REAL ESTATE

# European Real Estate: Can the U.K. Continue to Lead the Recovery?

The U.K. led the rest of the world's property markets in 2024—but now faces higher U.S.-style interest rates, and a much cooler Eurozone-style growth climate.

RESEARCH QUARTERLY


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# Executive Summary

## ECONOMY

- The Eurozone and U.K. economic recoveries disappointed in 2024, with no strong pick-up forecast in 2025.
- The ECB and BoE are set to continue to cut interest rates, despite global bond market volatility around the new U.S. administration's potential policies.
- Assuming prime rents continue to grow, and interest rates fall, further real estate value appreciation looks highly probable this year—yet jittery global bond markets in early 2025 are a reminder that the path will not be plain sailing.

## PROPERTY MARKETS

- Prime rental growth is largely the consequence of chronic modern space shortages. With the development pipeline generally slowing, this lack of supply is only going to worsen over the next few years.
- U.K. prime rental growth is outpacing other parts of Europe. The U.K.'s ultra-transparent property market is expected to continue to outperform the rest of Europe in 2025 and perhaps into 2026.
- Pressure to invest at the beginning of a new property cycle means capital will be tempted to seep into other sectors, with less than positive long-term prospects.
- At the country/city and property sector levels, the speed of interest rate cuts, pace of rental growth and manageable refinancing debt funding gaps will likely dictate relative performance.
- Retail may see some modest income growth but only where rents have been re-set low (relative to nominal turnover).

# Economic Outlook

The Eurozone and U.K. economic recoveries both disappointed in 2024 at just over 1% p.a. GDP growth **(Figure 1)**. Oxford Economics expect momentum to remain modest over the next two years, with the U.K. up 1.6% p.a. this year and 1.7% p.a. in 2026. That outpaces the Eurozone at 1.3% p.a. in 2025 and 1.5% p.a. the following year, but only just.

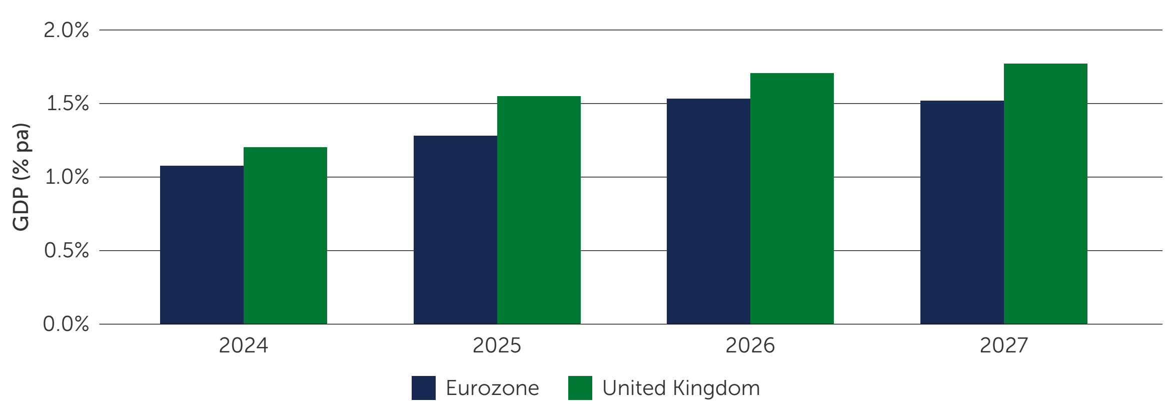
U.K. marginal outperformance comes despite significantly higher interest rates weighing on households across the country. In the Eurozone, outlook risks are focused on tariff threats from President Donald Trump's second-term agenda, with their impact likely greater on a more export-reliant business sector than the U.K. Potential impacts from tariffs possibly say more about corporate sentiment and ultimately hiring intentions and labor markets, rather than direct trade.

Eurozone headline inflation increased for the third consecutive month to 2.4% p.a. in December, pushed up by expected energy-related base effects, while U.K. inflation unexpectedly edged lower to 2.5% p.a. Inflation remains a risk, particularly in the U.K. where some inflation stickiness is anticipated—especially given the increase in employer national insurance contributions (NICs) from April 2025.

The European Central Bank (ECB) is expected to continue to cut interest rates as pricing pressures trend lower and growth momentum remains elusive. Similarly, the Bank of England (BoE) should look through one-off tax impacts and continue to steadily cut rates to help boost growth. By the end of 2025, Oxford Economics is forecasting a 150 basis points (bps) fall in the ECB policy rate to 1.9%, and a 100 bps decline in the BoE policy rate to 3.85%.

Despite the weak economic climate, prime European rents are growing above inflation and their historic trend (see below), largely due to the chronic modern space shortages. With ongoing constraints in the development pipeline, rents should continue to rise for the best properties. Positive rental growth and falling interest rate expectations suggest that some modest property yield compression is possible later in 2025 and into 2026.

**Figure 1: Economic Growth**




Source: Oxford Economics. As of January 2025.

# Capital Markets

Liquidity remained more heavily subdued than anticipated last year, with Savills estimating total European commercial real estate (CRE) investment reached around €170 billion—an increase of 15% on 2023, but still below average. The market refrain of recent years to "stay alive until 25" is proving to have been remarkably prescient, albeit bond market jitters in early 2025 are a reminder the path to recovery will likely not be plain sailing.

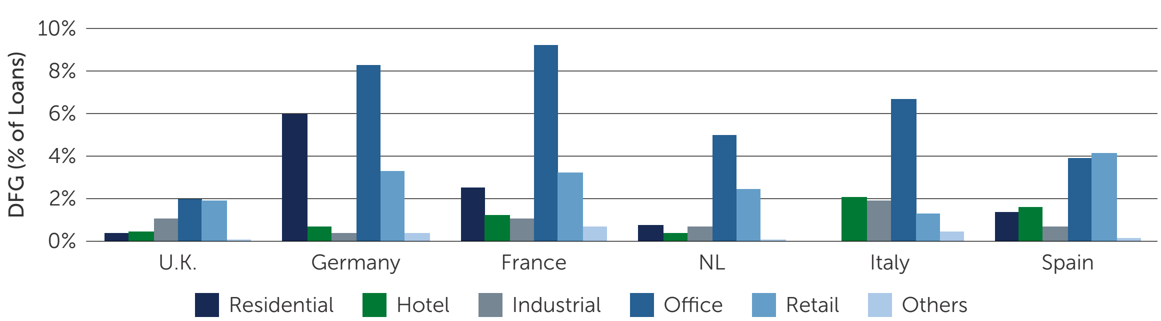
U.K. and Eurozone total returns are set to rise this year, making it a favorable time to invest in both markets. Income return will be the primary performance driver, with some rental-driven capital growth and even a little modest yield compression expected. With property yields typically higher in the U.K., and prime rents outpacing other parts of Europe, the ultra-transparent U.K. property market should continue to outpace the rest of Europe this year and maybe even in 2026.

As investors continue to heavily focus on select property market segments (mainly beds and sheds), this limits the opportunity set, likely slowing the recovery in transaction volumes this year. Pressure to invest at the beginning of a new property cycle means capital will likely begin to seep into other sectors, with some having better long-term foundations than others. Shopping centers currently look like a prime target for "hot money"—particularly for investors with an opportunistic mindset and ultra-short run property investment horizons (see Retail Sector below).

Lending market conditions also improved in the final quarter of 2024, with Chatham Financial noting, "After lenders became more comfortable with competing on higher leverage levels last quarter, they have now started to compete on a margin basis." Through the quarter, margins moved 10-20 bps narrower in the mainstream commercial sectors, and remained flat in the already keenly priced residential market.[1]

Although U.K. market interest rates are now roughly double the Eurozone (5-yr U.K. SONIA is at 4% versus 5-yr EURIBOR at 2%[1]), refinancing debt funding gaps are actually greater in the core north Eurozone markets, where reference rates were close to zero five years ago **(Figure 2)**. This refi base effect is another reason the U.K. and Spain should continue to lead other parts of Europe in the initial stages of the growth cycle phase. It also explains why the office sector will lag logistics.

**Figure 2: Refinancing Debt Funding Gaps**




Source: MSCI; Moody's; MSCI. As of September 2024.

1. Source: Chatham Financial. As of December 2024.

# Occupier Markets

## OFFICE SECTOR

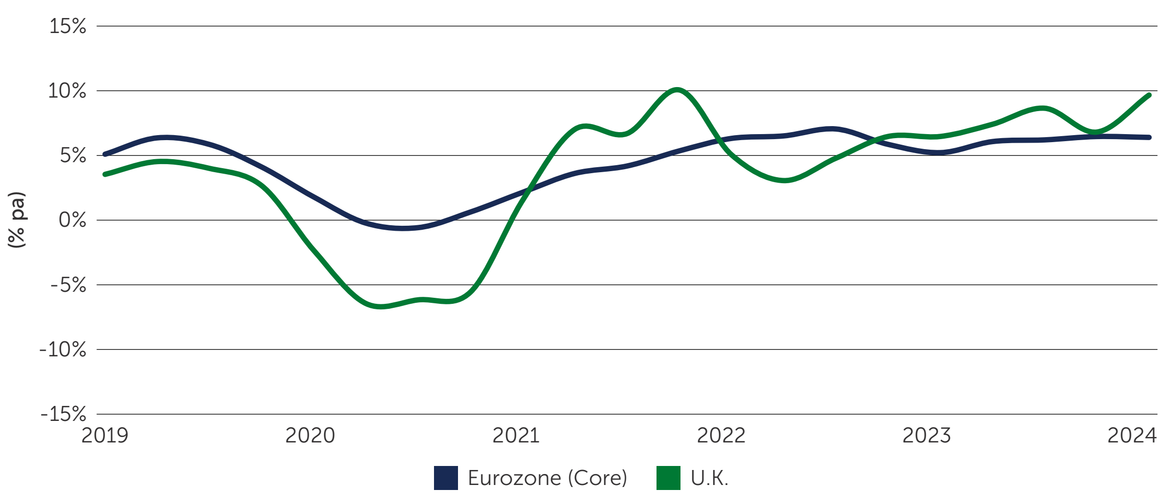
The European office vacancy rate will likely peak at just over 9%in 2025—similar to previous cyclical highs in 2004 and 2011.[2] Annual take-up is currently around 10% below the long-run average, and broadly flat on the year. These supply and demand dynamics, while negative, are remarkably robust compared to what many predicted with the rise and persistence of working from home back in the pandemic years of 2020/21.

The European vacancy rate increased around 80+ bps p.a. in the year through September 2024.[2] This contrasts with key U.K. markets where office voids have been shrinking, with vacancy down around 40 bps p.a. in London's West End and by around 80 bps p.a. in Manchester.[2] This places U.K. office markets slightly ahead of their mainland European peer group.

While the overall European office market saw a 12% decrease in development activity in 2024, U.K. office space under construction picked up 15%.[2] Much of this is focused on central London, where the drive toward new build, and the upgrade and refurbishment of existing buildings to meet sustainability regulations, is now in full swing. At around 5% of existing stock, current central London office development is considered manageable, given that ESG orientated tenant active requirements are currently outpacing new supply levels by many multiples.[2]

As Savills noted earlier this year, "occupiers are prioritizing higher-quality space in well-connected locations with established amenities and good sustainability credentials." That explains the two-tier market, where strong prime rental growth is possible despite the excess of supply over demand at an overall market level. In core Eurozone cities, rental growth is currently running at over 6% p.a., and nearly 10% pa in U.K. cities **(Figure 3)**.

**Figure 3: Prime Office Headline Rental Growth**




Sources: MSCI; C&W. As of October 2024.

2. Source: Cushman & Wakefield. As of September 2024.

# Occupier Markets

## RETAIL SECTOR

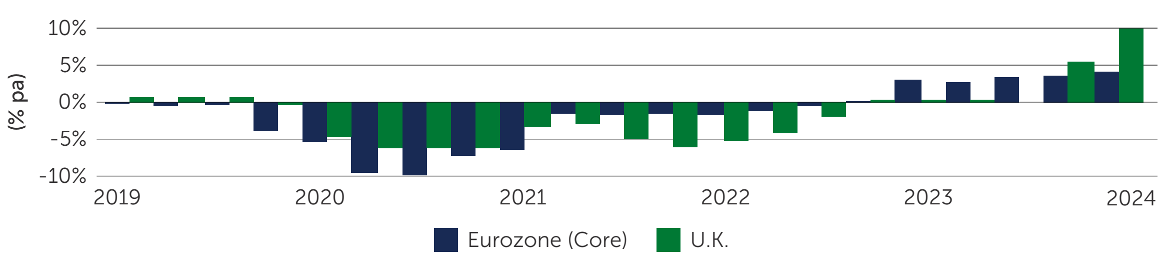
While U.K. consumer confidence edged up in December (GfK -17[3]), the Eurozone eased back slightly (EC -14.5[4]), although both remain subdued and below their respective long-term averages. This reflects the impact of the lingering cost-of-living crisis, with concerns about higher store prices and mortgage interest rates continuing to filter through. Short-term trends in retail sales volumes (the quantity of goods bought) are also showing a similar pattern, with anemic growth in the U.K. at 0.2% m-o-m[5] and 0.1% m-o-m[6] in the Eurozone in November.

Despite the highly subdued retail climate, prime shop rents are growing. Analysis of Cushman & Wakefield's prime rents for Europe's top shopping streets show an average uplift of over 5% p.a. to September 2024. It also reveals an accelerating trend with most growth occurring in the past six months. Disaggregating the analysis into core Eurozone and U.K. shows that U.K. prime pitches are outperforming with rents rising 10% p.a. compared to 4% p.a. **(Figure 4)**.

The apparent paradox of poor consumer sentiment and retail sales, yet rising prime rents, is probably best understood through the lens of what has been happening to retail rental "effort rates" (the ratio of rent to turnover). Over the past three years, Eurozone retail sales volumes have been flat, and in the U.K., they have actually fallen 7%.[7] This contrasts with sales values (cash through the tills), which increased 10–15% on the back of surging inflation in recent years.[8] In Spain, in particular, sales values rose by 30% in just three years, eclipsing other key European markets by some way!

Where rents have shown previous softness (perhaps more in major shopping malls than the prime pitch shops rents mentioned above), the inflation surge in nominal turnover is driving effort rates down and rental growth scope upwards. However, the soft outlook for the consumer climate and anticipated ongoing e-commerce expansion across Europe suggests rising rents are likely to prove a temporary cyclical phenomenon. This is better suited to opportunistic investors with ultra-short run property investment horizons than strategic long-term real estate investors.

**Figure 4: European Consumer Confidence**




Source: Eurostat. As of September 2024.

3. Source: GfK Group. As of December 2024.
4. Source: European Commission. As of December 2024
5. Source: Office for National Statistics. As of November 2024.
6. Source: Eurostat. As of November 2024.
7. Source: Oxford Economics. As of December 2024.

# Occupier Markets

## INDUSTRIAL SECTOR

Despite the inherent structural tailwinds for the industrial sector, it continues to face a cyclical slowdown. Since the beginning of 2023, the rolling 12-month European take-up figure has been trending downward, and in the third quarter of 2024 it troughed at a little over 20 million sq m, down roughly 16% a year ago.[8]

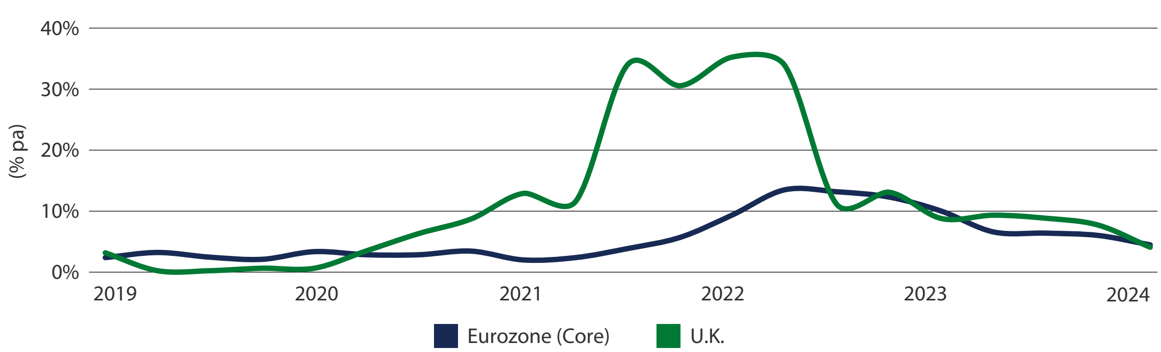
According to CBRE, U.K. leasing activity has outperformed, rising 33% over the 12-month period to September 2024. This contrasted with the Benelux, France and Germany, with declines of -34%, -27%, and -25%, respectively. Southern Europe's slowdown has been more moderate, with Italy and Spain recording declines of -15% and -9%, respectively.

JLL has attributed recent underperformance to the decline in third party logistics operators (3PLs), which usually account for the majority of activity, alongside softer manufacturing activity, especially via Europe's auto industry.  Savills also anecdotally reported increased demand from manufacturing occupiers in Central and Easter Europe, with Asia Pacific occupiers particularly active—perhaps on the back of a near-shoring supply chain resilience building trend.

Through the third quarter, the aggregate European vacancy rate eased very slightly to 5.9%.[9] There were also signs of supply levels stabilizing, with 60% of the markets tracked by Savills recording vacancy rate declines, compared to 30% of markets (including the U.K.) recording vacancy rate increases.

Rents continued to grow, increasing by around 4% p.a. in both the core Eurozone and U.K. markets in the year through to September 2024 **(Figure 5)**. That said, on a quarterly basis, there was little growth momentum. Tariff concerns may yet place more leasing activity on ice and hinder rental growth in the near term. However, the tailwinds of e-commerce expansion and supply chain resilience building will continue to maintain favorable long-term support.

**Figure 5: Prime Logistics Headline Rental Growth**




Source: Cushman & Wakefield. As of December 2024.

8. Source: CBRE. As of September 2024.
9. Source: Savills. As of December 2024.

# Occupier Markets

## RESIDENTIAL SECTOR

Eurozone and U.K. house prices increased by 2.6% p.a.[10] and 2.5% p.a.,[11] respectively, in the third quarter. Growth continued to strengthen in the U.K., with prices rising 3.6% p.a. in the fourth quarter.[11] Even the hardest hit German housing market saw prices grow 3.7% p.a. through December.[12]

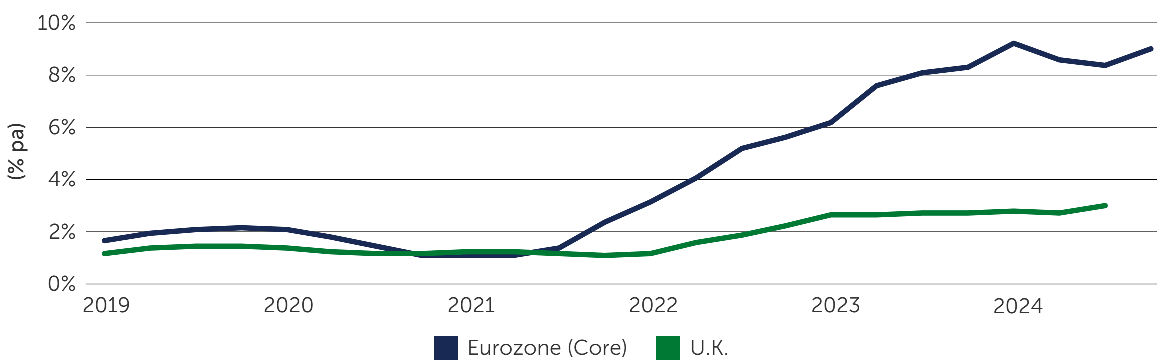
Last year's housing market recovery surprised to the upside, particularly as the ongoing cost-of-living crisis continued to cast a cloud over the consumer sector (see Retail Sector above). Strong rental growth in recent years has also not helped the ability of first-time buyers to save for a mortgage deposit, and they remain vital to the market as transaction chain initiators.

While interest rate cuts are a plus for future capital appreciation prospects, those having to re-mortgage will see their monthly interest payments double, maybe even treble. House prices remain high relative to earnings, with the recent modest price correction doing little to improve buyer affordability. Only strong recent wage growth over the past two years of around 10% can explain the market rebound.[13]

Eurozone rents increased by 3.0% p.a. and by 8.4% p.a. in the U.K. in the third quarter **(Figure 6)**. Strong wage growth has also helped renters absorb rising rents, but with wage growth projected to moderate, rental affordability will likely worsen. Supportive market conditions—housing shortages, impending rate cuts and the tight labor market—are expected to underpin further gentle rental and house price appreciation, perhaps in the 2–4% p.a. range in the next few years.

The long-term case for residential investment remains compelling, with housing shortages likely to prevail, as high land prices and increased construction costs weigh on profitability and limit new developments.

**Figure 6: Residential Rental Growth**




Sources: Eurostat; Office for National Statistics. As of September 2024.

10. Source: Eurostat Eurozone House Price Index. As of September 2024.
11. Source: Nationwide U.K. House Price Index. As of September 2024.
12. Source: Europace House Price Index. As of December 2024.
13. Source: Oxford Economics. As of December 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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