

Private Markets

September 2024

European Real Estate Outlook: If not now, when?

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European Real Estate Outlook

BlackRock Real Estate Research

September 2024

Key takeaways

- The **European economy has held up well** in the face of macroeconomic headwinds. We expect the second half of the year to be characterised by policy easing, steady recovery, ahead of growth next year.
- Real estate investors can take advantage of the **cyclical uplift arising from the procyclical, interest rate sensitive nature of the asset class**, capitalizing on repricing and market distress.
- We expect to observe a **longer-term bifurcation in performance** which will be driven by strategic alignment to the mega-forces.

Is this what a soft landing looks like?

Despite the fastest interest rate hike in history and record levels of inflation, the European economy has held up well, avoiding a deep recession. The procyclical, interest rate sensitive, nature of real estate enables investors today to enter the market at attractive pricing levels and to capture the uplift arising from economic growth.

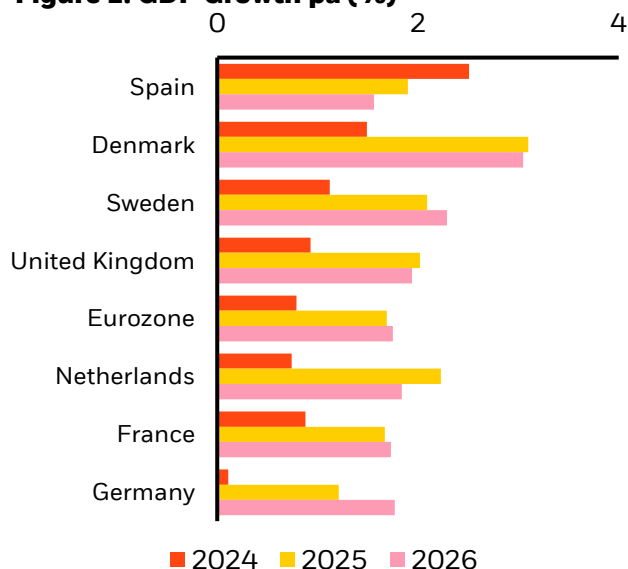
Headwinds to growth continue to dissipate enabling central banks to kick off the easing cycle. Inflation has come down significantly, coming close to the 2% central bank target¹. Fluctuation around the 2% target is expected in the near term as central banks try to balance monetary controls. We saw the European Central Bank (“ECB”) loosen monetary policy in June, bringing rates down by 25bps. The Bank of England (“BoE”) followed suit, bringing the main policy rate down by 25bps to 5.00% in August. Markets are currently pricing in two 25bp cuts this year, which will be contingent on inflation and the labour market remaining under control. In August, the Bank of England (“BoE”) followed suit, bringing the main policy rate down by 25bps to 5.00%. In Sweden, the easing cycle is also well underway, with the Riksbank bringing rates down to 3.5%, marking the second time borrowing costs have been lowered this year.

Now is the time to benefit from the procyclicality of real estate. It is forecast that GDP growth will reach 0.8% in the Eurozone this year, before strengthening to a robust level of 1.7%

pa in 2025, and in the UK, growth is expected to average 0.9% in 2024 followed by almost 2%² next year. Whilst this would not be characterised as a momentous resurgence, it is indicative of a steady recovery. There will continue to be a divergence in the pace and depth of recovery across Europe. As highlighted in Figure 1, Denmark is forecast to be an outperformer in 2024 and 2025, as the economy continues to be bolstered by the pharmaceuticals sector.

Forecasts for UK growth have been upgraded, reflecting a more positive outlook, as the real economy exceeds expectations, and a new government is expected to finally bring a post Brexit calm. Germany on the other hand is expected to continue to underperform as industrial and manufacturing limits growth.

Figure 1: GDP Growth pa (%)



Source: Oxford Economics August 2024. Past performance does not guarantee or indicate future results. Forecasts may not come to pass.

All signs point to the bottom

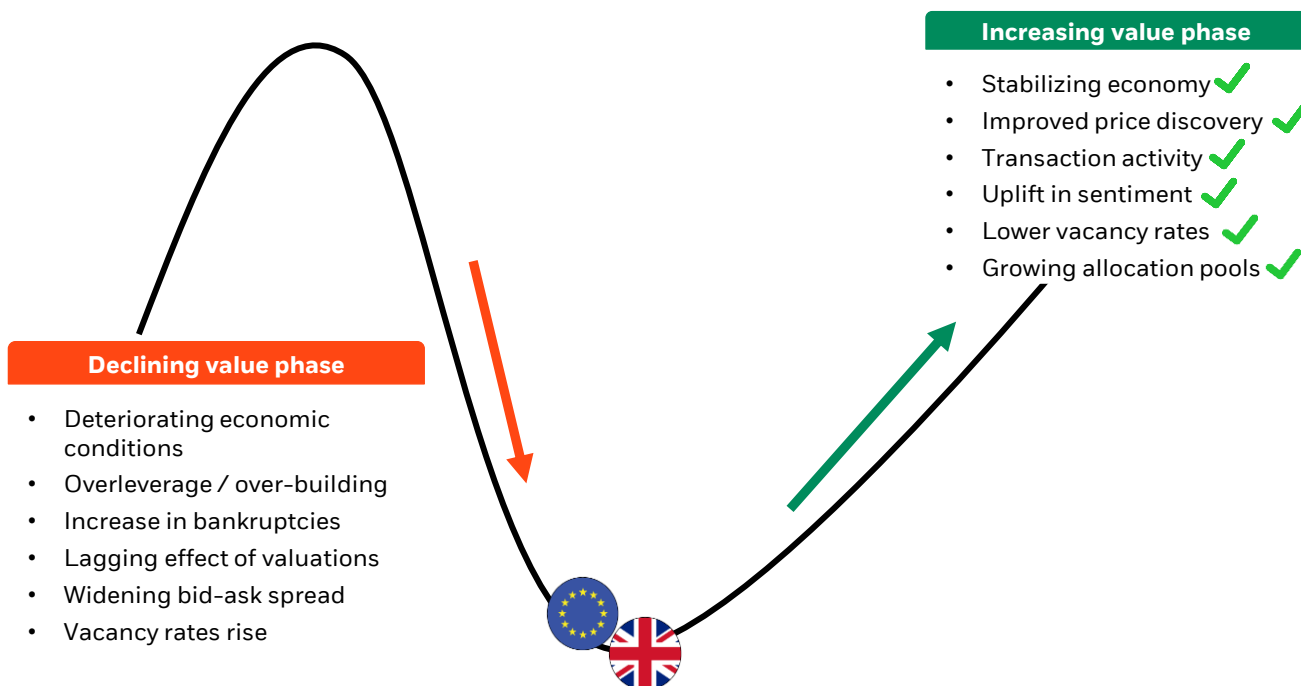
Signals point to the bottom of the market having been reached. Outward yield shifts have driven a decline in capital values that started in the middle of 2022. To date, all property valuations in the Eurozone have declined by 20%³, whilst in the UK values have declined by at least 25%. There is significant variance between countries and sectors, with the office and logistics sectors having faced the strongest declines. The pace of correction has slowed significantly. The UK was the first market to see prices and values undergo substantial correction and has been the first to rebound. Valuation uplift has been reported in all sectors except offices. Cooling inflation allied with less restrictive monetary policy should gradually support the stabilisation of yields. In short term, we expect rental growth to be the main driver of performances as we move into the next cycle.

As highlighted in the chart below, we see many indicators supporting our view that we are now at an inflexion point. We are moving into a phase in the cycle where will begin to see signs of uplift, for example this has is starting to be observed through capital value growth, improving sentiment, and a more active transaction market.

Although capital market activity remains constrained today, we expect deal flow to pick up as investors take advantage of the cyclical opportunity. Q2 2023 saw total European transaction volumes reach €44bn, which is down only 2% versus the same period last year. According to RCA, the higher frequency data which comes out of the UK, shows monthly volumes are now improving. As rates are cut further, sentiment improves and greater price transparency is achieved, we expect to see an increase in dealmaking.

Even though real estate is sensitive to interest rates, we know that investors are not solely going to be able to ride to the wave of easing monetary policy to drive performance. In the short term, we may see some yield compression due to falling interest rates, however rental growth will be the main driver. Markets are currently pricing that rates will stabilise at around 2.50% in the Eurozone and 3% in the UK by end 2025. Rates are not expected return to the levels observed post GFC. Therefore, to generate outsized returns, through a security of income and capital appreciation, investors must align their strategy with the long-term structural trends or the ‘mega-forces’ (Figure X). Investors today can position themselves to benefit from the shorter-term cyclical opportunity, whilst aligning their strategy with long term structural trends.

Figure 2: Real estate cycle key indicators



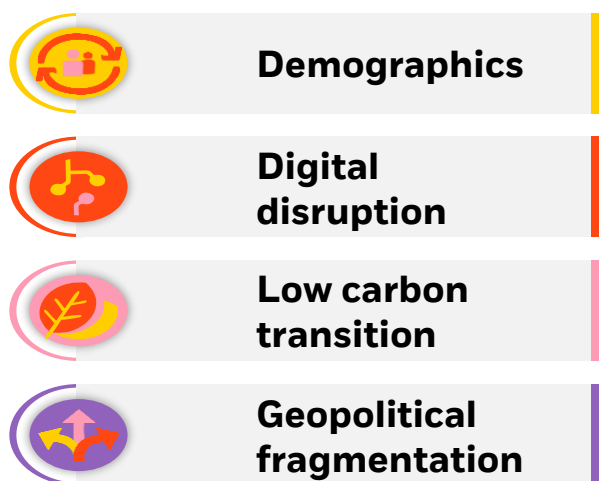
Source: BlackRock 2024., with MSCI Capital Value Decline UK Monthly and European Quarterly,

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Beyond the cyclical opportunity...

As previously discussed, in the short-term investors can benefit from the cyclical window of opportunity. **We believe the most successful real estate investors will be those who have also aligned themselves with the long-term structural trends,** or the megaforges (Figure 3). It is critical that investors build conviction around which sectors and markets will remain in demand as societal demands from the built environment change. In all sectors there are opportunities for investors to align themselves to these shifts.

Figure 3: The BlackRock Megaforges



We maintain high conviction in the logistics sector. Despite significant repricing over the past two years, occupier and investor appetite for the sector is expected to pick up quickly, benefitting from increased business activity.

We are seeing early signs of stabilisation, with vacancy starting to shift in key markets with some valuation uplift. We expect to see solid rental growth, particularly in undersupplied markets, where there are constraints on further development. Over the long term, the sector is perceived to be integral for the development of several structural trends, in particular, higher levels of nearshoring in Europe and increasing e-commerce penetration.

An attractive and stable income profile will continue to bolster investor appetite for the residential sector. Investor appetite for the residential sector has been driven by increasing affordability constraints of homeownership due to rising interest rates, housing shortages in key cities and the ability to benefit from stability of income. The sector aligns clearly to the demographics structural trend, whereby a granular understanding of population dynamics will be critical to asset and submarket selection.

Selectivity is key in the retail sector. Despite ongoing competition from e-commerce, opportunities still exist in the sector. Investors must remain selective, targeting mixed use schemes, retail parks and prime shopping centres, in locations where attractive market dynamics are playing out.

The outlook for the office sector remains uncertain. We have observed interest in the sector dwindling, as investors try to understand how the demand will evolve in the future as hybrid working becomes further embedded into the societal norm. Fundamentals have weakened throughout the course of the year, with vacancy rates rising steadily across most major cities and the outlook for future take up remaining relatively weak. Although stable growth is expected in the prime portion of the market, there is industry-wide uncertainty surrounding the prospects for secondary stock. Competition from remote working is tempering occupier demand and concerns are exacerbated by growing ESG requirements alongside risks around accelerating obsolescence.

Alternatives set to make up a growing portion of the investment universe. We have observed an increase in investor appetite for sectors such as life sciences, childcare, self-storage and healthcare facilities. This reflects our expectation that alternatives will form a growing part of the market as the core universe contracts. The case for investment into these sectors is compelling to investors as not only a way to diversify, but also to align themselves to societies changing needs from the built environment.

Global Research Team

Simon Durkin

Global Head of Real Estate Research
and Portfolio Analytics
simon.durkin@blackrock.com

Chloe Soar

EMEA Real Estate Research
chloe.soar@blackrock.com

Rukeyah Syeda

Real Estate Portfolio and Analytics
Rukeyah.Syeda@blackrock.com

Alex Symes

Head of U.S. Real Estate Research
alex.symes@blackrock.com

Yasmine Kamaruddin

U.S. Real Estate Research
yasmine.Kamaruddin@blackrock.com

Tobias Gotfredsten

Real Estate Portfolio and Analytics
Tobias.Gotfredsten@blackrock.com

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