Opportunities Persist in European Real Estate Despite Geopolitics

European Real Estate Research Quarterly

MAY 2022

22-2160519

Executive Summary

ECONOMY

- Uncertainty remains elevated surrounding the growth outlook for the Eurozone economy, resulting from the Russia-Ukraine conflict, with negative implications for inflation, private consumption and business investment.
- In line with other central banks, the ECB is prioritizing controlling inflation, despite the economic headwinds from the conflict.

PROPERTY MARKETS

- The duration of the Ukrainian conflict and its macro-economic impact on the rest of the world remains key to assessing market pricing prospects—but the current significant property yield bond spread will soften any fallout.
- This year will see corporates audit the suitability of their office space, testing market consensus that tenants will pay for higher quality buildings that are able to meet rising staff wellness and sustainability benchmarks.
- Despite a pandemic re-opening retail renaissance, and even some renewed property investor interest, physical retail still faces technological headwinds.
- Rising logistics land prices and development costs will limit the ability of the development pipeline to meet surging demand for storage space, until rental levels significantly ratchet upward.
- The need for large deposits for house purchases will continue to frustrate market entrants. Ongoing poor buyer affordability will likely continue to boost and sustain future rental demand.

Economic Outlook

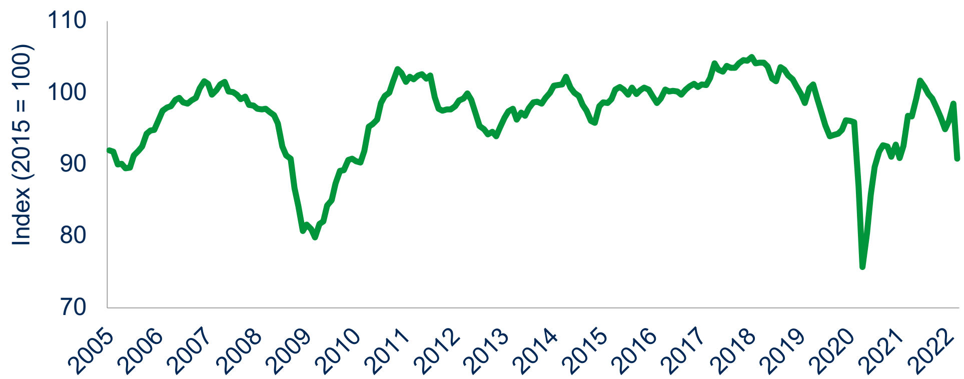
The Eurozone's Composite PMI was 54.9 for March (55.5 in February). This remains expansionary reflecting that the negative impact of the Ukraine conflict was partially offset by the lifting of Omicron restrictions on Europe's service sector, especially tourism and hospitality.

Eurozone inflation, which reached an all-time high at 7.5% in March, will most likely persist for even longer, as input costs and prices charged to customers rise at unprecedented levels. The primary driver behind surging inflation is soaring energy prices, due to Europe's high dependency on Russian gas—which makes up around 40% of Europe's total supply. In Germany, which is an export-oriented but highly dependent energy import economy, there are signs of slowing growth, with the ifo Business Climate indicator falling to a 14-month low in March at 90.8 (98.9 in February).

It was assumed that corporate investment and household consumption would be the primary post pandemic growth engines, propelling the recovery. However, persistent high inflation means squeezed real household income levels and a reduction in purchasing power; while companies struggle with rising costs and weakened business confidence, which will likely delay much hoped for corporate capital expenditure. Europe's manufacturing sector is also suffering from the triple whammy of escalating costs, a resurgence in supply chain bottlenecks and a drop in export demand.

The Ukraine war is adding to pressures in terms of both price levels and duration uncertainty. Even if the war should end tomorrow, the impact on energy prices will not dissipate overnight, as the conflict forces Europe to rapidly reduce its heavy dependence on Russian oil and gas and look for reliable alternatives, which includes renewables. The sourcing of new supplies, the re-routing of supply chains, and the building of required infrastructure takes time, which could potentially mean an extended period of higher energy prices. While this will impact energy intensive sectors hardest, its affects will spread across the wider economy, including consumers who will continue to feel the squeeze on real household income levels.

GERMANY: IFO BUSINESS CLIMATE INDEX



Source: ifo Institute. As of March 2022.

Economic Outlook

The European Central Bank (ECB) is seeking to maximize monetary policy flexibility, to allow a rapid response to future unknown events. In line with other central banks, it is prioritizing controlling inflation, despite the economic headwinds from the Russia-Ukraine conflict. At the ECB's March meeting, it agreed to quicken its reduction in asset purchases and announced plans to stop net bond purchases in Q3 2022. However, Oxford Economics do not foresee European interest rate hikes until early 2023.

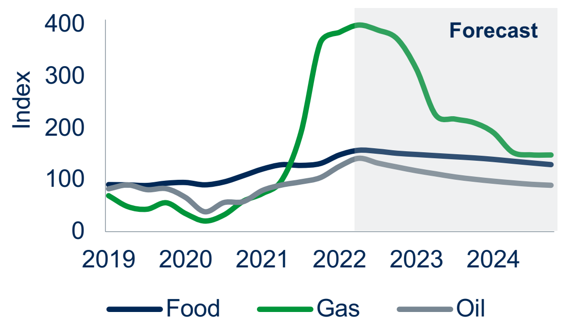
Eurozone GDP is forecast to be close to 3% this year, which has been revised down from almost 4% last quarter. With risks firmly to the downside, the likelihood of more downgrades to the short-term outlook are escalating. If the Ukraine conflict should become protracted, Oxford Economics modelling suggests that the impact of raised energy prices beyond 2023 on inflation and activity levels, the ratchetting up of sanctions, and the restricted Russian gas flows, could result in the Eurozone economy being 4% smaller in 2023 than the baseline. In light of the Ukrainian crisis and deteriorating outlook, property investors need to adjust their expectations for near-term inflation, interest rates, economic activity, letting levels, rental growth and, ultimately, their preferred tactics and strategies.

GDP COUNTRY FORECASTS (% P.A.)

Country	2020	2021	2022	2023	2024	2025	2026	2022-2026
France	-8.0%	7.0%	3.0%	2.0%	1.9%	1.6%	1.4%	2.0%
Germany	-4.9%	2.9%	2.0%	3.1%	2.2%	1.2%	1.0%	1.9%
Italy	-9.1%	6.6%	2.8%	2.4%	1.5%	0.7%	0.3%	1.5%
Netherlands	-3.8%	5.0%	3.2%	1.6%	1.5%	1.5%	1.3%	1.8%
Spain	-10.8%	5.1%	4.8%	3.9%	3.2%	1.9%	1.2%	3.0%
Sweden	-3.1%	4.6%	2.8%	2.8%	1.9%	1.7%	1.7%	2.2%
United Kingdom	-9.3%	7.4%	3.6%	1.7%	2.2%	2.2%	1.9%	2.3%

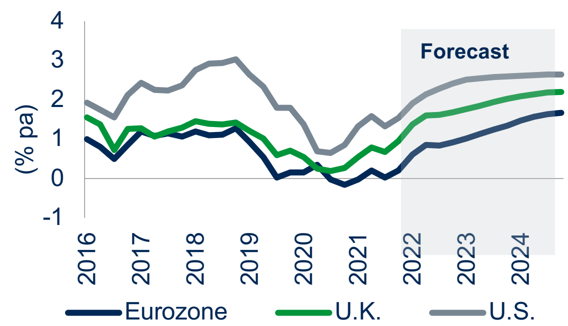
Source: Oxford Economics. As of April 2022.

FORECAST GLOBAL COMMODITY PRICES



Source: Oxford Economics. As of March 2022.

INTEREST RATES: 10 YEAR GOVERNMENT BONDS



Source: Oxford Economics. As of March 2022.

Capital Markets

Central banks are increasingly looking to control inflation and press ahead with rate hikes, despite a weaker outlook. With the U.S. Treasury as the global benchmark, and thus in the driving seat, the 10-year German bund yield increased 90 basis points (bps) to 0.6% through Q1. With core/prime European property yielding roughly 3.9%, a generous 330 bps spread helps reduce any immediate capital market pass through to real estate pricing.

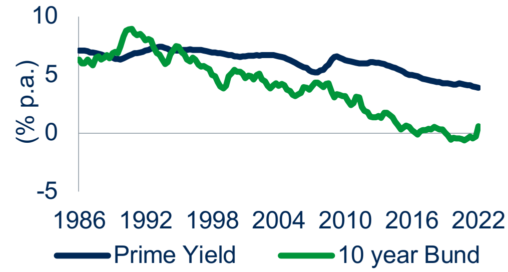
Property is a hybrid, with a part bond like stable cashflow, combined with a rental growth expectation pricing component. That largely explains why core European property yield movements (yield shift/impact) have been heavily correlated to the European Commission's Economic Sentiment Indicator (ESI) over the past 35 years! Accordingly, the duration of the Ukrainian conflict and its macro economic impact on the rest of the world remains key to assessing market pricing prospects, but the current significant property yield bond spread will soften any fallout.

Any negative pricing trends should be most apparent first in the REIT sector. Despite escalating interest rate and growth anxieties, European REIT prices were only 2–3% down during the first month of the Ukraine conflict.

Delivering net zero targets and other commitments to decarbonize under the United Nations' *"2030 Agenda for Sustainable Development"* means a polarization in property market pricing is occurring. Rental premiums are already emerging in the office sector where regulations are tightening fastest, and are closely following in the other property sectors. Where rental values are low, and the cost of remedial initiatives are higher, the risk of stranded assets is rising and a two tier investment market is increasingly emerging.

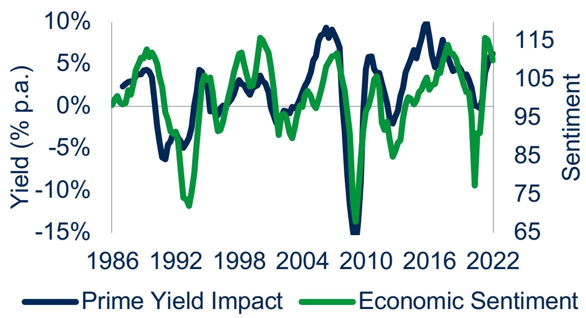
ESG will further filter into the pricing of unlisted property funds, through the EU's Sustainable Finance Disclosure Regulation (SFDR). This categorizes all private equity funds as either integrating or having no ESG integration (Article 6), promoting ESG (Article 8), or having a sustainable investment objective (Article 9).

EUROPEAN ALL-PROPERTY YIELD VS. BUND YIELD



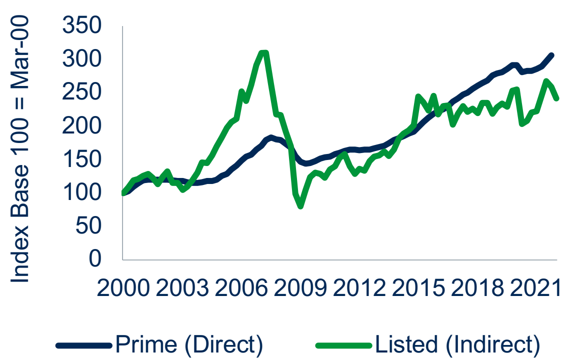
Source: CBRE; OECD. As of March 2022.

EUROPEAN YIELD IMPACT VS. ECONOMIC SENTIMENT



Source: EuroStat; Cushman & Wakefield. As of April 2022.

EUROPEAN CRE CAPITAL VALUES/SHARE PRICE



Source: Bloomberg; Cushman & Wakefield. As of March 2022.

Occupier & Investment Markets

OFFICE SECTOR

Vacancy continues to increase, rising to 7.5% at the end of 2021. This is roughly.75 bps below the 10-year average, but roughly 200 bps above pre-pandemic 2019 levels. We had expected vacancy to rapidly fall back in 2022, but conflict in the Ukraine probably means a more subdued economy and thus lower letting expectations during its duration.

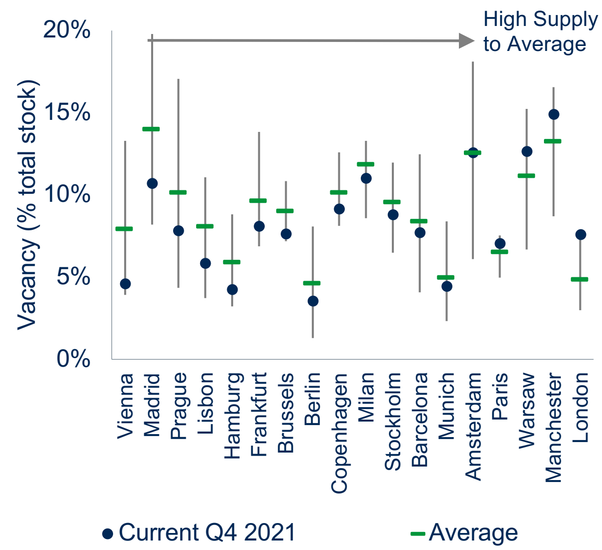
Under 5% of current stock is being built and due to complete in the next two years. This is broadly equivalent to just two years of natural stock attrition, assuming a 40-year life cycle of an office building. On the upside, these new completions enter a chronically undersupplied market, where modern office accommodation is lacking.

Having been temporarily postponed by Omicron, the return to the office will progress once again in the coming months. Working-from-home (WFH) is a partial headwind for office demand, but the benefits of a physical centralized corporate meeting place—including collaboration, staff wellness, building corporate culture, training and recruiting—will steadily continue to shift to the fore.

This year will see corporates audit their space suitability, and test the new market consensus that tenants will pay for the higher quality buildings that are able to meet rising staff wellness and sustainability benchmarks. While this bodes well for owners of Grade A offices with strong ESG credentials, it will prove a burden to landlords of more average quality buildings, who potentially face an accelerated pace of obsolescence and higher capital expenditure.

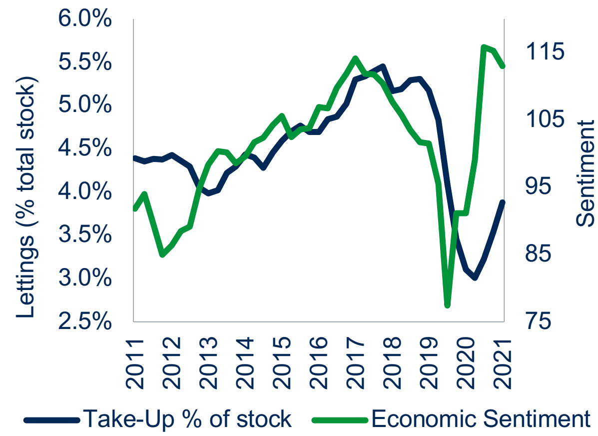
European office investment totalled €31.7 billion in 2021, which equates to 30% of the All-Property total. Offices remained the most traded property sector, despite falling below the long-term average which is closer to 40%. The average prime office yield stood at 3.65% p.a. at the end of 2021, a fall of around -5 bps during the fourth quarter of 2021 and nearly -15 bps over the year. With the prospect of rising interest rates, a more sluggish macro economy, and WFH headwinds, further prime yield compression will be mainly reliant on the 'occupier flight to quality' materializing sooner rather than later.

EUROPEAN OFFICE: VACANCY RANGE (2011–2021)



Source: CBRE; Cushman & Wakefield. As of Q4 2021.

EUROPEAN OFFICE: DEMAND



Source: Cushman & Wakefield. As of Q4 2021.

BARINGS

Occupier & Investment Markets

RETAIL SECTOR

Just when the prospects for a brighter retail outlook were forming for 2022, prolonged and higher than previously thought inflation is now set to weigh on consumer purchasing power. With the price of essentials rising sharply, there will be less cash available for discretionary purchases. The recent sharp drop in consumer confidence suggests that sales of "big-ticket" items, including cars and consumer durables like furniture and household goods (i.e. retail parks) could be more vulnerable in the short term.

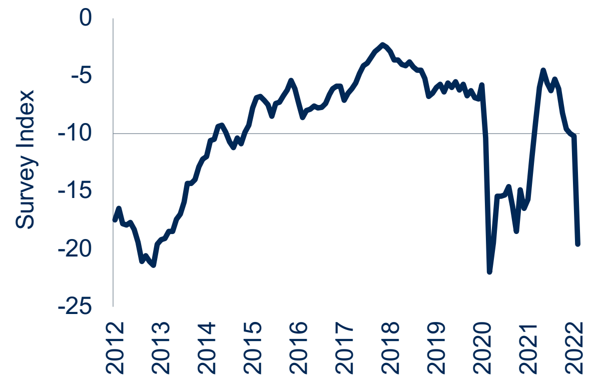
Despite a pandemic re-opening retail renaissance, and even renewed property investor interest, physical retail still faces technological headwinds. This rise of internet shopping is most advanced in the U.K. where online purchases account for about 30% of total sales. This shift in shopping patterns, while still in its infancy in Italy and Spain, is gaining momentum, with the penetration rate now at around 9–11%, compared to 3–5% pre-pandemic.

Levels of retail floorspace per capita and cultural differences in a shopping context are important, as they will determine future floorspace redundancy. With most countries now increasingly comfortable with transacting online, the speed of logistics supply chains and their ability to meet online customer delivery expectations will likely dictate the pace of adoption.

Grocery retail remains resilient, but not immune, to online growth. This is because low margins on food and high delivery costs are still a challenge for grocery operators. Neighborhood retail remains investable due to its convenience nature, as do some retail warehousing schemes that are optimally sited for final mile logistics repurposing, mixed used or residential conversion.

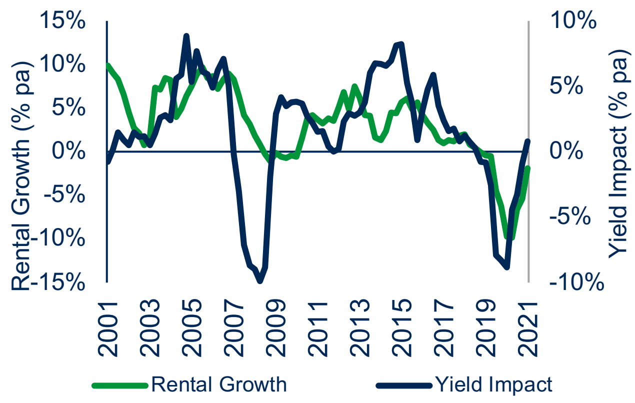
During the pandemic years, prime retail rents fell -12% and yields increased by 50 bps. This translates to a peak to trough decline of around 20% for the very best prime European retail pitches. Despite ongoing structural challenges and only limited signs of a revival in investor demand, prime retail yields managed to modestly harden in a select number of locations in late 2021.

EUROPEAN (EU ONLY): CONSUMER CONFIDENCE



Source: Eurostat. As of April 2022.

EUROPEAN RETAIL: PRIME RENTS AND YIELDS



Source: CBRE; C&W; Barings. As of Q4 2021.

Occupier & Investment Markets

INDUSTRIAL SECTOR

According to JLL, European logistics take-up reached a record high at over 33.5 million sq m in 2021, up 35% on the previous year. There was robust demand across the board, with lettings above the five-year average in key European countries.

E-fulfilment centers accounted for roughly one-quarter of European take-up in 2021. Supply chain bottlenecks initially generated by the pandemic and now the Russia-Ukraine conflict will boost future logistics demand, as businesses shift to more resilient "just-in-case" stock levels.

Vacancy declined to 3%, with levels even tighter in key markets such as Germany, U.K. and Belgium (CBRE).

Strong fundamentals have boosted developer activity, with more than 24 million sq m under construction at the end of 2021. Speculative development comprises 8.5 million sq m, circa one-third of space under construction. Although this is a decade high, it is unlikely to significantly alleviate the current excess of demand over supply.

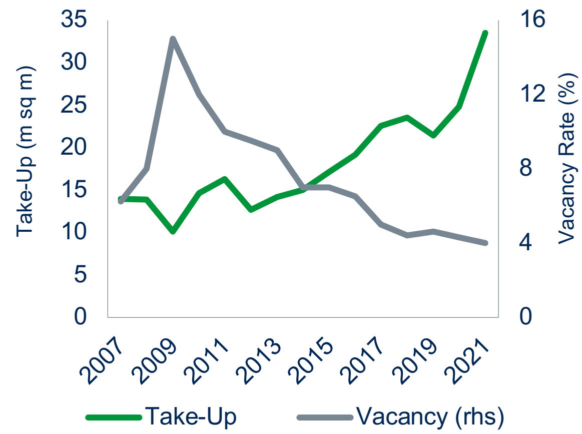
Activity is exceptionally strong in the U.K. with CBRE recording take-up of roughly 970,000 sq m in the first quarter of this year, double the same period a year ago. With the volume of space under offer surging to a record 210,000 sq m, elevated leasing activity will continue.

Structural support for Europe's logistics sector remains highly favorable—especially with the growth of e-commerce and current global supply chain woes, which are intensifying storage space demand for the foreseeable.

Prime European logistics rents increased nearly 5% p.a. in 2021. Rising land prices and development costs will limit the ability of the development pipeline to meet surging demand, until rental levels significantly ratchet upward.

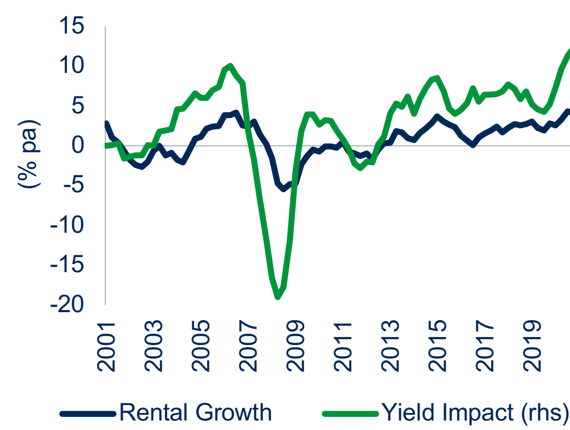
Despite a more sluggish economic outlook, rental growth prospects remain very bright. European logistics real estate is therefore an asset class with growth prospects more than a match for current soaring inflationary expectations. This is why we believe yields for Grade A logistics assets in prime hubs will likely nudge yet lower over the next few years—despite rising interest rate expectations.

EUROPEAN LOGISTICS: SUPPLY AND DEMAND



Source: JLL. As of February 2022.

EUROPEAN LOGISTICS: PRIME RENTS AND YIELDS



Source: CBRE; C&W; Barings. As of Q4 2021.

Occupier & Investment Markets

ACCOMMODATION SECTOR

European residential rents and house prices increased by 1.3% p.a. and 10% p.a. respectively, during 2021. Price rises were strongest in the Netherlands (18% p.a.), Germany (12% p.a.) and Sweden (11% p.a.), while Italy (4% p.a.) lagged.

Over the past 10 years, European house prices have increased by 45%, while rents rose 15%. Ultra-accommodative central bank stimulus explains why prices have outperformed rents over this period. The transmission mechanism is largely twofold: directly via a reduction in mortgage financing costs/interest rates; and indirectly through low interest rates diverting savings into property investment.

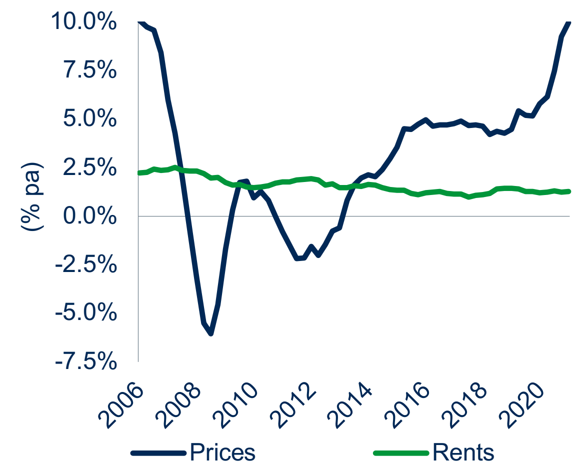
Despite rising interest rates, the cost of servicing mortgage debt will remain low by historic standards. Yet the need for large deposits will continue to frustrate market entrants. This has been evident in the rising average age of first-time buyers (FTBs). Ongoing poor buyer affordability will likely continue to boost and sustain future rental demand.

Investment interest in European residential property has surged, with transaction volumes trebling to nearly 30% of total deal flow over the past decade. This rise has been driven not only by a desire to plug the gap left by retail property's e-commerce-driven demise, but also by the compelling investment rationale detailed above. We anticipate that this sector will be the dominant form of property investment in Europe within the next five years.

Over the next few years, intense investor demand means the current scarcity of stabilized private rented (PRS) single and multi-family assets will persist. Values will therefore likely continue to appreciate. Opportunities to develop (i.e. build-to-rent or BTR) will be more readily accessible, including lower risk forward funding, which is more appropriate for core investors.

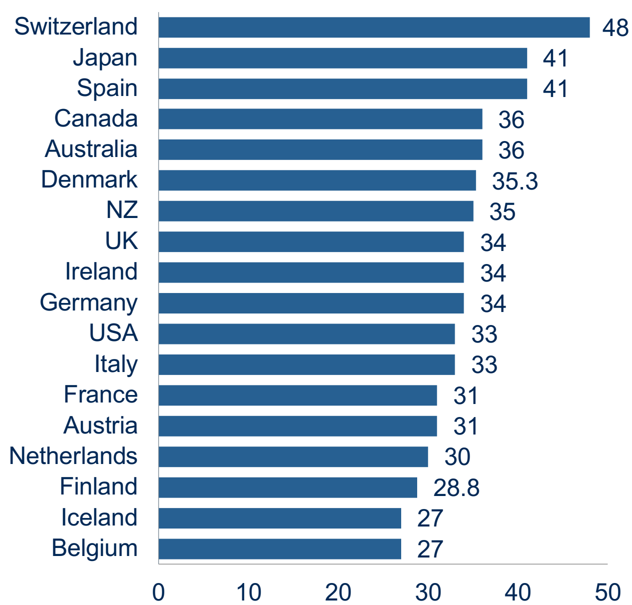
More stringent regulations is an increasing political risk to the sector. While rent controls would limit future growth potential, on the upside, increased security of tenure reduces tenant turnover and increases certainty and duration of rental income. Rising pressure to modernize existing housing stock via a stricter ESG regulatory environment will present additional investment opportunities.

EUROPEAN HOUSE PRICE RENTS



Source: Oxford Economics. As of December 2021.

EUROPEAN RESIDENTIAL: AVERAGE AGE OF FIRST-TIME BUYER



Source: OECD. As of December 2020.

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.

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