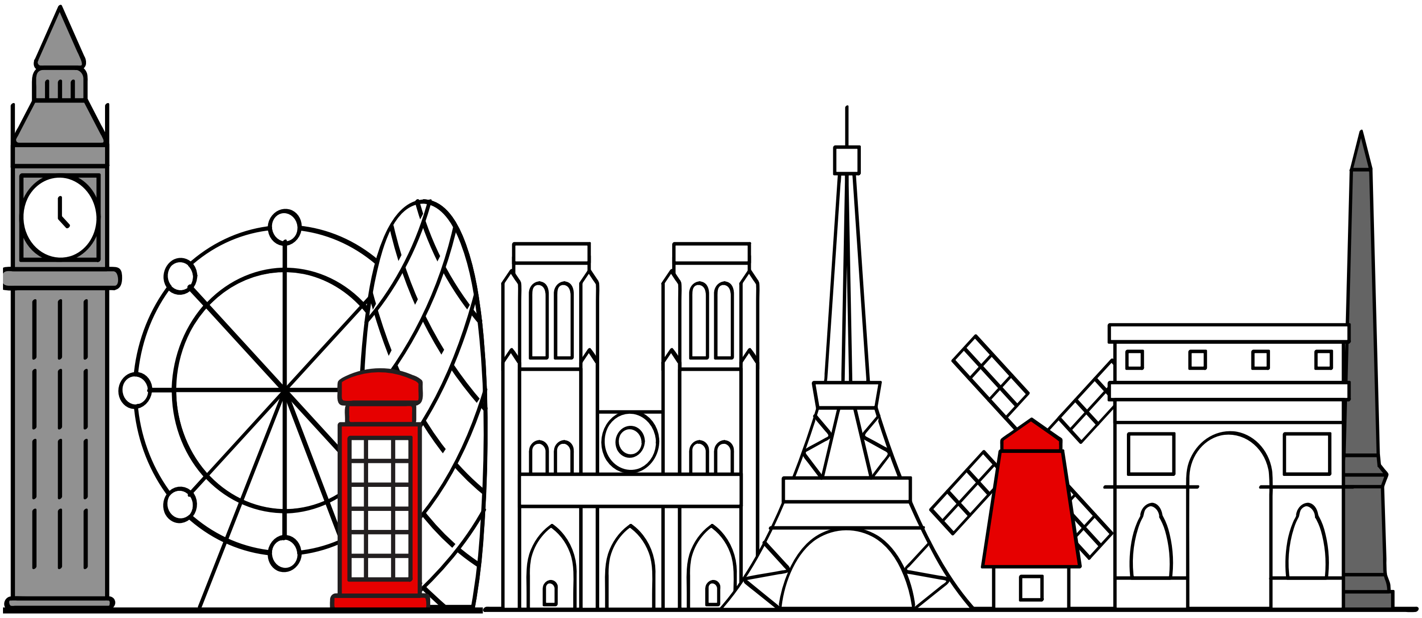
Edition September 2022

REO

Real Estate Outlook – Europe



Re-pricing underway.

UBS

UBS Asset Management

Zachary Gauge
Head of Real Estate Research & Strategy – Europe ex DACH

"European real estate faces a tough 2H22, as a necessary re-pricing adjusts yields to reflect the increase in debt costs and risk-free rates that have materialized, impacting returns in the short-term, while creating opportunities in high conviction sectors."

Complex economic outlook

Economy

The economic outlook for the UK and eurozone deteriorated further over the course of 2Q22. An optimistic scenario is for a soft-landing, where economic growth slows significantly in 2023 but narrowly stays in positive territory on an annual basis. But there are significant downside risks of a full recession, particularly if gas supplies are rationed over the winter. The key drag on economic growth will come from inflation, which has consistently come in above expectations during 2Q22. Eurozone inflation reached 8.9% in July, whilst in the UK it hit 10.1%. Even at these levels further increases are anticipated in the coming months, particularly in the UK where revised energy caps could push inflation into the high teens in early 2023. The higher cost of living has already had a sharp impact on consumer confidence surveys and retail spending is expected to weaken significantly in 2H22.

Both the ECB and BoE have taken a more aggressive tone in their monetary policy guidance and have made it clear that their primary focus is to bring inflation under control, even if that results in a sharp slowdown in economic activity. The BoE has increased the base rate to 1.75% and is forecast to reach 2.75% by the end of the year. The ECB increased its policy rate in July for the first time in over a decade and by more than expected (50bps to 0%). Further hikes are forecast over the remainder of the year to bring the ECB base rate to 1% by end-2022 and 1.75% by end-2023. Forward markets are pricing in more aggressive hikes, demonstrating the downside risk to the forecasts shown here.

The pace of tightening by the US Fed has placed further pressure on European central banks to keep pace, as both EUR and GBP are down by around 10% against the USD since the start of 2022, adding further weight to European inflation. After a bit of a recovery during the summer, 5-year swap rates in both the eurozone and UK have moved back out, reaching 1.9% and 3.3% respectively by the end of August. At these levels, the all-in-cost of debt is significantly above the property income yield for most core sectors and markets.

Occupier markets

Despite the relative turmoil in liquid asset classes, occupational markets for European real estate remained relatively sanguine in 2Q22. Office take-up continued to recover from the pandemic trough, although it now appears to be leveling off at around 20% below pre-pandemic levels (see Figure 1), as occupiers switch to a hybrid working pattern which ultimately enables net space reductions. To facilitate this change there is a clear preference for better quality space, with prime rents in all the main German markets, Italy and some of the regional Dutch and UK markets reporting positive growth in 2Q22. However, we continue to have significant concerns over the secondary market and peripheral assets.

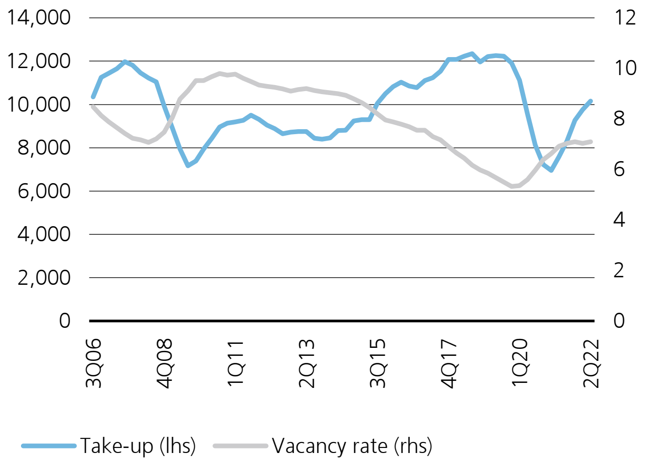
Yield correction has started

Assets with structural vacancy will come under pressure as loans need to be refinanced at higher rates and the income will not be sufficient to cover repayments. As assets then have to be sold or rents heavily reduced, which may be the trigger for a sharp downward movement in capital values that we have been anticipating for some time.

Despite some significant challenges on the capital market side, logistics occupier markets continue to demonstrate positive demand characteristics and rental growth, which continued to be widespread in 2Q22. Retail markets were largely stable, but trading is likely to suffer in the second half of the year. However, the retailers which are still operating across Europe are coming at this challenge from a relatively strong base, having survived the more significant crises of the structural shift to online and the COVID-19 pandemic.
And assets in strong tourist locations may have a strong summer, as spending on holidays appears to have been ringfenced from any cost pressures that households may face over the course of 2022.

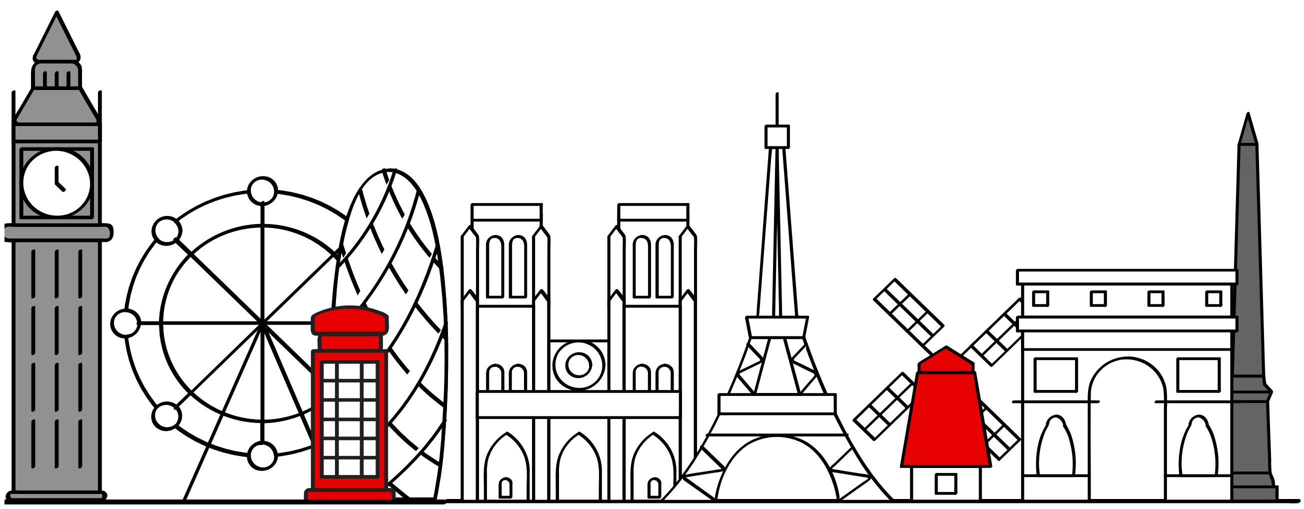
Capital markets
The second quarter of 2022 was a turning point for European capital markets, ending a cheap capital-fueled bull-run which has lasted for the best part of a decade. Although there were warning signs in 1Q22, sentiment shifted rapidly in the second quarter. There was the realization that real estate wasn't going to escape the repricing which occurred in every liquid investment market that had sunk in. The primary trigger for this was the lending market, as the increase in swap rates pushed the all-in-debt costs above the property income yield for most core income producing asset classes, effectively knocking a significant proportion of potential buyers out of the market.

Figure 1: European office vacancy rate and take-up
(%, '000 sqm)



Source: JLL, 2Q22.

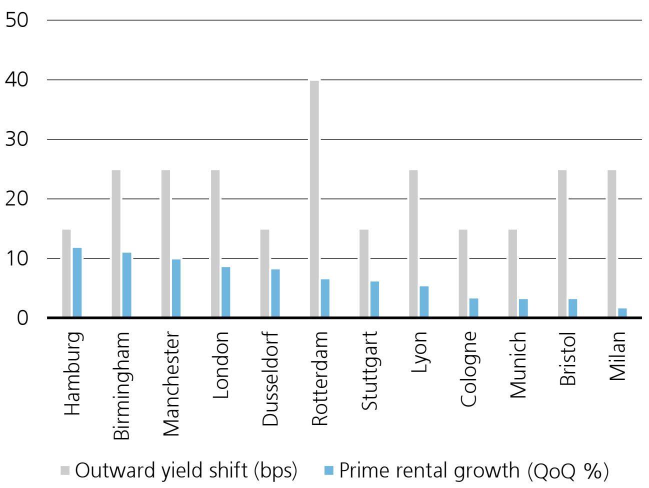
The initial impact was felt in a number of high-profile deals falling through, as buyers' and sellers' expectations moved further apart. Leveraged buyers generally adjusted the entry yield to make debt accretive, but without sell-side pressure many vendors have opted to hold out for improved market conditions. Quarterly investment volumes for Europe fell by 25% on the previous quarter. Evidence is still fairly thin on the ground, but there is an acceptance that a re-pricing is necessary, with some markets already reporting outward yield shift and more set to follow in the second half of 2022.



The fickle nature of real estate sentiment

Reversal in sentiment should lead to opportunities
At the end of 1Q22, many real estate investors remained in a pretty bullish mood despite the narrowing spread to bond yields and the economic headwinds stemming from the war in Ukraine. What has been quite surprising is the pace at which sentiment turned – almost in a matter of weeks early in June. A key driver of this has been the rapid increase in swap rates which had the direct impact of preventing leveraged buyers transacting for the majority of core income producing assets.

Figure 2: Logistics markets showing both outward yield shift and rental growth in 2Q22



Source: JLL, 2Q22.

When real estate markets do turn negative, sentiment can build and pricing can move quite quickly. Whilst this isn't great news for anyone who purchased a logistics asset in the past twelve months, market downturns in real estate markets have historically presented some of the best buying opportunities. For investors who are prepared to look beyond the noise and take a long-term view, the rapid deterioration in sentiment which has snowballed since June, is again expected to throw up some very interesting opportunities at rebased pricing.

Strong conviction calls back on the table
Interestingly, it is some of the most popular sectors of the past few years that are seeing the quickest outward movements in pricing. Logistics is the clearest example, with prime yields in 2Q22 moving out across a wide number of European markets, despite being high up investors' wish lists just a few months ago. Part of the reason behind this, is that the most popular sectors (generally the *beds and sheds* assets) saw the strongest yield compression. These exceptionally low yields are now fully exposed to rising debt costs and the narrowing spread between government bonds and income producing real estate.

But the key question now is, at what point do these sectors become good value again? The positive supply-demand dynamics which pushed so many investors towards these sectors are generally still in place. Using logistics again as an example, there were a number of markets that saw yields move out at the same time as reporting positive rental growth (see Figure 2). This is not unheard of, but it is uncommon. And with supply-side levels remaining very favorable and development financing becoming increasingly hard to obtain at a level that stacks up, the rental growth outlook for existing stock remains pretty positive.

For most of the past decade, it's been very difficult to generate alpha from top-down property investments as so much capital was moving in the same direction. With many investment managers using similar data and forecasting models, the obvious wins were in many cases too obvious and any upside was fully priced in. But pricing dislocation should change this and IRR driven investors that were priced out of long-term sector convictions may find these investments stack-up again. Sell-side pressures are likely to build in the second half of the year. This puts investors who can move quickly and take a long-term view of the relative value of an asset in a strong position to benefit from any market dislocation and deploy into sectors which ultimately still have a positive outlook on the Income growth side.

For more information, please contact:

UBS Asset Management
Real Estate & Private Markets (REPM)
Research & Strategy

Zachary Gauge
+44-20-7901 5534
zachary.gauge@ubs.com

Follow us on LinkedIn

To visit our research platform, scan me!

www.ubs.com/repm-research