EUROPE

2024 Real Estate Outlook

Investment Research

Hear From Our Experts

EXECUTIVE SUMMARY

Europe

Real estate returns are set to remain weak going into 2024 as pricing continues to adjust to higher interest rates and liquidity remains depressed.

Occupier markets have held up in 2023 and the outlook for next year is stable, although downside risks dominate.

Investment opportunities are starting to emerge in markets where pricing adjustments are nearing an end and demand remains positive.

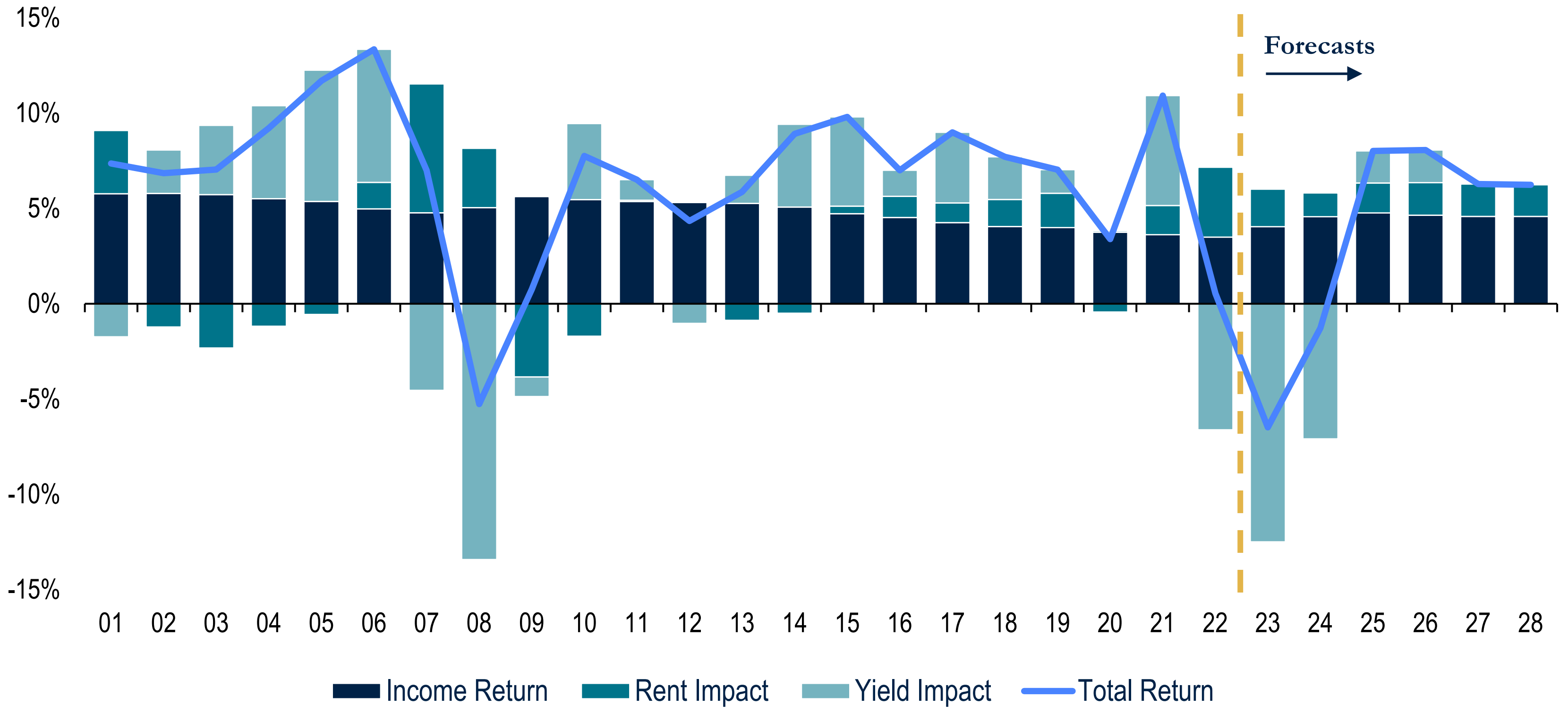
MARKET OUTLOOK

The sharp repricing of European real estate assets continues as interest rates remain elevated and liquidity low. Overshooting is increasingly looking likely. There are positive trends supporting occupier markets, but downside risks dominate going into 2024.

1

European Real Estate Returns Are Set to Remain Weak Going Into 2024

MSCI Europe Annual Property Index, Unlevered All Property Total Returns (% p.a.)



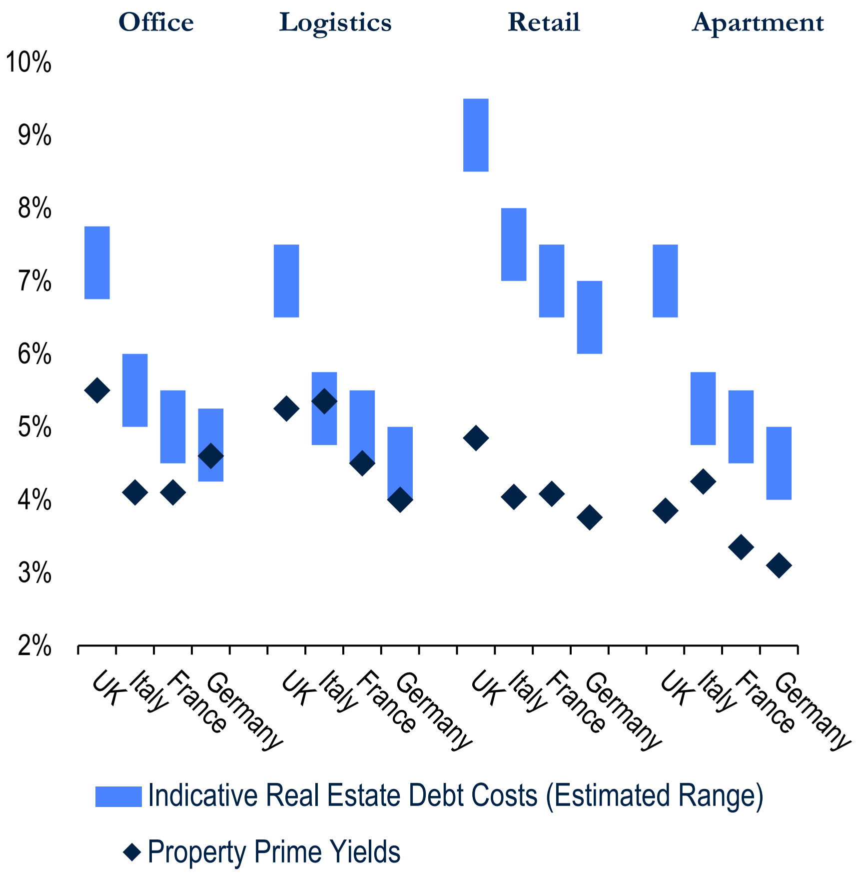
Sources: MSCI, PGIM Real Estate. As of November 2023.

Yield shift is set to act as a drag on total returns until mid-2024, which means annual total returns will remain negative next year.

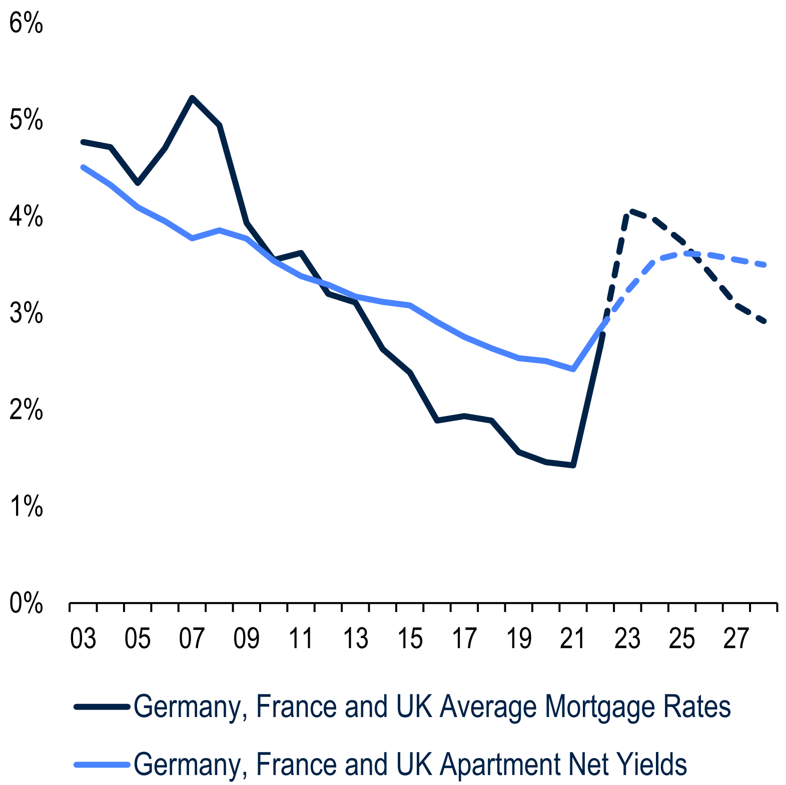
From 2025 onwards, once pricing has adjusted sufficiently, European real estate will once again be in a position to deliver attractive core returns and be competitive for capital versus other asset classes, such as fixed income.

As Elevated Interest Rates Are Putting Pressure on Pricing

Indicative Real Estate Debt Costs vs. Prime Yields



European Mortgage Rates and Apartment Yields



Sources: Oxford Economics, PMA, Real Capital Analytics, CBRE, PGIM Real Estate. As of November 2023.

LEFT

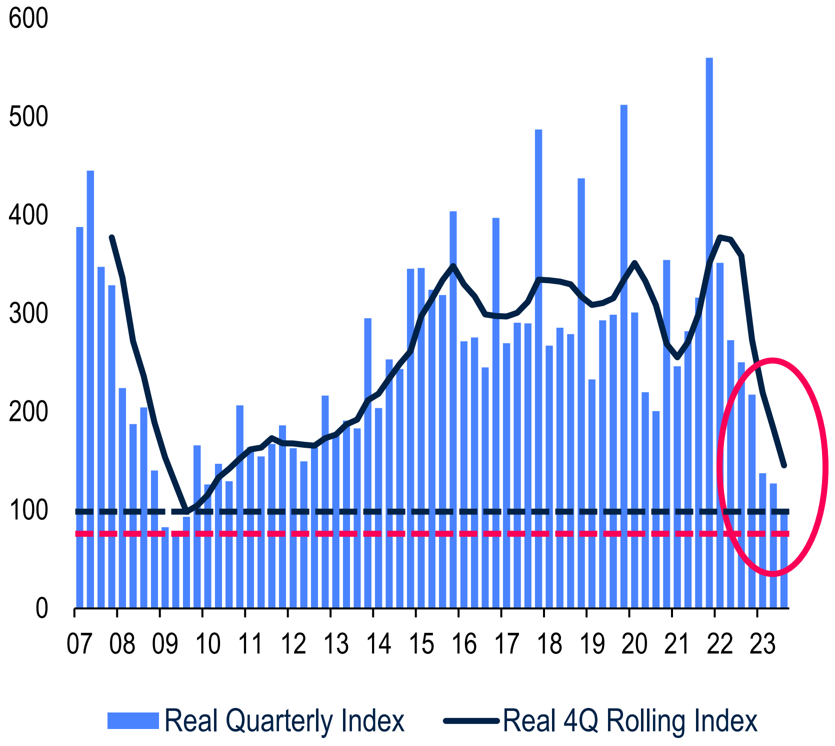
Elevated interest rates are pushing up debt costs, which stand at levels above prime real estate yields across most markets and sectors.

RIGHT

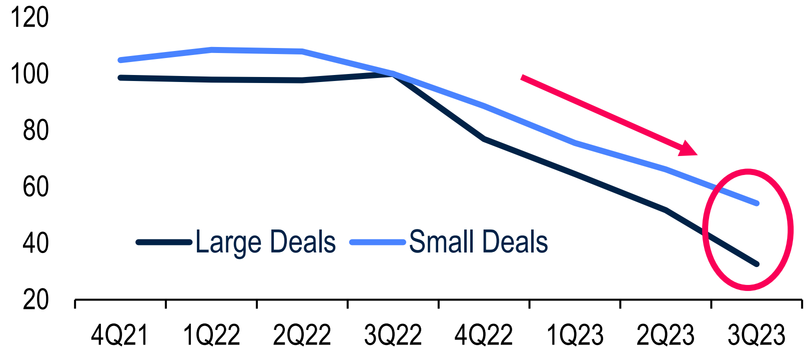
The high spread between debt costs and real estate yields continues to put pressure on pricing, for example in apartment markets in Germany, France and the UK. The outlook is for these pressures to persist into 2024.

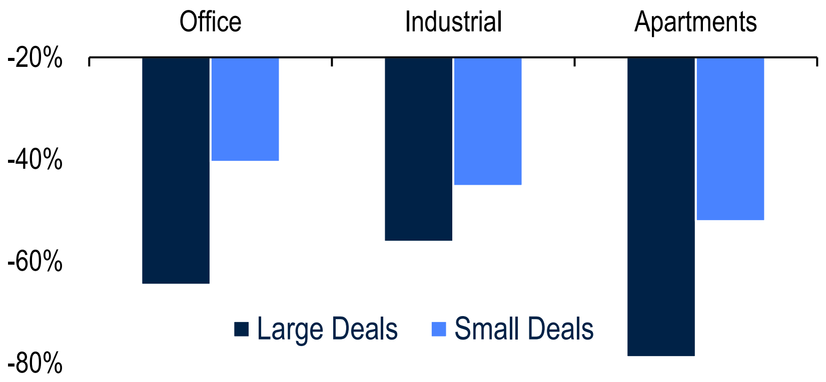
Depressed Transaction Volume Is Threatening to Exacerbate the Downturn

European All Property Transaction Volume Index (Real Volume, 3Q23=100)



Europe All Property ex. Retail Transaction Volume by Size (4Q Rolling, Index 3Q22=100)





Sources: Real Capital Analytics, Oxford Economics, PGIM Real Estate. As of November 2023.

LEFT

As real estate values fall, transaction volume in real terms has pulled back sharply and is close to lows recorded during the global financial crisis (GFC).

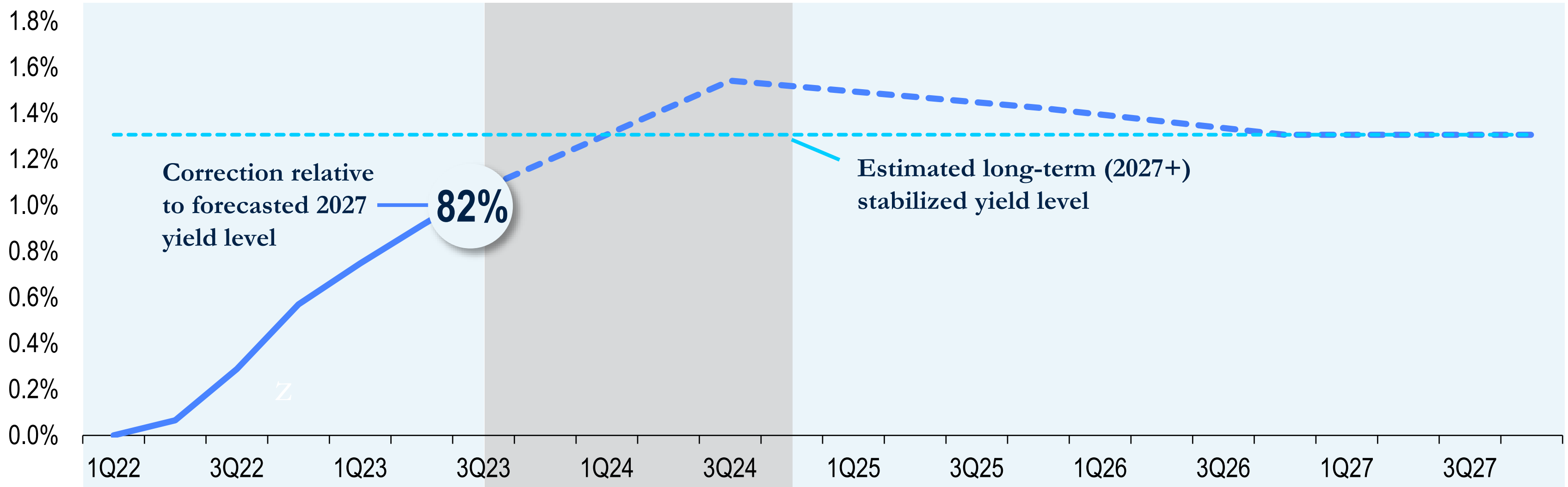
RIGHT

With debt financing hard to secure on attractive terms, large transactions fell the most over the last 12 months.

Challenging conditions for transactions threaten to prolong the downturn and cause an overshooting in the value adjustment process.

Real Estate Pricing Is Falling and Overshooting Is Likely

Cumulative All Property Yield Shift Since 1Q22 (%)



Phase:

Initial Repricing

Markets are adjusting to higher borrowing rates, lower liquidity and higher required returns as returns on other assets, e.g. fixed income, move higher.

Overshooting

Shortages of capital, tight monetary policy and weak economic conditions drive yields above expected long-term equilibrium levels.

Recovery / Stabilization

Real estate values correct to a level that makes them competitive versus other asset classes. Monetary policy starts to be loosened, debt finance availability improves and becomes accretive to returns, transactions start to recover and sentiment toward pricing is also boosted by an improving economic outlook.

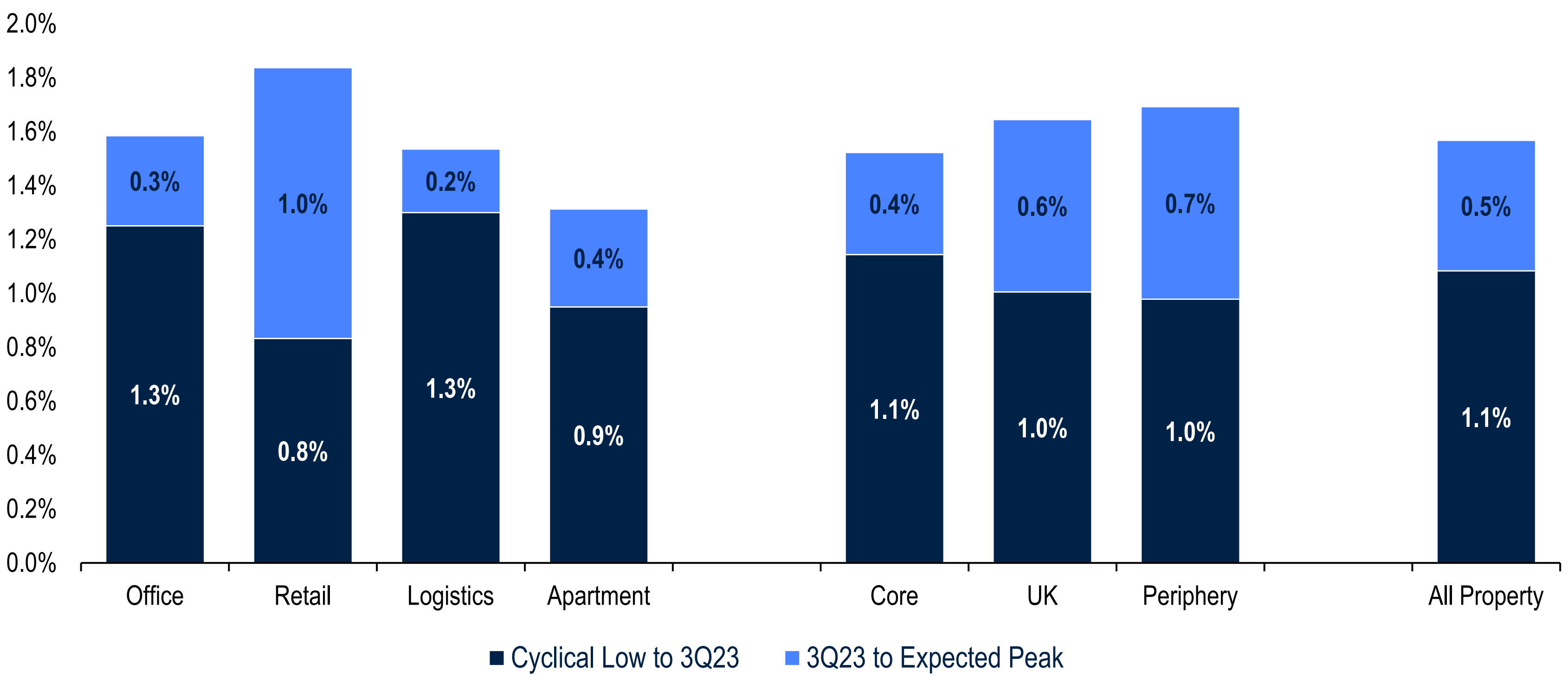
Source: PGIM Real Estate. As of November 2023.

Over the past six quarters, we estimate that, across Europe, 82% of the yield correction required to restore an estimated long-term stabilized yield level has now taken place.

Nevertheless, with interest rates staying higher for longer than initially anticipated and liquidity shortages continuing, overshooting is looking likely in 2024.

But Repricing Has Gone a Long Way in some Sectors – Logistics Close to Fair Value

Yield Correction to Target Acquisition Yield by Sector and Group (%)



Source: PGIM Real Estate. As of November 2023.

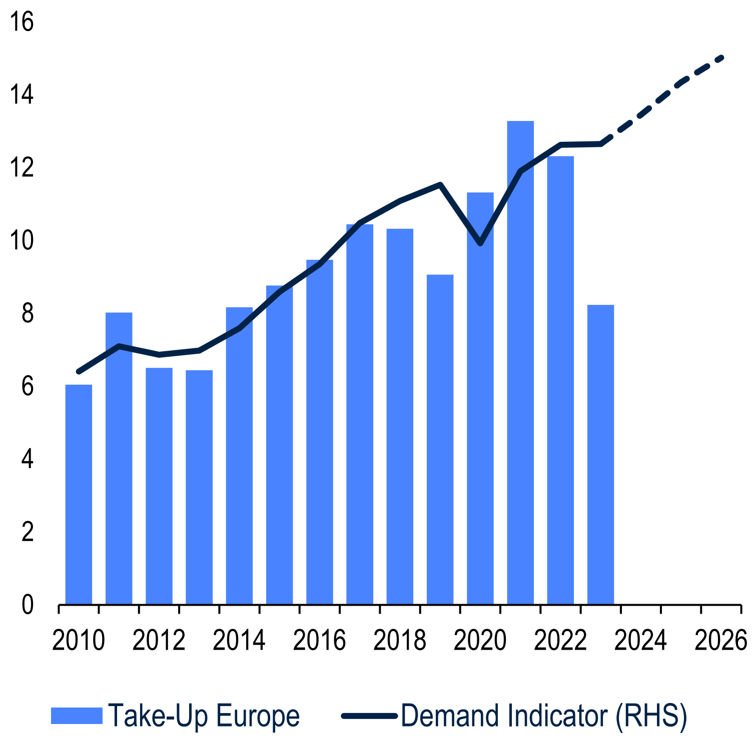
The correction so far has been relatively even across sectors and markets, although logistics repricing is closest to our target, offering an attractive long-term entry point.

While office pricing looks close to fair value, overshooting will be more pronounced due to elevated uncertainty of underlying rental income.

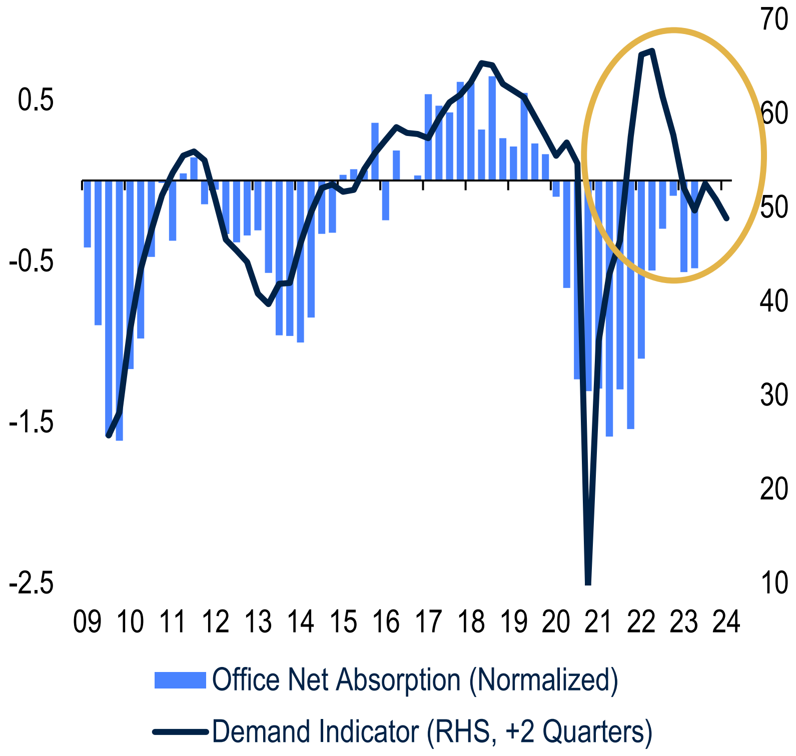
Retail still has a long way to go as the adjustment to rising online sales penetration plays out, especially in continental Europe.

Occupier Markets Holding Up But Outlook Downbeat Outside of Logistics

Logistics Demand Indicator (Index, 2010=100) and Take-Up by Sector (Million square meters)



Office Net Absorption and Demand Indicator



Sources: Oxford Economics, PMA, PGIM Real Estate. As of November 2023.

LEFT

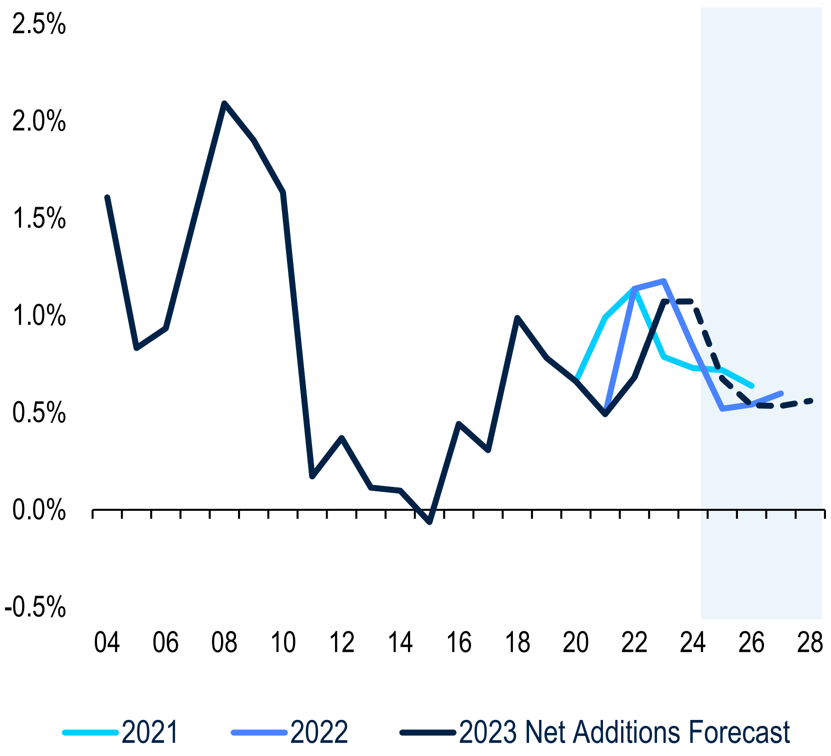
Our demand indicator drivers are pointing to a further pick up in logistics space demand beyond 2023, although take-up has been sluggish this year on the back of slowing economic growth.

RIGHT

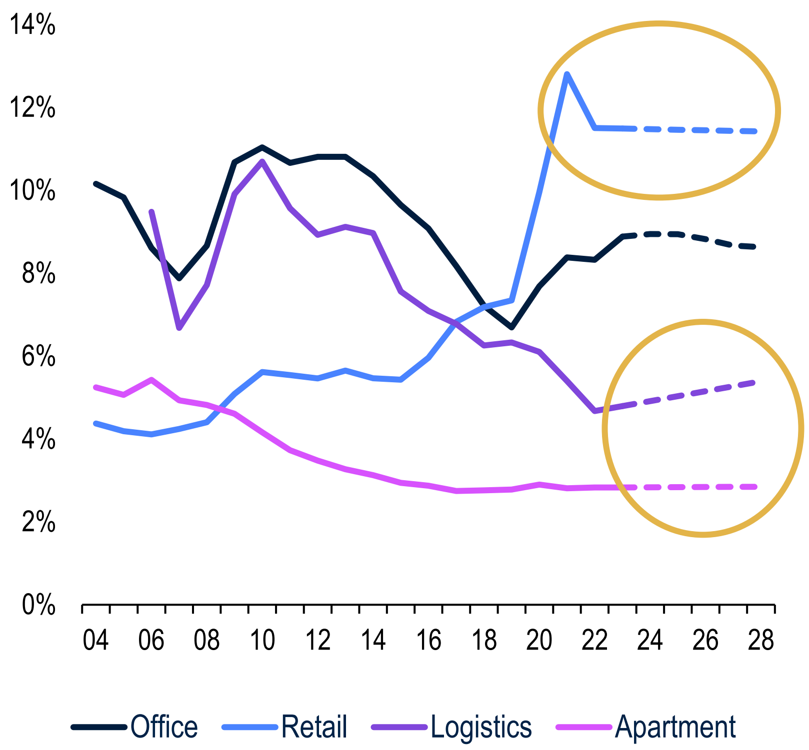
In struggling sectors, including office, net absorption is still well below long-term average levels. Our demand indicator is turning negative as the economy slows and hiring intentions ease.

However, Supply and Vacancy Remain Low Compared to History…

Net Additions as Percentage of Existing Office Stock – Major European Markets (%)



European Vacancy Rates (%)



Sources: PMA, Cushman & Wakefield, MSCI, PGIM Real Estate. As of November 2023.

LEFT

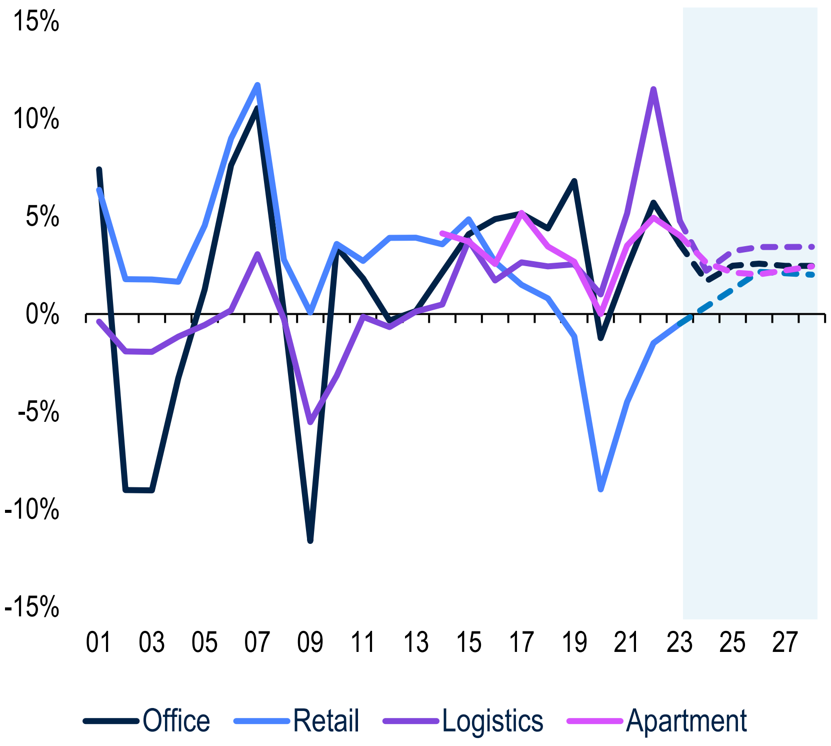
The last cycle was characterized by low building rates, a trend set to continue as developments are put on hold. This is expected to support rent levels despite a subdued occupier demand outlook.

RIGHT

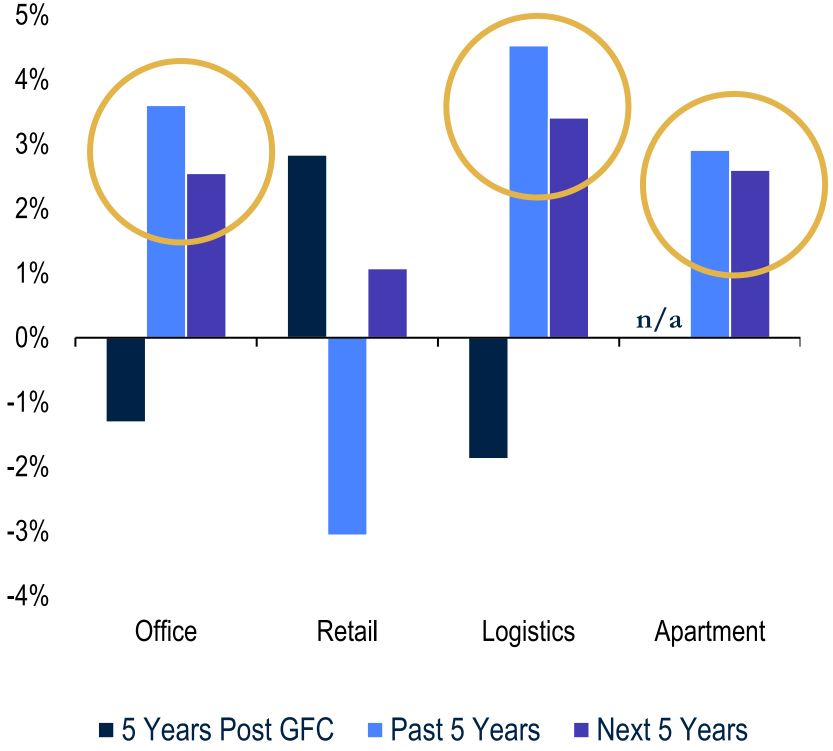
The retail outlook is being hampered by elevated vacancy rates, but office availability remains contained. Logistics and apartment vacancy are set to remain structurally low compared to demand, given constrained construction activity.

…And the Rental Growth Outlook Is Stable, Comparing Favorably to the Post-GFC Period

Headline Annual Rental Growth Forecasts by Sector (%)



Annual Rental Growth After the GFC and This Downturn (%)



Sources: PMA, PGIM Real Estate. As of November 2023.

LEFT

Because the downbeat demand backdrop is set against limited supply and structurally low vacancy, headline rental growth is set to remain resilient, especially in sectors in which landlords can capture the effects of elevated inflation, such as in logistics and apartments.

RIGHT

Looking ahead, the rental growth outlook is for modest growth of 2-3% per year, but this is significantly stronger than compared with the years following the GFC.

INVESTMENT THEMES

Despite the ongoing repricing and likely overshooting of values, some pertinent investment opportunities remain and will emerge. As the value correction gives way for a recovery and growth phase, the opportunity set is expected to grow significantly.

2

DEBT AND EQUITY INVESTMENT THEMES

Dynamic Opportunity Set

	STRUCTURAL			TACTICAL
	Demographics	Digital Transformation	Decarbonization	Mispricing / Short-term Growth
2023-24 Initial Repricing and Overshooting	**Selective opportunities** *e.g. unique assets, deep repricing, forced sellers, strategic acquisitions*			
2025+ Stabilization and Recovery	Affordable housing Senior living Purpose-built student accommodation	Urban & big box logistics Data centers	ESG-compliant offices	ESG-compliant offices Tourism-driven hotels **Retail** *short-term focus on grocery or tourism* Cyclical niche sectors

For illustrative purposes only. Source: PGIM Real Estate. As of November 2023.

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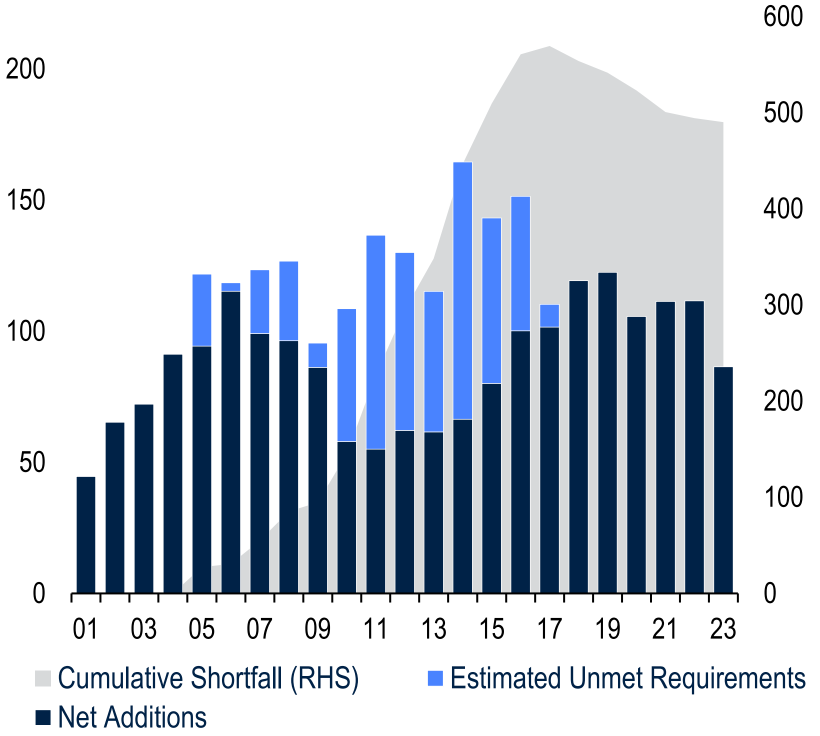
Despite markets correcting and real estate repricing due to higher interest rates, there are some debt and equity investment opportunities under current market conditions based on resilient demand and rental growth.

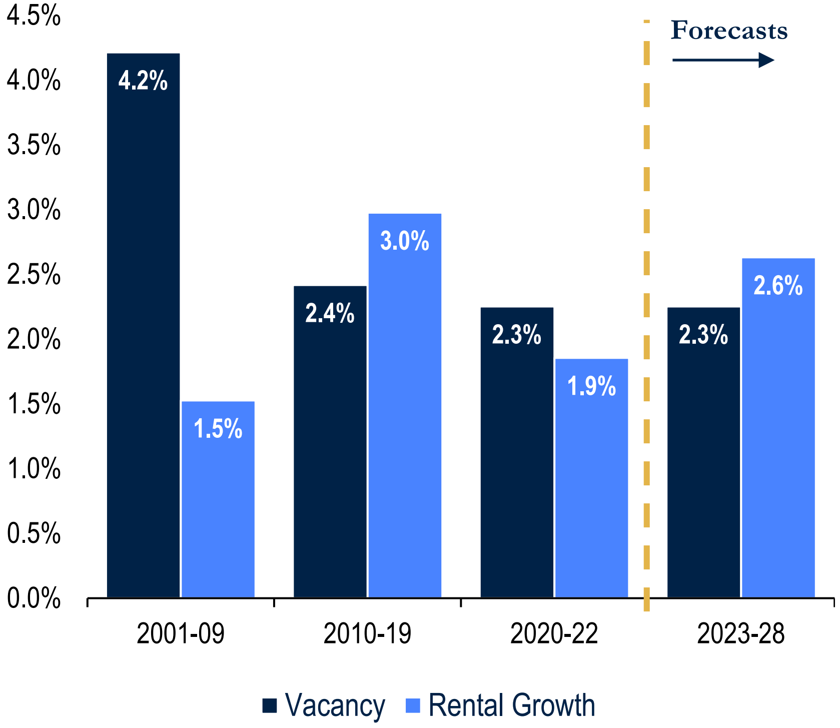
Looking ahead, more sectors will start looking attractive again once the repricing has played out and we enter the "recovery and growth phase."

Residential: Legacy of Supply Shortfall and Low Availability Point to Solid Rental Growth

Net Additions to Housing Stock – Major European Housing Markets (000, Units)



Housing Vacancy vs. Annual Rental Growth by Time Period – Major European Housing Markets (%)



Note: "Major European Housing Markets" comprises Copenhagen, Paris, Berlin, Frankfurt, Hamburg, Munich, Milan, Amsterdam, Madrid, Stockholm, London, Birmingham and Manchester.
Unmet requirements are implied in years in which the growth in the number of households exceeds the change in the dwelling stock.
Sources: PMA, Oxford Economics, PGIM Real Estate. As of November 2023.

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LEFT

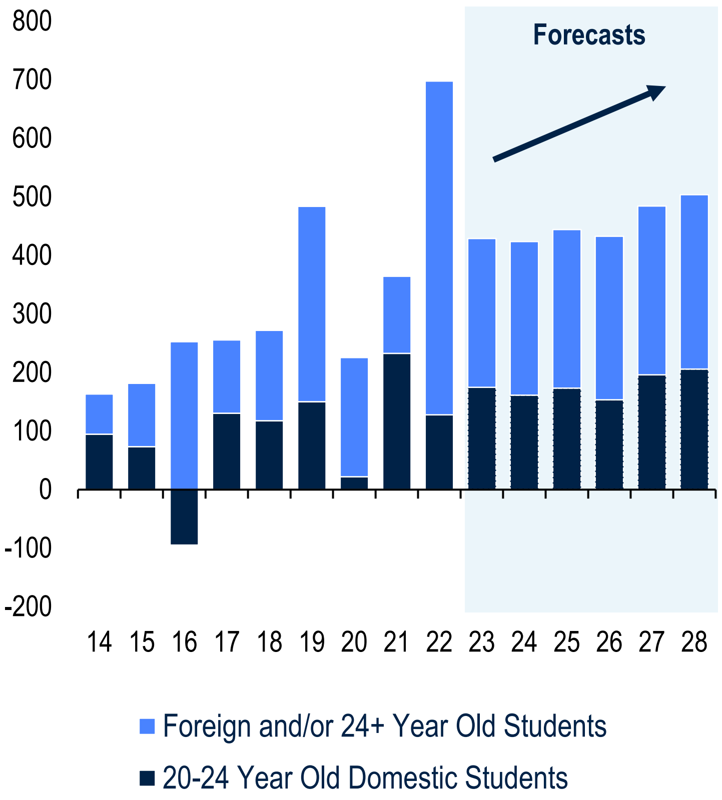
While completions have picked up recently, the supply shortfall that built up through the last cycle remains substantial at 500k units across 13 major cities.

RIGHT

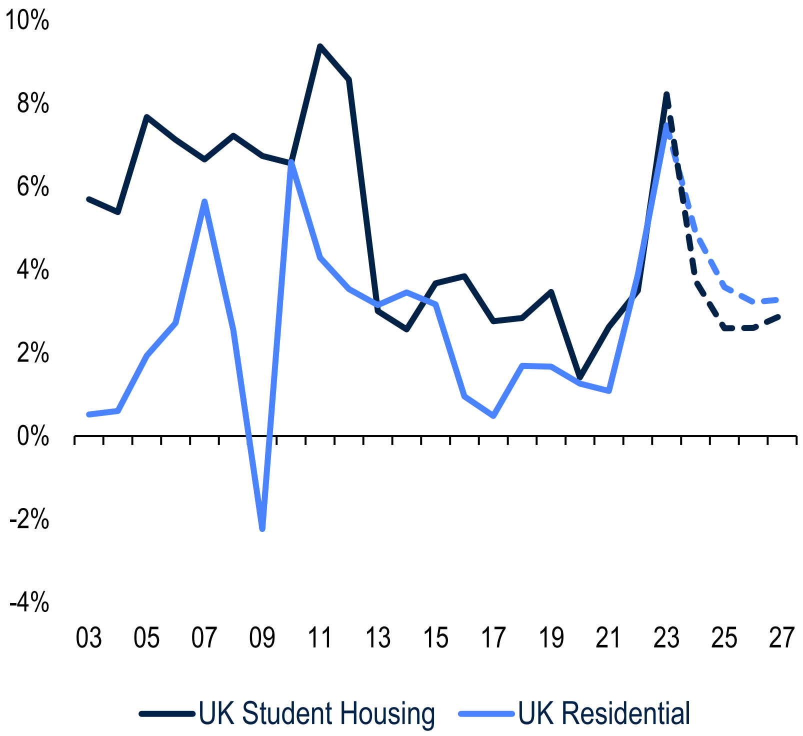
Vacancy has come down by 200 basis points over the past 20 years and is supporting an outlook for a solid pace of rental growth in the next cycle.

Student Housing: Strong Growth Drivers for Student Accommodation Demand

Change in Student Numbers in Europe (000s)



Annual UK Student Housing and UK Residential ERV Growth (%)



Sources: Eurostat, HESA, Oxford Economics, PMA, PGIM Real Estate. As of November 2023.

LEFT

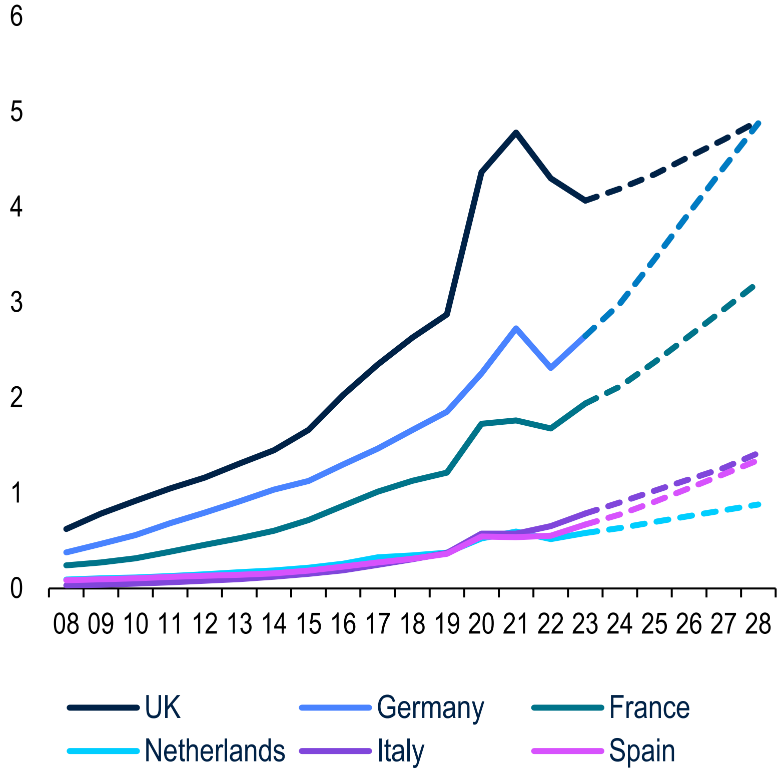
Student numbers are set to rise by over 400k every year on the back of population growth, prolonged studying periods and overseas students coming to Europe for tertiary education.

RIGHT

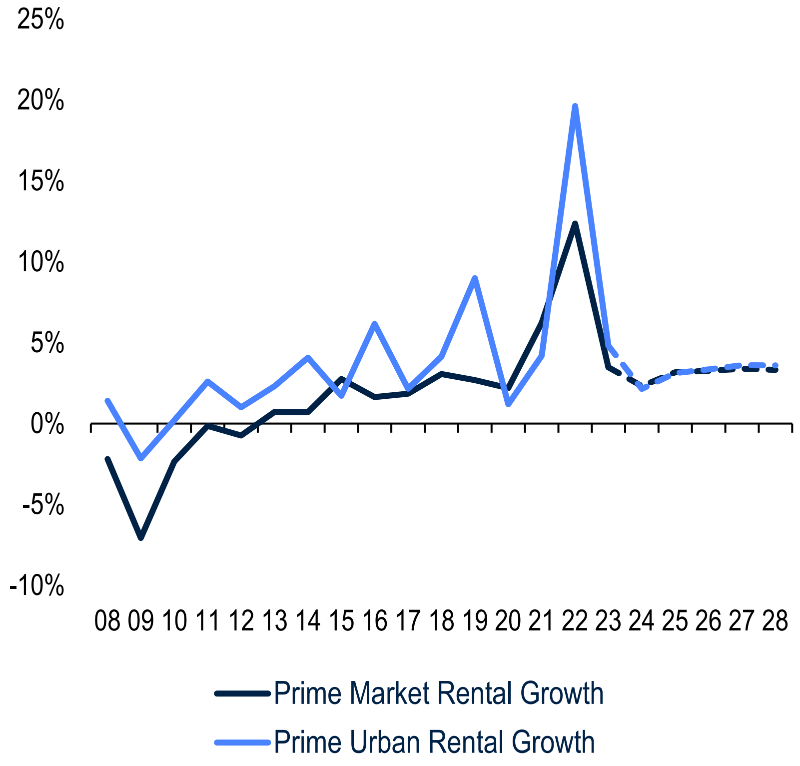
The resilient demand backdrop bodes well for ongoing ERV growth potential of purpose-built student accommodation, following the example of the UK where rents have risen rapidly in recent years.

Logistics: E-commerce Demand Remains a Key Driver for Ongoing Rental Growth

E-commerce Related Urban Logistics Demand (Million Square Meters)



Annual Logistics Rental Growth by Type (%)



Sources: Oxford Economics, PMA, Knight Frank, Eurostat, PGIM Real Estate. As of November 2023.

LEFT

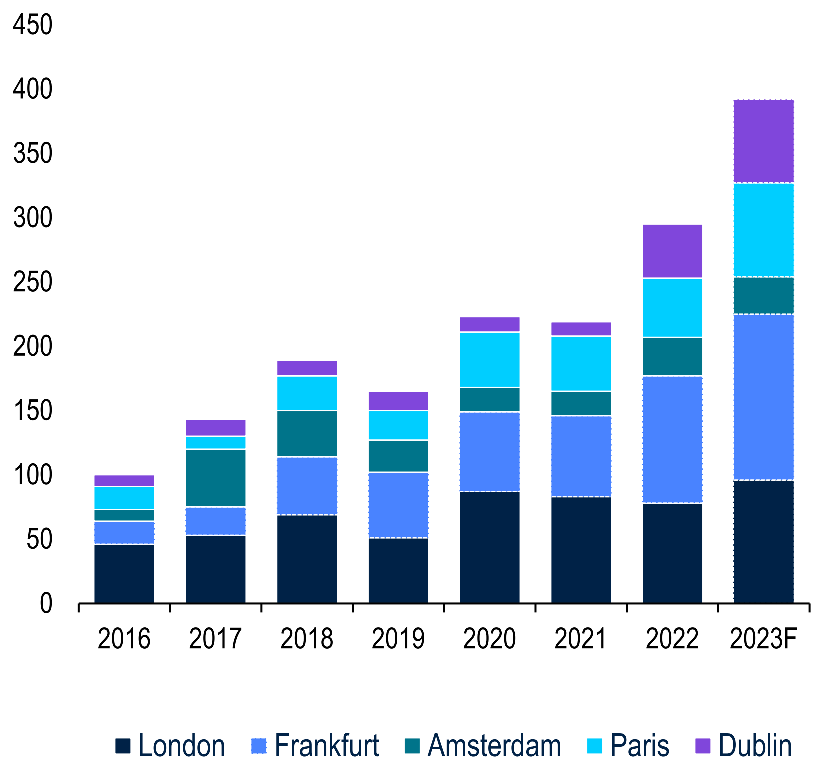
E-commerce related demand requirements are set to increase over time as online spending gains a stronger foothold in less dense, continental European markets.

RIGHT

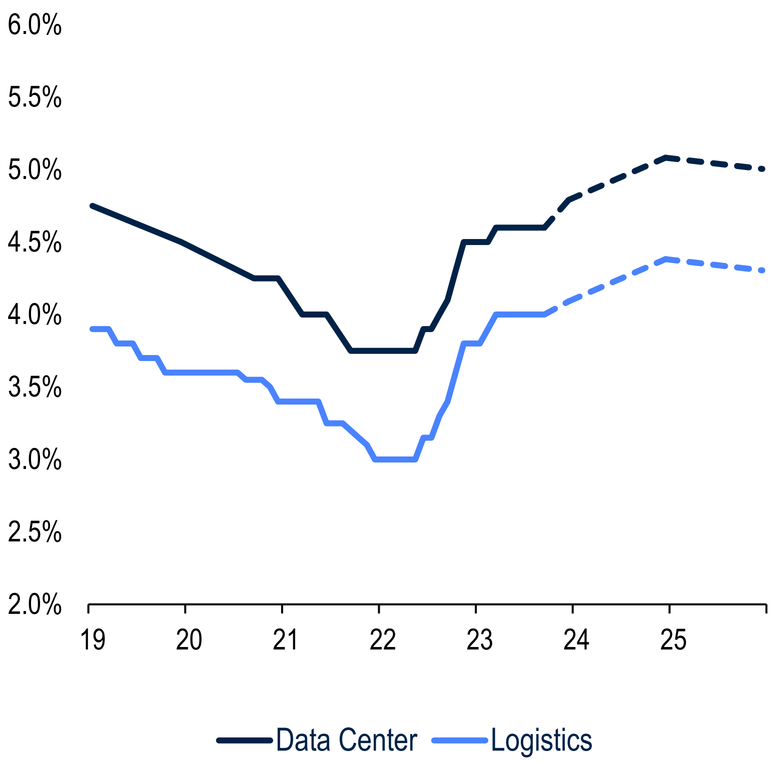
The result of this structural trend playing out is expectations of ongoing, broad-based rental growth across all logistics sub-sectors and geographies.

Data Centers: Strong Leasing Momentum and Pricing Is Set to Look Attractive Again in 2024

European Data Center Take Up (Megawatts)



Data Center Pricing - Prime Yields (%)



Note: German data center and logistics monthly yields are used here as a comparison due to data availability.
Sources: CBRE, JLL, PMA, PGIM Real Estate. As of November 2023.

LEFT

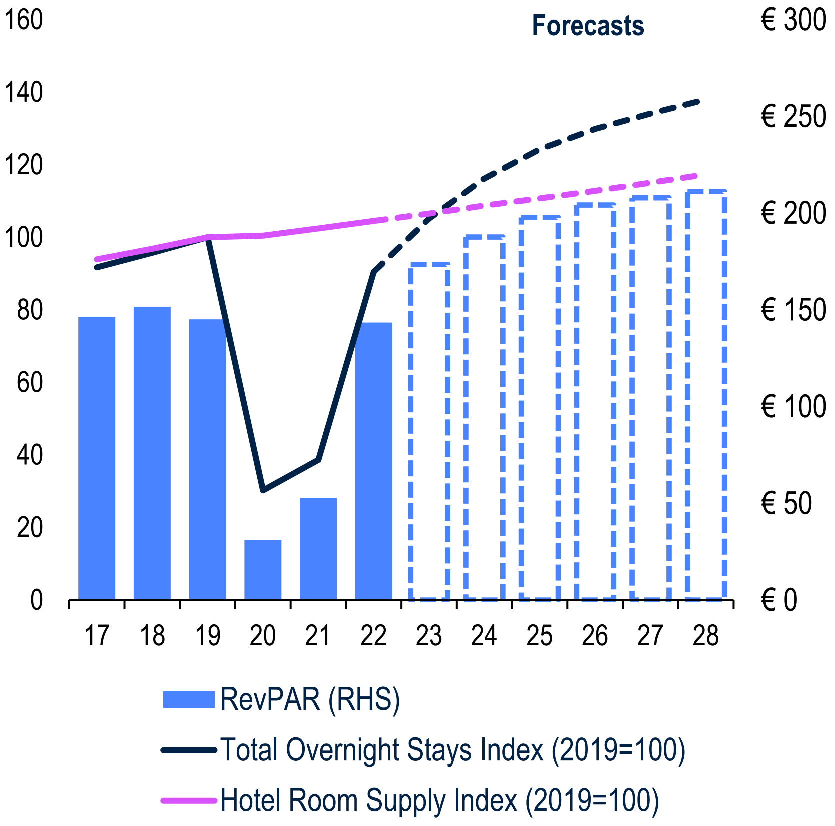
Despite rising efficiency in existing data centers, demand for more physical data center space is rising.

RIGHT

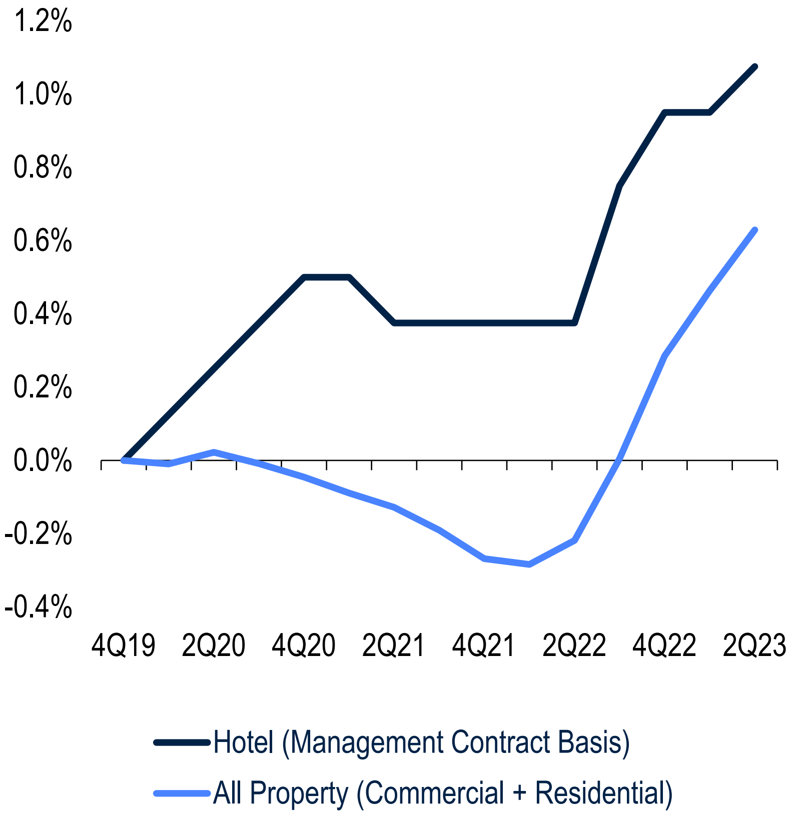
Pricing has already corrected significantly in line with logistics and is set to look attractive again in 2024/25 as yields stabilize.

Hotels: Recovery in Demand Driving Hotel Performance, Supply Growth At Subdued Levels

Total Overnight Stays, Hotel Room Supply & Hotel Revenue Per Available Room (€)



European Hotel Yields Relative to 4Q19 (%)



Sources: CBRE, Eurostat, Oxford Economics, PMA, PGIM Real Estate. As of November 2023.

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LEFT

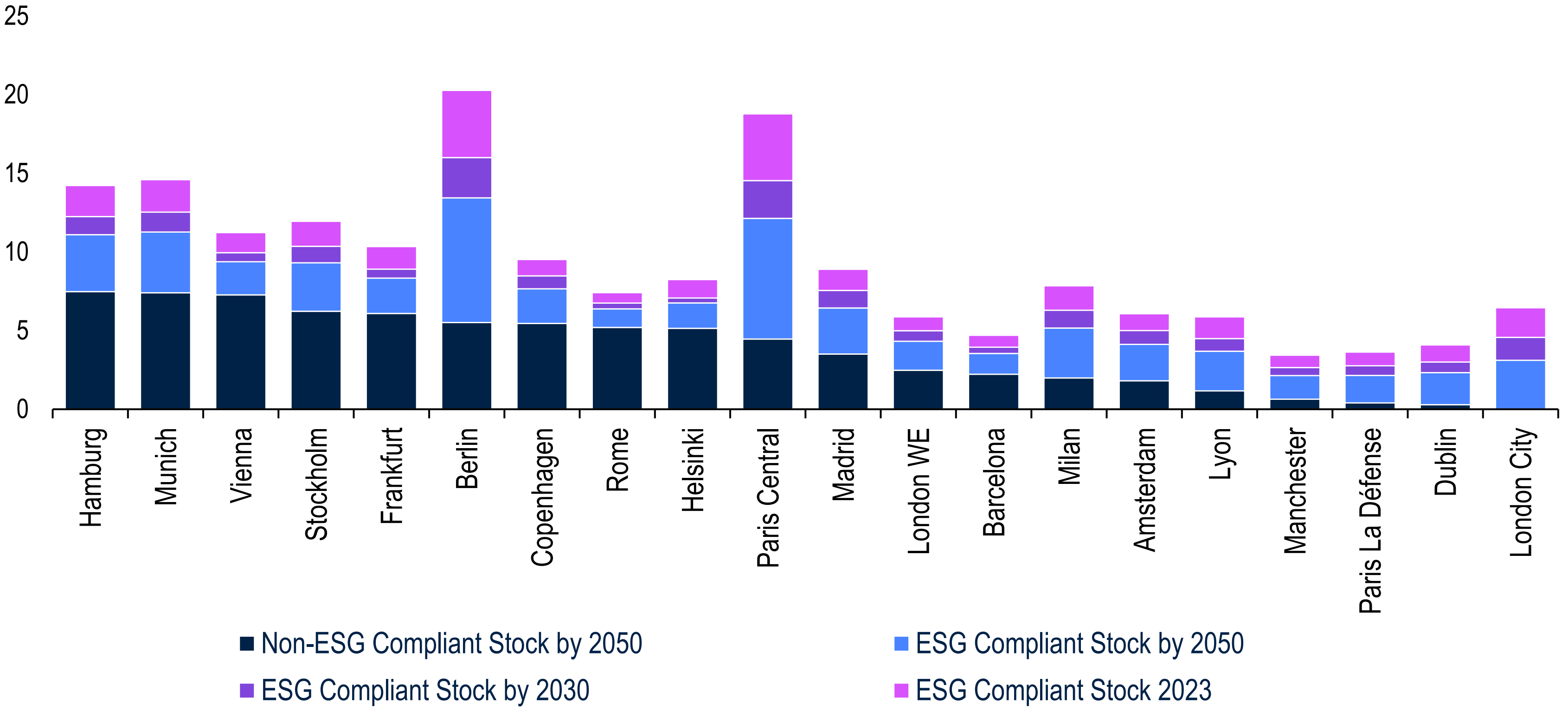
A strong recovery in travel demand since the Covid pandemic is feeding through into rapid growth in revenue per available room (RevPAR), while hotel supply growth is at subdued levels.

RIGHT

Since 2020, the cumulative hotel yield correction has effectively been much steeper than other major property sectors. A relatively attractive entry point is set to support prospects for capital value growth.

Office: ESG Occupier Preferences and Capital Requirements Are Driving Performance

European Office Stock by Year of Becoming "Green" (Million Square Meters)



Sources: PMA, McKinsey & Company, PGIM Real Estate's Bird's Eye View 2021, Real Capital Analytics, Cushman & Wakefield, PGIM Real Estate. As of November 2023.

European office stock is largely old and therefore unlikely to be compliant with modern ESG standards even by 2050.

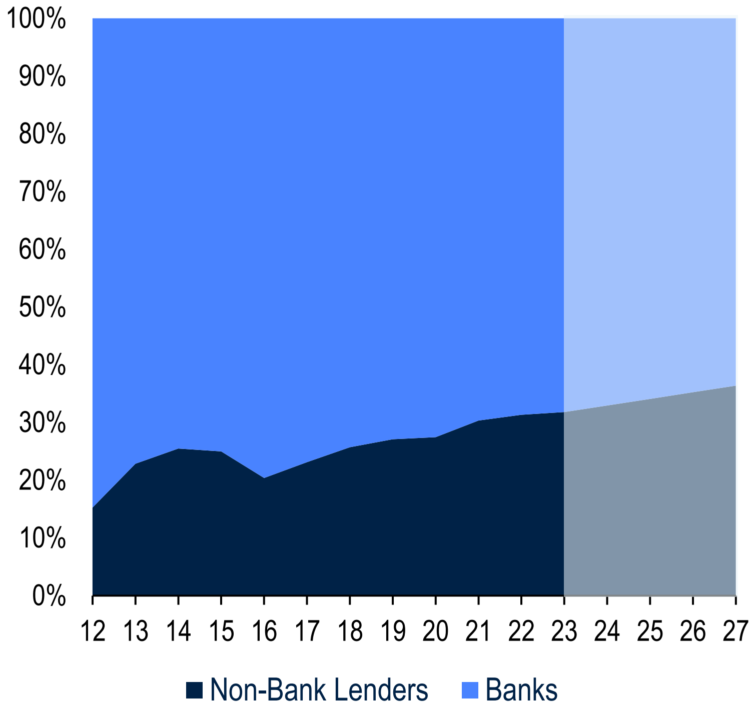
A relatively small percentage of office stock is already ESG compliant or expected to be ESG compliant by 2030 taking into account current completion trends.

Without significantly more capital injections, hardly any European office markets will be compliant with current ESG regulations by 2050.

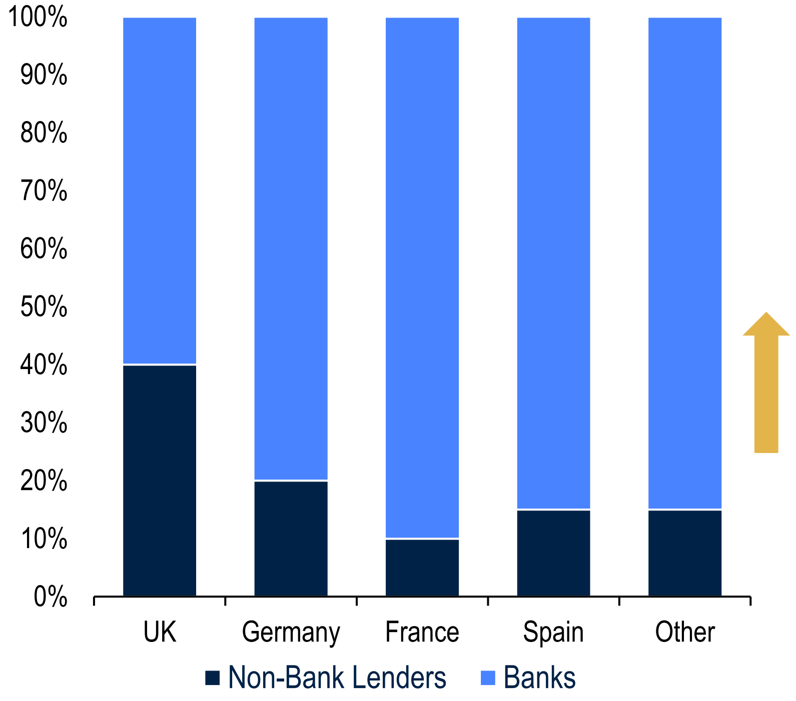
INVESTMENT THEMES

Debt I: Market Share for Non-Bank Lenders Set to Increase

Non-Bank Lenders to Further Increase Market Share of UK Loan Origination[1]



Non-Bank Lenders to Gain Market Share as Regulators Impose Minimum Capital Requirements[2]



[1]Shaded area depicts PGIM Real Estate's estimates.
[2]Market composition of debt outstanding as of 1H 2023.
Sources: European Banking Authority, Bayes Business School, PGIM Real Estate. As of November 2023.

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LEFT

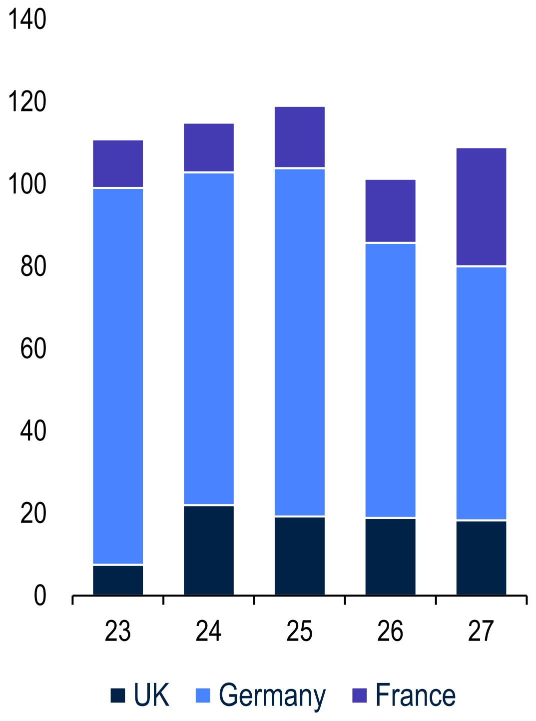
Banks face a more stringent regulatory capital framework as they prepare for the finalization of Basel III (also known as Basel 3.1), which will increase minimum regulatory capital that banks are required to hold against their loans.

RIGHT

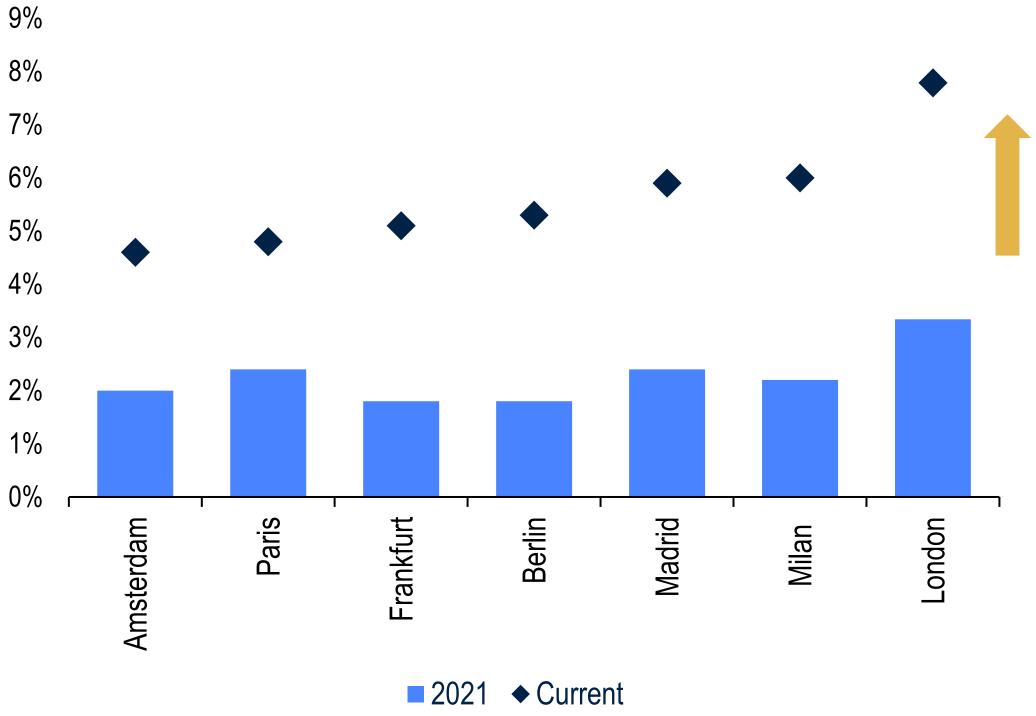
Banks will become laser-focused on strategic positions and key relationships, leaving a market opportunity for non-banks to gain market share.

Debt II: Higher Financing Costs Will Constrain Senior Leverage, Giving Rise to Elevated Interest Income

Loan Maturities Will Face Higher Refinancing Costs[1] (US$ Billions)



Interest Income to Remain Elevated as Interest Rates Stay High With No Sharp Fall Anticipated[2]



[1]Germany includes institutionally held residential.
[2]Refers to fixed rate senior loans on prime assets at 50-60% LTV for Europe and fixed rate senior loans for the UK.
Sources: Bayes Business School, IREBS, IEIF, PGIM Real Estate. As of November 2023.

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LEFT

Loan maturities face higher refinancing costs as borrowing rates and hedging costs have risen sharply alongside base rates. This will constrain leverage as senior lenders focus on debt service.

RIGHT

Higher financing costs also translate into higher interest income for debt investments, which will be at lower attachment points offering attractive risk-adjusted returns.

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