REAL ESTATE

What's Shaping the Value-Add Opportunity in European Real Estate?

INSIGHTS

While investing in European real estate still poses challenges, attractive value opportunities are emerging as we approach a cyclical bottom.

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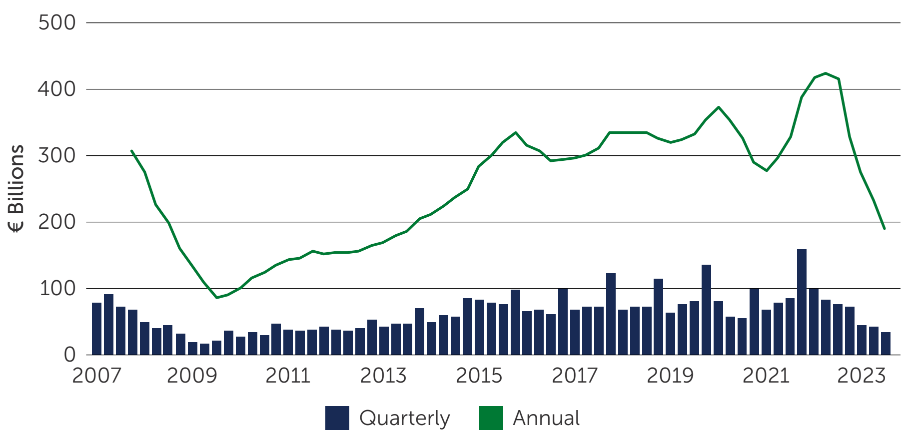
High prolonged inflation and interest rates have caused a steep decline in European real estate values. The current pall over the asset class is beginning to clear, enhancing its long-term attractiveness at a favorable market entry point. A compelling opportunity is available today for value-add investors. In particular, we believe there are a number of cyclical and structural forces that will drive occupier and capital demand, and therefore growth, in the short- to medium-term.

Cyclical Themes

The unwinding of more than a decade of low interest rates acted as a harsh reminder of the cyclicality of European real estate, with transaction volumes dropping over 60% from their 2021 peak **(Figure 1)**. The trough of the property cycle is here, and the pace of valuation decline is expected to continue but at a much reduced rate. A peak to trough correction of about 20% looks likely.[1] Significantly, where sellers are stressed and perhaps unable to refinance, opportunities for even greater discounts may emerge—in some cases, 40% off peak pricing could be possible.[2]

Figure 1: European Real Estate Capital Flows



Source: Real Capital Analytics/MSCI. As of September 30, 2023.

While closer to bottoming out, the higher rate environment and value correction stresses borrowers who face refinancing events, particularly for assets with cash flow interruption, at a time when debt market liquidity from traditional sources is constrained. Through to 2027, it is estimated that there will be a €90 billion debt funding gap.[3] In many cases, refinancing will require an insertion of fresh equity, providing an opportunity for investors who can take positions across the capital structure.

1. Source: Real Capital Analytics/MSCI. As of September 30, 2023.
2. Source: Barings Real Estate Research. As of December 31, 2023.
3. Source: AEW Research. As of October 2023.

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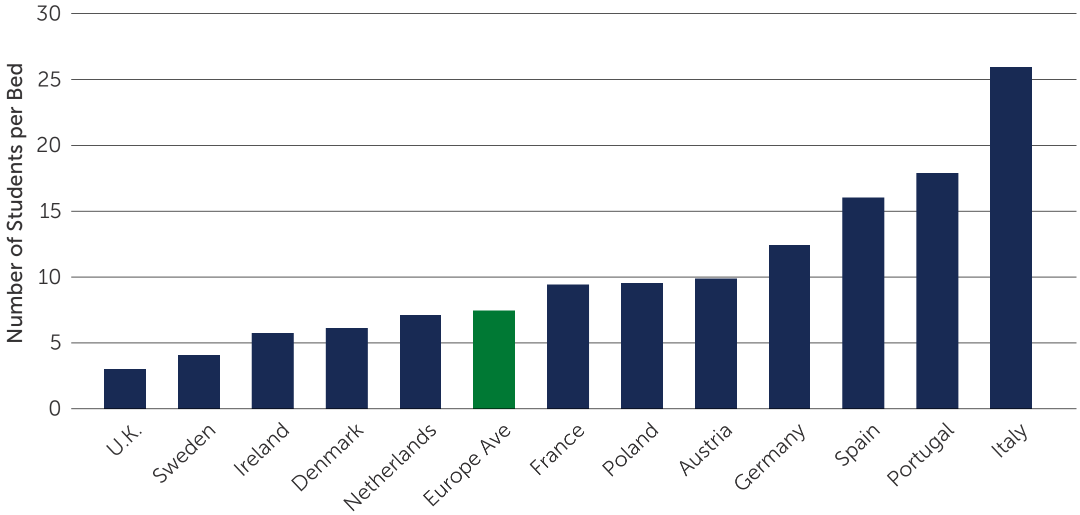
The risk of resurgent inflation is receding, but global geopolitical instability means it has not completely disappeared and values are still adjusting. But we are convinced these risks are outweighed by the potential upside of investing into a heavily corrected market. We seek to combine this value play as the cycle turns with a focus on sectors likely to benefit from three key structural megatrends:

1. URBANIZATION & DEMOGRAPHICS

The number of urban dwellers—already accounting for 56% of global population—is forecast to double to over nine billion people by 2050.[4] The dearth of free-market and subsidized housing supply in many western European cities, compounded by restrictive construction policy, provides sustained upward pressure on rents. Student housing represents a 'micro version' of the problem. While Europe is home to roughly half of the top globally-ranked universities,[5] there is a chronic undersupply of modern fit-for-purpose student accommodation, particularly in Italy and Iberia **(Figure 2)**.

Figure 2: Number of Students to Number of Beds



Source: CBRE. As of May 31, 2023.

4. Source: The World Bank. As of April 2023.
5. Source: Times Higher Education rankings. As of June 2023.

2. TECHNOLOGY

Technology's impact on real estate can perhaps best be seen in how fast-growing e-commerce is changing logistics supply chains. Simply put, e-commerce—which already accounts for 25% of total sales in the U.K.—requires large warehousing space near urban areas to satisfy customer demand for quick deliveries.[6] Supply of warehousing facilities, however, is constrained. For instance, while London's population has grown by 32% since 2000, its supply of industrial land has shrunk by over 40%.[7] Similar situations throughout Europe result in extremely tight supply of modern warehouse stock, which is likely to remain low as construction continues to lag growing demand. That provides an opportunity for new development. We see particular value in industrial outdoor storage (IOS) in the U.K.

In addition to e-commerce, we see other potential opportunities arising from generative AI during the coming cyclical upswing.

3. SUSTAINABILITY

Regulatory and social pressures have made sustainability a priority issue, with the most sustainable buildings attracting rental and cap rate premiums over others. Since sustainability has long been integrated in our value-add approach as an alpha generator, whenever we are retrofit or redevelop assets we target net zero carbon emissions, which we believe will become the future standard. We have been successful in doing this at our recently completed Open 336 office development in Milan, Italy and in numerous other assets including the Tide Bankside office and Momentum logistics park, both in London, which we believe will be market-leading on completion.

Takeaway

While real estate remains challenging, the current landscape presents attractive opportunities given the likelihood that the current cycle is reaching its bottom. Preparing for the coming upswing, we are focused on sectors benefitting from the strongest structural tailwinds—logistics and living, in particular—while also being prepared to capitalize on tactical value opportunities from market dislocation and distress. Overall, we remain convinced that the current vintage will be a compelling one for European value-add.

6. Source: ONS. As of July 2023.
7. Source: The Industrial Land Commission. As of January 2022.

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