Private Markets

December 2024

European Real Estate Outlook:
Poised for Recovery

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European Real Estate Outlook

BlackRock Real Estate Research

December 2024

Key takeaways

- **Gradual recovery continues.** Economic resilience in Europe has meant a recession has been avoided. Although we expect slowing growth in Europe will incentivize central banks to further ease monetary policy.
- **Riding the upswing** – now the bottom of the market has been reached, in our view, the bid-ask spread narrows and the use of debt becomes more accretive, we expect transaction volumes to pick up in 2025.
- **Entering a new cycle in a new regime.** The next stage of the real estate cycle is set to be characterised by clear leaders and laggards as performance becomes determined by expertise in aligning strategy to the mega forces.
- **Sustainability as a strategic advantage.** The challenges faced by the real estate industry over the past two years has, for some, caused sustainability to drop down the agenda. We view the transition as an opportunity, rather than an obligation, and a prerequisite for long term value creation, protection and income generation.

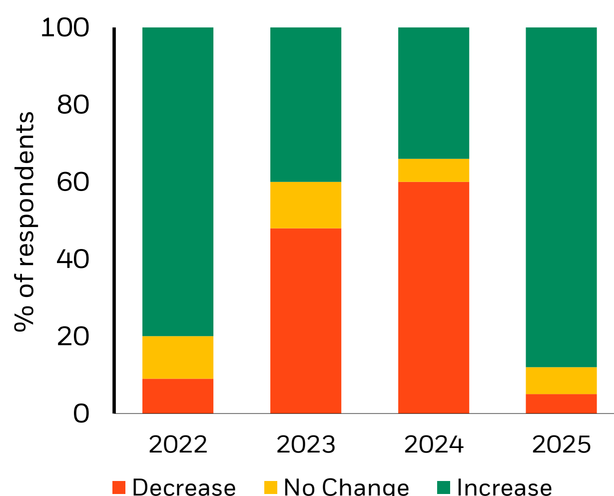
Entering 2025 with the stage set for recovery

A corner has been turned, following a challenging couple of years, investors are now in a position where they can capitalise on the pro-cyclical nature of real estate. During this cycle, polarization has grown both within and between sectors, and we expect to see further dispersion in performance going forward.

Headwinds to growth continue to dissipate. Deep recession has been avoided; the pace of inflation has decreased substantially across most major economies from 2023 highs, and employment remains relatively healthy. This points to the soft-landing scenario having been realised. We are not naïve to the fact that there are idiosyncratic challenges facing some national economies, for example, the high debt-to-GDP ratios in France and subdued manufacturing in Germany. A key impact of such economic slowing is that it will further incentivise central banks to bring rates down in a bid to avoid Europe falling into disinflationary territory.

Policymakers will struggle to continue justifying restrictive monetary policy. As inflation comes down and growth in European economies slows, the pace of rate cuts will be faster than previously forecast. The ECB continues to bring the main policy rate down, with markets currently pricing in the rate settling at around 1.5% by year end 2025[1]. A slightly diferent dynamic is playing out in the UK. Rate cuts are expected to be more gradual because of upgraded forecasts for growth over the medium term. In the UK, the terminal rate is expected to be around 4%, with this level being reached by the end of 2025[1]. Even though there is volatility in the pathway for rates over the short term, we remain confident that if all things remain constant, there will be a much clear outlook for the terminal rate by mid-year 2025.

Figure 1: Revenue Expectations for Real Estate owners



Source: 2022, 2023, 2024, and 2025 Commercial Real Estate Outlook Surveys , Deloitte. Forecasts may not come to pass.

What does an improving macroeconomic environment mean for us? This environment is conducive of improving sentiment towards the real estate market with investors recognising that the worst is behind us. As highlighted in Figure 1 sentiment is improving which should start to translate into capital market activity into next year.

1. Capital Economics Forecasting, November 2024.

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Starting a new Cycle in a New Regime

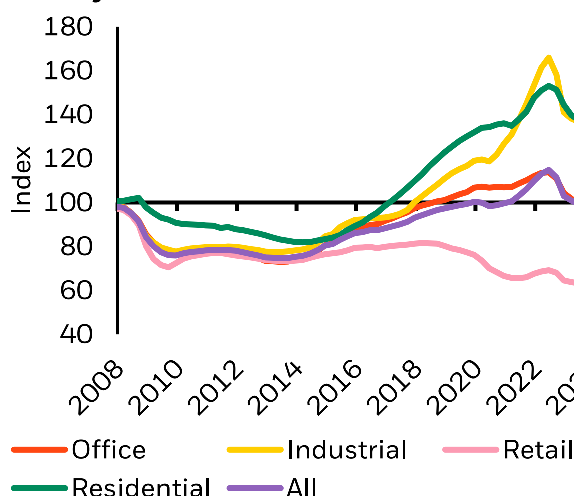
Stabilisation underway. Following a total of 25% downward revaluation across all property in the UK and 20% in Europe, the correction in valuations appears to be coming to an end[2]. Sentiment continues to improve and lingering concerns around refinancing or utilizing debt for acquisitions are being alleviated as the trajectory for interest rates becomes clearer. Bottom of the cycle pricing dislocations still exist; however, they will not be around forever and are likely to be sourced off market through deep industry relationships. Even though transaction volumes remain subdued today, as the bid-ask spread moves closer together we expect to see deal flow pick up.

Key characteristics of the next real estate cycle?

1. A **higher interest rate** environment
2. Greater levels of geopolitical volatility
3. Requirements from built environment changing, need to align with **structural trends.**
4. Continuation of **ongoing polarization in performance** within and between sectors to continue.

Manager selection is critical as performance dispersion will persist. We believe most successful strategies will align with long-term structural trends—such as digitization, demographics, and geopolitical shifts—that we call the "mega-forces." By understanding long-term demand drivers, market dynamics, and employing strong asset management and industry networks, investors can position themselves to benefit from this polarization. As shown in Figure 2, dispersion between sectors grew during the last cycle, and we expect this to continue. There continues to be opportunities in all parts of the market, however selectivity is more important than ever.

Figure 2: Dispersion in valuations over the last cycle



Source: European Capital Values 2008 onward, 4 November 2024.

This cycle will be characterised by a more volatile and less predictable world order, in our view. Real estate investors will need to consider the downside risks and opportunities associated with such uncertainty, as well as how resilience can be built into portfolios to protect against this volatility.

The new world is driven by a range of factors such as shifting global alliances, economic sanctions, trade tensions, and conflicts over resources, which significantly influence economic stability and investment patterns. Geopolitical risk is and is set to remain structurally elevated.

Implications of this new environment for a real estate as an asset class are expansive. We expect to observe greater capital flight to safety whereby investors look to the most mature and transparent markets during times of turbulence. Risk premiums are likely to increase in a regime whereby higher interest rates and uncertainty are the norm. It will require the most skilled investors to generate the higher returns required to offset elevated risk. Investors will need to focus on stable income producing assets, that are strategically located, with a creditworthy tenant base to seek true diversification and subsequent resilience.

2. MSCI Capital Value Decline, November 2024.

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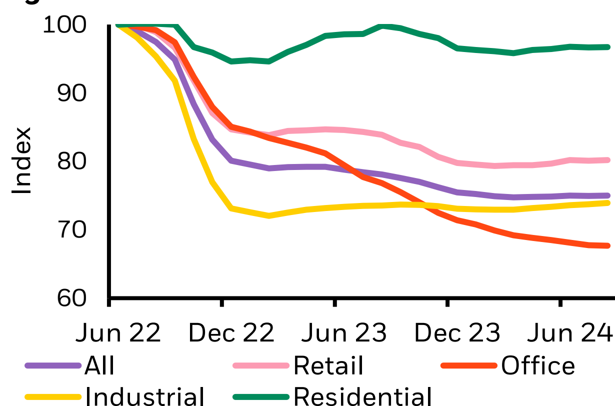
Strategic convictions as we enter next year

What we like and why? We maintain high conviction in the logistics and residential sectors. Yields have started to come in, and fundamentals remain strong. As highlighted in Figure 3, solid valuation uplift is being reported these parts of the market.

Figure 3: UK Valuation Decline from Peak



Source: MSCI Capital Value Decline UK monthly from peak, 14 November 2024.

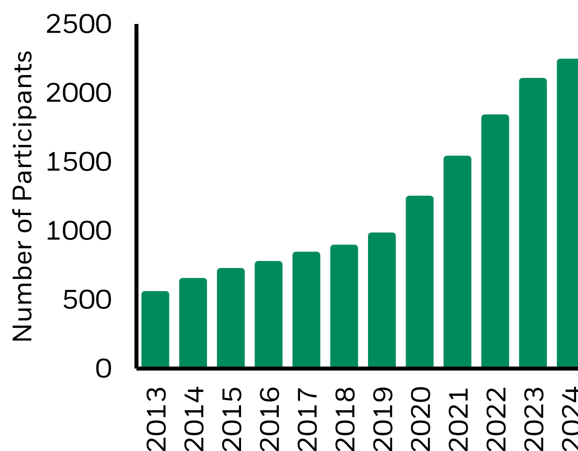
We also believe these sectors most clearly align themselves with the mega forces, which will drive demand into the future. For example, investment into logistics aligns with the rewiring of supply chains. Geopolitical fragmentation has caused uncertainty surrounding the complex nature of globalized supply chains, with companies today looking to build greater resiliency. This re-orientation involves reshoring or nearshoring of warehousing and manufacturing. Whilst the residential offers strong prospects for growth enabling investors to tap into differentiated demographic dynamics.

Which part of the market will become more important into next part of the cycle? One of the key trends we have observed over the last cycle is the re-allocation of capital away from offices, into living and logistics. We have also seen this capital shift towards the more alternative parts of the real estate market. This includes, but is not limited to student housing, life sciences, data centres, and self-storage. The sectors that were once deemed alternative are now far from it, growing in maturity and making up an increasingly meaningful portion of the investment universe. Attractive risk-adjusted returns, and diversification benefits can be targeted by introducing these assets to a portfolio. As such, we expect them to continue growing in importance as we enter the next cycle.

Where does selectivity remain key? Over the long term we have seen structural headwinds create a challenging backdrop for investment into the retail and office sector. For example, remote working uptake and compliance with new sustainability regulations has resulted in weakening appetite for offices. Whilst growing e-commerce penetration has created some uncertainty surrounding what the future holds for some of the retail sector. We do not hold the view that these parts of the real estate market are dead, rather we hold the view that granularity is more important than ever. For example, in top office markets, such as Paris CBD or London West End, where clear construction and supply constraints exist, there will be opportunities to source accretive office deals. In terms of the retail sector, we believe that retailers who can combine their physical and in-store footprint will be the most successful. Typically, we favour retail parks and shopping centres anchored by grocery.

In this cycle, **sustainability is not optional, in our view.** What was once wrongly labelled a compliance-driven exercise, is now imperative to financial return. Sustainability should underscore all strategic decision making, be integrated into investment approach and business plan execution. The benefits are not only limited to operational efficiency and cost saving but also future liquidity and reduced levels of depreciation. As highlighted in Figure 4, the industry is waking up to the challenge that lies ahead, with reporting on sustainability increasing meaningfully. We expect to see more sustainability-linked loans, as well as government-backed programs to finance such initiatives, and energy retrofits will become more commonplace.

Figure 4: Growth in GRESB Submissions



Source: GRESB – Validated ESG performance and benchmarking, 14 November 2024.

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