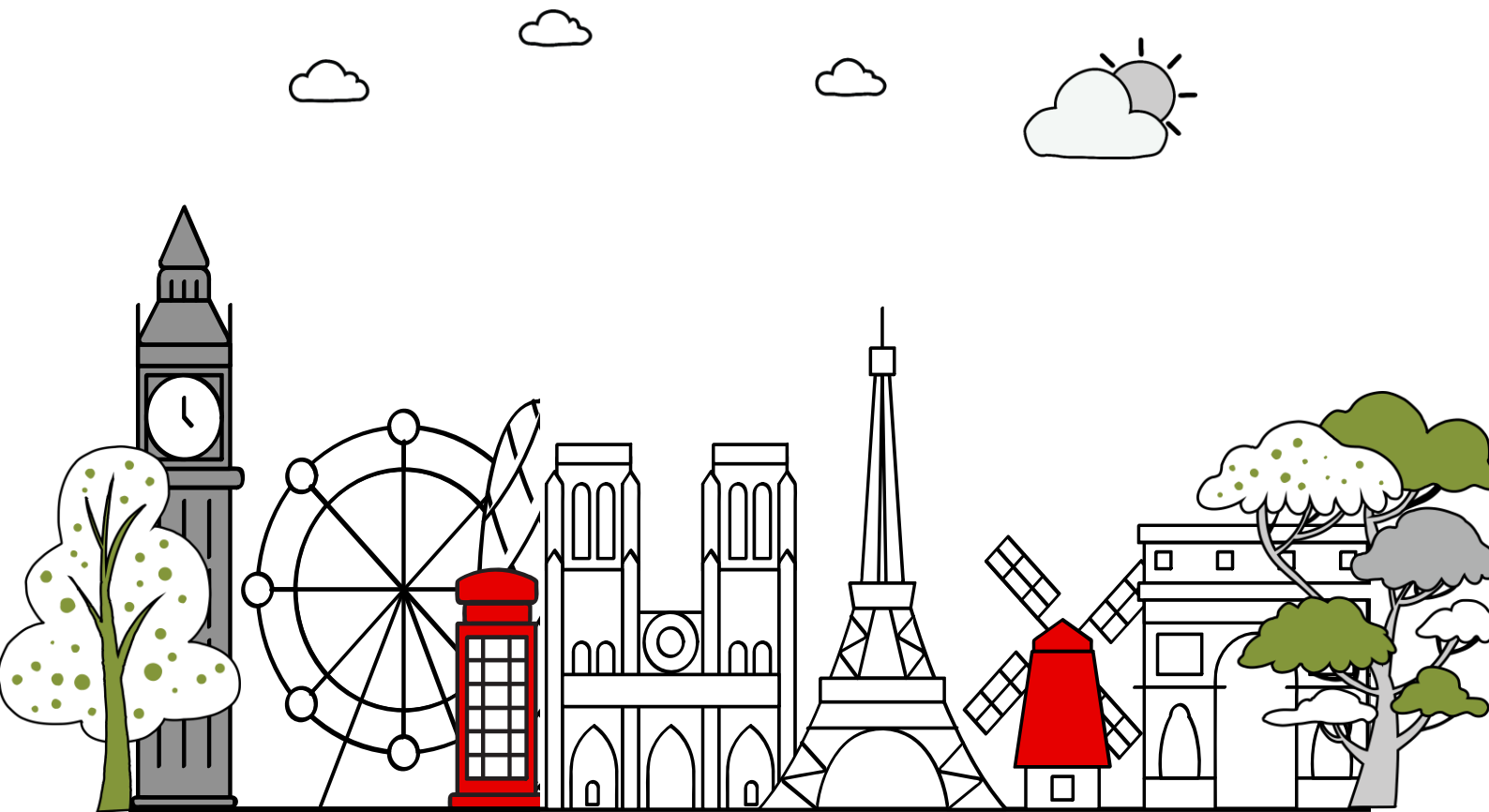


REO

Real Estate Outlook – Europe

Edition May 2023



Europe real estate

Bid offer gap slows the market

Economy

The European economy is currently defined by a number of contradictory forces. Firstly, the positive. GDP growth has continually surprised on the upside over the past six months. The eurozone economy is now expected to grow by 0.8% in 2024, compared to expectations of around 0% growth at the start of the year. The UK has seen even bigger swings – in November 2022 the BoE was anticipating “the longest recession on record” and a decline in GDP of -1.5% in 2023. In their May 2023 forecasts, this was upgraded to +0.25% growth. The BoE was somewhat of an outlier in the scale of its negative expectations, but other forecasters have generally moved from a modestly negative expectation to between +0.5% and +1% for 2023.

On the face of it, this is good news. However, the surprising strength of the economy is creating a challenge for both the BoE and ECB. One of the key drivers of the better-than-expected economic performance has been the employment market, which remains very tight by historic standards. This means European consumers are still spending money, despite real wages being negative as they have the confidence to draw on savings and / or credit to maintain living standards. In some areas, such as travel, demand remains extremely strong and prices are continuing to rise, exacerbated by expanding profit margins. Inflation has come down since the start of 2023 (eurozone 7% from 9.2%, UK 10.1% from 10.5%), but at a slower rate than expected, particularly in the UK.

The consequence: higher expectations for interest rates. UBS IB now forecast the ECB to peak at 3.75% in 2023, before being cut by 100bps in 2024. Terminal rates in the UK have also been increased to 4.75% with 200bps of cuts coming through in 2024. Forward markets however have stuck with a higher for longer view, with rates peaking even higher than these forecasts, and only coming down gradually over the next five years.

And whilst the economic outlook in Europe has improved, some darker clouds are gathering on the other side of the Atlantic. The health of European banks (with the obvious exception) appears to be robust and there have been no indications of a systemic fallout from that noted exception. In the US the challenges are entrenched within a far wider range of lenders. A downside scenario of tighter lending standards adding further strain to corporate and consumer borrowers already facing higher inflation and interest payments cannot be disregarded. This could potentially lead to a recession with global fallout.

“European markets are still coming to terms with structurally higher interest rates. Yields are moving out, but for some sectors there is some distance before an equilibrium between buyers and sellers can be reached.”

Zachary Gauge

Head of Real Estate
Research & Strategy –
Europe ex DACH



Better GDP but at the cost of higher rates

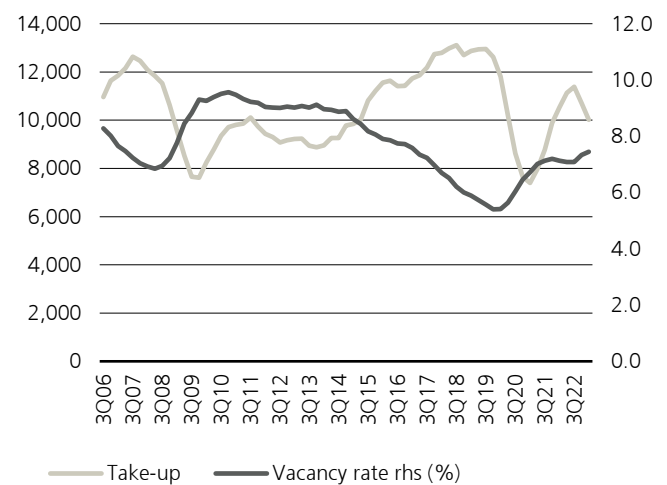
Occupier markets

Despite the improved economic outlook, office occupier dynamics continue to move in the wrong direction (see Figure 1). Take-up in 1Q23 declined for the third consecutive quarter, falling to the lowest level since 2009 with the exception of 2Q and 3Q20 when the market was effectively shut down during the COVID-19 pandemic. The vacancy rate is also increasing, albeit at a relatively modest pace and on an aggregate level it remains at a low level by historic standards. Despite the weak demand, prime rents continued to move up in a few markets including Central London, Munich, Hamburg and Brussels although the vast majority were flat. Grade B rents are under pressure and are forecast to decline by ca. 6% in 2023.

Logistics take-up has fallen away, dropping by 50% in 1Q23 compared to 1Q22. The weaker economy and higher rates are certainly a factor. However, there is also the reversal of some of the COVID-19 trends which saw logistics companies rapidly acquire new warehouses to respond to changing supply chains and a surge in e-commerce shopping. But the supply-side remains very limited – based on markets where data is available the average vacancy rate is just 2.7%. So, we're still seeing strong rental growth and aggregate prime rents in 1Q23 in the eurozone increase by 3.2%. Even at higher rental levels, development appraisals for new warehouses are struggling to stack-up, so despite weaker demand we still see upward pressure on both prime, and secondary space over the medium term.

And there are selectively some positive signs from the retail sector – with some prime high streets now seeing positive rental growth benefiting from a rebound in luxury spending from tourists. And even the Grade B market is showing signs of rental stabilization, with a very small growth forecast for 2023 coming off the back of three years of decline which reduced rents by 22.7%.

Figure 1: Office take-up ('000 sqm) and vacancy rate (%)



Source: JLL, 1Q23.



Significant regional differences in office outlook

Capital markets

The effects of rising interest rates and higher borrowing costs are very obvious in the European capital markets. According to RCA, the annual investment volume in 2022 (EUR 321.9 billion) was around 22% below the previous year's figure. The quarterly investment volume in 1Q23 amounted to only EUR 36.5 billion, which was 62% below the previous year's figure where the first quarter still showed strong at EUR 95 billion. The strongest decline was recorded in the industrial segment, where transactions fell by 76% YoY. This is partly due to the very low levels that yields had reached during the logistics bull-run, but is also partly explained by the low liquidity that the sector showed in general. Yet, also in the residential (-69%) and the office (-64%) segment, transaction volumes reduced significantly.

Although the retail segment had a very strong first quarter in 2022, it still recorded a comparatively modest decline of 43% compared to the previous year. Part of the strong reductions in transaction volume stem from the wide gap between where buyers would realistically come into the market and valuations, respectively – prices that sellers would be willing to accept. This becomes evident in the above average transaction levels in the UK, where values corrected significantly in 2022, and liquidity is recovering much quicker than the rest of Europe.

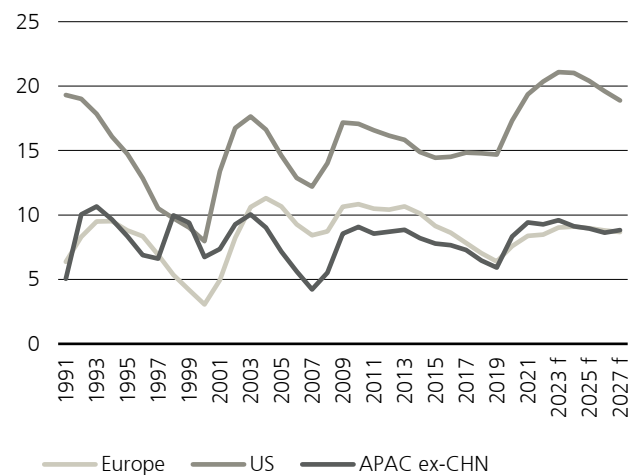
Are offices the new retail – part 2?

At the height of the COVID-19 pandemic, real estate investors tried to quantify the potential impact of a permanent shift to increased home working on the office market. They also aimed to determine if this structural shift would have a comparable effect to the impact e-commerce had on the retail sector. The consensus answer at the time was essentially no, with caveats. And whilst interest rates stayed at exceptionally low levels this by and large held true. Secondary offices with structural vacancy rates of 20% or even 30% could still deliver strong returns over fixed income yields, utilizing low debt costs that were hugely accretive to returns.

Now the paradigm has reversed, things are starting to look very different as those structural challenges lurking below the surface are thrown into the spotlight. Refinancing a building at current interest rates with that structural vacancy is almost impossible. In many ways, the global outlook for offices is bleak.

But it's important to note some significant regional differences. In particular, the structural impact of home working has been far greater in the US, than in Europe or Asia. And whilst occupier demand has come down across the world, it is only in the US that vacancy rates have hit record high levels, and we're seeing numerous examples of office buildings falling into default (see Figure 2).

Figure 2: Office vacancy rates (%)



Source: PMA, May 2023. **Past / expected performance is not a guarantee for future results.**

Peripheral European offices undoubtedly face the same challenges, and vacancy rates are in some cases well above 20% with little sign of recovery. But whilst some US CBDs have become ghost towns, European city centers have remained attractive places to work and are again bustling with tourists, shoppers and (other than Friday) office workers. The permanent home working has not taken off in the same way that it has in the US.

And as build costs, development finance and target returns have all risen at the same time exit cap rates have moved out, an interesting dynamic is developing. It has become incredibly difficult (in some markets impossible), to make office development appraisals stack-up. And even when they do, appetite to fund them is thin on the ground. With replacement costs higher than existing assets, we think the potential for medium to long-term rental growth is underestimated. But if investors turn away from the sector as a whole, entry yields could get to a level where prime European offices offer a very strong risk-adjusted return for investors who are prepared to be counter-cyclical.

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