SPOTLIGHT
Savills Research

European Property Themes 2023

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2022 was a year of (un)predictable political events, of an (un)anticipated economic slowdown, of (un)expected surging inflation, of what seems (un) stoppable warming weather, and for European real estate, the turning point of a cycle. 2022 was characterised by a progressive declining flow of capital in real estate and softening yields, notably due to surges in both interest rate and debt cost.

According to Oxford Economics, the eurozone economy is forecast to slow sharply from 3.2% in 2022 to a 0.1% contraction in 2023. The energy crisis will be the main factor dragging the economy to a short-term recession. Once the energy emergency eases following the winter, a gradual recovery is expected as a decline in inflation should allow household real incomes to recover.

While the market has undoubtedly became more challenging as the year progressed, 2023 promises more opportunities for investors who are ready to take on some risk by repurposing distressed real estate assets after strong price correction. As pricing becomes more transparent, this should encourage more sellers to bring products to the market at the right price, unlocking liquidity.

In this publication, we provide our predictions for the European property themes of 2023.

EUROPEAN INVESTMENT HOT SPOTS

TOP PICKS FOR CORE /CORE+

- **Prime multifamily housing** is particularly well placed to weather current high inflation as it is one of the few asset classes where landlords can regularly rebase rents to capture growth, driving strong income returns. **Particularly in capital or large cities in Germany, the UK, the Nordics, Spain and France**, where the supply and demand imbalance leads to significant rental growth.
- **Prime logistics** markets in the **UK, Germany, Netherlands, France, and Spain** have historically low vacancy rates and speculative development is set to decline. Whilst occupier demand is set to fall from Covid-19 highs, we expect that vacancy rates will remain tight, which will keep upward pressure on rents.
- **Trophy office buildings** in flagship CBD locations with low vacancy rates, such as **Berlin, Munich, Paris CBD, Stockholm, and London,** will retain the attention of cash-rich cross-border investors.
- **Mid-size food retail** units, especially stores hosting discounters such as Lidl **across all tiers 1, 2 and 3 European cities** as long as it is strategically located. Historical data show discount retailers are expanding fast during downturns. In today's high inflationary environment, consumers shop with a price-sensitive mindset.
- **European data centre portfolios**- Whilst the industry navigates with the wind in its sails thanks to strong demand ahead and insufficient supply, we expect operators will increasingly need large amounts of cash to secure energy by building on-site energy power, expanding their footprint to keep their profit margin, "greening" their portfolio… Hence we expect more sale and lease-back opportunities to arise in the next 2-3 years.

TOP PICKS FOR VALUE-ADD

- **Prime retail parks/shopping centres** in Southern Europe (**Spain, France, Portugal, Italy**), where inflation and stock per capita are relatively low compared to the rest of Europe.
- **Repositioning brown office buildings to green standards**, where the proportion of old stock is high such as Paris and Frankfurt and in countries where the deadline to achieve strong EPC ratings is tight, such as Amsterdam. **In the Netherlands**, all buildings should reach EPC C by January 2023, and 40% of the existing stock is still below a C.
- **New PBSA development in Spanish or Italian cities** where the provision of PBSA beds per student is amongst the lowest across European cities, whilst forecasted demographics suggest the future student population will expand.
- **Life science** in Western Europe as rising demand for digital health has boosted investment into the sector, spurring investor demand for office and laboratory facilities, notably located in the **UK, Germany, France, Netherlands, Belgium or Switzerland**.

TOP PICKS FOR OPPORTUNISTIC

- **Repurposing of distressed real estate assets** after strong price correction.

#1 Recessionary environment

As Europe's economy is sliding into recessionary territory, cost-control will become a major theme impacting real estate occupiers throughout 2023.

It is firstly worth remembering that the Eurozone unemployment rate remains at a record low, which should help position the economy for a softer landing. Economists forecast some of the stronger economic growth among the countries who are more energy resilient and less exposed to manufacturing sectors. Southern Europe, for example, is generally observing lower levels of inflation and is still benefitting from a recovering tourism industry which will help support growth.

We expect that hiring sentiment among European employers will weaken throughout 2023, which will have a noticeable, but lagged impact on office demand. Weaker headcount growth and business confidence is likely to see leasing deals postponed until we see further clarity. A number of big tech companies have already announced job cuts and have begun marketing their office space for sub-lease, whilst we may begin to see more activity from the accounting and legal sectors in response to insolvencies and liquidations. However, occupiers will still be competing to sign for the highest quality office space to fit with their ESG strategies and we anticipate rents will diverge between the best and the rest. We may also begin to see a rise in presenteeism as employees compete to avoid job cuts in an environment of hybrid working.

Given weaker employer hiring sentiment, we expect to see a rise in overall student applications across major European markets. With occupancy levels already high (ranging from 95-98%) and a shortage of new purpose-built student accommodation assets in Spanish and Italian cities, we expect to see rental growth emerge.

Multifamily renters will be, first and foremost, focussing their incomes on meeting their monthly rental payments. Tighter regulation on rental uplifts in mainland Europe will protect tenants from larger-than-inflationary uplifts. We may begin to see more evidence of young adults living with their parents to reduce costs, although the shortage of affordable rental accommodation across major cities will not go away with rising urban populations.

On the consumer side of the equation, real incomes have fallen due to higher inflation, which is beginning to squeeze consumer purchasing power. Whilst we expect food-anchored retail to remain most resilient, weaker consumer sentiment is most likely to impact big ticket purchases such as household goods/appliances and non-essential goods, such as clothing and footwear. This will create an increase in inventory for retailers who will require additional logistics space to store stock. Despite the possibility of some logistics operators returning stock to the market in 2023, demand continues to outstrip supply, and given the shortage of new development entering the market, we expect the logistics rental growth story to remain positive.

Increased economic uncertainty is likely to delay some occupier decision making as companies review their business plans and future expenditure. Occupational markets remain well positioned for 2023, and we expect fundamentals will keep markets in equilibrium in the coming year.

#2 Debt and pricing

As 2022 draws to a close and focus shifts towards 2023, fortune will favour the brave investors who are willing to act early to take advantage of repricing opportunities.

A final rate hike in December 2022 from the European Central Bank has marked a year of disruption for financial markets and real estate investors. However, the most timely data indicates that headline inflation is peaking across the Eurozone as the energy-driven increases are beginning to slow. According to Capital Economics, core inflation is expected to rise throughout H1 2023h is likely to see interest rates peak at 3% by mid-year, providing more certainty for investors to run cash flows.

Post Global Financial Crisis (GFC), real estate investors have been used to a low inflation environment, with artificially low (and even negative) risk-free rates to stimulate demand. Property yields hit record lows, although property risk premiums remained above the long-term, and we expect this premium to moderate to levels more in line with pre-GFC.

All-in debt rates have risen in excess of prime office yields across Europe, which has increased caution within the lending community. Although we have not seen much noticeable distress emerge, further yield rises are needed, and more forced sellers will bring products back to the market next year, reflecting higher borrowing costs. Similarly, some multi-asset investors who have observed falls in their equity and bond holdings are now overweight to real estate and may now look to reduce exposure. This will create buying opportunities for those cash-rich investors who continue to seek discounts.

We are now seeing more alternative lenders bridge the debt gap brought about by rising refinancing rates. Traditional banks have increased their lending margins to account for higher risks, particularly for asset management plays, which have been reflected more in secondary pricing than prime. However, given Europe's pressure to decarbonise, debt funds will look to expand their ESG loan book, focusing on repurposing assets.

However, we expect the overall impact on pricing to be more limited than some commentators suggest. Lower loan-to-value ratios compared to the Global Financial Crisis, resilient market rental growth, plus rental indexation will hedge investors from inflation in much of mainland Europe. There also remains a build-up of dry powder ready to be deployed for the right product at the right price.

So who will be the buyers? Whilst some of the European funds will begin 2023 more cautiously, US private equity investors are circling Europe for discounts and to take advantage of the currency plays. Likewise, Hong Kong, Singaporean and Malaysian investors will be looking to Europe's gateway cities in 2023.

Investors now have three main options. Firstly, investors can wait and see where pricing will settle. However, those active, cyclical investors are treating the slowdown in fundraising as an opportunity to buy assets at a discount, although by the time investors can see the nadir in capital values, it is likely too late to buy. Alternatively, the thematic, longer-term investors will ask themselves, 'Have any themes that attracted us in early 2022 actually changed during the last 12 months?' These core investors may see 2023 as an opportunity to buy whilst the competition is thinner.

#3 Energy

With Russia's invasion of Ukraine in February 2022, concerns around energy availability, security, and affordability arguably became the most discussed topic.

Many countries reviewed their energy dependency ratios, the amount of energy that needs to be imported to meet the demand, and their energy resources. The latest Eurostat data highlights the relatively high energy dependency in Europe. In 2020, a total of 573k Kote energy was produced in Europe, whilst the energy demand was 1.3m Kote, reflecting an energy dependency ratio in Europe of 57%. The Ukraine/Russia conflict also fuelled rapidly increasing energy and gas prices. In the first half of 2022, the average household electricity and gas prices in Europe rose from €22.0 to €25.3 and from €6.4 to €8.6 per 100kWh, respectively according to Eurostat. This rapid price increase caused many governments to step in with support schemes, subsidies and allowances to cap energy and gas prices.

Consequently, the energy dependency ratios and rising costs caused countries to top up their gas stock levels, increase their renewable energy production capacities, and improve energy efficiency. At the end of November, the EU gas storage was 94% filled, well ahead (+14%) of the EU's target to meet the expected demand in the winter months. Furthermore, according to a study by E3G and Ember, renewable energies have allowed the EU to avoid €99 billion in fossil gas imports since the beginning of the Ukraine/Russia conflict, up by €11 billion compared to last year thanks to record growth in wind and solar capacity.

All of this will partially roll through into the coming years, impacting all of society. One of the major things to look out for is what will happen when the temporary energy support schemes and price caps expire, potentially causing energy bills to soar for both individuals and businesses. This is particularly important for high energy-consuming economies such as Germany, which planned a €200bn energy relief package that will more than double the government's debt coming year.

Secondly, the real estate sector will be impacted in the coming years by these energy concerns. Unsurprisingly, development costs are increasing due to higher energy prices and are challenged by the capacity of the existing power grid. In London, new home development projects are delayed till 2035 due to electricity capacity limitations as data centres have absorbed excess energy capacity. Whilst in other European countries, the opposite is happening, with data centre developments being postponed or cancelled to prioritise residential developments.

On a positive note, these growing concerns have forced public bodies and all industries, including real estate, to improve energy efficiency and increase renewable energy usage when possible, hence enabling a quicker transition towards suitability. More investments in renewable energy production capacities are made, with for example, more PV panels being installed on top of homes and industrial buildings. According to Statkraft, in 2022, nearly 40GW of PVs will be installed compared to 27GW last year to cope with the Ukraine/Russia conflict implications. Furthermore, Statkraft forecasts that the yearly PV instalments across Europe will increase from 33GW to 45-52GW per year towards 2030.

It is safe to state that 2023 is set to become a pivotable year regarding the energy and real estate sector. Increased prices and capacity limitations will continue to challenge all sectors and countries, specifically those most reliant on energy consumption, such as data centres and Germany. Whilst economies with more renewable and independent energy sources, such as Nordic countries and countries less reliant on Russian gas, such as southern European countries, will face fewer headwinds.

This may reshuffle the cards in the European investment market and change the investment inflows' destination. Some core countries, long considered safe-haven in Europe, will likely lose some investors' interest.

#4 Construction

As core inflation is still expected to rise throughout H1 2023, the challenges surrounding construction are likely to persist.

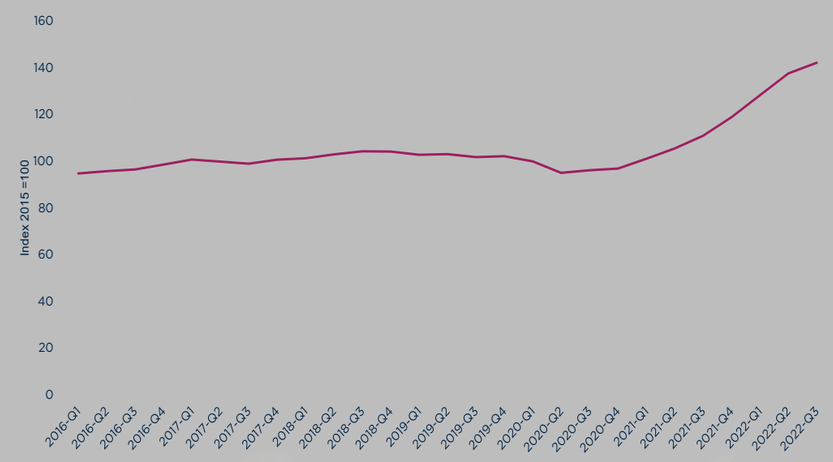
Rising construction costs and an uncertain economic landscape will likely exacerbate an already delayed construction pipeline as we expect construction activity to weaken in 2023, with inflationary pressures being felt throughout the supply chain.

Commercial sectors will be affected to differing levels, though this is an issue reaching all corners of commercial real estate. New supply of stock will be lower as the high cost of materials, and labour will erode more of developers' margins: office fit-out costs have risen by 21% on average across Europe, led by Frankfurt (+30%), London City (+30%) and Madrid (+26%), all above the global average of 10%. Import prices have also been rising in the Euro area since the start of the pandemic, which saw a sharp increase in Q4 2020 that has remained on a steep upward trajectory. However, this has since started to gradually level off as of Q2 2022, perhaps giving a more positive outlook for 2023. Though, even once the European market begins to stabilise and activity resume following a halt as Europe heads into a recession, pre-existing supply issues will have intensified, which will create further issues down the line.

EU HRC steel prices fell by 30% quarter on quarter in Q3 2022, with production and demand contracting ahead of the expected recession in Europe. At the height of the pandemic, steel prices increased by 153% between Q2 2020 and Q2 2021, which pre-covid had remained fairly stable. The 30% decrease in Q3 2022 is the largest seen since the GFC in Q1 2009, where steel prices fell by 28%.

Exacerbated by already high costs and supply chain difficulties, we can expect a slowdown in new developments. Developer sentiment remains cautious as we approach 2023, with construction projects delayed. This could impact sectors to different extents, with the logistics sector more exposed, given the larger development completions over the last couple of years, where vacancy rates have remained at record lows. This lack of new development, which will typically be more sustainable, energy-efficient buildings, and delayed refurbishment projects aiming to transform older stock will add pressure to occupiers who are looking to move into the best-in-class space due to the lower levels of existing stock with high environmental credentials, especially as corporate ESG strategies increasingly restrict the leasing of buildings that are not green certified.

Chart 1: Import prices in the Euro area



Source: Eurostat

#5 ESG

ESG will be another major theme in 2023, gaining momentum from last year, due to increasing regulations and growing corporate sustainability concerns...

With increasing focus on carbon emissions, the sourcing of materials and their lifecycle and how commercial buildings are affecting the health of the environment, regulatory frameworks are being applied within businesses and portfolios in a bid to keep up with corporate sustainability goals.

For real estate, this type of governance means ensuring sustainable operation at the property level, including legal compliance, asset management, green certification and ESG reporting. Fuelled by increasing regulation, ESG matters will continue to dominate the public and political sphere as stakeholders' concerns for transparency and disclosure are enhanced. Considering environmental compliance, resource use, social impact, and governance is an integral part of a property acquisition and management approach. For investors, this forms a part of their analysis and decision-making process to identify risk and growth opportunities in the market, with a broad range of criteria incorporated into core assessments. For occupiers, this means signing leases for buildings with the highest environmental credentials to satisfy tenant demand and corporate ESG strategies. Though the tightening of ESG regulation across Europe and the current hikes in interest rates make the transformation into these assets even more difficult for occupiers.

Increased legislation and mandatory disclosures are increasing the risk associated with stranded assets within real estate portfolios. As we move into 2023, we are more likely to see investors seeking to avoid assets at risk of stranding and even incurring penalties for failing to comply with tightening legislation. As awareness increases around how the real estate sector impacts the environment, and with investors and developers incentivised by the risk of obsolescence, 'green finance' is becoming increasingly important to lenders and borrowers to enable building upgrades. Finance strategies and the reduced risk associated with investments that are partly formed around ESG principles present an opportunity for increased financing opportunities, for example, sustainability-linked and green loans, which have been designed to link borrowing costs to specific company-level sustainability targets.

As the role played by the real estate sector in reducing GHG (greenhouse gas) emissions is put into the spotlight, we are seeing a further emphasis on the transition from carbon reduction to net zero. The race to net-zero means investors will be looking at the best way to reduce emissions from assets, including the most cost-efficient. The reconstruction versus refurbishment debate is likely to be a key theme in 2023 as there is a choice to be made between decarbonising existing assets and demolishing and rebuilding new assets. Unlike operational carbon emissions, which can be reduced over time with energy efficiency upgrades, embodied carbon emissions are sealed into the building when it is constructed. Repositioning and refurbishing existing buildings to meet energy targets can significantly reduce embodied carbon emissions in comparison to new construction processes. Although net-zero regulation varies by region, industry-wide goals will be to secure and improve the capital value of assets.

#6 Labour

European companies are growingly pointing at their inability to recruit suitable workers. In June, around six million jobs were up for grabs across the EU. The labour shortage is directly affecting the construction sector.

The labour market continued to perform strongly in 2022 and has proven to be resilient to the economic uncertainty. Unemployment rates are at record lows with the average European unemployment rate sitting around 6.2% at the end of 2022. The European Commission forecasts that unemployment rates in the EU will stabilize around the 6.4-6.5% mark in 2023 and 2024.

The labour market does face challenges in 2023 and beyond. First of all, the inflow of new talents do not keep up with the outflow of retiring staff. This 'silver tsunami' raises concerns about training new staff in the coming years. This is reflected by Oxford Economics forecasts, which show that the working-age population in Europe is set to shrink from 64.2% in 2022 to 63.7% in 2025, reflecting a loss of nearly 1.5 million available workers. This lack of available workforce is a challenge for employers. They increasingly have to offer attractive terms with increased flexibility to attract new talents. Wage growth reflects these attractive terms and provides employees with ways to counter the increased costs of living. This wage-price spiral (real earnings vs inflation) makes forecasting the longevity of the uplifted inflation rates and central bank policy rates difficult, as wage growth is one of the factors fuelling inflation.

Secondly, there appears to be an imbalance between the demand and the availability of specific-skilled workforces. During the second half of the year, some large tech companies announced cutting down on staff due to less demand and overcapacity of employees. Conversely, some big and more traditional employers, especially in the professional service industry, are on a hiring spree to meet the anticipated demand in the coming years. This mismatch is also occurring in the lower-skilled job markets. Currently, more than 75% of companies in the EU experience difficulties in finding workers with the necessary skills. In addition, already in 2021, 28 occupations ranging from construction and healthcare to engineering and IT experienced shortages, showing a growing demand for both high and low-skilled workers. The pandemic partially contributed to this as people are studying longer or are even going back to study to improve their job chances. Also, a decline in immigrants and seasonal workers in certain countries, mainly in Western Europe, adds to the lack of available and qualified workforce.

The European Commission (EC) believes that green and digital transitions open up new opportunities for the economy and people and that it is essential to have the relevant skills to successfully navigate labour market changes. Furthermore, a workforce with the right skills contributes to sustainable growth, leads to more innovation, and improves companies' competitiveness. Especially the lack of basic digital skills is a concern for the EC. The Digital Economy and Society Index shows that currently, 4 out of 10 adults in Europe lack basic digital skills. To address this imbalance, the EC made 2023 the European Year of Skills. With the coming year being labelled as the Year of Skills, the EC aims to kickstart one of the EU 2030 social target goals; by 2030, at least 60% of adults should participate in annual training. This lifelong learning will be promoted by multiple collaborations, investments and funding, training, and campaigns to promote learning and stimulate people to increase their (digital) skills in preparation for changes in the labour market.

Therefore, the labour market will be one of the major themes to look out for in 2023 with the ongoing challenge for employers to find and attract the workforce with the right set of skills, whilst the workforce will have further opportunities to enhance their skill set and working conditions.

Savills Commercial Research
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