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ROUNDTABLE

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Sentiment is slowly improving in Europe

After a bruising 2023, real estate investors anticipate further falls in prices and a longer buying window for those seeking value across the region. By Mark Cooper

European real estate markets spent 2023 reeling from a series of body blows, the most damaging being sharp rises in interest rates, while geopolitical upheavals added a few nasty punches to the mix. Transactions volumes collapsed to the lowest levels for more than a decade and values dropped sharply across the board.

Nonetheless, an apparent end to rising rates sparked hopes of stability toward the end of the year, if not a sharp recovery. The four managers taking part in *PERE*'s Europe roundtable in London point to pockets of resilience around the region, steady or falling interest rates and the potential for a prolonged buying window. However, they are also extremely cautious in their outlook.

MSCI data shows European transaction volumes halved in 2023 to €166.1 billion. Cross-border capital flows fell to their lowest level since 2010, with US acquisitions less than half of the 2022 total. However, while fourth-quarter volumes were down 43 percent year-on-year, they represented an improvement on the third quarter, suggesting a narrowing of the bid-ask spread. Meanwhile, the European Commission's Economic Sentiment Indicator ticked up in the last quarter of 2023, but remained below Q1 levels.

"I'd say there is less pessimism rather than more optimism," says Rob Wilkinson, European CEO at Boston-headquartered manager AEW. "Certainly the end of 2023 was better than midway through the year. However, there are still a lot of uncertainties around inflation and interest rates. There is a real mix of opinions about the effects of wages and energy prices on inflation. As always, I think it will take time for investors to adjust to what the market has been through."

A "mix of opinions" is a key reason why the transaction market has been so subdued. Although real estate values have fallen across the board, buyers and sellers are yet to fully align on pricing, especially in markets that have not seen dramatic repricing. For example, MSCI points to a 32 percent price expectations gap between buyers and sellers for the office sector in Germany.

Randy Giraldo, head of real estate, Europe at Chicago-based manager Nuveen, observes a wider pullback from the real estate sector by institutional investors. "There is a net divestment out of the asset class taking place with the rise of other alternatives, such as private credit, infrastructure and the like," he says. "When those asset classes become overvalued, the pendulum will swing back as people see opportunity and value in real estate."

Participants noted little evidence of distress so far. However, the pressure on asset owners has yet to been released, with interest rates

PHOTOGRAPHY: **RICHARD DAWSON**

Randy Giraldo

Head of real estate, Europe, Nuveen

Giraldo moved to London last year to take up the role of head of real estate, Europe for Nuveen, after 16 years with the investment manager in New York. Nuveen Real Estate has approximately $28 billion of European real estate assets under management, as of September 30, out of a global total of $149 billion.

Renaud Haberkorn

Managing partner and head of real assets, Eurazeo

Haberkorn is managing partner and head of real assets at Eurazeo, a listed European private equity group with €1.4 billion of real estate assets under management. Before joining Eurazeo in 2014, he was a partner at Soros' spin-off Grove International Partners.

Rob Wilkinson

European CEO, AEW

Wilkinson is European CEO at AEW, which has €40 billion of assets under management in Europe and over €80 billion globally. A 25-year real estate veteran, he joined AEW in 2009 from Goodman Group.

Shane Scully

CEO and co-founder, Eagle Street Partners

Scully is CEO and co-founder of Eagle Street Partners, a pan-European real estate manager with offices in London and Dublin. Before founding Eagle Street in 2020, Scully was on the executive board of Glenveagh Properties, where he was responsible for the 'living' part of the business. Eagle Street Partners is part of alternative asset manager Arrow Global.

holding steady. Shane Scully, CEO and co-founder of Dublin-based real estate manager Eagle Street Partners, says: "We still have senior debt coming to maturity and having to be refinanced, with valuations down. This could perhaps lead to people being forced to push a lot of product into an illiquid market. That would put further downward pressure on pricing. Distressed sales are coming, I think, but in pockets."

Participants agree there is no sign of material price improvements for now, which is a source of optimism for those with capital seeking buying opportunities. Renaud Haberkorn, managing partner and head of real assets at Paris-based private equity group Eurazeo, is more upbeat about the opportunities ahead, saying: "I think 2024 could be a great vintage. The market is beginning to echo this view and opening up to conversations, which was not the case in late 2022 and most of 2023. This year there will be opportunities for new investments; however, we will remain selective."

Giraldo adds: "We have been concerned that the window of opportunity would shut when everyone got the memo to start investing again. However, it seems this window will be wider than we thought and it looks like 2024 will still be an attractive time to invest. We don't think that the late 2023 improvement in sentiment has yet to materially change pricing in the private real estate market, and that's a positive for investors with dry powder."

Nonetheless, even at current pricing, investors are reluctant to push the button on deals. Wilkinson says: "That opportunity to buy at the very least 20-30 percent below the peak is still there, and that is what is sparking conversations. But whether these are translated into actions depends on the transaction news flow we see over the next few months."

"What worries me is we have another year like 2023, where indecisiveness, or lack of certainty, just brings a continuation of the big freeze in activity"

SHANE SCULLY
Eagle Street Partners

Resilient occupier markets

The positive signal for buyers is that occupier markets, with the exception of the office sector, have held up well. Haberkorn says: "We have seen the capital markets correct across all sectors, leading to a 150-250 basis point cap rate correction. But operationally it is quite sound, other than for suburban office which has not found the bottom yet, and the capital market element of the pricing can be partly offset by operational performance."

The office sector has been the hardest hit, with transactions in Europe down 59 percent in 2023, according to MSCI's *Capital Trends Europe* report, while Wilkinson reckons values in the sector fell 20 percent last year, too. "I think there's further to go," he says. "The problem is price discovery, as there isn't a lot of deals."

Haberkorn points out that the

No miracle cure from European life sciences real estate

The niche sector has its skeptics

Real estate has moved away from the core sectors of office, retail and industrial to embrace a multiplicity of niche sectors. But the roundtable participants were skeptical about some.

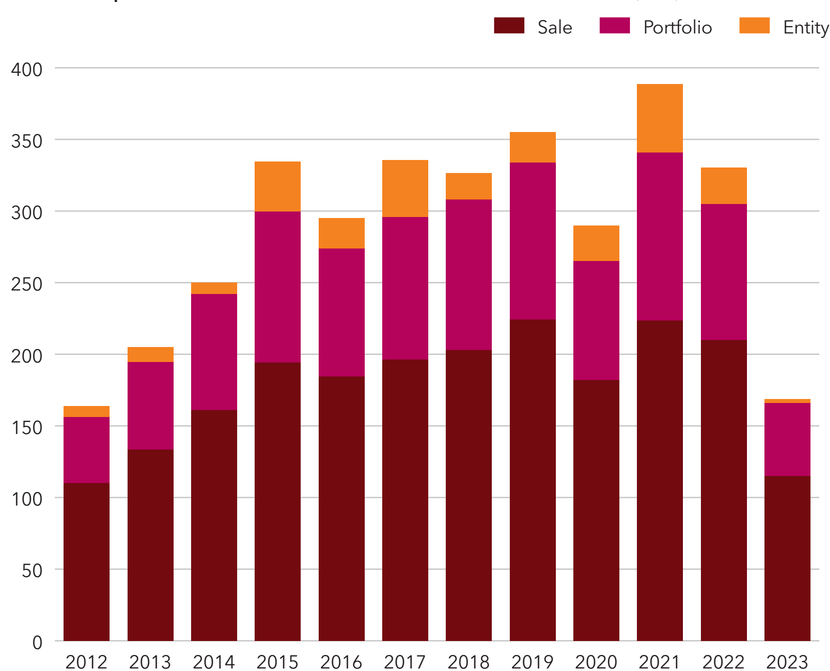
Life sciences real estate developed as a niche in the US, but became a global phenomenon during the pandemic and has medical advances and aging populations as its underlying drivers. The sector performs best in clusters near universities and hospitals.

Panelists see opportunity in clusters such as Cambridge in the UK. But they are less convinced this approach can be replicated all over Europe. Eurazeo's Renaud Haberkorn says: "In the US and UK there is a synergetic relationship between a few large research universities, which are outside the largest cities, and the life sciences industries. So you can build clusters of parks there.

"It is not the same in continental Europe, where research universities and hospitals are scattered. People pretend the life sciences label means there will be a massive yield shift, but that should not be the case."

Shane Scully of Eagle Street Partners, says: "With it being such a nascent sector, people are going to get it wrong. We have seen life sciences schemes proposed which are just in the wrong areas, such as Canary Wharf, which I think is misguided. However, there are areas in the UK and Ireland which are eminently suited to life science clusters."

Annual European transaction volume in 2023 was at its lowest since 2012 (€bn)



Source: MSCI

travails of the office sector are following the same pattern as those of retail. "In retail, e-commerce took 15-20 percent of the market and made what was meant to provide stable, predictable income look shaky. Now we have working from home, which is driving 20 percent less occupancy in the office market. Large allocators of capital realize they are overallocated to a sector which is no longer as safe as they thought. I think the office sector may undergo a similar fate as retail; the sector is yet to fully recover from seven years of allocation downgrading."

Even so, the office sector is not universally moribund. Wilkinson points to prime offices in Paris, which have been "pretty resilient" and seen some deal activity. "Assets were trading at sub-3 percent a couple of years ago and now people are talking about a range of 4-4.5 percent," he says. "However, if you talk to US investors about offices in Europe at those kinds of rates, you get complete disbelief, given the significant challenges that sector is having on the other side of the Atlantic."

Scully also makes the point that some of the risks to the office market "are behind us," as the market is adapting to changing working practices and ESG has become the agenda for many asset owners. "We are coming to a new understanding of what is really prime. It is then logical to price that prime stock at low yields because that is where the rental growth is going to be. There will be bifurcated markets: prime and everything else."

The data suggests he is correct, as it shows a widening gap between the best and the rest in the office sector. The MSCI UK Quarterly Index for December 2023 showed the lowest-yielding offices were generating the most rental growth (just under 6 percent), while the highest-yielding assets generated minimal rental growth.

The picture for rental residential and the broader 'living' sectors is

rather more positive due to underlying demand and, for those building new space, a leveling-off in construction costs, which had been rising since the pandemic.

And while for-sale residential prices have been under pressure across the continent, that is not necessarily an impediment for those building multifamily or student accommodation.

Scully says: "We are beginning to see the hyperinflation on the construction side easing and even correcting a bit, so we have a window where we have cost certainty and can go ahead and build things. Higher construction costs and exit yields have hit the price of land in Ireland and some areas of the UK by as much as 50-60 percent. However, the land repricing is a real opportunity for us, as we're looking at making a meaningful start on a student accommodation strategy."

The sharp rise in interest rates hit commercial real estate investors and home buyers alike. For the latter, so much so that it drove changes in strategy. Haberkorn says: "We have a residential business in Paris which was traditionally 30 percent build-to-rent and 70 percent build-to-sell, but that 70 percent has disappeared because of the affordability issue and mortgage rates going from 1 to 4 percent. So we flipped toward build-to-rent. However, many residential markets are fundamentally undersupplied so they should come back one way or another."

Just as the gulf between the best and the rest is growing in the office sector, it is starting to appear in the build-to-rent sector, says Scully. "Anything that was built five or six years ago is a different generation, from an energy efficiency point of view. The next stage for private rental sector (PRS) investors, I think, is community building. If you can generate 'sticky' tenants who stay for the long term, that will make the income more sustainable and should add value."

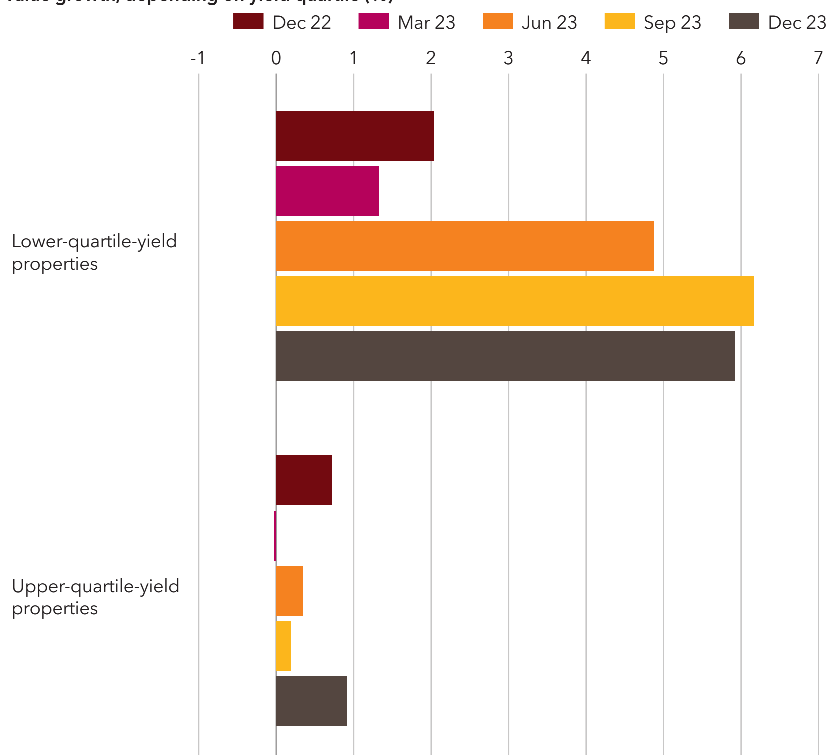
"I think the office sector may undergo a similar fate as retail; the sector is yet to fully recover from seven years of allocation downgrading"

RENAUD HABERKORN
Eurazeo

"If someone is prepared to put multiple hundreds of millions of pounds on the table to buy UK retail, that is a sign that we're reaching the bottom"

ROB WILKINSON
AEW

Central and inner London offices show a significant discrepancy in year-on-year market rental value growth, depending on yield quartile (%)



Source: MSCI UK Quarterly Property Index, Unfrozen

Rent caps in the PRS sector are a bugbear for real estate investors, but Scully predicts they are becoming the same for governments. "In most markets there is chronic undersupply, so anything – like rent caps – which stifles the delivery of that product isn't something even a left-wing government would want." He predicts that an end to rental caps in Ireland could compress PRS yields by 100bps. "I know it's something that is being debated behind the scenes in government, but I don't know whether they're brave enough to do it in an election year."

Having reached an unprecedented pricing peak after the end of the pandemic, the logistics sector was hit quite dramatically by rising interest rates. Data from Fitch Ratings and Cushman & Wakefield suggests cap rates have risen to 5 percent from 3-4 percent in Q1 2022, and transaction volumes fell 51 percent last year. However, the gap between capital values and rental performance is largest in this sector.

Wilkinson says: "Logistics prices took a hit right away in late 2022, but I think have a little bit further to fall. However, the occupational side is still pretty good, vacancy rates are still pretty low and there doesn't seem to be significant supply."

Giraldo adds: "We see the operational side of logistics decelerating, but when vacancy rates are as low as two percent, you are still going to see positive rent growth. It is easy to turn the supply spigot off if the market seems to be building too much."

Sectors to watch

Retail volumes fell 39 percent in 2023, according to MSCI, a smaller decline than that of office and industrial. Giraldo asks: "Which will be the first sector to bounce back and see value increases? That could be the retail market because the entry yields are really high, the assets are operationally sound and we are starting to see significant rental

growth. So value-add money is starting to move into that sector."

Wilkinson believes what happens in the UK retail sector this year could be an important signpost for market sentiment more broadly. He says: "There's a couple of big shopping center deals out there in the UK market; it is going to be fascinating to see what happens with those. If someone is prepared to put multiple hundreds of millions of pounds on the table to buy UK retail, that is a sign that we're reaching the bottom.

"At the moment, no one wants to be the one who buys before everything goes down another 10 percent. If they don't happen, that is not going to be good for the market, it will lose confidence again."

INREV, the European Association for Investors in Non-listed Real Estate Vehicles, published its *2024 Investment Intentions Survey* in January, which showed 84 percent of respondents are keen to increase their allocation to European real estate debt. The panelists agree the past couple of years have opened up a long-term opportunity for debt investors. However, they suggest its relative value peak is passing as interest rates look likely to fall.

But, Giraldo notes: "Investor demand for debt has been, surprisingly, not as robust. Aggregate fundraising into the space has been lower than the opportunity would suggest."

Wilkinson adds: "Many thought this would be the moment for real estate debt to shine, but the problem, I think, was that whether debt or equity, real estate was a bit of a dirty word. There was also a feeling that debt returns should be higher due to the risks underlying the real estate market."

Standout deals

A sign of how challenging real estate markets have been in the past couple of years is the difficulty with which *PERE*'s roundtable guests nominate standout deals, especially deals they wish they had done. Sentiment suggests that missing out is better than buying at the wrong price.

Haberkorn says: "One of the things we've seen over 2023 and up to now is that the few deals which have been done were small in size and mainly to longer-term holders." He also points to many of the better transactions being on the debt side.

Nuveen's Giraldo points to Blackstone's privatization of UK real estate investment trust Industrials REIT: "It aligns with one of our key sector preferences, was in our backyard and of a scale that we could have executed."

Indeed, a retrospective indicator of a successful 2024 will be that *PERE*'s 2025 Europe roundtable participants have a host of deals to choose from. Meanwhile, there is a still a lot of 'wait and see' to come. "There has to be increased certainty in the broader economy for real estate conditions to improve because we are an asset class that is shaped by what is happening at a macro level. 2024 still has tremendous amounts of uncertainty," says Giraldo.

"Only when a lot of those things are resolved, and investment committees, limited partners and other allocators of capital start to feel like there's balance in the system, will we see the purse strings start to loosen for real estate."

Nevertheless, there are concerns

ESG becomes the agenda for real estate

Environmental, social and governance issues are front of the industry's mind

No real estate discussion can take place these days without mention of ESG. It is now "the agenda" for market players, says Shane Scully at Eagle Street Partners.

Most of the panelists are confident about their own portfolios, but are still concerned about the scale of the problem for the real estate industry, which is responsible for nearly 40 percent of global greenhouse gas emissions.

Eurazeo's Renaud Haberkorn says: "My view is that every major player in the market today has sustainability in mind and is either voluntarily or forced by law to deal with decarbonization. No one wants to have stranded assets somewhere down the line."

Randy Giraldo at Nuveen says: "We established a target of net-zero carbon by 2040, with a near-term target of 30 percent energy reduction across the portfolio by 2025. We are on target for that, but it'll be a heavy lift to get to the ultimate target. Most of the stock that will be here in 2040 already exists, so the repositioning of real estate must be a very large part of that journey."

AEW's Rob Wilkinson, meanwhile, sees ESG as "a very challenging area" for real estate and one where complexity is a barrier to practical action. "There has been a raft of somewhat uncoordinated regulation at national legislation, European and to some extent global levels.

"Every operator is clearly focused on energy consumption and emissions and the weight of regulation and reporting is taking up some of the time we should be spending dealing with those real-life issues."

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>
> **RANDY GIRALDO**
> **Nuveen**

The European Commission's Economic Sentiment Indicator ticked up at the end of last year

Source: European Commission - Directorate-General for Economic and Financial Affairs

over the wider economic and political landscape. Haberkorn says: "In the short term, while forward-looking indicators are running good in the US and Europe, the main risk is driven by the lack of fiscal consolidation which could lead to a sovereign bond 'meltdown.' That would completely paralyze us and I think translate into the biggest pain."

However, Scully sums up the table's mood with the assertion that the worst thing for the year ahead would be for it to resemble the last. "What worries me is we have another year like 2023, where indecisiveness, or lack of certainty, just brings a continuation of the big freeze in activity. There was a lot of sitting on hands during covid and then we kind of came back to the world and then we got back into a market freeze again. Inactivity is my big worry." ■