Private Markets

June 2024

European Real Estate Outlook:

If not now, when?

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European Real Estate Outlook

BlackRock Real Estate Research

June 2024

Key takeaways

- Following 18-24 months of uncertainty, several key macroeconomic headwinds in Europe are subsiding. Inflation continues to moderate, and recovery is appearing to be underway.
- Given the procyclical nature of real estate, investors are now able to consider how they are poised to benefit from the uplift. But this is not to say that all investors will benefit in equal measure.
- This business cycle continues to be diferent. No longer can investors rely on cheap leverage, instead acute asset selection, granularity, market expertise and alignment with long term structural trends are pivotal.

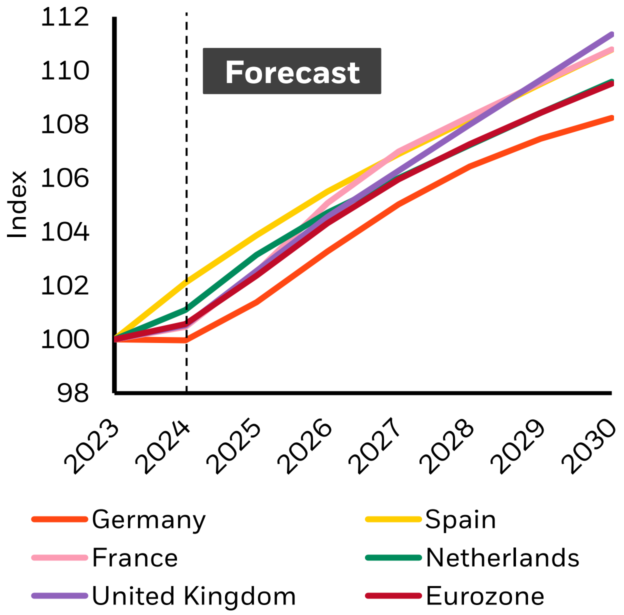
Easing macroeconomic headwinds

Over the past two years, the bleak macroeconomic backdrop allied with the uncertainty that characterises the new normal. has taught us the importance of remaining cautious, and to have humility! However, headwinds are easing, valuations are stabilising, and near-term rate cuts are likely to mark a cyclical inflexion point. This begs the question, if not now when? The window of opportunity to generate cyclical outsized returns is narrow and investors need to consider what else, above and beyond what we are observing today, would provide them with the confidence to enter the European real estate market.

A deep recession has been avoided. The expansion of GDP in Q1 across Europe was broad based, with Eurozone GDP rising by 0.3% whilst UK growth sat at 0.6%[1]. All things remaining constant, we expect economic activity to continue to strengthen for the remainder of this year as positive cyclical tailwinds in the form of lower inflation, and monetary policy easing come to fore.

Inflation continues to come down meaningfully and is anticipated to reach the 2% target in the latter half of the year. We expect to see some fluctuation around this mark over the medium term as central banks seek to control the inflation dynamic, with inflation falling below the 2% level earmarked as a concern for the BoE in particular.

Figure 1: GDP Growth Outlook



Source: Oxford Economics Forecasting Index Base 100 = 2023, 22 May 2024. Forecasts may not come to pass.

Rate cuts will mark a cyclical inflection point. At it's latest meeting, the ECB cut rates by 25bps, highlighting that the easing cycle has begun. If inflation continues to move in the right direction, and lingering worries about wage growth subside, we expect the BoE to cut rates over the next few months. Rates are expected to stabilise at 3% in the UK and 2% in the Eurozone by 2025[2]. Even though, this is a more restrictive monetary environment than that investors had become accustomed to post GFC, rates sitting at this level aligns more closely to the longer-term average level for interest rates.

[1] Capital Economics, 10 May 2024,
[2] Capital Economics, 22 May 2024.

Taking advantage of pro-cyclicality

The outlook for real estate is becoming increasingly positive. However, this cycle will be different, in fact all cycles are uniquely defined. Unlike the GFC, investors will not be able to leverage cheap debt to generate outsized returns, as the cost of finance is expected to remain elevated compared to the post GFC era. Instead, specialized asset management, granularity and an acute focus on long-term value generation will drive a polarization in real estate performance.

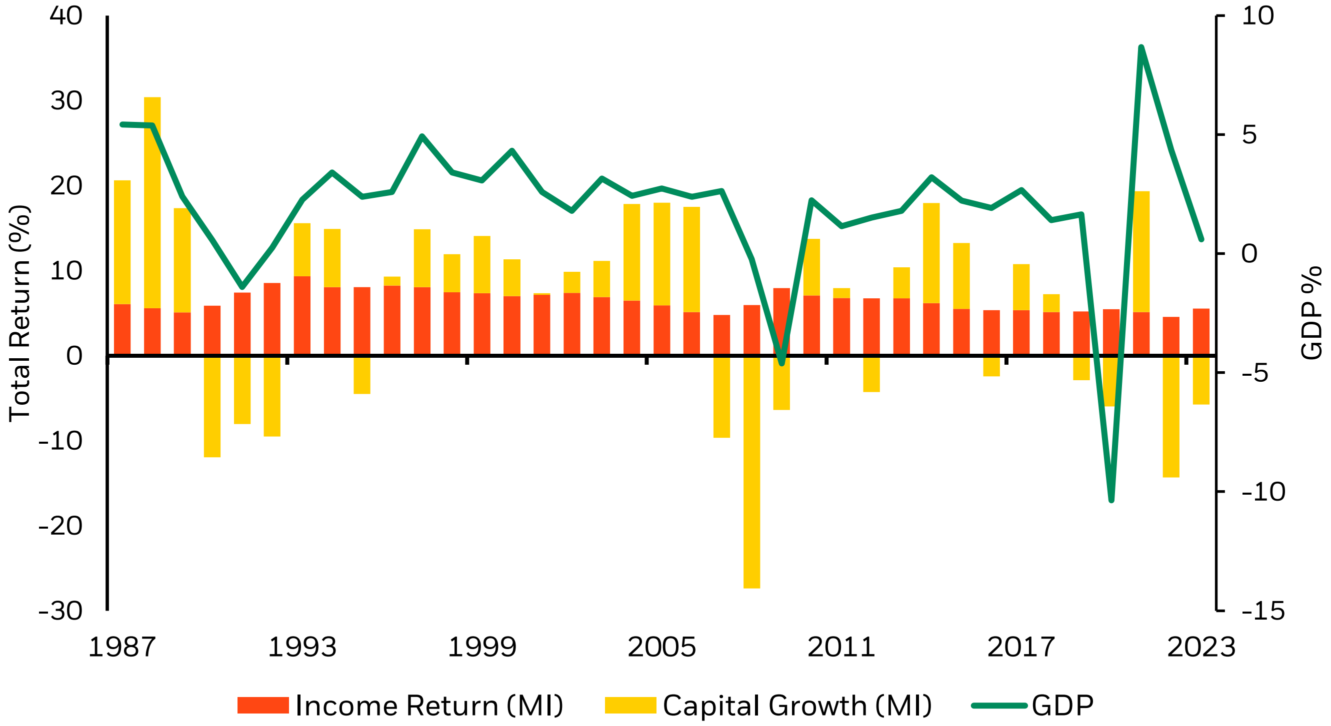
We expect the bulk of revaluations to be behind us. At the time of writing, all property values are currently 25% and 18% below peak pricing in the UK and Eurozone, respectively. Although we are closer to the bottom of the cycle for prime stock, secondary stock in weak locations remains at risk of further correction with increased depreciation and obsolescence. These assets will be more vulnerable to weakness in the real economy, and therefore liquidity in these markets will remain constrained and debt financing will be very limited.

For now, liquidity remains constrained. The ongoing correction has given sellers little incentive to bring properties to market unless forced to. We continue to expect an uplift in sentiment alongside the first interest rate cut, driving deal flow. The shift in market dynamics has the pepensity to happen quickly, meaning before we know it the bottom of the market could quickly be behind us.

Early signs that deal flow is recovering. High frequency data coming from the UK revealed that in March, commercial investment volumes reached their highest level in 12-months. This suggests investors are beginning to attempt to capitalize on the bottom of the market. We expect volumes to pick up this year as yields respond to falling risk free rates and as financing becomes more tenable.

As highlighted in Figure 2, one of the most attractive features of real estate investment is the generation of income return. However, we see the 'new normal' being characterised by uncertainty mainly driven by elevated geopolitical uncertainty, putting such return at risk. The most successful investors will build higher degrees of income protection into their portfolio. This can be achieved by alignment with long term structural trends.

Figure 2: UK Real Estate Cycle



The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Source: MSCI UK Annual Returns, GDP Growth Oxford Economics, 22 May 2024.

[3] MSCI Capital Value Decline, 22 May 2024.
[4] RCA Transaction Volumes, 22 May 2024.

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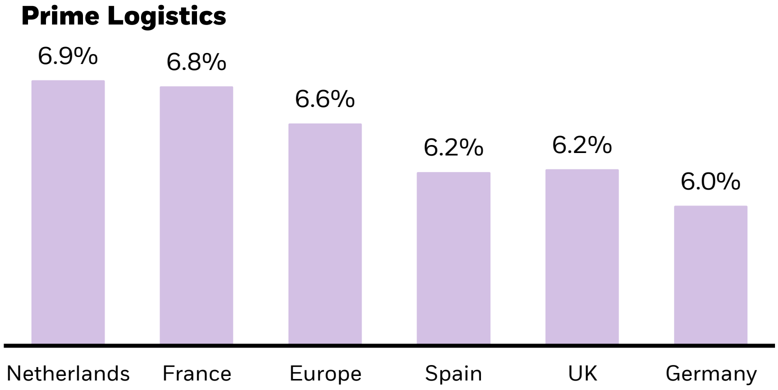
Sector Convictions

Logistics

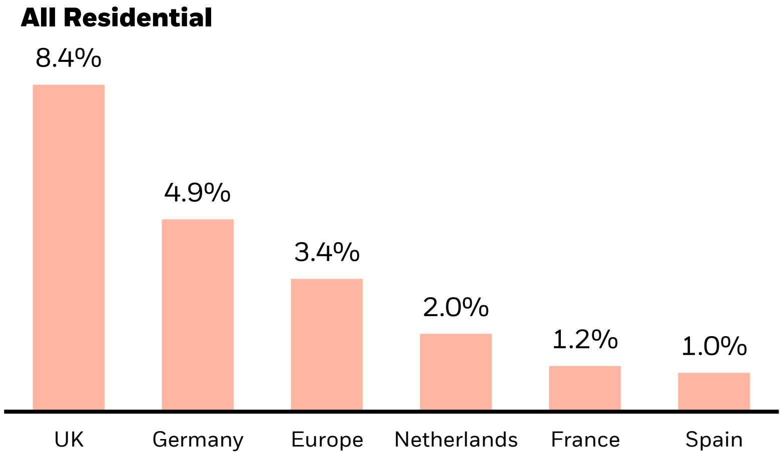
The sector continues to be supported by robust market fundamentals and strong rental growth prospects. We expect that as capital returns to the European real estate markets, it will likely target the logistics sector. Due to the slowdown in development, we have already started to see the increase in vacancy rates slowing. Take up remains stronger than the pre-pandemic average, highlighting that the structural mega-forces, namely e-commerce and nearshoring, are continuing to bolster demand.

Figure 3: Annualised 3-year projected returns



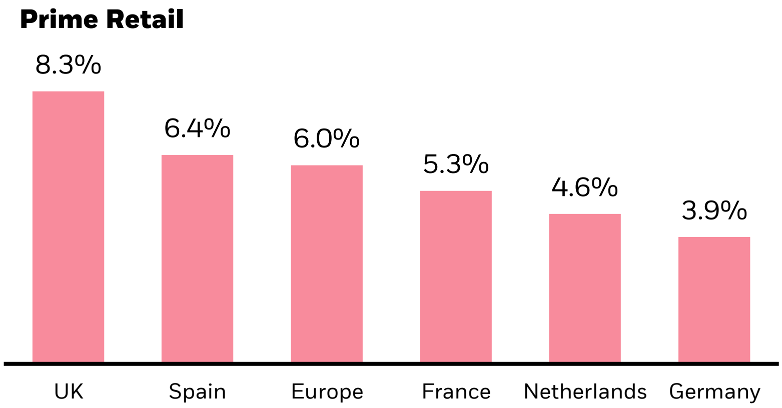
Residential

Investor appetite for the residential sector continues to be driven by increasing affordability constraints of homeownership due to rising interest rates as well as the severe housing shortages in key cities. Demand will also be bolstered by growing household formation across Europe. This has meant changing segments of the residential sector, namely micro-living, have become attractive as these seek to alleviate the challenges surrounding a lack of supply and unaffordability.



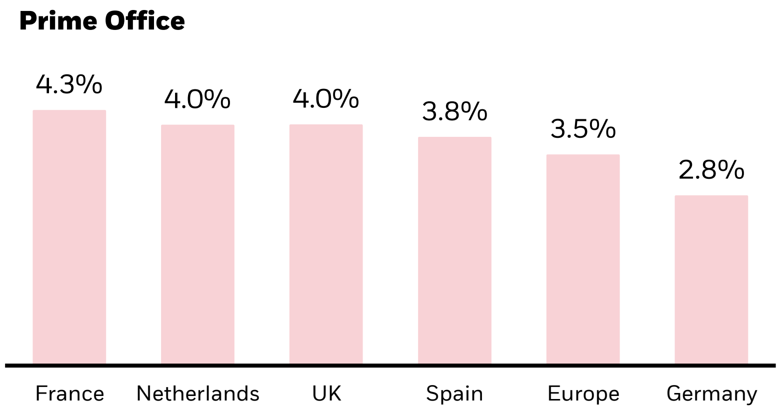
Retail

The retail sector should benefit from an improving real economy, but long-term structural challenges persist. Given that significant correction had already taken place in this sector, pricing did not move out largely during the downturn. We expect the retail sector will continue to grapple with competition from e-commerce. The most successful retailers will ally their physical footprint with an online presence.



Office

Uncertainty clouds the outlook for the office sector, potentially leading to missed opportunities. Sentiment has remains weak, given structural and cyclical headwinds. However, the risk of such cynicism is that investors overlook the opportunity that exists in the prime part of the market. Many European cities continue to grapple with shortages of good quality stock, and as net additions slow down, best in class space should generate attractive rents going forward. Such polarization in performance will be further exacerbated by the shortfall of ESG compliant stock.



Source: PMA Prime Forecasts (bar Multifamily represent all). **NOTE: Represents indicative forecast returns. Forecasts may not come to pass.** 22 May 2024.

Focus: Revisiting the UK Property Fund Index

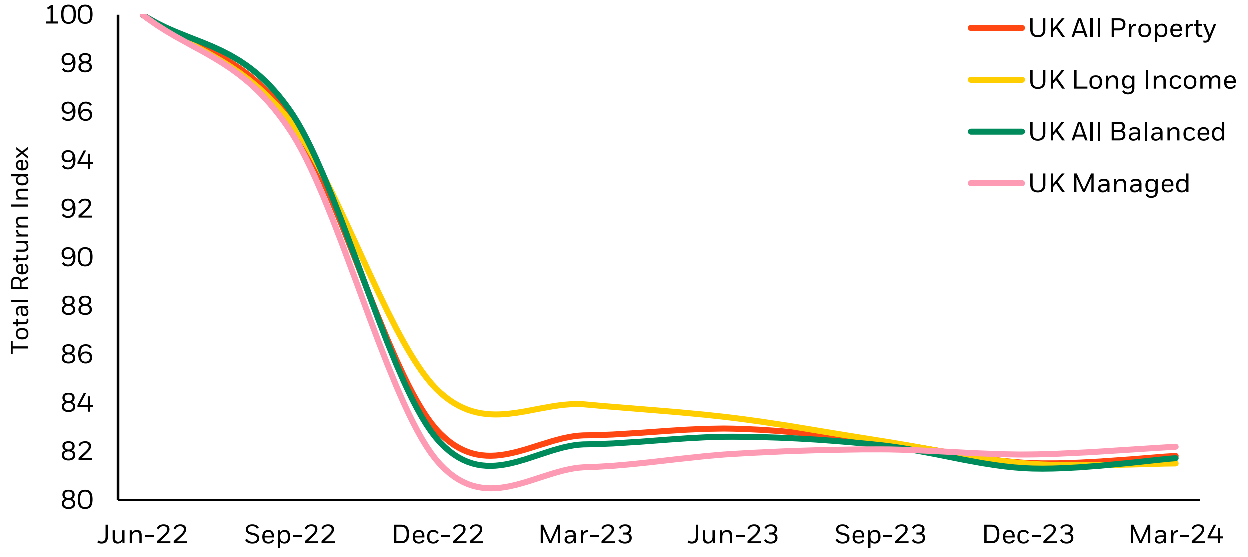
In Q3 2023, we explored leverage and sector allocations as explanatory factors for performance volatility and concluded that the UK Property Fund total return index had started to converge across index types. We noted how Managed Funds had reflected the market decline most rapidly with Long Income funds proving resilient and how this correlation reversed over the period.

Since then, we have started to observe greater dispersion across indices again. Three funds have dropped out of the Quarterly Index due to distress and redemption pressures despite the relative market stabilization in recent quarters. Thus, the MSCI/AREF UK Quarterly Property Fund Index now counts 38 actively contributing funds with property value amounting to £39.3bn spanning across sectors. The chart below depicts an indexation of Net Total Returns since peak valuations in June 2022.

We observe how Managed Funds, which underperformed initially, has been the top performing group in recent quarters. The implied relative volatility for Managed Funds is despite of a relatively modest use of leverage and being characterized by large fund sizes. Therefore, the explanation is more likely found in the allocation strategy and the broader shift from DB to DC schemes, which is particularly relevant for Managed Funds (Property Pension Funds).

Our analysis indicates that Managed Funds faced larger redemption requests, which could explain the short-term underperformance due to selling in a thin market. Meanwhile, comparing the allocation in both Q2 2022 and Q1 2024, the Managed Funds exhibit a relatively smaller allocation to offices and a relative overweight to industrial. This implies that the Managed Funds has had a relatively strong allocation but has been affected by redemption pressures. This goes well with the fact that 'All Assets' property returns, which reflect the impact of sales, have consistently underperformed the 'Standing Assets' category, which excludes sales.

Figure 4: Managed Pension Funds positioned for outperformance



Past performance is not a reliable indicator of current or future results. Source: MSCI/AREF Quarterly Index, Q1 2024.

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