



European Real Estate Market Outlook

Q1 2023

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“Headline inflation is easing off and fixed income yields have begun to fall too, offering some tentative signs that the squeeze on real estate’s relative value might have peaked”

European real estate market outlook

Executive summary

- Europe is entering a mild recession, which should abate around the third quarter of this year. Forecasts have improved as hard data has been resilient and the threat of gas rationing has subsided significantly. The European Central Bank (ECB) will have to sail on these turbulent waters, but it has been more hawkish of late as core inflation has increased.
- Headline inflation looks to have peaked and fixed income yields have begun to fall too. This offers some tentative signs that the squeeze on real estate’s relative value might have peaked. An 80-basis point (bp) European All Property yield increase since June 2022 has also helped to re-establish some of the spread that was destroyed by the rapid 300bp increase in borrowing costs last year. There is further to go in this market downturn, but we expect a turning point in the third quarter of 2023.
- Capital flows into European real estate are slowing as a result of the pressures in the market. We estimate that European investment in 2022 was 35% lower than in 2021. Given the rapid rate of correction in yields, we anticipate that direct valuations will reach a floor around early summer. The listed market and expectations for interest rate cuts in the second half of the year suggest a turning point for the direct market from June this year.
- The impending recession is likely to be felt in occupational markets this year, exacerbated by higher operational costs. On a positive note, reduced construction pipelines support the resilience of income and income-growth prospects. Logistics vacancy rates are below 2% in many parts of Europe, rented residential accommodation is undersupplied, and prime office availability is limited to a few options.
- Following a sharp drop in real estate values in the fourth quarter of 2022, we now expect a fall in all property total returns of 7% over the year to December 2023. The pace of the yield revaluation phase outlined below has been breath-taking. This supports the theory that values could find a floor sooner than previously anticipated, with the listed market suggesting that a turning point could emerge as early as the middle of 2023.
- We continue to prefer sectors where there are strong thematic demand drivers from demographic, technological and social change. These exist primarily in logistics; most parts of the residential market; many alternatives, such as healthcare-related real estate; and also in core offices. We remain cautious towards most retail types, especially as we enter recession and as tenant risks rise. We do expect to see attractive opportunities to increase as prices adjust.
- During this period of elevated uncertainty, we advise our strategies to reduce risk wherever possible, to increase cash weights, and to reduce leverage until there are broader signals of a stronger recovery emerging. Cash positions should also enable funds to take advantage of cyclical opportunities in coming quarters.

European economic outlook

- The Eurozone proved more resilient than we previously expected last year. Gross domestic product (GDP) growth was solid at 0.6% (quarter-on-quarter) in the first quarter and 0.8% in the second quarter, mainly led by services. It slowed to 0.2% in the third quarter, but it still left the economy 2.1% larger than it was before the pandemic.
- The labour market remains a bright spot, with unemployment falling to a historic low of 6.5% in November. This will provide tailwinds for the coming months. However, six consecutive months of declining values for retail sales, and lead indicators (such as purchasing managers indices (PMIs)) remaining in contraction, act as a stark reminder that the outlook is vulnerable. Indeed, activity is challenging across all the major European economies amid the energy and cost-of-living crisis, terms-of-trade shock, and tightening financial conditions.
- Although uncertainty remains, the risk of gas rationing has greatly reduced. The key reasons for this are a reduction in gas demand (20% below 2021 for north-west EU), rapidly increased gas storage capacity, energy supply diversification, and milder weather. We have reduced the magnitude and likelihood of industrial rationing in our baseline. Fiscal support from national governments, and the ongoing revision of EU-level policies – both the fiscal rules, and energy markets – also mitigate the energy shock on activity. Support remains from the EU Recovery Fund too.
- Growth was above trend in 2022, but the economy has slowed since the fourth quarter. Inflation reached a new record high of 10.6% in October but slowed sharply to 10% in December. Core inflation accelerated to 5.2%, keeping policy makers on a more hawkish path.
- We think headline inflation will decelerate on the back of base effects, contractions in spending and activity, tighter monetary policy, and financial conditions. Energy policy interventions, both at EU and national levels, will mitigate further increases – but will also support demand and core inflation.

“The ECB will eventually pause its tightening cycle later in 2023, before returning to a more accommodative stance as inflation pressures ease”

- The ECB has now hiked by a cumulative 250bps, bringing the deposit rate to 2%. The policy outlook for 2023 remains more clouded, given the conflicting forces at play and recent signs of resilience. We think further tightening in the first half of 2023 is likely and that the deposit rate could exceed 3%. However, the ECB will eventually pause its tightening cycle later in 2023, before returning to a more accommodative stance as inflation pressures ease. We expect quantitative tightening to start gradually in 2023, with passive run-off in the asset purchase programmes.

Figure 1 – Eurozone economic forecasts

	2020	2021	2022	2023	2024
GDP (%)	(6.2)	5.2	3.1	(1.4)	1.0
CPI (%)	0.3	2.6	8.6	5.7	2.3
Depo rate (%)	(0.50)	(0.50)	2.00	1.75	0.0

Source: abrdn Research Institute, December 2022.]

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European real estate market key drivers

- Since our last outlook in October 2022, the negative pressures on European real estate have shown signs of moderating. We believe 2023 will be a pivotal year for performance. Now that we are approaching what many economists expect to be the peak in policy rates for this economic cycle, we believe we are closer to the end than to the start of the revaluation phase of the downturn.
- Headline inflation looks to have peaked and fixed income yields have begun to fall too. This offers some tentative signs that the squeeze on real estate’s relative value might improve from here. An 80bp European All Property yield increase since June 2022 has also helped to re-establish some of the spread that was destroyed by the sharp increase in borrowing costs. There is further to go in this downturn, but we see signs of a better situation emerging in the second half of the year.
- While financing challenges remain an ongoing issue for REITs, share prices have shown stability since October 2022, with discounts to net asset values (NAV) recording an improvement in January 2023. With a six- to nine-month lag between turning points for the listed market and the direct market, the current signals suggest that prospects could begin to improve around the middle of the year.
- While interest rate changes are being rapidly priced-in, the strength and impact of the anticipated recession is the uncertain part of the outlook. GDP forecasts have improved, yet there are clear signs that higher input costs and lower sales revenues are starting to hurt corporate balance sheets. Smaller companies are especially vulnerable, as a lack of financing at a reasonable cost means they might not be able to survive if revenues dwindle. Furthermore, most fiscal packages designed to ease the pressure on companies are set to expire this year. In the second half of 2022, Sweden had a record-high level of corporate insolvencies, and Allianz is forecasting a 24% increase in corporate failures in 2023 compared with 2022 in Western Europe. The spread between BBB corporate bond yields and sovereign bonds has stabilised recently but remains elevated. This highlights the reason why we should carefully consider tenant risk.
- The continued shortage of new supply coming through is a clear differentiator this cycle, especially given the tight supply of modern properties across sectors. Reduced construction pipelines support the resilience of income (tenants will have fewer options to move) and income-growth prospects in some parts of the market. Vacancy rates for logistics are below 2% in many parts of Europe, rented residential accommodation is undersupplied almost everywhere, and prime office availability is limited to a few options in most major cities. In our view, income growth (supported by indexation to inflation on the continent) should offset some of the yield impact from higher interest rates this year, before becoming the key driver of value appreciation in the medium-to-long term.
- One key risk to consider, particularly for more operational real estate or labour-intensive activities, is the rising cost of operational expenditure. This is coming through in the form of nominal wage growth and energy costs. This is squeezing profit margins while revenues will be under pressure through the recession. So even in preferred sectors, such as logistics, senior living, student accommodation and hotels, the near-term outlook remains challenged from a tenant risk perspective.

“The sheer pace of value correction is a new phenomenon for continental European real estate”

Chart: Real estate performance signals – Europe Q1 2023

Downward pressure in European drivers; markets repricing rapidly

	Performance Signals	Current Signal	Longer term Outlook	Comment
Macro	Economic fundamentals	●	➔	Eurozone expected to enter recession in Q4 22 and stay in contraction until Q3 23. 1.24% peak to trough GDP decline expected – below consensus. Cost of living crisis, weak sentiment to be exacerbated by a US recession in H2 23. Forecasts have been revised up as fears of gas rationing and energy crisis have subsided due to higher than expected gas supplies, a mild winter and low demand from China due to its Zero Covid policy. Inflation to fall back in 2023, but not as much as previously expected.
	Monetary policy	●	➔	The ECB has now hiked by a cumulative 250bps, bringing the depo rate at 2%, following a 50bps hike in December. The policy outlook for 2023 has turned more hawkish with core inflation rising to 6.9% in December. We think further tightening in H1 23 is likely, albeit we currently expect the peak level for the depo rate at 3.0%. The ECB will eventually pause its tightening cycle in H2, before returning to a more accommodative stance as the recession bites.
	Margin over bonds	●	➔	German 10 year bund trended up to 2.3% from -0.5% Dec 21. Rising rates and stubborn inflation likely to sustain high bond yields in H1 2023. Some spread widening between CEE/Italy and core Europe. All property spread peak is behind us and has narrowed substantially. Spreads likely to begin to stabilise in H1 and widen in H2 2023 based on current interest rate forecasts.
Real Estate	Supply ¹	●	➔	Supply chains have eased and construction cost inflation appears to have peaked. Funding costs remain high and construction company insolvencies are rising. Completion not expected to return to trend for the foreseeable future. Total office vacancy rising and grey space elevated; residential, most alternatives and logistics still critically undersupplied. Supply outlook to be further restricted by ESG factors. Weak macro demand drivers will be mostly offset by structural undersupply in the best sectors.
	Flows of capital	●	➔	Volumes down roughly 30% vs last year. Deals being pulled from the market where pricing expectations will not be met. Cost of debt is prohibitive for leverage investors, so many pools of capital are stepping back. Some capital raises have been announced which provides a pipeline of equity to be deployed (€7 billion Blackstone), but most of this will not be invested while the market is still falling. Some corporate/portfolio deal activity expected in German residential market, but not without value adjustments.
	Lending ²	●	➔	Availability of financing is not the problem with both bank lenders and institutions still active in the market. The cost of debt is prohibitive for most borrowers at current underlying yields. 5 year Euribor swaps are at 3% with the volatility providing a challenge to deal underwriting and valuations. Margins have edged up slightly for good quality assets, although a recession is likely to push them higher.
	Fund flows	●	➔	Weak picture today with low number of equity raises and investors playing “wait and see” game. Of the capital that is raised today, the vast majority may not be deployed for some time, only once the market has bottomed out. Weak Euro could push an increase in flows from outside the region if signs of improving economic outlook emerge next year.
	360° view	●	➔	Listed markets remain down 25–50% y–on–y, but have shown stability in the last quarter. Listed propco credit downgrades still coming through suggesting balance sheets will be under pressure from rising costs, weaker revenues. Some non-listed strategies in capital raises to catch the bottom of the market. Secondaries are trading now at modest discounts, particularly in the UK where valuations have moved faster. Funds have €100–200m redemption queues. Investors wait to see before committing new equity.

Sources: Views reflect our view on Europe excluding the UK. MSCI/IPD; Thomson Reuters Eikon; RCA; CBRE, Investment Association; abrdn. 360° view encompasses direct, indirect, lending and multi-manager views and market signals. Q1 2023.

¹ Wide spread in supply situation. Prime offices, logistics, residential and alternatives undersupplied; retail and secondary offices are challenged from supply side.

² Based on bank finance on fix term, for bankable assets.

Key: Supportive / Neutral / Unsupportive. ➔ Stable / ↗ Upward trend / ↘ Downward trend.

“As a consequence of values moving quickly, and buyer and seller expectations differing substantially, we have seen liquidity fall sharply”

European capital market trends

- Based on data by Real Capital Analytics (RCA), we estimate that European investment in 2022 was 35% lower than 2021. However, looking at the final quarter of 2022 alone, there was a significant slowdown, with a 120% decrease in volumes compared with the five-year fourth-quarter average – a fall from €116 billion to €52 billion. With values moving quickly, and buyer and seller expectations differing substantially, we have seen a number of deals pulled from the market.
- Residential and industrial transactions in the fourth quarter of 2022 were down 77% and 66% quarter-on-quarter, respectively. Despite lower residential transaction volumes, the average for residential in the fourth quarter of 2022 remained 20% above the long-term quarterly average. Retail is down 45% quarter-on-quarter and remains out of favour, given the rise of e-commerce and the pinch on consumers with the higher cost of living. Industrials continue to experience a slowdown, with a 4% decline since the third quarter of 2022. The sector is also down 57% quarter-on-quarter and 12% less compared with the long-term quarterly average. This is no surprise as industrials was the most sought-after sector in the past year; therefore, it's only natural that it would decelerate and correct the quickest. Senior living is also down 65% quarter-on-quarter but remains 20% higher than the long-term average. According to Greenstreet, occupancy rates for nursing homes are up, albeit they remain 5–10% lower than pre-pandemic levels, and investors are focusing on sectors that are countercyclical to GDP trends.
- From a regional perspective, the largest share of investment was made in the UK (27%), followed by Germany (18%) and the Nordic markets (13%). France ranked fourth (12%), with notably lower volumes. During the 12 months to the fourth quarter of 2022, investments in Germany were 122% lower than a year ago, given the fact that Germany had significantly fewer transactions in the residential sector, with a particular absence in portfolio deals involving property companies. The Netherlands remains the fifth-largest market in Europe, despite a downturn in its industrial and residential volumes (-28%) in the fourth quarter of 2022.
- Cross-border capital accounted for around 51% of fourth-quarter volumes, the highest share in the last three years. The largest cross-border source remains the United States, which increased by 33% over the year to the fourth quarter of 2022. The euro's slide towards parity with the dollar could further support flows from the US as the market recovers later this year. A lack of investment by real estate investment trusts (REITs) has been a notable trend. Purchases were at their lowest level since 2012 at just 4.7% of the total. There are two key reasons for this: REITs continue to see depressed share prices, which make it difficult to raise new equity to invest; and the increase in debt costs further fuels challenges for REITs to invest, as they are heavily dependent on leverage.
- Rising financing costs have caused outward shifts in yields in several geographies and sectors, which suggest weaker valuations. According to CBRE, 96% of segments in their European coverage had an outward yield shift in December 2022. This is the first time since the Global Financial Crisis that no markets have seen any yield compression too. The number of weakening markets is significantly higher than those that saw outward yield shifts in our last analysis in September. At this point, 75% of the market had seen outward yield shift, following 25% in June and just 5% in May.
- During the fourth quarter of 2022, secondary-quality assets saw a notable acceleration in outward yield shift. Dutch, Irish and German secondary offices all recorded at least a 100bp outward yield shift in the fourth quarter, following the 200bp outward yield shift in UK regional secondary offices – the most affected segment in the European CBRE sample. Prime offices have been much more resilient so far given better fundamentals. But we feel the sector has some structural challenges that will lead to some further yield expansion in the first quarter of 2023.
- Given the rapid rate of yield correction, we anticipate that direct valuations will reach a floor around early summer. The listed market and expectations for interest rate cuts in the second half of the year imply a turning point for the direct market from June this year.

“We expect logistics rents to remain resilient as the vacancy rate is below 2% in most good locations, and structural demand drivers should offset some of the macro economic weakness”

European occupier market trends

- The impending recession is likely to be felt in occupational markets this year. To add to corporate profitability challenges, tenants will also be battling higher operational costs through higher labour costs and energy. It is estimated that fuel bills alone have increased by 30% in 2022. Fiscal support will be removed gradually in many countries this year, leaving tenants more exposed to economic forces. We anticipate a material increase in insolvencies, especially for retailers, construction companies and those industries with high input energy costs. Smaller companies with fewer financing options will be most affected.
- Office markets continue to show resilience when it comes to leasing, but undoubtedly some of this is due to delayed decision-making during the pandemic. We estimate that annual take-up across the key cities in Europe increased by 7% in 2022, roughly 6% above the long-term average. Dublin, London, Warsaw and the regional German markets were some of the strongest performing cities. Brussels and Amsterdam were two of the weaker markets. Total availability has stabilised at around 7.4% of available stock. We continue to see significant vacancies in peripheral office submarkets, while core locations are performing a lot better. Prime rents increased further in 2022, setting new records in most major European office markets. Competition remains strong, while the supply pipeline in core locations is generally very constrained.
- It is a more negative picture for secondary offices as a two-speed market takes hold. Vacancy rates in poor-quality offices and in weaker locations are increasing as occupiers cut costs and reduce inefficient space. We believe that the existence of 'grey space' is sizeable in poorer-quality offices and that tenants will continue to shed excess floorspace in properties that don't meet corporate environmental, social and governance (ESG) criteria.
- For logistics, the milder recession expectation is supportive. While we have seen yields come under pressure from higher debt costs, some of the yield impact is being offset by rental growth or rent indexation in lease contracts. Prime logistics rents increased by an average of 13.7% over the 12 months to the third quarter of 2022 and by as much as 33% in Warsaw, 25% in Prague and Oslo, 20% in Paris, 9% in Munich and 5% in Venlo. We expect logistics rents to remain resilient as the vacancy rate is below 2% in good locations and structural demand drivers should offset some of the macro economic weakness.
- Retail is set for a very tough year ahead. Consumer confidence appears to have hit a floor at record low levels, yet the combination of rising operational costs

and lower revenues because of the cost-of-living crisis are likely to drag on profit margins. Tenant defaults are expected to rise in this environment, and we believe retail rents will be vulnerable to declines in this context. Supermarkets and convenience-based retailers will be more resilient, but they are not immune to recession. Fashion, consumer electronics and home furnishings look most vulnerable to cutbacks in spending.

- Residential occupier markets remain relatively resilient. While vacancy rates remain very low, tenants are coming under pressure from elevated inflation and the knock-on effect of indexation in their lease terms. Rent regulation is being introduced across many jurisdictions in response to this trend, most notably in the Netherlands, Denmark, France and Spain, with varying impacts on rental levels. We believe that the significant rise in mortgage rates and other difficulties in the mortgaged housing market will mean renting is increasingly the chosen option. This supports the demand side of the residential sector. Construction activity remains very depressed, falling a long way short of required levels of completions.

Opportunities in European real estate

While market conditions are uncertain, we continue to believe in the long-term fundamentals in several key areas of the market.

In the near term, we could start to see specific opportunities to 'step in' where shortfalls in equity or debt arise from a lack of liquidity in the market. This could be at an asset, company or entity level and it is important to think broadly while the market is going through a correction. Weak European and UK currencies increase the attractiveness of these types of opportunities and we expect to see a rise in international investment flows into special situations.

- Thematic tailwinds remain in place for the residential, logistics, core office and alternatives sectors. These tailwinds result in demand exceeding supply, which supports growth and the strength of long-term cashflows derived from assets in these baskets.
 - The office market is expected to be two-speed, with secondary offices and weaker locations suffering from long-term oversupply and obsolescence. Tighter regulation around building efficiency and emissions will mean weaker offices underperform or require substantial capital expenditure to meet tenant and investor expectations. Secondary offices are repricing rapidly, but still have further to go. Core, centrally located offices with strong ESG credentials are increasingly finite; and with development pipelines at historic lows, we expect tight vacancy and rental growth to persist.

"The pace of the yield revaluation phase has been breathtaking, which supports the theory that values could find a floor sooner than previously anticipated"

Chart: Global real estate conviction themes Q1 2023

Sectors	Alternatives	Residential (PRS/BtR)	Industrial & logistics	Retail	Offices
Allocation tilt	↗	↗	↗	↘	↘
Conviction within segments	Healthcare Life sciences Student Accommodation Caution: Low tier PBSA; Data centres	City centre and fringe locations, AAA rated BTR / PRS, mixed use Caution: poor efficiency; poor layout; luxury; regulation possible	Urban logistics e-fulfilment & mid-box Caution: Big box let to discretionary retailers; older buildings; inefficient buildings	Supermarkets, non Fashion Retail Parks Convenience / grocery Caution: Shopping C's, luxury high streets	City centre, constrained No compromise on location – follow "FACTS" guidelines Caution: short income; business parks; weak EPC
Potential risk strategies	Diversification of value drivers Long income	Core assets / repositioning Longer income (leased) Indexation	Core assets, value add in best locations Longer or short income Indexation	Longer income Indexation Dominant schemes Retail park reposition	Core assets / Long income Value add and ESG uplift
Key risks	Operational risk / costs Changing legislation Indiscriminate capital inflating values	Rent regulation Operating costs Reputational risks Sudden supply increase	Tenant quality Mispricing of risk in strong market conditions Global economy/ supply chains	E-commerce Revenue linked lease terms Weaker household incomes	Higher volatility of income Long term structurally lower demand possible
3 Year Global Total Return Forecast (ann.)	5.8%	4.5%	4.5%	1.4%	0.7%

Past performance is not a guarantee of future returns. Forecasts are offered as a guide only and actual results may differ significantly

Source: abrdn. non risk-adjusted, local currency, absolute returns, excluding transaction fees. "Invest Today" colour scheme reflects the qualitative assessment of how accessible investment is within the four categories. Arrows reflect recommended portfolio sector tilts for balanced funds, Q1 2023.

- Europe faces a decade of industrial evolution and supply chain reconfiguration. The undersupply of modern logistics space in good locations across the supply chain means that cashflows should be resilient and strong income growth should persist. Recession in Europe will dampen tenant demand, but we expect a strong rebound with a broader economic recovery to come. We continue to prefer fringe city locations where land supply is more constrained, and where tenant and investor demand is more active.
- Demand drivers for residential assets, including student accommodation and senior living, are typically uncorrelated with the broader economic cycle, and we continue to believe in their long-term performance outlook. The shortage of all formats of housing should support robust cashflows from these assets. Rent regulation is increasingly likely to be introduced while inflation remains at exceptional levels. Those who are underwriting cashflows should be mindful of this. We prefer fringe city locations where rent controls are less common and where affordability measures are less stretched.
- Alternatives and operational real estate assets carry differing demand drivers and income risks to the mainstream commercial and residential sectors. This offers clear diversification benefits. The latest data shows a rise in nursing home occupancy rates in Europe, heading back towards pre-pandemic levels, while data centre take-up continues to hit new records as the sector evolves. We believe some operational assets offer strong appeal in the long term, providing their risks are fully understood and managed appropriately.

“In the near term, we could start to see specific opportunities to ‘step in’ where shortfalls in equity or debt arise from a lack of liquidity in the market”

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Following a sharp 10% drop in real estate values in the fourth quarter of 2022, we now expect a fall in all property total returns of 7% over the year to December 2023.

The pace of the yield revaluation phase has been breath-taking, which supports the theory that values could find a floor sooner than previously anticipated. The listed market suggests a turning point could emerge as early as the middle of 2023. Over the longer term, we do expect a recovery to materialise through a rebound in economic growth and the return to lower interest rates from 2024. The stages of the three-phase outlook are outlined below.

1. Phase 1: Re-valuation, relative value and recession –

Values are rapidly recalibrating to the current inflation and policy backdrop – this has been painful and mostly unavoidable. Recession risk is easing with surprising levels of resilience, yet tenant risk is expected to rise this year.

2. Phase 2: Recovery – The mild recession and even the quarters following are expected to continue to be uneasy times, with geopolitics and other downside risks lingering. However, the sharp correction in real estate values combined with lower fixed income rates should make real estate’s relative value recover. Improved sentiment should stimulate a rebound in values, although not all of the decline will be recovered.

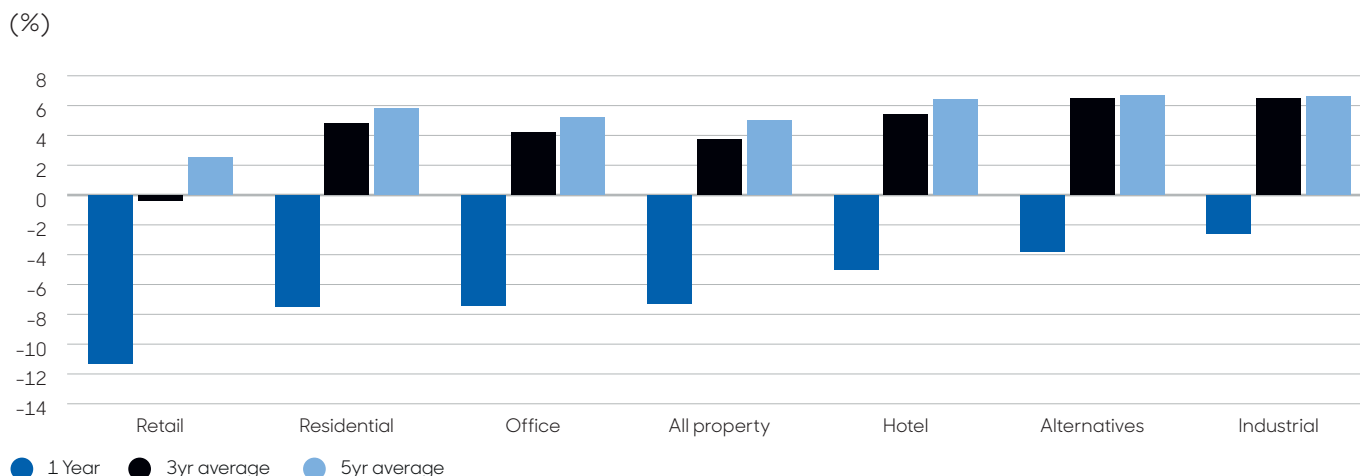
3. Phase 3: Income growth outlook – Supply looks extremely limited now and will be further constrained by ESG, development costs/finance, tighter planning regimes, and a level of caution around breaking ground on speculative schemes. This supports cashflow resilience and income-growth prospects.

Risk management:

While we believe that a turning point will be reached in 2023, there is further pain to come and some sizeable downside risks still overhang the market. Therefore, we still advocate a low-risk investment approach.

- Reduce risk wherever possible – particularly loan-to-value ratios and void risk, including undertaking any speculative development and extending leases where possible. Certainty of income will outperform.
- Retain or increase cash holdings, initially to provide liquidity in case of unexpected costs, higher refinancing charges or to meet redemptions (secondaries are not likely to shift at current discounts).
- Avoid the temptation to target higher-yielding assets with bigger spreads. These often carry additional income risk – better to focus on quality at a more attractive entry price.
- Ensure ESG credentials are strong to defend against further re-valuation and to capture the full strength of recovery. Weak assets will not recover when sentiment improves.

European total return forecast by sector, annualised, ungeared, in percentage terms, January 2023



Source: abrdn European forecasts January 2023.

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