Real Estate Research

September 2022

Iberia Real Estate Strategic Outlook

Third Quarter 2022

IN A NUTSHELL

- Slowing economic growth and higher borrowing costs are likely to start a period of real estate price correction across Europe.
- We remain positive on Spanish residential, although regulation poses a risk in some locations. Regional cities like Valencia offer attractive, affordable investment options. Social housing strategy through partnerships with local authorities can also provide stable returns as well as social benefits.
- Strong growth in the over 70-year-old age cohort and foreign retirement population supports investment in the assisted living sector. We also see opportunities in the student housing sector due to the internationalisation and modernisation of higher education.

Across Europe, the first half of 2022 has been defined by rapidly rising inflation, weakening economic growth and changes to the geopolitical landscape. During the immediate post-Covid recovery, Southern Europe benefited from a resurgence in tourism, with visitor numbers in Spain looking particularly strong[1]. Domestic demand, however, has been more muted. Employment data and short-term indicators point to robust momentum, yet the prospect of a Eurozone recession this winter, likely further monetary tightening, and the threat of persistently high energy inflation are all leaving their mark on the economic outlook.

Repricing of the real estate market

The Iberian real estate market is expected to face headwinds such as slowing economic growth and higher financing costs. Local government bond yields have increased sharply in a volatile fixed-income market and as a result, like elsewhere in Europe, a price correction in the Iberian real estate market is likely underway. At present, evidence of any price movement is largely anecdotal, but over the next 18 months we expect yields to move out across almost all sectors, and prime values to decline by around 10-15%. Property yields are now predicted to peak much earlier in the cycle than we had previously forecast, before edging lower again in the medium term as the economy recovers and investment activity returns. Towards the back end of the ten-year forecast period, our outlook for property yields remains largely unchanged.

Affordable and social residential our top picks

We remain positive on Spanish residential, and the sector is expected to perform well relative to the wider Pan-European residential market. Market fundamentals have strengthened in recent months and rents continue their upward trajectory. However, regulation remains a major concern in some markets, hence we continue to see the attraction of affordable residential. Within

[1] Oxford Economics, August 2022

this segment, we also see investment opportunities within larger regional markets – such as Malaga and Valencia – where the rental offering is still in an early stage of development, while good economic and demographic fundamentals support new developments. Looking ahead, we expect the strongest rental growth in Valencia and Barcelona.

The appeal of affordable housing is somewhat replicated in the social housing segment. Our experience in Spain has shown that through partnerships with local authorities in cities like Madrid, private equity real estate can play an important part in the provision of low-cost housing, while also meeting investor risk-return requirements. The appeal of social housing is clear: stable, government-backed and often CPI-linked income, as well as obvious social benefits.

Senior living and student housing attractive sectors

Operational residential assets such as senior living and student housing typically offer a 100-175 basis point yield premium over multi-family residential, with the size of the premium generally dependent on micro location, maturity of the market and security of rental income. At the same time, these sectors have many of the same safe-haven characteristics as the private residential sector, including low vacancy, continuous demand, and a lack of good-quality stock. The higher entry yield in part reflects additional operational and alternative use risk, but the combination of a higher income return and strong rental growth could result in attractive total returns for institutional investors.

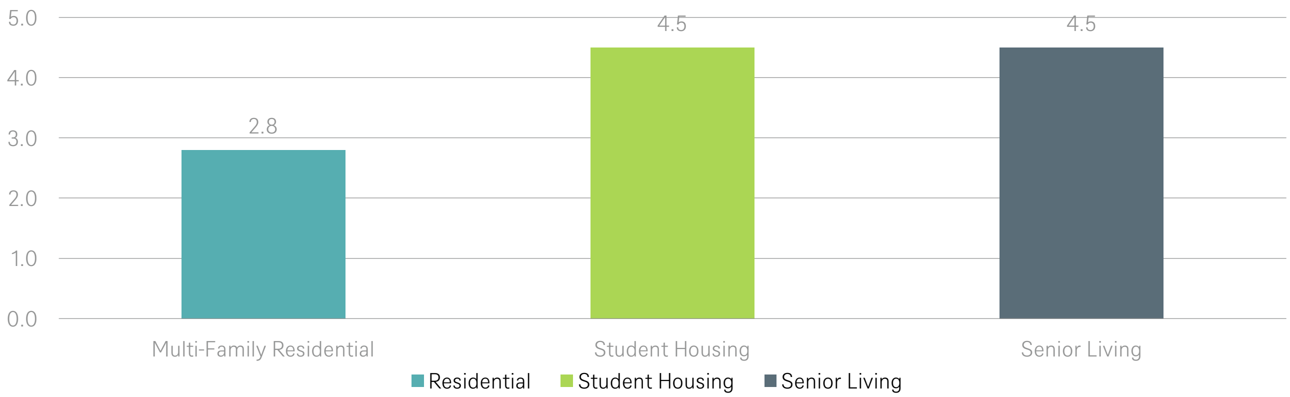
The senior living market in Spain is set to benefit from rising tenant demand, given an ageing population. The number of people aged over 65 is expected to grow by nearly 40% over the next 15 years, compared to just a 5% increase in the overall population[2], while Spain also benefits from a relatively wealthy foreign retirement population. Our focus is be on coastal markets such as Alicante, Barcelona, and Malaga, based on lifestyle preferences of both domestic and foreign retirees.

Purpose-built student accommodation (PBSA) is also an attractive sector, driven by growth in the domestic student population and by increasing international student mobility. PBSA is expected to perform well throughout the economic cycle, as student enrolment is typically inversely related to the economy: The tougher the job market, the more likely the decision to study. Spain and Portugal have seen growing demand for PBSA due to the modernisation and internationalisation of higher education, yet the student housing market remains immature and fragmented. Both countries have a lack of good-quality student accommodation, and current stock is often outdated and unsatisfactory.

The number of PBSA beds relative to the full-time student population – also known as the provision rate – is estimated to be around 7% in Barcelona and Madrid, around four times lower than in mature markets such as London and Amsterdam. Provision rates in Spanish regional cities such as Valencia and in the major Portuguese cites are even below 5%[3]. Given demand from both domestically mobile and international students, a case can be made for both a mid-range and high-end student housing investment strategy.

[2] Eurostat, August 2022
[3] DWS, Savills and Bonard, 2021

Prime Net Initial Yield (%), 2021



Source: DWS, Savills, July 2022.

Urban logistics and Next Generation office

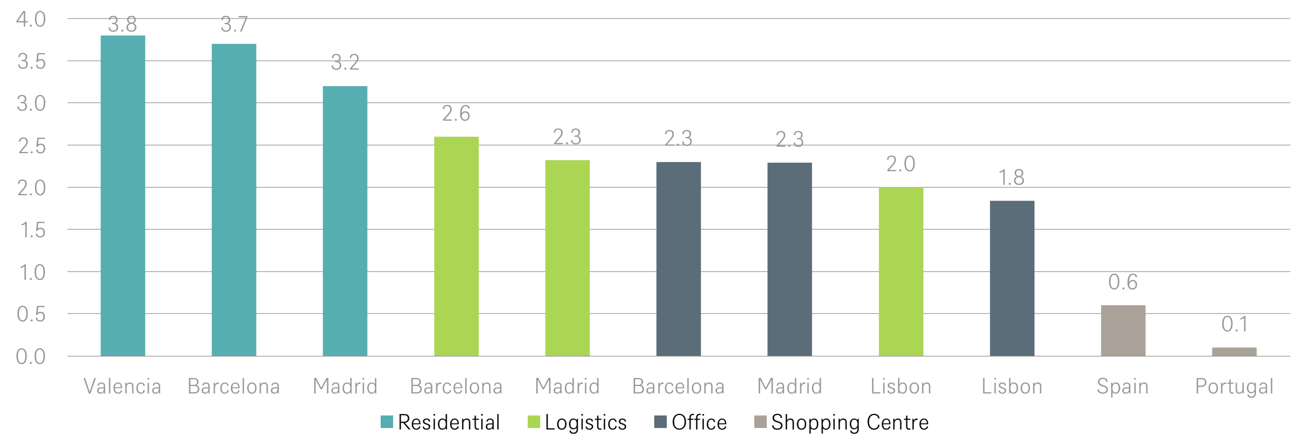
Logistics also appears to be resilient in the face of economic disruption, and with vacancy across most logistics markets running at record low levels, the short-term outlook remains one of rising rents. However, the sector is not without its difficulties: low-margin distribution businesses today are facing a wave of challenges, from rising costs to falling retail sales. Corridor logistics in Madrid also looks exposed to risks around supply, with few barriers to development and an already elevated vacancy rate. Barcelona on the other hand looks more likely to outperform, given exceptionally tight vacancy and limited availability of land, alongside its position as a port city.

Coming from a low base, further growth in online sales could support demand for urban logistics more than elsewhere in Europe, where e-commerce supply chains are already established. Third-party logistics providers are likely to prefer locations closer to large cities given rising fuel costs, while there may also be an ESG angle to an urban logistics strategy in Spain, as occupiers in urban areas are increasingly turning to solar energy to power delivery fleets as a way to reduce air pollution. We would expect last mile logistics schemes in Barcelona to outperform Madrid, given the lower availability of supply within an hours' drive time and limited land availability.

The office sector looks to be less resilient. The market looks vulnerable to voids, with uncertainty over future demand in case of job losses. However, across many Iberian cities the availability of grade A space remains low. Therefore, we are cautious on acquiring prime office stock but could see opportunities to invest in well located, grade B stock, with a plan to refurbish into Next Generation space. We prefer Madrid over Barcelona in the near term, with the potential for rent growth in Barcelona held back by high new supply figures.

Iberian retail suffered greatly during the pandemic, although the sector is likely to recover some of this decline over the next five years. Regionally dominant and grocery-anchored retail in particular is expected to bounce back after next year, although most shopping centres in Iberia face vacancy risk and erosion of the local retailer base, and in general we expect rent growth to be weak over the ten-year horizon.

Prime Rent Growth Forecast (2022-2031f, % p.a.)



Source: DWS, July 2022. 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.

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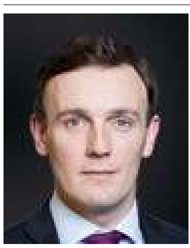

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Important information