European Commercial – January 2024

SPOTLIGHT
Savills Research

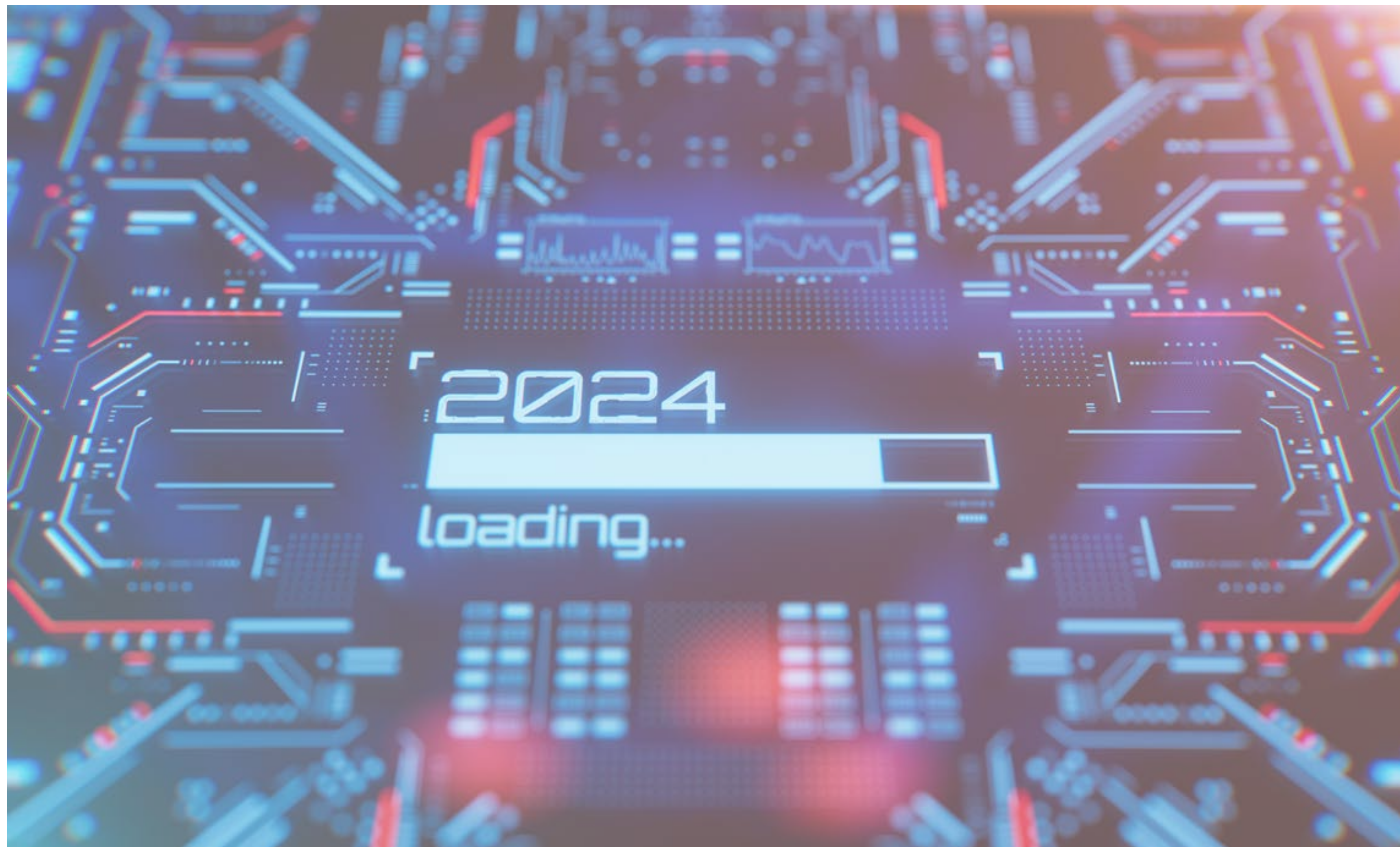
European Property Themes 2024

2023 will be remembered for what was record eurozone inflation, record eurozone interest rates and a year of elevated investor caution, as European investment transaction recorded the lowest levels since the aftermath of the eurozone debt crisis. Higher energy prices dragged Europe's manufacturing economies into a recession, while businesses grappled with rising wage costs amid persistent labour shortages.

The eurozone is expected to record zero GDP growth in 2024 as it emerges from a mild recession in the first half of the year, according to Capital Economics, before expanding by 1.0% in 2025.

Where real estate yields adjust to reflect the higher cost of debt, 2024 will provide opportunities to investors who are willing to secure prime assets at discounts and ride the wave of yield compression in the second half of the year. Investors willing to asset manage secondary into prime by repurposing distressed assets in good locations will also be rewarded.

We hope you enjoy reading our European Property Themes 2024 publication.



EUROPEAN INVESTMENT TOP PICKS

TOP PICKS FOR CORE /CORE+

- **Prime Logistics** markets in the **UK, Germany, Netherlands, France and Spain** will remain appealing to investors, driven by robust rental growth and index-linked rental structures. The market has undergone a structural shift towards stronger demand from occupiers in the long term, with the return of eCommerce tailwinds set to boost demand over the next decade.
- **Prime CBD office** stock with diversified tenant mix in western and southern European markets with low vacancy rates and resilient economic growth prospects, including **Paris CBD, Madrid, London WE, and Copenhagen.**
- **Prime multifamily** in all capital or large cities but increasingly in **Southern Europe**.
- **Small and mid-size grocery stores**, particularly those accommodation discounters, in **all cities** with good connectivity.
- **Prime retail parks across Europe**, in strong catchment areas anchored at least by one large supermarket, as the sector is outperforming all other retail formats and showing strong rental growth.

TOP PICKS FOR VALUE-ADD

- Comprehensive **refurbishment of older CBD office** stock in undersupplied markets to capture rental uplift- particularly markets where EPC regulation has not yet been introduced and a green rental premium will emerge in the coming years, including in **Germany's top six cities.**
- **Modern Logistics** assets with 2-3 years UXT providing the ability to capture market reversion in rents are attracting significant investor interest at present.
- **New PBSA schemes**, due to the continued rise in domestic and international students across the continent, bolstered by increased levels of English language courses. Most particularly in **Southern Europe**, where the level of provision is very low.
- **Life science** in Western Europe as rising demand for digital health has boosted investment into the sector, spurring investor demand for office and laboratory facilities, notably located in the **UK, Germany, France, Netherlands, Belgium or Switzerland**.
- **European data centres** in tiers two cities such as **Prague, Genoa, Munich, Dusseldorf, Berlin, Milan, Cambridge, Manchester and Birmingham** due to fast catching up digital transformation and low cost of land while traditional locations are constrained by power grid restrictions.

TOP PICKS FOR OPPORTUNISTIC

- Nascent Industrial and Logistics sub-sectors, including Industrial **Outdoor Storage (IOS), Self-Storage and Electric Vehicle charging,** are seen as having high potential amongst investors.
- **Repurposing of distressed real estate assets** after strong price correction.

#1 Price discovery

ECB expected to cut rates following Eurozone inflation dip, impacting real estate markets and emphasizing resilient sectors & locations.

Amid Eurozone inflation falling faster than anticipated, European financial markets are expecting an earlier rate cut from the European Central Bank, which sent bond yields into freefall at the end of 2023. 2023 has marked a year of price adjustment, and with economists' consensus that interest rates have peaked at 4.00%, the next question is when the first interest rate cut will come through. Capital Economics is now expecting the ECB to cut rates in April 2024, which will then fall to 2.75% by the end of 2024.

As a result, investors have enjoyed elevated risk-adjusted returns in recent years. However, investors still consider real estate an attractive asset class, as institutional investment allocations to real estate remained stable at 10.8%, according to Cornell University's asset allocation monitor. As interest rate expectations have fallen, the risk premium for investing in prime offices is currently above the long-term average for core European markets, and with a shortage of prime stock available, the IPF forecast office rental growth to exceed the levels recorded pre-GFC. Nevertheless, there remains a gap in buyer and seller expectations, and vendors who bought in 2020/21 are unwilling to sell at a loss.

Debt costs remain well above the pre-2022 levels, and banks can no longer continue to extend existing terms. Credit committees are becoming more selective on the sectors and quality of assets they are willing to lend against in order to manage risk, delaying the investment recovery for office and retail sectors. During H1 2024, we expect core office investors will focus on refinancing existing assets before prime yields gradually begin to compress in H2 2024.

Savills latest European investor survey indicates the most positive sentiment towards the beds and sheds sectors, where we expect transactional activity to return first. Yields moved out fastest in the logistics sector during 2023, and given the positive tailwinds with rising eCommerce sales and nearshoring, we anticipate resilient rental growth prospects will support capital value growth in 2024.

Income returns will be the main driver of total returns, as investors will seek markets where economic growth has been resilient, with an undersupply of prime stock and, thus, rental growth. Value-add investors with dry powder ready to deploy will asset manage secondary assets in prime locations in order to achieve rental uplift as core investors will be more active in H2 2024. Given the UK's relatively fast price adjustment and France's resilient economic growth, investors will focus their attention on core locations.

Motivated sellers are finding the buyer pool is gradually returning, and we anticipate that equity-rich investors who are able to secure discounts for core stock before the competition returns will be rewarded. Among the more active buyer groups will be the newer French SCPIs, European insurance companies, Middle Eastern investors and US private equity firms.

Investors are also increasingly having to consider the latest tenant requirements as occupier markets become more operationally intensive. Access to the power grid for logistics operators, more flexibility and enhanced amenity offerings for office occupiers, and retailer interest shifting towards city centres will intensify the demand for well-located stock across all sectors.

European Property Themes 2024

#2 Energy

Empowering real estate through energy evolution by seizing opportunities amidst challenges.

Energy has been an ongoing topic in real estate for years – in Europe, buildings are collectively responsible for 40% of our energy consumption and 36% of greenhouse gas emissions, which mainly stem from construction, usage, renovation and demolition, according to the European Commission. However, recent shifts in energy dynamics have significantly impacted the real estate sector, prompting responses to mitigate challenges and seize opportunities.

Energy security has emerged as a critical concern, particularly in light of geopolitical tensions and disruptions in energy supply chains. The Ukraine/Russia conflict and subsequent energy price spikes have reverberated across Europe, leading to heightened energy dependency and rising costs. This energy crisis has not only affected operational costs but has also directly impacted real estate development. Escalating energy prices have increased development expenses, while challenges in power grid capacities have led to delays in projects. Instances like London's postponement of new home developments due to electricity limitations and other regions prioritising residential projects over data centres underscore the tangible impact on real estate initiatives.

Yet, this adversity spurs changes, with public bodies and industries growingly pivoting towards energy efficiency and renewable energy adoption to embrace the needed transition. The real estate industry grapples with monumental shifts as ESG commitments drive demand for alternative energy, altering operational practices, and climate change dictates location preferences. Moreover, the changing energy landscape is reshaping investment patterns within real estate. Traditional safe-haven destinations in Europe might witness a shift in investor interest due to varying energy reliance and renewable energy adoption across regions. Economies with more independent energy sources or stronger renewable energy infrastructures are expected to navigate these challenges more adeptly, potentially altering investment flows within the European market.

While minimum performance standards and building codes progress, meeting Net Zero Emissions (NZE) targets require accelerated transitions. Operational energy usage remains a significant slice, demanding drastic measures for all new buildings and substantial portions of existing ones to be zero-carbon-ready by 2030. Global venture capital (VC) investment in c lean energy start-ups developing building technologies increased threefold since 2020 and reached 1.07 billion USD in 2022. Among early-stage start-ups, construction and renovation (nearly 40%) and energy management and control systems (33%) were the top areas for building VC investments in 2022. Smart, connected buildings leveraging IoT, AI, and ML will increasingly support the optimisation of energy management.

In 2022, the total building floor space in Europe was estimated at 384 million sqm, of which roughly 75% is energy inefficient, according to the European Commission. The International Energy Agency (IEA) estimated that the floor area in advanced economies will increase by approximately 10% by 2030. Hence, to get on track with the NZE Scenario, the energy intensity of the building sector needs to decline nearly five times more quickly over the next decade than it has in the past decade. This means the energy consumed per square metre in 2030 must be around 35% less than in 2022.

#3 AI

AI's transformative potential revolutionizes real estate, driving efficiency, enhancing productivity, and reshaping demand dynamics..

For decades, AI (Artificial Intelligence) straddled a strange line: simultaneously on the cusp of upending life as we know it, yet also a distant and futuristic technology, the stuff of science fiction. In the last year, AI has veered sharply into the former, with the rapid proliferation of generative AI, especially ChatGPT, igniting a new arms race amongst Big Tech. Like any nascent technology, accurately predicting the impact and speed of adoption is difficult: While many businesses started utilising the internet in the 90s, many companies didn't have a website until the mid-00s. That said, it is clear that 2023 was a year of explosive technological advance in the sector and adoption in the mainstream is underway.

Weak labour productivity growth has plagued Advanced Western economies for decades, negatively affecting overall economic wealth and contributing to rising national debts and declining quality of life. In a recent IMF report on the potential outcomes for labour productivity, a low growth and a high growth scenario are considered:

In a low-growth scenario, AI is used as a substitute for labour, displacing labour into less productive and less dynamic jobs. Under pressure from constituents, politicians may opt for policies that curtail the adoption and development of AI rather than channelling its use as a tool to complement labour.

In a high-growth scenario, AI complements labour, speeding up repetitive, non-creative tasks, such as calendar management, data entry and document summarisation. Workers would, in turn, spend more time focusing on more non-routine, creative and inventive tasks such as problem-solving, idea generation and client-focused engagement. AI can embody tacit knowledge of information across individuals, firms and industries, allowing firms to communicate and apply that knowledge. This would reduce the gap between skilled and unskilled and experienced and inexperienced workers, improving productivity. AI is set to significantly influence the landscape of retail, office, and logistics real estate across various aspects. Notably, in the instance where AI is used as a complement to labour and helps to improve labour productivity, we could see a secular shift in demand as the standard of living improves in economies where it is well implemented.

In a high-growth scenario, retail would benefit from increased demand, as AI-powered tools make it easier to analyse customer behaviour, preferences and purchase history, driving engagement and spending and capturing additional discretionary spending. Predictive analytics would streamline inventory management, optimising stock levels and implementing AI-driven checkout systems, potentially reducing the need for extensive storage areas and checkout counters.

There is clearly a downside risk to office demand, given that many routine, process-driven roles could be automated. However, AI is expected to have a net positive impact on high-skilled, professional employment, according to PwC- businesses will ultimately invest more in upskilling and reskilling staff in order to ensure they are able to effectively utilise AI solutions and enhance productivity.

Like the retail sector, AI will allow logistics occupiers to fine-tune their supply chains, predict demand, and optimise routes and warehouse operations. This could lead to a greater emphasis on strategically located warehouses over the larger distribution centres that have become central to many occupiers' strategies.

Additionally, AI will dovetail with automation in warehouses. This will reduce the need for less skilled manual labour but will dramatically increase the need for technicians and engineers. As occupiers automate their warehouses, they will increasingly need to secure greater capacity from energy grids and modern logistics units to accommodate novel layouts in their warehouses.

Overall, AI's influence on real estate is likely to manifest in more efficient space utilisation, agile design, and technology-driven advancements, transforming traditional approaches to planning and utilising real estate spaces. While space is expected to be used more efficiently, potentially reducing occupational footprints, an increase in labour productivity could drive greater consumption as living standards rise, offsetting this decline in demand.

#4 ESG

ESG regulations reshape real estate with compliance challenges, rental impacts, and economic hurdles ahead.

The theme of ESG is becoming increasingly present within the real estate sector, and in 2024, we expect this to heighten. The most important regulation affecting European investors and landlords in the industry is the Energy Performance of Buildings Directive (EPBD), an EU-wide legislation requiring member states to reduce the energy consumption of buildings in a bid to meet net-zero targets. As part of this, all commercial buildings in the EU will require a minimum Energy Performance Certificate (EPC) 'E' by 2027 and 'D' by 2030.

Though, while 2023 was characterised by a high interest rate environment and higher than usual inflation levels, which may have led to investors and landlords re-thinking capital expenditure budgets for ESG improvements, tightening European and UK regulation will mean many are forced into upgrading assets to avoid the risk of obsolescence. With many buildings not currently meeting EU regulations, there is a risk that such assets will be unlettable.

In addition to environmental regulation, new directives from the European Union mean that real estate firms will need to start reporting on their social and environmental impact under the Corporate Sustainability Reporting Directive from 2024.

Regulation, the risk of obsolescence, and sustainability are expected to only increase in importance in the future. But while the PwC 2024 emerging trends in real estate Europe notes that nine out of ten respondents believe ESG will have the biggest impact on real estate by 2050, fifty-four percent of respondents in Europe expect compliance to be a challenge. Firms need to be equipped with the data, processes, and internal controls in order to be compliant, which will require future investment.

Despite the challenge, green-certified office buildings provide a competitive advantage in the market and can experience increased occupier demand from firms adhering to corporate sustainability targets. Savills' rental growth analysis indicates that prime rents (reflecting the highest achievable rents) are outperforming the top quartile of MSCI rents. Comparing 2023 to 2019, the top quartile of MSCI rents have grown by an average of 6%, while Savills average prime rents have grown by an average of 15%. Clearly, the definition of 'prime' is becoming more selective in key European cities as demand intensifies for the very best space.

Whilst at the country level, governments will introduce their own regulation, corporate occupiers will demand a minimum green rating as part of their ESG strategy, which will impact office space in all geographies. As a result, the percentage of take-up of ESG-compliant buildings is expected to increase over the years and investors will be able to anticipate this by increasing the availability of these kinds of properties.

Certainly, investors view properties that have achieved the highest green rating as more resilient due to their faster leasing velocity, future-proofed against further tightening regulations, ability to secure debt and lower liquidity risk upon disposal. This increased demand and competition among occupiers to sign for such buildings can lead to higher rental growth in markets where there is a lack of availability, causing rents to diverge from non-compliant assets.

However, despite the benefits, one of the main barriers to upgrading standing stock to meet regulation is higher construction costs. In times of economic downturn where investment levels are at record lows, ESG retrofits may be delayed or scaled back.

Where retrofits or new constructions are taking place, the letting velocity of office buildings which have been constructed with ESG requirements in mind are expected to let at a faster rate than older, non-compliant stock in some markets. In markets where there is stricter environmental regulation, such as in London, Paris and Amsterdam, there may not be any added value in terms of the speed of letting, but rather these buildings will be able to be let at all.

Savills Commercial Research
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