OUTLOOK | NOVEMBER 2023

PRIVATE MARKETS EUROPEAN REAL ESTATE OUTLOOK

For Professional Investors in Switzerland or Professional Investors as defined by the relevant laws

UNION BANCAIRE PRIVÉE

Wealth Management | Private Markets Group | Marketing communication

Key points

- *In 2023, the eurozone had to battle with rising inflation and interest rates, and with weakening demand and contracting exports. Most recently dramatic events in the Middle East have been clouding the economic horizon for Europe.*
- *As markets prepare for a 'higher for longer' scenario, the real estate market is in the process of finding its new equilibrium.*
- *The rapid rise in interest rates has triggered the most severe contraction in real estate transaction volume the region has seen in over a decade.*
- *As investors start reconsidering the asset class, it appears evident that a more active management will be required to generate positive returns.*
- *Higher costs of capital imply that execution excellence will be essential, and value-add strategies will be less forgiving than in the past. As a result, manager selection will become critical due to a greater dispersion in performance.*
- *Long-term trends continue to develop as investors rebalance their exposure between different sectors. Office space, which used to constitute the majority of investors' real estate portfolios, is now expected to be underweighted.*
- *Conversely, logistics, hospitality and alternative assets, including data centres, are growing thanks to strong fundamentals and secular underallocation by institutional investors.*
- *Retail too, which initiated a repricing before the pandemic, has shown strong signs of resilience.*

Introduction

Recent macroeconomic and geopolitical developments have left many investors wondering how to approach the real estate market. As we have left a world of low interest rates, the days of carry trade on core assets are probably behind us. Instead, investors will have to increase their risk exposure and move towards value-add strategies. However, the higher cost of capital will also mean that these strategies will be less forgiving than in the past. A greater performance dispersion will reinforce the need for thorough manager selection.

WHAT HAPPENED OVER THE PAST 12 MONTHS?

Historically, real estate yields are priced at a premium over 10-year bond yields. Since 2014, bond yields have remained at levels of between 0% and 1% when they did not slip into negative territory. Over that period, spreads have been unusually wide, creating a particularly favourable environment for carry trades on core assets.

In general, real estate yields are characterised by low levels of volatility, and short-term movements in base rates are usually absorbed by a temporary compression or expansion of spreads. But this only remains true as long as the movement in the base rate is perceived as a temporary phenomenon and the spread remains positive.

In late 2020, inflation made a comeback as the result of the disruptions to supply chains created by the pandemic. It later made its way to energy prices, further accentuated by the war in Ukraine. As inflation rates reached levels unseen in decades, bond yields rebounded rapidly, leading to a sharp contraction in spreads (Figure 1).

At the same time, borrowing costs skyrocketed: 5-year interest swaps moved from ~0% to 3.5% between 2021 and Q4 2022. Lenders also started to tighten their credit requirements, lowering their loan-to-value and covenants, and increasing their margins. The combination of all these factors ultimately led to a contraction in transaction volumes in 2022 which accelerated in 2023 (Figure 2).

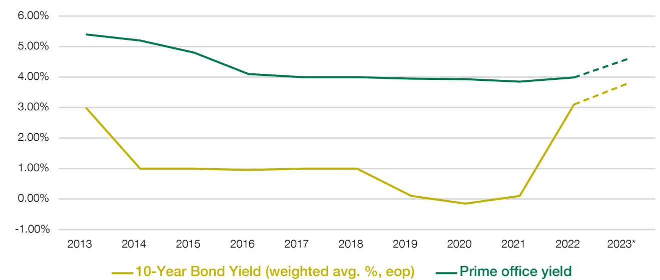
WHAT'S NEXT?

The secular trends observed in the property market over the past few years are likely to continue for the foreseeable future. After decades of office dominance, investors are expected to build a more balanced exposure between office, residential, retail, industrial/logistic and alternative assets such as student housing.

Investors will have to block out the short-term noise to focus on the long-term fundamentals and select those sectors with strong pricing power. Liquidity is not necessarily expected to recover to the levels seen in the past six years, and investors allocating capital to the asset class should be comfortable with longer holding periods. Inherently, this implies shifting their focus from internal rate of returns (IRR) to multiples of money (MoM) (Figure 3).

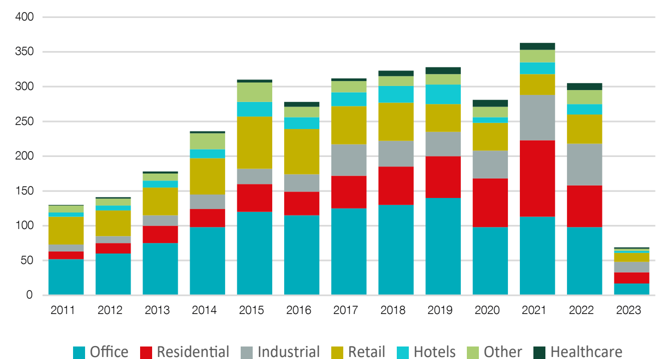
For investors seeking opportunities with stronger income profiles, private real estate credit should offer an attractive venue. As traditional lenders reduce their exposures, the vacuum is likely to be filled by private lenders. Climbing the capital structure will enable investors to benefit from attractive risk-adjusted returns.

Figure 1 - 10-Year European bond yield vs prime office yield



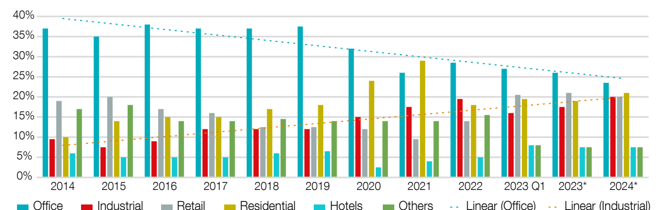
Sources: Savills, Focus Economics, *Forcast

Figure 2 - Investment Volumes (annual by sector)



Source: CBRE Research, 2023 annual figures included through to 30.06.2023

Figure 3 - Investment volume breakdown per asset type



Sources: Savills Reasearch 2023, *Forcast

European Real Estate Outlook

OFFICE (OUTLOOK: NEGATIVE TO NEUTRAL)

Since the end of the pandemic, the office market has been subject to a paradigm shift. Tenants now demand more premium locations, smaller but higher-quality spaces, greater lease flexibility and higher ESG scores. It has created a divergence between high-quality, prime office space that continues to enjoy low vacancy rates and increasing rents, and the rest of the market.

On the investors' side, the market diverges greatly depending on the quality of the tenants, with more resilience in government office space which is deemed to be more predictable than its corporate equivalent.

Repositioning older inventory to fit the new standards may be a solution in certain cases, but it also faces headwinds. Rising construction costs and complex structural layouts may complicate refurbishments, upgrades, or conversions, and make them financially unattractive. Careful selection and underwriting will be essential to reach target returns.

As a direct consequence, investment volumes significantly contracted in 2023, with a 50% year-on-year decrease over the last 12 months. Within Europe, Germany and Sweden have been particularly impacted, with a 62% and 67% decrease, respectively.[1]

While the outlook for the European office space market is generally negative, there is an emergence of attractive entry points for fundamentally sound assets being disposed of by motivated sellers, either due to refinancing pressures or as part of portfolio rebalancing exercises.

RETAIL (OUTLOOK: NEUTRAL)

Retail initiated its repricing in 2019 under the pressure of e-commerce. As the sector emerged from the Covid pandemic, retail demonstrated unexpected resilience, particularly in the luxury segment. This sector has produced strong sales growth, driven by demand from ultra-wealthy individuals and young shoppers. As a result, luxury retailers have expanded their physical footprints, often in conjunction with a wider use of technology for an enhanced consumer experience.

Another notable trend has been the success of the omnichannel model relative to pure online retail. As profit margins of online retailers have started to dive, more online retailers are turning to physical retail space to interact with their customers. This trend is bound to continue in the future, with more and more retailers opting for the omnichannel model.

On specific sub-segments of the market, retail parks and grocery stores have delivered strong operational performances, both enjoying low vacancy rates and rising rents due to inflation indexation.

However, similar to the rest of the real estate market, credit tightening has altered investors' appetites, leading to a 27% contraction in transaction volume compared with 2022[2]. Once the credit market stabilises, retail assets could be a beneficiary of the general rebalancing in the asset class, which justifies our neutral outlook.

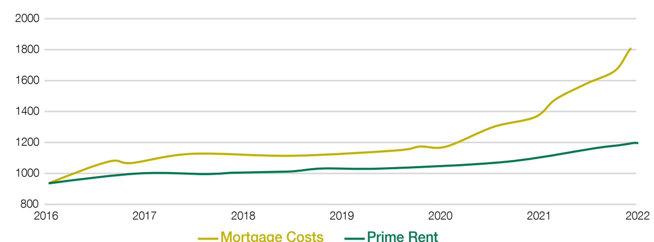
RESIDENTIAL (OUTLOOK: NEUTRAL)

Residential assets are subject to conflicting trends leading to an uncertain outlook.

The recent surge in mortgage rates has made ownership significantly less attractive compared with renting, driving up the pricing power in the sector which is already at an historic high. As mortgage loans mature, one might start seeing more assets returning to the market due to rising refinancing costs (Figure 4).

Figure 4 - Rising Mortgage Rates Makes Renting More Attractive for Europeans

Mortgage payments vs. Rent for a 60sqm apartment in the city center. Cities include Amsterdam, Barcelona, Berlin, Cologne, Copenhagen, Dusseldorf, Frankfurt, Gothenburg, Hamburg, Helsinki, Lyon, Madrid, Malmo, Munich, Paris, Rotterdam Stockholm, Stuttgart, Vienna and Warsaw.



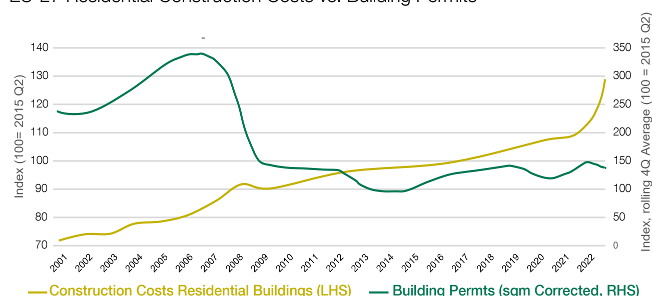
Source: CBRE Research 2023

[1,2] CBRE, European Real Estate Investment Volumes Q2 2023

In parallel, owners face stricter regulations on energy ratings. In certain countries, these regulations will remove the least energy-efficient properties from the available inventory, putting further pressure on an already undersupplied rental market. Capital expenditure will be required to make these older assets compliant, which, at current property prices and interest rates, may not always be economically sensible. This will impair their value while creating a lot of value-add opportunities for investors (Figure 5).

Figure 5 - Rising financing and construction slows development activity

EU-27 Residential Construction Costs vs. Building Permits



Source: CBRE Research 2023

The secular undersupply of homes in Europe is not expected to be resolved anytime soon. The reasons for this are the rising financing and construction costs, and the possibility of further rent controls being imposed by local governments in the face of public discontent. This uncertainty may discourage investors from further investing in residential real estate despite the strong fundamentals.

HOSPITALITY (OUTLOOK: POSITIVE)

The European hospitality market has delivered solid performances over the past couple of years, with average daily rates far exceeding the pre-pandemic levels, and up to 40% year-on-year.[3] The end of Covid restrictions have sparked the return of tourists from North America and Middle East, while Asian and Chinese travellers have not yet come back to the region.

The hospitality market in Europe is characterised by a dominance of unbranded hotels operated by independent owner-operators. These hotels are often well located but lack the benefits of internationally recognisable brands, such as central reservation systems, yield/revenue management programs, loyalty programmes, cumulative purchasing power or brand awareness.

These benefits become particularly valuable at times of stress. Despite an impressive rebound in average daily rates and occupancy rates across the major hubs in Europe, a relatively large number of owners are still struggling to finance the necessary capital expenditures. As seen in other sectors, operators are facing tighter credit conditions and could be forced to sell assets to generate liquidity.

This creates a unique opportunity for investors to acquire attractively priced assets with a strong value-add potential. We also continue to see the benefits of management contracts over lease contracts to capitalise on the strong performance of the hospitality sector.

In parallel, the market for stabilised, luxury hotels remains relatively liquid compared with other sectors, supported by strong demand from institutional investors.

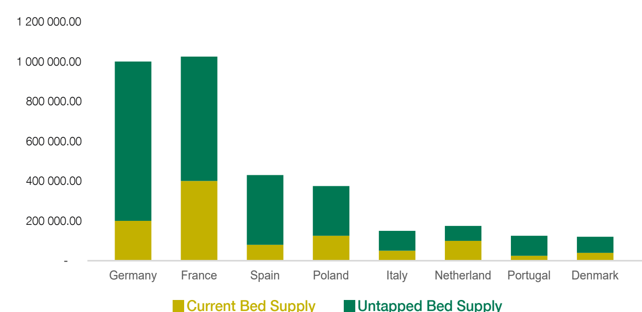
Overall, we continue to be positive on the hospitality sector for the near future, particularly on value-add strategies.

STUDENT HOUSING (OUTLOOK: POSITIVE)

The European student housing market, also known as purpose-built student accommodation (PBSA), has been supported by a growing number of domestic and international students enrolling at European universities. Across the region, the sector benefits from increasing rents, low vacancy rates and insufficient supply for a market that demands higher quality, institutionally managed residences.

Despite the significant amount of capital that has been invested in the sector, there is still an acute undersupply of quality student housing in Europe, including the UK, which is probably the most mature PBSA market in the region (Figure 6).

Figure 6 - Student Housing Supply vs Estimated Demand



Source: Savills (2023)

[3] CBRE, European Hotel Market, Q2 2023

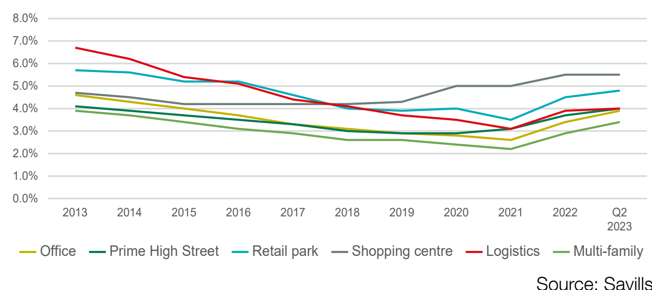
Available liquidity on the PBSA market has contracted in step with all other sectors. The strong operational performances are currently not fully compensating for the uncertainty surrounding the evolution of interest rates, and, with the exception of very opportunistic buyers, investors have taken a wait-and-see stance.

We remain cautiously optimistic on the outlook of student housing in Europe, and we particularly like its counter-cyclical nature that is welcome at a time of economic uncertainty in the region.

LOGISTICS (OUTLOOK: POSITIVE)

The logistics sector has seen a significant boom over the past decade, further accelerated by the success of e-commerce. As the sector has attracted more investor appetite, yield spreads with more established asset types have decreased. In Germany, logistics prime yields decreased from 6.7% in 2013 to 4% in Q2 2023, after hitting a bottom at 3.1% in 2021.[4] This is the largest contraction of yields in the real estate market (Figure 7).

Figure 7 - Prime yields (avg. Top 6) in Germany



Source: Savills

Investment volumes decreased in H1 2023 compared with the record levels attained during the pandemic, but the share of logistics in real estate transaction volumes reached 17%, which remains above the long-term average, illustrating resilient demand from investors.

Among the challenges faced by the sector, rising rents and labour shortages continue to be occupiers' main concerns. Lack of supply also continues to be an issue, while new concerns have emerged regarding power supply and lack of development sites. These concerns are all good news for investors, who expect to maintain or increase their allocations to the sector this year.

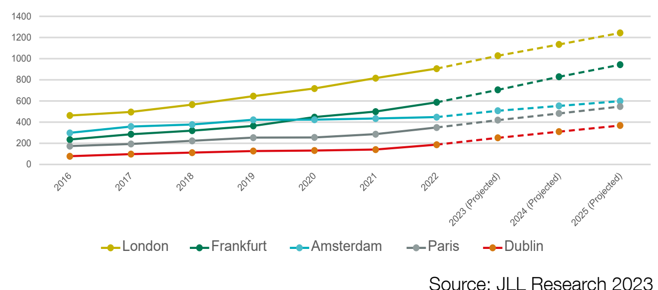
Our outlook is positive on logistics. The recent repricing is favourable to investors who are looking to build up their exposures and benefit from the recent repricing coupled with strong rental growth prospects.

DATA CENTRES (OUTLOOK: POSITIVE)

Data centres continue to benefit from a strong secular demand driven by 5G, artificial intelligence, the Internet of Things, gaming, and e-commerce. These growth drivers are not expected to fade in the foreseeable future, giving confidence to the sector's outlook.

At the same time, increasing construction costs, stricter regulations, tighter credit markets and power supply bottlenecks are many factors that will raise barriers to entry. The industry is also reacting to water consumption concerns, and last year 73 data centre operators signed the Climate Neutral Data Centre Pact (CNDCP), a self-regulatory initiative that aims to address the impact of data centres on climate change (Figure 8).

Figure 8 - Total IT Load (measured in MW) in FLAP-D Clusters



Source: JLL Research 2023

On the supply side, new capacity is coming to market this year in the region's leading hubs (Frankfurt, London, Amsterdam, Paris and Dublin, also referred to as 'FLAPD'), with an additional 432 MW, representing a 17% year-on-year growth. Demand is also increasing, with 392 MW of take-up, representing a 32% increase on last year.[5]

As the market is increasingly dominated by hyperscale developments, which represent 83% of all transactions in 2022, we are maintaining our strong conviction on this asset class. Data centres remain underweighted in investors' portfolios and this exposure is bound to increase in the coming years.

[4] Source: Savills 2023

[5] Source: JLL Research Q1 2023

CONCLUSION

Investors should expect the conditions in the European real estate market to be durably affected by interest rate increases. Trends, such as the secular rebalancing of sector allocations that emerged several years ago, are expected to continue for the foreseeable future.

While these developments bring undeniable challenges to the asset class, we foresee a growing set of investment opportunities for value-add investors looking to capitalise on market dislocations.

Active management will become more prevalent, but the higher cost of capital will also make these strategies less forgiving than in the past. Strong manager selection will be essential as performance dispersion increases.

We remain cautiously optimistic on the asset class and continue to believe that real estate has a role to play in investors' asset allocations, no longer as an alternative to fixed income, but as a source of value creation until the market reaches a new equilibrium.

Pierre Escande

Head of Real Estate
Private Markets Group

Geoffroy Troesch

Head of Investments
Management
Private Markets Group

Disclaimer

This document is a marketing communication containing GENERAL INFORMATION on financial services reflecting the sole opinion of Union Bancaire Privée, UBP SA and/or any entity of the UBP Group (hereinafter “UBP”) as of the date of issue. It is not and does not purport to be considered as an offer nor a solicitation to enter into any transaction with UBP, buy, subscribe to, or sell any currency, product, or financial instrument, make any investment, or participate in any particular trading strategy in any jurisdiction where such an offer or solicitation would not be authorised, or to any person to whom it would be unlawful to make such an offer or solicitation. This document is meant only to provide a broad overview for discussion purposes, in order to determine clients’ interest. It does not replace a prospectus, KID, KIID or any other legal document relating to any specific financial instrument, which may be obtained upon request free of charge from UBP or from the registered office of the issuer of the instrument concerned, where applicable. The opinions herein do not take into account individual clients’ circumstances, objectives, or needs. UBP performs analysis on the financial instruments based on market offer and may maintain and/or seek to develop business affiliations with third parties for that purpose; furthermore, UBP may create its own financial instruments. This generic information is therefore not independent from the proprietary interests of UBP or connected parties, which may conflict with the client’s interests. UBP has policies governing cases of conflicts of interest and takes appropriate organisational measures to prevent potential conflicts of interest. The information contained in this document is the result neither of financial analysis within the meaning of the Swiss Banking Association’s “Directives on the Independence of Financial Research” nor of independent investment research as per the EU’s regulation on MiFID provisions. EU regulation does not govern relationships entered into with UBP entities located outside the EU. When providing investment advice or portfolio management services, UBP considers and assesses all relevant financial risks, including sustainability risks. Sustainability risks are defined by the EU’s Sustainable Finance Disclosure Regulation (2019/2088) as “an environmental, social or governance event or condition that, if it occurs, could cause a negative material impact on the value of the investment”. For further information on our sustainability risk management approach please visit [www.ubp.com]. Reasonable efforts have been made to ensure that the content of this document is based on objective information and data obtained from reliable sources. However, UBP cannot guarantee that the information contained herein and gathered by the Bank in good faith is accurate and complete, nor does it accept any liability for any loss or damage resulting from its use. Circumstances may change and affect the data collected and the opinions expressed at the time of publication. Therefore, information contained herein is subject to change at any time without prior notice. UBP makes no representations, provides no warranty and gives no undertaking, express or implied, regarding any of the information, projections or opinions contained herein nor does it accept any liability whatsoever for any errors, omissions or misstatements in the document. UBP does not undertake to update this document or to correct any inaccuracies which may have become apparent after its publication. This document may refer to past performance which is not a guide to current or future results. All statements in this document, other than statements of past performance and historical fact, are “forward-looking statements”. Forward-looking statements do not guarantee future performances. The tax treatment of any investment depends on the client’s individual circumstances and may be subject to change in the future. This document does not contain any tax advice issued by UBP and does not reflect the client’s individual circumstances. This document is confidential and is intended to be used only by the person to whom it was delivered. This document may not be reproduced, either in whole or in part. UBP specifically prohibits the redistribution of this document, in whole or in part, without its written permission and accepts no liability whatsoever for the actions of third parties in this respect. This document is not intended for distribution in the US and/or to US Persons or in jurisdictions where its distribution by UBP would be restricted.

Switzerland: UBP is authorised and regulated in Switzerland by the Swiss Financial Market Supervisory Authority (FINMA).

UK: UBP is authorised in the United Kingdom by the Prudential Regulation Authority, and is subject to regulation by the Financial Conduct Authority (FCA) and limited regulation by the Prudential Regulation Authority.

Dubai: This marketing material has been communicated by Union Bancaire Privée (Middle East) Limited, a company regulated by the Dubai Financial Services Authority (“DFSA”). It is intended for professional clients and/or market counterparties only and no other person should act upon it. The financial products or services to which this material relates will only be made available to a client who meets the professional client and/or market counterparty requirements. This information is provided for information purposes only. It is not to be construed as an offer to buy or sell, or a solicitation for an offer to buy or sell any financial instruments, or to participate in any particular trading strategy in any jurisdiction.

Hong Kong: UBP is a licensed bank regulated by the Hong Kong Monetary Authority (HKMA) and a registered institution regulated by the Securities and Futures Commission (SFC) for Type 1, 4 & 9 activities only in Hong Kong. The securities may only be offered or sold in Hong Kong by means of documents that (i) are addressed to “professional investors” within the meaning of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) and any rules made thereunder (the “SFO”); or (ii) are defined as “prospectuses” within the meaning of the Companies Ordinance (Chapter 32 of the Laws of Hong Kong) (the “CO”) or constitute offers to the public within the meaning of the CO. Unless permitted to do so under the laws of Hong Kong, no person may issue or have in their possession for the purpose of issuing, whether in Hong Kong or elsewhere, any advertisement, invitation or document relating to the securities, directed at, or likely to be accessed or read by, the public in Hong Kong, except where the securities are intended to be disposed of only to persons outside Hong Kong, or only to “professional investors” within the meaning of the SFO.

Singapore: UBP is a bank regulated by the Monetary Authority of Singapore (MAS), is an exempt financial adviser under the Financial Advisers Act 2001 of Singapore to provide certain financial advisory services, and is exempt under section 99(1) of the Securities and Futures Act 2001 of Singapore to conduct certain regulated activities. This document has not been registered as a prospectus with the MAS. Accordingly, this document and any other document or material in connection with generic recommendations may not be circulated or distributed, whether directly or indirectly, to persons in Singapore other than (i) institutional investors; or (ii) accredited investors as defined under the Securities and Futures Act 2001 of Singapore. This advertisement has not been reviewed by the Monetary Authority of Singapore.

Luxembourg: UBP is registered by the Luxembourg supervisory authority the Commission de Surveillance du Secteur Financier (CSSF).

Italy: Union Bancaire Privée (Europe) S.A., Succursale di Milano, operates in Italy in accordance with the European passport – held by its parent company, Union Bancaire Privée (Europe) S.A. – which is valid across the entire European Union. The branch is therefore authorised to provide services and conduct business for which its parent company, Union Bancaire Privée (Europe) S.A., has been authorised in Luxembourg, where it is regulated by the Luxembourg financial supervisory authority, the Commission de Surveillance du Secteur Financier (CSSF).

Monaco: This document is not intended to constitute a public offering or a comparable solicitation under the Principality of Monaco’s laws, but might be made available for information purposes to clients of Union Bancaire Privée, UBP SA, Monaco Branch, a regulated bank under the supervision of the Autorité de Contrôle Prudentiel et de Résolution (ACPR) for banking activities and under the supervision of the Commission de Contrôle des Activités Financières for financial activities.

© Union Bancaire Privée, UBP SA 2023. All rights reserved.

Photo credits: @Getty Images

Union Bancaire Privée, UBP SA | Head Office
Rue du Rhône 96-98 | P.O. Box 1320 | 1211 Geneva 1 | Switzerland
ubp@ubp.com | www.ubp.com

Signatory of: PRI Principles for Responsible Investment

Subscribe to our newsletter on ubp.com