BARINGS

REAL ESTATE

European Real Estate: Prime's Time?

A cooling economic backdrop in Europe and prospects for further monetary policy easing favor core property—given its bond-like investment attributes—over secondary assets.

RESEARCH QUARTERLY

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Executive Summary

ECONOMY

- Economic momentum in Europe remains elusive, with hopes for real wage growth and firm labor markets to prevail.
- Financial market attention is now shifting toward disinflation and prospects for further monetary policy easing to boost economic growth.
- The current macroeconomic backdrop favors core real estate over secondary assets.

PROPERTY MARKETS

- The recovery phase of the property cycle has begun. More bond-like core property cashflows should immediately benefit through the lower cost of finance and narrowing in market debt funding gaps.
- Only a gradual pickup in investment transaction volumes is anticipated for the rest of the year, partly because of a reduced financeable opportunity set.
- Rents will likely continue to rise for best-in-class CBD office and logistics assets.
- Residential rental growth is broad based, but regulatory risks are higher.
- Retail may see some modest income growth but only where rents have been re-set low (relative to nominal turnover).

Economic Outlook

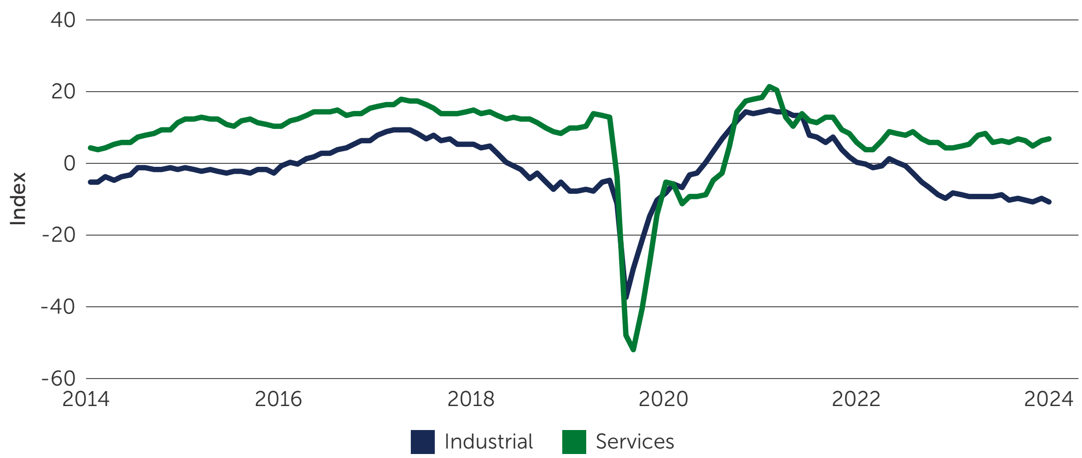
Eurozone GDP increased by a modest 0.3% quarter-over-quarter in Q1 2024, and then slowed to 0.2% in the second quarter. Growth expectations for the rest of the year are broadly similar, largely because high-frequency survey data over the summer period remained soft. The Eurozone's economic sentiment indicator (ESI) stood at 96.2 in September, down slightly from 96.5 in August and is still below the 100-growth tidemark.

European economic momentum remains elusive and the divergence between the struggling manufacturing and more robust service sectors will likely start to narrow—however, in a less encouraging direction with services likely to decline rather than manufacturing rise. Ongoing growth next year and beyond is predicated on modest real wage growth leading to rising household consumption, and labor markets remaining in decent shape to facilitate this.

Headline CPI inflation fell below the European Central Bank's (ECB) 2.0% target to 1.8% in September, and financial markets are now shifting their attention toward the likelihood of disinflation. Further monetary policy easing now looks inevitable and markets are currently pricing in another 150 basis points (bps) of cuts over the next 12 months.

With lower interest rates, but also reduced growth expectations increasingly the consensus, more bond-like core property values are likely to see an immediate benefit through the lower cost of finance and narrowing in debt funding gaps. In contrast, the recovery in more growth-dependent secondary assets will likely be pushed back.

Figure 1: Eurozone Economic Sentiment



Source: European Commission. As of October 2024.

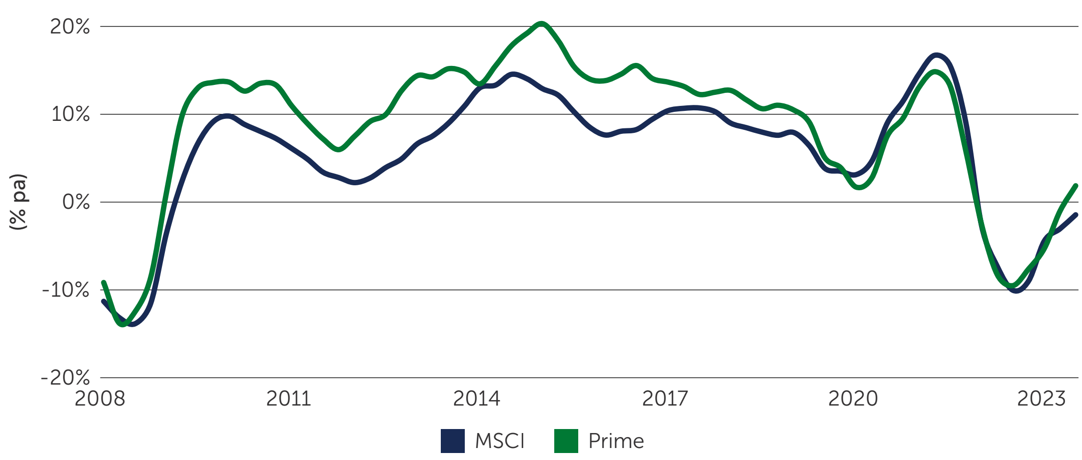
Capital Markets

With inflation beaten and interest rates falling back, European property yields stabilized this summer and investment returns are now swinging back into positive territory **(Figure 2)**. The recovery phase of the property cycle has therefore begun, but transaction volumes remain heavily muted today. The volume of deals under offer during the third quarter is still subdued and therefore only a gradual pickup in transactions is anticipated for the rest of the year. With investor interest mainly focused on the beds and sheds sectors, and away from offices for now, a limited opportunity set is another reason why sluggish transactional activity is likely to persist a little longer.

European lender surveys show an increasing appetite to boost lending activity, although understandably for now this will be mainly focused on refinancings in preferred sectors. Despite robust fundamentals for prime sustainable CBD offices, this property sector remains heavily out of favor, with lender preferences largely focused on industrial, student and multifamily assets. MSCI European senior and whole-loan debt fund total returns were around 6% and 7% per annum, respectively, compared to an annual unleveraged direct equity property return of -1.5% for the MSCI Europe Quarterly Property Index.[1]

While lower interest rates are supportive for real estate capital values, the impact will vary by asset type and quality. For property sectors and locations with decent demographics and other favorable societal trends, more bond-like core property cashflows will likely immediately benefit through a lower cost of finance and narrowing in market debt funding gaps. For value-add investors, the shift should prolong the opportunity to acquire existing secondary stock in need of improvement in core locations, at attractive prices.

Figure 2: European Real Estate Total Returns



Sources: MSCI; Cushman & Wakefield. As of October 2024.

1. Source: MSCI. As of June 30, 2024.

Occupier Markets

OFFICE SECTOR

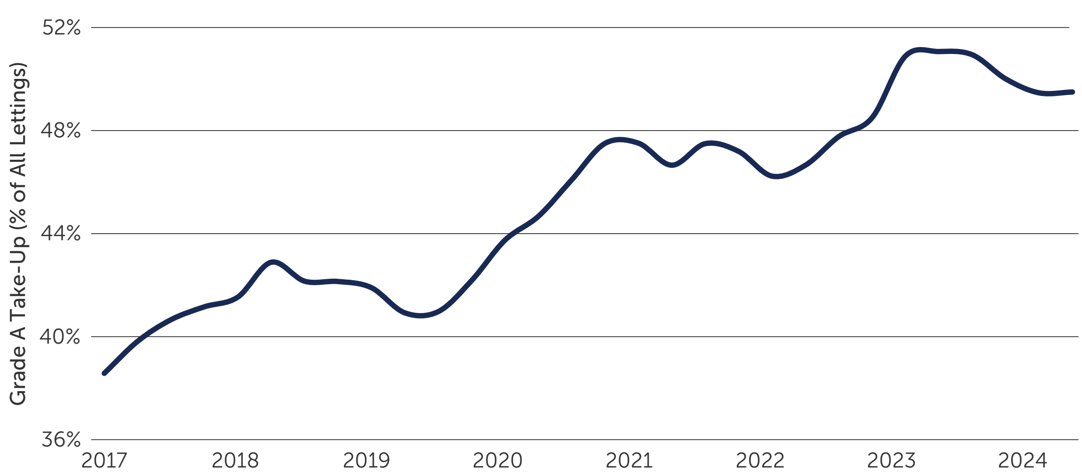
The top European office markets saw prime rents rise by over 6% per annum through the third quarter.[2] The "mega" office markets London and Paris both recorded 10% annual increases—pushing them into the top five—broadly in line with Madrid and Warsaw at 11% per annum, but lagging Brussels at 18% per annum.

London recorded a robust 25% increase in lettings in the third quarter, outpaced by much smaller Dublin where activity doubled, and Barcelona, Brussels and Munich where volumes were up by 30% to 40%.[3] Local agents report that the surging take-up in these locations was driven by large lettings (exceeding 10,000 sq m). This is encouraging for overall market confidence in this heavily beleaguered and out-of-fashion sector.

Pan-European office vacancy continues to drift upward to just over 8%.[4] Letting agents attribute this to a demand polarization—in other words, a flight to quality. In particular, there is strong demand for best-in-class assets in prime locations, while lower-quality peripheral offices remain heavily out of favor. In many markets, CBD vacancy rates are much tighter, typically below 5%.

As noted in our recent paper, office investment once accounted for the lion's share of institutional property allocations at 50% or more in some markets. With office transactions over the past year accounting for less than 25% of investment activity, it could potentially indicate where office allocations may be trending over the rest of this decade.

Figure 3: European Grade A Office Take-Up



Source: Cushman & Wakefield. As of July 2024.

2. Source: BNP Paribas Real Estate. As of September 30, 2024.
3. Source: BNP Paribas Real Estate. As of September 30, 2024.
4. Source: JLL. As of September 30, 2024.

Occupier Markets

RETAIL SECTOR

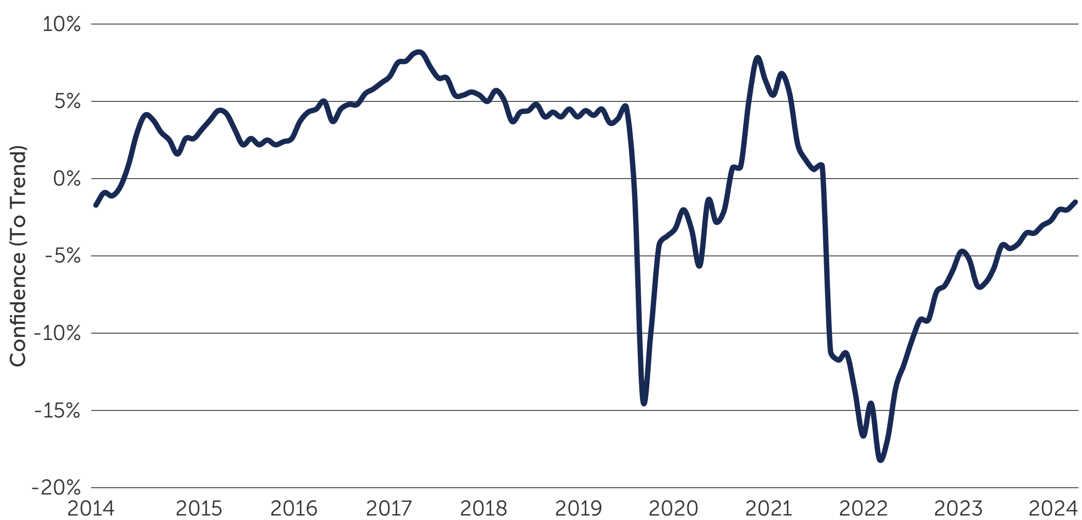
The retail climate remained challenging this summer. Eurozone retail sales volumes were up 0.2% month-over-month in August and broadly flat in July.[5] They were also still very subdued at 0.8% year-over-year.

A restrained spending backdrop aligns with consumer confidence that is only gradually recovering **(Figure 4)**. Falling interest rates should provide an added boost to sentiment and sales in 2025, providing labor markets remain tight, and wages continue to increase and claw back purchasing power following the 2022/2023 inflation shock.

European tourism rallied this summer, mainly due to rising internal European trips and the return of U.S. international visitors. This is not only a boon for hotel, hospitality, and leisure/experiential operators, but also retail spending on luxury brands.

Some scope for rental growth for physical retail may exist where rents have previously been appropriately rebased. The inflation spike has driven up nominal turnover and therefore the effort rate (the rent to turnover ratio) has plunged. The more online-resilient the retail category the better—for instance, hardware (DIY), homeware, garden and grocery. That likely explains, in part, why CBRE's European retail park footfall is now higher, and vacancy has fallen from around 6% to just 1% compared to pre-pandemic levels.[6]

Figure 4: European Consumer Confidence



Source: Eurostat. As of September 2024.

5. Source: Eurostat. June 30, 2024.
6. Source: CBRE European Shopping Centres Performance Index. As of June 30, 2024.

Occupier Markets

INDUSTRIAL SECTOR

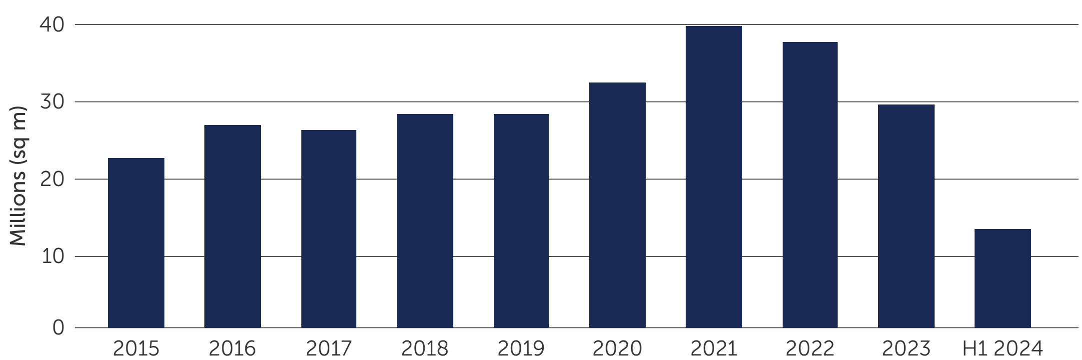
According to Savills, industrial leasing activity retrieved some ground in the second quarter, recording a quarterly increase of 20% **(Figure 5)**. However, the total seen in the first half of this year was slightly below the same period last year. Soft economic conditions have no doubt impeded outperformance, with e-commerce providers pulling back (for now). An emerging bright spot is demand from manufacturing, which increased its share to 20% this quarter (particularly in EV production and pharmaceuticals).[7]

CEE countries outperformed in the second quarter with quarterly increases in leasing activity recorded in Romania, Budapest and Poland (which were all in excess of 90% quarter-over-quarter), while the Netherlands and Italy were down -4%.[8] The U.K. is also performing well, with the first half of 2024 up 43% on the same period last year.

The European logistics vacancy rate edged up to 6.0% in the second quarter, up 25 bps over the quarter and 144 bps over the last 12 months.[9] CBRE reports that space currently under construction is down almost 20% compared to Q2 2023; easing completions should support the absorption of existing vacant space.

Near-term occupier performance might look soft compared to 2021/2022 when lettings activity levels hit all-time highs, but underlying conditions remain structurally sound, as evident in rental growth performance. Average prime European industrial rental growth has softened compared to pandemic era highs (17.3% per annum in 2022), but remains strong at 5.7% per annum in the second quarter.[10] Growth prospects remain positive, underpinned by a resumption in the build out of online retail channels, and rising re- and near-shoring activity as businesses strengthen supply chains.

Figure 5: Logistics Take-Up



Source: Savills. As of June 30, 2024.

7. Source: JLL. As of June 30, 2024
8. Source: Savills. As of June 30, 2024.
9. Source: JLL. As of June 30, 2024.
10. Source: Cushman & Wakefield. As of June 30, 2024.

Occupier Markets

RESIDENTIAL SECTOR

House price falls are behind us. In the second quarter, Eurozone house prices increased 1.8% quarter-over-quarter, and 1.3% on an annual basis.[11] At an individual country level, the Netherlands and Spain are leading the recovery with prices up about 8% per annum. In the heavily hammered German market, prices increased 1.3% quarter-over-quarter, pushing the annual growth up to -2.6%. In the U.K., more timely Nationwide data show that house prices increased 0.7% quarter-over-quarter during the third quarter, with the annual rate rising to 2.5% **(Figure 6)**.

The ECB's mortgage rate declined to 3.7% in August, down from 4.0% last November, but up from an early 2022 low of 1.3%. In addition to lower mortgage rates, gently rising wages and salaries underpin the house price recovery.

Where demographics growth is positive, housing demand should remain strong. Paradoxically, the propensity to rent has increased with higher interest rates making renting relatively more than owning—a significant market rental growth support.

While a sector favored by lenders, residential development financing costs have surged. While build cost inflation has leveled off in line with general inflation, labor and material costs remain elevated.[12] Pricing is down and while exit certainty is set to improve, positive development viability is currently a stretch.

The protracted planning process, impending sustainability legislation, and possibility of increased rent controls in some markets all point toward less future development. That means the current housing crisis across European cities will likely intensify. This is why, despite concerns about the absolute affordability of either buying or renting, prices look set to see a period of gentle positive appreciation.

Figure 6: U.K. House Prices

Source: Nationwide. As of October 2024.

11. Source: Eurostat. As of June 30, 2024.
12. Source: Eurostat. As of June 30, 2024.

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.

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