LAKEWARD

Zurich, First Quarter 2021

Many factors indicate that global economic development will remain volatile and uncertain during the first half of 2021. Uncertainties about the pandemic and delays in vaccinating the general population will continue to harm short-term growth. This contrasts with the generally optimistic consensus opinion, which already assumes a strong improvement in the global economy for the leading industrialised nations into the second-half 2021 and full year 2022.

2021 – a year to move forward

Our base case assumption is that the world economy will remain decoupled as developed economies progress along a path of slow recovery and emerging markets roar back to pre-pandemic growth rates. China has already demonstrated its ability to decouple from the pandemic crisis during 2020, and 2021 is likely to be no different.

Looking briefly at current economic forecasts, the distribution is broad, but generally, they are all consensus with the direction – up! Just taking one sample from the OECD*, their 2021 (2020) GDP growth forecast for the G20, Euro area and Germany are +4.7% (-3.8%), +3.6% (-7.5%) and +2.8% (-5.5%) respectively.

As the figures above suggest, the recovery of developed economies should gain momentum providing the vaccine distribution continues. This will help to alleviate some uncertainty and is met with the desire to return to pre-pandemic lifestyles. However, there are also risks that have the potential to negatively impact the projections and slow the normalisation.

These include, for example, mutating strains of COVID-19, delays in the vaccine production, rising unemployment, increasing social imbalances and Brexit's impact on trade within the EU.

Last year, capacity utilisation was lower across the industrial sector, leading to inventories falling at an above-average rate as orders recovered much faster than production, especially in the export market. Due to the low inventory levels and the normalisation of growth in Europe, prices are also expected to rise despite reduced production capacities. This indicates that European, and especially, German industrial production should experience a robust and expansive cycle well into 2022.

However, private consumption and investment is likely to remain subdued through the year due to uncertainties and still low confidence levels, which will impact the service industry through 2021 and long into 2022.

Source: OECD (2020), OECD Economic Outlook, December 2020, (OECD Economic Outlook: Statistics and Projections (database))*

Monetary and Fiscal Policy

Global central banks have embarked on a massive policy response to the pandemic and have committed to keeping short-term interest rates close to zero or even below. This is unlikely to change this year or even into 2022, especially in the EU region.

Compared to the measures taken during the GFC of 2008/09, the current expansion of fiscal stimulus in G20 nations represents a significant difference. Even if the measures undertaken in the Eurozone have not reached the level of the USA, the mere fact that the European Union is relying on fiscal stimulus represents a radical change from previous policies.

Inflation or disinflation

There remains a compelling case for both outcomes and will undoubtedly be a subject of many debates and disagreements. There is currently scarce evidence of inflationary pressures, and we do not expect this to change over the next year or two.

However, we warn against being overly complacent as the combination of monetary and fiscal stimulus is creating the ingredients for a perfect inflation storm. A combination that did not exist during the GFC of 2008/09.

As Milton Friedman once succinctly quoted, "Inflation is always and everywhere a monetary phenomenon."

Widening income inequality

Over the past decade, income inequality has worsened despite significant aggregate wealth increases in developed nations. The pandemic will further increase inequalities, and the problem will become even more visible due to differences in social structures, education, professional qualifications and related income structures.

For most better-qualified workers, the pandemic has so far had a limited impact on livelihoods, as they have been able to swap the office for the workplace at home. Workers in lower-skilled occupations, in part-time jobs or specially affected sectors, have been hit disproportionately harder. The restrictions have had a substantial impact on their income, increasing the social and health risks posed by the COVID-19 virus.

If income inequality cannot be brought under control, social and economic unrest is inevitable, undoubtedly leading to more extensive political intervention and regulation.

Examples of this existed even before the pandemic: the political intervention in Berlin on rising rents and the regulation of "rent capping" introduced with it. Although the idea itself is welcome, the longer-term effect of such intervention in the free-market economy is negative, leading to a greater undersupply of affordable housing.

A new face in the White House

Although his actions are not likely to directly impact our view on European real estate, his posturing will have a more considerable global impact.

President Biden has many challenges ahead, not only on the domestic side but also with foreign policy. He is very likely to push the US back into its multilateral role, which is already evident with the US re-joining the Paris Climate Accord. Discussion of the US reaching out to Iran to renegotiate a nuclear deal is also on the table.

But with China, he is expected to remain rigid, and tensions surrounding trade and intellectual property are unlikely to fade rapidly.

In general, however, we can assume a somewhat friendlier attitude of the USA towards Europe again.

Redefining how we live, work, and reside

The pandemic and its effects have permanently changed and accelerated existing trends in how we live, work, reside and spend leisure time. This directly impacts the planning and development of real estate construction projects, thus intensifying the challenges for investors and real estate project developers alike.

For example, the impact on supply chains, cross-border trade, access to materials, and labour availability has not yet been fully priced in and could lead to cost increases in construction projects in the future.

The focus on ESG and sustainability has given more priority to environmental issues. A stronger emphasis on human health and consumer wellbeing has become more important in daily life, leading to a sustainable change in existing behaviour patterns. This includes less complicated and everyday tasks such as shopping and fundamental issues such as public and private transport.

It is difficult to foresee how these changes will affect consumer and business behaviour in the real estate sector in the future. We assume that changes that were already underway before the pandemic will continue to accelerate and intensify. The steadily increasing demand for living space per person (home office), the shift towards modern and flexible office space or the shift towards more online shopping, which has a negative impact on retail, are just a few examples.

Until the world has "normalised" it is safe to assume that current normal conditions will continue to challenge perceptions.

The key to success is to decipher whether behavioural changes are structural or cyclical, and it is essential to recognise emerging trends at an early stage and to be able to react actively to them.

The office – a place to work or a place to collaborate

The future of offices remains a significant theme of debate. We believe that demand for prime, well-located office space will remain as the office is very much part of a business' identity and flagship space is essential in attracting talent. Indeed, a significant shift towards more open space provides flexibility and greater autonomy.

Additionally, technology has helped us stay connected during the lockdown, but it has not, and will not, replace the human interaction with colleagues and clients.

Work is a place of exchange, emotion and experience that only the office can genuinely provide.

Residential – affordable and multi-functional

We believe that the multifamily (residential) sector will remain in high demand. Due to the chronic shortage of medium-sized affordable apartments, coupled with the structural urbanisation trend from rural areas into cities, German metropolises will continue to grow and increasingly spread to surrounding agglomerations.

There is still a strong desire to be part of a city as this provides cultural diversity, infrastructure, mobility and most of all, employment opportunities. These are key factors determining a city's ability to attract and retain residents, businesses and innovation.

Our observations across Germany support the idea that the urban agglomeration spread will continue to grow away from the centre, leading to expanding boundaries, or mini cities within a larger city. The ongoing expansion enables residents to relocate from the centre, where affordability becomes a vital issue, to more affordable regions but still maintaining the urban benefits, i.e., infrastructure, mobility, employment and cultural diversity.

The lockdown restrictions imposed across Europe highlighted that, while small apartments cater to the need for high-density housing solutions in metropolitan cities, they proved inadequate in providing adaptable and multi-functional space to live and work from.

Going forward, the typical apartment design will have to reflect the need for greater flexibility and space but remain within the realms of affordability. A growing trend towards more working flexibility means that the ability to do home office becomes a factor to be considered when renting an apartment.

As such, the residential design will evolve, but this does not necessarily imply more square meters, but smartly utilised urban square meters allowing for evolving demands and greater flexibility.

New "old" development models in the real estate sector – a compelling investment case

Pandemic driven dislocations are accelerating changes and creating opportunities that will evolve through 2022 and well beyond.

We see the following factors that support our European real estate investment case:

- European banks increasingly selective: While capital remains plentiful and ultralow interest rates continue to be supportive; banks are also generally much better capitalised in this crisis than they were in the GFC. However, just because banks have larger buffers, it does not mean that all is rosy. Financing for development projects has become more selective and, for example, real estate projects in the accommodation and retail sectors have sometimes come to a complete standstill. These actions increase imbalances and cause dislocations across the real estate market providing opportunities for longer-term investment strategies.

- Real estate as an alternative to fixed income: The gap between bond and real estate yields that consistently increased for the past decade remains. While specific sectors face challenges, real estate generally is seen as one of the few asset classes to generate acceptable positive returns at a time of negative interest rates. As such, we see real estate as an excellent alternative to the fixed income asset class.

- Growing structural demand: We believe that the urbanisation and increased concentration in Germany's major metropolitan areas will continue – even though the pandemic has also shown the negative consequences of living in tight conurbations. With a move towards increased working from home and need for space, both in the house and surroundings, urban boundaries are more likely to extend. Similarly, the pandemic has catalysed change and growth across the mega-trends of e-commerce and digitalisation. These ongoing mega-trends support our thesis of growing opportunities in mixed urban schemes and residential investments.

- Inflation – "to be, or not to be": Should the inflation theme materialise, this would be positive for rental and income figures for residential, hotels and good quality office buildings, and thus provide a natural hedge against inflation.

Conclusion

In these uncertain times, it is essential to focus on long-term developments and not lose sight of the bigger picture. The pandemic will influence the needs and behaviour of real estate users. However, many of these developments are within the framework of long-term evolving megatrends and will have not have a profound impact on people’s existential need for space to live, work and play.

A prime example of how real estate evolves is best illustrated by the "L65 Factory Berlin”; a real estate project purchased by Lakeward in 2016. The property, which is now a listed building, was originally built in 1901 as a factory for the Actien-Gesellschaft für Anilin-Fabrication, better known as Agfa survived two world wars but also all financial crises since then. Today, the "L65 Factory Berlin" is considered an innovative office campus that brings together the most ambitious and creative minds from the world of technology and industry on 14,000 m^2 and has international appeal as a start-up hub for budding entrepreneurs.

Simon Koenig
CEO

Jeremy Baker
Senior Sales & Business Development