Real Estate House View

Europe

SwissLife
Asset Managers

Second half-year 2023

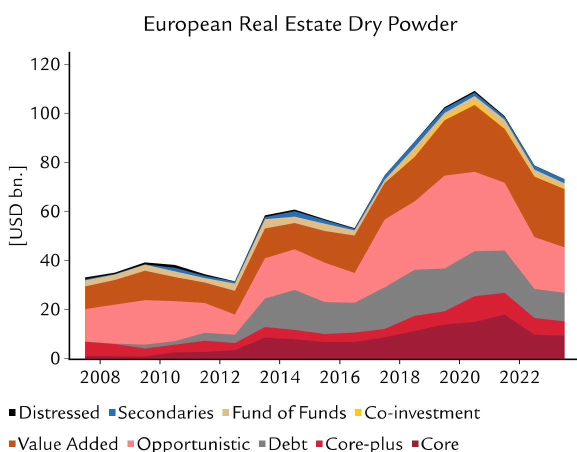
Key takeaways

- **Planning security for investors ahead:** The monetary policy tightening cycle is coming to an end. The future is thus likely to offer more planning security for long-term investors in real estate markets.
- **Taking advantage of the new cycle:** While yields will need more time to adjust, in the medium term, prices will be supported by a clear lack of supply coming into the market. This offers entry opportunities.
- **Seizing opportunities:** The differentiation in terms of building quality will increase further to benefit prime assets. Additional opportunities also arise from investors cleaning up their portfolios.
- **Exploring changes in usage or densification potential:** With a clear focus on quality and transaction volumes set to remain subdued, this is the time to invest in the existing portfolio and ensure that assets meet the quality requirements when it comes to ESG, tenant needs and ongoing structural changes.
- **Unlocking income potential:** Changes in price when interest rates shift are a sign of a functioning market. Focusing on income-generating assets, the structural changes are of greater importance over an investment horizon of 10 years or more, and hence generate performance.

What does it take to reach a new equilibrium?

At mid-year 2023, the bid-ask spread seems to be stickier than anticipated at the beginning of the year. This clearly has to do with the extension of the interest rate hiking cycle into the third quarter 2023. On the other hand, a lack of evidence for a variety of transaction prices is making negotiations even more difficult and the impact of financial cost increases remains to be seen, especially in portfolios too. We expect the monetary tightening cycle to end soon and long-term sovereign yields already seem to have peaked. If confirmed, investors will soon regain greater planning security and there will also be new evidence as regards the "right price" of real estate.

Chart in focus



Weaker fundraising in Europe could see dry powder continue to fall, after peaking in December 2020. Across strategies, the bulk of available dry powder remains in the added value and opportunistic bucket, suggesting that the strong fundraising seen in Q4 2021 has not led to a significant increase in deal activity. It also highlights asset managers' caution when deploying capital. This is also driven by changes in the interest rate environment, enhancing uncertainty. But especially in times like these, adjusting tactics and maybe finding new partnerships can be rewarding.

In the first half of 2023, the central banks in Europe were forced to tighten monetary policy more than expected at the beginning of the year. So the awaited planning certainty of financing costs for long-term investment decisions has not yet returned. However, inflation rates are falling significantly, which is why we expect the end of the interest rate hike cycle in the third quarter of 2023. Manufacturing is feeling the effects of a significant cyclical drop in demand. As well as tighter credit conditions, the weak recovery of the Chinese economy is contributing to this development. Meanwhile, labour markets in all European countries remain only slightly affected by the economic slowdown. This supports private consumption and the service sectors over the coming months.

The future starts now

In order for transaction activity in real estate to regain momentum, we believe that the above-mentioned planning certainty for investors is needed. In our base case assumption, we expect transaction activity to resume in 2024 after both interest rates and real estate price adjustments have settled. At the same time, we expect polarisation across the markets to continue, driven by structural changes and a focus on ESG credentials. That said, prime assets are expected to be most resilient in terms of transaction prices, valuations and rental growth. Rental growth (and also price trends) will continue to be supported by subdued supply due to higher construction costs and labour shortages. To acquire and keep high-quality assets, we expect to see greater pressure to convert space to more suitable uses – be it at the ESG level or in regards of tenant requirements. This includes careful planning to avoid stranded assets.

Short-term tactics

For the rest of 2023, we expect transaction volumes to only recover slowly with little evidence of actual transaction prices. Nevertheless, now is the time to have a closer look at all the opportunities on the market and to determine what the strategic fit is in individual cases. Looking at transaction volumes, the first indication of Q2 2023 data from RCA shows that in markets like Germany (+25% q-o-q), the Netherlands (+20%), Sweden (+150%) and Norway (+9%), activity is increasing compared to the Q1 2023. Yet the main markets UK (-60% y-o-y) and France (-50% y-o-y) are still well below 2022 levels, although Paris and London remain the two biggest investment markets in Europe. Our confidence in the quest for opportunities is confirmed by a positive Q1 2023 for Barcelona (+49% y-o-y), which was driven by hotel transactions. Further Madrid was the third-biggest transaction market in Europe at the same time, due to residential portfolios traded. This shows that an active participation in the new cycle can pay off.

Firm belief in the "living" sector

Looking at our investment strategy, we would not change the features an asset needs in order to be attractive – in any of the sectors. It is really about the price and sensitivity to economic cycles. Having said that, we still firmly believe in the living sector (i.e. residential including senior and also student housing) as the fundamental demographics-driven trend is not impacted by macroeconomic cycles. The increase in rents due to higher inflation is beneficial for owners and the increase in mortgage rates pushes more people towards renting. At the same time, an overallocation from the investor's perspective must be monitored, and the same holds true for ongoing political regulations. When we talk about the senior housing/ healthcare sector, attention is firmly focused on the operator's abilities.

Logistics still going strong

In the logistics sector, supportive fundamental drivers are in place, and rental markets are robust. Structural drivers such as e-commerce and securing of supply chains need not be overestimated, while logistics and light industry remain the basic factors that run an economy and society. This is also visible in rental growth (expected average of 2.8% in 2024), which is driven by both strong fundamentals and a low availability of modern space. After the sharp yield compression in recent years, there has been a significant increase in initial yields with the reversal of interest rates in 2022 and 2023, from Helsinki (+ 100bp) to London (+ 150bp), Warsaw (+120bp) and Lisbon (+ 40bp) since 2021. This includes further price adjustments expected in 2023. At the same time, the expectation of further rent increases also leads us to expect a slight yield compression already starting in markets such as Paris, Berlin and Amsterdam in 2025.

The best and the rest

We are slightly more cautious with regards to the office sector. Although the overall investment strategy remains unchanged with a clear focus on quality, there is clearly a "best and the rest" mindset: the polarisation between very good assets and secondary assets is ongoing. Also within cities, demand for individual locations can vary greatly. Prime rents are expected to increase over our forecast period (1.8% from 2024 to 2027), with noteworthy variations between cities. London's rental growth is expected to be very weak (-0.1% in 2024), while Paris will outperform (+3.4%). This highlights the importance of understanding the dynamics in different locations. Especially when it comes to structural changes, future demand remains to be seen. Supply shortages are expected to become more acute as occupier demand is also focused on the prime segment. This supply-demand imbalance will underpin the rental growth expectations for prime assets. Some further increases in yields are anticipated this year due to the impact of higher interest rates and a higher government bond yield of around 50bp on average. We expect to see stabilisation over the next 12 months. From 2025, there is scope for some yield compression at the prime end of the market in Paris and Berlin, with London and the Nordics following in 2026. Investors may be able to tolerate a narrowing of the risk premium for these types of assets, given the potential for rental growth as well as a shortage of prime assets for sale, which supports competitive tension in bidding. This expected inward shift is relatively modest – around 10-25 bp in most markets (from end-2023 levels). Meanwhile, secondary pricing remains more vulnerable.

AI in retAIl?

We are adhering to highly selective investment advice in retail, reflecting the ongoing structural headwinds that face the sector. Pockets of opportunity can be found in convenience-led shops, food stores and retail parks, in particular those let on a long index-linked lease. At the same time, vacancy rates peaked in 2021 in many high street markets, including cities such as London, Paris, Dublin, Budapest and Madrid, having a negative impact on rental growth over the period. Rental values have stabilised in most markets since 2022. In 2023, more variation in rental growth is expected, this being mostly driven by local inflation rates. Growth is expected to rebound in Paris, Berlin and Madrid. We are keeping an eye on the impact of transformative technology and artificial intelligence AI, as there are examples of retailers using AI to improve and enhance customer support and inform shelving decisions based on real-time shopping trends.

"Bleisure" along

The hotel sector has recovered well over the last 18 months, with twice as many people travelling during the first quarter of 2023 than in the year-back period. Asian tourists are still holding back, but European and American travellers are back to exploring the world. In many places, arrivals are close to or even above pre-pandemic levels. Having said that, a focus on hotels that can meet both business and leisure (i.e., bleisure) needs is seemingly the best strategy.

Figure 1: Rental and CPI Forecast

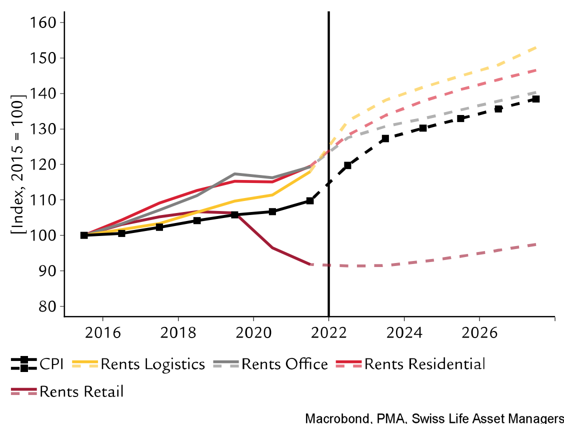
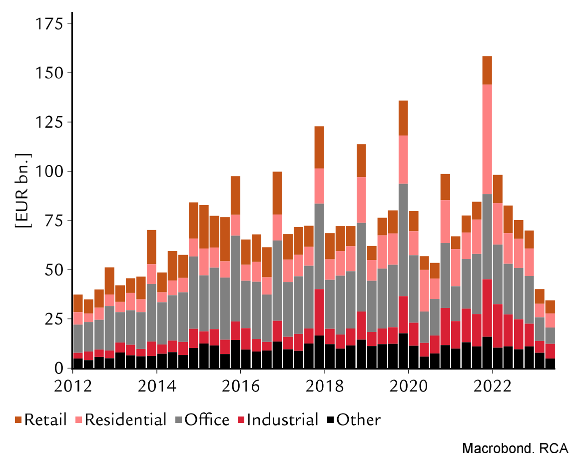


Figure 2: European transaction volume



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