BARINGS

European Real Estate: Structural Reprice, But Secular Trends Endure

European Real Estate Research Quarterly

MAY 2023

23-2871603

Executive Summary

ECONOMY

- Europe’s economy escaped an energy crisis-induced recession this winter, growth remains positive, and headline inflation is rapidly cooling—albeit core inflation is proving stickier.
- After 15 years of balance sheet repairs and a tightening of regulation and supervision, European banks entered the recent market turmoil on a strong footing.
- ECB rate hikes may exceed market expectations if core inflation remains stubbornly high.
- The U.K. economy appears to be on a slightly divergent path, with weaker growth and stronger inflation due to lingering structural shocks.

PROPERTY MARKETS

- Interest rate hikes have been heavily felt in CRE prices, with value shifts of around -20% and transaction levels down -60% in the past 12 months.
- Negative repricing has been greatest in the lowest-yielding, most sought-after sectors with the best long-term prospects, while the least attractive sectors have outperformed in the downturn.
- Barring capital market events and refinancing risks, the opportunity to invest at or near the bottom of the European property cycle appears close.
- The cost of debt will likely remain high, and investors will need to work harder for returns in the coming cycle. ESG will play a crucial role for investors to extract alpha and avoid obsolescence.

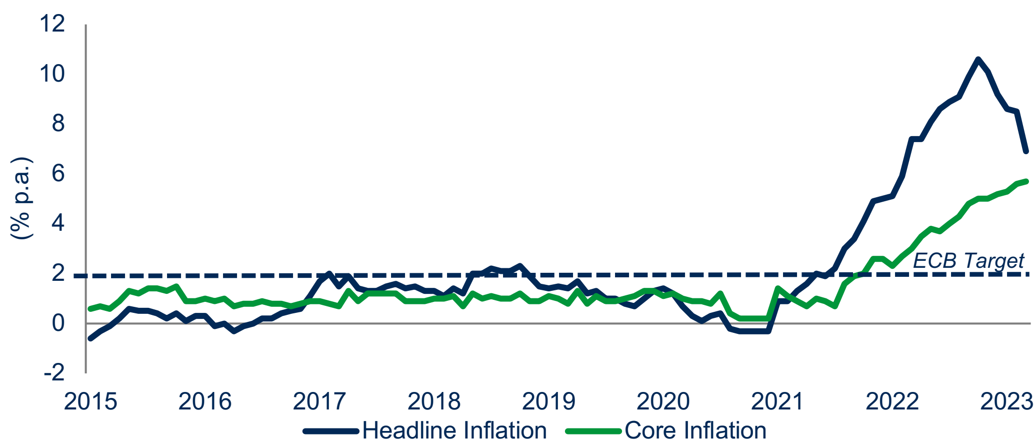
Economic Outlook

As Europe transitions to spring, there is a palpable sense of relief that winter passed without energy shortages occurring. The economy is performing better than expected, with modest Eurozone GDP growth during the first quarter (0.1%). That reflects the Eurozone Composite PMI surpassing the 50+ growth threshold for the third consecutive month in March at 53.7, after a February reading of 52.0. Still, the European Commission's Economic Sentiment Indictor (ESI) at 99.3 in March was marginally below its expansion mark of 100.

Eurozone inflation is falling, down to 6.9% in March from its October 2022 peak of 10.6%, driven by strong energy price base effects (Figure 1). Core inflation (which excludes volatile energy and food prices) is proving stickier, reaching a record high at 5.7% in March, pushed up by the services component. On the upside, labor market conditions remain strong with the participation rate continuing to trend upward and unemployment in February at a record low of 6.6%. Only a very small rise is projected this year. This will provide some support to households struggling with elevated inflation and higher credit costs, but also could put upward pressure on wages, thus increasing the risk of a wage-price spiral developing.

Testing the stability of the global financial system has been the recent U.S. regional banking crisis, which was followed in quick succession—albeit for very different reasons—by the collapse of Credit Suisse and its subsequent purchase by rival UBS. The rapid regulatory response, a better capitalized bank sector with 15 years of balance sheet repairs and tighter post-GFC regulation and supervision helped weather the volatility. Yet the banking crisis is a timely reminder that exogenous shocks can derail the economy. Banking turmoil means credit conditions will likely remain tight during 2023. For real estate, the most structurally challenged sectors (secondary offices, non-food retail and others) could experience elevated near-term refinancing risks.

FIGURE 1: EUROZONE INFLATION



Sources: Eurostat. As of April 2023.

BARINGS

Growth and inflation continue to show more resilience than expected. While base effects have started to push headline inflation down, core inflation remains stubbornly high. The latter usually follows the former with a lag and has become the European Central Bank's (ECB) focus. If core inflation does not abate, the ECB may be forced to raise its policy rate above the 3.5% currently priced in by markets.

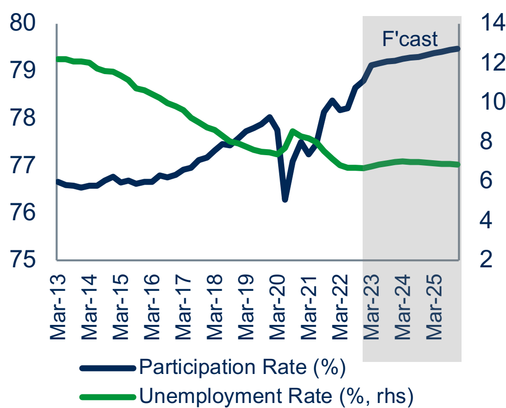
The U.K. economy appears to be on a slightly divergent path from the Euro area, with weaker growth and stronger inflation due to lingering structural shocks. The Bank of England may be forced to hike even in a slowing economy.

FIGURE 2: GDP COUNTRY FORECASTS (% P.A.)

GDP (% p.a.)	2021	2022	2023	2024	2025	2026	2027	2023-2027
France	6.8%	2.6%	0.5%	1.0%	2.6%	2.4%	1.9%	1.7%
Germany	2.6%	1.9%	-0.1%	1.2%	2.3%	1.9%	1.1%	1.3%
NL	4.9%	4.5%	1.2%	1.4%	1.6%	1.3%	1.2%	1.3%
Italy	7.0%	3.8%	0.8%	1.0%	1.0%	0.5%	0.3%	0.7%
Spain	5.5%	5.5%	1.6%	1.4%	2.2%	2.0%	2.0%	1.8%
Sweden	5.2%	2.7%	-0.7%	1.2%	2.3%	2.4%	2.3%	1.5%
U.K.	7.6%	4.0%	0.0%	1.5%	2.5%	2.2%	1.4%	1.5%
Eurozone	**5.3%**	**3.5%**	**0.6%**	**1.2%**	**2.1%**	**1.8%**	**1.4%**	**1.4%**

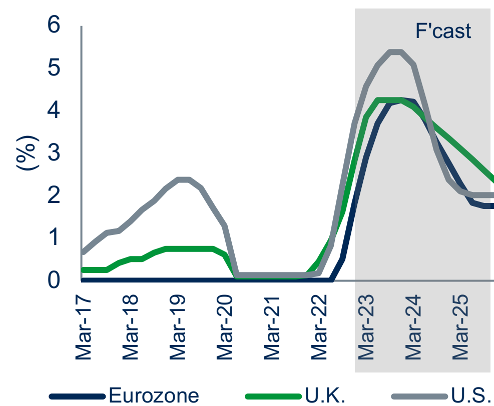
Source: Oxford Economics. As of April 2023.

FIGURE 3: EUROZONE LABOR MARKET



Source: Oxford Economics. As of April 2023.

FIGURE 4: INTEREST RATE OUTLOOK



Source: Oxford Economics. As of April 2023.

Capital Market/Pricing

According to CBRE, European commercial real estate (CRE) investment continues to slow with just €34 billion transacted in the first quarter of 2023, down -63% from a year ago.

Interest rate hikes have been heavily felt in European property markets in the past year. Prime yields have responded with an increase of about 100 basis points (bps) to about 4.25% (Figure 6). That represents a negative capital value impact in excess of 20% p.a.

Yield movements slowed to around 10-15 bps in the first quarter of 2023 (Figure 5). Barring capital market events and refinancing risks, and accepting that transactions will likely remain sluggish this year, the opportunity to invest at or near the bottom of the European property cycle appears to be close.

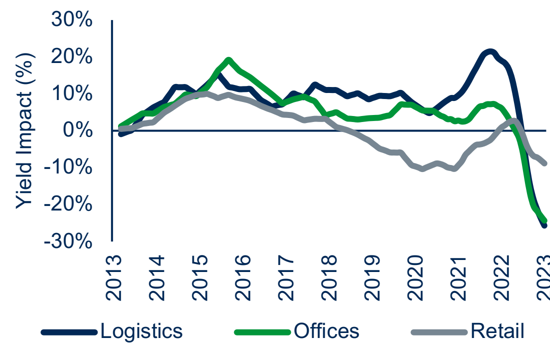
Logistics have seen a yield-driven downward capital adjustment of some -30% on an annual basis, yet fundamentals remain bright (see industrial sector). Even the very best top-rated ESG/STEM offices, multifamily, and internet resilient grocery retail property values have fallen -20% to -25% p.a. In comparison, retail warehouse and shopping centers are down only -5% to -10% p.a., despite negative online headwinds. These formats now generate income returns of 5.5% to 6% per year, which would be compelling if there is certainty to retain tenants, scheme "offer", and critical mass.

Assuming that peak interest rate anxiety and associated "unknown" financial consequences are behind us, real estate investment volumes should begin to pick up later this year. However, the cost of debt will likely remain high, and investors will need to work harder for returns in the coming cycle. ESG will also play a crucial role for investors to extract alpha and avoid obsolescence.

The availability of property bank credit has become ever more selective in terms of both sector and asset quality. The EURIBOR 5-year swap was stable at 2.8% in the first quarter. Property debt margins also have stabilized at 150-200 bps, implying a total cost of CRE debt at around 4.5% to 4.75%. Margins are higher in the U.K. at 175–250 bps depending on the sector.

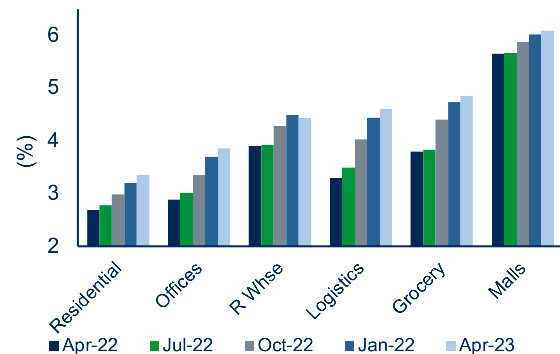
Refinancing risks for CRE, particularly in non-perfect assets and underappreciated sectors (e.g., secondary offices and non-grocery retail) are central concerns. For example, the REIT sector, while just 5% of the European CRE investment universe, faces a wall of expiring corporate bonds (Figure 7). A considerable opportunity exists for alternative lenders.

FIGURE 5: EUROPEAN PRIME CRE YIELD MOVEMENTS



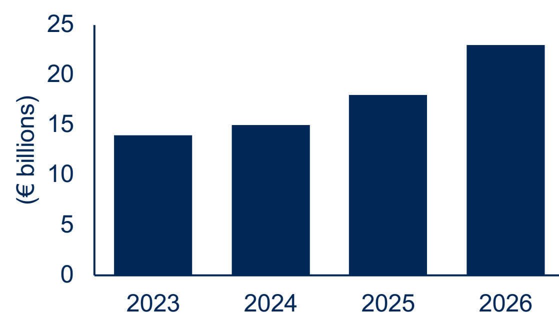
Source: CBRE. As of April 2023.

FIGURE 6: EUROPEAN PRIME CRE YIELDS



Source: CBRE. As of April 2023.

FIGURE 7: EUROPEAN REIT DEBT MATURITY



Source: Bank of America. As of March 2023.

Occupier Markets/Pricing

OFFICE SECTOR

European office leasing activity held up remarkably well in 2022. Annual take-up totaled 11.9 million square meters (5.0% of total office stock), a post-pandemic high and slightly above the 10-year average (Figure 8).

The European office vacancy rate moved toward stabilization through 2022, only marginally increasing to 7.8% and still below the long-run average of about 8.3%. Markets with above-average vacancies include London and Dublin, while markets with below-normal vacancy rates include Copenhagen, Vienna and Madrid.

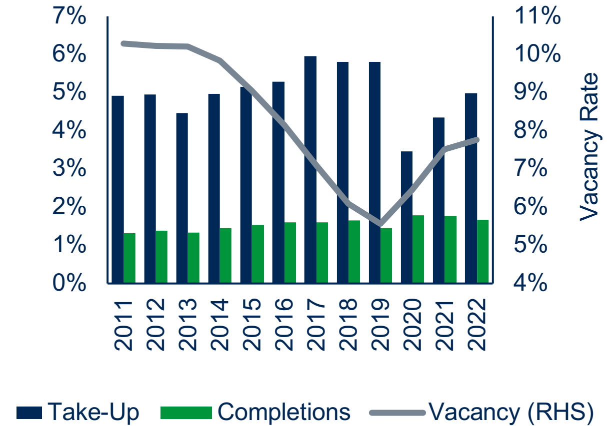
European office completions in 2022 totaled 1.7% of overall office stock, which is below the obsolescence rate of about 2.5% p.a., assuming a 40-year building life. It is expected that 2023 will deliver the highest year of completions since the GFC (2.2% of stock, still below the obsolescence rate), which will ease back thereafter. Projects beyond 2023 may be delayed as higher development costs and lower capital values squeeze developer profits.

The return to office (RTO) continues across Europe. Savills report that physical occupancy has improved, increasing from 43% to 55% since last summer. This compares to the pre-pandemic norm of around 70%. Across markets, the improving trend is clear. It is not just a case of smaller cities with shorter commutes leading the pack, with Paris well ahead of London in this respect.

Despite concerns over the RTO and considerable economic headwinds, prime office rents are still growing strongly, increasing 6.7% p.a. through March 2023. Rental prospects remain best for offices with top-rated ESG credentials. Shortages of this type of space will likely intensify in the years ahead—and thus where our office investment activity will mainly focus over the coming years.

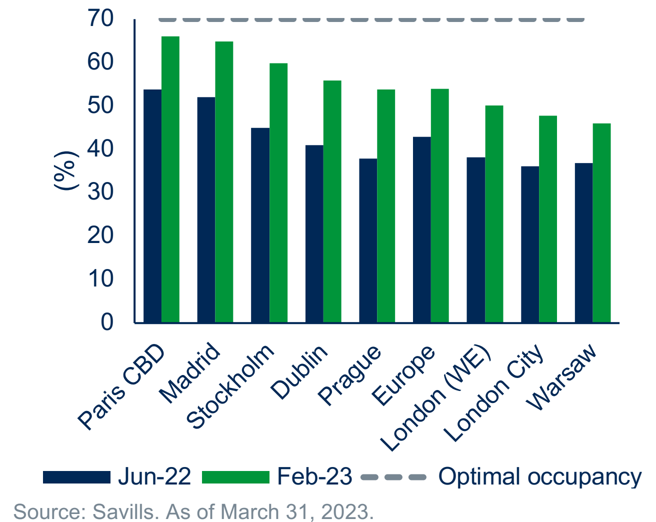
European prime office yields have shifted out almost 100 bps in the past year, to average about 4% through March 2023. They are expected to continue to weaken further. Dutch and German prime offices have seen the most aggressive shift in investment pricing—rising 125-150 bps.

FIGURE 8: EUROPEAN OFFICES: MARKET BALANCE



Source: Cushman & Wakefield. As of December 31, 2022.

FIGURE 9: EUROPEAN OFFICES: PHYSICAL OCCUPANCY RATE (%)



Source: Savills. As of March 31, 2023.

Occupier Markets/Pricing

RETAIL SECTOR

European retail sales remain negative, falling by -3.0% in the 12 months to February 2023 (Figure 10). Consumer confidence remains in the doldrums, albeit improving slightly. The consumer confidence indicator at -19 is up from a September low of -29, but remains below the long-run average of -12.

Resilient labor markets are a positive for nominal household incomes, but wage increases are currently undershooting inflation. That means a fall in real purchasing power, also known as the "cost-of-living crisis."

As expected, the immediate post-COVID retail revival proved short lived, halted by falling real incomes. While e-commerce adoption rates have eased from the pandemic years, they are reverting to the long-term positive trend. The brief renaissance enjoyed by physical stores has passed due to the rising cost of living and the slower economy as well as the relentless onward march of technological change in the form of e-commerce.

Retail rents have fallen by almost -3% over the last 12 months, with large declines recorded in Germany, Finland, and the Netherlands. Gradual downward rental pressure looks set to persist.

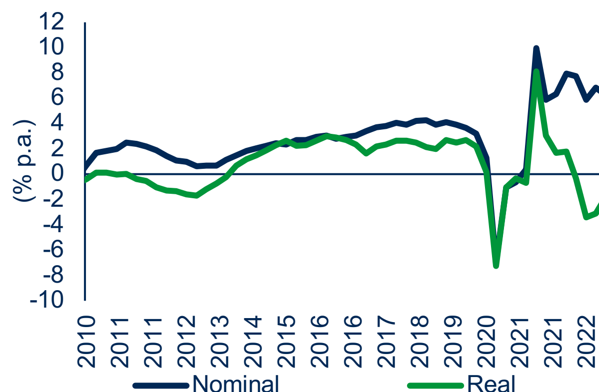
We continue to favor the grocery sector because food is a necessity and thus largely immune to price increases. Capacity constraints, low margins, and high delivery costs also imply a considerable degree of internet resilience; with recent growth in the sector coming from grocery, focused on in-store picked "instant" services such as Deliveroo and Uber Eats.

Non-food retail has outperformed in the past year, with yields increasing just circa 50 bps and a current stable valuer outlook for European malls and retail parks. The latter have even begun to harden in the U.K. Is this a structural shift in investor demand, or more likely that they were already repriced to reflect much weaker long-term fundamentals?

FIGURE 10: EUROPEAN RETAIL CLIMATE

Source: Eurostat. As of April 2023.

FIGURE 11: EUROZONE: WAGE GROWTH (NOMINAL & REAL)



Source: Oxford Economics. As of April 2023.

BARINGS

Occupier Markets/Pricing

INDUSTRIAL SECTOR

Logistics demand remained robust across Europe in 2022, recording over 31 million square meters of take up, just -6% below the all-time high achieved in 2021 (Figure 12). There was a modest softening in demand from retailer and e-commerce tenants, but rising demand from manufacturers looking to build resiliency.

The Global Supply Chain Index indicates that pressures are passing, which could taper excess near-term occupier demand. But other secular trends favoring e-commerce, onshoring, and the need to maintain inventories in a less global world are likely to compensate. Vacancy rates remain at historic lows, at just 2.6% at the European level, which is marginally up on the quarter but still incredibly tight.

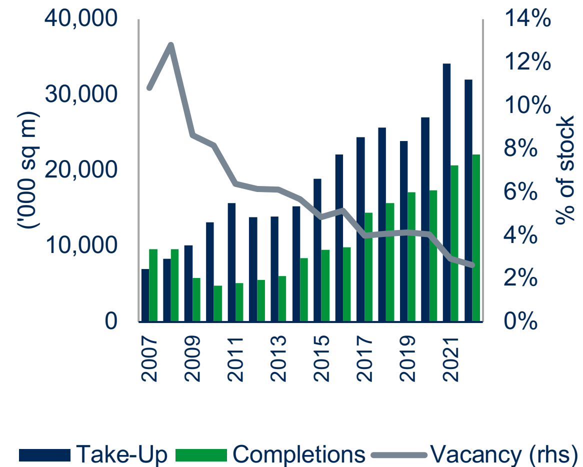
JLL reports that development activity dropped by -12% in the fourth quarter, with the slowdown largely driven by the U.K. and Poland. Speculative development in the fourth quarter totaled 9.5 million square meters (exceeding 40% of the total), largely concentrated in Poland, the U.K. and Spain. The lack of available space and higher construction costs are likely to impact development viability and impede take-up activity going forward. Build-to-suit will increasingly be the preferred option for occupiers seeking top quality buildings.

European logistics rental growth remains strong, but the pace eased over the quarter; average prime rents were up 2.1% over the quarter compared to 4.3% last quarter. The annual pace of rental growth is 13.4%, more than four times the 10-year average.

It is notable that even in the hottest occupational property markets in recent years, development was unable to match demand. Despite incredibly strong rental price signals, this lack of speculative behavior simply reflects tighter lending for property development in a post-GFC Basel III regulatory environment.

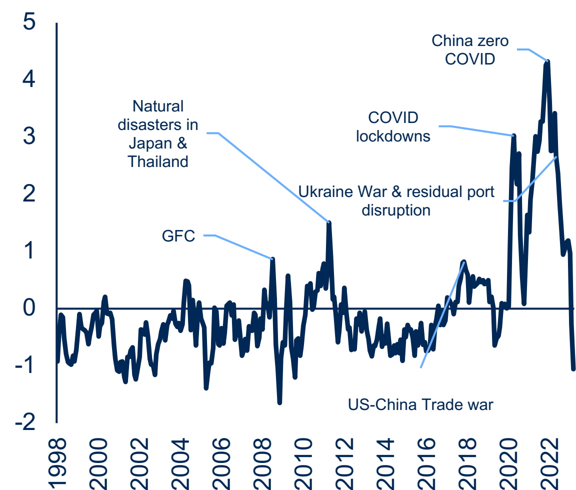
Despite still highly compelling fundamentals, prime logistics yields have shifted out in the past year by 100-200 bps to average about 4.5% through March 2023. While further rate hikes are likely to come, we hopeful we are past peak interest rate anxiety. Given the still compelling outlook for logistics, some modest yield compression is entirely possible over the next few years.

FIGURE 12: EUROPEAN LOGISTICS: MARKET BALANCE



Source: CBRE. As of December 31, 2022.

FIGURE 13: GLOBAL SUPPLY CHAIN PRESSURE INDEX



Source: Federal Reserve Bank of New York. As of March 31, 2023.

BARINGS

Occupier Markets/Pricing

ACCOMMODATION SECTOR

According to Eurostat, E.U. house prices fell -1.5%, while rents grew 0.6% during the fourth quarter of 2022. On an annual basis, price appreciation slowed to 3.6% and rents were up 2.5%. Prices declined in 15 of the 27 member nations. In the U.K., ONS PRS rental growth on an annual basis is at a record 4.6% through March 2023 (Figure 14).

More current data shows that the downward pricing trend continued into the first quarter. Through March 2023, the U.K.'s Nationwide House Price Index fell an annualized -3.1%, while Statistics Netherlands reported prices were down -2.3% p.a.; prices in Sweden declined -12% p.a. according to Danske Bank.

There is no paradox in falling house prices and rising rents or vice versa. Our analysis shows evidence that residential rents tend to lag house prices by around 12-24 months. House prices are falling due to rising interest rate payments. Rents are increasing, not just due to landlords passing higher mortgage payments on to tenants, but because first-time buyer mortgage affordability also has deteriorated, which sustains and increases the pool of renters.

In general, Oxford Economics forecasts that since house price declines correlate to where the run up in prices was higher during the pandemic years, a larger correction is in store for Sweden and the Netherlands, while a mere softening is likely for Spain and Italy (Figure 15). The U.K. is an outlier, probably reflecting additional structural shocks. House prices also will be more vulnerable to interest rates where a higher proportion of mortgages are on variable terms or rate fixes are shorter.

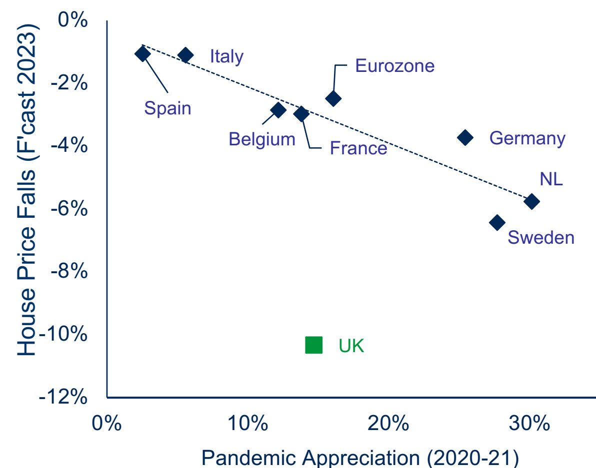
European multifamily yields have shifted out 75 bps in the past year to average just under 3.5% through March 2023. They are expected to continue to weaken further. Paris, Amsterdam, and Stockholm have seen the most aggressive shift in investment pricing, out about 100 bps in the past year.

Over the long term, the focus remains on locations with positive demographics and where housing supply pressures are greatest. Rent controls could constrain future growth potential, but also will increase the security of tenure by reducing tenant turnover and income duration. Rising ESG regulations will also likely lead to considerable investment and refurbishment opportunities.

FIGURE 14: U.K. RESIDENTIAL: PRICES VS. RENTS

Source: Nationwide, ONS. As of April 2023.

FIGURE 15: EUROPEAN HOUSE PRICES



Source: Oxford Economics. As of April 2023.

About the Team

Barings Real Estate's research team is structured by sector and geographic expertise, with efforts led by Dags Chen in the U.S. and Paul Stewart in Europe. The 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.

Paul Stewart

Head of Real Estate Research & Strategy—Europe

Ben Thatcher

Associate Director

Jo Warren

Director

Important Information

Any forecasts in this document are based upon Barings opinion of the market at the date of preparation and are subject to change without notice, dependent upon many factors. Any prediction, projection or forecast is not necessarily indicative of the future or likely performance. Investment involves risk. The value of any investments and any income generated may go down as well as up and is not guaranteed. Past performance is no indication of current or future performance. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. Any investment results, portfolio compositions and or examples set forth in this document are provided for illustrative purposes only and are not indicative of any future investment results, future portfolio composition or investments. The composition, size of, and risks associated with an investment may differ substantially from any examples set forth in this document. No representation is made that an investment will be profitable or will not incur losses. Where appropriate, changes in the currency exchange rates may affect the value of investments. Prospective investors should read the offering documents, if applicable, for the details and specific risk factors of any Fund/Strategy discussed in this document. For Professional Investors / Institutional Investors only. This document should not be distributed to or relied on by Retail / Individual Investors. Barings LLC, Barings Securities LLC, Barings (U.K.) Limited, Barings Global Advisers Limited, Barings Australia Pty Ltd, Barings Japan Limited, Barings Real Estate Advisers Europe Finance LLP, BREAE AIFM LLP, Baring Asset Management Limited, Baring International Investment Limited, Baring Fund Managers Limited, Baring International Fund Managers (Ireland) Limited, Baring Asset Management (Asia) Limited, Baring SICE (Taiwan) Limited, Baring Asset Management Switzerland Sarl, and Baring Asset Management Korea Limited each are affiliated financial service companies owned by Barings LLC (each, individually, an "Affiliate"), together known as "Barings." Some Affiliates may act as an introducer or distributor of the products and services of some others and may be paid a fee for doing so.

NO OFFER: solicitation for the purchase or sale of any financial instrument or service in any jurisdiction. The material herein was prepared without any consideration of the investment objectives, financial situation or particular needs of anyone who may receive it. This document is not, and must not be treated as, investment advice, an investment recommendation, investment research, or a recommendation about the suitability or appropriateness of any security, commodity, investment, or particular investment strategy, and must not be construed as a projection or prediction.
In making an investment decision, prospective investors must rely on their own examination of the merits and risks involved and before making any investment decision, it is recommended that prospective investors seek independent investment, legal, tax, accounting or other professional advice as appropriate.
Unless otherwise mentioned, the views contained in this document are those of Barings.

These views are made in good faith in relation to the facts known at the time of preparation and are subject to change without notice. Individual portfolio management teams may hold different views than the views expressed herein and may make different investment decisions for different clients. Parts of this document may be based on information received from sources we believe to be reliable. Although every effort is taken to ensure that the information contained in this document is accurate, Barings makes no representation or warranty, express or implied, regarding the accuracy, completeness or adequacy of the information.

These materials are being provided on the express basis that they and any related communications (whether written or oral) will not cause Barings to become an investment advice fiduciary under ERISA or the Internal Revenue Code with respect to any retirement plan, IRA investor, individual retirement account or individual retirement annuity as the recipients are fully aware that Barings (i) is not undertaking to provide impartial investment advice, make a recommendation regarding the acquisition, holding or disposal of an investment, act as an impartial adviser, or give advice in a fiduciary capacity, and (ii) has a financial interest in the offering and sale of one or more products and services, which may depend on a number of factors relating to Barings' business objectives, and which has been disclosed to the recipient.

OTHER RESTRICTIONS: The distribution of this document is restricted by law. No action has been or will be taken by Barings to permit the possession or distribution of the document in any jurisdiction, where action for that purpose may be required.
Accordingly, the document may not be used in any jurisdiction except under circumstances that will result in compliance with all applicable laws and regulations.
Any service, security, investment or product outlined in this document may not be suitable for a prospective investor or available in their jurisdiction. Any information with respect to UCITS Funds is not intended for U.S. Persons, as defined in Regulation S under the U.S. Securities Act of 1933, or persons in any other jurisdictions where such use or distribution would be contrary to law or local regulation.
INFORMATION: Barings is the brand name for the worldwide asset management or associated businesses of Barings. This document is issued by one or more of the following entities:
Barings LLC, which is a registered investment adviser with the Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940, as amended (Barings LLC also relies on section 8.26 of NI 31-103 (international adviser exemption) and has filed the Form 31-103F2 in Ontario, Quebec, British Columbia, Alberta, Nova Scotia, Manitoba, New Brunswick, Newfoundland and Labrador, Prince Edward Island and Saskatchewan); Barings Securities LLC, which is a registered limited purpose broker-dealer with the Financial Industry Regulatory Authority (Baring Securities LLC also relies on section 8.18 of NI 31-103 (international dealer exemption) and has filed the Form 31-103F2 in Ontario, Quebec, British Columbia, Alberta, Nova Scotia, Manitoba, New Brunswick, Newfoundland and Labrador, Prince Edward Island and Saskatchewan);
Barings (U.K.) Limited, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 194662) and is a Company registered in England and Wales (No. 03005774) whose registered address is 20 Old Bailey, London, EC4M 7BF.

The document is for informational purposes only and is not an offer or Barings Global Advisers Limited, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 552931) and is a Company registered in England and Wales (No. 07622519) whose registered address is 20 Old Bailey, London, EC4M 7BF and is a registered investment adviser with the SEC; Baring Asset Management Limited, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 170601) and is a Company registered in England and Wales (No. 02915887) whose registered address is 20 Old Bailey, London, EC4M 7BF; Baring International Investment Limited, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 122628), and is a Company registered in England and Wales (No. 01426546) whose registered address is 20 Old Bailey, London, EC4M 7BF, is a registered investment adviser with the SEC (Baring International Investment Limited also relies on section 8.26 of NI 31-103 (international adviser exemption) and has filed the Form 31-103F2 in Quebec and Manitoba;
Barings Real Estate Advisers Europe Finance LLP, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 401543); or
BREAE AIFM LLP, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 709904);

Baring Fund Managers Limited, which is authorized as a manager of collective investment schemes with the Financial Conduct Authority in the United Kingdom and is authorized as an Alternative Investment Fund Manager in several European Union jurisdictions under the Alternative Investment Fund Managers Directive (AIFMD) passport regime;

Baring International Fund Managers (Ireland) Limited), which is authorized as an Alternative Investment Fund Manager in several European Union jurisdictions under the Alternative Investment Fund Managers Directive (AIFMD) passport regime and, since April 28, 2006, as a UCITS management company with the Central Bank of Ireland;
Baring Asset Management Switzerland Sàrl, which is authorized by the Switzerland Financial Market Supervisory Authority to offer and/or distribute collective capital investments;

Barings Australia Pty Ltd (ACN 140 045 656), which is authorized to offer financial services in Australia under its Australian Financial Services License (No: 342787) issued by the Australian Securities and Investments Commission;

Baring Asset Management (Asia) Limited, which is licensed by the Securities and Futures Commission of Hong Kong to carry on regulated activities Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities), Type 5 (advising on futures contracts) and Type 9 (asset management) in Hong Kong in accordance with the requirements set out in the Securities and Futures Ordinance (Cap 571);

Barings Japan Limited, which is registered as a Financial Business Operator (Registration No. 396-KLFB) for Type II Financial Instruments Business, Investment Advisory and Agency Business, and Investment Management Business with the Financial Services Agency in Japan under the Financial Instruments and Exchange Act (Act No. 25 of 1948);Baring SICE (Taiwan) Limited, an independently operated business (Business license number: 2008 FSC- SICE- Xin- 030; Address: 21 F, No.333, Sec. 1 Keelung Road, Taipei 11012; Taiwan Contact telephone number: 0800 062 068); or
Baring Asset Management Korea Limited, which is authorized by the Korean Financial Services Commission to engage in collective investment business and is registered with the Korean Financial Services Commission to engage in privately placed collective investment business for professional investors, discretionary investment business and advisory business.

Copyright
Copyright in this document is owned by Barings. Information in this document may be used for your own personal use, but may not be altered, reproduced or distributed without Barings' consent.