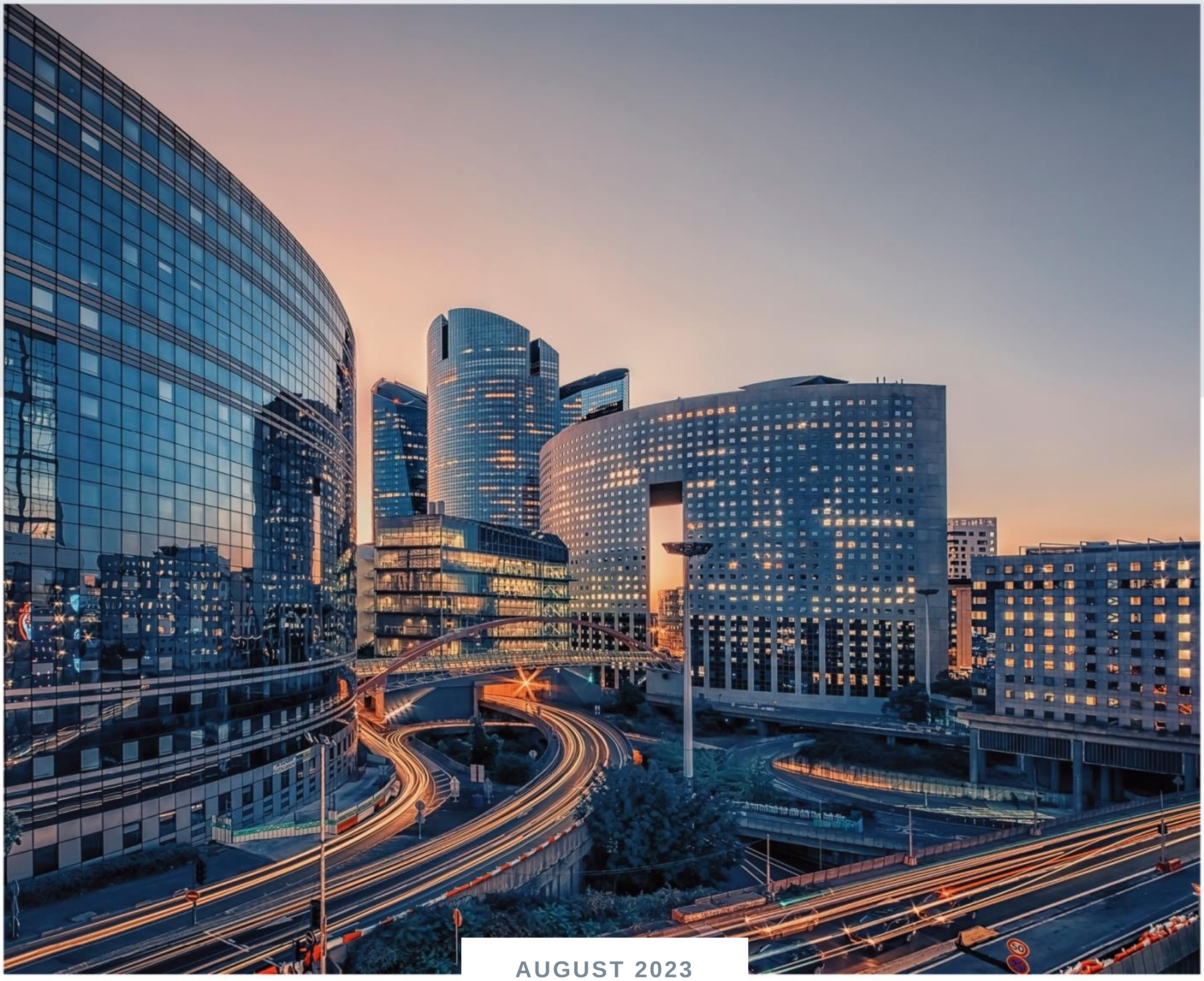
T(r)ough Times: Have European Property Yields Peaked?

European Real Estate Research Quarterly



AUGUST 2023

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Executive Summary

ECONOMY

- Inflation decelerated over the second quarter in the U.S. and the Eurozone, an encouraging development for the trajectory of interest rates.
- The rising cost of living and elevated interest rates have continued to stall economic growth; survey data also indicate softness ahead.
- Typically, there is a lag between headline and core inflation falling to target.
- We are now hopefully past peak interest rate anxiety, which has positive implications for real estate market prices.

PROPERTY MARKETS

- Shifting inflation and interest rate expectations resulted in real estate investment transaction activity plummeting over the past year.
- While REIT prices remain volatile, they have not meaningfully breached the lows recorded during the height of the energy crisis.
- The slower pace of decompression could soon encourage buyers back into the market as the trough of the cycle may be in sight.
- Pricing is not reflected in many valuation-based property indexes yet; this will vary according to local market practice.
- Office rental prospects remain best for assets with top-rated ESG credentials. Shortages of this type of space will likely intensify in the years ahead.
- Industrial rental growth traditionally has followed the economic cycle, however, the strength of the e-commerce ‘revolution’ since 2015 has insulated the sector from periods of economic softness.
- Purpose-built student accommodation (PBSA) product serving high-quality institutions and attracting affluent overseas students who can absorb higher rents remains the most sought after.

Economic Outlook

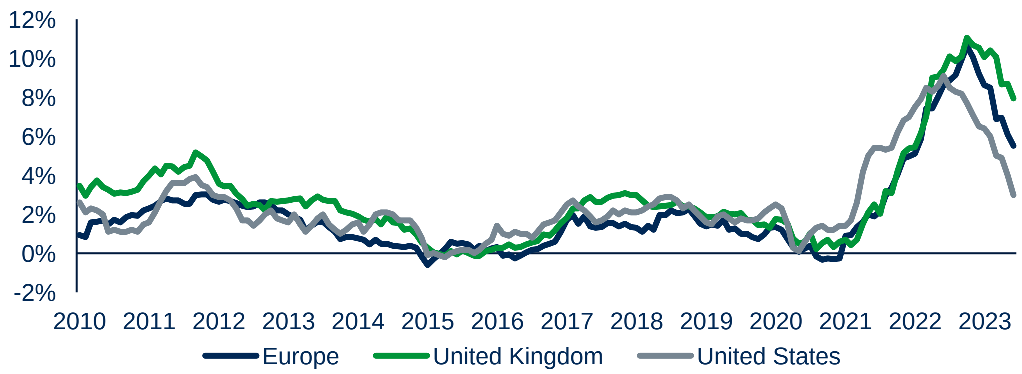
The Eurozone economy has begun the year broadly flat, with a marginal decline in GDP of -0.1% in both Q4 2022 and Q1 2023.[1] Economic activity has held up better than the dire predictions of many at the height of last year's energy crisis. However, tighter financial conditions are now affecting the outlook. Oxford Economics expects GDP to be flat again in the second quarter, and the annual growth rate to average just 0.6% for 2023 before accelerating thereafter, averaging 1.6% annually through to 2026.

The Eurozone Composite PMI also signals that the economy is cooling; it slipped to 49.9 in June from 52.8 and is now marginally below the 50+ growth threshold.[2] In addition, the Eurozone Economic Sentiment Indicator (ESI) slowed over the second quarter, falling back to 95.3 in June from 98.8 in March, also below its expansion mark of 100.[3]

Inflation remains well above target but continues to fall. The annual Eurozone inflation rate was 5.5% in June 2023, down from a rate of 6.1% in May, with falling energy prices making the biggest contribution to the decline (Figure 1). Core inflation on the other hand edged up to an annualized 5.4% from 5.3% in May, but down from the March rate of 5.7%. With country-specific factors at play, U.K. inflation remains stubbornly high, although falling more than markets expected to a 7.9% annual rate in June.

The European Central Bank (ECB) remains concerned about lingering inflation, with the most recent Eurozone wage data higher by more than 5% year-on-year. At its latest meeting the ECB raised interest rates by 25 basis points (bps) to their highest level since before the 2008 financial crisis. Yet, most encouragingly of all, U.S. inflation was down to just an annualized 3.0% through June. Given that the U.S. dollar is the global reserve currency, resulting in the U.S. Federal Reserve (Fed) setting the global monetary tone, the decline in inflation should assuage hawkish fears.

FIGURE 1: INFLATION RATES



Source: Eurostat; ONS; U.S. Bureau of Statistics. As of June 30, 2023.

1. Source: Oxford Economics. As of June 30, 2023.
2. Source: Markit Economics. As of June 30, 2023.
3. Source: Eurostat. As of June 30, 2023.

Over the past year, rising interest rates slammed the brakes on housing market momentum. While the trend varies from country to country, most European mortgage markets have transitioned away from variable-rate mortgages toward fixed-rate mortgages over the past 15 years, with Sweden, Norway and Finland being the notable exceptions. This shift in residential lending policy was deliberate and is yet another instance of proper banking oversight of property lending in the current property cycle. Some believe this stabilizer only delays the lag in monetary policy, but a meaningful house price correction, and all its attendant risk to the wider economy, would also need a significant rise in unemployment. With most European countries experiencing labor shortages and unemployment at near-record lows, the consensus among forecasters is for only a modest easing in house prices.

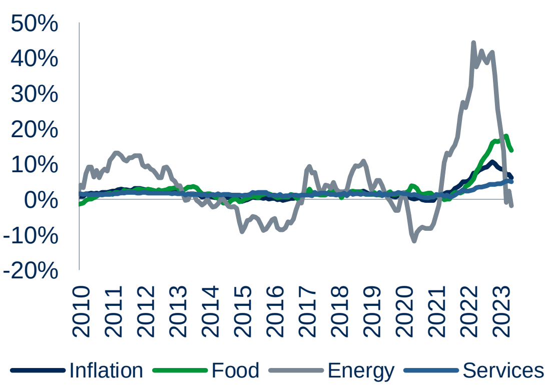
The softening survey data and easing economic growth are signs that further falls in inflation are on the way. It is normal for core inflation to lag headline inflation, but anxieties will linger and likely now focus on core and wage growth potentially filtering through to components like services. We are now hopefully past peak interest rate anxiety and that has positive implications for real estate market prices.

FIGURE 2: GDP COUNTRY FORECASTS (% P.A.)

	2021	2022	2023	2024	2025	2026	2027	2023-2027
France	6.4%	2.5%	0.5%	0.8%	1.6%	2.1%	2.2%	1.4%
Germany	2.6%	1.9%	-0.5%	0.9%	2.2%	2.2%	1.5%	1.3%
Italy	7.0%	3.8%	1.0%	0.8%	1.0%	0.7%	0.5%	0.8%
Netherlands	6.2%	4.4%	1.2%	1.2%	1.3%	1.1%	1.1%	1.2%
Spain	5.5%	5.5%	2.5%	1.3%	1.6%	1.9%	1.7%	1.8%
Sweden	5.9%	2.9%	-0.3%	0.7%	2.2%	2.2%	2.0%	1.4%
United Kingdom	7.6%	4.1%	0.4%	0.4%	1.4%	2.3%	1.6%	1.2%

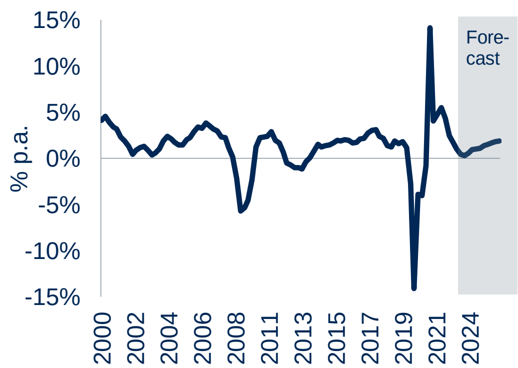
Source: Oxford Economics. As of July 2023.

FIGURE 3: EUROZONE INFLATION



Source: Eurostat. As of June 30, 2023.

FIGURE 4: EUROZONE GDP



Source: Oxford Economics. As of June 30, 2023.

Capital Markets

Rising interest rate expectations slowed commercial real estate (CRE) transactions over the past year. Real Capital Analytics' preliminary transaction volumes show that European CRE volume declined for the sixth consecutive quarter, slowing to US$18.7 billion or down 65% on Q2 2022 (Figure 5).

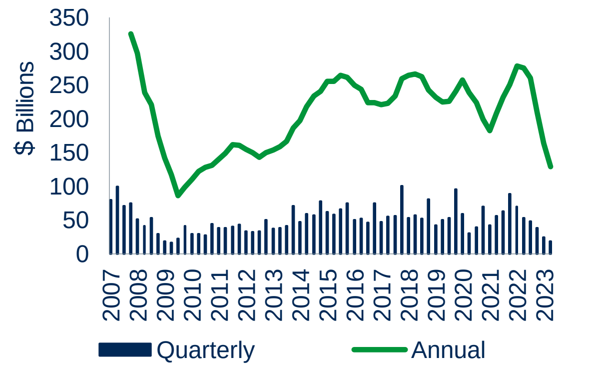
With inflation on the way down, we are past peak interest rate anxiety and hopefully close to the trough of the property cycle. The pace of yield compression is now moderating. CBRE reports that in the second quarter prime offices yields eased by a further 13 bps, comparable to 12 bps for prime high street retail. Logistics, having been hit hardest and fastest last year, was the most stable, easing just 5 bps.

The slower pace of property yield decompression could soon encourage buyers back into the market, but volumes are likely to remain soft in the coming quarters with pricing not reflected in many valuation-based property indexes yet. This will vary according to local market practice. Where high quality assets are dislodged due to refinancings, for example, the opportunity to favorably position for future outperformance is now likely here.

The underlying trend of European REITs is a useful barometer to assess the trajectory of lagging direct property valuations. REITs continue to be thrown around by the data, however, they have not meaningfully breached the lows recorded during the peak of the energy crisis. At a sector level, logistics have fared the worst since the rapid rise in interest rates, with low-yielding assets having the worst capital value adjustment via decompression regardless of the underlying strength of fundamentals.

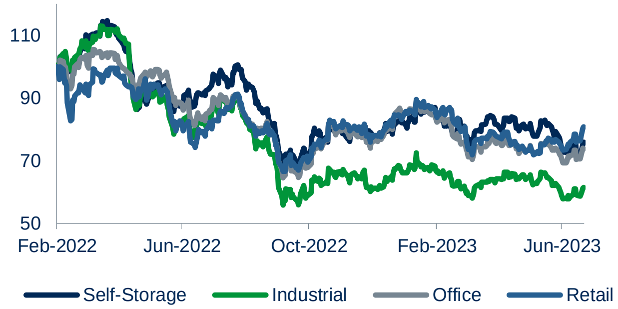
The spread between government and corporate bonds ended the second quarter largely where it began, but economic sentiment deteriorated meaning CRE debt margins have likely widened marginally during the quarter. The availability of credit for real estate remains tight, with the Bank of England credit survey remaining negative (Figure 7). Banks with tighter than normal lending criteria unlocks more opportunities for debt fund investors. Competition will be disproportionally concentrated in the preferred assets/sectors, and transaction volumes will be sluggish to recover—which may prolong deployment of debt investor capital.

FIGURE 5: EUROPEAN REAL ESTATE CAPITAL FLOWS



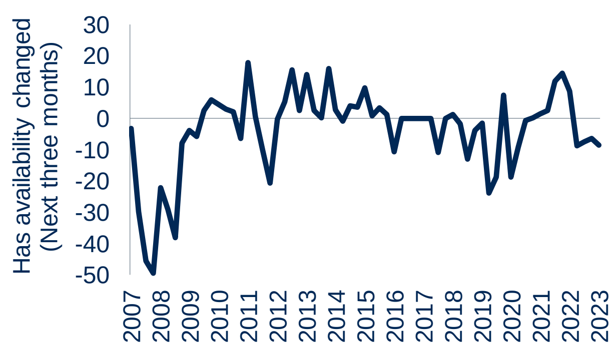
Source: Real Capital Analytics/MSCI. As of June 30, 2023.

FIGURE 6: EUROPEAN SHARE PRICES



Source: Bloomberg; FT. As of July 10, 2023.

FIGURE 7: BOE CREDIT SURVEY (U.K. CRE LENDING)



Source: Bank of England Credit Conditions Survey. As of June 30, 2023.

Occupier Markets

OFFICE SECTOR

In the first quarter of the year, European office take-up totaled 11.2 million sq m (4.7% of total stock).[4] There has been a slight easing in leasing activity recently, with quarterly take-up falling below the long-term average.

Despite the moderation in leasing activity, vacancy has shown resilience, only marginally increasing in the last 12 months, by just 0.4%, to 7.8%, compared to increases of 0.8% in 2021 and 1.3% in 2020 (Figure 8). Lower take-up is due to companies delaying relocation decisions amid high economic uncertainty, rather than downsizing due to the shift in post-pandemic working practices.

After years of soft development completions, 2023 will see a marked increase in office space being delivered to the market. Completions have averaged about 1.5% annually since 2011; in 2023, expectations are for 2.4% of stock to be delivered to the market, the highest since 2009.[5]

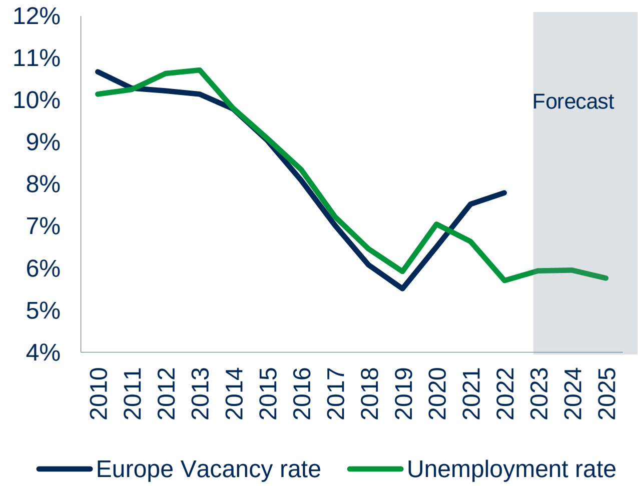
While development completions are set to hit a cyclical high this year, itself a classic trough of the property cycle indicator, upward pressure on market vacancy should be low—and chronic shortages of modern, flexible office space with top-tier ESG credentials will likely prevail.

Incoming building energy-use regulations and corporate ESG agendas should have a positive impact on leasing demand, particularly for the prime segment, but increased working-from-home may mean occupiers upgrade their space but require less of it.

While the economy has slowed, employment has remained resilient. Many markets, in fact, are characterized by labor shortages. High employment has no doubt insulated the office market from a significant unwinding in vacancy. With peak working-from-home appearing to have now passed, and many businesses mandating minimum return-to-office days, the prospects for the office market might be improving, albeit with an uptick of development to absorb.

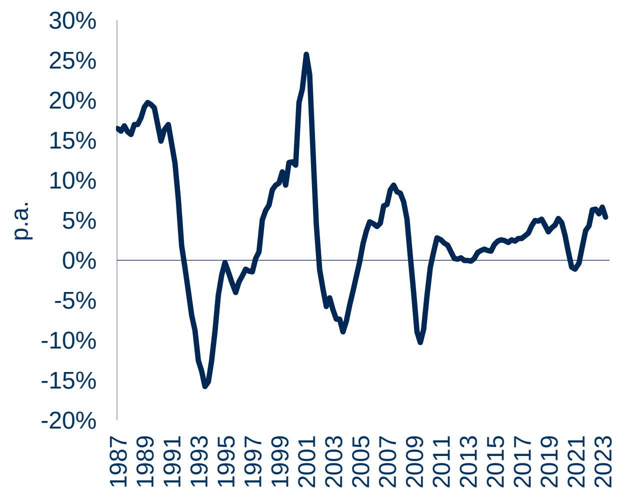
Prime office rental growth eased somewhat but remained strong. In the 12 months to the second quarter of this year, prime office rents increased by 5.4% (Figure 9). Rental prospects remain best for offices with top-rated ESG credentials. Shortages of this type of space will likely intensify in the years ahead.

FIGURE 8: EUROPEAN OFFICES: VACANCY VS. UNEMPLOYMENT



Source: Cushman & Wakefield; Oxford Economics. As of March 31, 2023.

FIGURE 9: EUROPEAN OFFICES: PRIME RENTAL GROWTH



Source: Savills; CBRE; Cushman & Wakefield. As of June 30, 2023.

4. Source: Cushman & Wakefield.
5. Source: Cushman & Wakefield.

Occupier & Investment Markets

RETAIL SECTOR

European consumer confidence continues to improve, rising to -16.1 in May from the September 2022 record low of -28.4 during the height of the energy crisis. Consumer confidence, however, remains well below its long-run average of -10.4 and post-lockdown high of -2.2 (Figure 10).

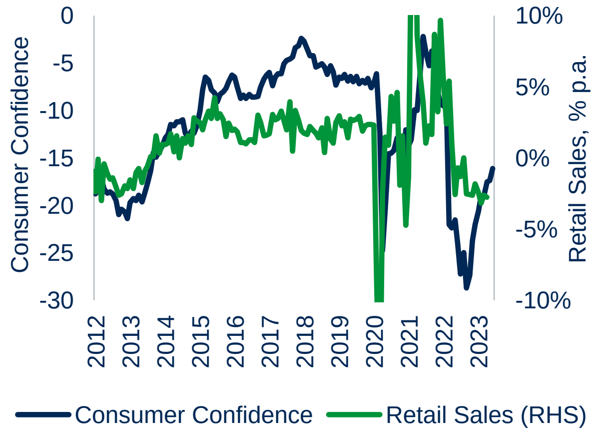
Soft consumer confidence has continued to dampen retail sales, with growth slumping to -2.8% over the last 12 months (Figure 10). Stickiness in core inflation and the duration of higher interest rates will have a major impact on the trajectory of confidence and thus retail spending. It is likely that the recovery could stall or reverse as the impact of rate rises are further felt by households.

The retail sector has underperformed in the last decade, with both rents and yields under pressure. This has been a direct result of the e-commerce rollout across Europe. While not immune to the effects of e-commerce, supermarkets have been the most resilient subsector because their low margins and high delivery costs pose logistical and profitability barriers to operators. Grocery thus holds a neutral recommended weighting within our heavily underweight retail allocation.

Supermarkets have been protected against some of the more dramatic falls in rents compared to other subsectors of retail. For example, since the pandemic, U.K. supermarket rental growth has declined just 0.5%, holding up better than shopping centers, standard shops, and retail warehouses, down 5.5%, 7.4%, and 0.7%, respectively, over the same period (Figure 11). Average prime retail rents moved further toward stabilization, declining by 1.6% over the 12 months ending in June 2023. This is an improvement from the nadir in December 2020 when rents had fallen by 10.0% on an annualized basis.

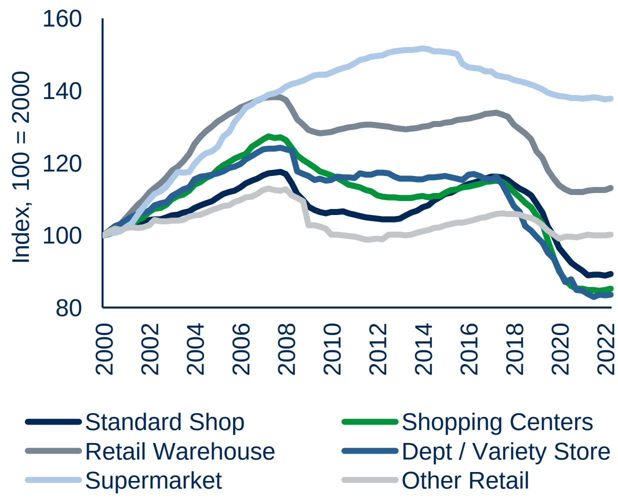
Over the long term, we continue to believe there is a future for the best retail assets in dominant locations. For now, however, stock selection risks are elevated, which is largely the reservation among more opportunistic investors. Store closure to openings may be key to determining the bottom of this structural shift.

FIGURE 10: EUROZONE: CONSUMER CONFIDENCE VS. RETAIL SALES



Source: Eurostat. As of June 30, 2023.

FIGURE 11: U.K. RETAIL RENTAL GROWTH, BY CATEGORY



Source: MSCI. As of March 31, 2023.

Occupier & Investment Markets

INDUSTRIAL SECTOR

The slowing economy, especially retail sales, is now filtering into industrial demand. In the first quarter of 2023 leasing activity slowed to 5.1 million sq m, around the long-term average of 4.7 million sq m per quarter (Figure 13). This is lower than recent performance, but only compared to the exceptionally strong pandemic run of leasing activity. It also aligned with online sales easing back to their pre-2020 trend from a pandemic surge.

While leasing has softened, supply conditions remain tight. Vacancy trended up slightly this quarter but is still sub 3% (Figure 12). Fewer available space options are impeding the ability to lease premises and are no doubt placing downward pressure on aggregate take-up figures. Tenant grey space also has increased, but only temporarily with it only short-term sub-leases.

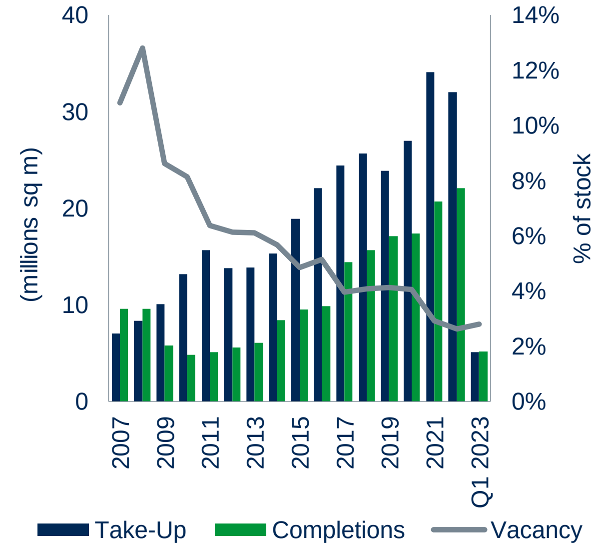
Development completions broadly matched take-up, which are higher partly due to a backlog of space delayed over the last 12 months. The rapid absorption of development completions underlines just how tight conditions still are. JLL currently estimates that around 21 million sq m is under construction, about half of which is being built speculatively. Prevailing tight conditions should see this absorbed and upward pressure of vacancy rates should be reduced.

Savills expect the upward trend in European vacancy to continue in the second quarter. The current slowdown in construction starts due to higher build costs, higher yields, and lower capital values should translate into reduced completions later this year.

Traditionally rental growth has followed the economic cycle, however, the strength of the e-commerce revolution since 2015 has insulated the sector from periods of economic softness. The correlation between rental growth and economic sentiment was 0.7 up until 2015. It is now -0.3, reflecting the structural shift from physical to online retail (Figure 13).

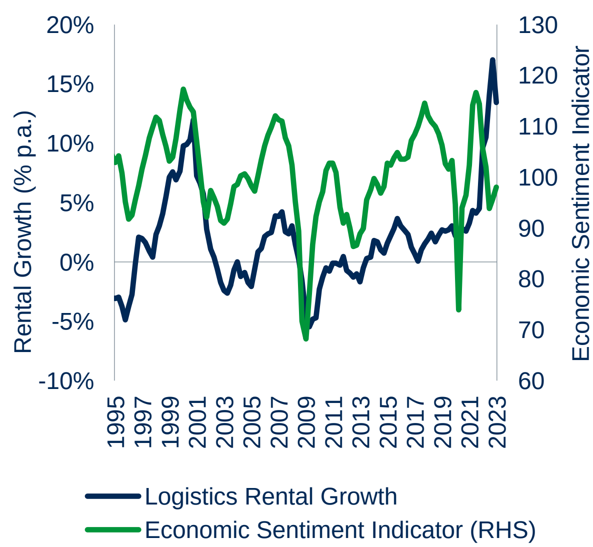
European logistics rental growth continued to be strong, expanding by 13% in the 12 months to June 2023 and up 1.6% quarter-over-quarter even as economic conditions have softened (Figure 13). This is a slight moderation in rental growth but from a double-digit pace, demonstrating that logistics is resilient, if not immune, to the wider economic slowdown.

FIGURE 12: EUROPEAN LOGISTICS: MARKET BALANCE



Source: CBRE. As of March 31, 2023.

FIGURE 13: RENTAL GROWTH VS. ECONOMIC SENTIMENT



Source: Eurostat; Cushman & Wakefield; CBRE. As of March 31, 2023.

Occupier & Investment Markets

ACCOMMODATION SECTOR

Higher interest rates continued to place pressure on house price growth. The OECD reports that Eurozone house prices fell by -0.4% in the first quarter of 2023, the second consecutive quarterly price fall. On an annual basis, however, house price growth is still positive at 0.3%. The annual rate of house price growth is falling fast from a high of almost 10% at the beginning of 2022.

Eurostat reports that many major markets recorded declines over the quarter, with Germany falling the most, by -3.0%, followed by -1.0% declines in France and the Netherlands. There was some price appreciation too, with prices in Italy up marginally 0.1% and Spain up 0.7%.

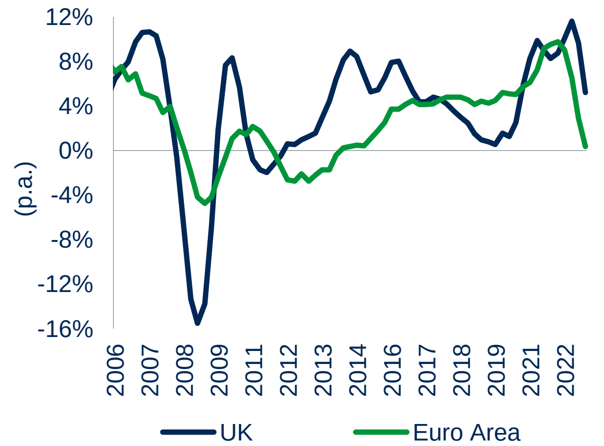
Student accommodation is a subsector that has inherent structural factors that make it a compelling investment opportunity. The rise of the global middle class is a megatrend that will continue as millions attain greater wealth, and with it a growing demand for higher education.

The quality of universities is key for attracting international students. Europe is uniquely placed to benefit from rising student demand as the region is home to about half of the top global ranked universities on the Times Higher Education rankings.

The other structural factor that makes development in the sector so attractive is the general shortage of purpose-built student accommodation (PBSA). Severely underdeveloped markets include Italy and Spain, where the number of students for each dedicated PBSA bed is 30 and 16, respectively (Figure 15). Other more established markets such as the U.K. do have existing stock, albeit increasingly aged product; the need for a generational refresh provides development opportunities there.

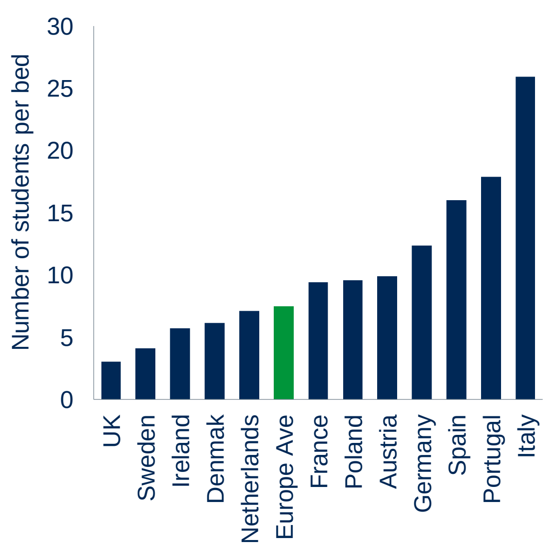
The PBSA sector will be very relevant in the years ahead, as the allocation shift away from retail requires deployment into other sectors. Along with private rental/build-to-rent (PRS/BTR), PBSA should provide fertile ground for investment. Product that can service high-quality institutions in markets with other cultural attractions will likely attract the affluent overseas students who can readily pay higher PBSA rents.

FIGURE 14: EUROPE: NOMINAL HOUSE PRICE GROWTH



Source: OECD. As of June 30, 2023.

FIGURE 15: PBSA: NUMBER OF STUDENTS TO NUMBER OF BEDS



Source: CBRE. As of May 2023.

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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