How Rising Rates are Shaping the European Real Estate Opportunity

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Executive Summary

ECONOMY

- As Eurozone inflation hits double digits, the ECB continues to ramp up efforts to tame inflation and maintain price stability.
- A winter European recession is now all but inevitable, but any labor market softness is from a position of relative strength.
- Inflation needs to be on a firm downward trajectory before monetary tightening eases—which could potentially be by the end of the first half of 2023.

PROPERTY MARKETS

- Rapid increases in property financing costs mean property yields are now rising. The repricing has been fastest for assets and sectors of the market where the underlying fundamentals are strongest.
- Interest rate levels and property yields will ultimately be determined by whether inflationary expectations eventually settle above or close to target.
- The current property cycle has featured greater banking oversight and a resultant lower use of financial leverage. That means a more modest buying opportunity / price correction than seen in the last cycle still looks more probable.
- Property rental markets are generally characterized by a paucity of high quality modern space. This is another result of restricted bank lending to the sector in the post-GFC era.
- This chronic undersupply of modern space is being exacerbated by rising sustainability regulations, increasing the pace of functional obsolescence. Rental prospects over the mid to long term remain highly favorable, at least for the top end of occupier markets.
- For investors seeking superior risk-adjusted returns, there are increasingly compelling opportunities in European real estate debt.

Economic Outlook

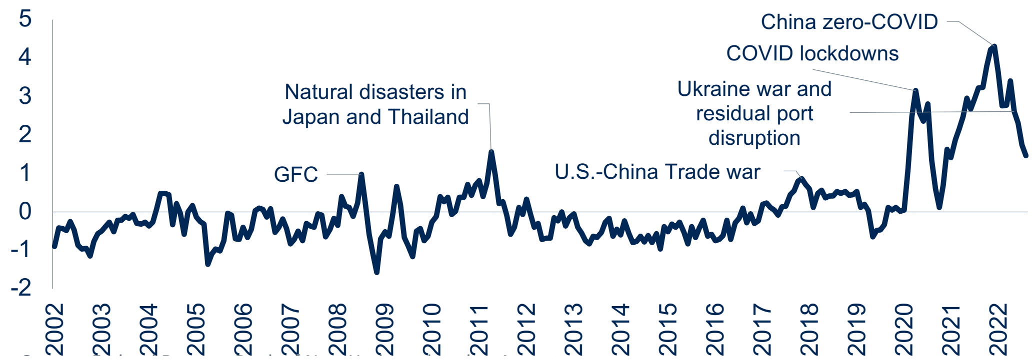
High inflation continues to persist—in the Eurozone, it almost hit double digits for the first time in September (9.9%). Over recent months, central banks have shifted to a more hawkish stance in an effort to tame inflation and maintain price stability. In September, the European Central Bank (ECB) delivered its largest ever interest rate hike of 75 basis points (bps), taking the official rate to 1.25%. The ECB also signaled further rate hikes over the coming months, seemingly irrespective of the consequences for both growth and employment.

The persistence of inflation is down to a series of consecutive events. The initial trigger was the easing of lockdown restrictions, and considerable supply chain bottlenecks, as the world economy awoke. While supplychain pressures had begun to ease, the Ukrainian conflict and Russia's 'weaponizing' of European gas supplies in retaliation to Western economic sanctions kept energy prices high. Recent OPEC production cuts mean the negative inflation surprises keep coming. European governments are ramping up fiscal support measures to help households and businesses through this period of surging energy costs.

To bolster Europe's energy security in preparation for the colder winter months ahead, the EU has implemented a coordinated response across Member States. Measures include a voluntary reduction in natural gas demand, which in itself will likely have negative implications for industrial production, impacting countries with a larger manufacturing base (e.g. Germany and Sweden). It has also set targets to fill natural gas storage sites by 80% by the start of November—an objective that has already been met—to minimize future energy supply disruptions.

A winter recession in the Eurozone now looks inevitable, with high frequency data indicating that the economy is currently contracting—September PMIs for services (48.8) and manufacturing (48.4) are now both below the 50 positive growth threshold. Consumer spending, which is a significant component of Eurozone GDP (typically 50-65% depending on the country), will also likely suffer a significant blow, as declining real household income levels are a drag on household consumption levels.

GLOBAL SUPPLY CHAIN PRESSURE INDEX



Source: Federal Reserve Bank of New York, Global Supply Chain Pressure Index. As of August 2022.

On the upside, labor markets remain robust with Eurozone unemployment at a record low of 6.6% (August), down from 7.5% a year ago, and only a very modest rise projected. While job security is supportive of overall economic and market stability, labor market tightness also potentially boosts employee powers in wage negotiations. The risks of a mid-term wage price spiral are increasing. Should inflationary expectations become de-anchored, the need for even higher interest rates might arise.

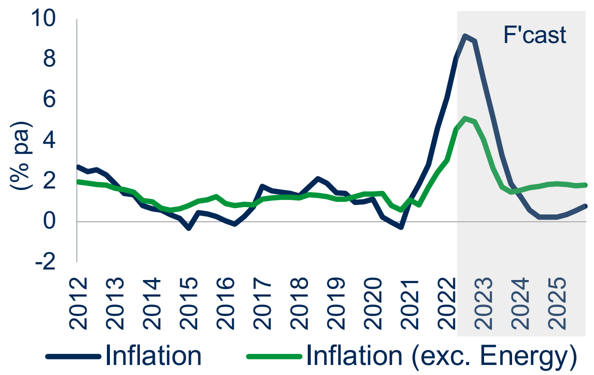
Inflation likely needs to be on a firm downward trajectory for several months before monetary tightening eases. Near term, rising interest rate expectations are expected to persist into spring next year. At this point, capital market anxiety may well shift toward where trend inflation expectations will settle. Should expected inflation drop back toward central bank inflation targets (roughly 2% p.a.), interest rates and therefore property yield expectations could potentially ease. However, if it looks like elevated inflation will persist, higher mid-term interest rate expectations imply a more prolonged correction for all asset prices, not just commercial property.

GDP COUNTRY FORECASTS (% P.A.)

	2020	2021	2022	2023	2024	2025	2026	2022-2026
France	-7.9%	6.8%	2.6%	0.2%	1.7%	2.3%	2.2%	1.8%
Germany	-4.1%	2.6%	1.3%	-0.8%	2.9%	2.3%	1.5%	1.4%
Italy	-9.1%	6.6%	3.3%	-0.1%	1.5%	0.9%	0.7%	1.2%
Netherlands	-3.9%	4.9%	4.7%	0.9%	1.6%	1.5%	1.2%	2.0%
Spain	-10.8%	5.1%	4.3%	1.0%	3.0%	2.7%	2.4%	2.7%
Sweden	-2.3%	4.8%	3.0%	0.9%	2.2%	2.1%	1.9%	2.0%
United Kingdom	-9.3%	7.4%	3.5%	0.2%	2.1%	2.8%	2.1%	2.1%

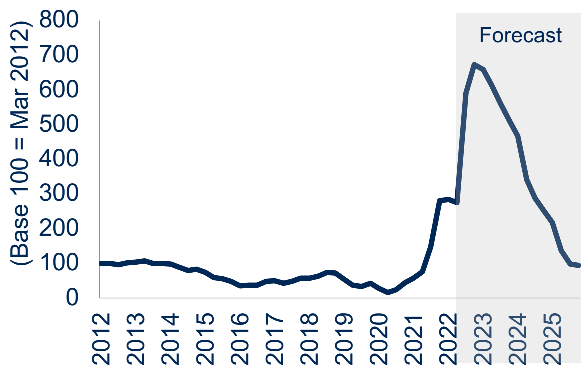
Source: Oxford Economics. As of October 2022.

EUROZONE INFLATION



Source: Oxford Economics, As of October 2022.

WORLD GAS PRICE, EUROPE



Source: Oxford Economics. As of October 2022.

Capital Market

CBRE report that €69.3 billion transacted in the third quarter, down 16% on a year ago. Propertydata.com numbers suggest transactions halved in the U.K. over the same period. With the bid-offer pricing spread still widening, the market is currently in a phase of intense price discovery.

The 5-year Euro swap rate stood at around 3% p.a. in October. A wider corporate bond spread and poor economic sentiment have combined to drive core property debt margins out to the 200–250 bps range (however, this is lower in Germany, where the Pfandbrief market supports pricing around 100-150 bps). With the cost of property debt at 4–5%, negative price pressures are mounting.

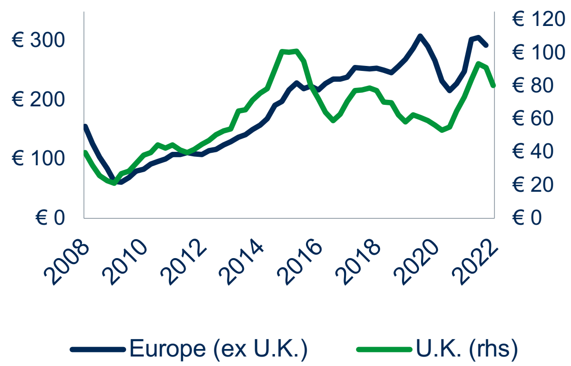
Liquidity still exists in real estate debt markets, but borrowing costs are now at least twice the price they were at the beginning of 2022. Core loan-to-values (LTVs) are likely to trend below 50%, with pressure on interest cover ratios mounting. The resultant gap in the capital stack is a considerable opportunity for alternative capital sources, particularly for refinancings.

European REIT prices are down over 40% year-to-date (YTD), implying a roughly 25–30% drop in property values after stripping out the leverage implicit in REIT prices. More volatile listed real estate also tends to overshoot lagging and smoother property valuations, as well as the underlying market itself.

CBRE report prime retail, CBD office and residential yields edged upward 20-25 bps this summer. Logistics saw nearly double that, typically softening by 40–50 bps. Logistics still has highly compelling fundamentals, but it is most keenly priced and low yielding. This meant 'sheds' were, in many cases, most directly exposed to the violent upward shift in the global interest rates.

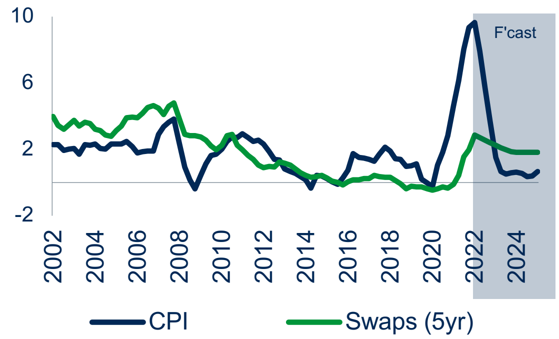
Should inflation ease back to target, so too will interest rates and property yields. If interest rates need to remain high to choke off more ingrained price pressures, a more prolonged correction for all asset prices will ensue.

EUROPEAN REAL ESTATE CAPITAL FLOWS (€BN P.A.)



Source: Real Capital Analytics/MSCI. As of Q3 2022.

EURO SWAPS VS. INFLATION



Source: Oxford Economics. As of October 2022.

U.K. REIT PRICES VS. MSCI U.K. PROPERTY INDEX

Source: Bloomberg, MSCI. As of October 2022.

Occupier Markets

OFFICE SECTOR

Occupier markets across Europe have been steadily recovering as lockdowns recede and workers gradually make their way back to the office.

Cushman & Wakefield figures show a return to post-pandemic normality with total European lettings in the year to June 2022 a healthy 5% of stock. In the second quarter, vacancy held steady at 7.6%—a level still well below the previous highs of over 10% a decade or so ago.

A recent Savills Property Management study, utilizing real-time Building Management Systems (BMS) data, shows that CBD occupancy levels are steadily recovering but to varying degrees in different cities across Europe.

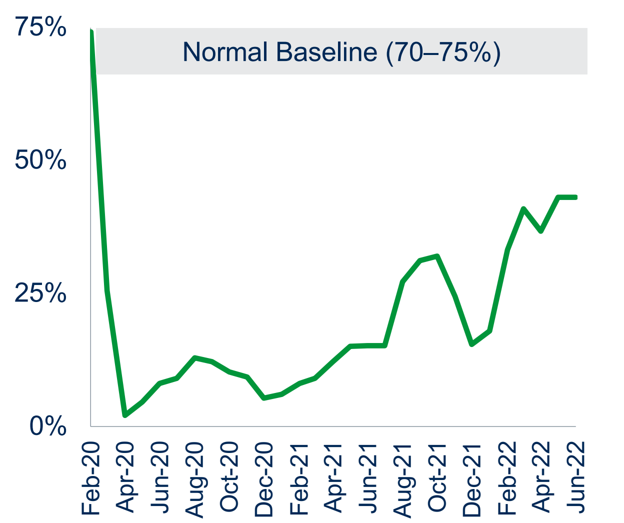
Space under construction is in line with the pace of stock attrition (around 2–2.5% of stock p.a. or a 40–50 year life span), however, projects in the pipeline are now being 'shelved' due to rising development financing, build costs, and increased uncertainty around end values.

The annual pace of prime European office rental growth remains robust at over 6% p.a., but the quarter-on-quarter rate slowed to 1.4% in the third quarter, down from 2.5% in the second.

In line with the wider economy, near-term demand and therefore the pace of rental growth is expected to cool. However, over the mid to longer term, a sluggish development market will likely underpin rental growth further down the line.

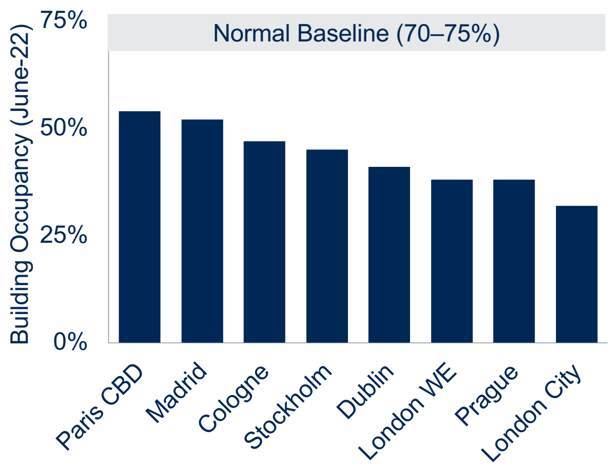
Rising occupational requirements, including ESG, mean the current chronic grade A under-supply will significantly intensify.

U.K. OFFICE: REAL TIME OCCUPANCY



Note: Based on sample of Savills Property Management BMS data
Source: Savills. As of August 2022.

EUROPEAN OFFICES: REAL TIME OCCUPANCY



Note: Based on sample of Savills Property Management BMS data
Source: Savills. As of August 2022.

Occupier & Investment Markets

RETAIL SECTOR

For the three months to August, Eurozone annual retail sales have been negative. A reversal this autumn is unlikely with consumer confidence reaching new depths (-28.8) in September. As winter approaches, on top of surging energy bills, households also face significantly higher credit charges. Against this backdrop, the mood of the European populous will not lighten anytime soon.

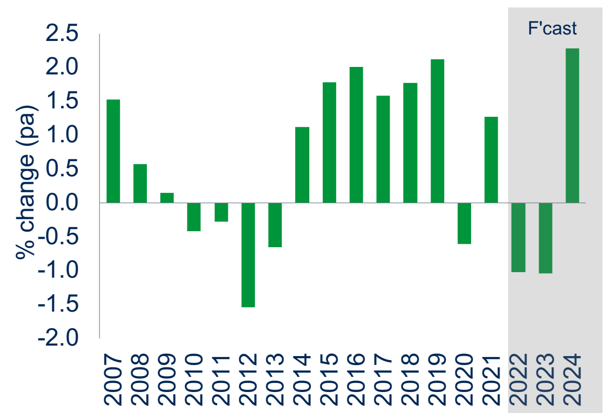
With mounting pressure on household finances from rampant near double-digit inflation, real purchasing power is being rapidly eroded. Oxford Economics forecast falling household real disposable income levels in 2022 and 2023.

Over the coming months, consumers will look to reduce spending on comparison goods. This bodes better for grocery retailers with spending expected to switch toward essentials like food. Supermarkets also offer greater e-commerce resilience (low margin/high delivery costs) and are “the most preferred asset type, in the least preferred sector”, for most investors.

The winding down of pandemic restrictions, and the boost from surplus lockdown savings, afforded the retail sector a temporary respite from the structural decline during 2021. Some property investors misread that. The retail sector now faces huge cyclical challenges (i.e. a cost of living crisis), combined with the relentless march of technological change (online shopping).

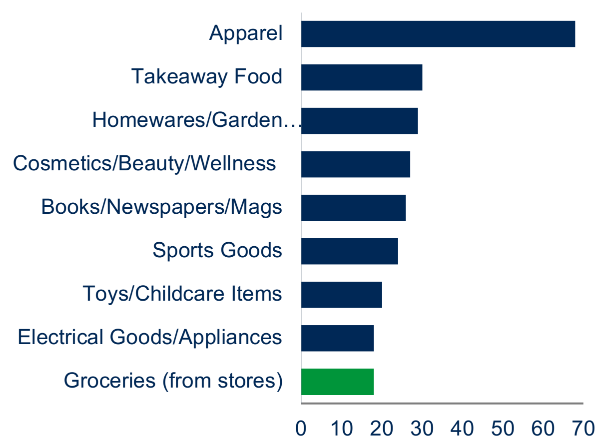
Following particularly tough pandemic conditions, retail rents had seemed to be moving toward stabilization, following double-digit falls during lockdowns. Rents fell -1.2% quarter-on-quarter in the third quarter, having been broadly flat YTD. Growth will likely head south in 2023 and 2024, and even potentially beyond.

EUROZONE: REAL HOUSEHOLD DISPOSABLE INCOME



Source: Oxford Economics. As of October 2022.

EU: ONLINE PURCHASES (2021)



Source: Eurostat. As of March 2022.

Occupier & Investment Markets

INDUSTRIAL SECTOR

Despite investor wobbles, European logistics fundamentals remain highly robust. Take-up is still very strong, with JLL recording just under 16 million sq m let in the first half of 2022, up 41% on the 5-year first half-year average. Strong demand from 3PLs (third-party logistics) reinforced their supply chains, but retail demand did fall.

Take-up trends varied between countries. While first half-year activity levels in Germany were particularly strong, there were signs of moderating activity in France, Poland, Spain and the U.K.—which letting agents largely attribute to the low availability of modern space.

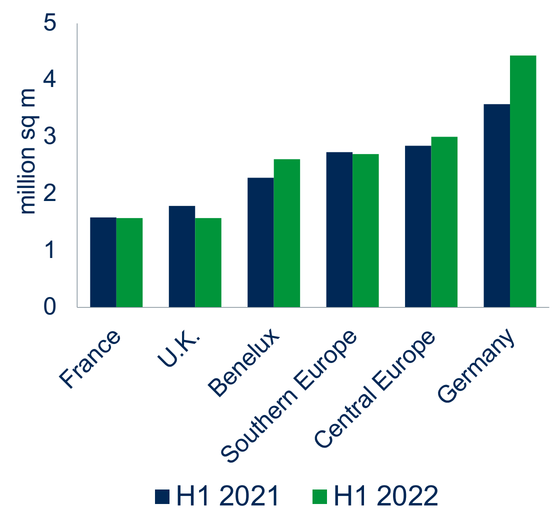
According to JLL, new development increased to 23 million sq m in the second quarter, but only around one third is speculative. New starts showed signs of slowing, driven by the challenges of higher borrowing costs, land shortages, rising construction costs, and building material shortages.

Aggregate prime European logistics rent significantly increased by roughly 14% in the year through to the third quarter, with the sector's highly supportive fundamentals driving growth performance. There's no sign of easing with a quarter-on-quarter uplift of 4.4% in the third quarter, compared with 2% during the second.

Softer near-term economic conditions tend to result in the tapering-off of excess tenant demand—but the structural undersupply of modern space that exists across key European markets means considerable growth momentum still exists.

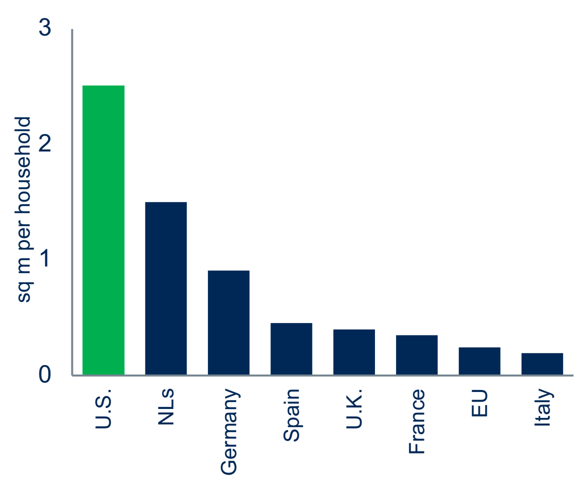
While investor demand has cooled off and logistics yields are rising quickest—by 40–50 bps in the third quarter—we remain convinced by the sector's long-term growth potential, driven by ongoing supply chain restructuring and e-commerce expansion. This applies strongly in post Brexit U.K., where trade inefficiencies are also further boosting demand for storage space.

EUROPEAN LOGISTICS: TAKE-UP



Source: JLL. As of September 2022.

MODERN LOGISTICS STOCK PER CAPITA



Source: Prologis. As of 2021.

Occupier & Investment Markets

ACCOMMODATION SECTOR

According to the European Commission, average EU house prices increased 9.9% in the year through to June 2022. Prices are up 5.2% in Italy, 7.1% in France and Sweden, 8.1% in Spain, 10.2% in Germany, and 18.2% in the Netherlands. According to the Nationwide house price index, U.K. prices rose 10.5% thorough the same period.

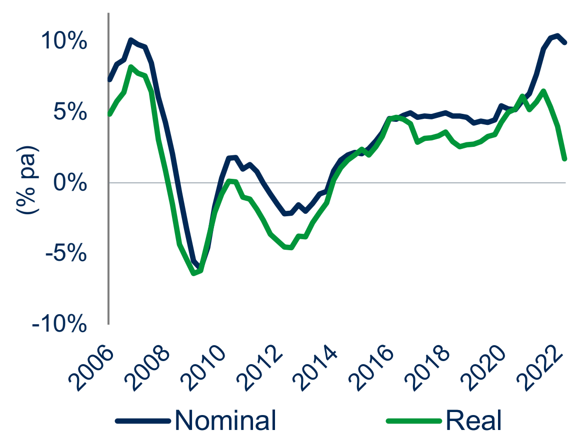
Driving this now historic performance was the combination of ultra-loose monetary policy and highly supportive pandemic fiscal policy support. With interest rates rising and cost of living concerns escalating, housing transaction volumes are expected to moderate, and house prices are close to falling in real (inflation-adjusted) terms already.

Rising interest rates are a negative for mortgage affordability. For example, even before the U.K. government's shambolic 'mini budget', average mortgage repayments had increased to 34% of take-home pay—which is broadly on the cusp of what is comfortably affordable for most.

Increased mortgage lender regulation in the post Global Financial Crisis (GFC) era has meant a shift away from variable interest rates payments and interest only loans, and toward lower LTV lending and need for higher deposits (down-payments). This means Europe's residential property market resiliency is a lot higher compared to 10–15 years ago.

Across major European cities, income and rental multiples on housing remain considerable, sustaining the pool of rental demand. From an investor perspective, the best prospects for Build to Rent (BTR) should be in these locations where housebuilding has not kept pace with the household formation rate, and buyer affordability is poor.

EUROPEAN (EU): HOUSE PRICE GROWTH



Source: OECD. As of October 2022.

AFFORDABILITY: U.K. MORTGAGE PAYMENTS

Source: Nationwide. As of October 2022.

About the Team

Barings Real Estate's research team is structured by sector and geographic expertise, with efforts led by Dags Chen in the U.S. and Paul Stewart in Europe. The team has a diverse background covering various industries, asset classes and countries, which is complemented by an analytics function enhancing the team's ability to collect, augment and analyze data to inform better decision making.

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