

Private Markets

March 2024

European Real Estate Outlook: Inflection Point is on the Horizon

BlackRock

European Real Estate Outlook

BlackRock Real Estate Research

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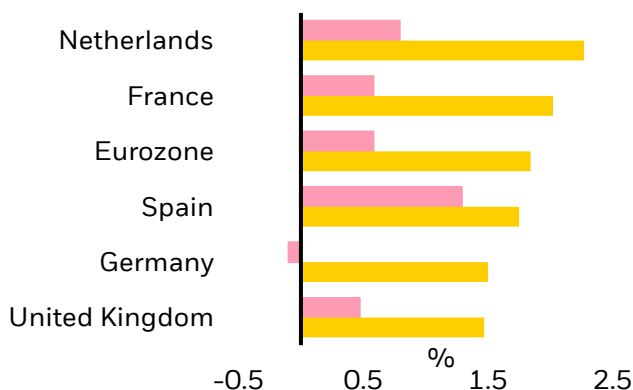
Key takeaways

- Macroeconomic headwinds are stabilising. We expect rate cuts to mark a clear inflection point in the cycle in the second half of 2024, with an improvement in investor sentiment.
- Subdued capital market activity and limited price discovery characterised 2023. Buyers with capital to deploy will be able to successfully take advantage of attractive pricing levels.
- Unlike the previous cycle, investors will not be able to ride the wave of leveraging cheap money alone to drive future performance, the rising macro tide will not lift all assets.
- The strategic implication is that investors who successfully align themselves with long term structural trends will be those who benefit from outsized returns through both security of income and rising capital value.

Improving Economic Backdrop

To date, Europe has weathered the economic challenges better than initially expected. Last year the economy did not sink into the deep recession that was forecast 12 months ago, however 2024 is likely to be another year of muted growth, before more meaningful growth returns in 2025 (Figure 1). Any technical recession will likely be mild and short lived.

Figure 1: GDP Growth pa (%) ■ 2024 ■ 2025



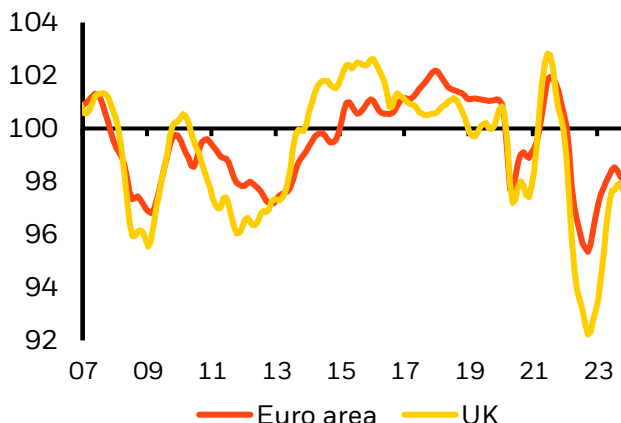
Source: OEF, 27 Feb 2024. Forecasts may not come to pass.

Underlying price pressures are easing, and inflation is coming under control. In the Eurozone, headline inflation has fallen steadily to 2.6% from its record high of 10.6% in October 2022. Similarly in the UK, inflation has come down to 4% from a peak of 11.6%. The deflation observed in the UK has occurred at a faster pace than forecast, which has contributed to improving confidence.

Restrictive monetary policy has proven effective, causing central bank stance to become more dovish. All things remaining constant, we believe rates are now at their peak level. The ECB kept rates unchanged at 4.0% in its last meeting, with forward guidance indicating the first cut could be this Summer. Similarly, in February the BoE voted to keep rates at 5.25%. Even though the Bank continues to push back against the view that rates will be cut in the first half of this year, they have conceded that if the evolution of data permits them to do so, they will loosen monetary policy before inflation reaches the 2% target.

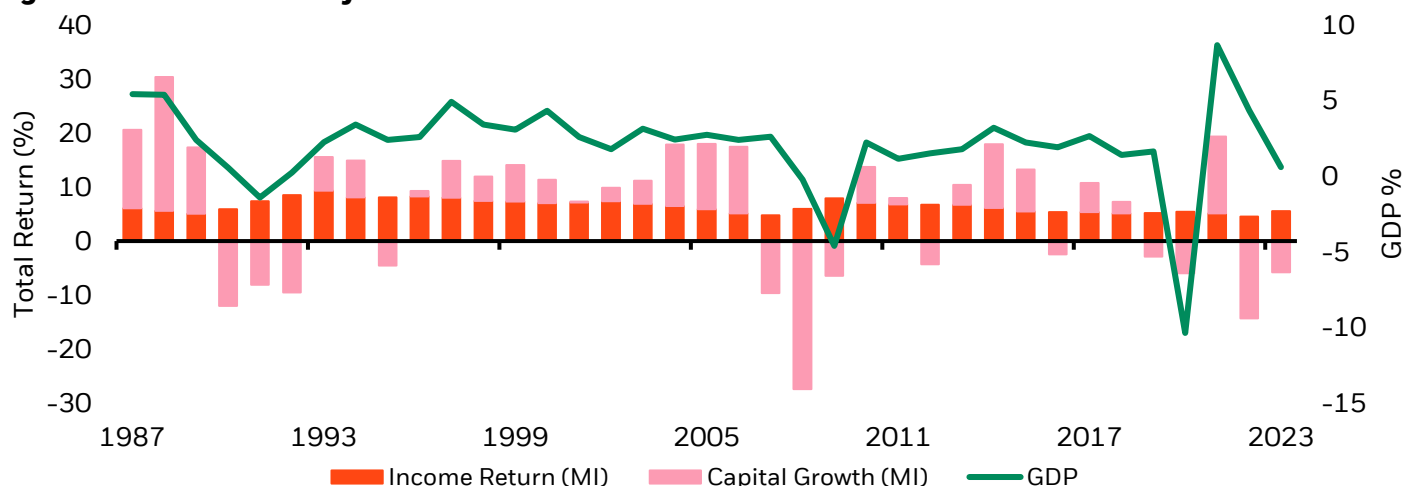
Leading indicators point to sentiment already moving in a positive direction. For example, in the UK, the composite activity PMI is moving further into expansionary territory. Meanwhile consumer confidence in both Europe and the UK also remains on an upward trajectory (Figure 2).

Figure 2: Consumer Sentiment



Source: OECD Consumer Confidence Index, figure above 100 suggests positive about economic outlook, 27 Feb 2024.

Figure 3: UK Real Estate Cycle



Source: GDP Growth Oxford Economics, MSCI Monthly UK Index Annualised, 27 Feb 2024.

Cyclical Entry Window

With a significant value correction already behind us, the question is the pace at which sentiment will improve. To date, values have declined by 25% in the UK and 15%¹ in Europe. We believe that we are approaching the bottom of the market correction in Europe, and as at today we are starting to see signs of value stabilization. As the economic weakness subsides, inflation declines and the case grows for interest rate cuts, the relative attractiveness of quality real estate will improve. Greater focus should be on quality of income as we see measures of insolvency rise increasing tenant risk.

Given the procyclical nature of real estate, we see now as an opportune time to enter the market to benefit from lower entry prices. However, a differentiating factor in this cycle is the that rates will not return to the historically low levels investors had become accustomed to. In turn we see alignment with the long-term megaforges of digitalization demographics and the transition, as key to ensure outsized returns.

Transaction activity should begin increase as sentiment improves. Limited price transparency and a disconnect between buyer and seller expectations mean 2023 annual deal volumes fell to levels last seen in 2012. Total volumes last year reached €166bn², 50% lower than the amount transacted in 2022. However, activity in Q4 2023 increased relative to the previous quarters, suggesting confidence may slowly be returning to the market.

Strategic Implications

We remain confident in our broad sectoral convictions, whilst being cognisant that opportunities can also emerge in all sectors however the rising macro tide will not lift all assets equally. This is where an acute understanding of city and asset level dynamics is pivotal.

Despite repricing, long-term prospects in the logistics sector remain positive. Economic uncertainty, increased financing costs, and limited price transparency, caused a sharp slowdown in deal making last year. Logistics investment volumes reached €32bn, which is down 51% vs 2022². Pricing in European logistics has since moved out significantly, with prime European yield expansion of c. 130bps from 3.6% at peak pricing³. As the speculative pipeline contracts, we expect to see vacancy rates decline. Several forces will continue to drive demand for logistics space. Namely this links to the ‘digitalisation’ mega-force, and the continued proliferation of e-commerce, partnered with the impact of geopolitical fragmentation acting as a catalyst for nearshoring.

A difficult paradigm persists in the office sector. During 2023, transaction volumes sunk to their lowest level since 2012 at €44bn². This reflects the impact of cyclical tightening alongside the risk of obsolescence, growing capex requirements, and uncertainty surrounding space requirements and ESG regulation.

Sources: 1. MSCI UK Monthly Index, European Quarterly, 4th March 2024; 2. RCA, year end 2023, 4th March 2023; 3. PMA Autumn 2024 Prime Forecasts, 4th March 2024

The occupier market is characterised by a preference for quality, with take-up declining by 18% in 2023⁴. However, leasing for ‘Grade A’ space remained relatively solid declining by only 6% compared to 2022 levels. Vacancy in core markets such as Paris CBD and Hamburg remain in line with pre-pandemic levels. This highlights that demand does exist, just for the right product in the right market that aligns with increasingly restrictive corporate ESG commitments. This will drive a greater divergence in rental levels.

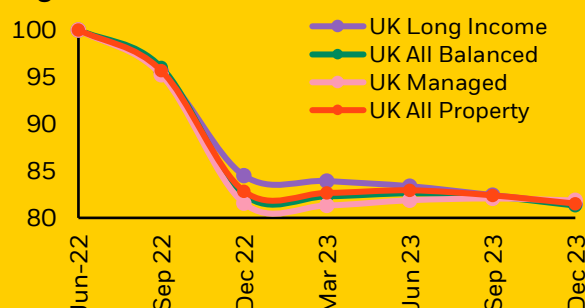
Persistent supply constraints, means the residential sector remains attractive on a risk adjusted basis. European apartment transaction volumes reached €31bn in 2023, which was 53% below the levels achieved in 2022⁵. The residential development pipeline has continued to shrink across key cities due to construction cost inflation. This will further drive the supply-demand imbalance, particularly for affordable stock. Moreover, home ownership is becoming increasingly unaffordable, this will only be exacerbated by the higher rate environment. In turn, rental growth is expected to remain strong over the medium term. One of the main downsides comes through in the form of policy risk, as demand for rental cap regulation persists across key cities such as London.

Despite being long out of favour with investors, selective opportunities exist in the retail sector. The retail sector continues to face short term headwinds alongside long term structural challenges. Transaction volumes reached €29.5bn last year⁵. This is due to faltering investor appetite and structural divestment out of the sector whilst being exacerbated by economic headwinds. Repricing has been less significant, given that a lot of correction had already happened in the sector. As inflationary pressures subside, and real incomes increase, pressures on consumers and retailers should dissipate. Occupiers and investors will continue to grapple with the ongoing structural challenge that is the growing prevalence of e-commerce. Retail which forms part of mixed-use schemes, and retail parks are expected to outperform. There will be ongoing challenges for shopping centres, but we do see opportunities where attractive pricing prevails, namely in Spain.

Focus: UK Performance

The MSCI/AREF UK Quarterly Property Fund Index, which comprises 41 Funds, released its final quarter performance for 2023, reporting a total return decline for UK All Property of -18.5%. The UK Managed Funds Index which tracks funds that deal daily and are a faster reactor to the market has outperformed all property in the past 3 quarters and suggests a possible inflexion point for UK property.

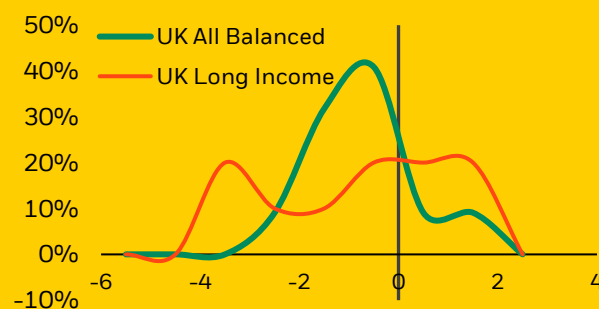
Figure 4: Total Return Since Peak



Source: : MSCI/AREF Quarterly Index, Q4 2023, 18 Jan 2024 **Past Performance is not a reliable indicator of future performance.**

H2 2022 saw total return contracting at different rates across fund types, ranging from 15.5% for the Long Income Index and 18.4% for the Managed Funds. However, from June 22 to Dec 23 all strategies have seen a total decline between -18.1% and -18.7% indicating an overall trend for UK property regardless of strategy. Quarterly returns are still varied across Funds as Managers vary valuation approach to tackle redemption pressures. Figure 5 demonstrates the dispersion in return for the quarter showing 93% of Funds in the Balanced Index performing between -1.5% and 1.5% contrasted against the Long Income Index where performance has relatively spread between -4.0% and 1.5%.

Figure 5: Dispersion of Quarterly Returns



Source: : MSCI/AREF Quarterly Index, Q4 2023, 18 Jan 2024. **Past Performance is not a reliable indicator of future performance.**

Sources: 4. Savills, European Outlook, 4th March 2024; 5. RCA, year end 2023, 4th March 2024.

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