

## QUARTERLY INSIGHTS | INVESTMENT RESEARCH

# EUROPE

### Key Themes

- How is falling liquidity affecting pricing in European real estate markets?
- What should investors look for in these challenging conditions?

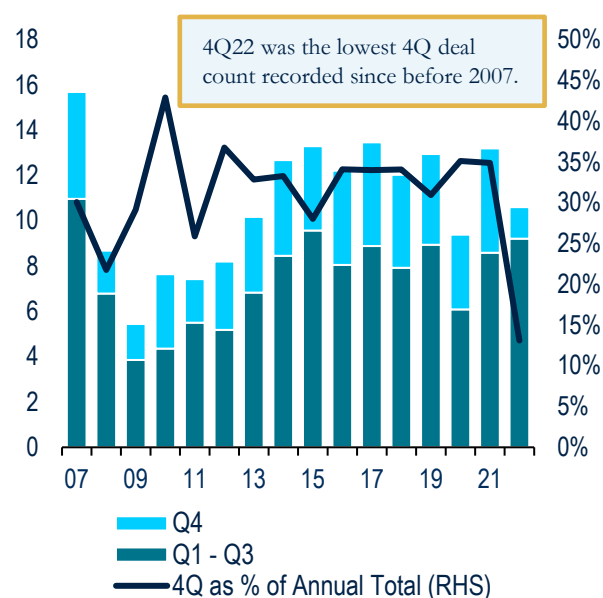
### How is falling liquidity affecting pricing in European real estate markets?

While there are signs that the pace of interest rate increases is decelerating, uncertainty about the economic outlook remains elevated, which is resulting in falling liquidity across real estate markets that in turn has started to negatively affect real estate pricing.

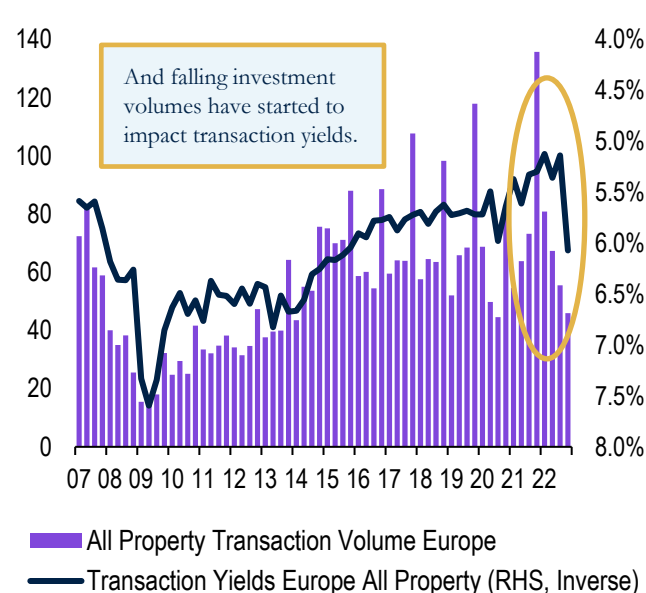
Investment volumes were weak in the fourth quarter of 2022. Usually investment activity picks up toward the end of the year as market participants are motivated to fulfill annual targets, and historically around a third of annual transactions by deal count are completed in the last quarter. However, in the fourth quarter of 2022 this number fell to 13%, marking the weakest 4Q recorded since 2007 (**Exhibit 1**).

### Exhibit 1: Liquidity is Retrenching Quickly

Europe – Annual Deal Count (000)



Transaction Volume (€ Billion) and Transaction Yields



Sources: Real Capital Analytics, PGIM Real Estate. As of February 2023.

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As uncertainty about the outlook remains high, there are signs that existing owners are pulling deals from the market fearing a need for further price cuts to complete transactions, while buyers are waiting for prices to fall further. This has significantly affected transaction yields in the fourth quarter of 2022 (**Exhibit 1**).

While transaction yields were still holding up in the third quarter, drying up investment volumes in 4Q in Europe have added to pressures on pricing linked to a sharp increase in the cost of capital over the past year. As transaction volumes declined for the fourth quarter in a row for the first time since 2007 (just prior to the global financial crisis), all property transaction yields moved out by nearly 100 basis point in the fourth quarter 2022 alone.

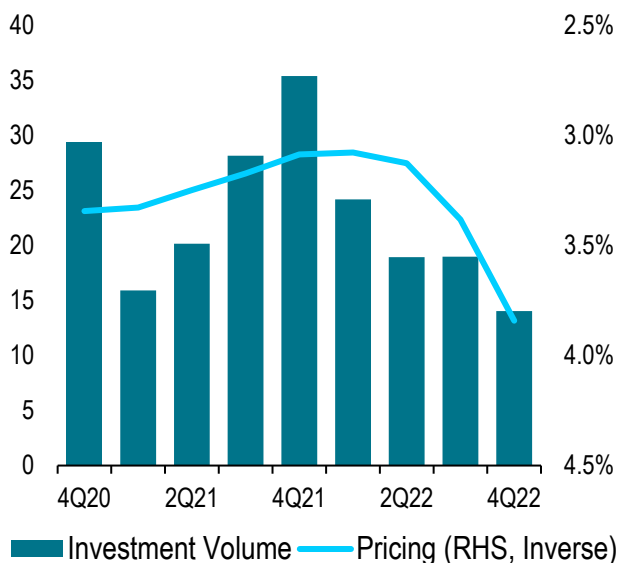
Judging from available evidence, the drop in liquidity has also started to negatively affect real estate valuation yields, adding to the effects of higher

interest rates and falling debt availability that started to be felt mid-way through 2022. The weak activity in 4Q22 suggests that smooth market functioning is being affected and all property valuation yields moved out by 50 basis points in the fourth quarter of 2022 (**Exhibit 2**), representing a pace of adjustment that is faster than even during the global financial crisis.

Falling liquidity is now clearly affecting pricing in European office markets (**Exhibit 2**), for example in Germany. In Berlin, transaction volumes fell by over 60% compared to their long-term average and capital values driven by yield shift fell by over 40% over the course of 2022, as rising interest rates quickly made debt financing of deals very challenging at previously very low yield levels of 2.5% and market participants pulled back as uncertainty spiked due to the Ukraine war.

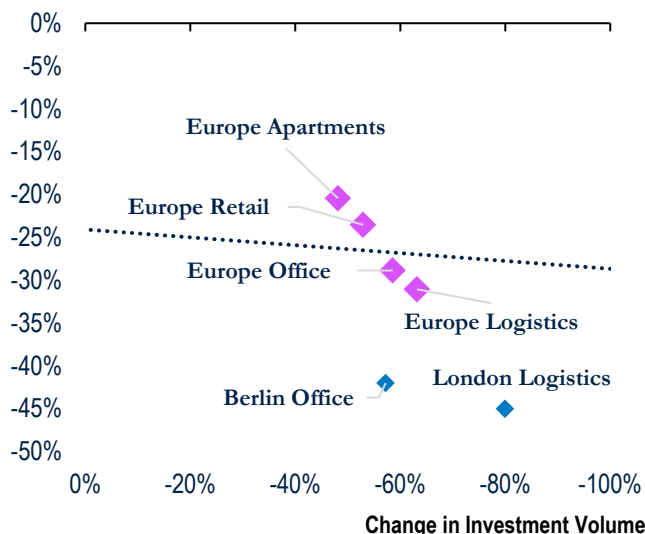
## Exhibit 2: Falling Investment Volume Weighing on Values

Prime Net Yields and Major Cities Transaction Volume (€ Billion)



4Q22 Transaction Volume Decline vs Peak to Current Value Falls

Value Decline Through Yield Shift



Note: Germany Apartment excludes 4Q21 Deutsche Wohnen Take-Over.

Sources: Real Capital Analytics, Cushman & Wakefield, PMA, PGIM Real Estate. As of February 2023.

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Similarly in logistics, for example in the London metropolitan area, pricing has adjusted from levels that became unsustainable as interest rates moved up sharply in the second half of 2022 and which has been reinforced by falling transaction volume. The pricing move has come despite rental growth coming in stronger than had previously been expected, emphasizing that the repricing is very much a capital markets driven story and not much affected by fundamentals at this stage.

In short, in many parts of the market, falling liquidity is now exacerbating pricing movements, raising the risk of an overcorrection of pricing where volume declines most severely.

### What should investors look for in these challenging conditions?

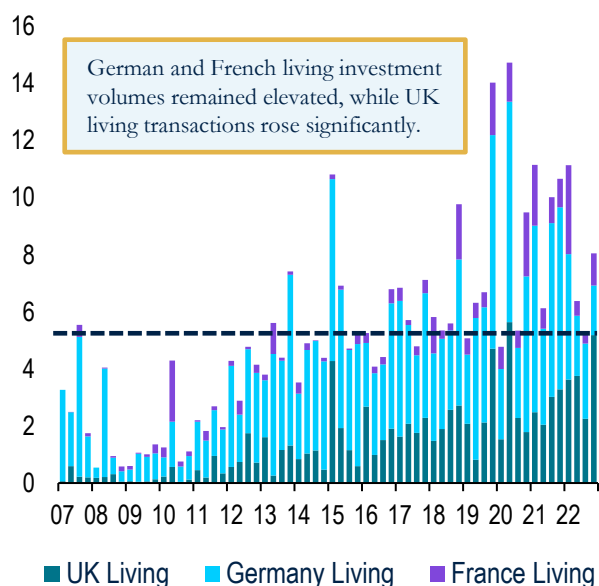
As repricing linked to higher interest rates is taking place across all sectors and markets, investors should

focus on two areas of opportunity where liquidity is playing a role. The first is where investment volume is showing some resilience and therefore pricing is expected to hold up better, while the second opportunity is to look for markets where investment volume has fallen quickly and the price correction has gone far enough.

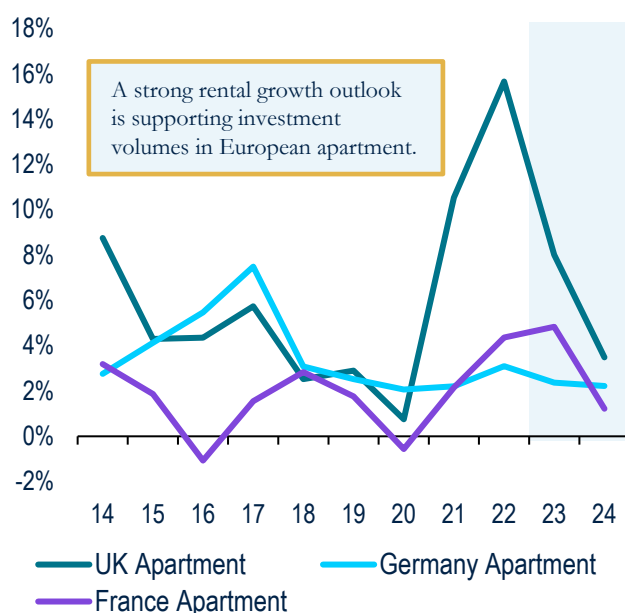
The former is the case in the European living sector (Exhibit 3), where in the fourth quarter transactions in Germany and France only fell by small amounts, while they rose strongly in the UK, boosted by some large M&A student housing activity. A driver for living real estate investment appetite – and limiting the fall in investment volumes and the adjustment in yields – was that investors are still seeing a resilient rental growth story for example in apartments as supply shortages interact with rising demand for rental stock given high mortgage rates, which is expected to continue especially in the UK (Exhibit 3).

### Exhibit 3: Living Investment Volume a Bright Spot Across Europe

Big Three Living Sector Transaction Volume (€ Billion)



Big Three Apartment Rental Growth and Forecasts



Note: Germany Apartment excludes 4Q21 Deutsche Wohnen Take-Over.

Sources: Real Capital Analytics, Cushman & Wakefield, PMA, PGIM Real Estate. As of February 2023.

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The second opportunity is to look for markets where falling investment volumes have sped up the correction and pricing is approaching long-term fair value. Using our internal pricing model that factors in interest rates, risk premiums and expected rental growth, we've identified a target yield range expressing fair value (**Exhibit 4**). When yields reach that range, we are looking at opportunities on a long-term buy-and-hold basis.

Based on an analysis of major European markets across different sectors, taking into account the target yield ranges, our estimate is that the correction in pricing is already halfway done (**Exhibit 4**).

In some sectors, the adjustment is playing out more quickly, with the sharp drop in liquidity being an important contributing factor. After a quick pricing adjustment over the last two quarters and taking into

account a still largely positive occupier market, logistics is already two-thirds of the way to adjusting to long-term fair value. The sector could soon turn into an attractive proposition again, in particular as positive medium-term demand drivers linked to online spending and supply chain expansion remain in place.

Our expectation is that investors with capital available to deploy will quickly see a window of opportunity opening up for new transactions at more attractive yield levels, either where resilient transaction volume is limiting the expected rise in yields or where drying up liquidity is leading to prices adjusting quickly toward long-term fair value. These target yield levels could be reached as early as in the middle part of this year.

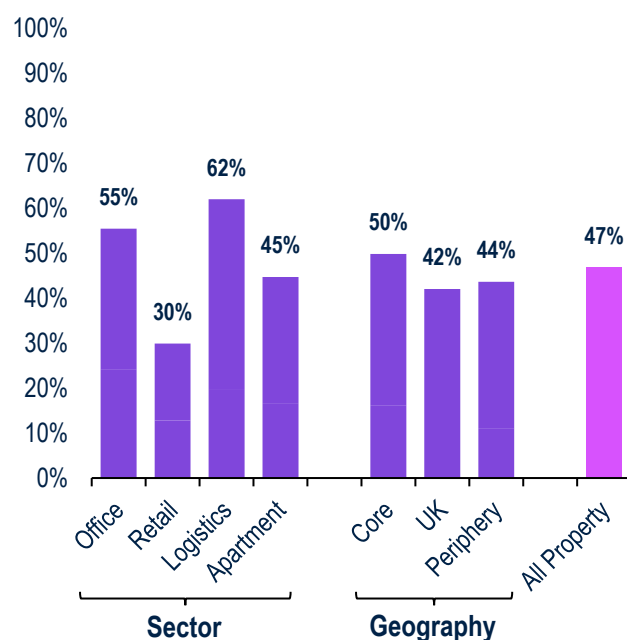
#### Exhibit 4: Yield Shift Has Gone a Long Way in Logistics

Prime Net Initial Yield, Europe All Property (%)



Sources: CBRE, PMA, PGIM Real Estate. As of February 2023.

Estimated Percentage of Required Yield Correction: Cyclical Low to Dec. 2022 (%)



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