European Real Estate Market Outlook

Q4 2022

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"During this period of higher uncertainty, we advise reducing risk wherever possible."

European real estate market outlook

Executive summary

- Despite surprising levels of resilience across the European economy, the outlook is uncertain and markets are digesting the effects of a stagflation scenario. We expect the European Central Bank (ECB) to frontload its tightening cycle, pausing its hikes once the recession hits.
- The continued rise in both short- and long-term interest rates has had an immediate impact on real estate values, largely as a result of the spike in the cost of debt. We believe this revaluation of real estate yields is just the first phase of a broader correction. Public listed markets are currently pricing in a fall for direct market valuations of around 15% to 20%, depending on sector and geography.
- Capital flows into European real estate are slowing as a result of the pressures in the market. Volumes fell sharply in the third quarter of 2022 as investors took a 'wait-and-see' approach, or were unable to source finance at levels that supported target internal rates of return. We expect deal flows to remain subdued in the fourth quarter.
- Occupier markets have held up extremely well so far. Vacancy rates remain generally low and demand levels are still very healthy overall. Some of this reflects the resilience of the underlying economy to date, but we also believe there is still some momentum from the pandemic recovery coming through in the numbers. We expect a recessionary environment to hit retail tenants hardest, although most commercial sectors are vulnerable to weaker demand drivers.
- The performance outlook for European real estate can be split into three broad phases: the initial period of revaluation and relative pricing we are seeing today; the recessionary and recovery phase; and the longer-term, low-supply driven rental growth phase, where limited supply of good-quality property underpins a healthy period of performance.
- We continue to prefer sectors where there are strong thematic demand drivers, mainly demographic, technological and social. This exists primarily in logistics, all parts of the residential market, many alternatives (such as data centres and healthcare-related real estate), and core offices. We remain cautious towards most retail types, especially as we enter recession and as tenant risks rise. We expect attractive opportunities to increase as prices adjust and risks become mis-priced by the market. We also expect opportunities for investors to 'step-in' to specific situations, where equity or debt shortfalls offer attractive pricing situations.
- During this period of higher uncertainty, we advise reducing risk wherever possible. This may involve extending leases and improving the resilience of tenancy schedules, increasing cash weightings, and reducing leverage, until there are broader signals of a stronger recovery.

European economic outlook

- We have revised our forecast from a 'double dip' to a prolonged recession, starting in the fourth quarter of 2022 and continuing for most of 2023. The post-pandemic rebound is fading quickly and falling real incomes will cause a sharp contraction in consumption later this year. The outlook is further aggravated for 2023 by the spillovers from a global recession. Higher energy prices also imply more stubborn inflation. We expect the ECB to frontload its tightening cycle and to pause its hikes once the recession hits.
- Eurozone gross domestic product (GDP) growth was more resilient than expected in the first half of 2022, growing at 0.7% in the first quarter and 0.8% in the second quarter. However, the economy is now slowing sharply, with tumbling retail sales and purchasing managers' indices (PMI), as a result of Europe's energy crisis.
- The impact of the crisis will increase as winter approaches. Disruption to gas supplies and higher electricity prices will cause significant demand disruption, and some measured rationing is likely. This will drag the bloc into contraction by the year-end.
- Uncertainty and tighter financial conditions are also set to limit investment, although governments are likely to provide fiscal support to mitigate the energy shock. Support should also come from the EU Recovery Funds.
- In Italy, though, a new right-wing coalition government risks reversing parts of the reform agenda, while reviving concerns of fiscal imbalances. This may make the Recovery Fund dispersal difficult.
- The labour market remains a bright spot, with unemployment falling to an historic low of 6.6% in July. While wage growth has been relatively moderate thus far, we expect these pressures to rise later this year. The strengthening labour market will not last, though, if recessions are coming.
- Inflation reached 9.1% in August, the highest on record. More worryingly, core inflation picked-up to 4.3%. Inflation is likely to accelerate further in the coming months, given the surge in European gas and electricity prices. Energy policy interventions, both at EU and

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national level, could mitigate the trend but are unlikely to provide a full offset. We now see inflation reaching over 11.5% around November, before falling on the back of tighter financial conditions, weaker activity, and base effects.

- The pressure is growing on the ECB to frontload its tightening cycle further. After the ECB abruptly abandoned its forward guidance in July, bringing the deposit rate to 0%, we now expect interest rates to reach 2% by end-2022. A steeper 75 basis points (bps) hike in September is likely to be followed by more hikes in October and December.
- The policy outlook for 2023 is more clouded, given the uncertainties related to energy supply and the approaching recession. The risk of hikes in the first quarter of 2023 cannot be excluded. But we think the ECB will eventually pause in 2023 once a recession hits the economy, and that it will eventually return to a more accommodative stance.

Figure 1 – Revisions to our Eurozone forecast: higher inflation, lower growth

	2020	2021	2022	2023	2024
GDP (%)	(6.2)	5.2	2.9	(2.2)	0.8
CPI (%)	0.3	2.6	8.7	5.6	2.0
Depo rate (%)	(0.50)	(0.50)	2.00	1.5	0.0

Source: abrdn, September 2022

European real estate market key drivers

- Since our last outlook in July, the core drivers of European real estate have weakened further. Real estate values are negatively correlated with interest rates and the continued rise in European central bank policy rates has had a detrimental effect on real estate yields. Central banks across Europe have been hiking in response to rising core inflation, so far ignoring the darkening economic clouds in the region. But a recent dip in the five-year Euribor swap rates, in response to very weak German manufacturing PMI data, suggests there is at least some acknowledgement that policy makers will turn more dovish in the event of recession.
- The recent spike in inflation, hitting 9.7% in the Eurozone during September 2022, has acted as a catalyst for rising interest rates. The five-year Euribor swap rate, which essentially guides on future base rate expectations, increased from -0.5% in March 2022 to 3.2% in September. This sudden spike, and the knock-on effects it had on the cost of capital for investors, pushed real estate yields higher. We estimate that the all-in cost of debt is around 4.5% for good-quality European assets as at September 2022. Development finance costs have risen to the highest level on record, at over 7%. While these levels represent a sharp increase, it is important to note that banks are still actively lending and their margins are stable.
- Corporate bond yields have also increased. The spread between AAA and BBB debt also increased sharply, in a sign of rising business risk in light of the recessionary outlook. The 20-30% fall in equity markets in recent months has pushed dividend yields higher too. As a result, real estate is now also looking more expensive on a relative basis. In September, Eurozone BBB bonds exceeded real estate yields, a key waymark for real estate pricing that is not fully reflecting income risk. We expect yields to continue to rise, as a result.
- Recent lead indicators in the economy have been weak and the likelihood of recession is yet to be priced-in, in our opinion. While the hard economic data has been surprisingly resilient, lead indicators such as PMI and confidence indices point to a particularly bleak outlook for businesses and consumers. A painful consumer recession is likely to hit retail assets hardest and we are cautious on the outlook for any assets with a cash flow driven by discretionary retail sales.
- We are already seeing signs of decreased investment liquidity as a result of the weaker outlook. Investment volumes were down in the third quarter and there is more anecdotal evidence of deals collapsing as pricing expectations are not being met. Fund flows are slowing, yet we believe there is still substantial equity waiting to be deployed. Seller expectations on pricing will need to adjust for liquidity to improve.
- Analysis of public listed real estate gives us an indication of what the impending correction could look like. Listed markets typically move six-to-nine months ahead of direct indices. And while they do not have a one-to-one relationship, we can rely on them for an indication of material turning points. Over the year to 3 October 2022, the FTSE EPRA NAREIT Eurozone Index was down 38.1%, the deepest drop since the index fell around 50% in 2008. The drop we saw in the MSCI/IPD All Property total return index in 2008 was 12.4% and the capital decline was 16.7%. When we take into account smoothing of the index, we believe the correction in the listed market implies an 18-20% fall in direct asset valuations within the next six-to-nine months in Europe. Some of this might be behind us already, given the speed at which the market is adjusting.

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Chart: Real estate performance signals – Europe Q4 2022

Sector spreads narrow in year 1, but structural drivers are in place over the longer term

	Performance Signals	Current Signal	Outlook	Comment
Macro	Economic fundamentals	Unsupportive (red)	Downward trend	Eurozone expected to enter recession in Q4 and stay in contraction until Q3 23. Manufacturing PMIs are in contractionary territory (August 22), the "cost-of-living crisis" is likely to hit consumption, while businesses grapple with higher input costs and constraints in energy usage. Germany, the Baltics and CEE economies more reliant on Russian energy supplies to be hardest hit. The impact on household finances will make this recession particularly painful for consumers.
Macro	Monetary policy	Unsupportive (red)	Downward trend	ECB joined the Fed and BoE on a hiking path, while also starting to shift to Quantitative Tightening. Following a 50bp increase in July and 75 bps in September, we expect a further 75bps this year, bringing the deposit rate from 1.25% to around 2% by December. Expectations for next year are for continued hiking as the ECB is set to look through GDP weakness and remain focused on combatting core inflation which currently sits at 4.1% in the Eurozone. Other risks to be managed with other tools (TLTRO etc.).
Macro	Margin over bonds	Unsupportive (red)	Downward trend	German 10-year bund trended up to 1.5% from -0.5% a year ago. All bond yields are expected to continue to rise as inflation gathers pace and policy is tightened further. All property spread peak is behind us and has narrowed substantially. Spreads close to 100bps or below in the strongest segments and likely to close further in Q4 2022.
Real Estate	Supply[1]	Supportive (green)	Upward trend	Continued bottleneck in materials pushing completions back and costs up across all sectors. Completions not expected to return to trend; less appetite and funding for speculative schemes. Total office vacancy stable, but prime remains constrained; residential, alternatives and logistics still undersupplied. Supply outlook to be further restricted by ESG factors and higher financing costs. Weaker macro could drive a rise in availability as firms cut back space requirements.
Real Estate	Flows of capital	Unsupportive (red)	Downward trend	Volumes down roughly 20% versus last year. Deals being pulled from the market where pricing expectations will not be met. Cost of debt is prohibitive for leverage investors, so many pools of capital are stepping back. Big capital raises have been announced, which provides a pipeline of equity to be deployed (€7 billion Blackstone), but most of this will not be invested while the market is still falling. Some corporate/portfolio deal activity expected in German residential market, but not without value adjustments.
Real Estate	Lending[2]	Neutral (yellow)	Stable	Availability of financing is not the problem with both bank lenders and institutions active in the market. The cost of debt is prohibitive for most borrowers at current underlying yields. Five-year Euribor swaps are rising in August and stand at 2.5% with the volatility in swaps providing a challenge to deal underwriting. Margins have edged up slightly for good quality assets, although a recession is likely to push them higher.
Real Estate	Fund flows	Unsupportive (red)	Downward trend	Weak picture with low number of equity raises and investors playing a "wait-and-see" game. Of the capital that is raised today, the vast majority may not be deployed for some time, only once the market has bottomed out. A weak Euro could push an increase in flows from outside the region if signs of improving economic outlook emerge next year.
Real Estate	360° view	Unsupportive (red)	Downward trend	Debt costs continue to impact pricing due to low yields and rising swap rates. Capital raising is more difficult as more investors are anticipating a weaker period for returns in 2023 and are holding cash for now. Listed markets are off 30% year to date, with discounts to NAV implying direct values could fall around15%. Key takeaway: overall risks to the Houseview are coming to fruition and the key drivers are all now generally a drag on the performance outlook for the next 12 months; still no single market "shock" noted yet.

Sources: Views reflect our view on Europe excluding the UK. MSCI/IPD; Thomson Reuters Eikon; RCA; CBRE, Investment Association; abrdn. 360° view encompasses direct, indirect, lending and multi-manager views and market signals. Q4 2022.

[1] Wide spread in supply situation. Prime offices, logistics, residential and alternatives undersupplied; retail and secondary offices are challenged from supply side.

[2] Based on bank finance on fix term, for bankable assets.

Key: Supportive / Neutral / Unsupportive. ➔ Stable / ➚ Upward trend / ➘ Downward trend.

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European capital market trends

- Based on data by Real Capital Analytics (RCA), we estimate that European investment over the 12 months to the third quarter of 2022 was 12.3% lower than the same period in the previous year. However, looking at the third quarter of 2022 alone, we estimate a notable slowdown, with a 34% decrease in volumes compared with the third quarter of 2021, a fall from €83 billion to €55 billion.
- The polarisation between sectors remains in place. However, deal momentum has decreased significantly across all sectors except senior living. Residential and office transactions in the third quarter of 2022 were down 36% and 32% quarter-on-quarter, respectively – but the office sector remains the largest share. Retail was down 25%, compared with 15% growth last quarter. It has fallen out of favour given the rise of e-commerce, which continues to take a toll on the sector. Industrials have experienced an abrupt slowdown, but still account for 19% of the total. This was no surprise since the sector was more sought after than other sectors last year, hence decelerating more rapidly. Moreover, pricing is relatively aggressive and debt costs have gone up, which is cooling flows into the sector. Despite weaker deal momentum, the average for industrials in the third quarter of 2022 remains 51.7% higher than the long-term quarterly average. Senior living is the only sector with an increase in volumes this quarter, rising 66%. According to Greenstreet, occupancy rates for nursing homes are up, albeit they remain 5-10% lower than pre-pandemic levels, and investors are focusing on sectors uncorrelated with GDP trends.
- From a regional perspective, the largest share of investment was made in Germany (26.2%), followed by the UK (23.4%) and the Nordic markets (15.2%). France ranked fourth (9.5%) in the second quarter of 2022, with notably lower volumes. Data from RCA shows that during the 12 months to the third quarter of 2022, investments in Germany were 29% higher than a year ago, but momentum has been slowing down rapidly since then. The French market has seen a significant slowdown, given the pressure on the retail and prime office sectors – both of which the country depends on heavily for deal flow. The Netherlands retained its position as the fifth-biggest market in Europe, despite a slowdown in its industrial volumes (-27%) in the third quarter of 2022.
- Cross-border capital accounted for around 52% of third-quarter volumes, the highest volume in the last three years. The largest cross-border source remains the United States, which increased by 34% over the year to the third quarter of 2022. The euro’s slide towards parity with the dollar for the first time in 20 years could further support flows from the US in the coming years. A notable trend was the lack of investments by real estate investment trusts (REITs). Purchases were at their lowest level since 2012 at just 4.9% of the total. There are two key reasons for this: REITs continue to see depressed share prices, which make it difficult to raise new equity to invest; and the increase in debt costs further fuels challenges for REITs to invest, as they are heavily dependent on leverage.
- Rising financing costs have caused outward shifts in yields in several geographies and sectors, which implies weaker valuations. According to data from CBRE, 75% of segments in the sample markets had an outward yield shift in September. It is the first time since the Global Financial Crisis that no markets have seen any yield compression too. The number of weakening markets is significantly higher than those that saw outward yield shifts in our last analysis in June, when 25% of the market had seen outward yield shift, following just 5% in May.
- During the second quarter of 2022, prime and very low yielding assets (such as modern long-lease logistics, rented residential and prime offices segments) had yields that moved out. However, the latest data to September shows that there is a broader range of sectors affected. These include high-yielding retail assets, particularly in Southern European markets and the Nordics (retail in Spain +75 bps, residential in the Netherlands +65 bps, retail in Germany +50 bps, retail in Sweden +50 bps, retail in Norway +45bps), prime logistics, and various Nordic markets where the hiking cycle is more advanced. We expect further outward yield shift in the final quarter of 2022, given continued pressure from tighter spreads. As the market goes into a more recessionary environment, all property types will be affected, including retail. This represents a broader market correction in yields.

“Supermarkets and convenience-based retailers will be more resilient, but they are not immune to recession.”

European occupier market trends

- Office markets continue to prove resilient, with stable vacancy rates at around 7.8% and headline rents pushing higher. In most tier one cities, prime office rents hit new records in the first half of 2022, owing to low levels of prime supply and the ongoing rebound in leasing activity since the pandemic.
- It is a more negative picture for secondary offices as a two-speed market takes hold. Vacancy rates in poor-quality offices and in weaker locations are increasing, as occupiers cut costs and reduce inefficient space. We believe that the existence of ‘grey space’ is sizeable in poorer quality offices. Tenants will continue to shed excess floorspace in properties that don’t meet corporate ESG criteria. They will therefore occupy fewer higher-quality offices.
- The logistics market will feel the effects of recession, although the clear message from our asset managers is that there is no sign of reduced demand – yet. While we have seen yields come under pressure from rising interest rates and higher debt cost, some of the yield impact is being offset by continued rental growth or indexation in lease contracts. This has meant that capital values have been more resilient than expected so far. Prime logistics rents increased by an average of 5% in the first half of 2022, and by as much as 10% in Belgium, 9% in France, 8% in Germany and 6.5% in the Netherlands. So far, most tenants have been able to absorb the full extent of rent indexation to CPI in their lease terms, with only a few looking to negotiate fresh terms.
- We expect logistics rents to remain resilient as structural demand drivers offset some of the macro economic weakness. Furthermore, prime rents in Europe are often set during the pre-letting of new schemes, so higher construction costs and development finance rates will need to be passed on to tenants. This will mean higher asking rents if developers are to retain profitability.
- Retail markets have come under renewed pressure from weaker consumer confidence. Consumers are feeling more negative than any time on record in most European economies. Higher interest rates, falling real household incomes and the war in Ukraine are all weighing on sentiment. House prices look particularly vulnerable to a correction as mortgage rates rise. Higher unemployment is anticipated in 2023, meaning that consumers will prioritise essential spending. They will cut back heavily on discretionary items, such as fashion, consumer electronics and home furnishings. Tenant defaults are expected to rise in this environment and we believe retail rents will be vulnerable to further declines, in this context. Supermarkets and convenience-based retailers will be more resilient, but they are not immune to recession.
- Residential occupier markets are experiencing a mixed picture. While vacancy rates remain very low, tenants are coming under pressure from higher inflation and the knock-on effect of indexation in their lease terms. Rent regulation is being introduced across many jurisdictions in response to this trend – most notably in Denmark, France, Scotland and Spain – with varying degrees of effect on rental levels. We believe that the significant rise in mortgage rates and other difficulties in the mortgaged housing market will mean renting is increasingly the chosen option. This supports the demand side of the residential sector.
- On the supply side, there are depressed levels of housing starts across Europe, and we expect the housing shortage to continue for the long term. In Germany, the latest data to July showed a 2.1% fall in housing permits, although permits for multi-family schemes increased. However, with rising construction costs and debt financing becoming increasingly expensive, we do not expect all of these permits to be fully developed in the next few years. Limited supply is expected to still be a positive driver of occupancy rates.

Opportunities in European real estate

- While the market conditions are uncertain and risks are stacked to the downside, we continue to believe in the long-term fundamentals in several key areas of the market.
- In the near term, we could see specific opportunities to ‘step-in’ where shortfalls in equity or debt arise from a lack of liquidity in the market. This could be at an asset, company or entity level, and it is important to think broadly while the market is going through a correction. Weak European and UK currencies increase the attractiveness of these types of opportunities and we expect to see a rise in international investment flows into special situations.
- Thematic tailwinds remain in place for the residential, logistics, core office and alternatives sectors. These tailwinds ultimately result in demand exceeding supply, which supports growth and the strength of long-term cash flows derived from assets in these baskets.
- The office market is expected to be two-speed, with secondary offices and weaker locations suffering from long-term oversupply and obsolescence. Tighter regulations around building efficiency and emissions will mean weaker offices will underperform or

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Chart: Global real estate conviction themes Q4 2022

Sectors	Industrial & logistics	Residential (PRS)	Alternatives	Offices	Retail
3 year existing allocation tilt	↗	↗	↗	→	↘
Long term conviction within segments	Urban logistics e-fulfilment & mid-box Caution: Big box let to retailers, older buildings	City centre and fringe locations, AAA-rated BTR/ PRS, mixed use Caution: poor layout, regulation possible	Data centres Life sciences Healthcare Leased hotels Caution: Low tier PBSA, labour intensive alternatives	City centre, constrained No compromise on location – follow '**FACTS**' guidelines Caution: short income, business parks	Supermarkets, non Fashion Retail Parks Convenience, DIY Caution: Shopping C's, luxury high streets
Potential risk strategies	Core assets, value add in best locations Longer or short income Indexation	Core assets/ repositioning Longer income (leased) Indexation Forward funding	Diversification of value drivers Long income	Core assets/ long income Value add and ESG uplift	Longer income Indexation Dominant schemes Retail park reposition
Key risks	Tenant quality Mispricing of risk in strong market conditions Global economy/ supply chains	Rent regulation Operating costs Reputational risks Shift in tenant demand	Operational risk Changing legislation Indiscriminate capital inflating values	Higher volatility of income Long term structurally lower demand possible Flexible office operators are vulnerable	E-commerce grows faster Revenue linked lease terms Weaker household incomes

Past performance is not a guarantee of future returns. Forecasts are offered as a guide only and actual results may differ significantly

Source: abrdn. non risk-adjusted, local currency, absolute returns, excluding transaction fees. "Invest Today" colour scheme reflects the qualitative assessment of how accessible investment is within the four categories. Arrows reflect recommended portfolio sector tilts for balanced funds, Q3 2022 Past performance does not predict future returns. Forecasts are offered as a guide only and actual results may differ significantly.

require substantial capital expenditure to meet tenant and investor expectations. Core, centrally located offices with strong ESG credentials are increasingly finite. And with development pipelines at historic lows, we expect tight vacancy and rental growth to persist.

- Logistics demand should remain robust, given the continued rise in e-commerce, the near-shoring of supply chains to Europe, and increased inventory to defend revenues against any ongoing supply chain disruption. A recession in Europe will dampen tenant demand, but we expect a strong rebound with a broader economic recovery to come. We continue to prefer fringe-city locations where land supply is more constrained, and where tenant and investor demand is more active.
- The demand drivers for residential assets, including student accommodation and senior living, are typically uncorrelated with the broader economic cycle. As such, we continue to believe in their long-term performance outlook. The shortage in all formats of housing should support robust cashflows from these assets. Rent regulation is increasingly likely while inflation remains at exceptional levels. It is best to be mindful of this when underwriting cashflows.
- Alternatives carry differing demand drivers and income risks to the mainstream commercial and residential sectors, which offers clear diversification benefits. The latest data shows a rise in nursing home occupancy rates in Europe, which are heading back towards pre-pandemic levels. Data centre take-up continues to hit new records as the sector emerges into a larger asset class for investors to consider. We believe that assets in sectors that are uncorrelated with GDP drivers remain appealing in the long term, as long as their risks are fully understood and managed appropriately.

“In light of a more difficult outlook, we strongly advise our funds to reduce risk wherever possible.”

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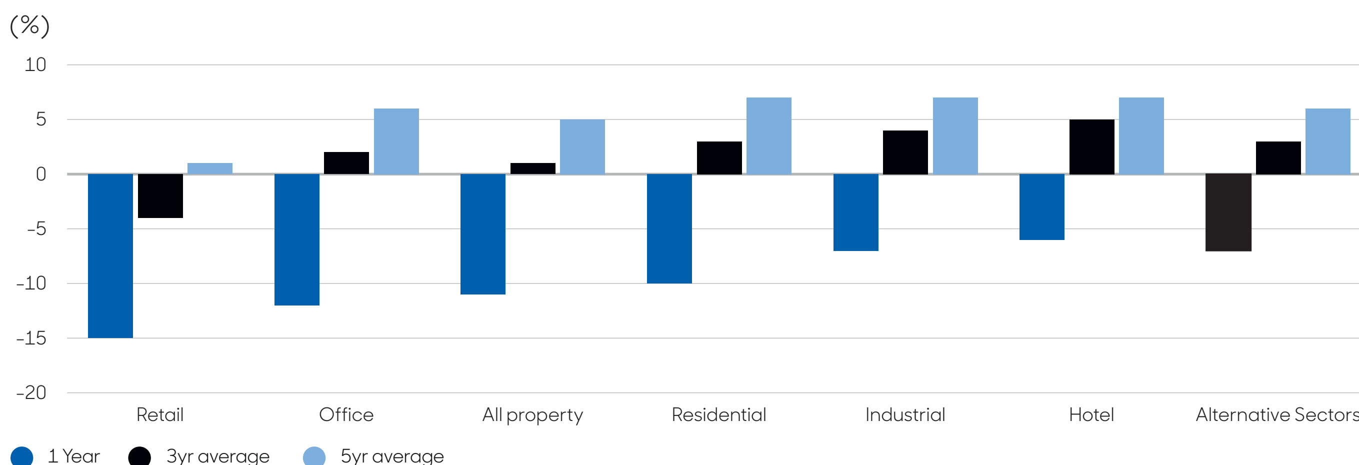
We now expect a fall in all property total returns of 11.3% over the year to September 2023, implying a sharp fall in capital values. Over the longer term, we do expect a recovery to materialise through a rebound in economic growth and the return to lower interest rates from 2024. We believe there are three phases to the forecast outlook as highlighted below:

1. **Phase 1 (years one and two?): Re-valuation, relative value and recession** – values are recalibrating to the current inflation and policy backdrop – this will be painful and mostly unavoidable. Recession is expected to bite in the fourth quarter of 2022, and this will trigger a second decline in rents and values.
2. **Phase 2 (years two and three?): Recovery** – the recession is expected to last four quarters, with inflation also dropping back to lower levels during this period. Rates are also expected to return to their lower bounds by 2024, reducing the pressure behind the recent re-pricing.
3. **Phase 3 (years three to five?): Rental outlook** – supply looks extremely limited now and will be further constrained by ESG (environmental, social and governance), development costs/finance, tighter planning regimes, and a level of caution around breaking ground on speculative schemes.

In light of a more difficult outlook, we strongly advise our funds to reduce risk wherever possible. Indeed, we advise all our European strategies to consider taking some of the following steps:

1. **Reduce risk wherever possible** – particularly loan-to-value ratios, but also void risk (including not undertaking any speculative development).
2. If you can’t reduce asset risk then you should try to **sell risk** – yields are unlikely to come back to where they are today until 2025/26.
3. **Retain or increase cash holdings** – initially to provide liquidity in case of unexpected costs, higher refinancing charges or to meet redemptions (secondaries are not likely to shift at current discounts).
4. In the recovery phase, certainty of cash flows is likely to outperform short income – **extend leases and re-gear where possible.**
5. **Avoid the temptation to target higher-yielding assets with bigger spreads.** These often carry additional income risk and it is better to focus on quality at a more attractive entry price.
6. **Ensure ESG credentials are strong** to defend against further re-valuation and to capture the full strength of recovery.

European total return forecast by sector, annualised, ungeared, in percentage terms, October 2022



Source: abrdn European forecasts September 2022.

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