European Commercial – October 2023

SPOTLIGHT
*Savills Research*

# European Investment
## Q3 Preliminary Results

# Recession risk still looming

During the first half of the year, improved global supply chain conditions breathed fresh life into industrial output, while a surge in tourist numbers provided a vital boost to the services sector. Nevertheless, the economy barely remained above water. In mid-September, the European Central Bank took the notable step of raising interest rates for the tenth consecutive time, driven by its commitment to fight against stubbornly high inflation in spite of the fact that higher borrowing costs could push the European economy into recession.

Although inflation is projected to have a smaller impact on the purchasing power of households in the forthcoming quarters, it is likely to be counterbalanced by sluggish growth in nominal wages. Furthermore, there is a looming expectation of fiscal policy tightening next year, indicating the likelihood of stagnant real household disposable incomes and subdued consumption. The prevailing lack of confidence and the weight of higher debt interest costs is predicted to bear down more heavily on business investment than on household consumption. The prospect for investment appears bleak, particularly in the housing market, where activity remains weak, with substantial drops in dwelling investment. The only bright spot is coming from the labour market, which is expected to remain tight.

All in all, economists revised their forecast downward, now predicting a mild recession in the second half of the year and a slow recovery in 2024. According to Capital Economics, the Eurozone GDP growth is expected to be at 0.3% this year and at 0% in 2024. Core inflation is projected to decrease to approximately 3% by the middle of next year, thanks to lower commodity prices and the ongoing improvements in global supply chain conditions.

In 2023, Portugal, Romania and Spain are forecast to have the highest annual GDP at 2.4%, 2.3% and 2.2%, respectively, while Hungary, Sweden and Germany will likely witness the weakest growth at -0.8%, -0.7% and -0.4% respectively. Next year, Ireland (4.6%), Romania (3.0%) and Luxembourg (2.9%) will lead the European growth, whilst Sweden (0.2%), the UK (0.4%) and Germany (0.4%) are anticipated to report the lowest GDP, according to Oxford Economics.

**Fig 1: Annual GDP growth**


**Source:** Capital Economics

# Investment volumes keep falling

In this lacklustre economic context, investment activity did not pick up in the third quarter of the year as we originally anticipated. The European investment volume is estimated to be approximately €30bn, according to our preliminary results. This reflects a decline of 8% compared to the previous quarter, which was already 8% down on Q1. Hence, the investment volume accumulated since the beginning of 2023 is likely to reach slightly more than €97bn and reflect a 57% drop on the same period last year.

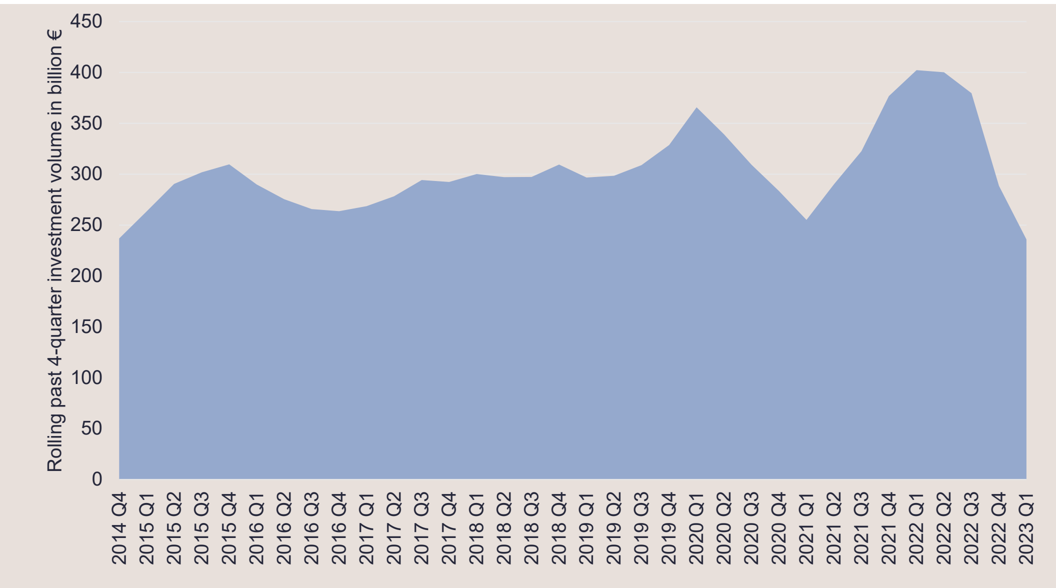
Greece is the only European country that is performing positively so far this year. The investment volume is expected to report a 50% YoY increase since the beginning of the year, notably thanks to the large transfer of a real estate portfolio, the "Skyline project", valued at the amount of €438 million. All other countries are in the negative territory, with Austria, the Czech Republic and the Netherlands faring slightly better than others.

Investment volumes experienced a widespread decrease across various asset classes, with the office sector continuing to face the most significant downturn. Nevertheless, certain sectors showed greater resilience than others, notably senior housing, hotels, and retail. Looking ahead, we anticipate that both the "beds and sheds" will maintain their status as preferred asset classes, benefiting from a persistent structural imbalance between supply and demand. According to our European Investment Survey conducted in September 2023, logistics and residential stand out as the two sectors where investors are most likely to focus their investment intentions over the next 12 months.

Activity in the market is mostly led by domestic investors. European cross-border investors have disappeared from the European scene, with the exception of French Investors buoyed by SCPI deployment, who became the second largest cross-border investors in Europe following the US. For the next 12 months, we expect cross-border investment activity to remain subdued and mostly fuelled by non-continental capital.

With financial institutions less inclined to undertake high-risk transactions, there has been a noticeable decline in the number of large and high-leverage transactions that were once the primary driver of the market's growth. In the first half of 2023, deals exceeding €1 billion constituted only 3% of the total transaction volume, a significant drop from the 9% average observed over the past five years. Conversely, smaller deals requiring less debt have gained prominence. Deals under €100 million, which historically made up 56% of the investment turnover over the past five years, now accounted for 63% of the total transaction volume during the first half of this year. Based on the limited number of large deals signed in Q3 and the results of our recent European Investment Survey (Sept 2023), suggesting that the cost of borrowing remains the main barrier to making new investments, we do not expect investment lot sizes to increase in the next six months.

**Fig 2: Slowing down investment activity**




**Source:** Savills

# Gradual recovery expected from Q4

Overall, we expect a gradual resurgence in investment activity starting in Q4 and extending in 2024 on the back of the downward price adjustments, which have created opportunities for cash-rich investors. This revival of activity is expected to be most pronounced in areas where prices experienced significant corrections, notably in the UK. According to our last Investor Sentiment Survey, the UK has ascended to the top spot as the most attractive investment destination, a noteworthy shift from its previous third-place ranking last year.

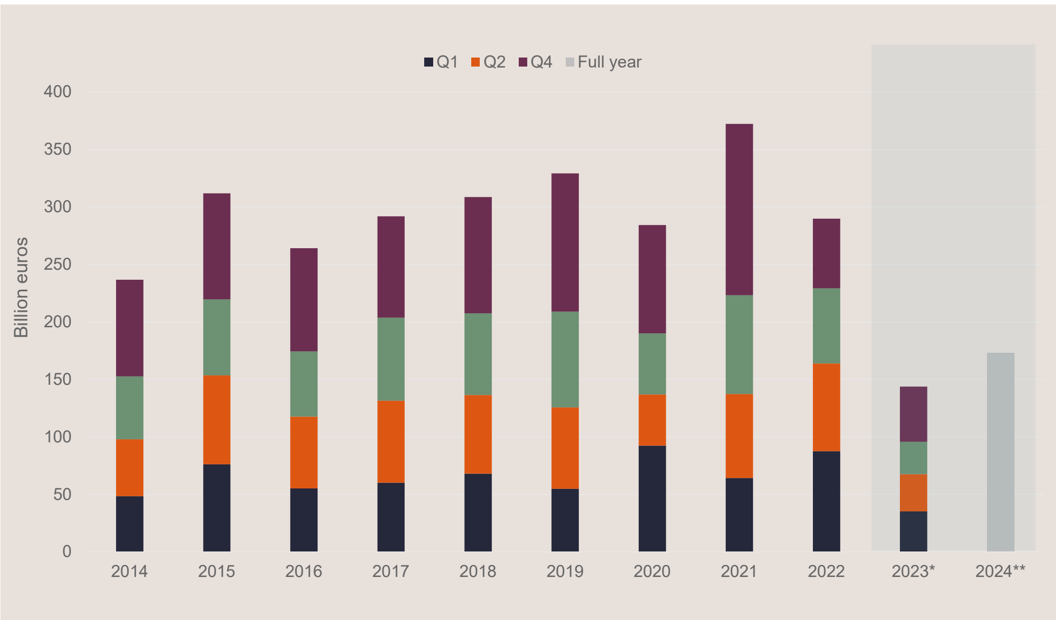
Nonetheless, the lacklustre economic landscape is poised to act as a drag on investment activity for the forthcoming six months. Consequently, investment volumes are not anticipated to approach the levels seen in the past half-decade.

Our projection for the annual investment volume in Europe by the end of this year is approximately €143 billion, reflecting a 50% year-on-year decrease. Looking ahead to 2024, we expect a modest rebound of 20% in investment activity, with transactions across Europe amounting to around €175 billion.

Investment activity will be driven by opportunistic investors enticed by the prospect of favourable pricing adjustments.  Investors will maintain their focus on the premium green segment of the market. Due to the decline in capital values, real estate returns will be predominantly driven by income returns rather than capital appreciation. Consequently, attention will be directed toward robust occupier markets, where there is potential for high rental growth and a strong emphasis on environmental, social, and governance (ESG) credentials.

While we anticipate some easing of conditions in the debt market, obtaining loans for large or non-prime deals will remain constrained. Consequently, investors will need to explore alternative avenues for financing their transactions. This is expected to lead to an increasing number of joint venture commitments, facilitating the execution of large portfolio deals.

### Fig 3: Investment volumes




**Source:** Savills / * Q4 forecast / ** Full-year forecast

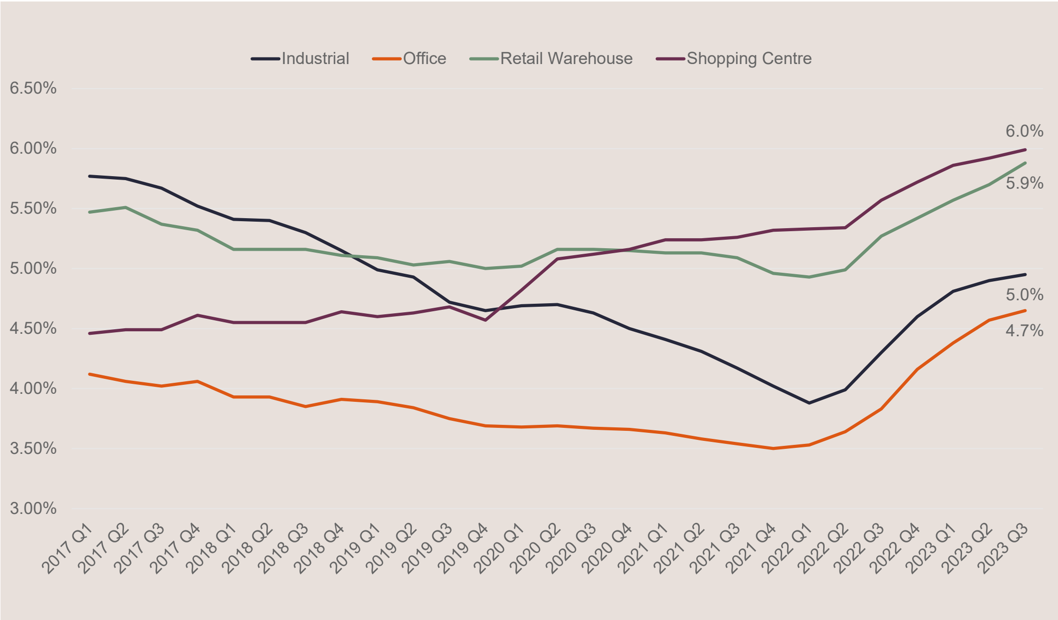
# Yield decompression to continue in the next six months

Due to the high cost of debt, the ability to achieve desirable yields on investments is increasingly complex, with refinancings facing negative leverage in nearly all sectors. Given these challenges, we anticipate that the property market will experience further yield shifts as sellers are expected to become more inclined to offload their properties at higher yields.

The increasing lack of liquidity in the office sector is exerting downward pressure on prices. On average, the European prime CBD yield stands at 4.65% in Q3 2023, reflecting an increase of 82 basis points compared to the same period last year. We anticipate that it will reach approximately 4.75% by year-end, with this relatively modest upward shift primarily attributed to the scarcity of expected transactions. Notably, major prime office deals may not see sellers willing to compromise. However, based on our quarterly internal survey, in 25% of the jurisdictions we cover, we anticipate that prime CBD yields will soften by more than 26 bps over the next six months. In non-CBD locations, the average prime yield, which was at 5.55% in Q3 2023 (+66 bps YoY), is projected to rise further by 25 bps, reaching 5.8% at the end of the year. Yet, in 36% of the jurisdictions we cover, a more substantial yield expansion for non-CBD offices, exceeding 26 bps, is expected in the next six months.

The robust fundamentals of the logistics sector continue to be a magnet for investors. Indeed, data from our recent logistics census reveals that 24% of investors perceive their allocation to logistics assets as insufficient. During this quarter, prime logistics yields have mostly remained stable across Europe, experiencing a minor upward trend in certain locations. On average, the European prime logistics yield stands at 4.90% in Q3 2023, compared to 4.85% in Q2, representing a 64 bps increase from the same period last year. We believe that logistics prices have nearly bottomed out, with a slight further decline expected this year. By Q4 2023, we anticipate that the average prime logistics yield will range from 4.90% to 5%. However, in 25% of the jurisdictions we have surveyed, we anticipate that logistics yields will soften by more than 26 basis points in the next two quarters.

## Fig 4: Prime average yields

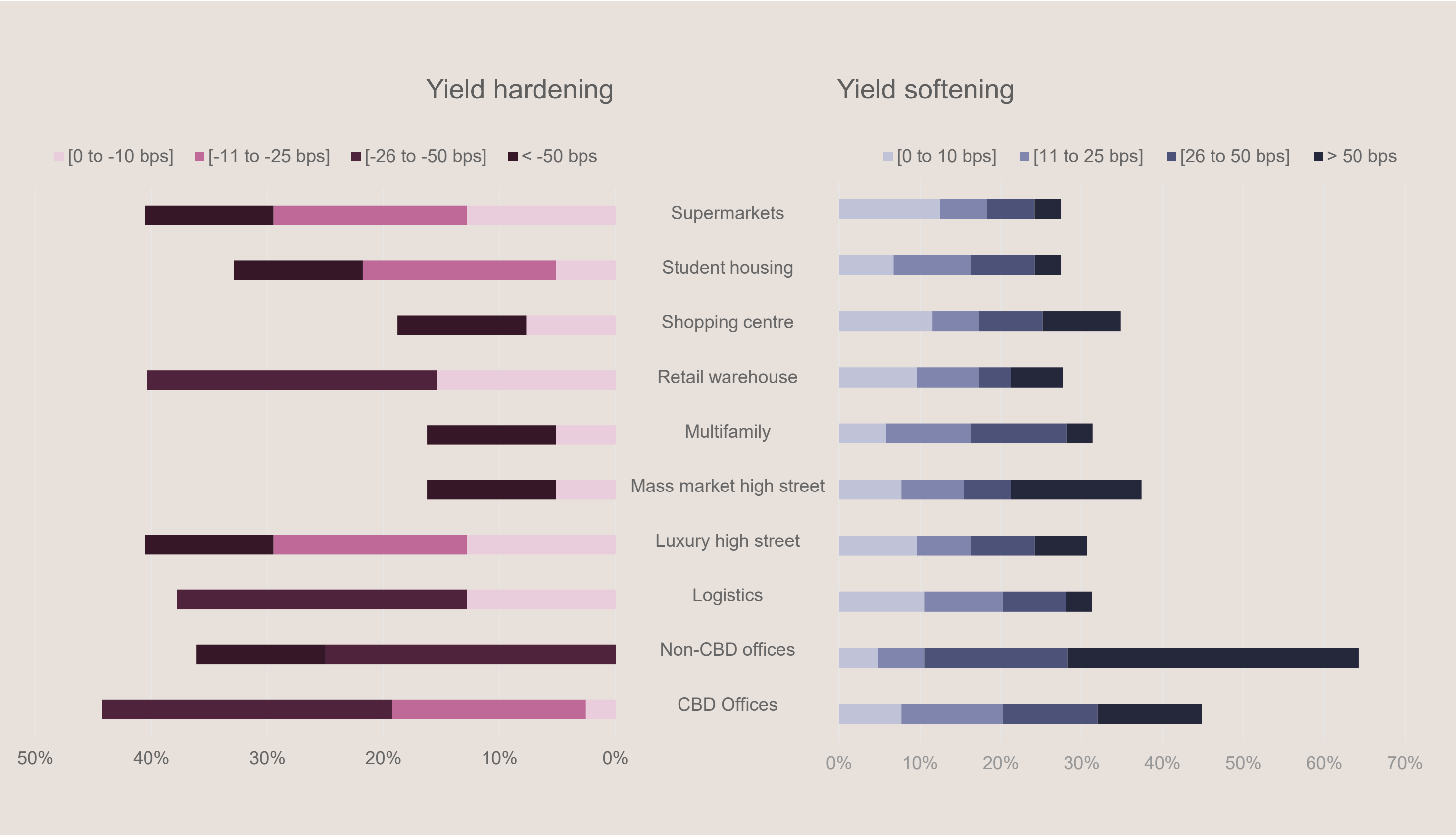



**Source:** Savills

Following six years of expansion, retail yields have emerged as an appealing prospect when compared to other asset classes, drawing renewed investor interest in the sector. Nevertheless, the prolonged period of economic restraint has steered investors towards super-prime opportunities offering attractive pricing. Consequently, we anticipate further expansion in yields within the retail sector, particularly for retail warehouses. In Q3 2023, the European average prime retail warehouse yield stands at 5.90%, marking a 61 bps increase compared to the same period last year. We project that it will reach approximately 6.10% by year-end. The European average prime shopping centre yield for Q3 2023 is 6.00%, which reflects a 42 bps increase from the same period last year. Our forecast suggests it will be around 6.10% by year-end, around the same level as retail warehouses.

In the current market conditions, the persistent ultra-low yields associated with the residential asset class have tempered investors' enthusiasm for residential units, leading to a decline in prices, despite the robust underpinnings of the market. In several European cities, prime multifamily yields continued to record strong outward yield movement in Q3 2023. In Berlin, prime multifamily yields expanded by 100 bps annually, reaching 3.60%. Oslo witnessed a 75 bps increase, bringing the yield to 4.75%. Milan saw a 50 bps uptick in yields, reaching 3.50%. Amsterdam also experienced a 50 bps increase, resulting in a yield of 3.40%.

## Fig 5: Annual yield movement expected in the next six months




**Source:** Savills

**Savills Commercial Research**
We provide bespoke services for landowners, developers, occupiers and investors across the lifecycle of residential, commercial or mixed-use projects. We add value by providing our clients with research-backed advice and consultancy through our market-leading global research team.

**James Burke**
European Capital Markets
Director
+44 (0) 20 7409 8874
JBurke@savills.com

**Lydia Brissy**
European Research
Director
+33 624 623 644
LBrissy@savills.fr