European Real Estate Outlook

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In Brief

- Although the outlook is still clouded with uncertainty there are some reasons for optimism in real estate markets and prospects are improving. The expectation of earlier than anticipated interest rate cuts is filtering through to debt costs and should support debt gradually becoming more accretive through 2024.
- Liquidity is very limited resulting in opaque pricing for many assets. Price discovery will improve throughout the year as transaction volumes slowly improve reflecting lower cost of funds, improving sentiment and a pick-up in distressed assets coming to market.
- We expect to see a window of opportunity to buy higher quality assets at temporarily discounted prices. Investors with equity have the potential to be early movers able to take advantage of these opportunities but will need to be aware of shifts within occupier markets.
- Longer term societal shifts, such as ecommerce, an increasing focus on sustainability and hybrid working are impacting both the type of assets and the location that occupiers desire. Stock selection and local market knowledge will be even more essential.
- Sectors where demand remains robust and is combined with supply constraints will create investment opportunities. For example, in logistics low vacancy is combined with development constraints and strong demand leading to an opportunity for investors to step up the risk curve and develop new stock in the right locations.
- The increasingly complex environment means that differentiating within real estate sectors will be extremely important in 2024. A focus on the longer term societal shifts and supply side constraints will help to mitigate risk along with identifying those assets and locations which will benefit from ongoing demand and income growth.

Uncertainty on several levels impacts real estate investment

Higher interest rates, combined with an uncertain economic environment, will continue to have a direct impact on real estate markets in 2024. Trends evident at the end of last year, such as low liquidity and limited pricing transparency, will continue for at least the first half of the year. However, there is now some optimism filtering through to the sector and prospects for the coming year are improving.

The expectation of interest rates cuts happening earlier than previously forecast is leading to lower bond yields and by association lower all in cost of debt. This is particularly positive for those with higher risk, leveraged strategies, and debt should gradually become more accretive as we move through the year.

Limited liquidity and pricing opacity to create opportunities

European real estate transactions are down by a similar magnitude to during the Global Financial Crisis and pricing for many assets remains very opaque. There are limited transactions to give investors any level of certainty as to how far values have actually fallen which creates an additional level of uncertainty and holds back transactions. Although, price discovery for direct real estate will lag the more public markets it is anticipated that this will improve in 2024 on the back of a few factors. These include an increase of transactions as more real estate assets come to market partially linked to an increase in distress, lower costs of funds and the improving investor and economic sentiment.

Real estate yields across all major sectors moved out quite sharply over the past 18 months and further outward shift is likely as the market establishes pricing. We anticipate that the logistics sector will be the first to stabilise in early 2024 along with slowly improving liquidity for both core and higher risk capital.

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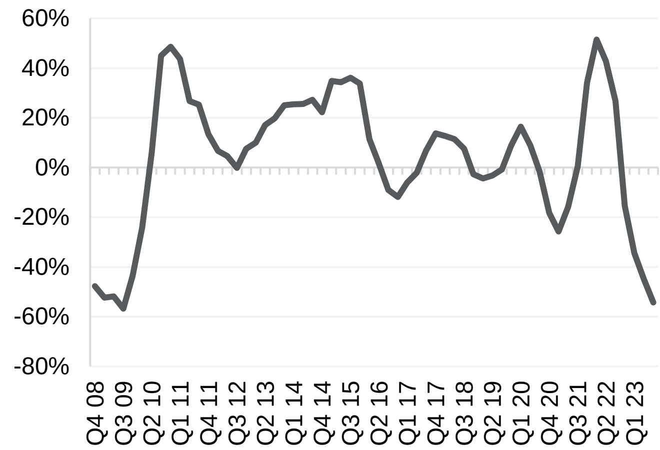
European real estate transaction volumes, rolling annual % change p.a.



Source: MSCI RCA; data as of November 2023.

Window of opportunity

Similar to post the Global Financial Crisis we will see a window of opportunity to buy higher quality assets at temporarily discounted prices. The UK appears to be slightly ahead when it comes to price discovery indicating opportunities are likely to arise there first. As such investors with equity who are bold enough to be one of the early movers will be able to seize opportunities, however, in a note of caution the recovery is likely to play out differently this time around due to occupier market conditions.

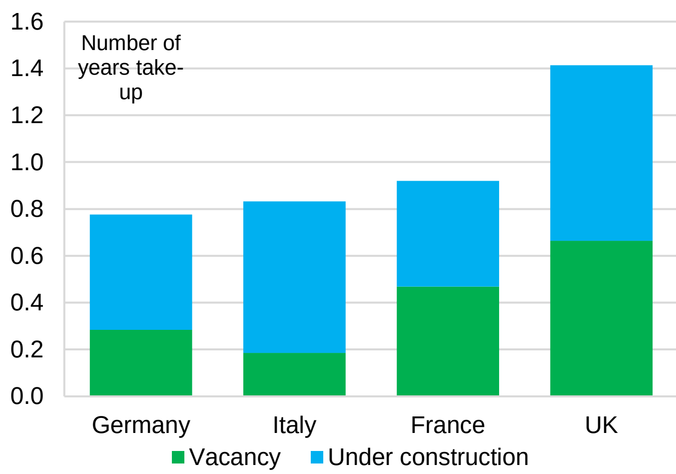
What's different this time around?

The occupier market is where we have seen a distinct difference to other cycles. So far occupier market fundamentals in Europe have remained robust for high quality well located assets with all the requisite ESG characteristics and certifications. This is especially true for the office sector where an increasing bifurcation between the highest quality assets and the rest is visible. Longer-term societal shifts will continue to remain relevant to real estate and are likely to create opportunities for those willing to allocate capital. However, these same trends will also create increased obsolescence so stock selection and local market knowledge are even more essential.

Limited supply creating opportunities across the sectors

The rise of logistics has been well-documented but this shift still has further to go, especially within continental Europe, where ecommerce penetration rates still lag significantly behind the UK. The constrained supply side of the sector will also boost potential growth. Logistics vacancy rates across Europe remain low, and with construction costs high and tough planning regimes, is likely to remain so. This will create investment opportunities for investors willing to step up the risk curve and develop new stock with rental growth likely to continue surprising on the upside.

Logistics supply (vacant stock + under construction) in number of years take-up,



Source: CBRE ERIX; data as of November 2023.

Office assets, regardless of quality or location, will continue to be perceived negatively amid changing tenant needs and further value declines are anticipated. Hybrid working is now fully established but the balance of home and office work is yet to be finalised. An increase in return to office rates seems likely in many markets as productivity concerns and company mandates are enforced. The combination of value declines and perceived negativity should create an opportunity to buy select offices at a discounted price with an aim to strategically refurbish and reposition assets in the right locations.

The residential sector is continuing to mature across Europe and the constrained supply side combined with positive demand fundamentals will ensure it remains attractive to investors. A switch in focus back to stable income profiles should entice core capital back to the sector and moving up the risk curve investors will look to develop or refurbish high quality stock. As always the looming threat of regulation in residential is one that needs to be considered.

Mitigate uncertainty by looking to longer term structural shifts

The theme of uncertainty is likely to continue through 2024 – the path to a lower inflation, lower interest rate environment is unlikely to be linear. In a period of elevated risk and uncertainty differentiating within real estate sectors will be extremely important in 2024. A focus on those aforementioned societal shifts and those sectors and assets where there are significant supply side constraints should mitigate risk. Investors willing to navigate an increasingly complex environment should be able to identify those assets and locations which will attract the highest calibre of tenants and will benefit from ongoing demand and income growth.

Next steps

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