Private Markets

March 2024

Turning Tides: Catching the Wave of European Value Add Real Estate

BlackRock

European Value Add Real Estate

BlackRock Real Estate Research
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Key Takeaways

- The window of opportunity has opened for real estate investors, underpinned by **cyclical and structural factors**. Relative to global peers, **Europe** is further ahead in its repricing journey.
- The **cyclical recovery will be different** this time. Active asset management, granularity and alignment with the **'mega forces'** will be key to success.
- **Value add real estate** is poised to capitalize on this unique environment and is **instrumental to creating 'future proof' stock** that is attractive to Core and other buyers.
- Investors can utilize European value add real estate as a **portfolio diversifier**, providing an **attractive risk-adjusted return** and **inflation protection.**

Adding value

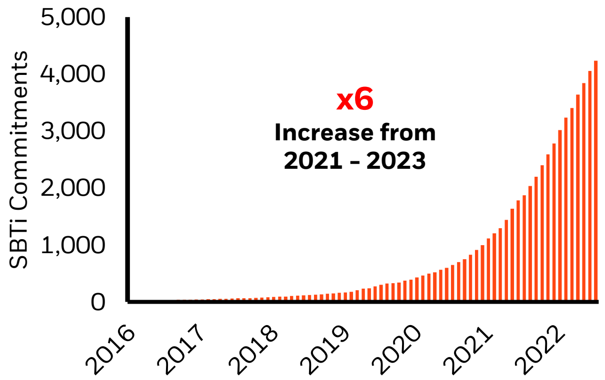
Today's market differs from previous cycles. We believe we are entering a new regime. Interest rates are unlikely to return to the historically low levels of the pre pandemic era. As such there is a window of opportunity opening driven by asset value repricing combined with the impact of long-term structural trends, or 'mega forces'. Successful real estate strategies today need to go beyond relying on unwinding monetary conditions alone to generate strong positive future performance. Off-market sourcing, astute market selection, access to competitive financing, and granularity in terms of asset management are key to generating outsized returns.

The need for value add real estate is exacerbated by the dispersion we are observing in the new regime. The polarisation between and within sectors is widening. Value add investment is a strategy that can seize on this opportunity and create 'future proof' product through renovation, ground-up development or repurposing existing buildings. The structural and cyclical correction has meant that submarket selectivity alongside active asset management is crucial for generating value and creating product that will be attractive for future occupiers and investors.

Structural forces are changing the way we interact with the built environment. This is supportive of, and justifies, the necessity for a value enhancing investment strategy. Assets can be repositioned or upgraded to unlock latent value through a change of functionality or to create alignment with changing regulation. An example can be seen through the opportunity to redevelop obsolete office stock into residential space, or to upgrade buildings to align with energy efficiency requirements.

Creating tomorrows Core Stock

Corporate ESG Commitments



Source: JLL 2024.

Value add enables investors to be agile in the face of a changing real estate market. Exit strategies are implemented once a business plan has been achieved (typically 3-4 years from acquisition). However, there is always potential for exits to be accelerated. This optionality enables investors to capture value appreciation in a quickly recovering market, and to capitalise on demand for income producing investments to provide diversification and inflation protection.

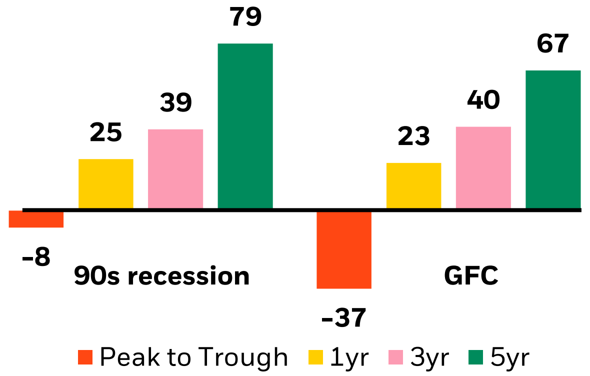
The risk that is taken in value add investment is compensated by multiple drivers of return. Investors can diversify the risk taken within their portfolio e.g. development risk, leasing risk. Binary risks (e.g. planning) can be avoided altogether. Value add is a compelling strategy at this stage in the cycle given its ability to deliver both income and capital gains, and the level of risk taken is compensated by the additional gains that can be achieved. Conviction around capital appreciation is the result of astute market timing, and the repricing of the past 18 months has mitigated the downside risk.

Vintage advantage

2024 marks a once in a cycle entry point to the European real estate market. To date, the UK and Europe have seen valuation declines of 24% and 15% respectively[1]. Market dislocations in pricing are expected to persist, creating opportunity to taking advantage of rebased prices on assets with value add potential.

Post Correction Outperformance

UK Cumulative Returns (%)



Source: MSCI Feb 2024.

Lower valuations, elevated financing costs and refinancing challenges have created an equity gap, forcing many owners to dispose of assets to generate liquidity. Notably, this is being observed in the UK and parts of Europe where distressed sellers and liquidity-squeezed developers have brought strong assets to market. Motivated investors with dry powder to deploy can take advantage of such distress, acquiring low risk real estate at a heavily discounted price.

Unlike other business cycles, fundamentals have remained robust in the face of macroeconomic headwinds. Vacancy rates remain largely stable, and rental growth is steady, particularly in high conviction sectors namely living and logistics.

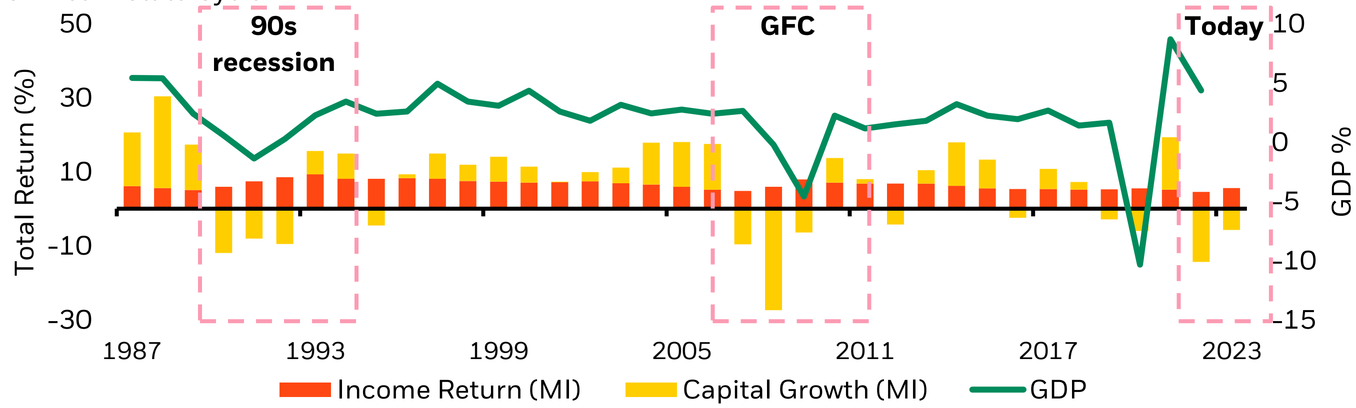
Historically, we have observed outsized market returns following a cyclical downturn. Timing the bottom of the cycle is an impossible task. However, European interest rates appear near peaks and inflation has stabilized. Investing in value add real estate is not without risk, however, these are compensated by the potential upside of investing to a heavily corrected market. Such value play can be paired with alignment with structural forces to promote a resilience of income. This creates a vintage advantage whereby the upside potential outweighs the downside risk.

Why Europe?

Macro-economic risks in Europe have stabilized and sentiment is improving. Over the past few years, persistent macro headwinds and geopolitical volatility have restricted global growth. In Europe these headwinds are subsiding. Restrictive monetary policy has been effective, and inflation is coming under control and is expected to reach Central Bank's 2% target in 2024. Markets have priced in the peak rates, this being 5.25% in the UK and 4.5% in the Eurozone, and respective central banks have held the policy rates at this level for considerable time. The market is currently pricing the first-rate cut in the first half of 2024, leading to improving sentiment, suggesting we are approaching an inflection point in this cycle. Real estate is countercyclical meaning we are set for strong performance as the economy recovers.

A Cyclical Opportunity

UK Real Estate Cycle



Source: Oxford Economics and MSCI Feb 2024. [1] MSCI Capital Values, Feb 2024.

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Catching the wave

Dealmaking set to rebound. In 2023, European commercial property investment fell to its lowest level since 2012, with transaction volumes down 50% versus 2022[2]. When interest rates are reduced, the market will have some breathing space as debt becomes more affordable providing a boost for investor sentiment. Reducing the upward pressure on yields and narrowing the gap between buyer and seller expectations. This will be the catalyst for investment transactions gradually recovering over the course of this year. Once pricing is deemed to have found its floor, market activity will soon pick up given the amount of dry powder targeted at value add real estate is circa USD 84bn globally.[3]

Europe is ahead of the curve in terms of repricing. The denominator effect has resulted in several funds requiring liquidity and looking to sell down some of their real estate to balance portfolio weightings. Such activity has driven down pricing and provided valuers with some transactional evidence. Moreover, in Europe, more than other markets, valuations are determined by sentiment in the absence of comparable transactions. This means repricing, like that we have seen in 2023, can occur swiftly and more dramatically than other regions. Relative to other regions, Europe has observed the steepest repricing, giving investors the greatest scope to capitalise on potential over-correction.

Europe is historically one of the most transparent regions for real estate investment globally. According to the latest JLL Global Real Estate Transparency index, Europe accounts for 60% of the top 10 most transparent markets. European countries have recorded the strongest average transparency improvements since 2020[4]. Elevated regulatory standards, governance and candid reporting makes Europe attractive to investors globally.

Across Europe we are seeing structural forces, or 'mega forces' play out, impacting the way we interact with the built environment. Dispersion will persist between and within sectors. By aligning with the mega forces in Europe, investors can put themselves on the right side of this polarisation. This can be achieved through value add strategies that are aligned to the structural shifts playing out across the Continent:

- **Geopolitical fragmentation:** Disruption including the pandemic, war in Ukraine and recently in the Red Sea has highlighted to corporations the need to build greater resiliency into their supply chains. Nearshoring and onshoring has become more widespread, reinforcing the already strong demand for European logistics assets.

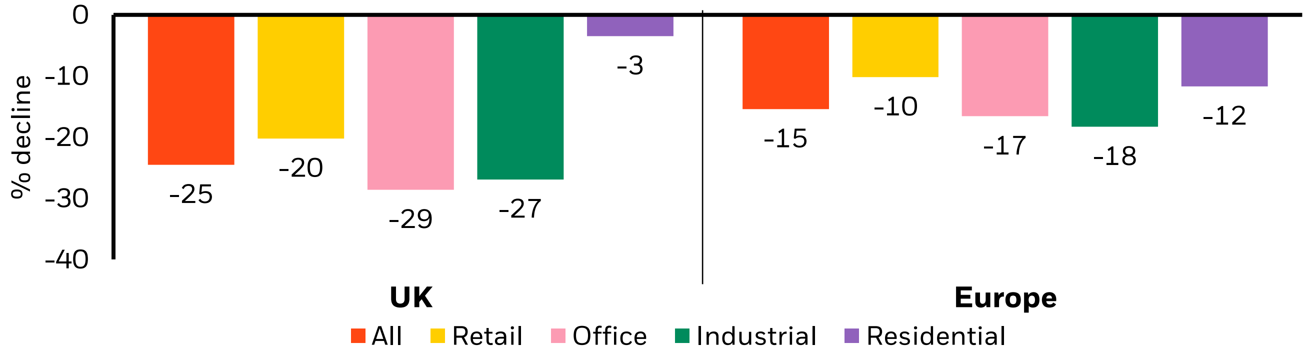
- **Digitalization:** Investors aligning themselves with the digitalisation megatrend can do this through more niche/alternative sectors such as life sciences and data centres.

- **Demographics:** Europe is an aging population; the silver wave is shaping various sectors. For example, we see opportunity for inclusive office spaces, healthcare, assisted and senior living.

- **Transition:** There is a growing polarisation in demand between sustainable and unsustainable assets, ESG compliant stock can command higher rents and values. Value add will be crucial for creating this stock.

Benefitting from the overcorrection

Valuation Decline Since Peak (June 2022)



Source: MSCI Capital Value Decline, Feb 2024. [2] RCA 2023 Transaction Volumes, [3] Preqin March 2024, [4] JLL Transparency Index 2022, Mar 2023.

Keeping Pace with the Transition

Value add real estate is a strategy through which investors can align themselves to, and benefit from the opportunities associated with the transition. There is now a cyclical and structural opportunity for investors to capitalise on this shift. We expect that a polarisation in performance will be observed, across all asset classes, and the winners will be those who position positively for the transition.

Europe is considered the front runner in terms of investor appetite for well performing sustainable stock. This is due to the high levels of regulation that are changing and evolving in the UK and the EU. Governments, investors, and occupiers alike recognise the scale of the challenge faced by the real estate industry, and as such alignment is rewarded.

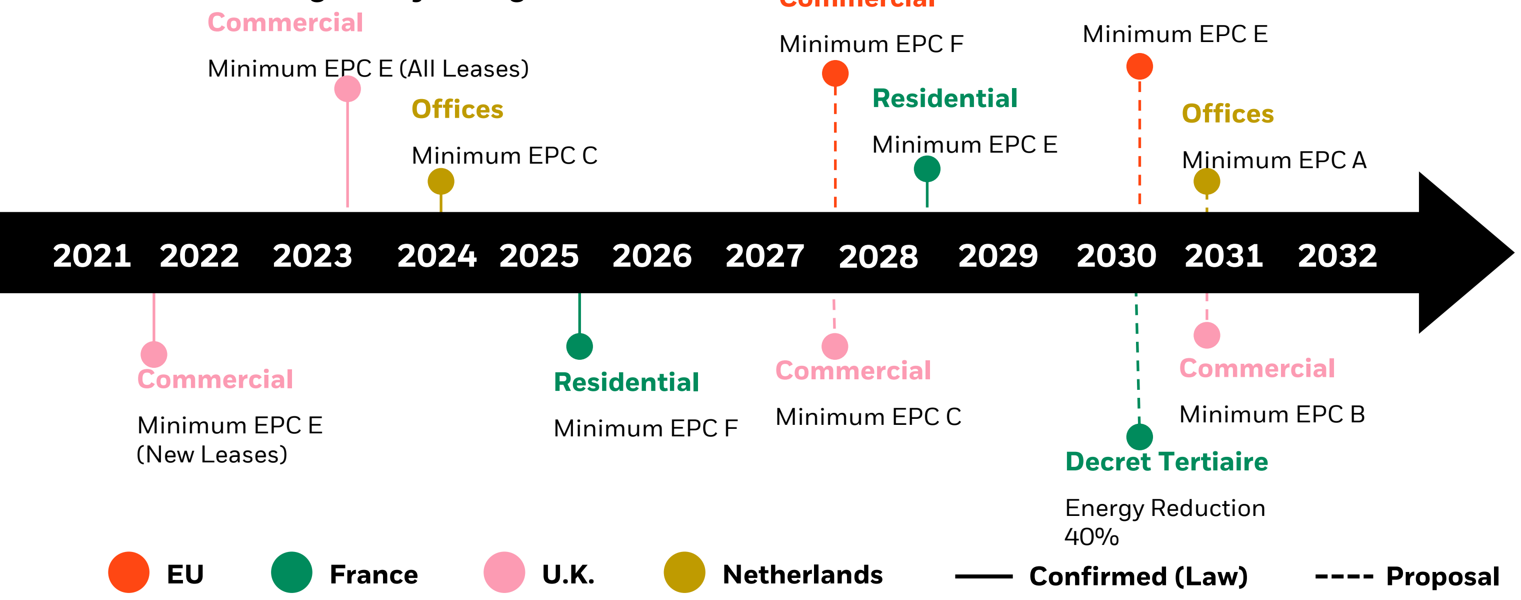
There is not just a strong investment case for incorporating ESG into an investment strategy, it is an imperative to preserve long term value. Many buildings that adhere to transition standards have delivered a clear green premium. These assets often carry lower operating costs, qualify for better finance terms and occupancy rates are boosted as corporates with increasingly tight ESG commitments have a smaller pool of assets they can occupy. There continues to be a distinctive shortfall of stock that meets regulatory standards. For example, more than 80% of office stock in London is rated below EPC B, which is the level anticipated to be required by 2030[5]. This raises the question of what will happen to such stock if investment is not made for upgrades or to change its use.

In addition to regulatory risks, there are also occupier demand uncertainties. Pressure is mounting from all company stakeholders to ensure the buildings they occupy align with the broader corporate ESG philosophy. This will be an important driver of the rental premium as the supply of buildings with the most sustainable credentials continues to fall short of the ever-growing demand. This is even more significant as we move out of the cyclical trough, because rising cost inflation has further slowed the development pipeline, exacerbating the growing supply/demand dynamic.

Investors have primarily considered the ESG upgrades that can be made in the office sector. However, new, and growing regulation means that investors are forced to look at the environmental impacts across all sectors. For example, in Europe circa 60% of homes have an EPC of rating of D. far below the government's 2025 target of C for rental property[6]. This is a risk for the market but presents an opportunity for value add investors.

Value add strategies will play a pivotal role in the transition of European real estate. There is a huge opportunity to unlock value through building upgrades, active asset management and refurbishments. To achieve this requires expertise and sufficient capex, partnered with a risk appetite that is often greater than that associated with core investment strategies. But, as discussed, a growing body of evidence highlights the additional return that can be achieved through a strategy that effectively incorporates ESG.

Imminent Regulatory Change



Source: BlackRock 2024. [5] PMA analysis, Mar 2024, [6] Savills 2024.

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