European Commercial – July 2023

SPOTLIGHT
Savills Research

European Investment
H1 Preliminary Results

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Economy - muddy waters

The worst has passed...

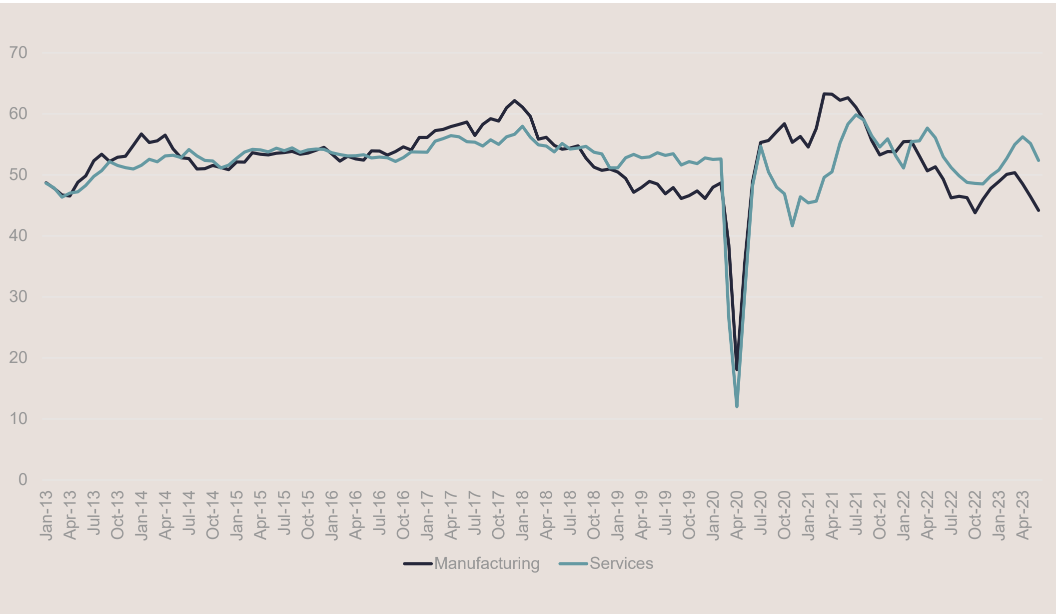
The eurozone entered a mild recession as the economy contracted by -0.1% q-o-q in Q4 2022 and Q1 2023 (Focus Economics). Weak demand due to rising interest rates and high inflation is likely to be a restraint on output activity, meaning GDP growth will remain stagnant. While services business activity has slightly declined, the manufacturing sector has declined at a much faster rate as new manufacturing orders have softened (chart 1). Exports in the euro area contracted during Q4 2022 and Q1 2023 at -0.3% and -0.1%, respectively, while imports also contracted at -2.5% and -1.3%, respectively. However, the productivity outlook looks more positive, with a small growth forecast for the remainder of 2023 and 2024. Hence, GDP is forecast to remain subdued in 2023, with higher growth forecast for 2024.

The consensus is that the worst has passed, and growth will now accelerate, albeit at a low rate.

Portugal and Spain are forecast to have the highest eurozone GDP growth in 2023 at 2.74% and 2.25%, respectively, and while Italy records lower GDP growth at 1.20%, this is still well above the eurozone average of 0.63%, highlighting that southern economies are forecast to perform relatively well in comparison (Oxford Economics). In the Nordics, Denmark and Norway are set to perform at a similar level with growth of 1.29% in 2023, while Sweden - whose market will be harder hit by rising interest rates due to the reliance on short-term debt - is forecast to contract with GDP growth of -0.31%. Core markets, UK, France and Germany, are all set to record lower growth than the eurozone average, with Germany reporting a decline in growth of -0.39%. In 2024 all markets are forecast to record positive growth. The eurozone is forecast to be at 1.24%, with Sweden reporting the lowest (0.69%) and Ireland the highest (4.42%).

As a result of economic instability and low growth, the unemployment rate is expected to rise in the eurozone to 6.72% in 2024, although this is up from a historically low base of 6.57% in 2023 (Oxford Economics). Positively, labour markets are forecast to remain tight as the employment intentions indicator remains slightly above the long-term average, helping to protect against any large increase in unemployment and knock-on effect on consumer spending.

Fig 1: PMIs in the eurozone



Source: Capital Economics

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...but the economic sentiment is still subdued

The effort to keep inflation under control meant that the European Central Bank (ECB) raised interest rates 25 bps in June 2023, marking the eighth consecutive hike and bringing the cumulative increase to 400 bps since July 2022. It is expected that the ECB will raise interest rates twice more, taking the deposit rate to 4.00% and will keep this peak until the middle of 2024.

Such efforts by the ECB have resulted in headline inflation falling from 6.1% in May to 5.5% in June in the eurozone, driven by lower food and energy inflation (Capital Economics). Certainly, lower commodity prices and a recovery in the global supply chain mean that headline inflation is expected to remain on a downward trend. Core inflation (which excludes energy, food, alcohol and tobacco), however, remains high and rose to 5.4% in June from 5.3% in May. Driven by stubbornly high services inflation (5.4% in June), which is characterised by a tight labour market and strong wage growth, core inflation is expected to remain above 2% until 2025.

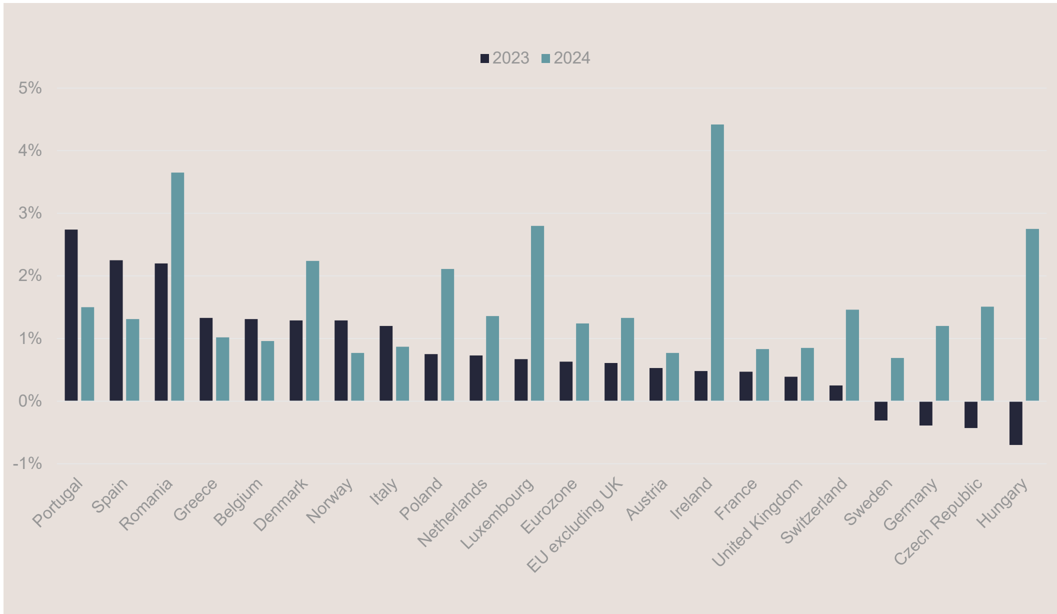
The economic landscape of continual interest rate hikes by the ECB and low growth has meant that the economic sentiment indicator (ESI) fell to 95.2 in June 2023 in the eurozone, the lowest level seen in 2023 and slightly below the long-term average (Eurostat). The decline was broad-based, with industry, services, retail and construction all recording a decline in confidence.

Consumer sentiment is slightly brightening

On the other hand, the eurozone consumer confidence indicator rose to -16.1 in June 2023, up from -17.4 in May. Albeit this is still well below the long-term average, this is currently the highest consumer confidence has been since February 2022, an outcome of declining inflation.

Still, inflation is comparatively much higher than consumers are used to and tightening monetary policy means retail spending is forecast to fall as disposable incomes remain squeezed. In 2023, retail spending is forecast to decline by 1% in the eurozone before increasing by 2% in 2024. While this is good news for retail sales, with retail indicators fairly positive, core inflation is expected to remain high.

Fig 2: Annual GDP growth



Source: Oxford Economics

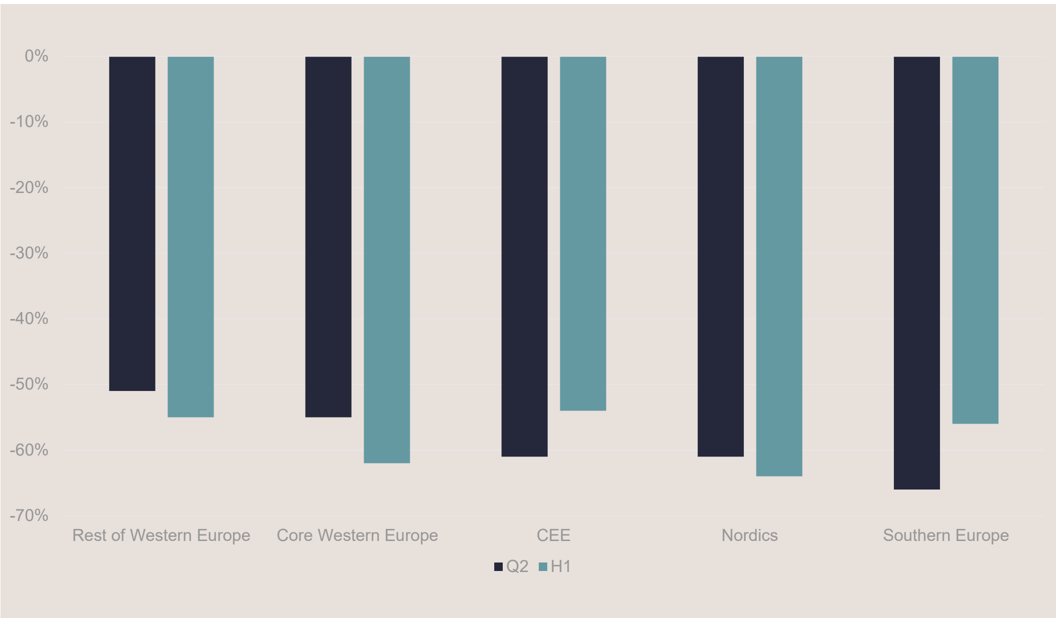
Investment transactions still stalling in Q2

Preliminary results suggest that the total investment volume for the second quarter of the year will be around €33bn, the lowest Q2 since 2010 and will represent a 57% drop compared to the same period last year. This would bring the first half of the year volume to approximately €65bn, and will represent a 61% drop for H1 2023 compared to H1 2022.

The slowdown is spread fairly evenly across Europe, with most markets reporting decreases from the European average (chart 3). Preliminary figures suggest Southern Europe recorded the largest annual decrease in Q2 2023. However, this is off the back of an exceptional year for investment in Southern Europe in 2022. The rest of Western Europe records the shallowest drop, albeit still significantly lower than in previous years. The Nordics are likely to record the highest H1 annual drop of approximately 64%, with the expectation that this downward movement will continue into the remainder of 2023.

A major trend that seems to be slowly gaining traction is renewed investor interest in retail assets. In Q1 2023, retail investment recorded the slowest decline of all sectors, with €6bn transacted, accounting for 20% of total investment transactions, the highest share recorded since 2015. According to our preliminary results, another €6 to €7bn was transacted during the second quarter of the year. This will bring the H1 result to approximately €12-13bn, with some large retail portfolios being signed in Q1 and Q2, notably the Signa AT Retail Portfolio 2023 in Austria for €400 million and the Sainsburys Reversion Supermarket Portfolio 2023 in the UK, worth €960 million. Retail has certainly fared well this year, considering the current climate. Positively, this may signal that retail, albeit limited due to the current economic landscape, may become a top pick for investors as there has been a less dramatic shift in retail values given a large proportion of the pricing correction had already taken place.

Fig 3: Annual change in investment volume



Source: Savills

Towards a rebalancing of allocations per asset type

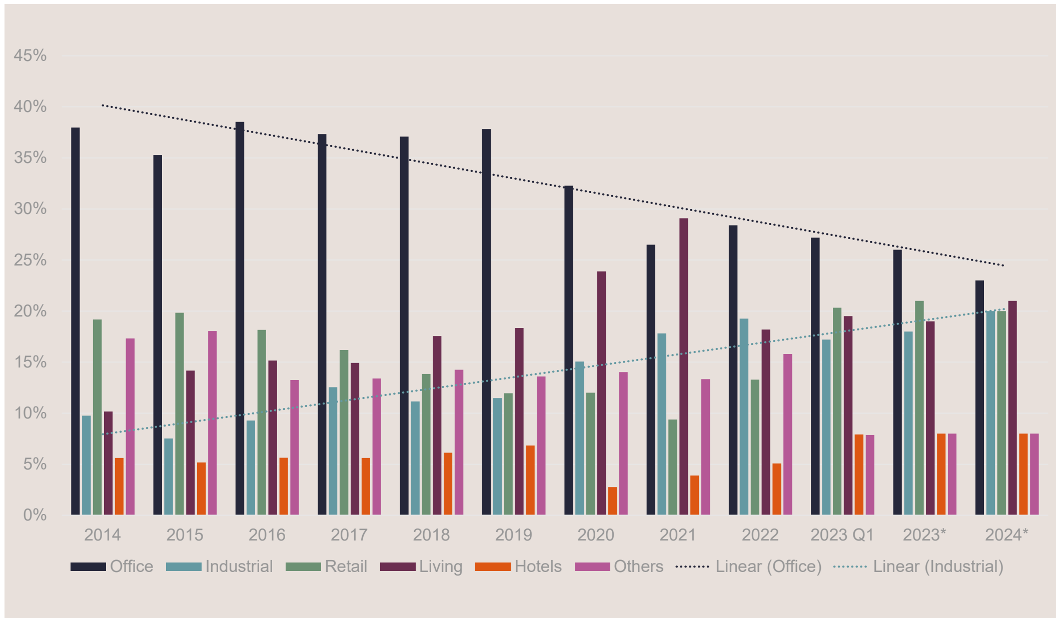
Over the past decade, there has been a substantial shift in investment volume across various asset classes, leading to a more evenly distributed breakdown. In 2014, European office and residential investments accounted for 38% and 10% of all sectors, respectively. However, as of Q1 2023, these figures had shifted to 27% and 19%.

This shift is notably more in line with the actual needs of society. Considering the current European population and the workforce predominantly engaged in office-based work, we estimate that the need for residential areas is six times higher than the need for office space. This trend also reflects the increased liquidity within each asset class in the real estate market, as well as the growing inclination towards wider portfolio diversification to mitigate potential risks.

Over the past decade, the retail industry has experienced profound transformations due to changes in consumer behaviour, particularly the rapid surge of online sales. The resulting uncertainty in the sector has led investors to reduce their exposure to retail. Concurrently, the escalating distribution requirements have generated increased demand for logistics warehouses, which has attracted more capital investment. As a result, the share of retail and logistics investments, which stood at 19% and 10%, respectively, in 2014, has now achieved a more balanced distribution at 20% and 17% in Q1 2023.

Going forward, we expect the major classes, including the living sector, offices, logistics and retail, will attract relatively similar levels of investments.

Fig 4: Investment volume breakdown per asset type



Source: Savills / * Forecast

Avenues of exploration

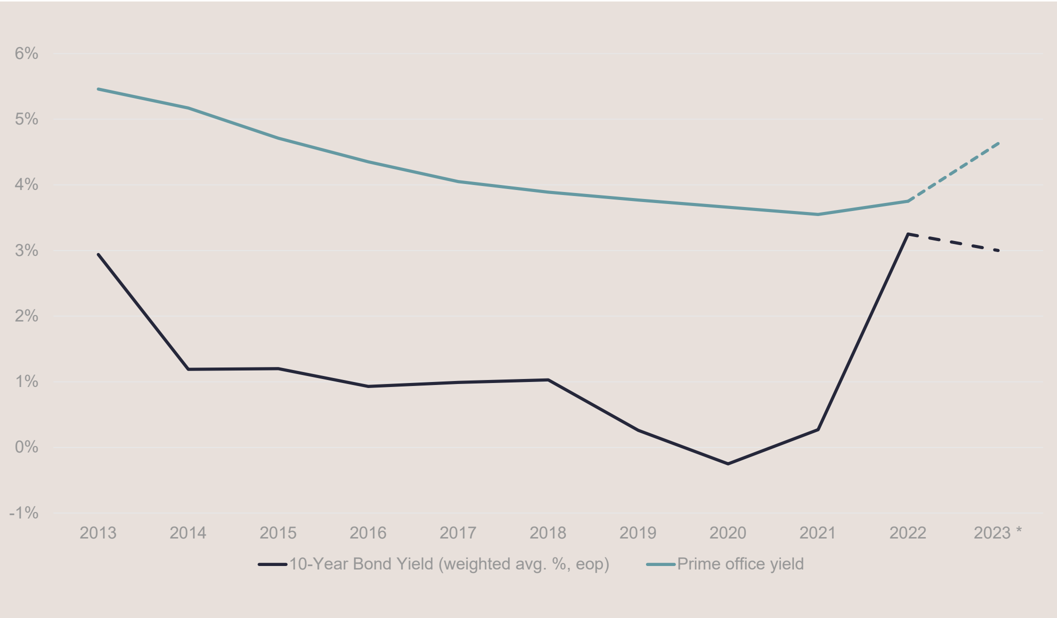
The instability in the market during the second half of 2022 carried over into 2023, and with it the same reasons responsible for the decreasing investment volumes across Europe.

High-interest rates are causing significant problems among borrowers and lenders in the market, which continue to be increased by central banks in a bid to bring inflation under control. As a result of the continued and rapid rate hikes, returns have increased on risk-free government bonds, and the gap between bonds and prime office yields has become squeezed, currently at 140 bps on average across Europe. Though this is still well below the 300 basis point average spread which investors had become accustomed to over the past 10 years.

Subsequently, debt has become harder to secure, given the increased risk associated with real estate and the interest rate hikes that have pushed the cost of borrowing up. Owners found themselves grappling with the need to create more liquidity as banks demanded increased equity for loan extensions. Meanwhile, lower valuations are compelling owners to bolster their equity position. Additionally, lenders want to avoid landlords being forced to return stranded assets due to falls in capital values and higher costs of debt.

Overall, apart from small, "very attractive", and ideally green projects, the banking sector is reticent about granting or extending loans for large transactions unless they mitigate risks by engaging in club deals with other lenders. Collaboration has become a prudent strategy for navigating the changing dynamics. Meanwhile, private property lenders have started to become more prevalent in the European property market.

Fig 5: European bond yield vs prime office yield



Source: Savills / Focus Economics / * Forecast

Deals - bound by constraints

With the banks essentially "closed for business", large, high-leverage transactions that had been the mainstream of the market's growth have seemingly dwindled in number, giving way to smaller deals requiring less debt.

In Q1 2023, deals up to €500m accounted for 97% of all deals, up from the previous five-year average of 95%. No deal over €1bn was recorded in Q1. However, within the €500 - €999m bracket, a few transactions were closed, notably including portfolios. The €960m Sainsburys reversion portfolio in the UK significantly boosted investment volumes in this bracket. Another example includes the sale of 55% of the build-to-rent (BTR) portfolio developed by Via Celere in five Spanish provinces (2,400 apartments in 12 apartment blocks), sold to Greystar for more than €400m in March.

More recently, in June, a few other large portfolio deals were signed, suggesting that tougher financing conditions have not completely deterred large ticket acquisitions. This includes notably the Galeria Kaufhof portfolio, eight department stores sold to Signa Group for €1.5bn, the largest deal recorded so far this year, and the Seniors Housing Portfolio, sold to NREP for €420 million, consisting of 22 properties.

That said, portfolios made up only 30% of the Q1 2023 turnover, the lowest level since 2019. Current economic headwinds mean lenders are more cautious towards the large volumes of debt that are required for portfolio deals, subsequently narrowing the pool of investors able to move ahead with such large acquisitions.

Given that private investors typically have relatively larger cash pools and transact in smaller deals, securing debt from cautious lenders is less of an obstacle. Hence, private investors increased their share of investment in 2023, making up 22% of total investments, the highest level in the last ten years. At the other end of the spectrum, REITs activity decreased quite significantly over the course of the past 12 months. In 2023, acquisitions from REITs accounted for 4% of total investments, the lowest this has been in the last ten years.

Fig 6: Share of deals by price brackets

Source: RCA

H2 to slowly set the new norm

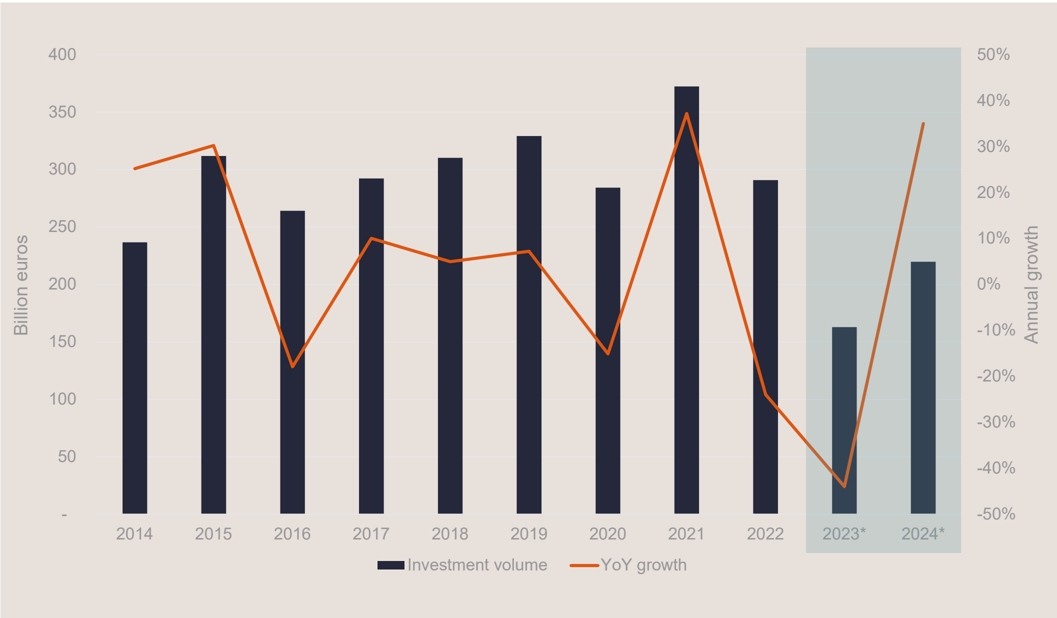
As both lenders and investors start to adapt to the new high "environment" (interest rate, debt cost, yields), we expect a slight regain of investment activity during the second half of the year, at a time when we expect the economy will start slowly picking up. Investors will continue to focus on the prime-green segment of the market. Due to the fall in capital values, real estate returns will be led by income returns rather than capital growth, and so focus will be placed on strong occupier markets, where high rental growth and ESG credentials can be achieved.

On the other hand, we also anticipate a growing activity driven by opportunity-led investors enticed by the prospect of pricing adjustments, as history shows that deals pursued during challenging times often yielded superior returns in the long run. This is why we believe retail will continue to fare better than other sectors in 2023.

Whilst we expect debt market conditions to ease somewhat in the second half of the year, securing loans for large or non-prime deals will remain restrained. As the dry powder is piling up, we believe investors will find alternative means to finance transactions. Hence, we anticipate a growing number of joint ventures commitment, enabling large portfolio deals to happen.

That said, investment volumes will be nowhere near the levels recorded over the past five years. We forecast the annual investment volume in Europe to be approximately €163bn by the end of the year, representing a yearly decrease of 44%. Should the European economy improve in 2024, as the economist consensus suggests, we anticipate a rebound of 35% in investment activity next year with approximately €220bn worth of transactions across Europe. As Europe is further ahead in the cycle compared to the US and Asia-Pacific, this should encourage long-haul cross-border investment activity on the old continent, going further.

Fig 7: European investment volume and year-on-year growth



Source: Savills / *Forecast

Yields – capitulation still ahead

With the escalation of financing costs, the ability to achieve desirable returns on investments has become increasingly complicated as refinancing encounters adverse leverage. Owners are likely to become more willing to sell at higher yields seeking to divest as lower valuations will force them to boost their equity positions. In light of these challenges, we anticipate further outward fluctuation in yields in the European property market, across all sectors, albeit to different degrees.

Offices – the "ugly duckling"

It has become unequivocal that hybrid work arrangements have become permanent. The far-reaching transformations to the way we work reverberate within the realm of the office sector and will certainly continue for the next five to ten years (as it did for the retail sector). Additionally, escalating energy costs have thrust energy efficiency and ESG concerns into the spotlight. With a regulatory impetus to mandate a minimum threshold for energy efficiency, many buildings will fall short of the new standards without adequate refurbishment works. Whilst there is no doubt that offices will remain the dominant workplace for many years to come, for now, their future role and shape are unclear. Hence, the viability and the performance of the vast office stock look questionable, especially for non-prime buildings located in non-CBD locations.

As such, offices are increasingly shunned by investors. The growing lack of liquidity in the office sector is pushing prices down. On average, the European prime CBD yield was at 4.5% in Q2 2023, 86 bps up on the same period last year. We expect it will reach approximately 4.6% at year-end, a relatively low outward movement resulting from the lack of transactions that we anticipate (notably large prime office deals for which sellers are not ready to capitulate). However, according to our quarterly internal survey, in 27% of the jurisdictions we cover, we expect prime CBD yields to soften by more than 26 bps until the end of the year. In non-CBD locations, the average prime yield, which was at 5.3% in Q2 2023 (+105 bps YoY), is expected to move further out by 40 bps until the end of the year to 5.7%. Yet, a stronger yield expansion, above 50 bps, is anticipated in 32% of the jurisdictions we survey. Hence, the prime CBD versus non-CBD yield gap is likely to reach 105 bps in the final quarter of the year, from 75 bps in Q3 2023, its lowest level.

Logistics – the early bird gets the worm

For cost control reasons in the current high inflationary environment, logistics occupiers are opting to maintain their current footprints rather than seeking larger spaces. Despite weaker demand and rising vacancy rates in Q1 2023, rental growth remained strong. Prime logistics rents across Europe increased by 10.4% annually, underlining the robustness of the logistics occupier market, notably compared to other sectors.

The logistics sector was the quickest to re-price. Yields adjusted more than the other sectors, by 90 bps on average across Europe since the peak in Q1 2022. However, this only partly compensates for the sharp yield contraction recorded between 2019 and 2022 (+112 bps). This and the strong fundamentals of the sector, which continue to attract investors, explain the rapid adjustment of the market. On average, the European prime logistics yield was at 4.7% in Q2 2023, 78 bps above the same period last year. We believe logistics prices have nearly reached their nadir, with a slight further decline foreseen this year. In Q4 2023, we expect prime logistics yields will reach approximately 4.9% on average across Europe, with still 22% of our surveyed jurisdictions expecting yields to soften by more than 26 bps.

Residential – the cost of rent spiralling

The surge in household mortgage rates is posing a considerable challenge to affordability which, in turn, has precipitated a notable upswing in the demand for rental properties. Furthermore, the structural supply and demand imbalance in the rental sector has been exacerbated by new regulatory legislation, particularly concerning energy ratings, which led to a striking depletion of available rental units, resulting in substantial spikes in rents. Whilst this is positive news for the financial performance of the sector, rental spiralling will certainly trigger more restrictions from local authorities. This threat, combined with low residential yields in the current market conditions, has retrained the investors' impetus for residential units and forced prices down in spite of the solid fundamentals of the market.

The European average prime multifamily yield was at 3.9% in Q2 2023, 56 bps up on the same period last year – a relatively shallow yield expansion compared to other asset types. We anticipate a slight further increase until the end of the year, to approximately 4.0% in Q4 2023, with, however, 27% of our surveyed jurisdictions expecting prime yield to expand by more than 26 bps.

There is continued strong investor interest in purpose-built student accommodation across Europe, driven by rising total numbers of students and a strong growth in international student numbers. However, due to the lack of suitable existing stock, notably in non-core countries, the main market entry is through forward funding of new developments, which has become challenging due to the escalating cost of construction.

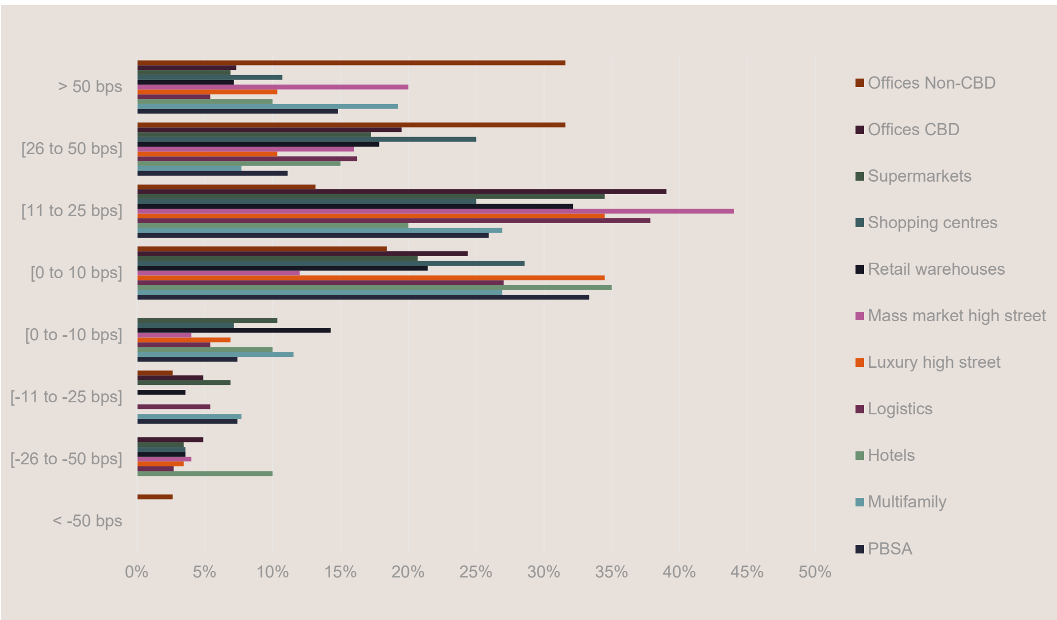
On average, in Europe, the prime student housing yield was at 4.4% in Q2 2023, 41 bps above the same period last year. We expect the average prime PBSA yield to be at approximately 4.6% at year-end, whilst a yield expansion above 26 bps is anticipated in 26% of the regions we cover.

Retail – not yet out of the woods...

Following a long period of profound changes, 2022 was set to mark a turning point for the retail industry. However, the Ukraine and Russia crisis and the pervasive inflation exacerbated by surging energy costs shattered expectations. In spite of improving footfall, notably thanks to the increasing number of tourists and the decline of online sales post-pandemic, retail sales will remain subdued this year with an increasing number of retailers filing for insolvency, particularly in fragmented markets.

Following three to six years of expansion, retail yields offer a compelling opportunity compared to other asset classes resulting in a renewed investor interest in the sector. However, the extended lean period led investors to focus on the super-prime opportunities at attractive prices. As such, we anticipate further yield expansion in the sector, most particularly for shopping centres and retail warehouses. The European average prime shopping centre yield was at 5.9% in Q2 2023, 55 bps up on the same period last year; we expect it will be at approximately 6.1% at year-end. The European average prime retail warehouse yield was at 5.5% in Q2 2023, 58 bps up on the same period last year ; we expect it will be at approximately 5.7% at year-end.

Fig 8: Annual yield movement expected at year-end



Source: Savills

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