2021

LUXEMBOURG REAL ESTATE

MARKET OUTLOOK

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A LOOK AHEAD

2020 has clearly brought many challenges. Sometimes destabilizing, sometimes unifying and sometimes redefining, this crisis has put the world to the test and shaken our preconceived ideas on a range topics. This is our take on what lies ahead.

Heavily hit by the COVID-19 pandemic like the rest of the world, the Luxembourg economy is holding up better than announced in the spring, and better than most European countries. To offset the effects of the crisis, the Grand Duchy has taken a series of measures to support the economy, but these are costly and lead to a sharp deterioration in public finances this year. However, it is safe to say that these decisions enabled a large majority of companies to avoid bankruptcies, and the economy to run while preserving overall health and security.

And as a second wave of infections hits the country, forecasts for 2021 remain highly uncertain due to the unpredictable course of the pandemic. Everything will depend on the speed with which vaccines will be available and how they will be welcomed by the general public, on European fiscal and monetary policy and, ultimately, on the return of confidence.

What about commercial real estate? Fundamentals in terms of leasing and investment activity in the office sector showed impressive results, driven by a resilient national economy. Take-up activity stood firm, as very few ongoing discussions during the lockdown were postponed to better days. The effective management of the COVID-19 crisis and a solid take-up have comforted investors looking for defensive investments in an uncertain environment.

The residential market experienced ever higher prices despite the limited number of transactions. Retail has suffered, deprived of the flow of cross-border workers due to the massive use of homeworking. Though, interest from international retailers is noted.

Resilience seems to be the most used word in 2020 after COVID-19, and this is what the Luxembourg economy and markets will still need in 2021. The crisis is a pivotal time for us to collectively re-evaluate our work, housing and lifestyle.

Despite all of the obstacles the pandemic has wrought, the office and residential occupier and investment markets are holding up in ways very few countries can match.

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ECONOMY

KEY TAKEAWAY

The Luxembourg economy held up well during the first lockdown and thus grew more moderately in the second half of the year, as there was less ground to make up compared to the rest of Europe. Earlier forecasts of a 3.5 to 4.0% decline in 2020 GDP could be as little as 1.4%, though uncertainty remains. 2021 growth is forecast at 4.0%.

The effects of the crisis have been asymmetric. Finance, IT and business services were able to adapt to homeworking rather well, increasing hours working and even value-add in some areas by Q3. Construction, too, has seen positive development.

ECONOMIC RESILIENCE

Economic changes in Luxembourg have been much less volatile compare to wider Europe. The decline in economic activity in the first half of the year was less severe and the recovery in Q3 thus less dramatic. Year-over-year, Q3 economic growth was actually positive at +0.5% - the only euro area country to claim such a feat. The earlier forecast of a 3.5 to 4% decline in GDP is now looking overly pessimistic and could be as little as a 1.4% decline, according to Statec in December. Growth is anticipated to return in 2021 with forecast growth of some 4.0%. Much, though, depends on Luxembourg's neighbors' lockdown and containment measures.

The crisis has had asymmetric effects on different sectors of the economy. Of course, retail and hospitality have been hard hit. Even in Q3 when activity was opening after the first lockdown, hours worked in horeca was down 17% since the start of the year. Finance, IT and business services were able to adapt to homeworking rather well, increasing hours working and even value-add in some areas by Q3. Construction, too, has seen positive development. This dynamic is likely to carry forward through at least the first half of 2021.

The government rolled out supportive measures during the first lockdown to support income, employment and guarantee loans. These measures helped cushion the effects from the crisis, leading to relatively moderate unemployment inreases to 6.3% in October - down from 6.9% in April and May. Still, the full effects will be seen in 2021, with unemployment expected to rise from 6.4% in 2020 to 6.8%. This figure, however, is still lower than the unemployment experienced as recently as 2014.

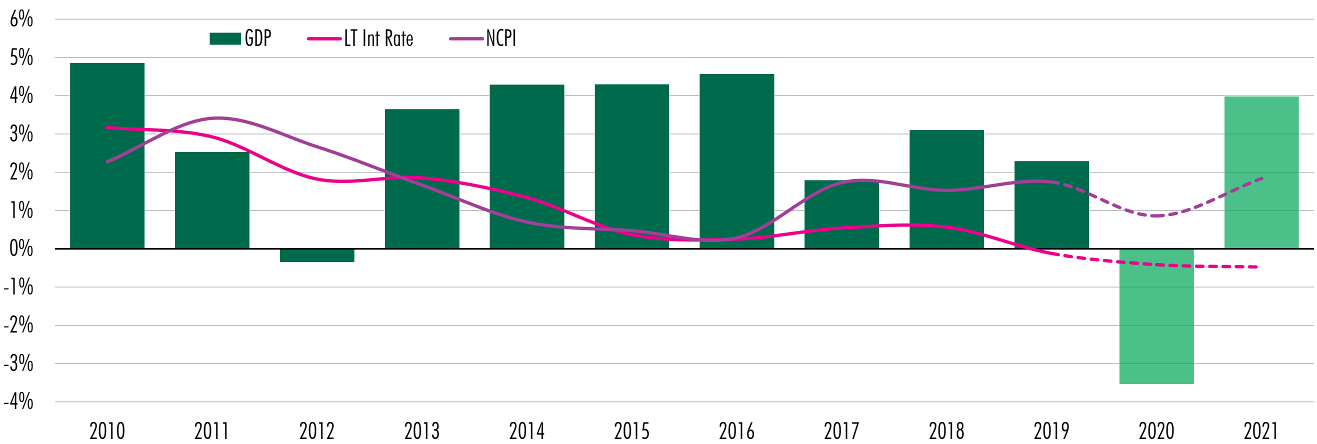
Interest rates on 10-year Luxembourg bonds were -0.55% at the end of 2020. Any spectre of a near-term increase can be put out of mind. The need for liquidity and economic stimulus will see rates lower for longer.

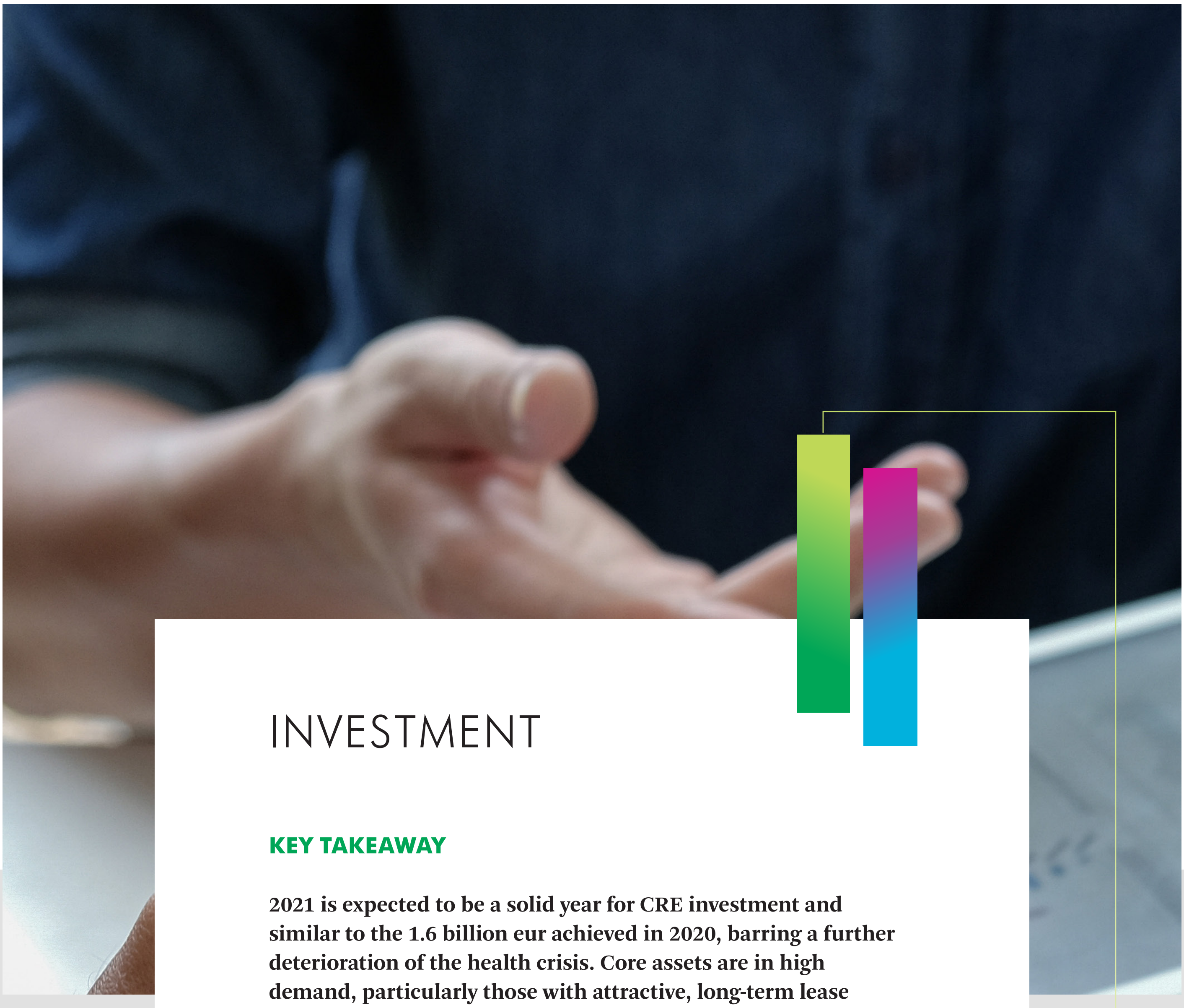
WAITING TO SPEND

As noted, the retail sector has suffered tremendously from lockdowns and mandatory store closures. At the lowpoint in April, retail sales were down by one-third versus the beginning of the year. Pent-up demand during this time led to a surge in some retail sales including household goods and IT equipment. Non-specialised stores remaining open through the year, such as supermarkets, have rised 8% YTD as of Q3. Consumer appear ready and willing to spend once the pandemic is in the rearview mirror, boding well for the future.

Luxembourg GDP growth, NCPI, and interest rates (10yr bond)

Source: CBRE, STATEC, Oxford Economics





INVESTMENT

KEY TAKEAWAY

2021 is expected to be a solid year for CRE investment and similar to the 1.6 billion eur achieved in 2020, barring a further deterioration of the health crisis. Core assets are in high demand, particularly those with attractive, long-term lease covenants. As a result, prime yields will be under pressure.

Residential investment is expected to attract more capital, while retail is likely to be quieter despite good activity in 2020.

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FOUNDATIONS FOR A POSITIVE 2021

Luxembourg recorded 1.6 billion eur in CRE investment volume, weathering the wait-and-see sentiment well that affected markets since March. While this is short of the volumes seen in the last two years, the lack of big ticket assets kept totals in check. All major assets cleared or are have received multiple bids, highlighting the liquidity of the market and appetite for Luxembourg real estate.

2021 should yield comparable levels of investment. The pipeline is building with approximately 200 million eur identified for Q1. And with continued development, Cloche d'Or will offer opportunities in a maturing district that will compete with more traditional central locations.

French investors filled in the gap left by Korean investors after travel restrictions made it difficult to complete deals. Korean investors are expected to return in the second half of 2021, or when travel resumes. Further to this point, the investor base is diversifying, particularly among family offices.

Competition is leading to yield pressure for the best assets. With prime office yields currently achieving 3.40%, further compression is possible. For underperforming assets or those with voids, short WALLs, or needing capital improvements, the yield gap versus core will increase as risk is repriced.

Investors have become more discriminating in their buying decisions in light of the economic challenges and uncertainty around future office use as a result of the pandemic. The strength and length of lease covenants are at the forefront of this concern.

BEYOND OFFICES

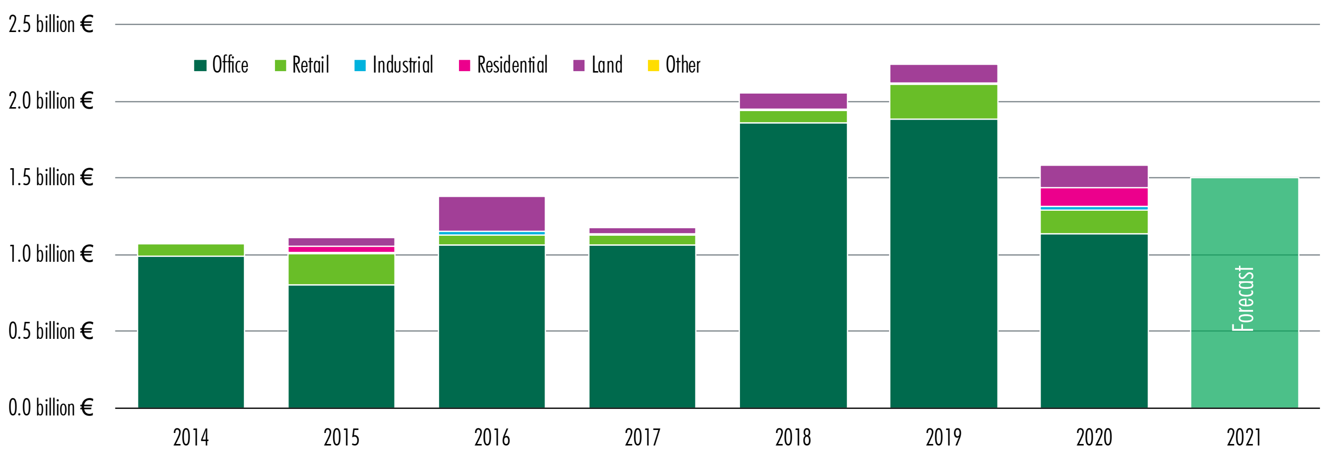
Despite the impact COVID has had on retail, the sector recorded a positive 157 million eur volume in 2020. The outlook for traditional retail is less sanguine in 2021, though food retail will be buoyant.

Multifamily investment will continue and grow after setting the stage with 121 million eur invested in 2020. Institutional investors are increasingly showing interest in this resilient asset class, but high city prices and the lack of product maturity for purpose BTR (Built-to-rent) - particularly around management - are obstables.

> ***Competition for core offices could lead to further yield compression in 2021 and a wider gap with non-core assets.***

CRE investment in Luxembourg

Source: CBRE



OFFICES

KEY TAKEAWAY

Despite the challenges 2020 posed, the Luxembourg market outperformed expectations, recording take-up of 344,000 m² and vacancy unchanged at 3.5%. The outlook for 2021 is positive but challenges in the form of limited available space and uncertainty around future market conditions will lead to more moderate activity. The pipeline will be impacted as both developers and banks become more risk averse.

Peripheral markets, though, are expected to benefit as these districts mature and offer attractive spaces, prices and car mobility options.

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VIBRANT 2020, POSITIVE 2021

The Luxembourg office market shook off notions of a pandemic-induced slowdown in 2020 to post record headline metrics. Take-up counted 344,000 m², vacancy remained unchanged at a very low 3.5%, prime rents in key markets increased and 92,000 m² of new space was delivered.

The general outlook for 2021 is positive, though unlikely to reach the heights seen in 2020. For one, take-up was boosted in Q4 by 115,000 m² of public sector pre-lets. Two, available space is limited across the market, with all submarkets registering vacancy below 10% for the first time. Third, though the circulation of vaccines is encouraging for the end of the pandemic, risks remain and are expected to manifest in demand changes.

DEMAND CHANGES

Two COVID-driven dynamics will continue to impact office demand. One is larger occupiers delaying decisions to re-evaluate their real estate strategies. Smaller occupiers of <1,000 m² are less impacted in this regard. The other is a potential revision around cross-border tax agreements and their impact on telework vs office work. Many of the +200,000 daily international commuters are affected by this.

Otherwise, occupiers are not taking significantly smaller spaces, but will use space differently as the role of the office evolves. Therefore, vacancy will not notably change and net absorption will remain positive in 2021.

Prime rent growth was noticed in several markets in 2020. However, given the discussed concerns, we expect these - and average rents - to stabilize in 2021.

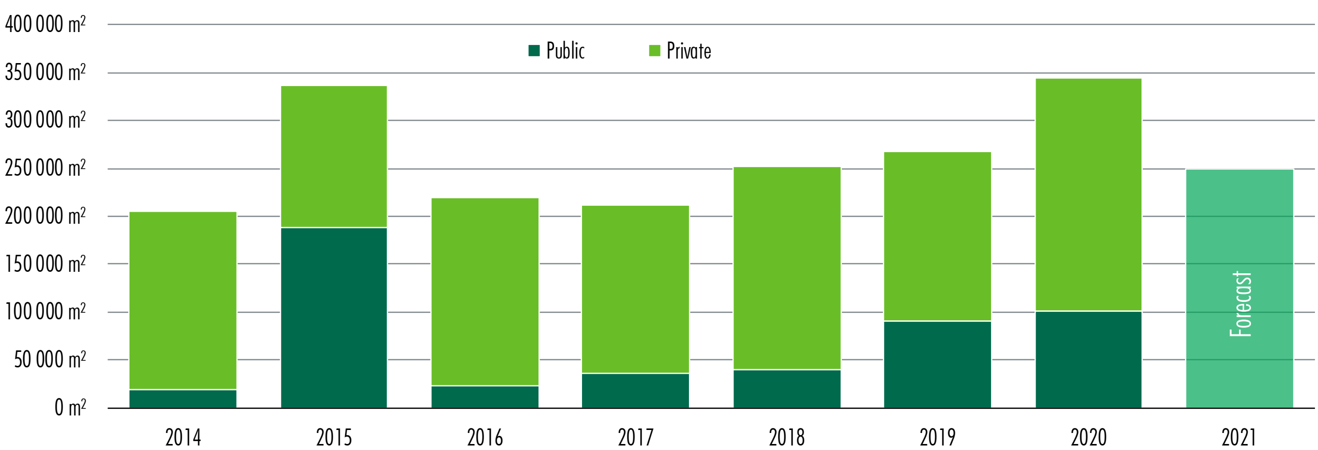
Coworking operators will be much more cautious going forward. They will still be an important offer as part of a landlord package/service to occupiers, but will be retooled to be more sensitive to health and safety.

Future speculative development will be hindered by developers being cautious around future office demand and banks repricing lending packages. Currently, 300,000 m² is expected to be completed in 2021, of which one-third is still available for lease.

Peripheral markets will see continued demand and grow in importance for three reasons. CBD markets are extremely tight while peripheral markets count vacancy up to 10%, so there is space available. Some companies will look to these markets for cost savings as a form of risk management amidst the uncertainty surrounding the pandemic. Finally, these markets have grown to be attractive places to work with growing clusters and better car accessibility than central locations.

Office take-up in Luxembourg

Source: CBRE



RETAIL

KEY TAKEAWAY

The Luxembourg retail market was already facing structural change when the pandemic brought a new dimension to the challenge. Lockdowns in neighboring countries have been a blow to travel-based retail, on which much of the market relies. Landlords are advised to work with tenants

Of the retail formats, out-of-town will continue to be the most resilient given its large store sizes, convenience and affordable rents and costs. High streets in secondary and tertiary locations will be under downward pressure.

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TRANSITION PERIOD

The Luxembourg retail market has been uniquely impacted by the COVID-19 pandemic. The retail market is, to a large extent, reliant on the 200,000 daily commuters, cross-border retail tourists, and other international workers as clientelle. Lockdowns not just in Luxembourg but in bordering countries therefore have an impact that reverberates through the market.

With the widespread adoption of homeworking, workers have by and large stayed in their home countries, leading to a sharp decrease in footfall, particularly in the Station district. Given the lockdown for Luxembourgers too, the crisis overall is somewhat magnified.

A CALL FOR FLEXIBILITY

COVID aside, local landlords have been reluctant to adapt to the structural changes in the market, which has led to low take-up and increasing vacancy, particularly on high streets.

More lease flexibility is desperately needed. Increasing capex provisions, adopting realistic/turnover rents and clarifying lockdown rules would go a long way in shoring up the market and absorbing the substantial new and planned retail projects.

Combined with the general pandemic uncertainty, 2021 is poised to be a year of risk management. Retailers are doing so by consolidating portfolios: Zara and Pull & Bear are each closing a high street shop, for example.

OUT-OF-TOWN MARKET IS RESILIENT

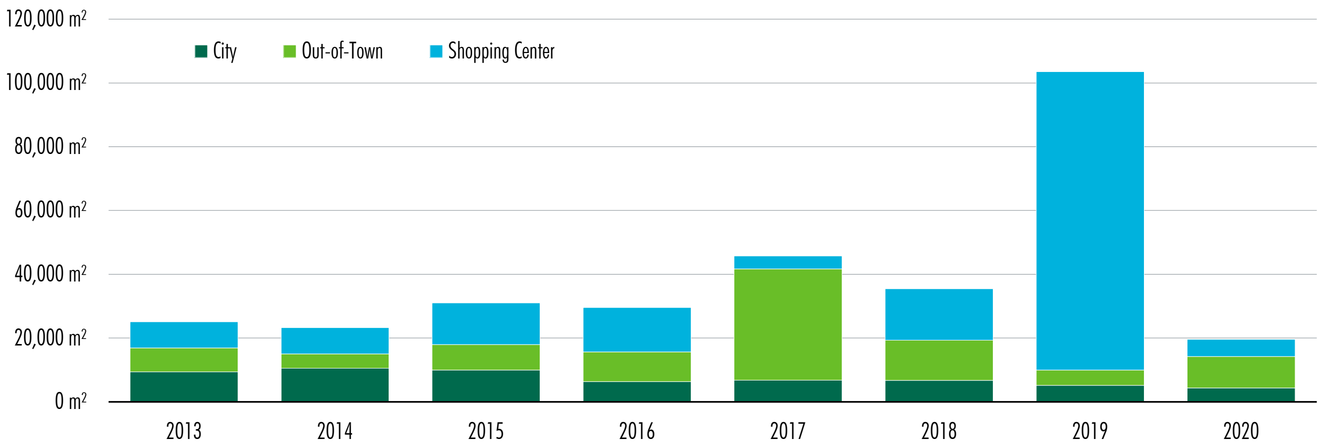
Not all parts of the market are struggling. Out-of-town locations and smaller markets, for example, are better supported given their affordability, customer convenience and safety. New developments such as Opkorn and Bettembourg have shown resilience, and current out-of-town projects like the MGRE retail park in Capellen are commercialising well.

Those retail markets and products more heavily supported by domestic demand will be more resilient. Supermarket real estate wil continue to perform, and the luxury segment is still a positive. Overall, retailer demand is there, but new deals will be difficult in the current environment.

> ***Greater lease flexibility and rent renegotiations will go far in shoring up high street retail.***

Retail take-up in Luxembourg

Source: CBRE



RESIDENTIAL

KEY TAKEAWAY

Residential prices continue to increase, supported by broad, positive fundamentals. Construction delays will keep supply in check in the first half of the year, while the rental market has seen commercialisation times lengthen from travel restrictions.

Insitutional investors are devising entry strategies into the multifamily market, but high prices, risk assessment and a lack of familiarity with the local product and customs are barriers. Still, this market has substantial room for growth as new residential supply has not kept up with demand.

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FUNDAMENTALS ARE PRESENT

The residential market in Luxembourg is well-supported by a rapidly growing populace, robust economy, and low interest rates. Apartment prices for new construction increased 3.1% in Q3 (y-o-y) and averaged 11,500 eur/sqm in Luxembourg City (data made available after the filming). The pandemic is unlikely to significantly alter this trend given the delays in project construction leading to a reduced offer, putting even more upward pressure on prices.

On the rental side, the widespread adoption of homeworking and reduction of international workers in Luxembourg has significantly increased commercialisation time.

CHALLENGES TO PROFESSIONAL PLAYERS

Investors - from private individuals to pension funds - recognize the potential value in residential investment, and many are exploring entry into the market. But, given the lack of history, risk assessment and understanding of local practices are proving to be obstacles. Additionally, management expertise for investment grade BTR (build-to-rent) schemes in the traditional multifamily market is missing.

Pricing is also a challenge. Sky high prices are a hindrance to the professionalisation of the market that requires a minimum investment of some 30 million eur for block sales in central markets. Presently, the market has only supported block sales of up to 40 apartments in a single building. Investors are reasonably hesitant to pursue this path, especially for empty blocks, given the lack of evidence for proven performance of the rented sector over the long term and the custom of relatively short rental periods for private tenants of one to two years.

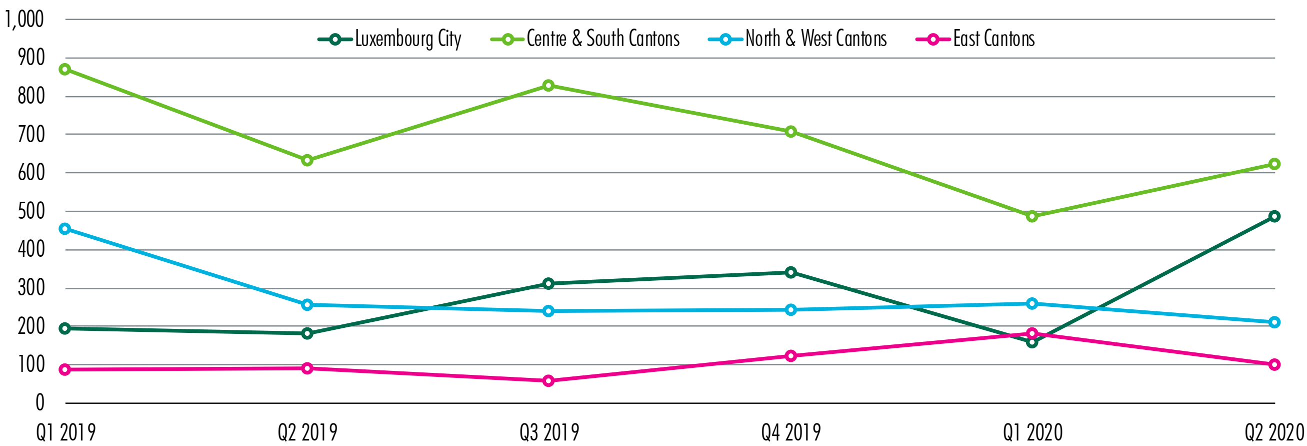
EXTRACTING VALUE

Block apartment sales in in-demand locations can achieve yields of 3.5%. For individual units in Luxembourg City, yields can be under 3.0%. If pricing in central markets is too sharp for investors, peripheral markets can offer more palatable yields with still very

With block apartment sales trading at yields comparable to core offices, peripheral markets could offer more attractive pricing for manageable risk.

New apartment permits in Luxembourg

Source: STATBEL



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