



Private Markets

November 2023

European Quarterly Insights – Real Estate

Q4 2023

BlackRock

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European Real Estate Market Insights

BlackRock Real Estate Research

November 2023

Key Takeaways

- Markets have come to the realization that we are now in a new regime of higher rates and heightened volatility.
- The dual drag of elevated rates and inflation will adversely affect the European economy. However, the depth and breadth of recession may not be as great as previously expected.
- Looking ahead, we continue to favor those investments that provide a stable stream of income whilst aligning themselves with the mega-forces. This is typically being the logistics and living sectors.

Markets are coming to the realisation that we are now in a new regime of higher rates and heightened volatility, meaning, we need a new investment playbook. Global long-term bonds have been rising steadily since the middle of July, the sharp rise in recent weeks reflects markets pricing in that rates will remain higher for longer. This has been our Houseview since the onset of the hiking cycle. We maintain the view that the dual drag of elevated inflation alongside higher rates will put stress on the European economy.

As the drag from higher rates intensifies, recession becomes imminent. However, the depth and breadth of such recession is expected to be limited. In the UK, GDP increased by 0.2% m/m in August, however following a 0.6% contraction in July, it is likely that the economy will shrink in Q3. Whilst European GDP contracted slightly in Q3. We don't think we will avoid recession, leading indicators including PMI's and consumer sentiment remain consistent with contraction and the hit to the real economy is yet to be fully felt. Given the economy has held up better than expected this year, we might see more weakness come through in the first quarters of 2024 (Figure 1).

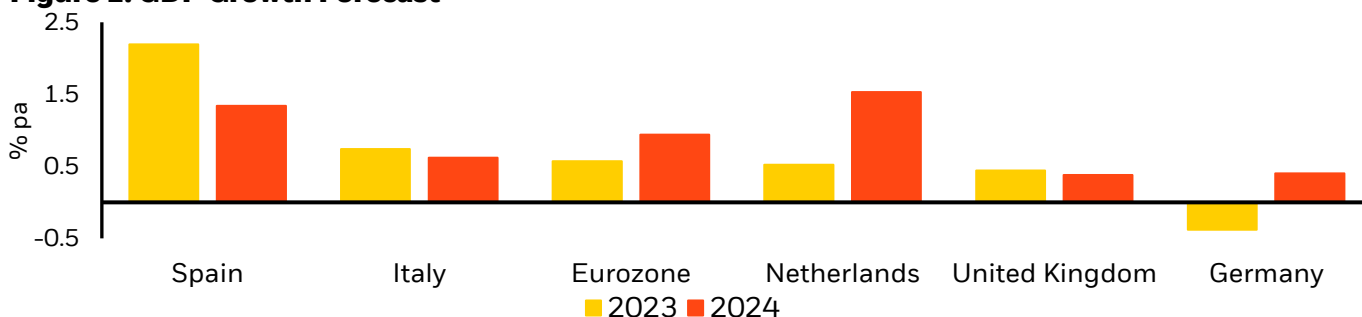
Consensus is that inflation has passed the peak, but we remain aware of downside risks.

Inflation has been coming down consistently for several consecutive months in the UK and Eurozone. The key risks to inflation remaining on a downwards trajectory are persistent wage growth and elevated geopolitical tension. For example, Geopolitical uncertainty in the middle east has caused a surge in commodity prices, natural gas prices have increased by 35% since the onset of the conflict¹.

Markets have priced in the end of the tightening cycle.

At its latest meeting, the BoE kept interest rates unchanged at 5.25%. Meanwhile the ECB held rates at 4%. Central banks are continuing to strike the balance between keeping inflation under control and avoiding unnecessary economic weakness. Consensus is rates will remain higher for longer. However, if disinflation were to outpace central bank forecasts and downside risks do not come to fruition, rates could be cut quicker than markets are pricing. Stickier core inflation and stubborn wage growth suggests the BoE is likely to keep rates at the peak for longer than the Fed or ECB.

Figure 1: GDP Growth Forecast



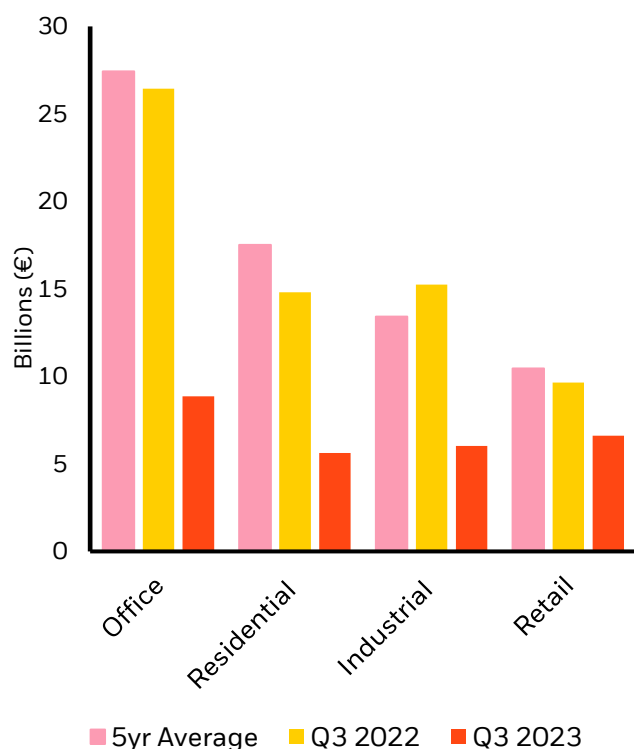
Source: Oxford Economics Forecasting, last update 28 Sep, 25 Oct 2023. Forecasts may not come to pass.

¹ Capital Economics, 20 Oct 2023.

What does this mean for Real Estate?

To date, liquidity in the real estate market remains limited. Transaction volumes in Q3 2023 reached €32.8bn³, 57% below the same period last year (Figure 2). We expect restrictive financing to continue in the short term as banks adjust to the new regime. The adjustment to a high-rate environment continues to cause disruption, as buyer and seller expectations remain dislocated. This gap will start to close as some of the uncertainty surrounding rates subsides.

Figure 2: Transaction Volumes



Source: RCA Capital Trends Q3, 25 Oct 2023.

This is not a typical business cycle. Unlike other cyclical downturns, we are currently observing stable fundamentals. Going forward, as we come out of the correction, investors must remain granular, as asset quality and cash flow resilience will be the key drivers of performance. Whilst markets play catch up with the new regime there is the ability to take advantage of relative disconnects in pricing and find opportunities at attractive entry levels. In addition to the cyclical opportunity resulting from the correction in valuations, our outlook for the medium term and beyond is centered on the mega forces shaping demand. These will drive returns now and into the future, defining the winners and losers.

Sector Convictions: Shaped by the Mega Forces

The office sector faces one of the most challenging corrections. Investment appetite for the office sector has remained subdued, with Q3 2023 volumes reaching €8.8bn, 67% below Q3 2022. Whilst occupiers are exercising caution, with prime European vacancy rates ticking out. The fall in the sectors attractiveness is attributable to both cyclical and structural factors. Given increasing recessionary concerns, occupiers remain reluctant to increase their outgoings, hence limiting any incentive to sign larger leases. This cyclical uncertainty has been partnered with sustained structural headwinds. The normalisation of remote working has made secondary locations less attractive. This will only be exacerbated by digitalisation, as global connectivity improves through technological advances. Furthermore, over the coming years landlords will need to allocate capex to make buildings greener, to counteract the risk of obsolescence. For example, in Europe by 2027 all non-residential buildings must obtain EPC level E labels as minimum and institutional tenants often expect higher labels as they aim to ensure the building, they occupy, reflects their corporate sustainability policy. As very few offices currently meet these levels, we expect the premium for best-in-class space to grow, reflecting the more secure income streams. Going into next year, we expect these shifts to continue driving the bifurcation of office space and subsequent rental growth.

Despite significant repricing, the long-term thesis for investment into logistics remains strong. Since Q1 2022 prime European yields have moved out from 3.8% to 4.9%⁵ once there is a greater degree of price transparency, we expect volumes to pick up. We have conviction in the long-term prospects of the sector as it aligns to several of the mega forces. Over the long term we have observed how digitalisation and subsequent e-commerce penetration has driven demand for the sector. We are starting to see the impact of geopolitical fragmentation materialise, as nearshoring becomes increasingly prevalent in Europe. The amount of industrial space taken up by manufacturers in key European cities has increased by 28% since last year, as companies focus on increasing their supply chain resilience⁶. Even though European vacancy levels have come out marginally, they remain below the historic average. The impact of mega forces, alongside the supply-demand imbalance we are observing in the sector should continue to support rents.

³RCA 25 Oct 2023.

⁴RCA 25 Oct 2023.

⁵PMA Prime Forecast 23 Oct 2023.

⁶Cushman and Wakefield, 27 Jun 2023.

Macro-economic uncertainty has created a challenging backdrop for the retail sector.

Transaction volumes reached €6.6bn⁷ in Q3, down 32% compared to the same period last year. The hit to the real economy is yet to fully materialise, and we are already seeing growing consumer uncertainty. In the UK, retail sales fell 0.8% q/q in Q3, whilst the latest data released in the Eurozone shows sales contracted by 1.2% in August, which does not bode well for final Q3 figures⁸. The gap between the strongest and weakest occupiers is continuing to widen. In the face of macro-economic headwinds, insolvency levels are increasing, and this is expected to continue into next year. Particularly as the sector continues to face competition from growing e-commerce penetration. In the Eurozone, e-commerce penetration is expected to increase from c. 12% today to 19% in 2027⁸. Limited rental growth is anticipated in 2023, averaging c. 0.4% in the key European markets, this is expected to pick up marginally over the next 5 years, averaging 1.7% pa⁹.

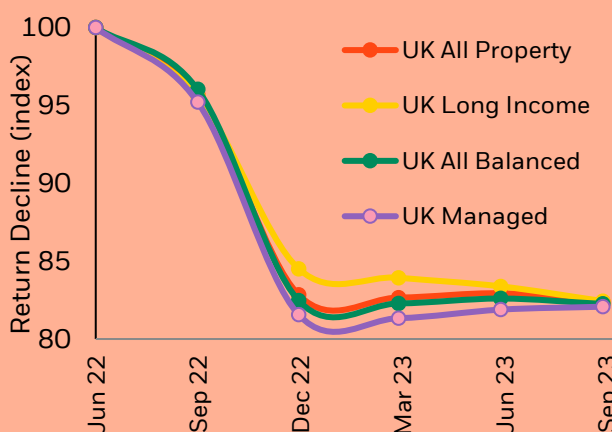
Alongside defensive characteristics, demographic shifts increase conviction when allocating to the residential sector.

Transaction volumes have come down 62% compared to Q3 2022, sitting at €5.6bn¹⁰. Increased household formation, shrinking household sizes, rising house prices and the increasing cost of debt has made rental accommodation a more attractive option in recent years. This year is expected to be another strong year for multifamily rental growth, with 2023 growth predicted to reach circa 5%¹¹. To understand where residential demand will derive from over the long term, we look at demographic shifts. Inorganic demographic shifts will drive demand for certain types of real estate, we are already observing this as growing numbers of international students push up demand for PBSA across key European cities such as London, Paris, and Barcelona.

Focus: UK Property Performance

The MSCI/AREF UK Quarterly Property Fund Index, which tracks 41 actively contributing Funds, was released in the middle of October. With 5 quarters of Total Return data since peak valuations around June 2022, this enables for comparison across Fund Strategies. The chart below depicts an indexation of Net Total Returns since peak

Figure 3: Total Return Since Peak



Source: MSCI/AREF Quarterly Index, Q3 2023, 26 Oct 2023.

The Fund Indices reported valuation declines at different speeds with the UK Managed Open-Ended Index contracting the most with a decline of 18.4% over the first 2 quarters since peak in June 2022. Meanwhile, the long income funds showed resilience in the short term with a decline of 17.5% over the same time-period. However, this trend has reversed in recent quarters where the long income funds have continued the decline and the other indices have bounced back moderately. Explanatory factors entail leverage and sector allocation. We observe that the long income funds generally have a lower level of leverage compared to the other indices. Thus, the lower volatility in the long income fund return index could be partly due to the lower leverage levels. We also note that the long income funds have a lower exposure to the office sector than the all-balanced open-ended funds. Nevertheless, the long income funds have performed worse than the all-balanced open-ended funds. In fact, the long income fund index is the only index to have seen 2 consecutive quarters of total return decline. On the contrary, we do observe that a lower relative office allocation for the UK Managed open-ended funds have resulted in better performance in recent quarters.

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⁷RCA, 25 Oct 2023.

⁸PMA Prime Retail Main Scenario 23 Oct 2023. **Forecasts may not come to pass.**

⁹PMA Prime Retail Main Scenario, 23 Oct 2023. **Forecasts may not come to pass.**

¹⁰ RCA, 25 Oct 2023.

¹¹ PMA European Multifamily Main Scenario, 23 Oct 2023. **Forecasts may not come to pass.**

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