European Real Estate: Frightening Tightening?

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Executive Summary

ECONOMY

- Interest rate adjustments continue to slow the Eurozone economy to a crawl.
- Despite renewed energy price volatility, inflation in the Eurozone continues its steady downward trajectory, but is proving more stubborn in the U.K.
- Dovish comments from the ECB contrast with more hawkish “higher for longer” rhetoric from the Fed.

PROPERTY MARKETS

- While further capital declines are still occurring, we are now technically past the trough of the property cycle.
- Upward yield movements have been indiscriminate to investment fundamentals, with the best sectors and assets seeing the largest negative re-pricing.
- A considerable opportunity has emerged for those with capital to employ for the next property cycle.
- A deeper second leg to the correction would likely require interest rates to remain elevated for a very prolonged period or ratchet up even higher.
- Offices: CEOs have strong aspirations to get employees back to the office, but this won’t solve Europe’s rising office obsolescence problem.
- Retail: Steady retail vacancy in the first half of 2023, although the rate will likely rise as further store/portfolio rationalizations appear inevitable.
- Industrial: Ongoing supportive industrial market fundamentals will likely drive future positive rental growth performance, albeit at a more moderate pace.
- Residential: Rental property shortages are unlikely to ease, new schemes are being delayed, and higher mortgage rates are locking out would-be buyers; rental growth prospects remain strong.

Economic Outlook

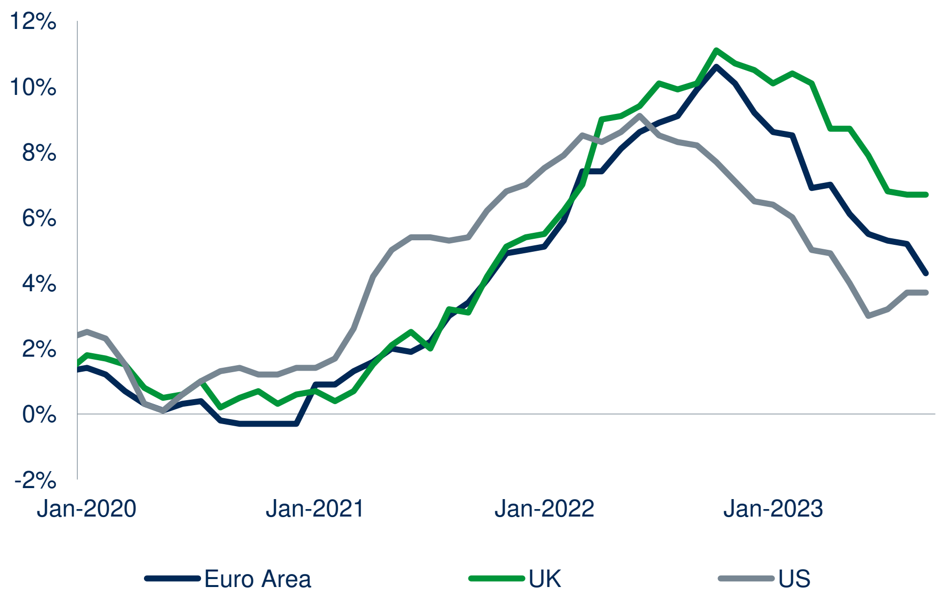
Unlike the U.S., the pace and magnitude of interest rate adjustments continue to slow the Eurozone economy to a crawl, with growth in the second quarter of 2023 a meager 0.1%. Economic softness was wide ranging, with flat consumer spending (from cost-of-living pressures), soft fixed investment, 3with Oxford Economics forecasting 2023 annual GDP growth at just 0.5% (Figure 2).

High frequency survey data also indicate further economic softness to come, with the Eurozone composite PMI at 47.2 in September 2023, up slightly from the previous month (46.7) yet still well below 50 indicating contraction. Services PMIs improved slightly in September (to 48.7 from 47.9), and manufacturing PMIs appear to be stabilizing after a steep 16-month deterioration to a miserly 43.4.[1]

Eurozone inflation continues its steady downward trajectory. In September the rate fell sharply to 4.3% from 5.2%, coming in below market consensus (Figure 1). Encouragingly, the core rate of inflation also dropped sharply in September to 4.5%, from 5.3% in August. However, U.K. inflation is proving to be stickier, holding steady at 6.7%, yet well below last October's peak of 11.1%. To some extent, the U.K. appears to have suffered from the worst of both worlds: a U.S.-style labor supply shock and a euro area-style energy and food shock.

At its September meeting, the European Central Bank (ECB) raised rates by 25 basis points (bps), to the highest level since 2001. Assuming no negative surprises, it appears that the terminal rate has been reached. Dovish comments from the ECB stated that rates, if maintained for an adequate duration, are now at a level to bring inflation back down to target.

FIGURE 1: INFLATION RATES



Source: Eurostat, ONS, U.S. Bureau of Statistics, Statista. As of September 29, 2023.

[1] Source: S&P Global. As of October 2023.

Evidence that U.S. monetary policy sets the template for central banks globally was seen in early October when statements from the U.S. Federal Reserve (Fed) fueled concerns that U.S. rates will have to stay "higher for longer." This sparked a major correction in global bond markets, although there has been some claw-back since. Fluctuations around interest rate concerns will remain a feature of the market until inflation has been unambiguously tamed or there are further indications the economy has turned.

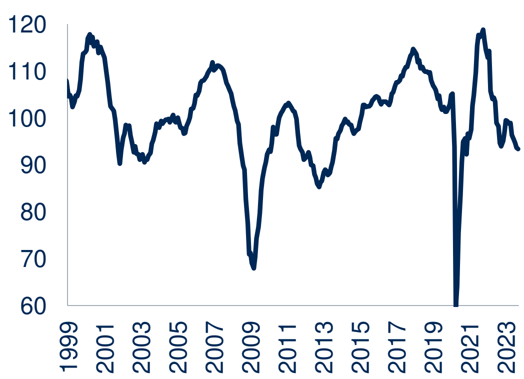
While high interest rates do appear to be having an impact on inflation, they are clouding the economic outlook, as is the recent instability in the Middle East. Softer GDP growth is expected in the Eurozone in 2024 (0.8% p.a.), before recovering in 2025 (1.75%), which is when the ECB will have likely commenced cutting interest rates. Downside risks to the outlook are that central banks have tightened too far, too quickly, monetary policy errors have already occurred, and economies deteriorate to a greater degree than anticipated.

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

	2021	2022	2023	2024	2025	2026	2027	2023-2027
France	6.4%	2.5%	0.8%	0.6%	1.5%	2.1%	2.2%	1.4%
Germany	3.1%	1.9%	-0.5%	0.4%	1.9%	2.2%	1.7%	1.1%
Italy	8.3%	3.9%	0.6%	0.6%	1.2%	0.8%	0.5%	0.7%
Netherlands	6.2%	4.4%	0.5%	1.3%	1.7%	1.3%	1.1%	1.2%
Spain	6.4%	5.8%	2.4%	1.3%	1.8%	1.8%	1.6%	1.8%
Sweden	5.9%	2.9%	-0.6%	0.2%	2.1%	2.2%	2.0%	1.2%
United Kingdom	8.7%	4.4%	0.7%	0.4%	1.4%	1.9%	1.4%	1.2%

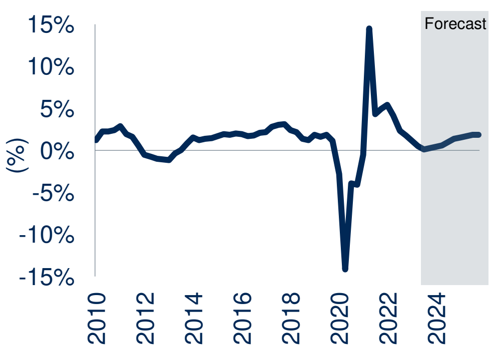
Source: Oxford Economics. As of October 2023.

FIGURE 3: EUROZONE ESI



Source: Eurostat. As of September 29, 2023.

FIGURE 4: EUROZONE GDP



Source: Oxford Economics. As of September 29, 2023.

Capital Markets

Commercial real estate transaction volumes remain exceptionally sluggish. Market liquidity remains at lows last seen in 2009. No sector or asset quality was immune from the sharp rise in interest rates. From a pricing perspective, the lowest yielding best prime properties have been negatively impacted the most (i.e., a yield convexity/multiplier effect). We believe considerable opportunity now presents.

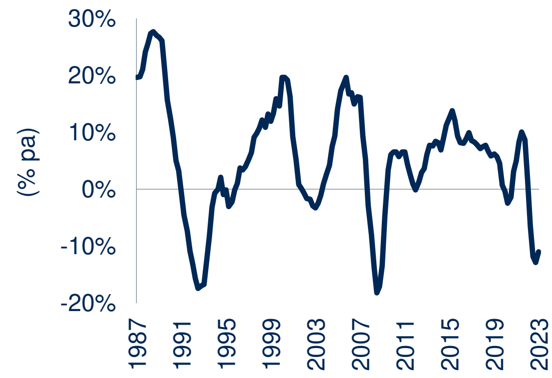
The trough of the property cycle is academically defined as the point at which the lowest rate of return occurs—that was earlier this summer (Figure 5). Further capital declines will still occur, albeit at a reduced pace. REIT pricing (a useful forward-looking direct market pricing indicator) has also bottomed out. A deeper second leg to the correction would likely require interest rates to remain elevated for a very prolonged period or ratchet up even higher.

At a sector level, upward yield movements have been indiscriminate to investment fundamentals.[2] Over the past 15-18 months, high street retail property, whose tenants have been pummeled by e-commerce, were up 50 bps to 4.5%. Logistics, which have benefitted from the same trends, saw a much larger 100 bps increase in yields to 5.25%. At the same time, despite an ESG turbocharged occupier "flight to quality" in the office sector, yields there, even though up 100 bps, are only 4.75% for even the rarest, greenest buildings. Residential yields have been slow to move, so far, but increases are now occurring.

In the early 1990s and during the GFC, prime capital values recorded downward adjustments of -20% to 30%, versus about -15% (so far) in the current cycle (Figure 6). This time, the impact has been partially offset by robust rental growth. Rents are up 8% versus a negative yield impact of -20% since mid-2022.

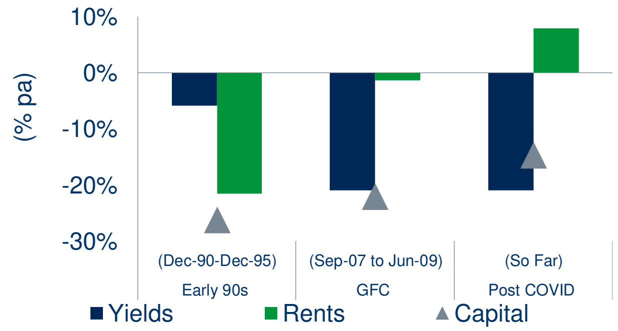
Real estate debt pricing held broadly stable in the third quarter, as central banks hopefully near the end of their tightening cycle. According to Chatham Financial, the five-year EURIBOR swap rate traded in a range between roughly 3% and 3.3%, while the SONIA equivalent was slightly more volatile, trading in the 4.4% to 5.3% range over the quarter (Figure 7). CRE debt margins were also stable, except for offices where prime margins drifted up 10 bps and secondary assets increased 20-30 bps. Lender activity will continue to focus primarily on the considerable challenge of refinancings and loan extensions.

FIGURE 5: EUROPEAN CRE CYCLE (CAPITAL VALUES)



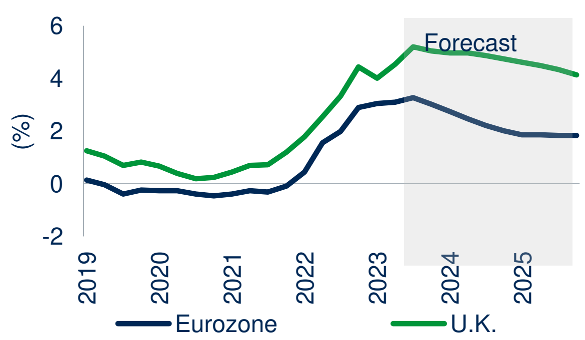
Source: CBRE, Cushman & Wakefield. As of October 2023.

FIGURE 6: EUROPEAN CRE PREVIOUS CORRECTIONS



Source: CBRE, Cushman & Wakefield. As of October 2023.

FIGURE 7: 5-YEAR INTEREST RATE SWAP



Source: Oxford Economic. As of October 2023.

[2] CBRE. As of October 2023.

Occupier Markets

OFFICE SECTOR

European take-up totaled 2.2 million sq m in the second quarter of 2023, down -28% from a year ago (Figure 8). Annual take-up reached 10.3 million sq m, down -10% on the 10-year average. Best-in-class, sustainable offices in well-connected locations are increasingly favored by occupiers. Existing tenants are increasingly focused on renegotiating leases to cut costs, which is likely the reason for the rise in reluctance to commit to long-term office space.

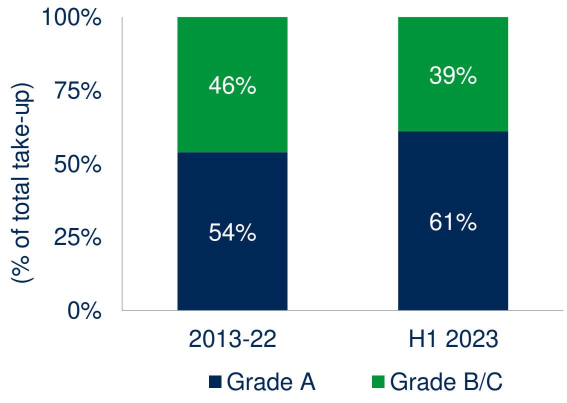
European office vacancy edged up to 8.1% in the second quarter, slightly ahead of the 10-year average (7.7%).[3] New-office starts—especially speculative new builds—have slowed, as higher construction and finance costs combined with labor shortages impact scheme viability. This should help to limit upward vacancy rate pressures.

KPMG's annual Global CEO Outlook survey suggests a corporate desire to return to the office (RTO), with 64% of the 1,300 respondents predicting a full return to in-office working by 2026 (Figure 9). And with 87% considering linking financial rewards and promotions with office attendance, this could be the impetus to get reluctant employees back in person. Business type will determine the extent of in-office working, with employers mindful of balancing their desires against the ability to attract and retain talent.

Despite a building RTO, a rising proportion of Europe's office stock faces redundancy. The best located will offer value-add opportunities to reposition for existing purpose, but a large proportion will likely need to be repurposed or redeveloped into alternative uses. This process could face some headwinds from the shift to a low carbon economy, as investors increasingly fear holding stranded assets. To minimize this risk, buyers are increasing incorporating transition risks into their acquisition due diligence. We expect some tough pricing negotiations to ensue.

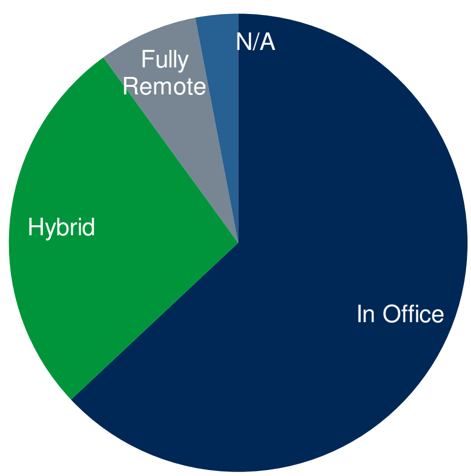
Prime office shortages continue to sustain positive rental growth momentum, with rents increasing by 0.9% quarter-over-quarter and 4.9% p.a. for the 12 months to September 2023.[4] Over the mid to long term, prime office growth prospects are to the upside, especially for net zero carbon offices—a product that barely exists in Europe and globally.

FIGURE 8: EUROPEAN OFFICE DEMAND



Source: Green Street, JLL, CBRE. As of October 2023.

FIGURE 9: CEO IN OFFICE EMPLOYEE EXPECTIONS[5]



Source: KPMG Global CEO Outlook survey. As of October 2023.

[3] Source: Cushman and Wakefield. As of July 2023.
[4] Source: CBRE. As of September 2023

[5] KPMG CEO Outlook 2023: In three years' time, how do you envisage the working environment for corporate employees whose roles were traditionally based in-office?

Occupier Markets

RETAIL SECTOR

From the cost-of-living crisis to weak consumer confidence, Europe's retail sector is facing cyclical challenges. Year-over-year Eurozone retail sales through August 2023 have been negative for 11 consecutive months (Figure 10).

On the upside, European retail footfall is steadily improving from pandemic lows, although it has yet to fully bounce back to pre-pandemic levels; visitor numbers in the first half of 2023 are down -7% versus 2019.[6] Retailer subsector performance has been mixed, with food & beverage, health and beauty, and sports still showing greater resilience to online. Operators are struggling, with rising debt costs weighing on independents and an uptick in mid-price fashion retailer bankruptcies.

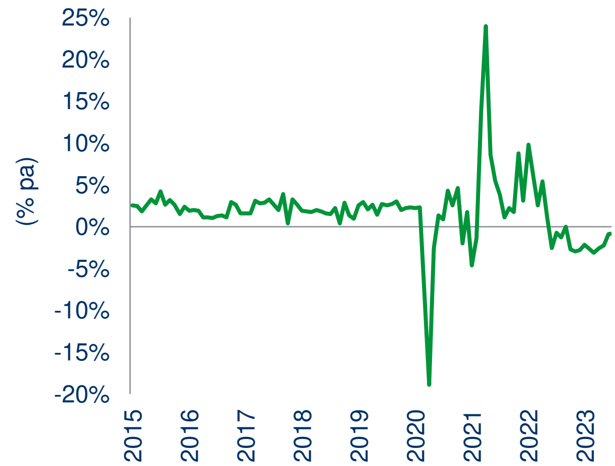
Retail vacancy held broadly steady through the first half of the year at 6.7%.[7] We expect to see some future upward pressures, with unit size reductions and store/portfolio rationalizations looking inevitable.

One upside of the recent surge in inflation is that nominal turnover is also up, and while other costs are also rising for operators, "efforts rates" (rent/turnover) have fallen and rent looks increasingly more affordable.

Following dire performance during the pandemic, prime retail rents seem to have turned a corner, rising by 2.6% p.a. in the third quarter of the year (Figure 11). In continental Europe, annual rental indexation is also sustaining positive net income growth, between reviews and lease renewals.

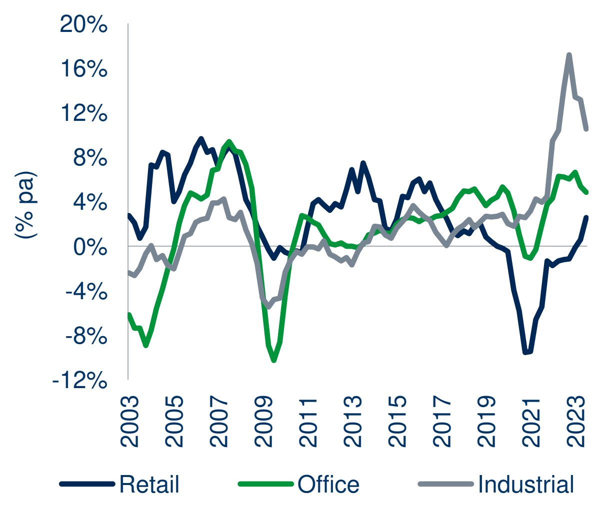
Our view remains unchanged: physical retail should remain relevant, with people continuing to visit stores. Omnichannel retailers—who embrace technology and find innovative ways to compete with online retailers should thrive. The metaverse has already created digital try-on technology. If social commerce— where customers that can buy goods via social media platforms rather than directly through the vendor website—takes off in Europe, as it has in China, in-store spending faces another threat.

FIGURE 10: EUROZONE RETAIL SALES



Source: Eurostat. As of October 2023.

FIGURE 11: EUROPEAN PRIME RENTAL GROWTH



Source: CBRE, Cushman & Wakefield, Barings. As of September 29, 2023.

[6] Source: CBRE. As of June 30, 2023.

[7] Source: CBRE. As of June 30, 2023.

Occupier Markets

INDUSTRIAL SECTOR

Take-up activity levels have slowed markedly, as market conditions revert to pre-pandemic norms and softer economic conditions weigh on logistics demand. In the second quarter of 2023, Italy was the only country where take-up exceeded the same quarter a year earlier (Figure 12). Third-party logistics (3PLs) remain the key demand driver, helping to compensate for the sharp drop in e-commerce demand as the sector readjusts back to pre-pandemic trend growth levels.

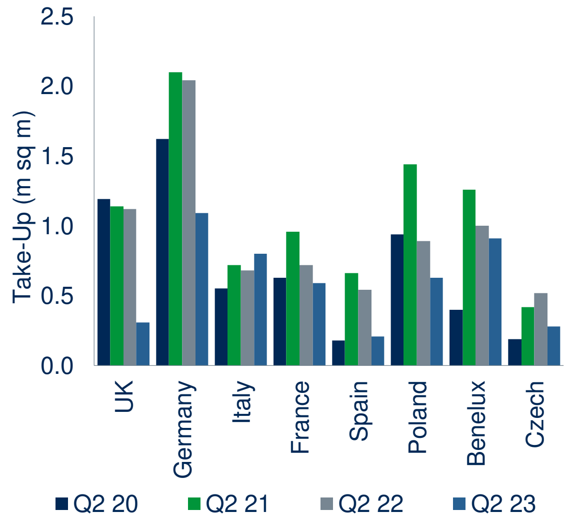
Strong development completion levels have pushed the aggregate European vacancy rate up to a still very tight 2.9%.[8] There has been a drop in new development schemes breaking ground due to rising property yields and higher borrowing and building costs that negatively impact scheme viability.

The European logistics sector is already suffering from chronic modern stock shortages (Figure 13). The market is lacking in suitable units capable of accommodating both rising technology and automation requirements, as well as satisfying rising green targets. We expect to see opportunities to upgrade, rebuild or repurpose older stock as the pace of obsolescence accelerates.

Resilient market fundamentals have underpinned double-digit rental growth performance. Through this year the pace has moderated, albeit growth remains very strong, with European prime industrial rents rising 10.5% p.a. or 2.1% quarter-over-quarter in the third quarter.[9] Ongoing supportive supply and demand conditions should help sustain future positive rental growth performance, albeit some further moderation in pace is anticipated, reflecting the softer near-term economic outlook.

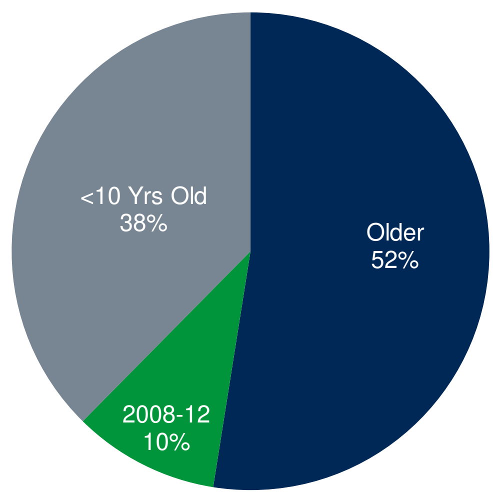
Post pandemic, occupiers continue to evolve strategies that boost resilience. Those with impending lease renewals are strategically evaluating their supply chain networks to ensure operations are optimally sited and efficiencies maximized. Manufacturers are also adding protection and actively relocating production closer to their customer base—but the challenge is finding suitable land with the necessary power supply and access to labor.

FIGURE 12: EUROPEAN LOGISTICS TAKE-UP (Q2 ONLY)



Source: CBRE. As of June 30, 2023.

FIGURE 13: EUROPEAN LOGISTICS STOCK VINTAGE



Source: JLL, Barings Research. As of June 30, 2023.

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[8] Source: CBRE. As of June 2023.
[9] Source: CBRE, Cushman & Wakefield, Barings. As of September 29, 2023.

Occupier Markets

ACCOMMODATION SECTOR

The imbalance between housing demand and supply is underpinning positive rental growth performance, with average Eurozone rents rising 2.6% p.a. in the third quarter of 2023 (Figure 14). In the U.K., rents have soared by 6.2% p.a., well ahead of France (2.2% p.a.), Germany (2.0% p.a.), Italy (2.6% p.a.) and Spain (2.0% p.a.). With long-term chronic supply-demand pressures expected to become acute, higher construction costs will likely delay new starts and elevated mortgage rates will sideline first-time buyers.

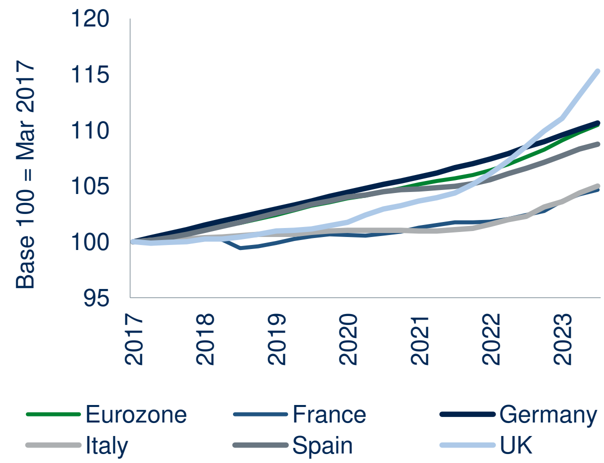
House price momentum has rapidly slowed, with Eurozone house prices declining -1.7% p.a. in the second quarter of 2023, compared to 9.2% p.a. a year earlier (Figure 15). Wide country variations exist, with the biggest declines in Germany (-9.9% p.a.) and Sweden (-6.9% pa). Growth remains positive in France (0.5% p.a.), Italy (0.7% p.a.), Spain (3.7% p.a.) and the U.K. (2.2% p.a.), albeit at a slower pace.

A modest Eurozone house price correction is forecast, although country performance will vary, with national mortgage market structure and pandemic house price run-up key influences. For example, while French and German borrowers typically favor fixed-rate longer maturity mortgages (i.e., 10-years and over), Germany's frothy pandemic house price growth and looser income limits imply a much sharper correction than in France.

In the U.K., the prevalence of fixed-rate mortgages initially shielded borrowers from rate hikes. But shorter U.K. mortgage fixes (typically five, and sometimes two years) mean an increasing number of households will soon need to "refi" at much higher mortgage rates.

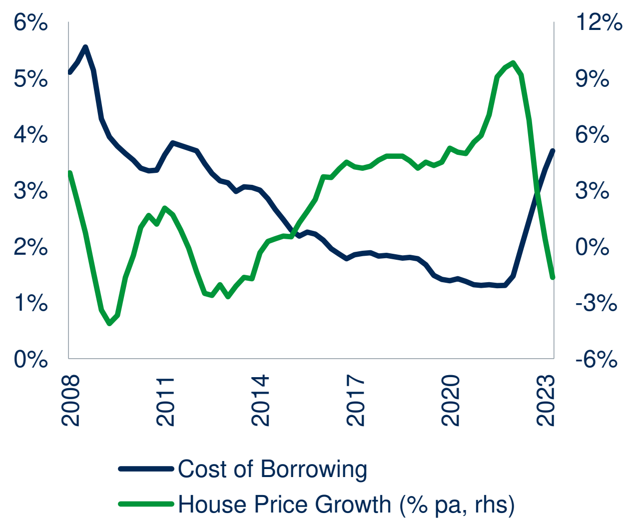
Europe's purpose-built student accommodation (PBSA) sector is performing strongly, with occupancy rates high at between 95% and 100% in the schemes tracked by sector data vendor Bonard.10 Demand is outstripping supply, with JLL estimating that only 15% of students in major European cities can access PBSA accommodation, forcing students into more costly private-market rental studio flats. Rising operational costs and no sign of the supply and demand balance easing bode well for future sector rental growth prospects.

FIGURE 14: RESIDENTIAL RENTAL GROWTH



Source: OECD. As of October 2023.

FIGURE 15: EUROZONE BORROWING COSTS VS. HOUSE PRICE GROWTH



Sources: ECB, OECD. As of October 2023.

[10] Source: Bonard. As September 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

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