PGIM REAL ESTATE

July 2025 | INVESTMENT RESEARCH

European Value-Add Real Estate: Capitalizing on Opportunities in the Next Cycle

Executive Summary

The case for value-add in Europe today is supported by several factors.

- Despite the recent increase in uncertainty around the economic outlook, European real estate values have gone through a big correction and are set for a rebound in the coming years. Some parts of the market are set to rebound faster than others.
- After a relatively subdued investment and building cycle, there are supply shortages, even in parts of the market with resilient demand. In addition, there is a need for capital to modernize existing stock and meet the growing ESG requirements of institutional investors.
- Low liquidity persists and today's market can offer an attractive entry point in terms of being able to selectively acquire assets below valuation and capture immediate upside.
- The value-add opportunity set is expanding to sectors not traditionally seen as part of the investment landscape, including operationally intensive sectors that offer higher potential returns but require more specialist expertise to execute on.

Five Key Themes Supporting Value-Add Investing in Europe Today

1. **Value Rebound** — Rising values, falling borrowing rates set to boost returns
2. **Attractive Entry Point** — Low liquidity and stressed capital structures
3. **Need for Capital** — Capex shortfalls and rising ESG requirements
4. **Supply Slowdown** — Constrained supply for most property types and locations
5. **Expanding Opportunity Set** — Operating platforms drive income growth potential

Note: this paper is an updated version of "*European Value-Add: Capitalizing on Opportunities in the Next Cycle*" published in January 2025.

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Why Does European Value-Add Make Sense Now?

We identify five factors that we believe are among the most important in determining the nature and scale of the opportunity in European value-add today.

1 Value Rebound

Rising values and falling borrowing rates are set to boost returns

Europe's property market has been through a significant correction over the past few years, with values down by more than 20% in nominal terms and 30% in real terms **(Exhibit 1)**.

Values stopped falling in 2024 as short-term market interest rates moved lower on the back of central bank policy easing, putting the brakes on yield expansion. Despite the recent increase in economic uncertainty, pricing conditions are set to improve further as policy rate cuts continue in 2025.

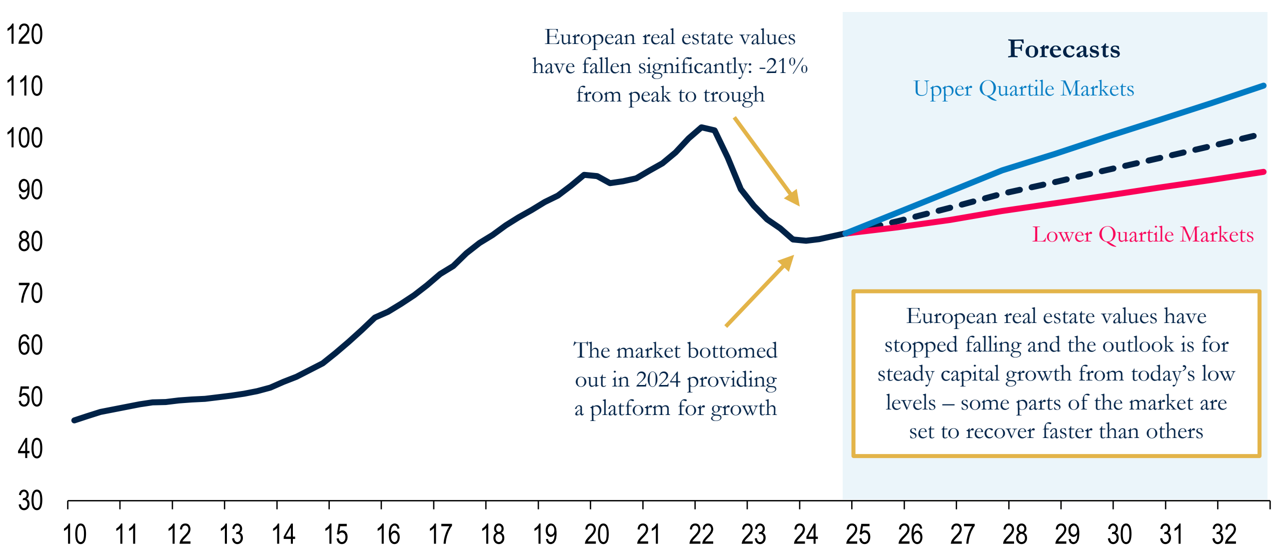
Lower values limit downside risk for investors today as a lot of bad news is effectively already priced in, and there is significant upside potential as the next real estate cycle gets underway.

We expect unlevered headline prime real estate value growth of about 3% per year over the next five years, but parts of the market are set to rebound faster.

In the traditional sectors, apartment and logistics markets are set to deliver rental growth-driven value uplifts, while we anticipate ongoing value growth in non-traditional sectors with structural demand expansion like data centers, hotels and alternative living.

Exhibit 1: Recovery From 2025 Onwards – Some Parts of the Market Are Set to Rebound Faster

Prime European All Property Nominal Capital Values (Index, 2021=100)



Note: Upper quartile markets reflect the best performers among 54 major markets forecasted across office, retail, logistics and apartment sectors comprising the years 2025-32. These markets include core continental and periphery apartment and logistics markets, and selective core continental office markets. Lower quartile markets are dominated by retail markets and secondary office locations.

Sources: Cushman & Wakefield, PMA, PGIM Real Estate. As of July 2025.

Forecasts are not guaranteed and may not be a reliable indicator of future results.

2 Attractive Entry Point

Low liquidity and stressed capital structures

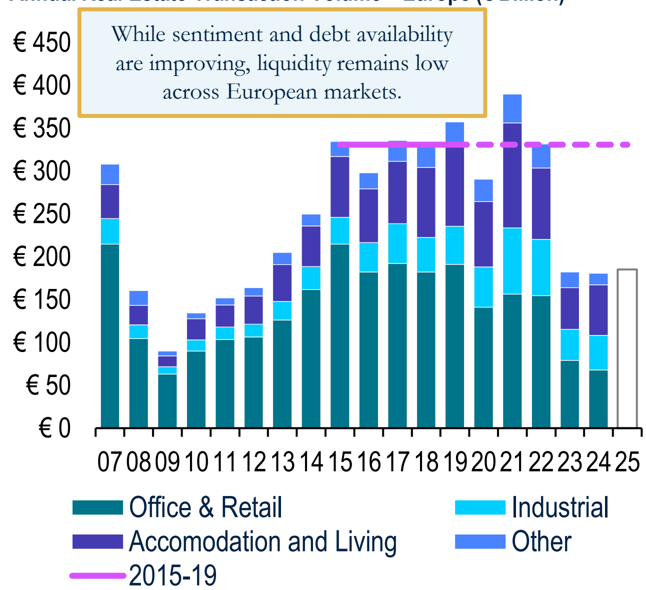
Sentiment toward real estate is subdued on the back of elevated financial market volatility, and debt and equity liquidity remains low compared to the last cycle (**Exhibit 2**). The combination of a significant drop in values and a shift to a higher interest rate environment is giving rise to a significant funding gap.

Low liquidity and funding pressures are creating stress around existing capital structures. Today's market can offer an attractive entry point in terms of being able to selectively acquire assets below valuation and capture immediate upside.

Such opportunities are most notable where there are cash flow challenges to overcome, such as a need for further capital investment or a relatively short lease expiry profile.

Exhibit 2: Liquidity Is Low Across Europe

Annual Real Estate Transaction Volume – Europe (€ Billion)



Sources: MSCI/Real Capital Analytics, PGIM Real Estate. As of July 2025.

3 Need for Capital

Capex shortfalls and rising ESG requirements

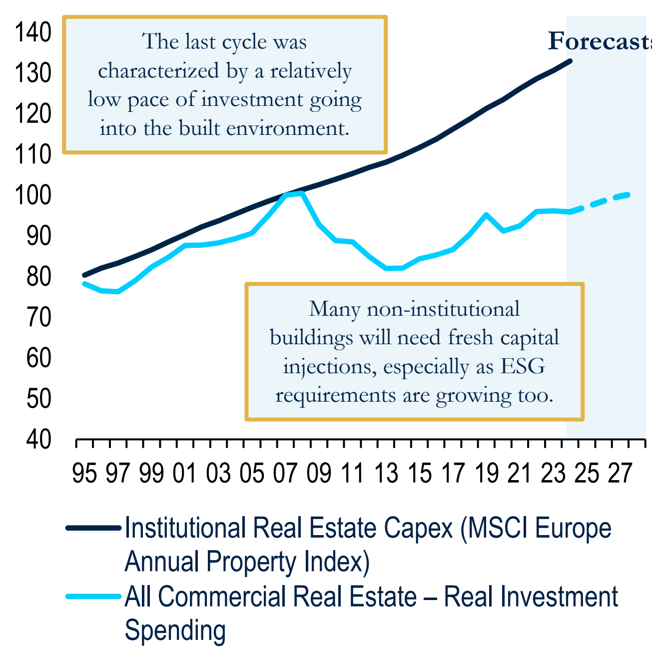
Before the global financial crisis, economy-wide investment broadly kept pace with institutional spending, but fell short over the past decade (**Exhibit 3**). At the same time, capex requirements are rising for institutional-quality real estate, most notably to meet toughening ESG standards.

There is a vast quantity of real estate that is not currently institutionally held, but that will need significant investment in the coming years. Financing such investment for smaller, existing owners is now much harder – given higher interest rates, lower credit availability and toughening ESG requirements – favoring investors with significant expertise and high liquidity.

Given the scale of the shortfall, our expectation is that the opportunity to modernize and institutionalize existing stock will remain substantial throughout the next cycle.

Exhibit 3: A Capex Shortfall Has Emerged

Index of European Capex Spending (2007=100)



Sources: OECD, Oxford Economics, MSCI, PGIM Real Estate. As of July 2025.
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4 Supply Slowdown

Constrained supply for most property types and locations

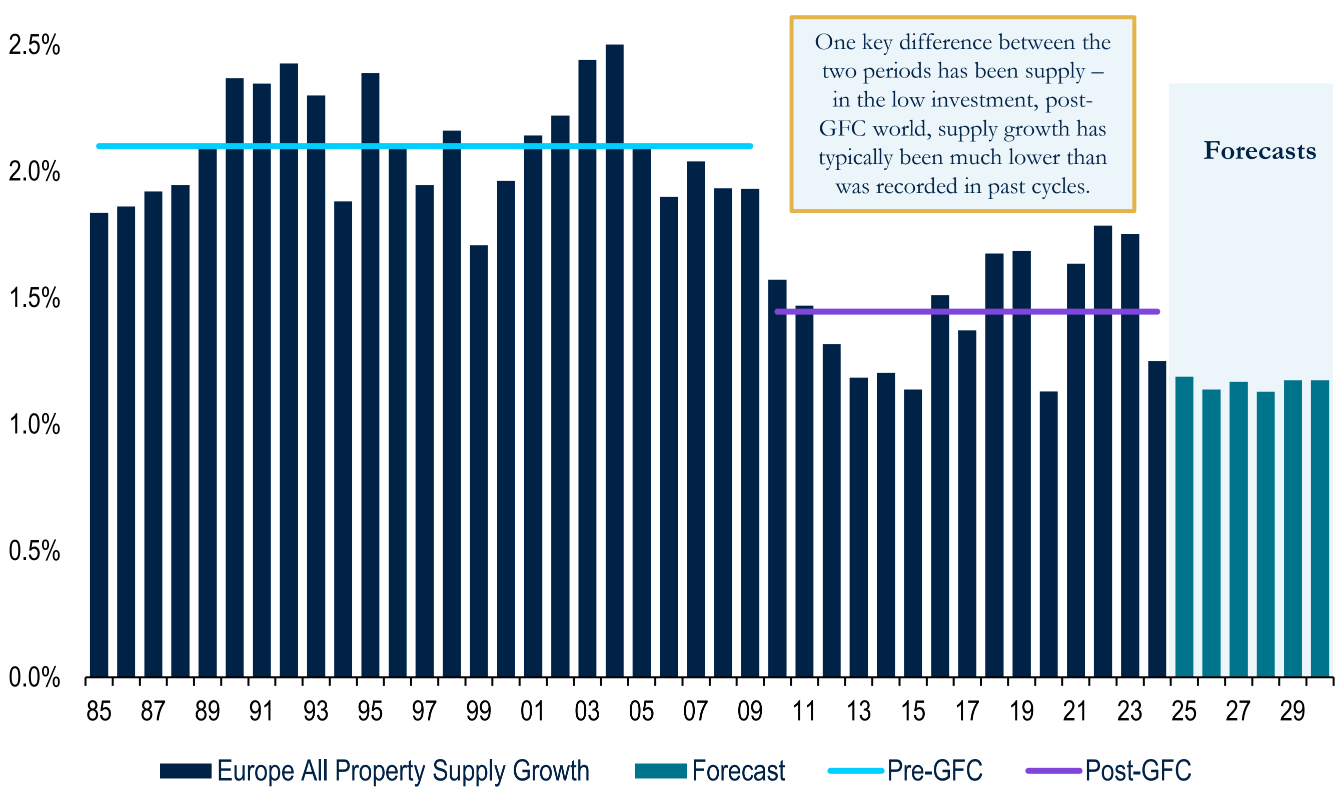
Trends in new supply mirror the broader investment picture – the pace of additions has been much lower since the global financial crisis. Sentiment toward development among investors remains subdued, and new supply continues to be limited by factors such as higher build costs and constraints around access to development finance, effects that will weigh on supply deliveries for several years due to lags in the construction process (**Exhibit 4**).

Low supply makes sense in parts of the market facing demand headwinds, such as suburban office or retail, and where demand has eased on the back of short-term economic weakness but for which supply can adapt quickly, such as for big box logistics.

However, supply growth is also low in parts of the market where demand is resilient and/or rising – housing, data centers, senior living, CBD offices and hotels, for example – and we anticipate further supply shortages to arise, giving owners greater pricing power to drive rental growth.

Exhibit 4: Low Supply Growth Is Set to Persist

Net Additions to European All Property Supply (% p.a.)



Sources: Cushman & Wakefield, PMA, PGIM Real Estate. As of July 2025.

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5 Expanding Opportunity Set

Operating platforms drive income growth potential

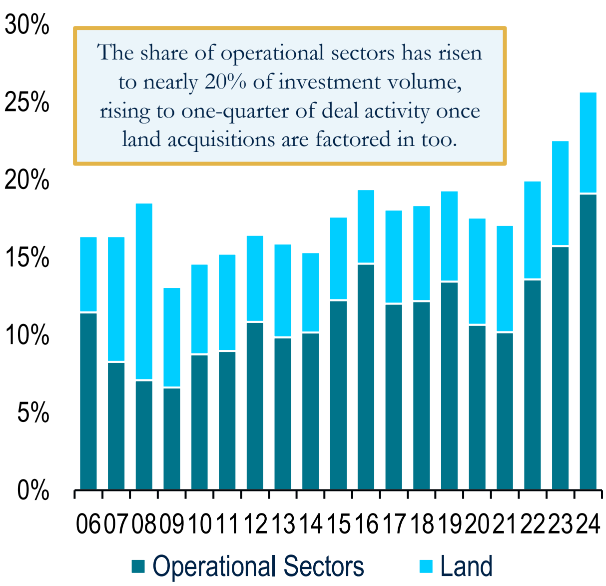
There are two principal routes by which we see the value-add opportunity set expanding in response to changing patterns of investing across the board.

The first route is via a shift away from traditional leased real estate (office, retail, big box logistics, for-rent apartments) toward non-traditional real estate sectors that are typically more operational in nature (including hotels, student accommodation, co-living, senior living, self storage, co-location data centers).

The shift toward a greater degree of operational real estate exposure in the investment landscape is already underway. In 2024, the share of investment activity for operational sectors and land plays rose to one-quarter of all investment activity, up from a historic average of about 15% (**Exhibit 5**).

Exhibit 5: Operational Sectors Growing as Part of the Investment Market

Share of Total European Transaction Volume (%)



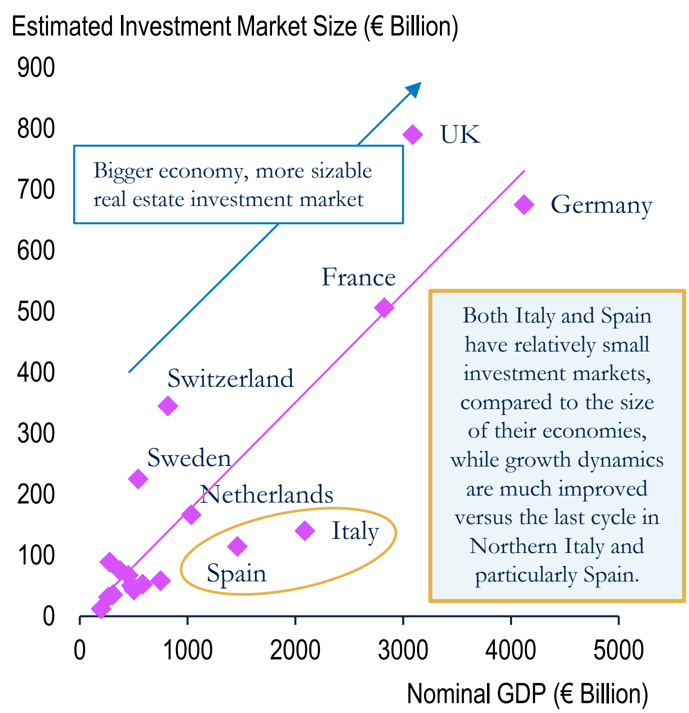
Sources: MSCI/Real Capital Analytics, PGIM Real Estate. As of July 2025.

The second route is by geography, as the trend of institutionalization plays out in markets such as Italy and Spain, which are underinvested compared to major core European markets (**Exhibit 6**).

Northern Italy and Spain also have favorable economic growth dynamics supporting return prospects and are more likely to have assets that offer an opportunity based on mispricing or a need for institutionalization.

Exhibit 6: Markets Like Italy and Spain Are Underinvested

Estimated Real Estate Investment Market Size by Country (€ Billion)



Sources: MSCI, Oxford Economics, PGIM Real Estate. As of July 2025.

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Recognizing the Challenges

Aside from typical risks value-add investors face – such as interest rate cycles, pricing, fluctuations in occupier demand and exposure to external shocks – we identify challenges that are specific to today's investment environment.

Challenge #1

Interest rates have come down, but are still much higher than in the last cycle

Short-term rates have started to fall, but long-term interest rates remain elevated compared to where they were in the last cycle. Forecasts are for long-term interest rates to remain at current levels through the next cycle.

WHAT THIS MEANS

The potential boost from leverage and for value growth from yield compression is much lower than in the last cycle. Returns will predominantly be driven by factors relating to income growth and cash flow durability, rather than market yield shift.

Challenge #2

Returns on traditional real estate won't be enough to generate high value-add returns

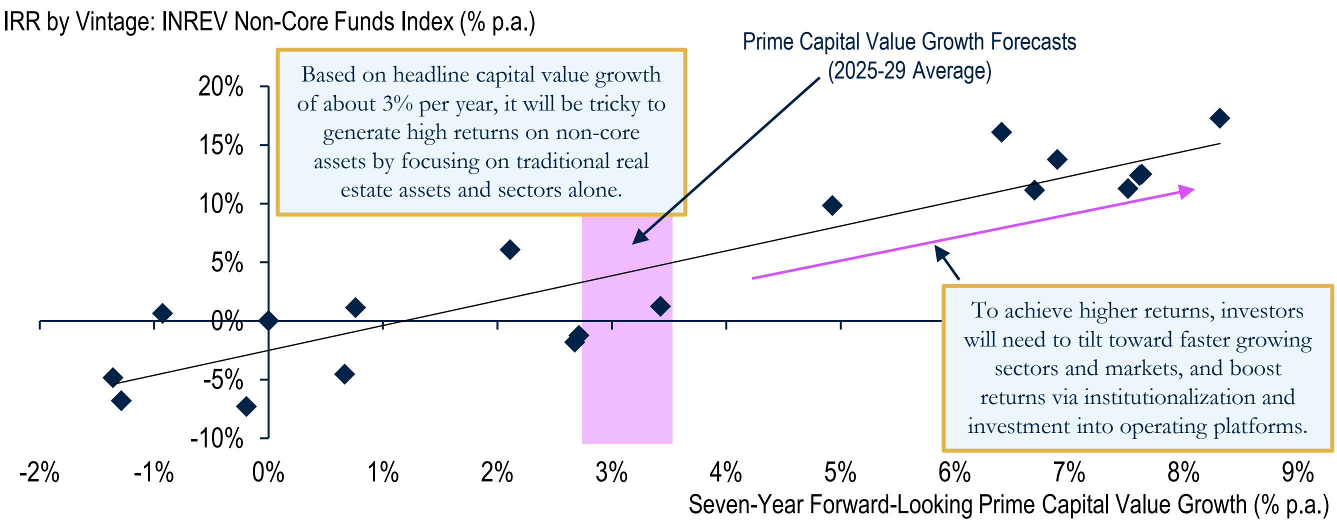
Traditional core assets are set to grow at about 3% per year in the coming years, but based on history, this is consistent with modest returns on non-core assets (**Exhibit 7**).

WHAT THIS MEANS

Investors will have to look beyond a portfolio focused on traditional assets and locations to drive growth to achieve higher returns. This will likely include investing in assets that need institutionalizing and in operational sectors, such as data centers, self storage, senior and student living and hotels, which have a strong rental growth outlook and where investments into the operating platform can further boost potential returns.

Exhibit 7: Low Returns on Traditional Assets Mean Value-Add Investors Will Need to Broaden Their Horizons

Europe Non-Core IRRs Versus Headline Prime Capital Growth, 2000-23



Sources: INREV, PMA, Cushman & Wakefield. As of July 2025.

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Capitalizing on Opportunities

Defining Value-Add

While style definitions in real estate are not set in stone, in contrast to income-driven, buy-and-hold core investments, a value-add portfolio will typically seek to generate capital value growth-driven returns over a limited period of time, based on most or all of the following factors:

- Improving the level, quality and durability of cash flows by active asset management, capex and development activities.
- Achieving a positive valuation effect by growing the income stream on a portfolio, improving its quality and risk profile to benefit from favorable yield shift and capturing upside from mispricing or market momentum.
- Taking on leasing risk and having an exposure to non-income producing assets, such as developments or refurbishment projects.
- Investing in a broad range of real estate asset types from traditional lease-based real estate, to secondary markets and locations, to operating platforms that have a business aspect on top of owning the underlying real estate.

Opportunities: Structural Versus Tactical Drivers

Broadly speaking, we split the opportunity set into structural and tactical groupings along sector lines, although geographical differences will play a role in portfolio allocation too. The following summarizes our views:

Structural Drivers

Investment conviction driven by basic needs and long-term structural themes that supports ongoing demand creation. Examples include:

- **Living and accommodation**: aging demographics, housing shortages and rising rental demand point toward a significant and ongoing opportunity set across Europe residential and living markets, while hotels are benefiting from rising tourism demand.
- **Digital infrastructure**: demand for data centers is being driven by digital transformation, a shift to cloud computing and the rise of AI.
- **Logistics and supply chain**: rising online spending, a need for facilities that can drive customer fulfilment in urban areas and supply chain optimization are among key drivers of logistics demand that are set to persist in the coming years.

Tactical Drivers

Opportunities arising from near-term growth, the anticipated cyclical value rebound and market dislocation that gives rise to potential mispricing. Examples include:

- **Traditional income-generating sectors**: Office has a lack of liquidity in the face of headwinds (including hybrid working) and potential mispricing in areas where strong demand persists, for example in low supply CBD markets. Retail opportunities are growing as in-store spending stabilizes at a time of stressed capital structures, discounted pricing and low liquidity.

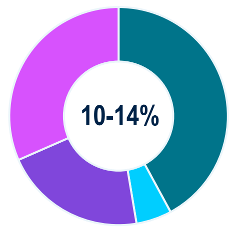
Sizing up Different Approaches to Value-Add Investing

We identify five different value-add investment approaches in **Exhibit 8**, each with a different emphasis on how capital growth is generated and a different risk-return profile. Over the course of a cycle, a value-add portfolio would likely comprise elements of all of these.

Exhibit 8: Stylistic Target Return Range and Breakdown for Different Value-Add Investment Approaches

Mispricing

Opportunities linked to mispricing in the market, for example due to low liquidity or stressed capital structures.



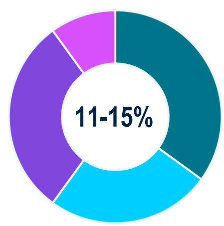
Key return driver(s): market performance plus yield shift.

Indicative target sectors: retail, office, hotels

Risk Level: Low-Medium

Active Asset Management

Taking on risk in under-managed or under-performing assets likely with vacancy or a challenging lease expiry profile.



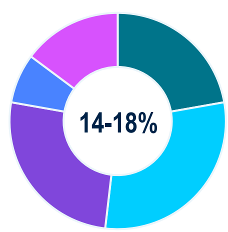
Key return driver(s): income growth via re-leasing and ERV reversion.

Indicative target sectors: apartments, student/co-living, urban logistics, retail, office

Risk Level: Low-Medium

Institutionalize / Heavy Capex

Invest significant capex into outdated assets to institutional quality to drive modernization and meet latest ESG standards.



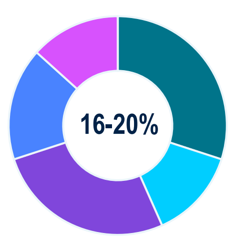
Key return driver(s): income growth and positive valuation effect.

Indicative target sectors: apartments, self storage, hotels, open-air hospitality

Risk Level: Medium

Operating Platforms

Investing in operating platforms alongside the real estate to allow greater control and enhance returns potential.



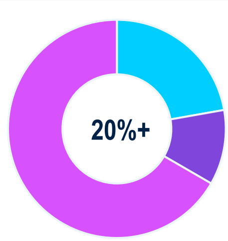
Key return driver(s): income growth, positive valuation effect and operational gain.

Indicative target sectors: student/co-living, senior housing, self storage, hotels, data centers, urban logistics, cold storage, flex office

Risk Level: Medium-High

Development

Ground-up development of assets in a low supply market environment.



Key return driver(s): valuation uplift and development profit.

Indicative target sectors: student/co-living, senior housing, self storage, hotels, data centers, urban logistics, cold storage

Risk Level: High

Income Return | Net Income Growth | ERV Growth | Operational Gain | Valuation Effect

Note: Net Income Growth reflects the gain from asset management activity while ERV Growth reflects the general boost to values from rising benchmark rents. This exhibit is presented for illustrative purposes only and should not be construed as investment advice or an offer to purchase or sell any security. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.
Source: PGIM Real Estate. As of July 2025.
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Building a Value-Add Portfolio for the Next Cycle

Here we assess how the different approaches to value-add investing affect portfolio allocation decisions relating to different sector and opportunity groups.

- One clear trend is that investing in **operating platforms** is becoming key to achieving higher rental growth and returns (**Exhibit 9**). This can be in truly operational sectors like senior living or hotels, in urban logistics or co-location data centers that require specialized expertise, or simply as a route to optimize performance in e.g. office by including flex space in the offering to improve leasing outcomes.

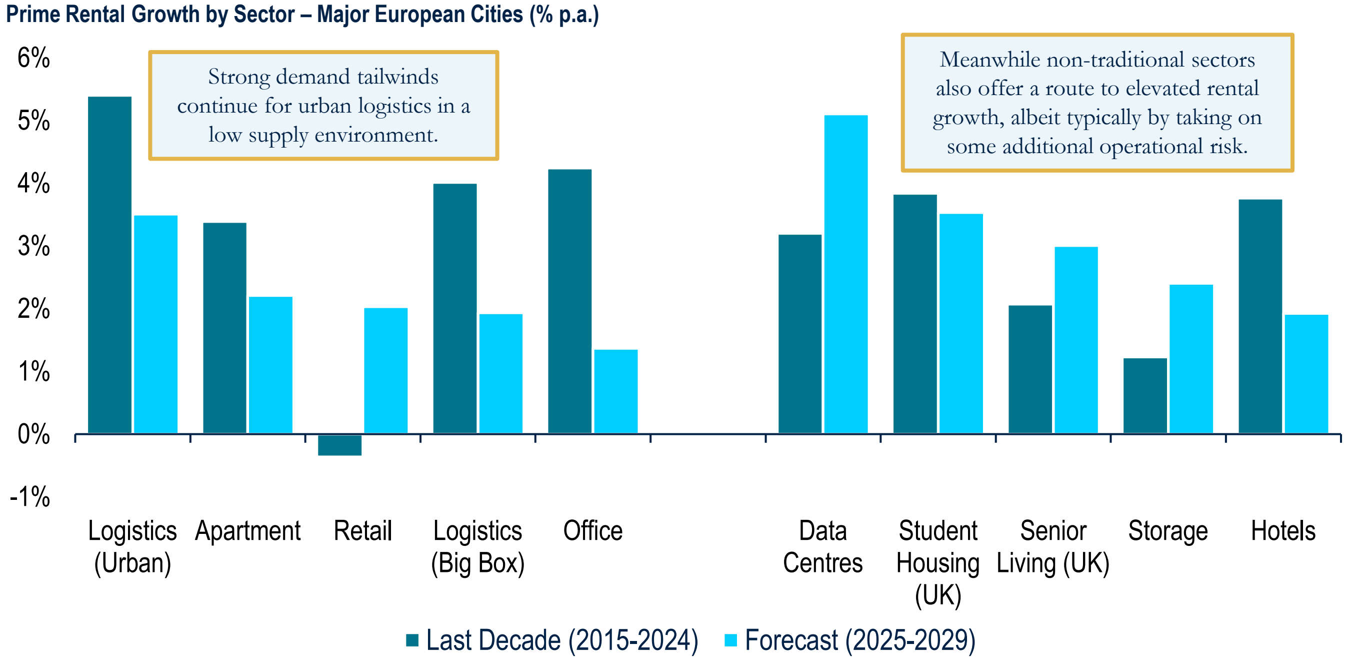
- **Development** strategies will likely focus on sectors with the strongest structural demand drivers including living, logistics and data centers, while **mispricing** is most likely to drive acquisitions in the traditional office and retail sectors, and in some hotel markets that went through a significant adjustment during the COVID pandemic.

- **Active asset management** is effectively a key feature of all value-add investing, but is set to be a key returns driver in traditional office, retail and living sector assets, where operating platforms are not used as widely.

- Opportunities related to **institutionalization** are set to play out most clearly in the living sector where many assets have been owned by small private landlords and are under-managed, in self storage where the industry is modernizing rapidly in response to rising demand and for hotels where significant capex budgets are hard for smaller independent owners to finance.

Exhibit 9: Look to Operational Sectors for Higher Rental Growth Potential to Drive Returns

Prime Rental Growth by Sector – Major European Cities (% p.a.)



Sources: PMA, PGIM Real Estate. As of July 2025.

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