REAL ESTATE

European Real Estate: To Build or Not to Build?

BARINGS INSIGHTS

Higher build costs and longer construction periods pose a potential headwind for profits. But in select markets, developers have the ability to charge a premium rent and potentially exceed required returns.

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European Economy Primed for Recovery... But Inflation is a Headwind

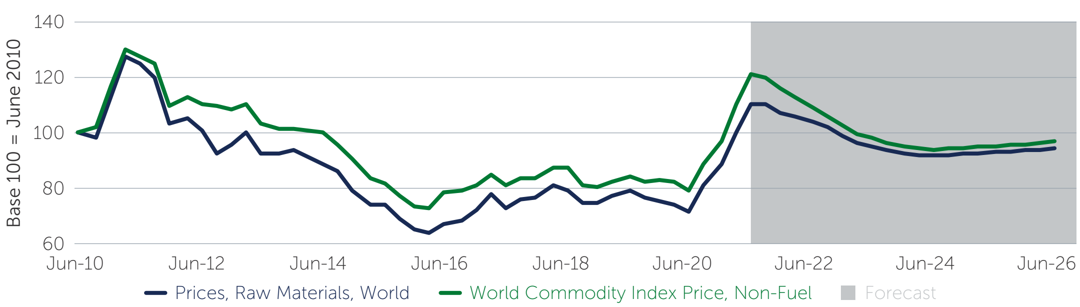
With vaccinations reducing hospitalization rates, lockdown restrictions are easing and Europe's economies are re-opening. High-frequency survey data is robust for both services and manufacturing sectors, indicating a broad-based recovery. In the immediate term, the pace of vaccinations—in particular, second doses—and new cases versus hospitalizations will be key to assessing the immediate risks around the recovery.

However, the specter of inflation has returned, as global shortages of key inputs and resource constraints boost pricing pressures. In our view, this inflationary bout is not reflective of an overheating economy reaching maximum velocity, but of one that is awakening early by surprise. Accordingly, Eurozone inflation could potentially rise to 2.5%–3% per annum in the second half of 2021, before falling back in 2022[1]. In early July, the European Central Bank (ECB) announced a new symmetric 2% inflation target, to maintain price stability and provide policymakers with the flexibility to keep interest rates lower for longer.

What Does Inflation Mean for Property Development Projects?

Property, while not a true inflation hedge, does provide cash flows with index-linked attributes, therefore offering a degree of inflation protection. In fact, inflation in small doses can even be beneficial for property markets, as it can stoke investor demand for the asset class. If in excess, however, inflation can be harmful to property market prospects, especially if it leads to interest rate hikes and negatively affects development appraisals through higher development costs.

FIGURE 1: Global Commodity Prices



SOURCE: Oxford Economics. As of July 2021.

Currently, building costs are rising and material shortages are lengthening development periods, with negative implications for European development projects' internal rate of returns (IRRs). As a result, the development pipeline could see activity levels slow overall in the coming months. However, in locations where the long-term structural outlook remains genuinely favorable—maybe even more so post-pandemic—prospective returns could actually be enhanced. These so-called 'developer profit hotspots' include the property sectors that are set to benefit from technology and ESG tailwinds. Embedded structural supply shortages/inelasticity, such as topographical challenges, site shortages and protracted planning processes, are also key to ensuring top rental levels. Where these structural factors align, developers will likely be price setters, with the ability to charge premium rents and thus underwrite appraisals accordingly. In sub-optimal markets, they will likely be price takers, and therefore unlikely to achieve their required returns/profitability, with no alternative but to mothball or cancel their plans.

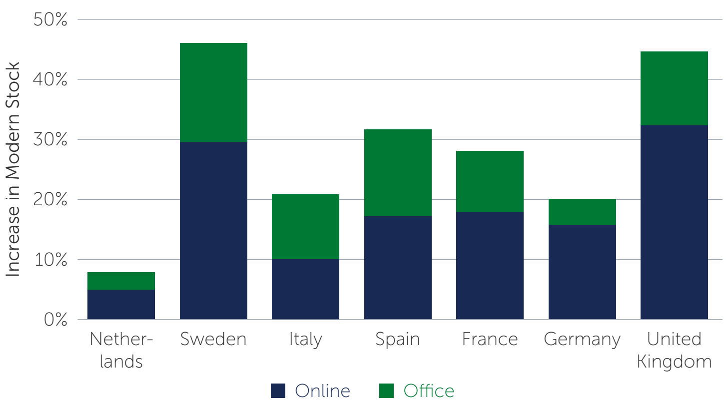
1. Source: Oxford Economics. As of July 12, 2021.

The Impact on Major Property Sectors

LOGISTICS

The European logistics sector has been a huge pandemic beneficiary, with space demand strongly boosted by the accelerating structural shift to online shopping. Our in-house research estimates that from retail demand alone, an extra 20%–25% of modern logistics stock will be required in Western Europe by 2024. The current endemic shortage of modern space, with new development insufficient to meet demand and a scarcity of permissioned development land in many markets, suggests strong rental growth potential exists.

FIGURE 2: European Logistics: Additional Occupier Demand (2020–2024)



SOURCES: Barings; CBRE; Capital Economics; Oxford Econmics; CRR. As of January 2021.

For development projects currently onsite, soaring steel costs and difficulties sourcing materials are proving problematic. Suppliers have reportedly closed order books indefinitely or are unable to deliver materials until the second quarter of 2022. If the current material shortages and higher build costs delay scheme starts and extend project build times, it may further exacerbate current supply pressures on modern space.

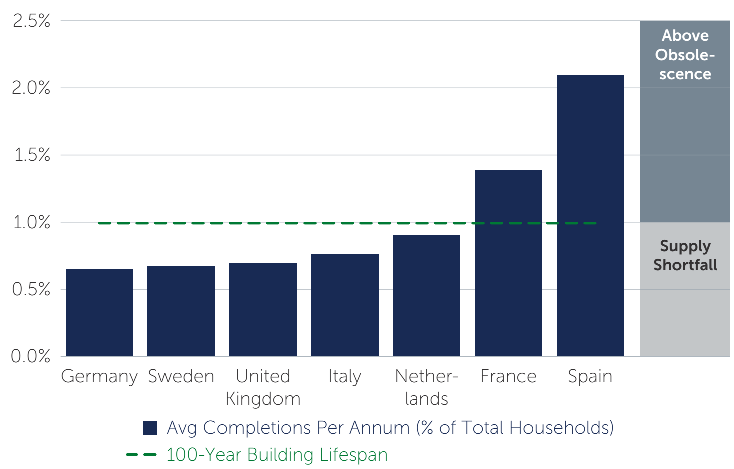
To absorb higher build costs and meet required project returns, developers active in preferential locations will be able to charge a significant rental premium. Our analysis of developer breakeven rents suggests logistics rents could rise by as much as 30% in the very best 'final mile' and top super-regional logistic hubs. This might make investors who are currently questioning the sustainability of prime logistics yield pricing reconsider—albeit the definition of truly prime is now perhaps narrower post-pandemic.

RESIDENTIAL

The appeal of Europe's residential sector is rising, particularly among investors seeking a viable alternative to retail and access to a steady income stream. Sustained house price growth, underpinned by low interest rates and housing shortages, shows no sign of slowing, making home ownership increasingly unaffordable and providing support for rental demand. In our view, widespread housing shortages and rising renter numbers, combined with wide country variations in institutional market sizes and maturity, suggests there are—and will continue to be—plenty of residential development opportunities to exploit.

While the underlying case to invest in residential assets remains solid, higher build costs and material shortages in the near team will negatively impact some development project IRRs. For instance, timber supply constraints and rising prices will be highly challenging, given the high wood content of a typical new build home.

FIGURE 3: Average Annual Development Completions in the Last 20 Years



SOURCES: Barings; ECB. As of December 2020.

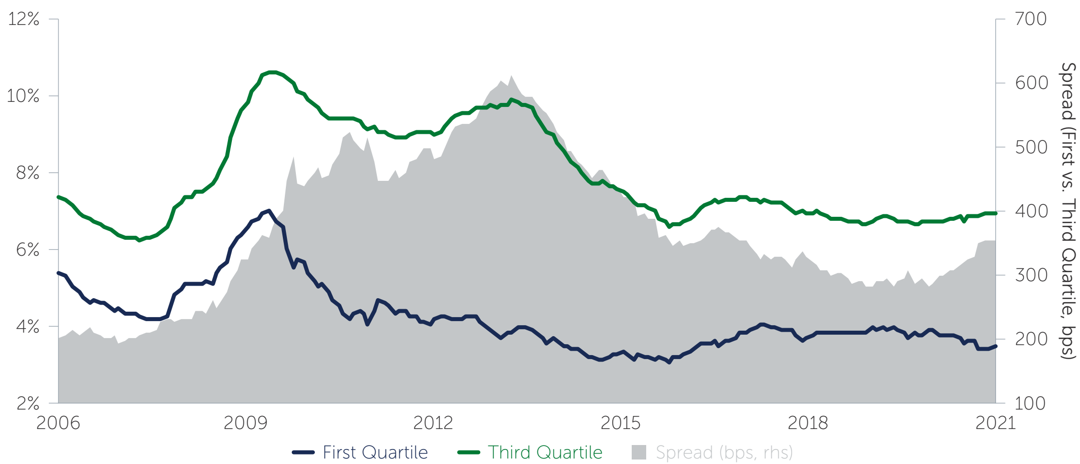
We estimate that developer breakeven rents on the strongest schemes potentially have a roughly 10%–15% premium waiting to be unlocked. However, these higher rents and sale prices will only be achievable in locations where housing supply pressures are greatest—in other words, where development has failed to keep pace with obsolescence. If tenants and buyers can afford to, and are prepared to pay more to live in brand new, high-specification accommodation, developers will be able to set premium rents and prices.

OFFICE

On return to the office, many corporates may look to embrace a hybrid work model, suggesting less demand for office space. At the same time, we expect to see a flight-to-quality, with flexible, ultra-hygienic modern office space with strong ESG credentials keenly sought after. Many European cities already suffer from chronic shortages of modern space, which will likely only worsen if there is a marked slowing in development activity. This builds the case for prime rents to grow over the mid to longer term.

Even through the pandemic, the best located, highest-quality office buildings have continued to command a premium. As corporates start to offload surplus second-hand space, the yield spread between the 'best' and 'the rest' has begun to widen.

FIGURE 4: U.K. Offices: Net Initial Yield



SOURCE: MSCI. As of July 2021.

In core markets, opportunities to reposition second-hand office buildings are starting to emerge, but much more emphasis is now on ESG ratings post-completion. The good news is that tenants are already willing to absorb a 'green premium,' with JLL finding evidence that central London occupiers will pay 6%–10% more for higher ESG-rated office buildings.[2] Moreover, with the pandemic accelerating the trend toward wellness and social responsibility, this premium is likely to accelerate going forward.

FIGURE 5: Grade A BREEAM Rating Rental Premium

	2011–2013	2014–2016	2017–2019
Outstanding/Excellent (441)	9%	11%	10%
Very Good (303)	9%	5%	6%

SOURCE: Source: JLL. As of May 2020.

2. Source: Jones Lang La Salle: The impact of sustainability on value. As of 2020.

“Developer profit hotspots will be in locations where wider demographic, technological and ESG societal trends align with structural supply constraints.”

Key Takeaway

Recovering economies are good news for Europe’s real estate sector. Less welcome is the impact of higher build costs and possibly protracted construction periods on developer profits. These cost implications and their resultant impact on IRRs will inevitably be negative for many planned projects, leading some to be shelved temporarily and others, possibly, permanently. However, in markets where developers are price setters, they have the ability to charge a premium rent and meet—if not exceed—required project returns. These ‘developer profit hotspots’ will be in locations where wider demographic, technological and ESG societal trends align with structural supply constraints.

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