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Real Estate Outlook – Europe

Sharp drop in liquidity.

UBS

UBS Asset Management

Zachary Gauge
Head of Real Estate Research & Strategy – Europe ex DACH

"European property values have only moved down marginally and have a long way to go to reach a level that reflects the higher interest rate environment. The UK is an exception, which after a –13% correction in 4Q22 appears attractively priced versus other global markets."

Some economic risks dissipate

Economy
Much of the economic commentary in 2022 focused on how higher inflation and interest rates would impact the European economy in 2023. But as we kick off the year, there is a cautious optimism that the actual impact on the economy may not be as bad as previously feared. The eurozone is now expected to avoid a recession in 2023 (UBS Investment Bank forecast +0.8% GDP growth). The risk of gas shortages has eased with the unseasonably warm winter and the economy has been boosted by the easing of supply chain stress, and the reopening of China lifting industrial production and export prospects. The UK is still forecast to have a recession in 2023 (UBS Investment Bank forecast -0.5% GDP growth), although this is lighter than anticipated towards the end of 2022. And importantly, unemployment is only forecast to rise marginally (0.3 percentage points in both markets to end-2024). CPI is forecast to come down sharply over the course of 2023, averaging 6.5% in the UK and 4.8% in the eurozone, largely driven by base-effects and the fall in wholesale energy prices.

Both the ECB and BoE hiked by 50bps in their January meetings, to 2.5% and 4% respectively. However, the tone of the commentary which accompanied the hikes has started to diverge. Although the BoE is still reiterating the need to fight inflation, assuming UK CPI does continue to fall, the BoE is expected to hike just once more in March, leaving 4.25% as the terminal rate. The BoE is then forecast to cut rates by 50bps in 2H23, and a further 125bps in 2024 to support the sluggish economy and bring the base rate closer to a neutral level at 2.5%. The ECB however gave a clear intention to hike by 50bps in March, with a further 25 or 50bps hike anticipated to follow in May to leave the terminal rate at between 3.25-3.5%. Interest rate cuts are not forecast to start until 1Q24 (75bps forecast for 2024), which would bring the ECB depo rate to just 25bps lower than the BoE. This perceived divergence in policy direction has narrowed the spread between 5-year euro and GBP swaps over 100bps at the end of 2022 to 75bps as at 6 February 2023.

Occupier markets
Despite the slight improvement in the economic outlook noted above, there are early signs that some of the negative sentiment has started to impact the office occupier markets. Take-up had recovered to around 80% of its pre-pandemic level but fell back in 4Q22 by 4.2% on the previous quarter and by 25% on 4Q21 (see Figure 1). Available supply, which had leveled out at an aggregate vacancy rate of ca. 7% since the pandemic, increased to 7.3% in 4Q22. Despite this, prime rents continued to move up in a number of markets including Paris, the big five German cities, Milan, Amsterdam and Madrid. This is reflective of the low availability of genuinely sustainable office buildings.

Liquidity dries up

Similarly, the logistics market also saw take-up reduce by ca. 25% on 4Q22, although this was coming off a much higher base than office markets. We do expect the economic slowdown to weigh on both consumer and business demand for goods in 2023. But with vacancy levels at just 2.6% and structural drivers negating some of the economic slowdown, the outlook for rental growth remains positive, albeit lower than previous years. Occupiers will become increasingly focused on quality and the sustainability of units, and in locations which can drive cost and operational efficiency.

The overall retail sector will see some challenging trading conditions as consumer spending power continues to decline as real wages remain negative throughout 2023. Christmas sales held up better than expected although this was partly due to the reserves of savings and credit being drawn upon which is unsustainable going forward. Prime pitches in tourism cities are likely to be more defensive as they continue to benefit from the surge in European travel post-pandemic, with luxury locations potentially seeing an even stronger recovery in footfall if Chinese tourists are able to travel again in 2023.

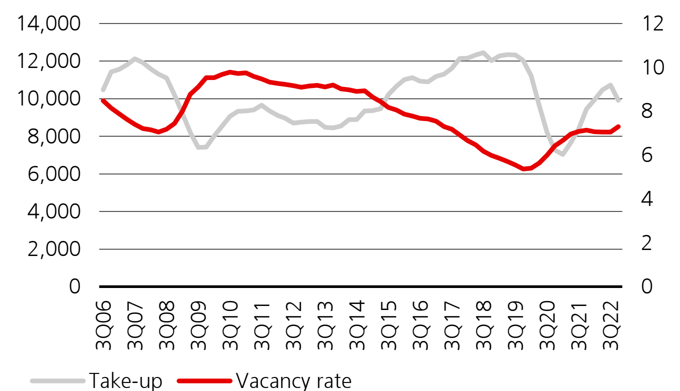
Capital markets

The impact of rising interest rates and debt costs is now clearly being felt in European capital markets. Quarterly investment volumes totaled just EUR 50 billion in 4Q22, compared to EUR 141 billion in 4Q21. This was the lowest quarterly volume in Europe since the height of the eurozone crisis in 2012. A number of high-profile deals have been withdrawn from the market as bids came in well below vendors' expectations, whilst deals which have gone through generally had significant discounts to their valuations.

Commercial agents have responded by moving out prime yields across all markets and sectors, with the largest movements coming in the logistics sector, despite the very strong occupational dynamics. Against a backdrop of strong rental growth, we believe yields in this sector have become attractive again. In sectors where occupational demand is weaker, investor demand is also weaker and, as a result, deals have completely dried up. Rather than taking this to imply a significant drop in pricing, some European valuers have opted to keep values relatively stable. The issue this creates is that there is now a wide gap between where buyers would realistically come into the market, and a price sellers can accept.

Figure 1: European office vacancy rate and take-up

(%, '000 sqm)

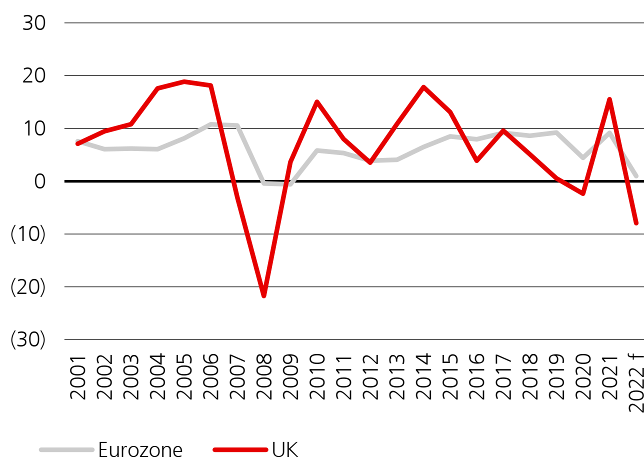


Source: JLL, 4Q22.

European versus UK valuations – who's right?

Performance data can be misleading
There is a sizeable discrepancy between UK and eurozone direct property performance, as inferred by the MSCI index. Between 2001 and 2021, the UK property index outperformed the eurozone by 1.2 percentage points, but at a level of volatility that was in theory three times higher (see Figure 2). Taken literally, on a risk-adjusted basis, this would be deemed to be a pretty poor pay-off for the much higher volatility.

Figure 2: MSCI all property total returns (%)



Source: MSCI; Oxford economics; February 2023. **Past / expected performance is not a guarantee for future results.**

The issue of course, is we're not comparing like-for-like. More European valuers use DCF models, which are naturally smoothed compared to the marked-to-market approach which is dominant in the UK. During a bull-run, this rarely causes an issue – most investors are happy to find that their assets can be sold at levels above their most recent valuation. But when the market turns, unrealistic valuations start to create liquidity problems.

Official numbers are yet to be released, but Oxford Economic forecasts values to decline by just -2.8% in the eurozone in 2022. With UK direct values falling by 13%, the gap is likely to be around 10 percentage points – a huge difference even by historic standards.

There are a few factors one could point at to explain the UK's apparent underperformance, and the disastrous mini budget undoubtedly accelerated the correction in 4Q22. But the reality is that methodology and a reluctance of European valuers to move the numbers to anywhere near a level that transactions would realistically happen at, is the biggest reason behind the discrepancy.

If assets never had to be sold during a downturn in Europe, perhaps this wouldn't be a problem – the valuation can be seen as more of an accounting mechanism rather than a realistic sale value. However, that's not the reality of the market – if anything, liquidity events increase during a downturn as redemption requests build and refinancings become more challenging. But potential sellers are unwilling or unable to accept large discounts on their most recent valuations. Potential buyers, on the other hand, need substantial discounts to underwrite deals to get to target returns which are appropriate in the new interest rate environment. As a result, transactions have fallen dramatically to EUR 31.9 billion in the eurozone in 4Q22, from EUR 86.1 billion in 4Q21. The lack of liquidity means an absence of market evidence to base values off, but rather than take a view on the fact that bids are coming in well below previous valuations, many European valuers have opted to leave values largely stable.

Unrealistic performance data doesn't help the market, or real estate as an investment asset class. Values fall sometimes as markets are cyclical and will be impacted by wider macro-trends. It happens across all asset classes, and a value correction in one or two years does not make the sector a bad long-term investment. But when values don't move during periods of uncertainty, the sector might appear even more illiquid and opaque. In the UK by contrast, the recent movements have restored credibility in the system, and with pricing now reaching a level where investors can now see attractive returns, we may see a recovery start for some sectors as early as 2Q23. In Europe, as was the case post GFC, this could continue for much longer until there's a willingness to accept reality.

For more information, please contact:

UBS Asset Management
Real Estate & Private Markets (REPM)
Research & Strategy

Zachary Gauge
+44-20-7901 5534
zachary.gauge@ubs.com

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