European Real Estate: Let the Recovery Commence

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Executive Summary

ECONOMY

- Higher interest rates are set to continue to weigh on households and businesses, yet lower inflation means positive real income growth—and a gradual consumer-driven recovery is still expected.
- Survey data shows that the growth outlook remains finely balanced—strong for the service sector, much weaker for manufacturing.
- Falling inflation supports the ECB’s decision to gradually start reducing interest rates, but only two more cuts are currently expected this year.

PROPERTY MARKETS

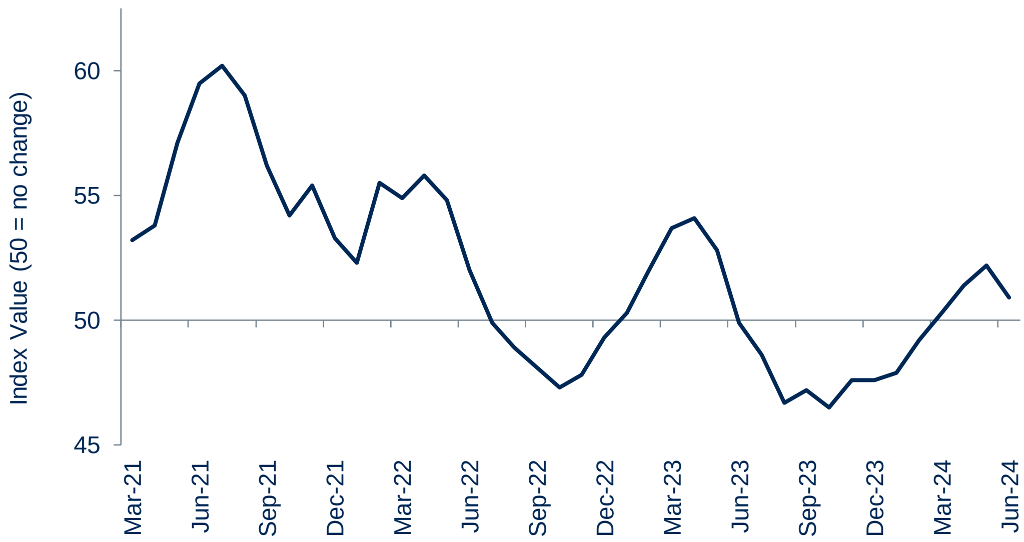
- The pace of the property market recovery will likely depend on variations in debt funding gaps by location and property type. The office sector, as well as the German and Swedish markets, could be potential laggards.
- Despite rising vacancy and sluggish letting activity, the occupier flight to quality explains why prime office rents are still rising.
- A consumer rebound driven by real wage growth, higher online costs and fulfilment dissatisfaction, plus historically low new development, potentially supports physical retail demand, but is still no match for e-commerce expansion headwinds.
- The logistics sector slowdown has been largely GDP driven. The green shoots of macro-economic recovery are already here; a revival in occupier activity is likely to follow soon.
- European house prices have proved remarkably resilient to the interest rates shock, partly due to tight labor markets and rising nominal wages, but also a shift to fixed-rate mortgage payments.

Economic Outlook

Oxford Economics forecasts Eurozone GDP growth of 0.8% for this year, rising to 1.7% in 2025. Higher interest rates are set to continue to weigh on households and businesses, but lower inflation means positive real income growth is likely over the near term. Gradual rate cuts will also help, with the normal inherent lags between monetary policy and the real economy.

High frequency survey data show the growth outlook remains finely balanced. The Eurozone composite PMI index dropped to 50.9 in June (just above the +50 growth threshold) from May's 12-month high of 52.2 (Figure 1). Strong service sector growth (52.8)—likely supported by strong tourism—helped offset a softer manufacturing sector that remains in contractionary territory (45.8). Labor markets remain resilient, with Eurozone unemployment well below the long-term trend (Figure 4).

FIGURE 1: EUROZONE COMPOSITE PURCHASING MANAGERS' INDEX (PMI)



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

Oxford Economics notes that following a strong tourist rebound in 2023, Madrid, Barcelona and Lisbon will see more moderate growth in their hospitality sectors in 2024 and 2025. The pace of expansion in Europe's two largest cities, London and Paris, will remain broadly stable in 2024, but stronger consumption will help boost their economic performance next year and beyond. They also note a strong rebound for CEE cities previously most impacted by Russian energy price inflation and reliance.

Eurozone inflation slowed to 2.5% per annum in June, from 2.6% per annum the previous month (Figure 3). Strong increases in services prices (4.1% per annum) partly offset a cooling in energy and fresh food costs. While this supports the European Central Bank's (ECB) June decision to start gradually reducing interest rates, elevated services prices will be cause for concern. A decline in U.S. inflation to 3.0% in June was an encouraging sign as U.S. numbers typically set the tone for global monetary policy.

The downward path of domestic inflation and wages is unlikely to be fast enough to reduce ECB hawkishness. Oxford Economics is now projecting only two additional rate cuts this year, probably in September and December (Figure 3).

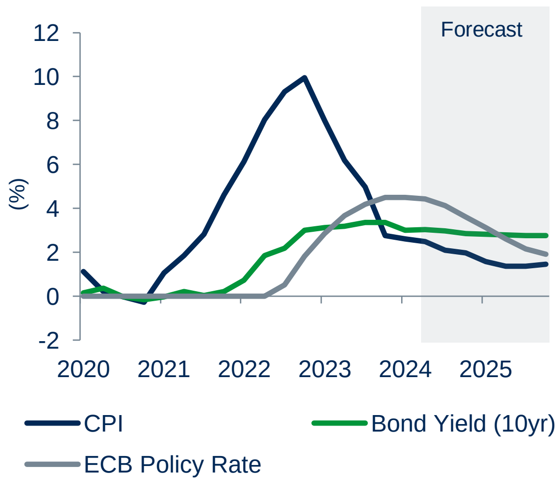
In European politics, the rise of the far right was thwarted in France while the Labour party secured a landslide electoral victory in the U.K., ending 14 years of Conservative rule. This has short-term positive implications for market stability, providing authorities maintain fiscal restraint and the discipline needed to avoid unnecessary global bond market volatility.

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

	2023	2024	2025	2026	2027	2028	2024–2028
France	1.1%	0.9%	1.7%	1.7%	1.4%	1.2%	1.4%
Germany	0.0%	0.1%	1.2%	1.8%	1.6%	1.3%	1.2%
Italy	1.0%	0.8%	1.1%	0.8%	0.3%	0.3%	0.7%
Netherlands	0.2%	0.7%	2.2%	1.8%	1.6%	1.6%	1.6%
Spain	2.5%	2.5%	1.9%	1.6%	1.5%	1.3%	1.8%
Sweden	0.1%	1.1%	2.1%	2.3%	2.0%	1.8%	1.9%
United Kingdom	0.1%	0.9%	2.0%	1.9%	1.6%	1.6%	1.6%

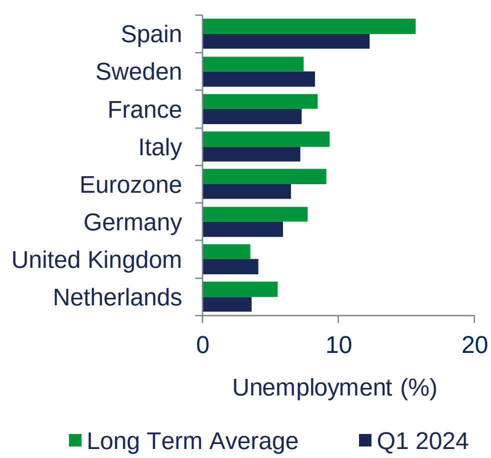
Source: Oxford Economics. As of July 2024.

FIGURE 3: EUROZONE INFLATION AND RATES



Source: Oxford Economics. As of July 2024.

FIGURE 4: EUROPEAN LABOR MARKETS



Source: Oxford Economics. As of July 2024.

Capital Market

European property market transactions remained subdued again this quarter, but real estate debt pricing and liquidity have improved. Refinancings and extensions still dominate lending activity, but lenders remain flexible despite loan covenant strains. Lenders are also now increasingly keen to deploy on new acquisitions, subject to appropriate pricing/valuation.

A more competitive core lending market means available leverage is beginning to rise again, with maximum LTVs at 60% for quality assets in preferred sectors such as logistics, living and data centers.[1] Chatham Financial reported a 10–15 basis points (bps) margin compression to sub-150 bps for prime logistics and residential deals in select markets. Office margins are yet to budge, remaining elevated at 200–250 bps for best-in-class properties. Non-bank lenders, providing core-plus loans, are able to charge much higher margins.

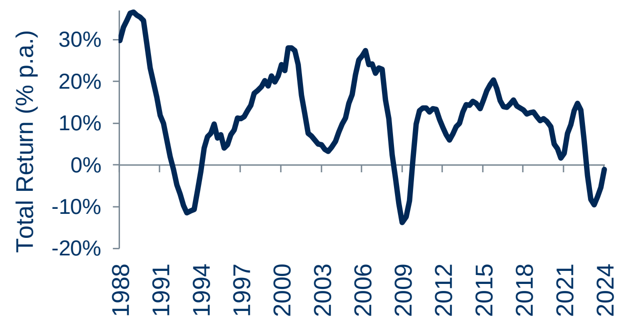
The trough of the property cycle passed when peak inflation and rate volatility occurred last summer (Figure 5). While market expectations have retrenched from multiple rapid rates cuts, the likely path remains downward and the largest declines in capital value are thus in the past. Transactions are set to gradually revive in the second half of 2024, but with capital heavily focused on select sectors the lack of suitable product could constrain deal flow.

Prime property yields have increased from 3.5% to 5.0% over the past 2½ years (Figure 6). Pricing is stabilizing, with CBRE reporting no significant yield movement during the second quarter of 2024. Excluding the positive impact of rental uplifts, the negative yield impact on prime values has been most pronounced in offices (-40%), followed by logistics (-30%), and least in shopping centers and student housing (-15%).

The shift to the growth phase of the property cycle has support via an economic pick-up underpinned by rising consumption, rising occupier activity and intensifying supply pressures for good quality accommodation. Positive rental growth combined with modest interest rate reductions point toward a little yield compression and rising property return prospects.

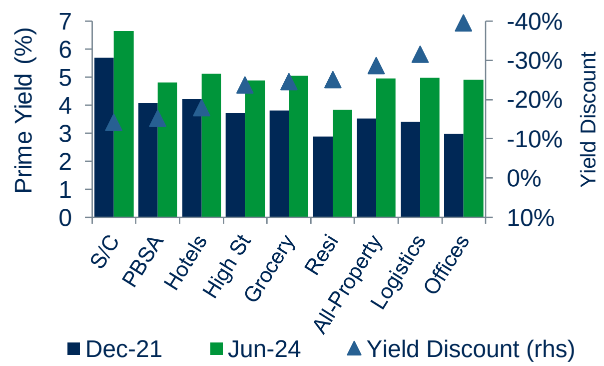
The pace of recovery will depend on variations in debt funding gaps (DFG) by location and property type (Figure 7). Offices account for about half of the DFG by asset type, and Germany and Sweden are also potential laggards on this same basis. Logistics looks relatively unimpeded, as does Spain and the U.K., meaning the recovery may be more rapid there.

FIGURE 5: EUROPEAN PROPERTY CYCLE



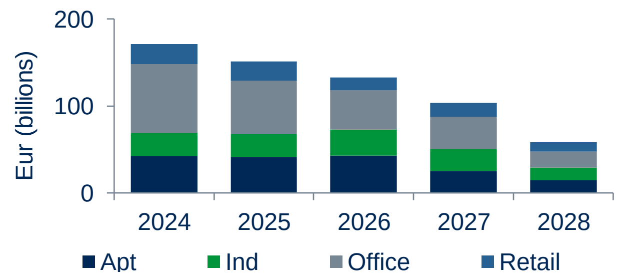
Sources: CBRE; C&W. As of July 2024.

FIGURE 6: EUROPEAN PRIME YIELDS



Source: CBRE. As of June 2024.

FIGURE 7: EUROPEAN DEBT MATURITY WALL



Sources: MSCI; Barings. As of April 2024.

[1] Source: Chatham Financial. As of July 2024.

Occupier Markets

OFFICE SECTOR

Cushman & Wakefield's European office vacancy rate continued to edge upward in early 2024 to 8.6%. Only marginally above its long-term average, it shows the sector's remarkable resilience given the negative news flow around offices. The volume of new supply (space under construction) totals just under 11 million sq m, or 4.5% of total stock. This is down -5% quarter-over-quarter and -10% year-over-year.

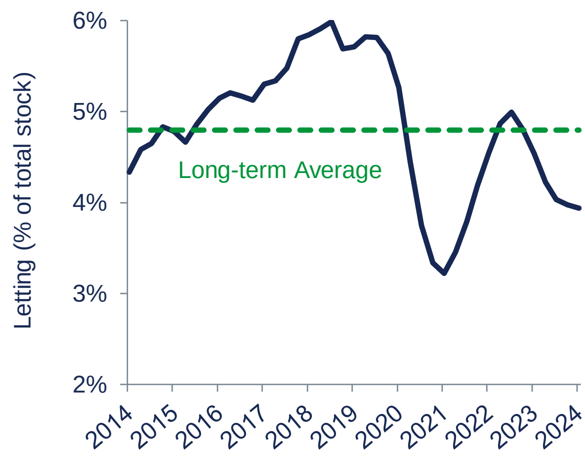
Lettings activity remains subdued, down over -15% quarter-over-quarter in the first quarter of 2024 and -20% below the long-term average (Figure 8). Spain's stronger economy helped it defy the overall European gloom, with lettings activity up 30% quarter-over-quarter.

Developer market conditions remain challenging. Savills notes that office build costs have risen by over 50% since the pandemic, ongoing labor shortages are prolonging completions, and lenders remain incredibly cautious around speculative office schemes. On the regulatory side, tighter whole-carbon planning policies and impending ESG occupational regulations means that an occupier shift toward pre-lets and heavy refurbished stock is occurring. The supply of new build, 'green' and state-of-the-art space will likely continue to struggle to match the occupier flight to quality.

Central Business Districts (CBDs) remain focal points for office developers, accounting for around 80% of space currently under construction, according to JLL. It is non-CBD locations that are expected to be impacted most by the net drop in office demand due to the rise in home working. The repurposing of obsolete city center offices to residential and hotels is increasingly prevalent, while some peripheral locations can be more suited to student housing.

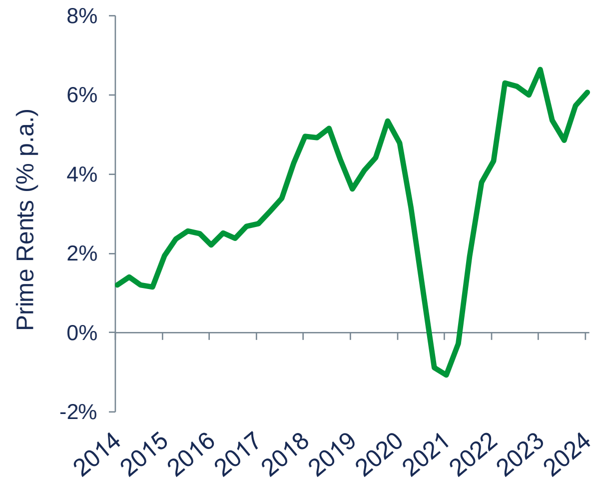
Despite rising vacancy, and still heavily subdued lettings activity, the occupier flight to quality explains why the pace of prime rental growth edged up again to over 6% per annum in the first quarter of 2024 (Figure 9). That contrasts with sub-par older space, currently suffering from accelerated obsolescence, rising vacancy and falling rental values. Today, the definition of a prime office extends beyond building specification, sustainability, and amenities to include transport connectivity and the quality of nearby leisure and retail provision.

FIGURE 8: EUROPEAN OFFICE TAKE-UP



Source: Cushman & Wakefield. As of June 2024.

FIGURE 9: EUROPEAN PRIME OFFICE RENTS



Source: Cushman & Wakefield. As of June 2024.

Occupier Markets

RETAIL SECTOR

Growth in real disposable income is the primary driver of real private consumption (+0.73 correlated over the past 20 years) (Figure 10). Consumption started to recover once the inflation surge began to ease last year. This continues into 2024, with inflation moderating toward the ECB's 2% target and wage growth outpacing prices. Anticipated interest rate cuts should provide further modest support, albeit higher interest rates typically increase savings propensity and thus reduce spending.

Eurozone retail sales volumes were positive for the third consecutive month in May, rising by 0.3% per annum.[2] While still weak, it's an improvement after the extended downswing following the fading of the 2021 pandemic reopening mini boom and the onset of the cost-of-living crisis. Property investors' hopes for a physical retail renaissance remain firmly on hold.

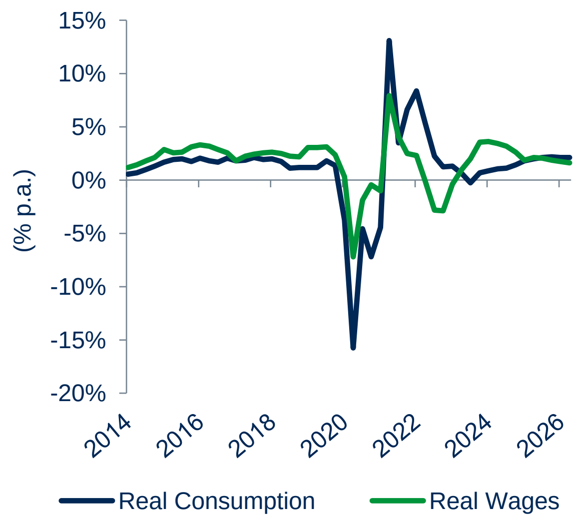
Footfall improved in 2023, up for top-end tourist hotspots, while secondary locations continue to lag. While competitive leasing conditions and even rental growth exist in the best locations, the rest are characterized by ebbing critical mass and reduced store offer/low in-store stock levels.

Retailer demand is thus mostly focused on top-tier city prime high streets, select dominant destination shopping centers and global tourist hotspots. While vacancy continues to rise at a national level, it is falling in the top cities.

Following a sharp drop during the pandemic years, prime retail rents are now growing, rising around 3% in the 12 months to the first quarter of 2024 (Figure 11). This lags office and logistics, where top rents are currently growing at double the pace.

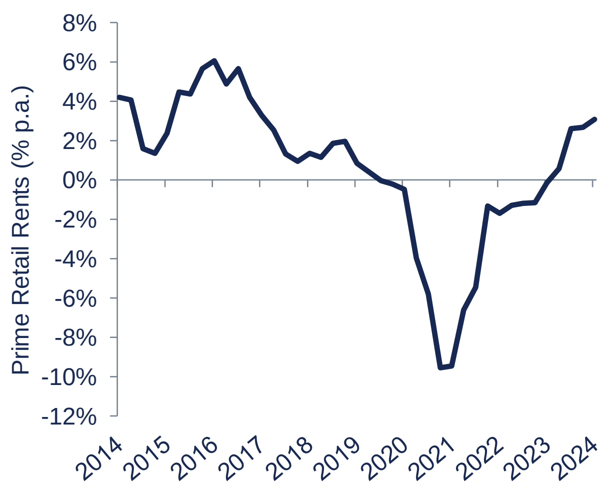
Retail bulls see sector upside, with real wage growth supporting consumption, higher online costs and customer fulfilment dissatisfaction, plus historically low new development that could potentially intensify retailer competition for quality modern space. While that is perhaps true for the very top pitches, we see the ongoing expansion of e-commerce continuing to weigh on physical stores.

FIGURE 10: REAL INCOME VS. CONSUMPTION



Source: Oxford Economics. As of July 2024.

FIGURE 11: PRIME RETAIL RENTS



Source: Cushman & Wakefield. As of June 2024.

[2] Source: Eurostat. As of June 2024.

Occupier Markets

INDUSTRIAL SECTOR

Savills reported European logistics take-up at 28.8 million sq m in 2023, down nearly 25% year-over-year but almost 10% above the pre-pandemic norm (Figure 12). The market awaits a pick-up in occupier activity, with just 6.2 million sq m of lettings in the first quarter of 2024.

The sector slowdown has been largely GDP driven. The green shoots of a macro-economic recovery should soon present, with consumption and investment set to become the main growth drivers. Rising consumption will likely boost industrial occupier activity.

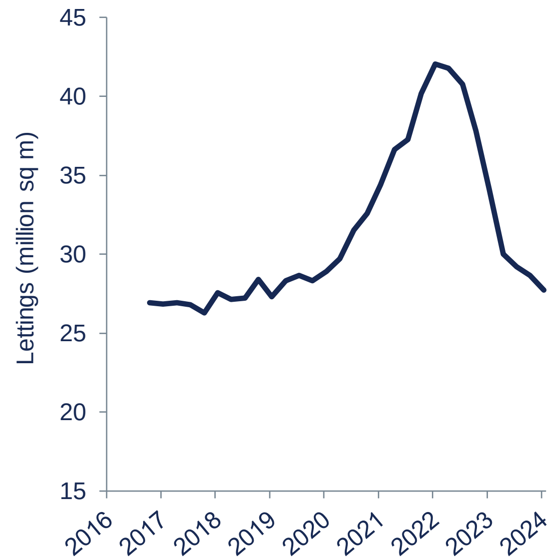
Higher interest rates have amplified the occupier slowdown, with corporates struggling to fund XXL build-to-suit (BTS) schemes. This part of the market is already showing renewed life in the U.K. Other parts of Europe are expected to follow suit relatively quickly, as access to finance improves, with lenders again open to looking at corporate real estate transactions.

The Savills' average European vacancy rate increased by around 50 bps during the first quarter of 2024 and about 200 bps over the past two years, to stand at 5.9% (Figure 13). Vacancy varies widely—double digit in Madrid and Poland (10% plus), but still sub 2.5% in Dublin, Prague and Denmark.

JLL reports new construction starts are currently at their lowest level in 10 years. Tighter planning, higher build costs, plus developer and lender restraint will limit the pipeline, meaning vacancy rates should soon start to edge down once again.

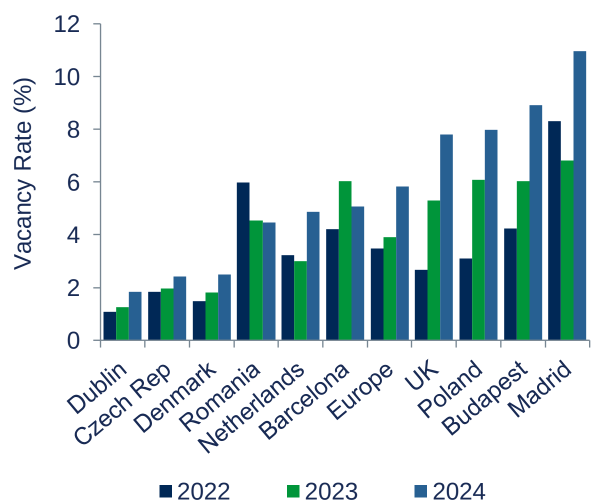
Despite sluggish letting demand and rising vacancy, rents continue to grow, with Cushman & Wakefield's prime logistics rents up 6.6% per annum in the first quarter of 2024. While the rate of growth has halved compared to a year ago, there remains considerable rental momentum at the top end of the market due to chronic shortages of modern space.

FIGURE 12: INDUSTRIAL TAKE-UP



Source: Savills. As of June 2024.

FIGURE 13: VACANCY RATES



Source: Savills. As of June 2024.

Occupier Markets

ACCOMMODATION SECTOR

European “living” real estate sectors are increasingly characterized by an intensifying structural undersupply due to lengthy planning processes, developers constrained by high construction costs, and a paucity of development financing. This will likely put considerable additional upward pressure on rents over the next few years.

Housing demand will remain strongest where demographics trends are most favorable in the key first-time buyer and renter (25–44 year-old) age cohort (Figure 14).

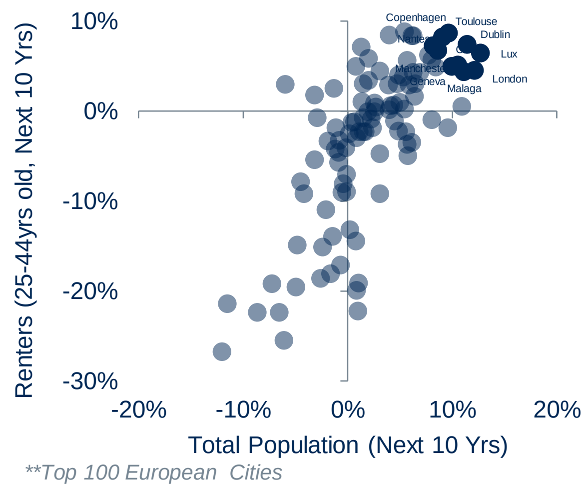
Surging interest rates over the past few years have made rents more “affordable” relative to mortgage payments, placing additional demand pressures on rental stock. Despite the threat of rising rent controls, the outlook for residential rental growth remains bright.

European house prices have proven remarkably resilient in the face of rising interest rates. This is partly due to tight labor markets and rising nominal wages, but also helped by countries shifting from variable-rate to fixed-rate mortgages (Figure 15). Ongoing wage growth, lower mortgage rates, and the likely persistence of long-term supply/demand imbalances, suggest further real house price growth looks likely.

The need for increased development of high-quality rental properties remains indisputable across Europe. Severe stock shortages partially explain why renters are staying in existing properties for longer. For example, in the U.K., Knight Frank reports more than 30% of renters have lived at the same address for more than five years, up from around 20% a decade ago. Reduced tenant turnover smooths cashflows and increases sector investment appeal to larger institutions.

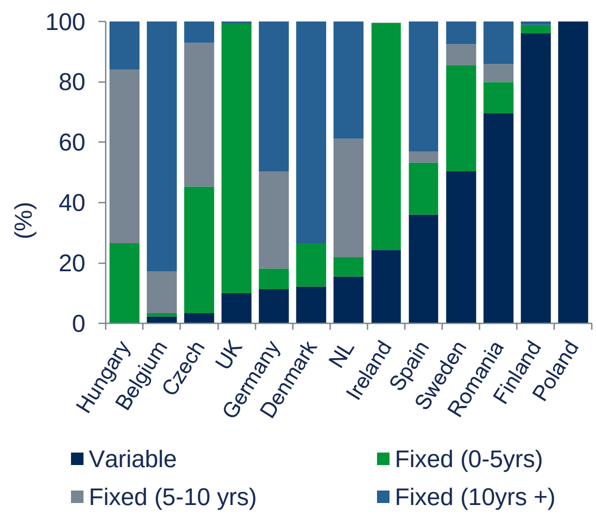
European student numbers continue to outstrip the supply of purpose-built student accommodation (PBSA). According to JLL’s European PBSA: Investing in the Future report, the current shortage of three million beds is set to deteriorate by 200,000 beds over the next five years. To match projected demand, the current private PBSA stock of 0.8 million will need to increase fourfold. That core unmet demand represents a €450 billion potential investment opportunity.

FIGURE 14: EUROPEAN POPULATION PROJECTIONS



Source: Oxford Economics. As of June 2024.

FIGURE 15: FIXED VS. VARIABLE MORTAGES



Sources: European Mortgage Federation; OECD Working Paper No 1693. As of 2019.

About the Team

Barings Real Estate's research 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

Ben Thatcher

Associate Director

Jo Warren

Director

Important Information