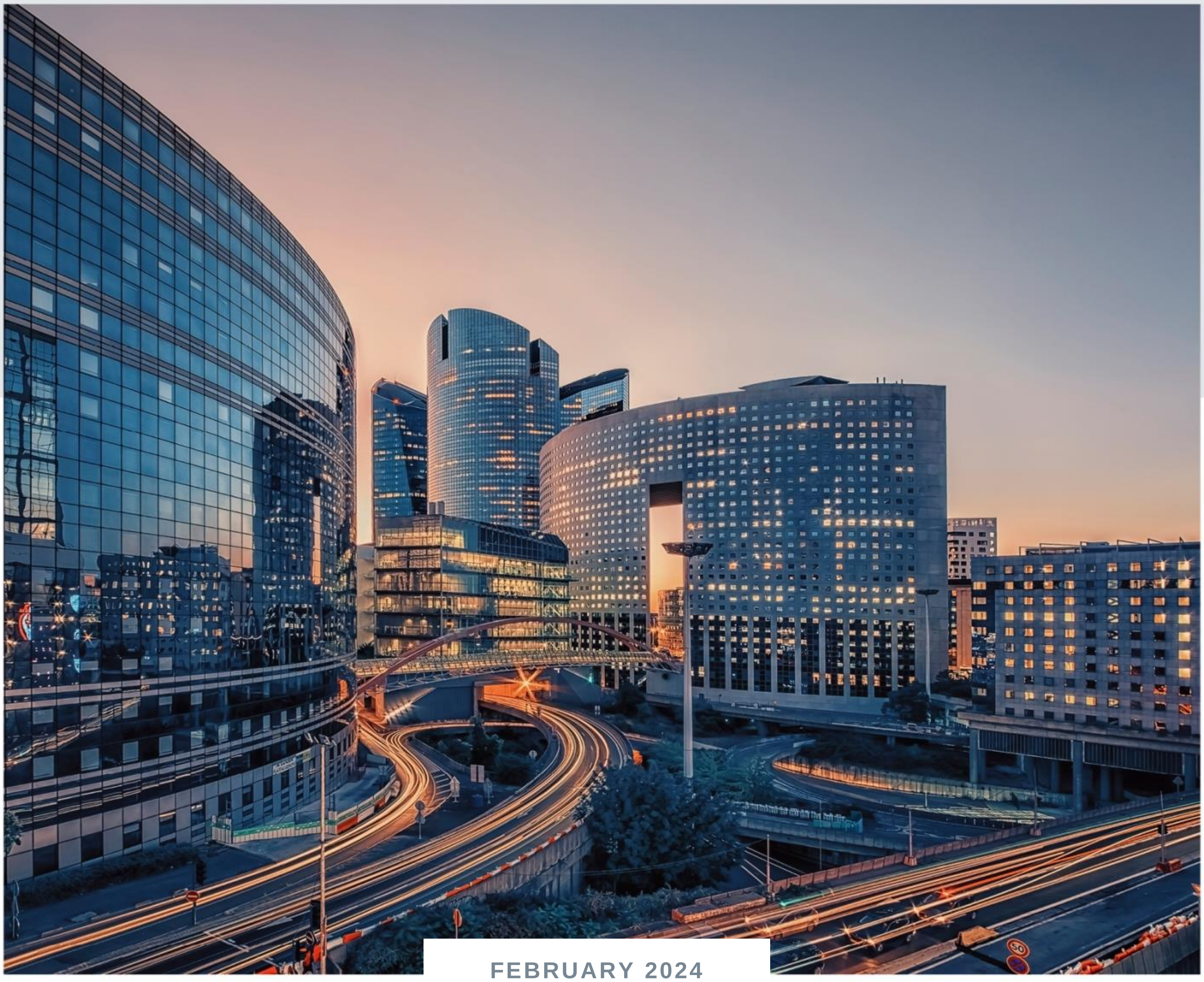
European Real Estate: The Fight Back Begins!

European Real Estate Research Quarterly



FEBRUARY 2024

24-3368192

Executive Summary

ECONOMY

- The Eurozone economy skirts a mild, technical recession as interest rates bite.
- Falling inflation and slower economic activity bolster the case for rate cuts in 2024.
- A gradual recovery should begin later this year, powered by building inventories and a consumer recovery.

PROPERTY MARKETS

- The lowest yielding assets in sectors and locations with the best long-term outlook have suffered the most pain.
- A brief and relatively shallow rental cycle slowdown should be insufficient to induce a second re-pricing leg and unlikely to push property yields up further.
- The timing of recoveries in property pricing by geographies and sectors likely will occur in line with variations in real estate debt refinancing funding gaps.
- Office: Tightening CBD vacancy rates and a shift in demand to Grade A bode well for a wider rental premium for best-in-class space.
- Retail: Improving outlook; we expect omnichannel experimentation to rise.
- Industrial: Take-up and rental growth are moderating, but from record levels; structural tailwinds remain supportive.
- Residential: The lagged impact of interest rate hikes is now filtering into house prices. Without a significant rise in unemployment, a modest correction in house prices was always anticipated.

Economic Outlook

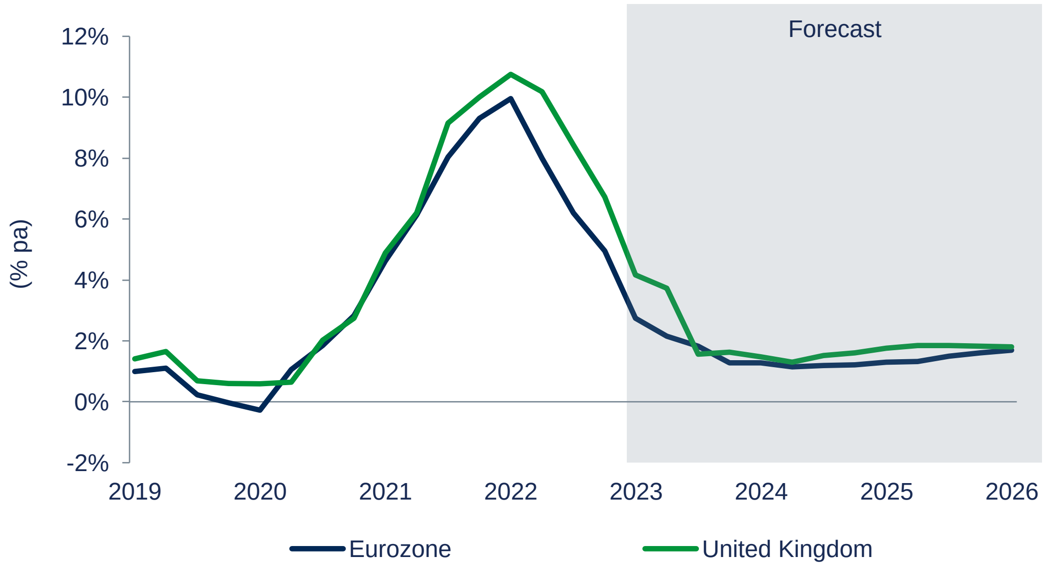
The Eurozone narrowly avoided technical recession in the second half of 2023, with GDP growth in the third quarter just -0.1%, while the fourth quarter was stagnated. Tight monetary conditions have constrained consumer and investment spending. Germany also remains a notable soft spot for Eurozone growth.

High frequency survey data remains contractionary and below the 50 threshold that would indicate positive growth. In January, the Eurozone composite PMI improved slightly to 47.9, manufacturing also clawed back some ground to 46.6, services is close to recovery but declined slightly to 48.4.

Eurozone inflation was 2.9% in December 2023, up from a two-year low of 2.4% in November, largely due to the energy subsidy withdrawal (Figure 1). While this tempered the market's expectations of rapid rate cuts as soon as this March, the general downward trend remains near immutable from a peak of over 10% in late 2022. Core inflation is also slowing, at 3.4% in December. The U.K.'s return to price stability continues to lag and be a little more volatile.

Looking ahead, the Eurozone economy is likely to continue to struggle, but a gradual recovery should begin later this year. This will be powered by a continued building of inventory stocks, and a consumer recovery with households regaining real purchasing power as interest rates begin to fall and wages outstripping inflation for the first time in many years.

FIGURE 1: EUROPEAN INFLATION (CPI)



Source: Oxford Economics. As of January 23, 2024.

The U.S. Federal Reserve, which sets the tone for all central bank monetary policy, tentatively tabled three rate cuts in 2024, starting in the third quarter. That trajectory is a little more moderate than what the equities rally toward the end of 2023 had initially anticipated.

Oxford Economics expects Eurozone economic growth of 0.6% p.a. this year, compared to 0.5% p.a. in 2023, rebounding to 1.8% and 2.0% in 2025 and 2026, respectively. Geopolitical tensions remain the primary source of downside risk.

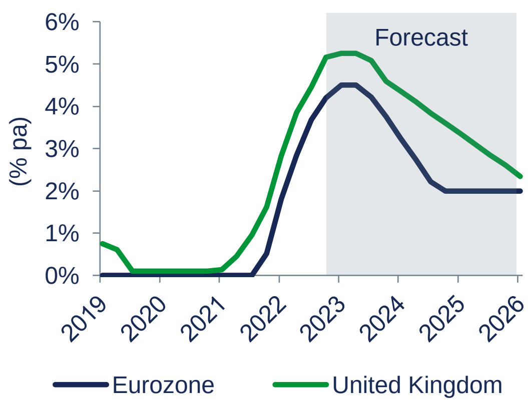
With the economy hopefully shifting through a shallow and brief recession, inflation tracking back to target, and interest rates beginning to fall, the shift to the arrival of the recovery phase of the property cycle is on track.

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

	2022	2023	2024	2025	2026	2027	2028	2024-2028
France	2.5%	0.8%	0.6%	2.1%	2.4%	1.8%	1.2%	1.6%
Germany	1.9%	-0.2%	-0.1%	1.5%	2.0%	1.8%	1.4%	1.3%
Italy	3.9%	0.7%	0.5%	1.2%	0.8%	0.5%	0.2%	0.6%
Netherlands	4.4%	0.0%	0.7%	2.5%	1.7%	1.1%	1.1%	1.4%
Spain	5.8%	2.4%	1.4%	1.8%	1.7%	1.6%	1.6%	1.6%
Sweden	3.0%	-0.3%	0.0%	1.9%	2.2%	2.0%	1.8%	1.6%
United Kingdom	4.4%	0.3%	0.6%	1.6%	1.9%	1.5%	1.4%	1.4%

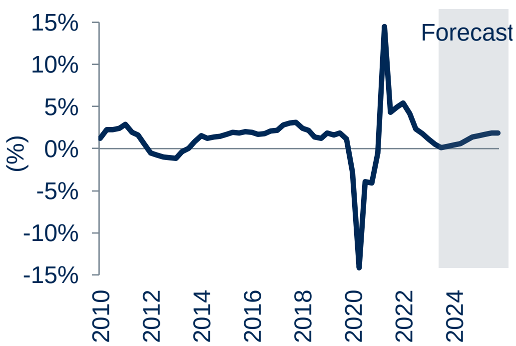
Source: Oxford Economics. As of January 2024.

FIGURE 3: EUROPE INTEREST POLICY RATES



Source: Eurostat. As of January 2024.

FIGURE 4: EUROZONE GDP



Source: Oxford Economics. As of January 2024.

Capital Markets

Having traversed the pandemic on government life-support (i.e., further QE, rate cuts, worker furlough schemes, etc.), Europe's property markets have been subject to a series of further external shocks. First, the post-pandemic double-digit surge in the cost of living, exacerbated by a Ukraine-induced energy crisis last winter, followed by sharp interest rate hikes intended to stall the economy in an effort to restore price stability. Key Euro market rates are up from zero to around 2.5% today.[1]

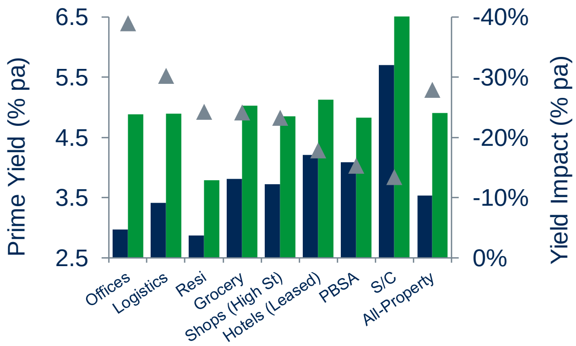
Property pricing has felt the full brunt of higher borrowing costs and 'risk-free' rates. The lowest yielding assets in sectors and locations with the best long-term outlook based on demographics, technology, and ESG/climate change have suffered the most pain. In the past two years, yield impacts were nearly -40% in offices yet less than -15% for shopping malls, where years of online retail attrition meant values had less of a peak to fall from (Figure 5).

Rate hikes also took the wind out of rental markets in 2023. Growth has slowed but remains positive in markets characterized by chronic shortages of modern stock; itself a symptom of increased banking oversight limiting development activity over the past 15 years. The anticipated brief and relatively shallow rental cycle slowdown (see sector commentary) should be insufficient to induce a second re-pricing leg and unlikely to push property yields up materially further.

Central bankers' next moves remain highly "data dependent", although the broad direction (if not the magnitude) of interest rates and therefore market property yields likely remains downward in 2024. This is reflected in rate-sensitive REIT pricing, which although drawing back in January, remains up around 20% from three months ago (Figure 6).

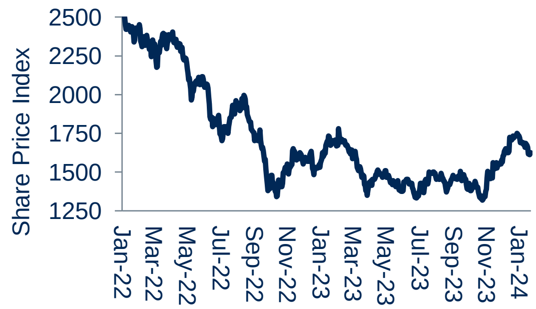
AEW identifies an approximately €90 billion debt funding gap that will weigh on the European market recovery over the next three years.[2] The most pronounced pinch points are in Germany, where yields have moved from a lower base and loan-to-value (LTV) numbers have blown out furthest, and Sweden, where investors took more leverage, especially in their large REIT sector. Conversely, pressures are lowest in the industrial property sector, and geographically in the U.K. (Figure 7). We suspect the timing of individual market recovery will occur in line with where these funding gaps are smallest.

FIGURE 5: EUROPEAN PROPERTY: RE-PRICING



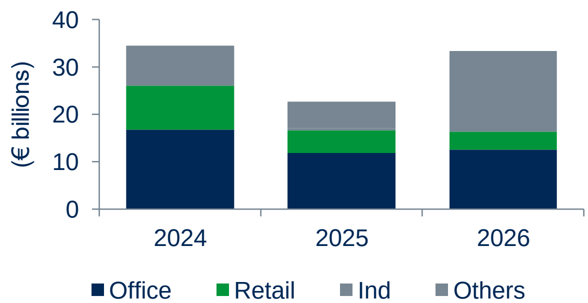
Source: CBRE. As of January 2024

FIGURE 6: REIT PRICES



Source: FTSE Developed Europe. As of January 22, 2024.

FIGURE 7: DEBT FUNDING GAP



Source: AEW. As of November 2023.

1 3-month EurLIBOR 5-year swap. As of January 25, 2024.

2 AEW Research – 2024 European Outlook.

Occupier Markets

OFFICE SECTOR

Office take-up data show demand is shifting up the space quality spectrum. Back in 2018-19, grade A space accounted for 42% of total annual take-up. Today, it has risen to just over 50% (Figure 8). As hybrid working and ESG become fully embedded, and companies "firm-up" their office space and specification requirements, we expect demand for high-quality, well-located space to rise further.

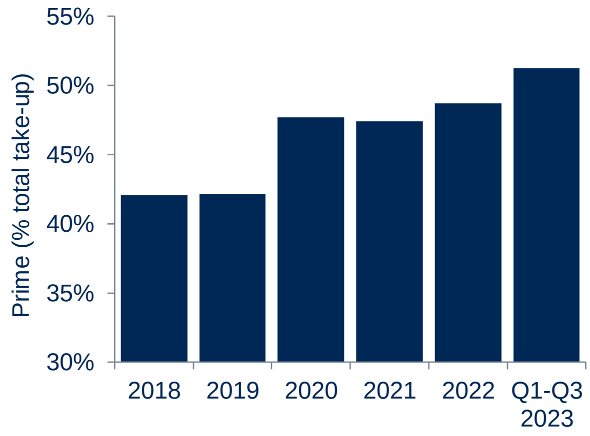
This demand shift can be seen in the divergence in office vacancy rates, with central business district (CBD) vacancies now falling and overall market vacancy rising (Figure 9). This trend is expected to continue, with forthcoming lease expiries pushing up overall market vacancy and forcing landlords to decide what to do with their existing space (e.g., re-let, refurbish, repurpose). CBD vacancy will further tighten as competition for well-connected grade A space intensifies; we expect rental premiums to emerge for best-in-class space.

With the pandemic in the distance, we are confident that for most corporates, physical offices will remain integral; hybrid working, however, could mean reduced footprints. Assuming the relationship between employment growth projections and office demand remains intact (AI's impact remains uncertain), this bodes well for the five-year office demand outlook, with more than one million square meters of potential office requirements in London and Paris.[3]

Higher interest rates have put downward pressure on capital values across all CRE sectors. It is offices that have recorded the biggest yield impact at around -40%, albeit rents are up about 10% over the same period.[4] Ongoing structural changes and the fact that offices account for roughly half of the debt funding gap (see Capital Markets section) suggest further capital value declines and a lag in the sector's recovery pace. On the upside, we expect to see select value-add repositioning opportunities start to emerge in stronger office markets.

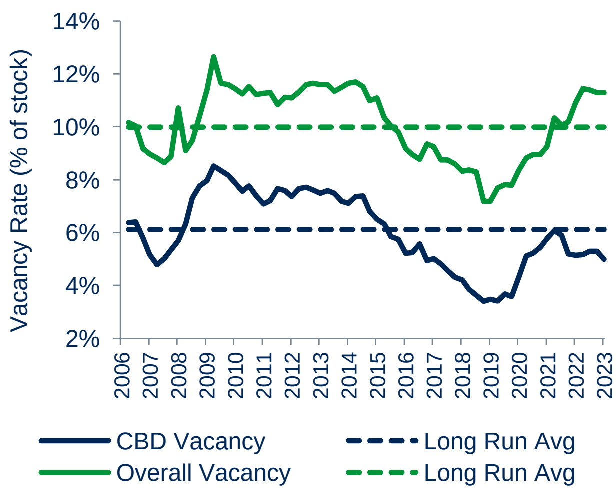
The rate of prime office rental growth remains solid at 5.7% p.a., although slightly down from 6.0% p.a. a year ago.[5] While prime rents are not expected to fall, the pace of growth will likely slow, as subdued economic conditions weigh on office demand.

FIGURE 8: PRIME OFFICE TAKE-UP



Source: Cushman & Wakefield. As of Q3 2023.

FIGURE 9: EUROPEAN OFFICE VACANCY



Source: Cushman & Wakefield; Barings Research. As of Q3 2023.

3 Source: Cushman & Wakefield; Oxford Economics; Barings Research. As of January 2024.

4 Source: CBRE; Cushman & Wakefield. As of Q4 2023.

5 Source: CBRE; Cushman & Wakefield. As of Q4 2023.

Occupier Markets

RETAIL SECTOR

Last year was challenging for Europe's retail sector. The combination of high inflation, rising interest rates and a cost-of-living crisis weighed heavily on retail sales volumes, with year-over-year sales contracting through 2023.[6]

The outlook for the sector is improving. While Eurozone consumer confidence is still below the long-run trend, directionally it has improved from the September 2022 low of -28.6 to -16.1 in January 2024.[7] As inflation subsides and real wage growth begins to recover, disposable income levels will pick up (Figure 10), providing a boost to consumer purchasing power, retail sales, and GDP.

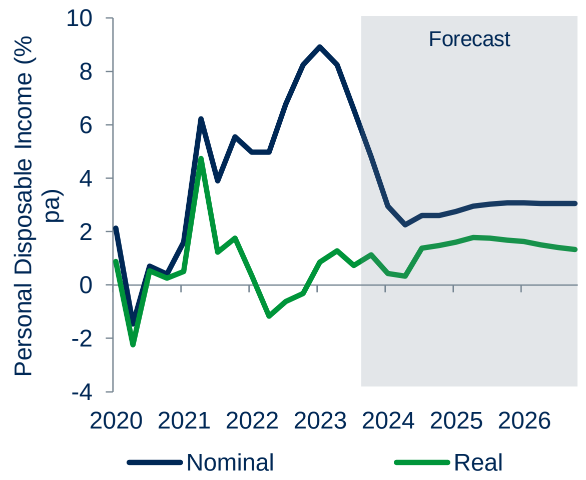
Having seen a post-pandemic pullback, online sales are again increasing their market share. We anticipate growth in line with the pre-pandemic long-term trend (Figure 11). Online retailers have also been negatively impacted by the softer consumer climate, coupled with rising fulfillment costs and fierce competition. For example, pure-play U.K. fast-fashion retailers including boohoo and ASOS are now having to cut costs to compete with cut-price overseas rivals such as SHEIN and Temu.

Recent footfall data prove that individuals still want to shop in physical stores. Footfall at CBRE's property managed portfolio of European retail assets, for example, is within 3% of the pre-pandemic footfall through late 2023.[8] Location and provision quality are paramount, with retailer demand "*mostly focused on prime high street locations, dominant shopping centers and tourist corridors*".[9]

In terms of trends going forward, we expect to see more omnichannel experimentation, with pure-play online retailers opening pop-up stores, and traditional brick-and-mortar retailers refining store formats and portfolios.

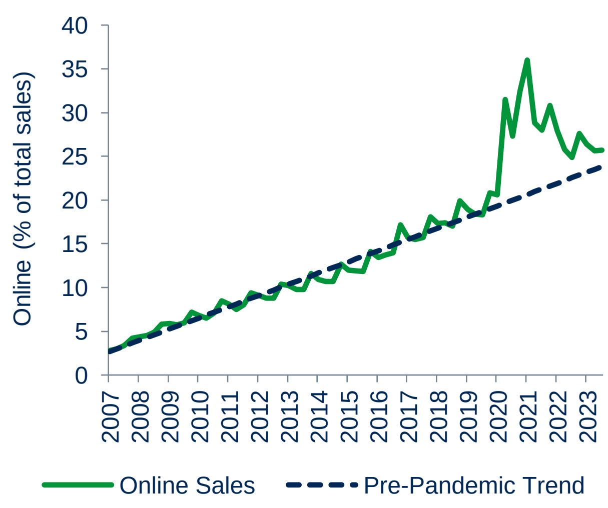
In terms of sector rental growth performance, retail rents appear in the nascent stage of recovery, following their full pandemic reset. In the fourth quarter, the best prime retail rents increased 2.6% p.a., compared to -1.2% p.a. a year ago.[10]

FIGURE 10: EUROZONE DISPOSABLE INCOME



Source: Oxford Economics. As of January 2024.

FIGURE 11: U.K. ONLINE RETAIL SALES



Source: ONS. As of January 2024.

6 Source: Eurostat Eurozone Retail Sales. As of January 2024.
7 Source: Eurostat Consumer Confidence Indicator. As of January 2024.
8 Source: CBRE Europe Market Outlook 2024. As of January 2024.
9 Source: JLL European Retail Market Outlook. As of November 2023.
10 Source: CBRE; Cushman & Wakefield, Barings. As of Q3 2023.

Occupier Markets

INDUSTRIAL SECTOR

Record-breaking levels of demand during the pandemic years were never sustainable. Following a soft second quarter, European logistics take-up clawed back some ground in the third quarter, increasing by 15.5% over the quarter to about 5.7 million sq. m.[11] The improvement was driven by several deals in the manufacturing and automotive industries.

Germany recorded the most logistics take-up (1.7 million sq m), around the post-Covid average, while leasing activity remained weak in the U.K. at 0.3 million sq m. Activity is likely to have ended 2023 below recent-year levels with the moderation likely due to a reversion to the pre-pandemic trend for e-commerce.

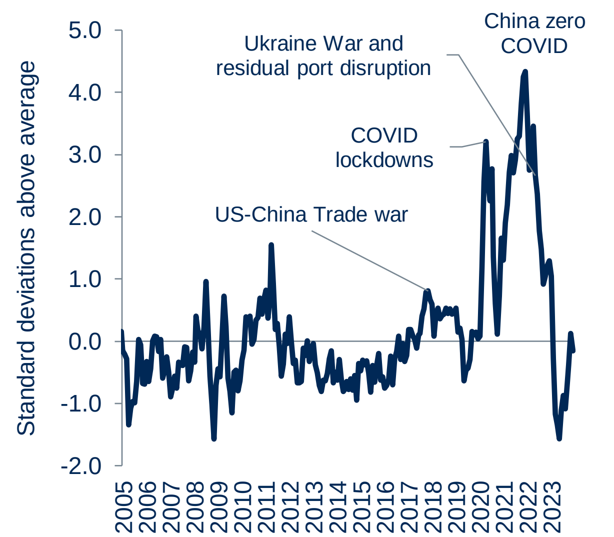
Development completions moderated in the third quarter, and with lower take-up, the European logistics vacancy rate increased to 3.4%, up 0.5%.[12] Although the supply of available accommodation is rising, modern space remains limited in most markets, and thus the balance of negotiating power remains with landlords for prime units.

Online sales will continue to increase, this shift underpinning the case for logistics investment. We estimate Europe's main markets will need over 12% more logistics space, or about 33 million additional sq m, in the next five years. This will be a positive tailwind everywhere, but Spain and the U.K. lead our current estimates.

Global supply chain pressure has been volatile in recent years, reaching record highs with Covid and the outbreak of the Ukraine conflict. Shifting from lean, "just-in-time" operating models toward a "just-in-case" approach involves near-shoring and holding greater inventory levels. The imperative to bolster supply chain resilience only increases with the recent events in the Red Sea. Uncertainty implies more demand for warehousing space.

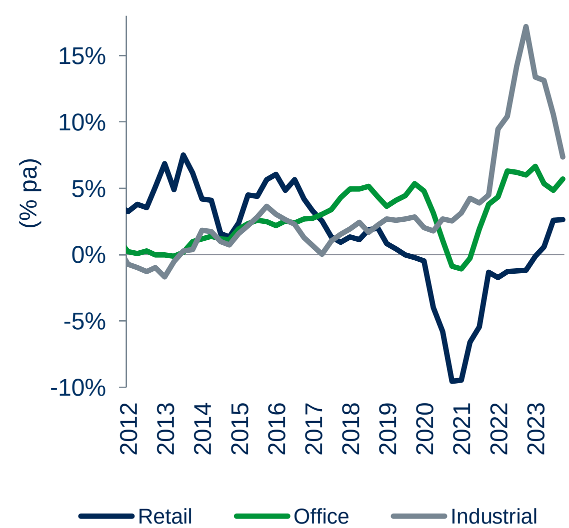
Despite moderating leasing activity, industrial rental growth is outperforming both office and retail. In 2023, rental growth totaled 7.4% p.a., although growth is easing from a peak of over 17% in 2022 (Figure 13). That goes a long way to ameliorate negative movements in yields over the same period.

FIGURE 12: GLOBAL SUPPLY CHAIN PRESSURE INDEX



Source: Federal Reserve Bank of New York. As of December 2023.

FIGURE 13: EUROPEAN PRIME RENTAL GROWTH



Source: CBRE; Cushman & Wakefield. As of January 2024.

11 Source: CBRE. As of Q3 2023.

12 Source: CBRE. As of Q3 2023.

Occupier Markets

ACCOMMODATION SECTOR

The lagged impact of interest rate hikes is now filtering into house prices. Oxford Economics estimates that in 2023 Eurozone house prices declined by -1.5% p.a., compared to growth of 7.0% p.a. in 2022 (Figure 14). Without a significant rise in unemployment, a modest house price correction was always anticipated.

Countries that recorded the strongest house price growth momentum in recent years have been subject to the sharpest declines, with prices down -9.4% p.a. in Sweden, -4.2% p.a. in Germany and -2.8% p.a. in the Netherlands.

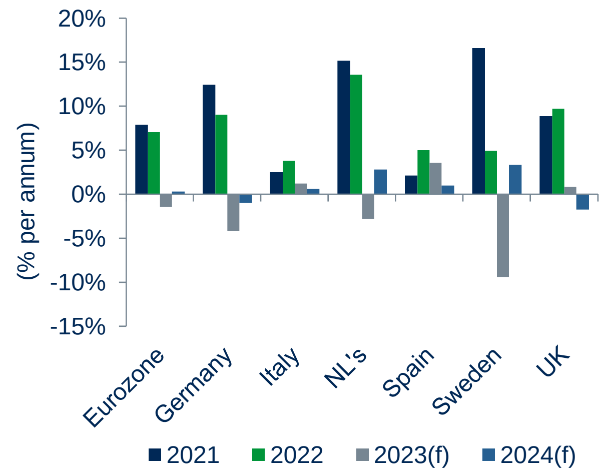
Higher mortgage rates are shifting occupier demand to the rental market. Rising demand and an undersupply of stock is driving up rental levels. In 2023, through September, Eurozone rents increased 2.7% p.a., up from 1.8% p.a. in the same period a year ago.[13]

Soaring building costs resulting from broad inflationary pressures and supply chains delays have made new housing developments unviable (Figure 15). While the pace of construction cost increases has eased, materials and wages remain high. Coupled with higher development finance costs and exit price/yield uncertainty, development activity looks set to remain muted. This has negative implications for new buyer affordability and therefore positive rental growth implications.

The sector faces greater pressure to meet rising energy performance targets. Recently, the European Commission reached a provisional agreement that will task member states to reduce the average primary energy use of residential buildings by 16% in 2030 and by 20%-22% by 2035.[14] This will be challenging to implement, given Europe's large proportion of aged housing stock.

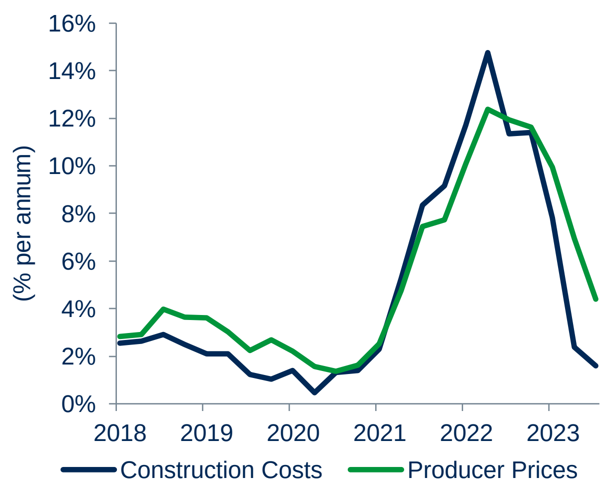
Most investors seem to view rising regulations as an investment opportunity. Knight Frank's European Living Sectors Investor Survey (2023/24) found: *"More than 77% of investors believe good ESG credentials will help improve the occupancy and tenant retention of their buildings. A further 63% agree that green properties will be able to charge premium rents"*. This alpha generation will most likely be achieved in locations where planning is tightly regulated and rent controls are light.

FIGURE 14: ANNUAL HOUSE PRICE GROWTH



Source: Oxford Economics. As of January 2024.

FIGURE 15: EUROZONE RESIDENTIAL CONSTRUCTION COSTS



Sources: Eurostat. As of Q3 2023.

13 Source: OECD. As of Q3 2023.

14 Source: European Commission. As of December 7, 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.

Paul Stewart

Head of Real Estate Research & Strategy—Europe

Ben Thatcher

Associate Director

Jo Warren

Director

Important Information

Any forecasts in this document are based upon Barings opinion of the market at the date of preparation and are subject to change without notice, dependent upon many factors. Any prediction, projection or forecast is not necessarily indicative of the future or likely performance. Investment involves risk. The value of any investments and any income generated may go down as well as up and is not guaranteed. Past performance is no indication of current or future performance. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. Any investment results, portfolio compositions and or examples set forth in this document are provided for illustrative purposes only and are not indicative of any future investment results, future portfolio composition or investments. The composition, size of, and risks associated with an investment may differ substantially from any examples set forth in this document. No representation is made that an investment will be profitable or will not incur losses. Where appropriate, changes in the currency exchange rates may affect the value of investments. Prospective investors should read the offering documents, if applicable, for the details and specific risk factors of any Fund/Strategy discussed in this document. For Professional Investors / Institutional Investors only. This document should not be distributed to or relied on by Retail / Individual Investors. Barings LLC, Barings Securities LLC, Barings (U.K.) Limited, Barings Global Advisers Limited, Barings Australia Pty Ltd, Barings Japan Limited, Barings Real Estate Advisers Europe Finance LLP, BREAE AIFM LLP, Baring Asset Management Limited, Baring International Investment Limited, Baring Fund Managers Limited, Baring International Fund Managers (Ireland) Limited, Baring Asset Management (Asia) Limited, Baring SICE (Taiwan) Limited, Baring Asset Management Switzerland Sarl, and Baring Asset Management Korea Limited each are affiliated financial service companies owned by Barings LLC (each, individually, an "Affiliate"), together known as "Barings." Some Affiliates may act as an introducer or distributor of the products and services of some others and may be paid a fee for doing so.

NO OFFER: solicitation for the purchase or sale of any financial instrument or service in any jurisdiction. The material herein was prepared without any consideration of the investment objectives, financial situation or particular needs of anyone who may receive it. This document is not, and must not be treated as, investment advice, an investment recommendation, investment research, or a recommendation about the suitability or appropriateness of any security, commodity, investment, or particular investment strategy, and must not be construed as a projection or prediction.

In making an investment decision, prospective investors must rely on their own examination of the merits and risks involved and before making any investment decision, it is recommended that prospective investors seek independent investment, legal, tax, accounting or other professional advice as appropriate.

Unless otherwise mentioned, the views contained in this document are those of Barings.

These views are made in good faith in relation to the facts known at the time of preparation and are subject to change without notice. Individual portfolio management teams may hold different views than the views expressed herein and may make different investment decisions for different clients. Parts of this document may be based on information received from sources we believe to be reliable. Although every effort is taken to ensure that the information contained in this document is accurate, Barings makes no representation or warranty, express or implied, regarding the accuracy, completeness or adequacy of the information.

These materials are being provided on the express basis that they and any related communications (whether written or oral) will not cause Barings to become an investment advice fiduciary under ERISA or the Internal Revenue Code with respect to any retirement plan, IRA investor, individual retirement account or individual retirement annuity as the recipients are fully aware that Barings (i) is not undertaking to provide impartial investment advice, make a recommendation regarding the acquisition, holding or disposal of an investment, act as an impartial adviser, or give advice in a fiduciary capacity, and (ii) has a financial interest in the offering and sale of one or more products and services, which may depend on a number of factors relating to Barings' business objectives, and which has been disclosed to the recipient.

OTHER RESTRICTIONS: The distribution of this document is restricted by law. No action has been or will be taken by Barings to permit the possession or distribution of the document in any jurisdiction, where action for that purpose may be required.

Accordingly, the document may not be used in any jurisdiction except under circumstances that will result in compliance with all applicable laws and regulations.

Any service, security, investment or product outlined in this document may not be suitable for a prospective investor or available in their jurisdiction. Any information with respect to UCITS Funds is not intended for U.S. Persons, as defined in Regulation S under the U.S. Securities Act of 1933, or persons in any other jurisdictions where such use or distribution would be contrary to law or local regulation.

INFORMATION: Barings is the brand name for the worldwide asset management or associated businesses of Barings. This document is issued by one or more of the following entities:

Barings LLC, which is a registered investment adviser with the Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940, as amended (Barings LLC also relies on section 8.26 of NI 31-103 (international adviser exemption) and has filed the Form 31-103F2 in Ontario, Quebec, British Columbia, Alberta, Nova Scotia, Manitoba, New Brunswick, Newfoundland and Labrador, Prince Edward Island and Saskatchewan); Barings Securities LLC, which is a registered limited purpose broker-dealer with the Financial Industry Regulatory Authority (Baring Securities LLC also relies on section 8.18 of NI 31-103 (international dealer exemption) and has filed the Form 31-103F2 in Ontario, Quebec, British Columbia, Alberta, Nova Scotia, Manitoba, New Brunswick, Newfoundland and Labrador, Prince Edward Island and Saskatchewan);

Barings (U.K.) Limited, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 194662) and is a Company registered in England and Wales (No. 03005774) whose registered address is 20 Old Bailey, London, EC4M 7BF.

The document is for informational purposes only and is not an offer or Barings Global Advisers Limited, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 552931) and is a Company registered in England and Wales (No. 07622519) whose registered address is 20 Old Bailey, London, EC4M 7BF and is a registered investment adviser with the SEC; Baring Asset Management Limited, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 170601) and is a Company registered in England and Wales (No. 02915887) whose registered address is 20 Old Bailey, London, EC4M 7BF; Baring International Investment Limited, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 122628), and is a Company registered in England and Wales (No. 01426546) whose registered address is 20 Old Bailey, London, EC4M 7BF, is a registered investment adviser with the SEC (Baring International Investment Limited also relies on section 8.26 of NI 31-103 (international adviser exemption) and has filed the Form 31-103F2 in Quebec and Manitoba;

Barings Real Estate Advisers Europe Finance LLP, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 401543); or

BREAE AIFM LLP, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 709904);

Baring Fund Managers Limited, which is authorized as a manager of collective investment schemes with the Financial Conduct Authority in the United Kingdom and is authorized as an Alternative Investment Fund Manager in several European Union jurisdictions under the Alternative Investment Fund Managers Directive (AIFMD) passport regime;

Baring International Fund Managers (Ireland) Limited), which is authorized as an Alternative Investment Fund Manager in several European Union jurisdictions under the Alternative Investment Fund Managers Directive (AIFMD) passport regime and, since April 28, 2006, as a UCITS management company with the Central Bank of Ireland;

Baring Asset Management Switzerland Sàrl, which is authorized by the Switzerland Financial Market Supervisory Authority to offer and/or distribute collective capital investments.

Barings Australia Pty Ltd (ACN 140 045 656), which is authorized to offer financial services in Australia under its Australian Financial Services License (No: 342787) issued by the Australian Securities and Investments Commission.

Baring Asset Management (Asia) Limited, which is licensed by the Securities and Futures Commission of Hong Kong to carry on regulated activities Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities), Type 5 (advising on futures contracts) and Type 9 (asset management) in Hong Kong in accordance with the requirements set out in the Securities and Futures Ordinance (Cap 571).

Barings Japan Limited, which is registered as a Financial Business Operator (Registration No. 396-KLFB) for Type II Financial Instruments Business, Investment Advisory and Agency Business, and Investment Management Business with the Financial Services Agency in Japan under the Financial Instruments and Exchange Act (Act No. 25 of 1948);Baring SICE (Taiwan) Limited, an independently operated business (Business license number: 2008 FSC- SICE- Xin- 030; Address: 21 F, No.333, Sec. 1 Keelung Road, Taipei 11012; Taiwan Contact telephone number: 0800 062 068); or

Baring Asset Management Korea Limited, which is authorized by the Korean Financial Services Commission to engage in collective investment business and is registered with the Korean Financial Services Commission to engage in privately placed collective investment business for professional investors, discretionary investment business and advisory business.