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Real Estate Outlook – Europe

Rents up but values down.

UBS Asset Management

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"European property markets reported a widespread outward yield shift in 3Q22, with more anticipated in 4Q22. High debt costs place equity buyers in a strong position as discounted opportunities start to emerge."

Energy crisis to trigger shallow recession

Economy
The economic outlook for Europe remains extremely challenging. Inflation in both the eurozone and UK has exceeded 10%, resulting in negative real wages across the board and consumer spending being impacted accordingly. Higher borrowing costs are also starting to impact households and businesses. The UK and eurozone are expected to be in a shallow recession by early 2023, with a weak recovery thereafter. Inflation should start coming down next year as base effects come into play and the impact from energy costs becomes deflationary in 1Q24. But core inflation will keep CPI above target in both markets at an annual average of 5.3% in 2023, before dropping to just above 2% in 2024.

The ECB and BoE have continued to tighten monetary policy in response to inflationary pressures and to maintain pace with other global central banks. At the October meeting, the ECB raised the deposit rate by 75 bps to 1.5%, whilst the BoE also hiked by 75 bps at the November meeting to 3%. Further hikes are expected from both central banks, and by spring 2023 the ECB is forecast to hike to a terminal rate of 2.75%, whilst the Bank of England is anticipated to reach 4.5%.

Although further hikes are almost certain, the longer-term path of interest rates is less clear. Forward markets are anticipating a *higher for longer* scenario, with rates hitting ca. 2.75% in the eurozone and ca. 4.25% in the UK in 12 months-time and only moving down marginally over the following years.

UBS Investment Bank has taken a differing view, which follows more conventional economic theory. As the economy slows in 2023 and inflation starts to come down, central banks will loosen monetary policy to stimulate the economy, particularly if unemployment starts to rise. Under their scenario, UK rates are forecast to drop back to 2.5% and eurozone rates to 1.75% by end of 2024. This would provide support for real estate pricing, and could support a recovery in transactional volumes as debt becomes accretive again.

Occupier markets
Despite the headwinds facing the economy, office occupational demand held up relatively well in 3Q22, with total European take-up falling by 5% on the previous quarter but continuing to show a strong recovery on the pandemic-impacted years. Annual take-up levels appear to be stabilizing at around 15% below the levels recorded prior to COVID-19. Aggregate vacancy rates have stabilized around the 7% level, helped by a modest supply of new space coming through to the market (see figure 1). Occupier demand for the newly developed space remains strong, and markets including London, Frankfurt, Hamburg, Munich, Milan and Amsterdam saw prime rental growth in 3Q22. However, we anticipate negative movements for secondary space to emerge over the next 12 months.

Values slowly starting to adjust

Aggregate take-up in logistics markets has fallen back in 2022, but remains very high compared to pre-pandemic levels. Despite the slight slowdown in take-up, vacancy rates have continued to come down with an average rate of just 2.6%. As a result, many markets are still delivering strong prime rental growth. Rental levels for prime retail markets were largely stable in 3Q22. The slowdown in consumer spending will impact the wider retail sector, but prime pitches, particularly in tourist hotspots, saw very strong footfall over the summer and helped to support in-store trading.

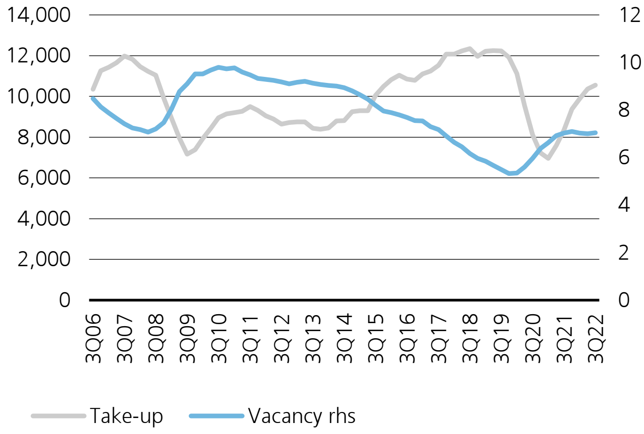
Capital markets

Unsurprisingly, investment volumes in Europe for 3Q22 fell sharply, dropping by 37% on 3Q21 and recording the lowest level since 2014 (excluding the pandemic-impacted 2020). Rising interest rates have pushed all-in debt costs above the income yield for most real estate assets – effectively excluding a vast pool of buyers from the market. The lack of price discovery and lagging valuations have made it riskier for potential equity-only investors to transact. In addition, there is still some resistance among sellers in continental Europe to accept the level of repricing which would be necessary to make real estate comparatively attractive again vs. other asset classes. In the UK, the market is moving quicker. There are more motivated sellers (which is helping price discovery), and we anticipate this will attract more interest to the market in 2023 as value-seeking investors become more active.

In terms of the official prime yield movements, logistics has seen the sharpest in 3Q22, with all main markets reporting at least 25bps of outward yield shift, whilst UK markets have seen 100bps or more. Most prime office markets have also seen outward yield shift, although these are generally smaller movements of between 10-50bps.

There was less movement in retail markets, although we believe this is more due to the lack of market evidence than any particular vote of investor confidence in the sector.

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



Source: JLL, 3Q22.

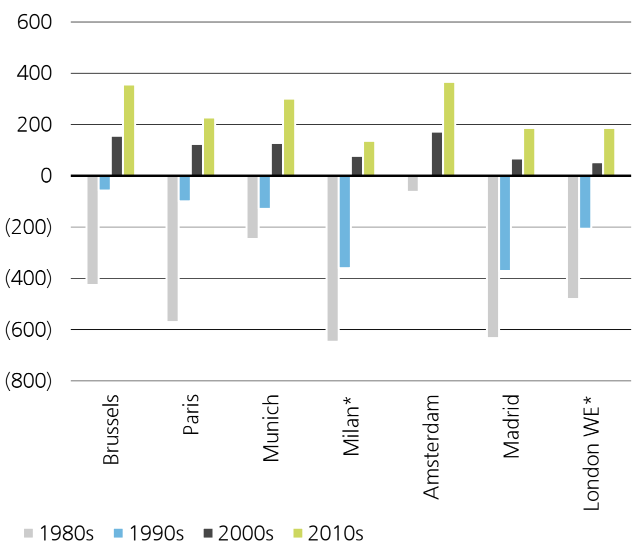
Our strategy in the current market climate would be to focus on the sectors having the strongest outlook on the rental growth side, rather than those with the highest yield spread to fixed income yields. In a period of high inflation and weak economic growth, the income component and the ability of a landlord to drive rental growth, will be critical to performance. So we believe there may be buying opportunities in sectors such as logistics where yields are now moving out quickly. Yields could reach levels, combined with the strong outlook for rental growth, that could start to look attractive again even in a multi-asset portfolio.

Where should property sit in relation to bonds?

The challenge of estimating a risk premium
The spread between property yields and government bond yields has gone from being very attractive at the start of 2022, to distinctively unattractive on the same measure just nine months later. As property yields started to adjust to the new interest rate environment in 3Q22, one of the most frequently asked questions has been: "What should a fair risk premium for property be?"

Unfortunately, the answer is far from straightforward. Taking a backward-looking approach, different decades were shaped by clearly defining characteristics which had a significant impact on where the property risk premium landed. Throughout the 1980s and 1990s, it was far more common for property yields to have a negative spread to government bond yields than a positive one (see Figure 2). During these decades, property was seen as a true inflation hedge, whilst the asset class was more insular from wider financial markets and less resilient on leverage. This in effect helped real estate set its own level of pricing and softened the correlation with liquid asset classes.

Figure 2: Average spread between prime office yield and 10-year government bond (bps)



Source: PMA, November 2022. Note: *Milan data starts 1985 and London WE 1982.

But as European real estate institutionalized in the 2000s and leverage played a greater role in acquisitions, the relative pricing of real estate versus other asset classes became more relevant. Property yields started to show risk-premiums to government bonds which ranged between 50-200bps on average, although in the run up to the GFC once again dipped into negative territory. The ultra-loose monetary policy that marked the post-GFC era, sent the spreads up to record levels and was the single most important factor in the property bull-run of the 2010s. But with interest rates heading back above what would be considered long-term neutral levels, how far do property yields need to move out to become attractive again on a relative pricing basis? The issue with answering this question in relation to straight bond yields, is that the income from property is variable, either derived from market rental growth movements or some form of indexation.

There is a stronger correlation between property yields and real (CPI indexed) bond yields, reflecting the ability of property to, in theory at least, capture some inflation within the income component. And this explains why, while the spreads between core office yields and straight government bonds have moved in by an average of 240bps between 1Q-3Q22, the gap between inflation linked bonds has narrowed by 175bps.

Nonetheless, this is a considerable margin, given that most prime office yields have only moved out by 25-50bps so far. But the distortion of the ultra-loose monetary policy of the 2010s means that coming into this downturn, spreads between property yields and bond yields were artificially high and have a reasonable cushion to absorb some of the impact. Property yields undoubtedly have further to move out. But if the outlook for rental growth on an asset is positive, then the outward movement doesn't have to be too dramatic before on an IRR basis property can again look attractive against other investment asset classes. And as monetary policy tightening may be reversed in the next 12-18 months to support economies through a slowdown, there is upside potential of property yield compression from the elevated levels they are reaching.

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