QUARTERLY INSIGHTS | INVESTMENT RESEARCH

EUROPE

Key Themes

- Falling Values: What Role are High Debt Costs Playing?
- How Much Further Does the Value Correction Have to Go?
- Is Now a Good Time to Buy Logistics?

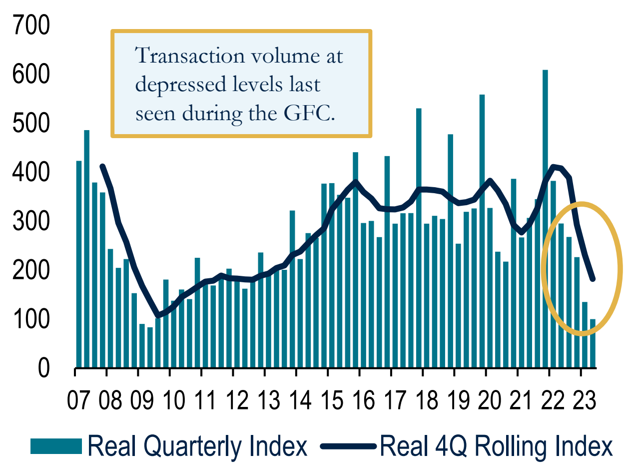
Falling Values: What Role are High Debt Costs Playing?

Given elevated interest rates, a weak economic growth outlook, a large bid-ask spread and higher returns on other asset classes, real estate transaction volume in real terms has fallen to levels last seen during the Global Financial Crisis (GFC) when investment volume deteriorated as credit effectively disappeared amidst financial market turmoil (**Exhibit 1**).

There are echoes of this today as financial markets adjust to higher real estate debt costs, which are currently above prime yields in many major European markets, implying debt is dilutive to investment returns unless significant rental growth is underwritten. This restriction on leverage is dampening investment activity, especially for large deals where substantial financing is required and in sectors in which the rental growth outlook is downbeat.

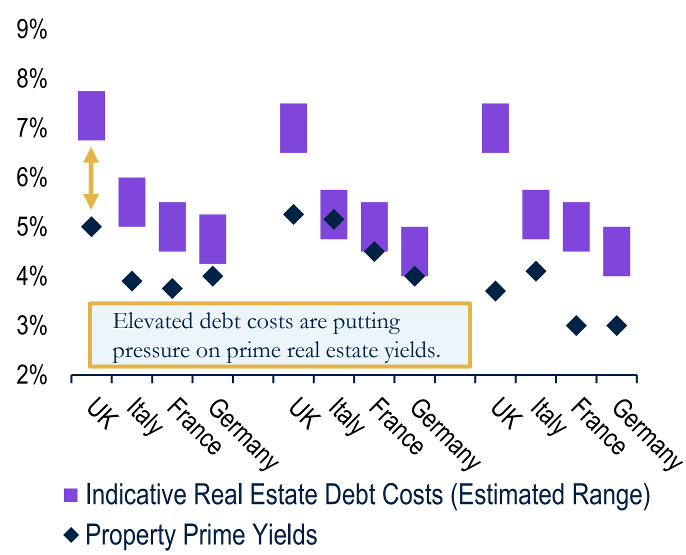
Exhibit 1: Transaction Volumes Down – Elevated Debt Costs a Crucial Factor

European All Property Transaction Volume Index (Real Volume, 2Q23=100)



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

Indicative Real Estate Debt Costs vs Prime Yields



For professional investors only. All investments involve risk, including the possible loss of capital.

The larger the gap between real estate debt costs and property yields the more pressure for yields to move up. Currently this is clearly playing out in the UK (**Exhibit 1**), in particular in office markets, where financing costs have risen by more compared to Continental Europe, and as such we are expecting further pressure and a bigger correction on UK yields before the market can clear, which is going to lead to market dislocation.

On the flipside, pressure on yields from elevated debt costs is less of an issue in logistics, where the typical deal size is smaller and where yields have already expanded the most, and in residential, which is benefiting from higher nominal growth potential via a strong link with inflation.

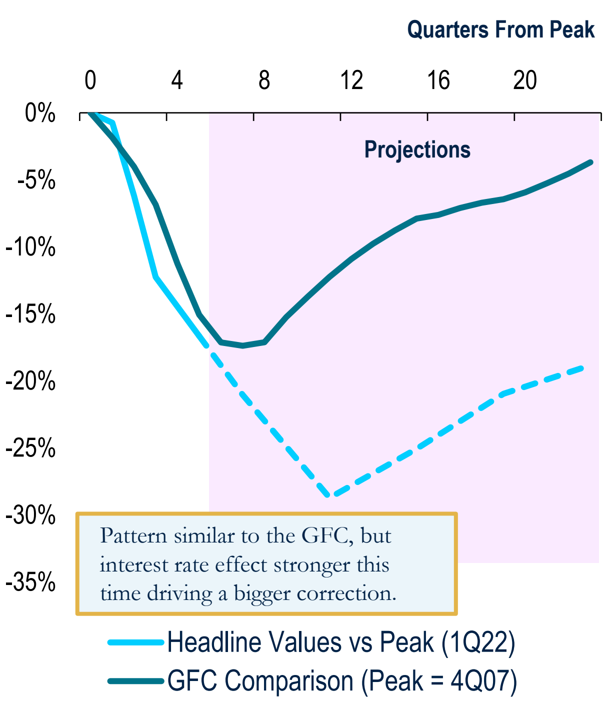
How Much Further Does the Value Correction Have to Go?

All property values fell for a fifth consecutive quarter in 2Q23. So far, the pricing adjustment has closely followed the path seen during the GFC; however, interest rate effects will be more punitive this downturn, as unlike during the GFC interest rates will not be cut back quickly.

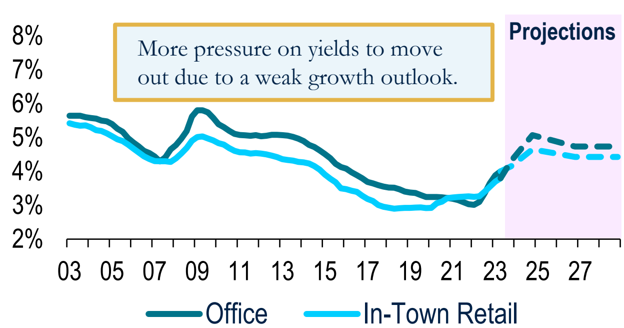
This means that the longer inflation (in particular wage-driven core inflation) surprises on the upside forcing central banks to keep policy interest rates elevated, the longer growth will be negatively affected and capital shortages will persist, and in turn the longer real estate values will remain under pressure. Our expectation is for another six months of falling values on aggregate, which would take prime capital values down another 10% (**Exhibit 2**), although this is masking a more varying story across different sectors.

Exhibit 2: Values Have Fallen a Long Way, But There's Further to Go

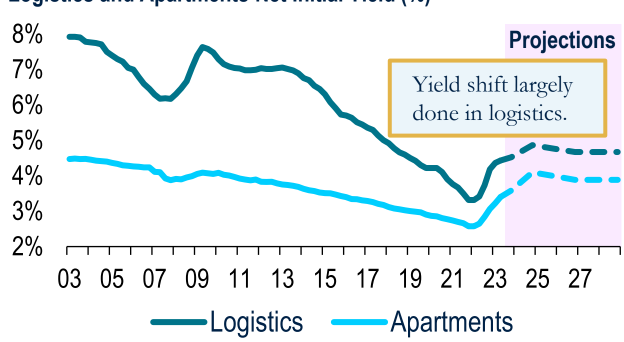
Prime Capital Values vs Peak – Europe All Property



Office and Retail Prime Net Initial Yield (%)



Logistics and Apartments Net Initial Yield (%)



Sources: PMA, Cushman & Wakefield, CBRE, PGIM Real Estate. As of August 2023.

Reflected in rising prime yields, office and in-town retail have seen values fall significantly as the rental growth outlook turned even before interest rates started to rise, mainly on the back of the rise of remote working and e-commerce, respectively. As the rental growth outlook remains more uncertain, values are set to fall further, which means yields are set to rise to restore risk premiums and required returns in those two sectors (**Exhibit 2**).

These dynamics are less pronounced in apartments and logistics. A stronger and more certain rental growth outlook has already started to positively cushion impacts of rising interest rates, and the value correction with the corresponding outward yield shift is expected to be more moderate looking ahead.

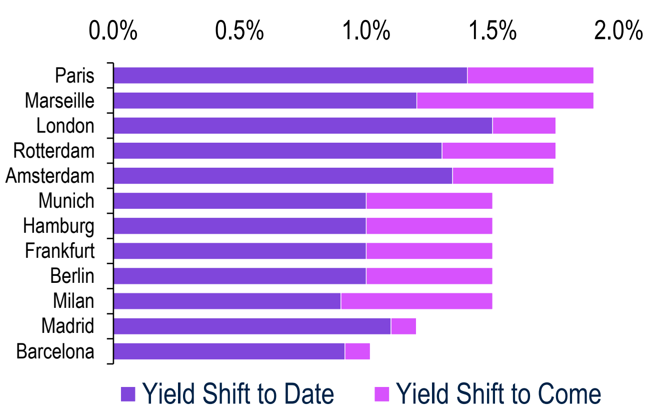
Is Now a Good Time to Buy Logistics?

Investor intentions surveys and investment flows into logistics point to the sector remaining the most favored across Europe. In particular, overseas capital is still chasing logistics stock, over retail and office investments, on the back of a strong structural rental growth outlook for distribution space close to major urban conurbations and transport nodes.

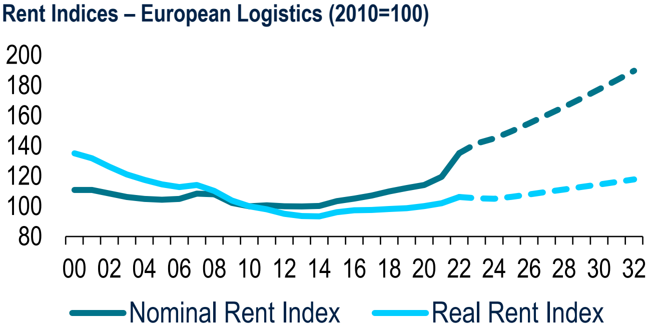
In addition, logistics yields have moved out by more than 100bps in many markets in a short period of time and, based on our estimates, are already two-thirds through the adjustment process that is playing out (**Exhibit 3**). In cities such as London or Madrid, the yield shift looks nearly done, pricing in resilient rental growth going into the downturn and a positive rental growth outlook looking ahead.

Exhibit 3: Logistics Repricing Has Gone a Long Way

Logistics Yield Shift Since 1Q22 and Projected (%)



Rent Indices – European Logistics (2010=100)



Sources: Cushman & Wakefield, PMA, CBRE, PGIM Real Estate. As of August 2023.

What Could Go Wrong for Logistics?

- Full impact of higher interest rates on household spending yet to be felt
- Supply spike of space that was started before the downturn hitting a weakening market
- Sub-leasing of space – low vacancy partly misleading
- Largest markets such as Germany, UK and Netherlands recording steepest demand falls
- Incoming ESG regulation driving market bifurcation
- Rental affordability becoming stretched
- Selective rental growth narrowing asset pool

In a broader sense we are seeing a strong structural rental growth story playing out across all of Europe as rents are rising in nominal and real terms on the back of elevated e-commerce adoption rates and supply chain restructuring that is enabling landlords to push inflation through to logistics occupiers (**Exhibit 3**). This has transformed logistics from a declining real rental sector into one that can absorb elevated inflation and looks to record further real rental growth on the back of structural tailwinds.

However, while it looks like a strong outlook, we have to ask ourselves what could go wrong. Among key risks, European economies have yet to feel the full impact of higher interest rates and there is also rising supply that is hitting the market just when question marks around occupier market performance are emerging. Another trend we are seeing play out is that rental growth is becoming more selective, focused on the best assets in the best markets, which is set to be reinforced by rising ESG regulation driving market bifurcation and limiting investment opportunities (**Exhibit 3**).

Compared to the other sectors, however, logistics remains in favor among investors who want to allocate capital to real estate as the rental growth outlook remains positive. Even so, the presence of these risks means that we should remain cautious and selective toward acquisitions in the sector, considering only assets that have significantly repriced and offer a significant returns premium.

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