floor  
New York  
NY 10022-6225  
United States  
Tel: +1 212 454 3414

### San Francisco

101 California Street  
24<sup>th</sup> Floor  
San Francisco  
CA 94111  
United States  
Tel: +1 415 781 3300

### Singapore

One Raffles Quay  
South Tower  
20<sup>th</sup> Floor  
Singapore 048583  
Tel: +65 6538 7011

### Tokyo

Sanno Park Tower  
2-11-1 Nagata-cho  
Chiyoda-Ku  
18<sup>th</sup> Floor  
Tokyo  
Japan  
Tel: +81 3 5156 6000

## TEAM:

Global

### Kevin White, CFA

Co-Head of Real Estate Research & Strategy

### Simon Wallace

Co-Head of Real Estate Research & Strategy

### Gianluca Minella

Head of Infrastructure Research

Americas

### Brooks Wells

Head of Research, Americas

### Liliana Diaconu, CFA

Office Research

### Ross Adams

Industrial Research

### Ryan DeFeo

Property Market Research

### Ana Leon

Retail Research

### Joseph Pecora, CFA

Apartment Research

Europe

### Tom Francis

Property Market Research

### Siena Golan

Property Market Research

### Rosie Hunt

Property Market Research

### Martin Lippmann

Property Market Research

### Aizhan Meldebek

Infrastructure Research

Asia Pacific

### Koichiro Obu

Head of Research & Strategy, Asia Pacific

### Natasha Lee

Property Market Research

### Seng-Hong Teng

Property Market Research

### Hyunwoo Kim

Property Market Research

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## The authors



**Simon Wallace**  
**Co-Head of Real Estate Research & Strategy**



**Tom Francis**  
**Property Market Research**

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