Iberia Real Estate Strategic Outlook

First Quarter 2023

IN A NUTSHELL

- In the short term, the Spanish and Portuguese economies are likely to face a mild recession, reducing retail sales volumes, curbing residential rental growth, and dampening office occupier expansion plans.
- Real estate repricing accelerated in the final quarter of 2022. While some further outward yield shift is likely early in 2023, we believe that much of the repricing has already happened, and that the market should soon begin to stabilise.
- Strong fundamentals continue to support outperformance in the residential sector, where we are increasingly focused on the growing investable sectors of affordable and social housing in Spain. Meanwhile, constrained supply and strong occupier demand make Barcelona one of our top performers in the logistics sector.

Iberian 10-year government bond yields increased by around 250 basis points last year,[1] and although transactional evidence has been scarce in the real estate market, commercial property yields are also reported to have risen significantly. And while we believe that a large proportion of the total repricing has already happened, we still expect some further repricing early in 2023. Certain sectors have been faster to correct than others, with logistics and retail seeing the largest change so far, as yields have moved out by between 75 and 125 basis points since their low point earlier in 2022. For logistics, this offers an opportunity to benefit from more attractive pricing in a market that still has strong underlying occupier demand. Pricing in the residential market – both operational and multifamily – has been more resilient on the other hand, with investors attracted by the ongoing supply deficit and solid demand fundamentals.

Milder economic slowdown expected

Both the Spanish and Portuguese economies are forecast to perform better during the current crisis than the Eurozone average. For Spain, its resilience is partly thanks to the country's relatively low reliance on Russian gas imports, which comprised just 10% of the total in 2021, compared to the EU figure of around 45%.[2] Another contributing factor has been the strong rebound in tourist revenues, which in 2022 are expected to almost match pre-pandemic levels.[3] Meanwhile, the country is benefitting from a €140 billion injection of funds from the EU Next Generation plan, which should translate into a boost to government spending.

However, the real estate market will still need to contend with significant macroeconomic challenges in early 2023. Consumer confidence is at a similar low point to the start of the Covid pandemic and inflation is running at close to 9%. We therefore expect weak but still positive GDP growth for both Spain and Portugal this year. The longer-term picture for Spain is also less promising, as structural unemployment is

[1] Macrobond, January 2023
[2] IEA, December 2022
[3] Oxford Economics, December 2022

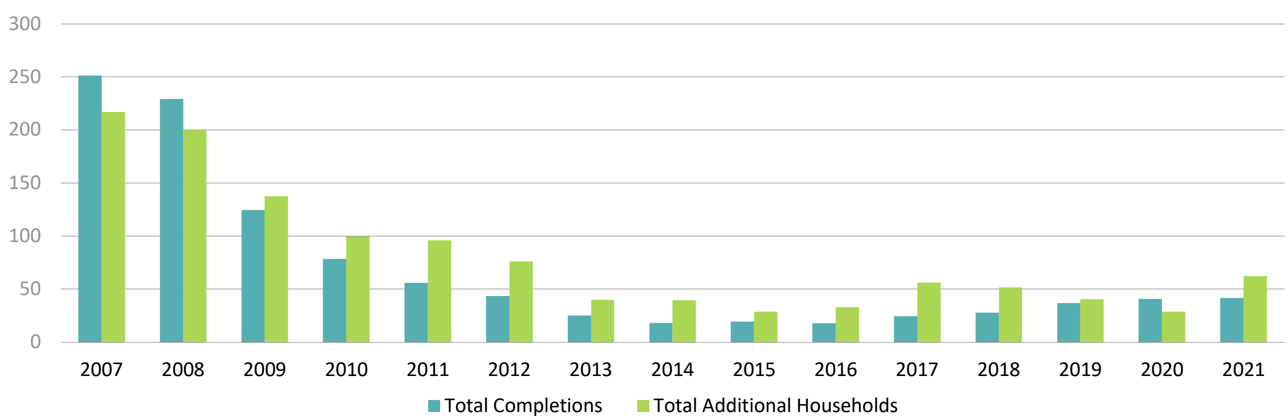
among the highest in the EU and this is likely to weigh on consumption, as well as resulting in a need for higher welfare spending.

Spanish residential remains a priority

The private rented sector (PRS) remains a strategic focus, while other residential sub-sectors, including social housing and student housing, also look particularly attractive. PRS rents are now bouncing back after a notable decline during the pandemic, and are likely to have grown by between 9% and 11% in 2022.[4] Looking ahead, healthy demand should be supported in the immediate term by an increasing propensity to rent due to higher mortgage rates. Household numbers also continue to grow in excess of the national average in the largest urban areas, with Madrid set to see particularly strong growth over the next 10 years, while household size is also expected to continue trending lower. At present, only 24% of households rent in Spain,[5] a figure which is likely to converge gradually with the EU average of 30%, driving additional demand for rented property.

The supply side has been slow to respond. While development activity has picked up in recent years, there is still a substantial gap between completions and household growth. This is particularly acute in Valencia, where many developers failed after the global financial crisis, resulting in nearly no new supply being built from 2011 to 2019. In Madrid, household numbers are forecast to grow at around 13,000 a year over the next five years,[6] while completions are set to average just 9,000 a year.[7] Overall, we expect PRS returns in Madrid and Valencia to exceed the European average over a ten-year horizon.

Residential Completions and Household Formation in Valencia, Catalonia & Madrid (thousands)



Source: Ministerio de Transportes, Movilidad y Agenda Urbana, October 2022; Oxford Economics, January 2023.

Regulation continues to pose a risk to the residential market in Spain, but with certain mitigants. The Catalonian government's controversial rent controls were ruled out by Spain's constitutional court earlier in 2022, although the National Housing Act currently under discussion in the national parliament remains a potential threat. However, it is likely that regional governments will be able to opt in or out of the Act, and the current right wing government in Madrid has set out to oppose the new legislation.

With the prospect of rental regulation on the horizon, we are increasingly positive about the prospects for social housing development in Spain. The sector is currently underdeveloped, representing just over 2% of the total residential stock. Capped rents (typically around 20% below market rates) offer stable cashflows and as the rents are already regulated, the introduction of rent controls is not a consideration.

[4] DWS, December 2022
[5] Eurostat, December 2022
[6] Oxford Economics, December 2022
[7] Ayuntamiento de Madrid, January 2022

Depending on the incentives offered by the regional government, the price point at entry can be sufficiently attractive to offset the lower rents.

Student housing is also undersupplied relative to demand and may offer attractive returns. Rental growth in the 2020/21 academic year ranged from 4% to 8% and yields offer a premium of at least 100 basis points over PRS.[8] Given the lack of stock (provision rates are generally 7% or lower),[9] most investment opportunities are likely to be in forward funding new developments. While Madrid and Barcelona are key targets, other regional cities such as Valencia, Granada, and Seville could also prove attractive. The main challenge in the larger cities is building new stock that is sufficiently close to a university campus to offer a short commute, given the lack of available plots for development.

Barcelona logistics among top-performing European markets

Repricing across the board in 2022 has brought logistics back into focus. With net yields now comfortably over 4.50% in both Madrid and Barcelona, compared to less than 3.70% in 2021, expected rental growth should be sufficient to bring prime total returns to around 9% per annum over the next five years. Barcelona is a particularly attractive market as the land available for development is more constrained, leading to persistently low vacancy and rental outperformance. Madrid, on the other hand, is just emerging from the latest supply cycle and vacancy at the start of 2022 was over 7%, falling to 6.4% by the third quarter of the year.[10]

The squeeze on household disposable incomes resulting from high inflation has not fed through into weak logistics occupier demand. Take up in both Madrid and Barcelona in the first three quarters of 2022 was above the long-term average, and while some slowdown is likely, in line with weaker economic growth this year, we still see growth in e-commerce driving strong take-up levels over the next five years.

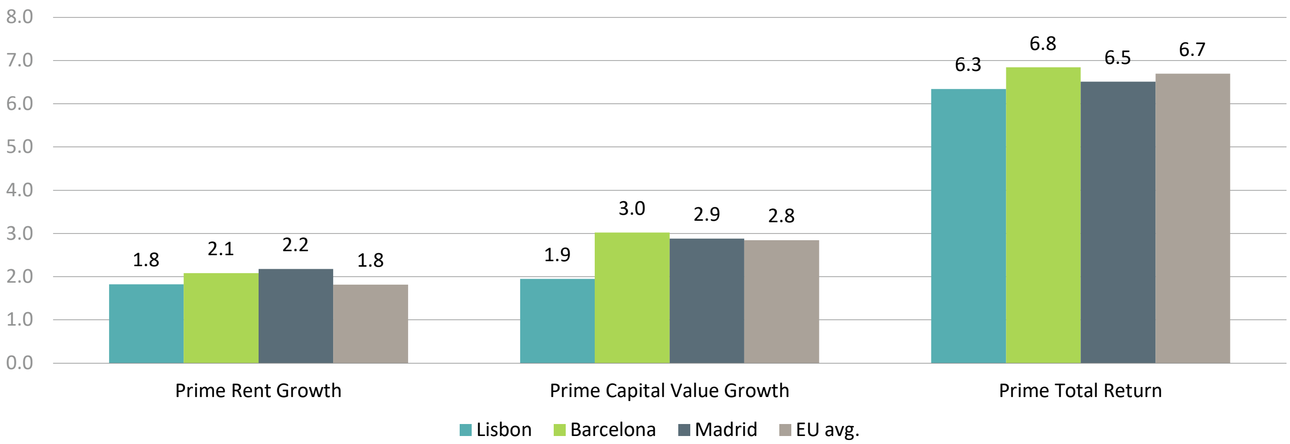
The Lisbon logistics market offers fewer opportunities as operators tend to serve the market from existing hubs in Spain. Only last hour locations such as Azambuja, from which a delivery can be made directly to customers, have strong potential for rental growth. Nevertheless, yields have also corrected in Lisbon. In the space of just two months, CBRE reported 50 basis points outward yield movement for prime logistics in the Portuguese capital, and we expect some further repricing in the first half of 2023. At this point, yields may be very attractive relative to the rest of Europe, but as rental growth is likely to be limited outside of urban locations, we would take a selective approach to new acquisitions.

Office value-add looks attractive

For the office sector, we see more opportunity in value-add than core investments, with a particular focus on Madrid, as supply growth in this market is more muted and office stock that meets current occupier requirements is lacking. Barcelona is undergoing a meaningful expansion of available supply, with expected net completions in 2022 and 2023 totalling almost 6% of current stock. Even with strong demand, it is likely to take several years for the market to absorb this volume of new product.

[8] Savills, October 2022
[9] Savills, October 2022
[10] CBRE, October 2022

Office Market Performance, 2023-32f (% p.a.)



Source: DWS, January 2023.

Compared to other European markets, Spanish occupiers have shown a greater commitment to the office, which is likely to support performance going forward. According to Eurostat, less than 10% of office workers in Spain work from home more than half of the week, compared to 17% in France and Germany, and 33% in Ireland. [11] Therefore we expect the trend of occupier downsizing to be less pronounced in Spain. This supports a slight rental outperformance in our longer-term forecasts, while total returns are broadly in line with the European average.

A value-add strategy would also work well in the Lisbon office market. Unlike Madrid and Barcelona, there was no rental correction in Lisbon during the pandemic and the market is proving resilient going into the current crisis. Take-up figures in 2022 were at a 10-year high as companies look to next generation space for their office needs. New entrants to the market and expansions represent a minority of transactions,[12] so after the current flurry of post-pandemic activity, demand is likely to slow. There is a current mismatch between the standard of space available and the high quality that occupiers are targeting, and this is likely to become more acute as European regulatory requirements for offices to meet certain efficiency standards tighten. Overall, Lisbon offices are not one of our top picks, but there may be tactical opportunities to plug the supply shortage of modern stock in central locations such as the CBD and Historic Centre, with the potential to realise an attractive rental uplift.

[11] Eurostat, May 2021
[12] PMA, October 2022

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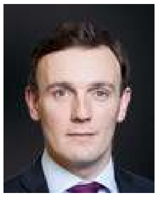

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