BARINGS

REAL ESTATE

European Real Estate: Why Now?

INSIGHTS

The European real estate market appears to have passed its cyclical trough—and potentially compelling core and value-add opportunities are emerging across logistics, living and select areas of the office sector.

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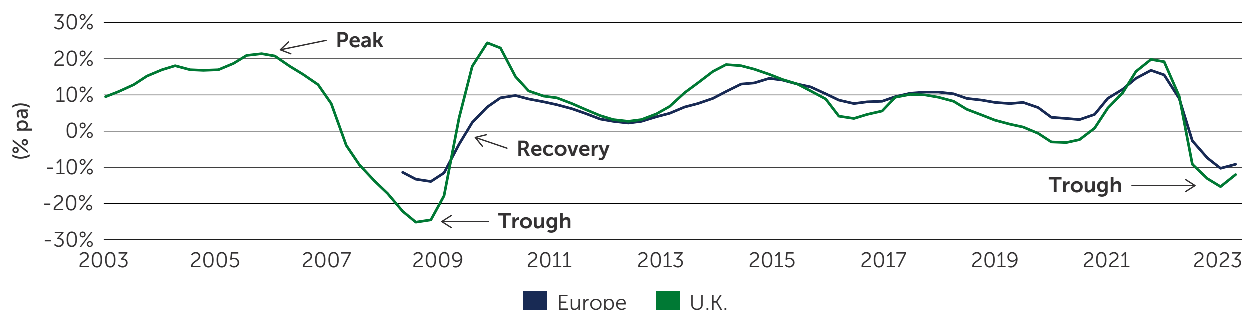
"Time to Re-enter the Market"

During a real estate correction of this magnitude, a rational response may be to place immediate acquisition plans on hold. However, we believe there comes a point in the cycle where waiting for the absolute minimum capital value is only of a marginal benefit. In our view, now is the right time to re-enter the European real estate market, otherwise the current pricing opportunity could likely be missed.

Figure 1: European CRE Total Returns Start to Recover (% P.A.)



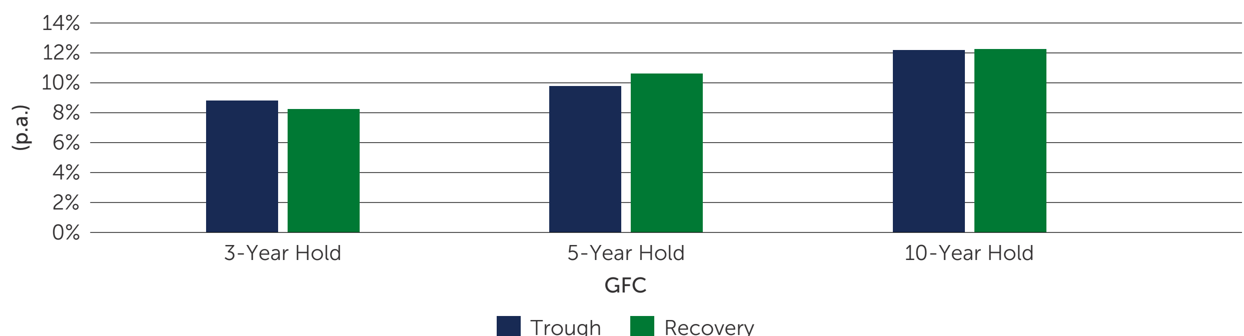
Source: MSCI. As of September 29, 2023.

The Trough of the Market Cycle has Passed

The 'trough' of a real estate cycle is defined as the point with the lowest rate of return. In our opinion, the European commercial real estate (CRE) market reached its cyclical trough in the summer of 2023. The pricing correction has almost entirely played out, with any further negative movements likely to be minor. There is potential for returns to stabilize in the near term, indicating the start of the recovery phase.

Looking at the previous cycle during the Global Financial Crisis, investing at the trough versus at the start of the recovery had only a minor impact on total returns over the typical value-add and core holding periods **(Figure 2)**. This suggests that now may be an opportune time to deploy capital and position for outperformance in the years ahead, rather than waiting for the recovery threshold to be reached. Indeed, waiting for the remaining (and likely minor) price falls to play out could mean missing potentially compelling opportunities.

Figure 2: CRE Returns at a Different Cyclical Entry Points



Sources: Cushman & Wakefield, CBRE and Barings. As of November 2023.

What suggests the recovery phase is approaching, and where might we see it first?

1. **Expectations for lower rates in 2024 support tighter yields**
   This year we expect central banks to start cutting interest rates. Market expectations at the beginning of 2024 may have been more bullish than what central banks have been telegraphing. However, the number of rate cuts in 2024 will not matter greatly, as it is the downward trajectory that will ultimately influence CRE pricing.

2. **REIT rally suggests stabilization in valuations**
   REITs reached a nadir in October 2023, however, the rapid fall in inflation and the adjustment of rate expectations saw REITs rally over 30% from these lows to the end of 2023.[1] They have since fallen back roughly -6%, but seem to be settling at this higher level. We estimate there is a six-to-nine-month lag with REITs and direct CRE valuations. This suggests that following last year's REIT rally, we could see some stabilization in CRE valuations as early as mid-2024. This is also when interest rates are expected to start falling.

3. **Dissipating inflation to improve economic sentiment and support yields**
   Positive economic sentiment typically presages yield compression. As cost-of-living pressures rapidly ease over 2024 with inflation set to be back to target and rates expected to fall, yield compression is likely to eventually follow.

4. **Markets/sectors with lower refinancing gaps to recover first**
   Higher yields and borrowing costs have lenders seeking to maintain interest cover ratios (ICRs) thus reducing loan-to-value ratios (LTVs). This opens up a debt funding gap where some borrowers struggle to refinance the shortfall. Markets and sectors where funding gaps are greatest (Germany and Sweden, as well as in the office sector) are likely to see a lag in recovery, mainly via investor sentiment. This passing distress may provide some of the more attractive opportunities.

Given these factors, the worst pain of the real estate cycle appears to have passed. With the next recovery phase approaching, there is potential for investors to have a greater impact on returns by allocating to the property sectors that are best-positioned for the long term.

1. Source: FTSE EPRA Nareit Developed Europe Index. As of March 27, 2024.

Capitalizing on the Structural Opportunities

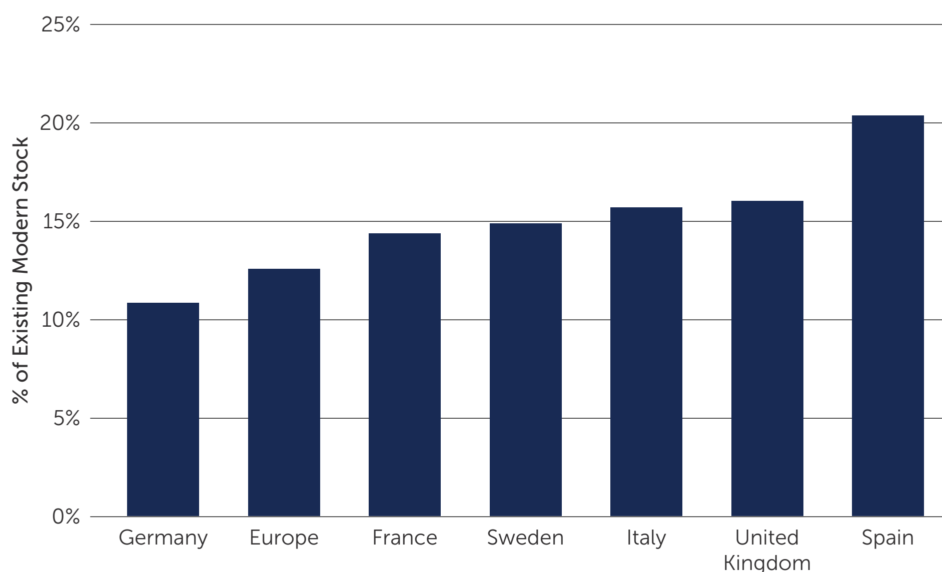
During this market adjustment, occupier markets have been remarkably resilient, acting as a mitigator to falling capital values. This underlines the importance of allocating to sectors with supportive structural trends.

LOGISTICS

Prospects for the logistics sector remain compelling, especially given the favorable occupational outlook and the level of discount in prices. In Europe, a multi-speed rollout of e-commerce across the region, and the consolidation of supply chains, mean the strong demand likely has years to run. After applying an appropriate multiple to future online sales projections, we estimate that an additional 33 million sq m will be required over the next five years **(Figure 3)**. Markets remain undersupplied with modern stock, and the developer response to increased demand has failed to rebalance toward more tenant-friendly conditions. In addition, robust fundamentals are spurring annual rental growth rates in excess of 10% since mid-2022.[2]

Despite the strong fundamentals, logistics values have fallen the most due to how tightly priced the sector was at the outset of the rate hiking cycle. The cyclical trough presents a favorable entry point for value-add projects, particularly in markets that have earlier progressed in e-commerce adoption and where modern supply shortages are greatest. Sound fundamentals, backed by prevailing structural trends, present an attractive avenue to obtain the secure cashflows that are crucial for core property investors.

Figure 3: Projected E-Commerce Logistics Demand (2024–2028)



Sources: CBRE; Oxford Economics; Euromonitor; Barings' calculations. As of December 2023.

2. Source: Cushman & Wakefield. As of September 29, 2023.

LIVING

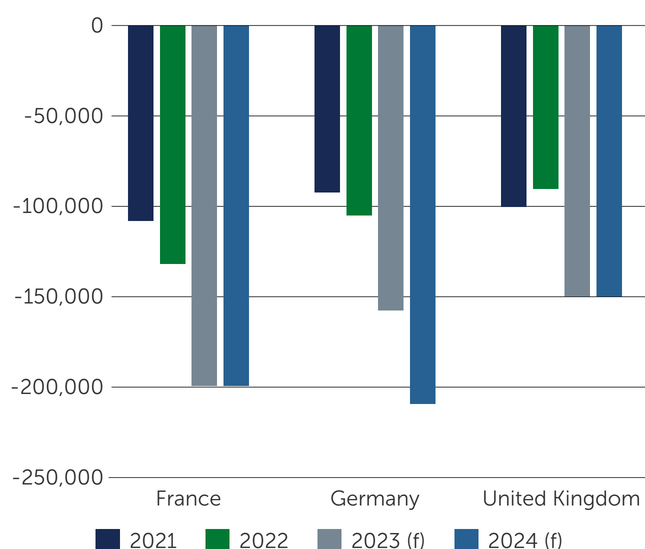
The structural undersupply of housing in many European cities underpins the case for residential assets. Development has undershot both the obsolescence rate and government housebuilding targets in the near and medium term, compounding unaffordability for first time buyers **(Figure 4)**. At the same time, rental growth is strong, and this tends to lag house prices by about 24 months. However, for house prices to fall significantly, a steep deterioration in the jobs market is typically required. In the U.K. for instance, the last time rents declined was during the GFC[3], where house prices fell by around 17%[4]. Any house price declines are expected to be modest.

The reliable rental flows from residential have seen the sector move to a mainstream investment option for core institutional property investors across Europe, particularly as an alternative to the much-reduced investable universe in the retail sector. For value-add investors, there are potential attractive opportunities in areas where there has been a greater pandemic price run up and there is a larger proportion of people with exposure to variable rate mortgages—in other words, in areas where prices are more sensitive to the current high interest rates.

PURPOSE BUILT STUDENT ACCOMMODATION

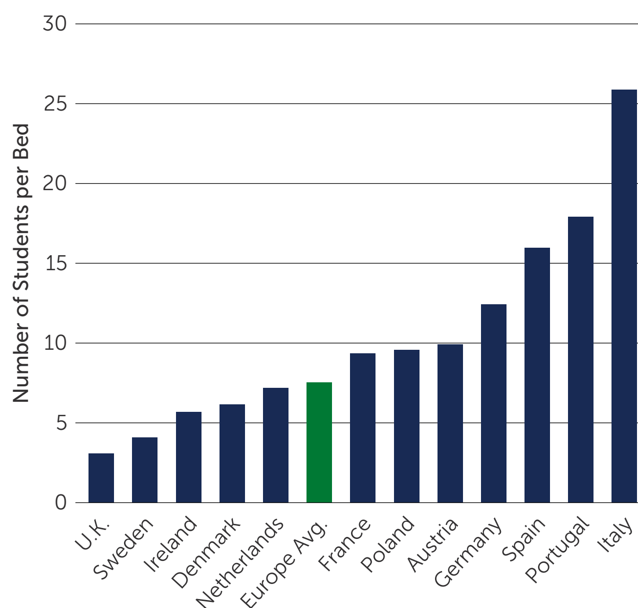
Europe is uniquely placed to benefit from the rise in global demand for higher education. The higher education sector in Europe is internationally renowned for its quality, with about half of the top-rated institutions globally located in the region. In the face of rising international demand from the growing global middle class megatrend is a student accommodation stock base that is either undersupplied or becoming obsolete **(Figure 5)**. While some risks exist around e-learning, the top-rated institutions are likely to be resilient to this trend, while assets servicing institutions at the other end of the spectrum could face challenges. The prevailing shortages are almost tailor made for a developing or repositioning value-add strategy, while a shortage of stock provides a steady income potential for core investors.

Figure 4: Shortfall in Housebuilding Compared to Government Target



Sources: JLL; ONS; Destatis; Cour des comptes.
As of November 2023.

Figure 5: Ratio of Students per PBSA Beds



Source: CBRE. As of May 2023.

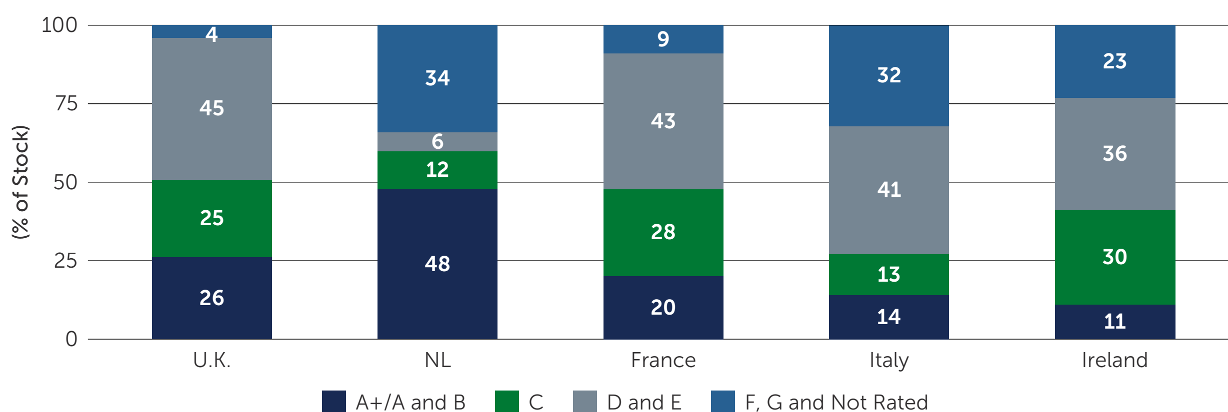
3. Source: Office of National Statistics. As of September 2023
4. Source: OECD. As of September 2023.

OFFICE

Undoubtably, the pandemic was a catalyst for lower aggregate demand for office space. While the U.S. is at the more extreme end of this, there are particular dynamics that soften this trend in Europe. Smaller cities in Europe, which are well serviced by public transport systems, as well as the smaller sized European homes that are less conducive to working-from-home, boost the case for offices. We believe that a place for the office will remain, but with demand disproportionately focused on top tier sustainable space.

Tenants may take less overall space with their employees working some of the week at home. In addition, these workspaces must be of the highest standard in order to compete with the commute, as well as tap into tenant demand for top tier ESG credentials. This is being driven by both investors and clients, and the minimum energy standards being enacted by law in certain European jurisdictions. While there is an established demand for modern space, post-GFC regulation on development finance has meant fewer new projects since—resulting in a chronic undersupply of the modern office stock that tenants overwhelmingly favor, particularly buildings with in-demand green credentials **(Figure 6)**. Opportunities for value-add investors lie with the creation of new modern office space—particularly in London—which taps into the emerging "green premiums".

Figure 6: Buildings with Energy Performance Certificates



Source: Savills. As of November 2022.

Key Takeaways

- The European CRE market passed its cyclical trough in mid-2023. The worst negative capital value adjustments have passed, and any further falls are likely to be minor.
- Falling interest rates, momentum in the REIT market, and improving economic sentiment all presage movement toward the recovery phase of the cycle. The first recoveries will likely be disproportionately concentrated in markets and sectors with smaller debt funding gaps.
- In our view, current pricing presents some compelling opportunities in the market. We believe waiting for the absolute minimum price could mean missing the potential opportunity altogether. In addition, waiting for the bottom has historically only had a marginal impact on potential returns at the current phase of the cycle.
- While perfectly timing the market is extremely difficult, we believe focusing on allocating in the best-positioned real estate sectors and strategies, and tapping into supportive structural trends that underpin performance, is crucial to investing through the cycle.

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**As of December 31, 2023*

24-3477985