European Real Estate: Darkest, Then a New Dawn?

European Real Estate Research Quarterly

FEBRUARY 2023

Executive Summary

ECONOMY

- There are tentative signs of easing headline inflation. PMIs are improving, but an economic slowdown is ongoing.
- With further ECB tightening anticipated and more interest rate hikes on the way, the risks to the outlook remain elevated.
- The ECB's response to inflation will influence real estate credit flows (i.e., refinancing risks) and transaction volumes, and thus where property yields settle in 2023.

PROPERTY MARKETS

- Falling REIT prices and prime yield shifts both point to a 15–20% price correction. This will continue to filter its way into real estate valuations and poor property index performance during the year.
- The worse impacted sectors so far have been agnostic to long-term fundamentals—rather, this is an interest rate duration impact.
- Debt LTVs are trending down with pressure on ICRs. A considerable opportunity for non-bank capital sources exists, especially refinancings.
- The economic slowdown will impact letting activity and near-term rental growth, although this could be mild if the economy proves resilient.
- Downside risks for property prices are focused on a paucity of bank capital for refinancings, geopolitics, central bank discretion, property's weight "denominator effects", and the depth and duration of the economic (rental) slowdown.
- The year ahead likely marks the trough in the property cycle. This will have implications for investment outperformance for years to come.

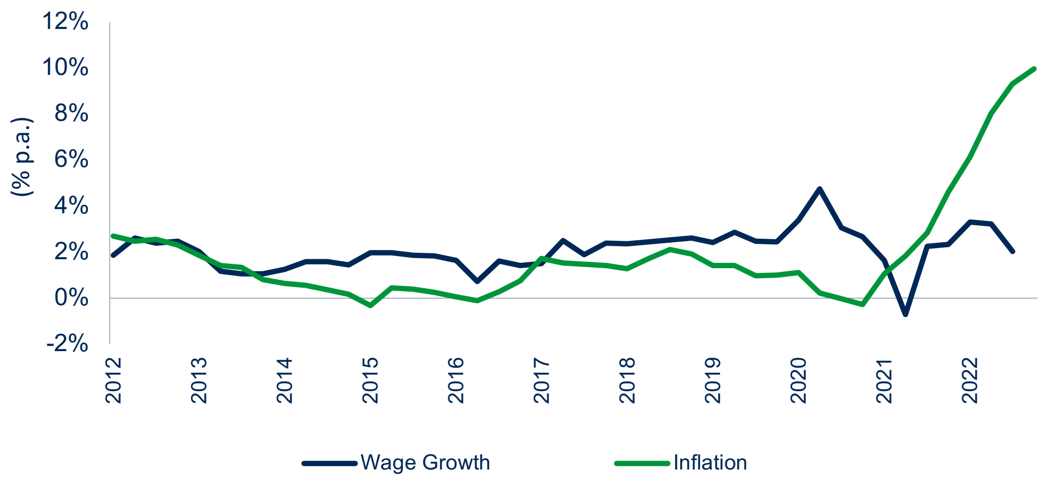
Economic Outlook

The latest Eurozone inflation data has brought the market some welcome relief, with the real possibility that pressures may now finally be easing. This follows months of price instability largely due to the Ukraine conflict's impact on energy and food prices. December marked the second consecutive month of falling prices, with headline inflation down to 9.2%, from the record October high of 10.6%. Energy prices have fallen sharply, which should help to bring inflation back down over the coming months. However, the core (excludes energy and food prices) rate ticked up to 5.2% in in December, and thus the European Central Bank's (ECB) focus will increasingly shift to this.

High inflation and the ongoing energy crisis point to a slowdown for the Eurozone economy this winter. The latest high frequency Eurozone Composite PMI swung back into positive growth territory at 50.2 for January (49.3 in December), building hopes that a recession might be avoided. However, low consumer confidence and falling household real incomes are still weighing on consumption, and an economic slowdown is occurring.

The labor market remains resilient, with the Eurozone unemployment rate at a record low at 6.5% in November, for the second consecutive month. However, the downswing means a moderate rise in joblessness is anticipated. This is already evident in the tech sector, as some of the "heavyweights" (e.g., Amazon, Meta, Microsoft) have announced large job cuts—partially due to the pandemic over expansion, but potentially also reflecting that these companies are reaching maturity. This should help prevent an inflation wage-price spiral developing, despite labor market tightness, allowing the ECB to avoid even more aggressive policy tightening.

EUROZONE WAGE GROWTH VS. INFLATION



Sources: Oxford Economics; Eurostat. As of January 2023.

How the ECB responds over the coming months to inflation and where interest rates settle will determine what happens in the real estate market later in the year. Benchmark "risk-free rates" and the cost of property debt will influence real estate credit flows (including refinancings), and ultimately transaction volumes and property yields.

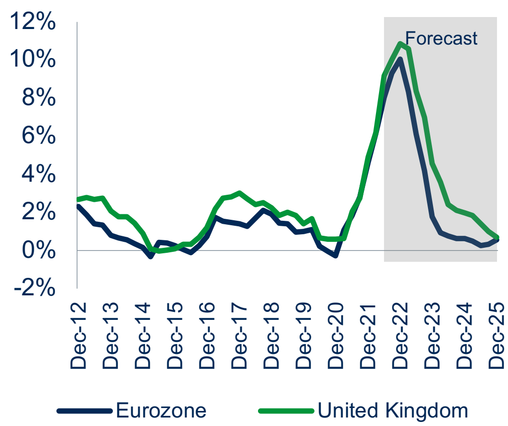
The ECB will be closely watching core inflation, given that it is well over their 2% target. Further tightening is anticipated, with more rate hikes to come this year. It may not be until late 2023 and into 2024 that rates might begin to fall, potentially settling at around 2% in the Eurozone in the mid-term. For the ECB, the current situation is maybe the long-awaited opportunity to "normalize" interest rates, end the need for quantitative easing, and boost financial market stability. But that is balanced against a desire to avoid inflicting unnecessary economic hardship or spark volatility in peripheral economies. The risks to the outlook therefore remain elevated.

GDP COUNTRY FORECASTS (% P.A.)

GDP (% pa)	2021	2022	2023	2024	2025	2026	2027	2023-2027
France	6.8%	2.5%	0.1%	1.9%	2.3%	2.2%	1.9%	1.7%
Germany	2.6%	1.6%	-1.0%	2.6%	2.5%	1.5%	1.0%	1.3%
NL	4.9%	4.2%	0.4%	1.8%	1.7%	1.3%	1.2%	1.3%
Italy	6.7%	3.8%	0.0%	1.0%	0.8%	0.6%	0.5%	0.6%
Spain	5.5%	4.6%	1.0%	2.3%	2.5%	2.4%	2.1%	2.0%
Sweden	4.8%	2.8%	-0.5%	2.2%	2.4%	2.4%	1.9%	1.7%
U.K.	7.5%	4.4%	-0.9%	1.5%	2.7%	2.2%	1.7%	1.4%
Eurozone	**5.3%**	**3.2%**	**-0.1%**	**2.0%**	**2.1%**	**1.7%**	**1.4%**	**1.4%**

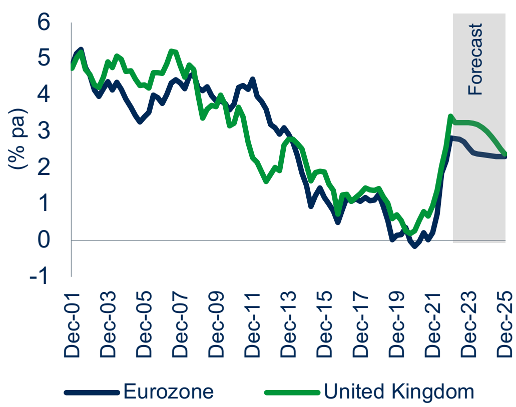
Source: Oxford Economics. As of January 2023.

EUROZONE INFLATION (% P.A.)



Source: Oxford Economics. As of January 2023.

10-YEAR GOVERNMENT BOND YIELDS



Source: Oxford Economics. As of January 2023.

Capital Market

A deteriorating economic outlook and sharp ratchet upward in global interest rates explain why the MSCI European Quarterly Property Index delivered its poorest quarterly total return (-2.2% in the third quarter of 2022) since the trough of the GFC (-6.5% in the final quarter of 2008).

European REIT prices have fallen approximately 30%. Accounting for leverage, and assuming stable rate expectations this year, a price correction of around15–20% is implied. While property price risks are skewed to the downside, public market volatility inherent in REIT prices normally exaggerates the property cycle's amplitude.

The market correction (down 15–20% in 2022 for prime) will continue to filter its way into property valuations during 2023. The assets and sectors that have been the most impacted so far have been agnostic to long-term fundamentals—instead, an unavoidable interest rate duration impact has occurred.

Euro 5-year swaps have increased from 0% to 2.7% p.a. in the past year. A widening corporate-sovereign bond spread and poor economic sentiment have driven senior debt margins out to a 200–250 basis points (bps) range, and perhaps 110–160 bps in Germany where the Pfandbrief offers added support.

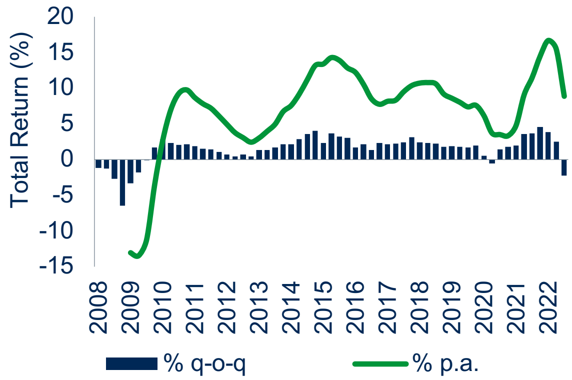
The sharp rise in property debt costs mean core loan-to-values (LTVs) are trending down, putting pressure on interest cover ratios (ICRs). The gap in the capital stack could be as high as 20%, creating an opportunity for alternative non-bank capital sources, especially for refinancings.

It is improbable that CPI will smoothly drop back to the 2% target in the next 18 months. Where the central bank policy narrative shifts is key. If it is felt that above target inflation is beneficial to erode real debt levels, interest rate expectations have already peaked. But should central bankers express a determination to double-down on high inflation, interest rate volatility could readily reignite.

Downside risks for property prices are focused on a paucity of bank capital for refinancings, sensitivity of inflation/ interest rates to geopolitics, central bank policy discretion, property's weight in multi-asset portfolios ("denominator effects"), and the depth and duration of the economic (rental) slowdown.

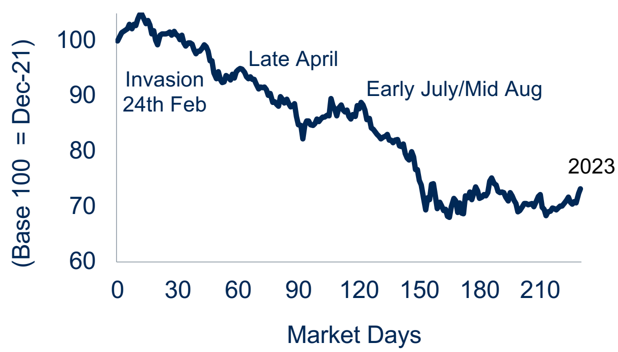
The year ahead likely marks the trough in the property cycle, creating opportunities to secure the best assets on the most favorable terms. That will likely have implications for investment outperformance for years to come!

MSCI EUROPE PROPERTY INDEX



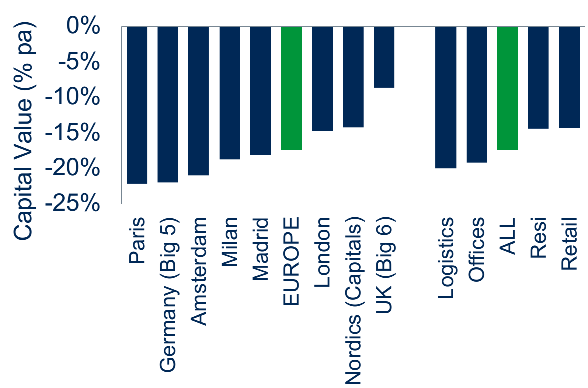
Source: MSCI. As of January 2023.

EUROPEAN REIT PRICES



Source: Bloomberg. As of January 13, 2023.

EUROPEAN PRIME YIELD IMPACTS



Source: CBRE. As of January 2023.

Occupier Markets

OFFICE SECTOR

Despite the turmoil in financial markets, third quarter demand continued to recover from pandemic lows. Take-up in Europe's major office markets over the 12 months to Q3 2022 reached 5.0% of total stock, which is 60 bps above the 10-year average.

Despite positive take-up signs, vacancy continues to edge up, reaching 7.7% in the third quarter. This is up 220 bps since the vacancy nadir in March 2020. However, the last two quarters have shown some resilience, increasing by only 40 bps. Through the pandemic years (since March 2020), vacancy increases have been most pronounced in Dublin and Amsterdam (around 500 bps increase) while Manchester (-120 bps) and Copenhagen (-250 bps) recorded tighter vacancy.

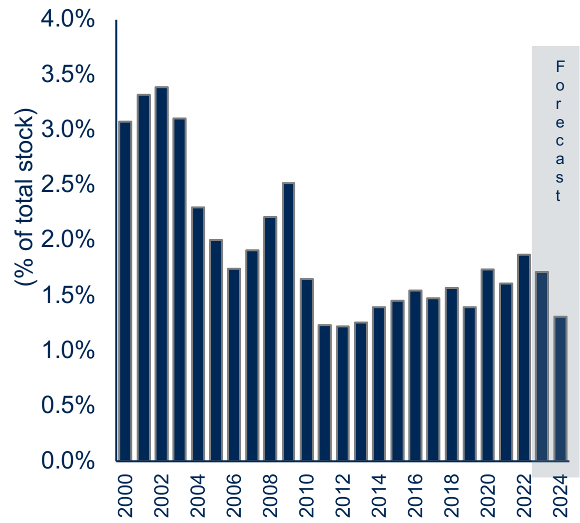
New development was just 1.9% of total stock in 2022, well below the replacement rate (say 2.5% p.a. assuming a 40-year building lifecycle). Development will continue to undershoot, averaging just 1.7% of total stock over the next two years. New starts will likely slow sharply in 2023, given high construction costs and poor economic sentiment.

Post-GFC banking regulations (Basel III) have severely impeded development finance, leaving Europe chronically under supplied with modern office space. The ESG agenda, combined with a tight labor market and a 'war for talent', have seen demand for 'best in class' space increase during the same period. This explains why highly robust prime rental growth has occurred (see below), despite the increasing prevalence of working-from-home (WFH) in the post-pandemic period.

Office rental growth over 2022 remained positive, expanding by 5.8% p.a. over the last 12 months. However, the pace of growth has slowed for the second consecutive quarter, rising by 1.1% in the final quarter, down from 1.4% in the third quarter and 2.5% in the second.

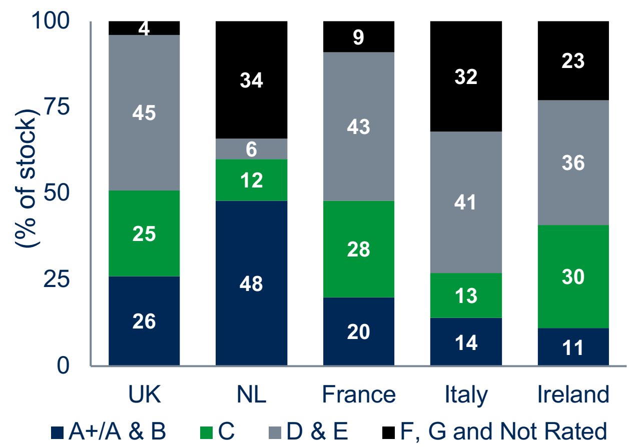
We expect occupier demand and thus rental growth to moderate further. However, long-term prime prospects remain favorable, given the ESG driven flight to quality and the lack of modern and green compliant space.

EUROPEAN OFFICES: DEVELOPMENT COMPLETIONS



Source: Cushman & Wakefield. As of Q3 2022.

EUROPEAN OFFICES: EPC RATING



Source: Savills. As of November 2022.

BARINGS

Occupier Markets

RETAIL SECTOR

European retail sales volumes decreased -2.8% p.a. in November 2022. A sustained recovery is unlikely until there's a sharp uptick in heavily depressed consumer confidence levels (-21.1 on the Eurostat measure through December, up from -29.2 in September, but well below the European long-run average -11).

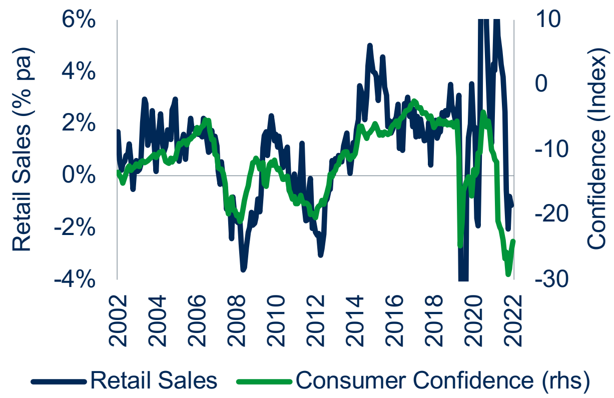
Retail leasing activity will likely sharply slow in 2023 and into 2024. While inflation is set to moderate, it may yet remain above the 2% target for some time (see Economy section). Wage growth is also still lagging a long way behind, which is great for central bankers and controlling inflation, but not great for retail operators. Household purchasing power has come under sustained negative pressure over the past year, with the "double whammy" of falling real incomes and higher debt servicing costs.

Downward rental pressures will likely be greatest in the north of Europe, where e-commerce headwinds are most pronounced. Local letting agents remain more upbeat about prospects in Southern Europe, but that could be an expectation and internet adoption lag. Retail operators will take the spending slowdown as an opportunity to 'right-size' stores and optimize formats. Retailer demand for space will pivot toward local convenience and high-end experiential destinations.

The pandemic re-opening retail rental "rally" was short-lived and remained negative. Prime rental growth was -1.3% in 2022, compared to -1.5% in 2021 and -10% in 2020. The pace is expected to fall back in 2023. This will reflect the combination of a cyclical downswing and the structural headwinds of the ongoing shift toward online retail channels.

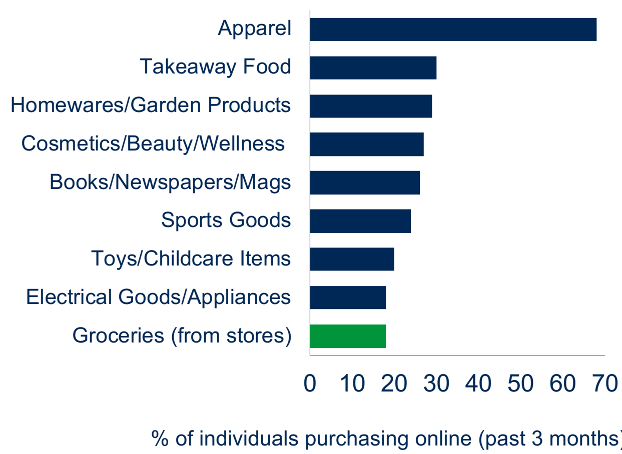
We retain a strong preference for food and convenience retail due to economic and e-commerce resilience. Food is a necessity, it is durable to the cost of living crisis and even rising food inflation itself. Capacity constraints, low margins and high delivery costs also imply a considerable degree of internet resilience; with recent growth in grocery, focused on in-store picked "instant" (i.e., Deliveroo, Uber Eats, etc.).

EUROPEAN RETAIL CLIMATE



Source: Eurostat. As of January 2023.

EU: ONLINE PURCHASES (2021)



Source: Eurostat. As of March 2022.

Occupier Markets

INDUSTRIAL SECTOR

JLL's logistics take-up in the first nine months of 2022 totaled 22.9 million sq m, in line with the 2021 level. Following a very strong first quarter, demand has moderated from recent record high levels. This is in part because of supply shortage issues, with vacancy rates close to zero in many key logistics markets, but also reflecting that the economy has slowed.

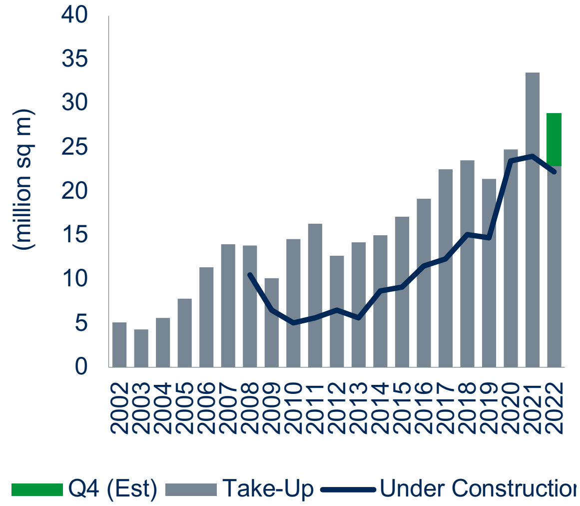
Total development activity remains strong, with around 22.2 million sq m under construction at the end of the third quarter, up 11% year-on-year. Speculative development has hit a 10-year high, with 8.7 million sq m under construction—albeit activity is heavily concentrated in Poland, U.K., Italy, and Spain. New starts are now slowing, as rising yields and higher development costs impact project viability.

Prime logistics rents continue to set a blistering pace, even smashing surging inflation at over 15% in 2022, up from 4.5% in 2021 and 2.6% in 2020. Near-term economic softness will likely slow the pace of growth, but current rental level stability will be supported by strong occupier market fundamentals.

While physical retail continues to face ongoing structural challenges, e-commerce continues to take market share. The latest CRR online retail sales data shows 2022 sales were markedly higher than pre-pandemic levels across all countries. However, a number of countries (e.g., U.K., Germany, Netherlands) did see levels fall back from the 2021 pandemic highs, reverting to a still strong pre-pandemic trend.

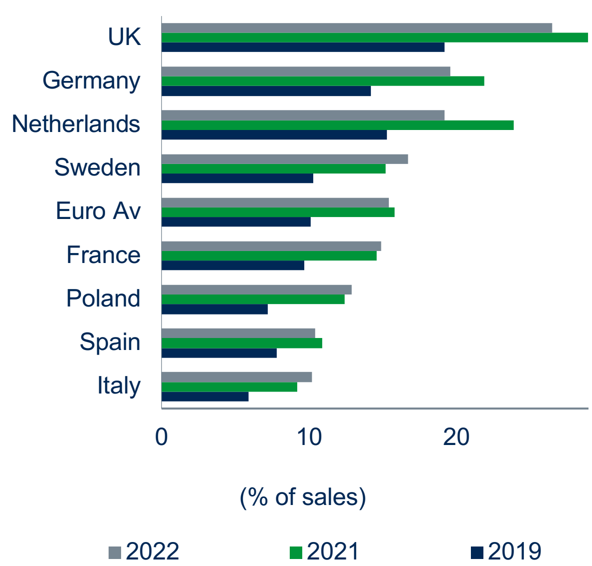
Restructuring plans announced by online retail giant Amazon has raised some concerns around e-commerce's long-term growth potential. Yet, e-commerce faces the exact same cyclical weakness as physical retail (e.g., weak consumer confidence, falling real income levels, etc.). Our positivity on the structural attractions of logistics remains unaltered, with future demand sustained by e-commerce expansion, and (some) onshoring against a persistent heavy undersupply of modern logistics space across Europe.

EUROPEAN LOGISTICS: TAKE-UP & U/C



Source: JLL. As of November 2022.

ONLINE RETAIL SALES



Source: Centre for Retail Research. As of January 2023.

Occupier Markets

ACCOMMODATION SECTOR

Eurozone house price growth has begun to moderate, down to 6.8% p.a. in the year to September 2022, from a peak of 9.8% p.a. in March 2022. According to the Nationwide, more timely U.K. data shows house prices continuing to soften into the fourth quarter, slowing to 4.8% p.a. to December 2022, compared to a peak of 12.6% p.a. last March.

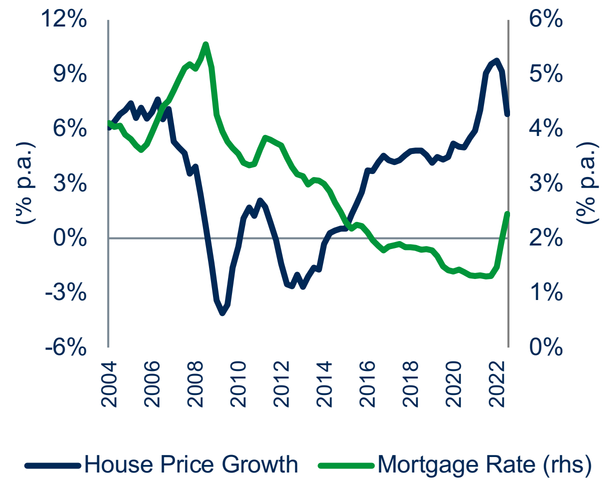
Central banks have been forced into a tightening cycle, sharply raising interest rates to tame rampant inflation. This has impacted borrowers, pushing mortgage rates up from record low levels. While prices will likely soften in 2023, they will remain high relative to earnings. The deterioration in buyer affordability only boosts the case for sustaining rental demand and therefore residential rental growth.

In addition to higher borrowing costs, housing market momentum also faces other short-term headwinds with weak consumer confidence, the cost of living crisis and anticipated labor market softness, weighing on housing transaction volumes and prices. The number of distressed sales should, however, be limited, with only a modest increase in unemployment and also thanks to "beefed-up" post-GFC mortgage lender regulations, which have lowered maximum LTVs and raised required deposit levels (down-payments).

Over 2022, Eurozone residential rents increased by 2.1% p.a. and by 4.4% p.a. in the U.K. Favorable fundamentals suggest the potential for further rental growth this year.

Core BTR investors, looking to hold for the longer term, should focus on locations with positive demographics and where housing supply pressures are greatest. More stringent regulations are an increasing political risk to the sector. For example, rent controls will constrain future growth potential, but on the upside, increase the security of tenure through reducing tenant turnover and increasing certainty and duration of rental income. Rising ESG regulations, that may require existing housing stock to be modernized, will likely present additional investment opportunities.

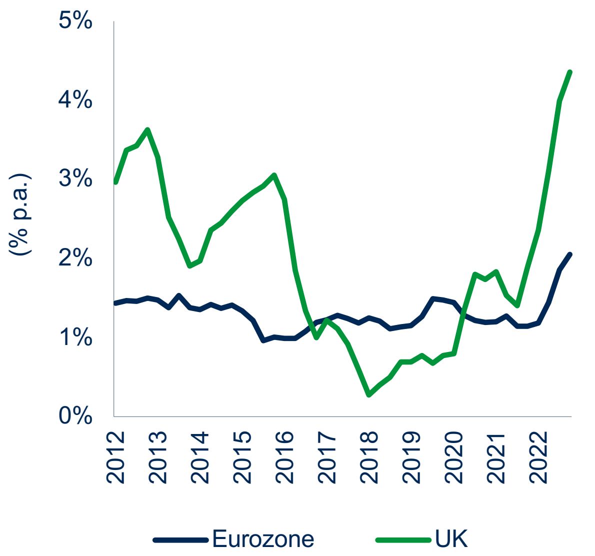
EUROZONE HOUSE PRICES VS. MORTGAGE RATE



***Cost-of-borrowing indicator—new house purchase loans*

Source: OECD; ECB. As of January 2023.

RESIDENTIAL RENTAL GROWTH



Source: OECD. As of January 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 (Barings 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.