BARINGS

European Real Estate: An Uneven Path Ahead

European Real Estate Research Quarterly

MAY 2024

24-3538729

Executive Summary

ECONOMY

- Tentative signs of an imminent pickup in the Eurozone, with the economic recovery likely gaining greater traction in 2025.
- Falling Eurozone inflation and softer economic growth differs to the U.S., where growth remains strong.
- ECB monetary policy could diverge from the Fed, given that it is currently signaling a possible rate cut in June.

PROPERTY MARKETS

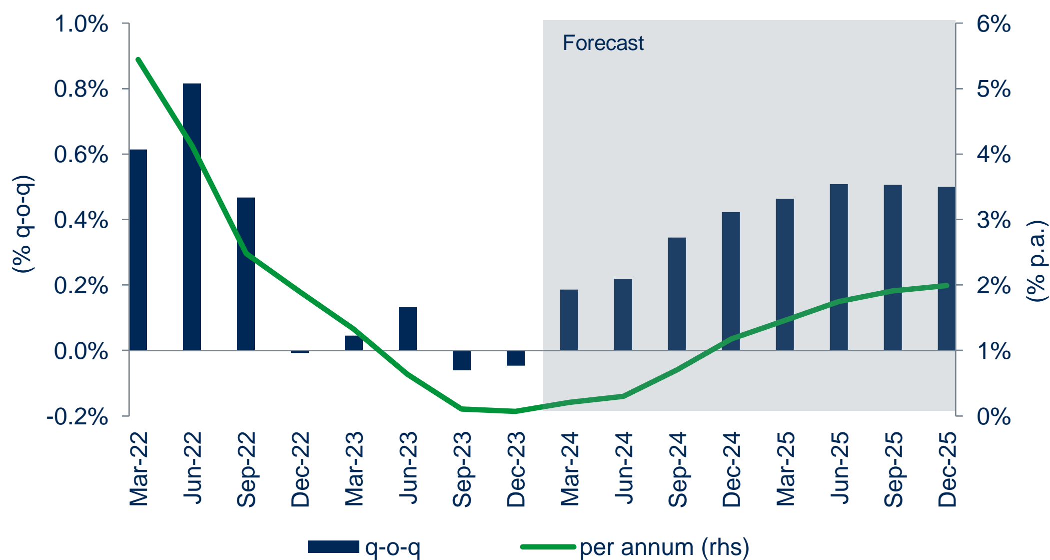
- Downward price pressures are easing, with the prime All-Property yield showing signs of stabilizing.
- Property investor conditions are improving, with the property bond spread increasing to 290 bps and credit conditions showing early signs of easing.
- The timing of recoveries in property pricing by geographies and sectors will likely occur in line with variations in real estate debt refinancing funding gaps and long-term growth drivers.
- Office: Particular corporate focus on organizational culture and ESG to drive further progress on the flight to quality.
- Retail: Improving retailer effort rates (calculated as store rents over store turnover) could provide scope for further rental growth.
- Industrial: Fundamentals are returning to their pre-pandemic (and still positive) trend.
- Residential: We anticipate a sustained period where residential rents will outperform prices through top-end and mid-markets.

Economic Outlook

Following the Eurozone's lackluster 2023 economic performance, with fourth quarter GDP stagnating (0% growth p.a.), there are tentative signs that momentum may be about to pick up. In April, for the second consecutive month, the Eurozone composite PMI reading (51.4) exceeded the 50+ growth threshold (Figure 3). Pricing pressures are continuing to ease, with March Eurozone headline inflation at 2.4%, down from 6.9% a year ago, and core inflation (which excludes food and energy) declined for the eighth consecutive month to 2.9%.[1] Services inflation, however, remains sticky, unchanged at 4% for the fifth consecutive month.

The situation in the U.S. differs, with the economy still growing strongly and inflation proving sticky. Through the first quarter disinflation has stalled, pushing back market expectations for the U.S. Federal Reserve's (Fed) first interest rate cut to potentially later this year. The upshot is that we may now see some divergence in U.S. and Eurozone monetary policy in terms of rate cut timings, with the European Central Bank (ECB) signaling that it could cut rates in June, subject to ongoing supportive inflation data. When the ECB does start cutting rates, the expectation is that it will be a measured approach, lest Euro currency weakness unleashes a resurgence of inflation.

FIGURE 1: EUROPEAN ECONOMIC GROWTH (GDP)



Source: Oxford Economics. As of April 2024.

The outlook for Eurozone economic growth is improving. Cyclical tailwinds from lower inflation should help strengthen real household disposable income levels, which will support consumer spending. Easing interest rates will also drive momentum, although this will take time, reflecting the lagged impact of monetary policy transmission. A slightly weaker currency also boosts export prospects.

Oxford Economics forecast Eurozone GDP growth at 0.6% this year, on a par with 2023's 0.5% growth rate. Thereafter, activity levels are expected to accelerate, with the economy expanding 1.8%

[1] Source: Eurostat. As of April 2024.

in 2025 and 1.9% in 2026. With real estate sector investment performance strongly entwined with the economic cycle, improving growth prospects bode well for the sector's recovery.

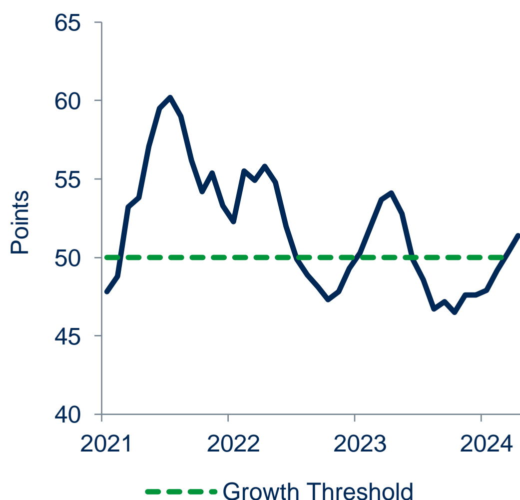
As ever, geopolitical risks remain the primary downside risk to the outlook. If Middle East tensions escalate, there could be some upward pressure on energy prices, which may be problematic if higher prices filter into core inflation. Should this happen, it could delay rate cuts timings, and thus their positive impact on growth.

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

	2023	2024	2025	2026	2027	2028	2024-2028
France	0.9%	0.5%	2.0%	2.5%	1.8%	1.2%	1.6%
Germany	-0.1%	0.0%	1.4%	1.9%	1.7%	1.3%	1.3%
Italy	1.0%	0.7%	1.1%	0.8%	0.4%	0.2%	0.6%
Netherlands	0.2%	1.0%	2.0%	1.6%	1.2%	1.2%	1.4%
Spain	2.5%	2.2%	1.7%	1.5%	1.3%	1.2%	1.6%
Sweden	0.0%	0.2%	1.6%	2.1%	2.0%	1.8%	1.6%
United Kingdom	0.1%	0.5%	2.0%	2.0%	1.6%	1.6%	1.6%

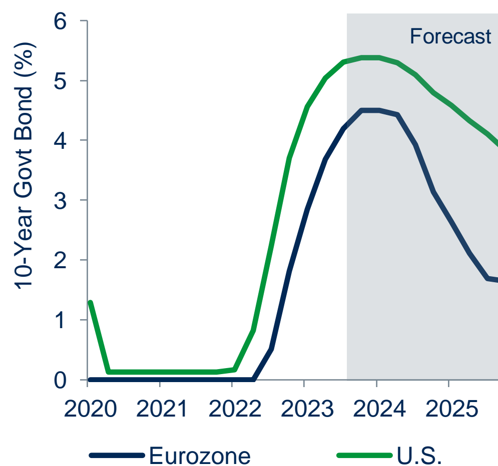
Source: Oxford Economics. As of April 2024.

FIGURE 3: EUROZONE COMPOSITE PMI



Source: S&P Global. As of April 2024.

FIGURE 4: INTEREST RATE OUTLOOK



Source: Oxford Economics. As of April 2024.

Capital Markets

European real estate investment market conditions remain soft, with Savills preliminarily estimating that around €34 billion transacted in the first quarter of 2024, down 12% year-over-year and 51% lower than the five-year average. Annual volumes showed signs of stabilization, estimated to total €144 billion in the first quarter, down only slightly from the €149 billion that transacted in the fourth quarter of 2023.

Downward price pressures are easing, with the prime All-Property yield stabilizing at 5.2% during the first quarter (Figure 5). The German 10-year bund also edged down slightly through the quarter to 2.3%, helping widen the property bond yield spread to 290 basis points (bps) from 240 bps a year ago.

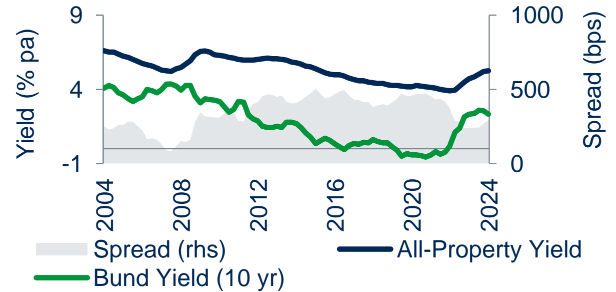
European REIT pricing trends remain a useful barometer to assess the current trajectory of current market pricing, well ahead of lagging property valuations. The brief pricing recovery that occurred in late 2023 in industrial, retail, and residential company share prices leveled off in the first quarter (Figure 6). This was mainly due to the delay in the timing of global interest rate cuts. Office REIT share price fell, reflecting rising fears of stock obsolescence that would require considerable capital expenditure from operators.

While widescale distress is not prevalent, higher borrowing costs and falling property values have pushed up loan-to-value (LTV) ratios and driven down interest-coverage ratios (ICRs), meaning that a growing number of loan covenants are being breached. Easing credit conditions (Figure 7) should also help to support market activity, although accessing financing for non-prime assets in less preferred sectors could prove challenging.

The timing of the pricing recovery will vary by sector and geography, and likely be determined by debt funding gaps and long-term future growth prospects. Funding gaps are largest in offices, accounting for 40-50% in most markets.[2] By country, gaps are largest in Germany, where yields have moved from a lower base (and have had a bigger impact on LTVs), and Sweden, where leverage levels were higher in the past cycle.

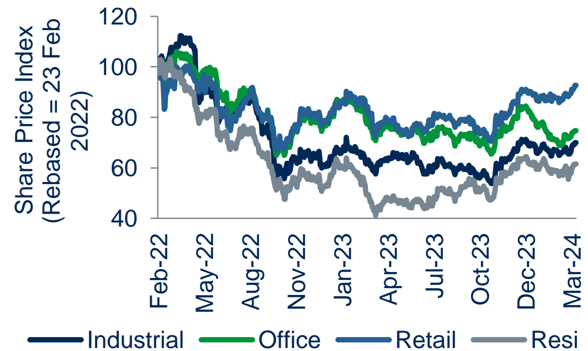
In terms of rental growth prospects, these are expected to reside in locations with the strongest economic growth prospects, highly supportive property market fundamentals, and where strong structural support (e.g., demographics, technological innovation, ESG factors) exists.

FIGURE 5: EUROPEAN PRIME ALL-PROPERTY YIELD VS. BOND YIELD



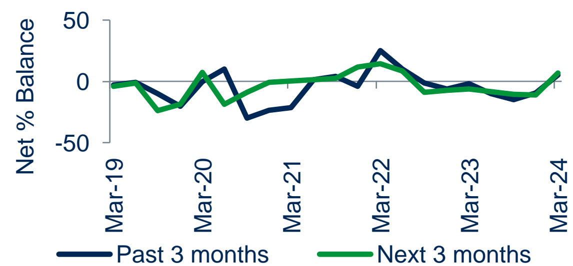
Source: CBRE; C&W; Oxford Economics. As of April 2024.

FIGURE 6: SECTOR REIT PRICES



Source: FTSE EPRA/Nareit Developed Europe. As of March 29, 2024.

FIGURE 7: U.K. CRE CREDIT AVAILABILITY



Source: BoE Lending Survey. As of April 2024.

[2] Source: AEW Research—2024 European Outlook; Barings Research. As of February 2024.

Occupier Markets

OFFICE SECTOR

In 2023, European annual office take-up totaled 9.6 million sq m (4.0% of stock), down about -16% from 2022 and about -13% below the 10-year average.[3] The fourth quarter of 2023 was the strongest quarter of take-up since the fourth quarter of 2022; in particular Milan and London (City) displayed strength (around 60% and 50% above average, respectively).[3] Meanwhile, softness prevailed in Amsterdam and Berlin (down around -65% and -45%, respectively, on average).

European vacancy rates remain well below U.S. office market levels, reaching 8.4% in December 2023, up just 0.6% on a year ago and near the long-term average.[3] Vacancy is well below the local long-term trend in Copenhagen, Madrid, Prague, and Vienna but is currently a little more elevated than normal in Stockholm and central London.

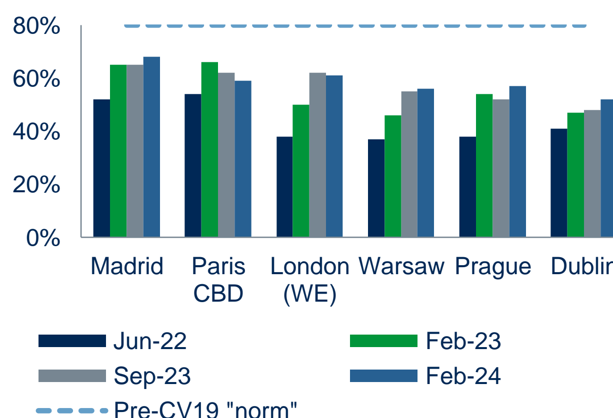
While working from home (WFH) is a headwind for the sector, physical office occupancy is showing some encouraging signs. Savills reports BMS (door swipe) data showing that average European office physical occupancy increased from 55% to 59% (the pre-pandemic average was around 80%). Most markets experienced an uplift in the last 12 months, except Paris where momentum slightly reversed.

A recent survey by PayScale reveals that return-to-office (RTO) mandates are being driven by companies' desire to build and maintain culture and foster collaboration (74% of respondents cited these as primary reasons for mandates). Physical offices play a crucial part in attracting talent and building culture and will likely be a driver for prime office demand, along with the shift to increased sustainability. Shortages of modern stock mean that much of this required space is yet to be developed.

While development was expected to reach a cyclical peak in 2023, only 3.8 million sq m was actually completed (1.5% of total office stock).[3] It is likely that inflation-related cost pressures and softer economic conditions pushed several projects into 2024. While an uptick in completions is expected this year (2.2% of total stock), completions remain under the replacement/obsolescence rate (2.2% p.a., assuming a 40-year building lifecycle).[3] Given the occupier flight to quality, the impact on total vacancy of rising development will likely be modest.

Despite a weak economy and slowing in aggregate leasing activity last year, a dearth of modern space largely explains why European prime office rental growth was a highly robust 6.1% p.a. in the year to March 2024.[4]

FIGURE 8: EUROPEAN OCCUPANCY RATES BY CITY



Source: Savills. As of April 2024.

FIGURE 9: LEADING REASONS FOR RTO MANDATE

Source: PayScale. As of August 2023.

[3] Source: Cushman & Wakefield. As of December 31, 2023.

[4] Source: Cushman & Wakefield. As of March 31, 2024.

Occupier Markets

RETAIL SECTOR

Retail turnover values have been on an upward trajectory, recording an increase of 8.6% since January 2022 (Figure 10). While increasing turnover is undoubtedly good for retailers, the actual amount of goods sold has decreased over this period, with retail volumes falling by -3.4%. Retailers have had to pass increased wholesale costs on to consumers via higher shop prices. Consequently, consumers have had to buy less (the definition of a rise in the cost of living and a fall in living standards).

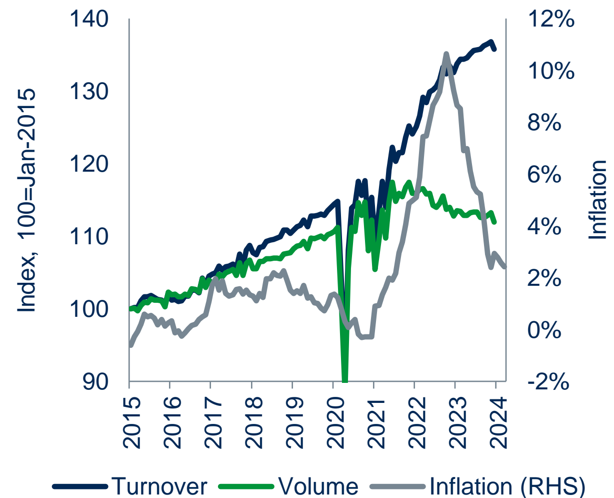
Falling living standards are also evident in the recovery, with consumer confidence stalling at -14.9 (compared to the longer run average of -11.7).[5] Household sentiment has been oscillating around this level since July 2023, although before there was a partial recovery from the all-time lows at the time of the energy crisis (-28.6). Nonetheless, confidence remains soft, well below the last peak of -2.2.

A revival in real retail sales will probably not occur until confidence recovers further (most likely when real wage growth accelerates). It is remarkable that during this time of high inflation and sluggish economic growth, there has been little movement in unemployment. Tight labor conditions are also supportive for a consumer recovery, with the Eurozone unemployment rate sitting at a record low of 6.5%.[6]

There has been an improvement in retailers' effort rates (calculated as store rents over store turnover). Typically calculated in nominal terms, the pace of rising turnover has outpaced changes in rents. In the past four to five years, rents have fallen relative to turnover. This dynamic provides some support for retail rental growth potential in the future, once the broader economy picks up.

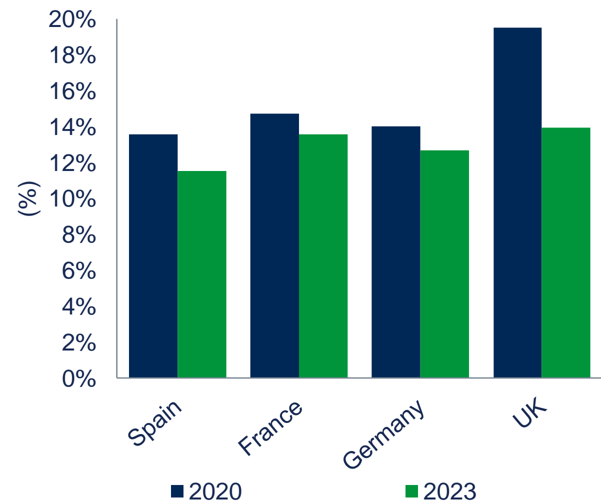
European prime retail rental growth totaled 3.1% in the year to March 2024.[7] Positive momentum in rents has been building since mid-2022 and last year represents the strongest 12 months since 2017. However, some (uncharacteristically) good cyclical news does not materially change the structural challenges the sector faces. While there has been some recent pullback in online sales, the overall upward trend prevails.

FIGURE 10: RETAIL TURNOVER VS. VOLUMES



Source: Eurostat. As of April 2024.

FIGURE 11: RETAILER EFFORT RATES



Source: Green Street. As of March 31, 2024.

[5] Source: European Commission, As of April 2024.
[6] Source: Eurostat. As of March 2024.
[7] Source: Cushman & Wakefield. As of March 31, 2024.

Occupier Markets

INDUSTRIAL SECTOR

Logistics take-up is normalizing with European leasing activity in 2023 down -25% from 2022 (Figure 12). Part of this is the interest rate-induced slowdown in GDP (and thus consumption), and partly that activity is coming off from record-breaking pandemic highs. Annual take-up was down in most major markets. The U.K. and Germany recorded the largest year-on-year declines (-43% and -38%, respectively). Italy bucked the trend, recording a marginal increase in take-up of 0.4%, a slight improvement on the record high of 2022.

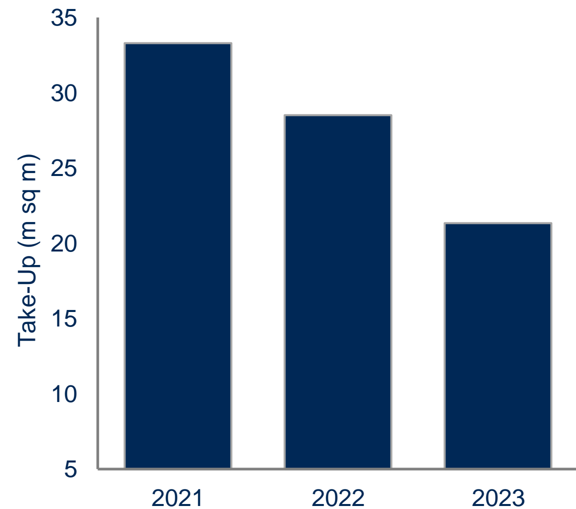
At a European level, third-party logistics continued to account for most take-up in 2023 (42%), followed by manufacturing (40%).[8] Car builders took space for EV/battery production to run concurrent with traditional combustion-engine production. With softer consumption, e-commerce tenants placed large scale expansion plans on hiatus.

Logistics vacancy increased to just under 4%, still below the long-run average and retreating from record lows.[9] Like leasing activity, vacancy appears to be normalizing back to pre-pandemic levels.

Higher development costs due to rising interest rates, tighter labor markets and higher commodity prices are impeding project viability. As a consequence, fewer projects are commencing construction. According to JLL, space under construction in Europe fell to below 19 million sq m, with speculative space under construction falling to its lowest level since 2021. Overall, there is a structural undersupply for modern logistics stock in Europe (when expressed on a per-capita basis). Even the most progressed e-commerce markets are unsupplied, with the U.K. and France placed at the more constrained side of the spectrum.

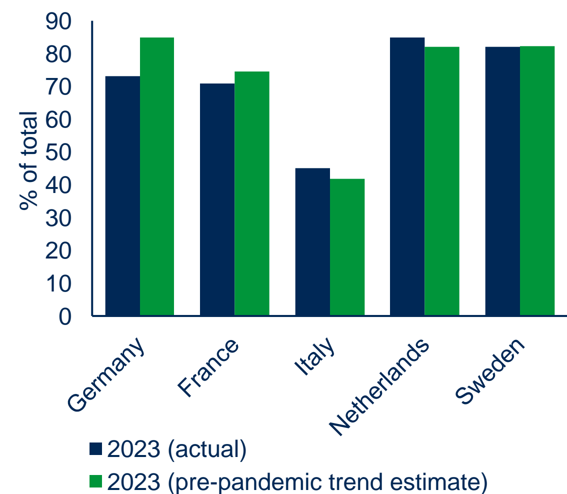
We see industrial fundamentals progressing on a more moderate and sustained (but still favorable) trajectory, over the long term. Despite easing leasing momentum, European industrial rents grew by a robust 7.4% p.a. in 2023, a fallback from the peak seen in 2022 (over 17% p.a.) but still the best performing "traditional" sector.[10]

FIGURE 12: INDUSTRIAL TAKE UP



Source: CBRE. As of December 31, 2023.

FIGURE 13: % OF POP. MAKING ONLINE PURCHASES



Source: Eurostat. As of March 2024.

[8] Source: CBRE. As of December 31, 2023.
[9] Source: CBRE. As of December 31, 2023.
[10] Source: Cushman & Wakefield. As of March 31, 2024.

Occupier Markets

ACCOMMODATION SECTOR

Elevated interest rates have triggered a modest decline in Eurozone house prices, but we appear to have passed the trough as expectations turn to approaching rate cuts later this year. In the 12 months to December 2023, house prices in the Eurozone declined by -1.1% p.a. (Figure 14), a material improvement over the change during the 12 months to September 2023 (-2.2% p.a.). This suggests the worst of the decline in house prices has already occurred.

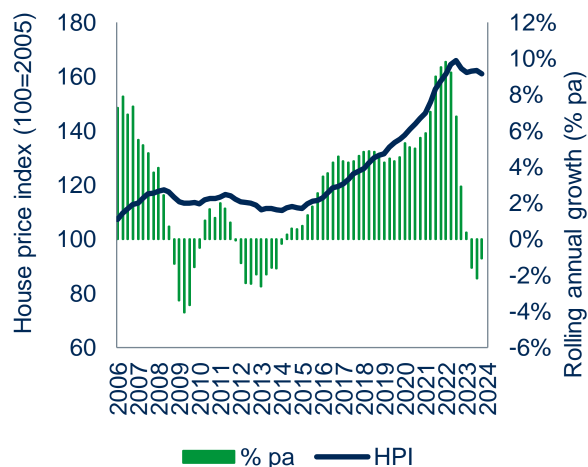
The relative resilience in house prices can be explained as mainly a function of a stubbornly tight labor market. The Eurozone unemployment rate is at a record low (6.5%), acting as a bulwark against rising mortgage rates helping to put a floor on price declines.[11] Prices have not had to dramatically adjust as there have not been large scale distressed sales coming to market during this time of higher financing conditions.

Variations exist at the country level. Softer economic conditions in Germany and France led to house prices falling by -7.1% p.a. and -3.6% p.a., respectively, in 2023.[12] In Spain and Italy, prices have risen, with increases of 4.3% p.a. and 1.8% p.a., respectively, last year.

With an approaching easing in monetary policy, we do not expect a significant correction in house prices. While there may be some further declines, structural factors support prices over the long term. House building has fallen short of government targets consistently for some time now, exacerbating shortages and eroding affordability.

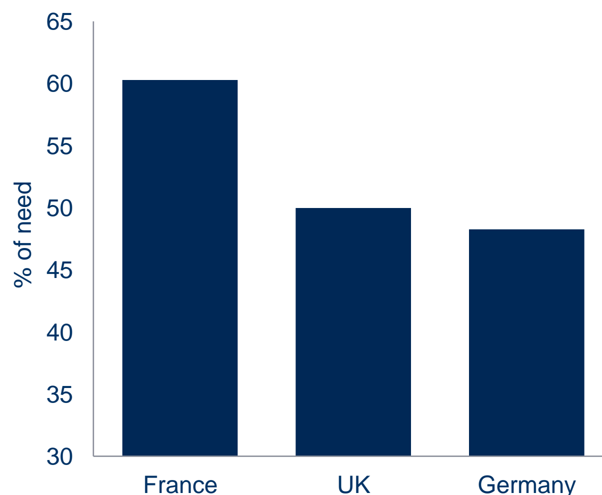
Elevated house prices and higher mortgage rates exacerbates poor buyer affordability and boosts the pool of potential renters. This heavily underpins the security on income and rental growth prospects. Even though prime residential is less reliant on mortgage affordability than mainstream residential, weak macroeconomic conditions are expected to dent buyer sentiment. We anticipate a sustained period where residential rents will outperform prices through the top-end and mid-markets.

FIGURE 14: EUROZONE HOUSE PRICE INDEX



Source: Eurostat. As of December 2023.

FIGURE 15: NEW HOUSING START (% OF NEED)



Sources: JLL. As of November 2023.

[11]Source: Eurostat. As of March 2024.

[12] Source: Eurostat. As of December 31, 2024.

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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