EUROPEAN PROPERTY MARKET

NAVIGATING THE RECOVERY

OUTLOOK **H2 2024**

RESEARCH & INSIGHTS

BNP PARIBAS REAL ESTATE

Real Estate for a changing world

CONTENT

BNP PARIBAS REAL ESTATE

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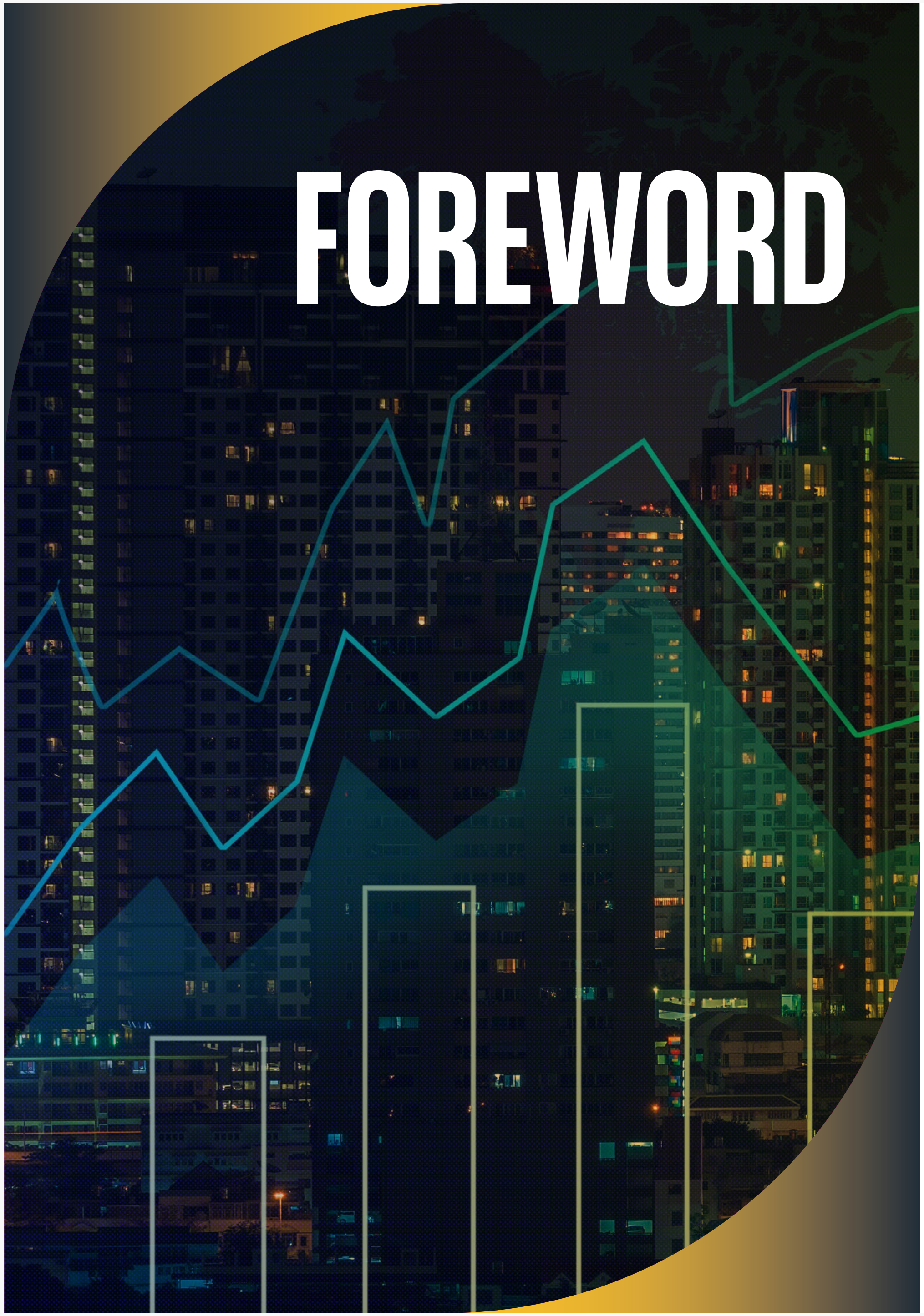


FOREWORD

CALM APPEARS TO HAVE DESCENDED UPON EUROPEAN ECONOMIES. MOST ARE GROWING AGAIN AND THE HIGH LEVEL OF INFLATION SEEMS TO BE IN THE REAR VIEW MIRROR. AS A RESULT, CENTRAL BANKS HAVE ENTERED INTO A POLICY EASING CYCLE WITH IMPLICATIONS FOR DEBT COST AND REAL ESTATE MARKETS.

Despite various geopolitical events, the prevailing view is that they are no longer having significant global economic effects, with most economies avoiding a hard landing. Additionally, consumer and business confidence indices are edging back up across most of Europe. One reason is that inflation rates in most countries have fallen significantly from their highs and are now stabilised around the target. This paves the way for monetary authorities to start reducing policy rates. Whilst the pace of cuts in interest rates remains clouded in uncertainty, we expect them to settle at a higher level than we have seen in the recent past.

Consequently, as the real estate market recovers from the significant adjustment of the last two years, some of the value destruction observed will be crystallised and the investment landscape that emerges will look different. First, institutional investors responsible for core money in the market have seemingly withdrawn from real estate and rotated back into fixed income. This has implications for turnover of investment activities. Second, with high interest rate debt strategy has become attractive, causing an increase in the number of investors in this segment of the market. Third, investors' appetite for the living (Residential, Hotel and Student Housing) and niche (Data Centres, and Life Sciences) sectors are growing at the expense of cyclical sectors (Offices and Retail).

The implications of these developments for the outlook of European real estate markets, amidst a renewed economic cycle, is the focus of this report. For the occupational market, overall demand for space in most sectors remains strong but concentrated in specific segments. In the case of Offices, this is in prime assets that are ESG compliant and located mainly in CBDs. The strong demand for Logistics over the pandemic period appears to have tapered off but new Logistic supply remains limited; hence there remains a good balance in the demand and supply dynamics. For the Retail sector, we see an uptick in demand for physical space in the luxury and mid-market segments. These developments, including improved economic conditions, mean we are forecasting above inflation rental growth in prime assets. We believe the investment market has bottomed out and will remain stable until the end of the year. Thereafter we expect values to increase. However, we expect yields to be stickier in coming down than it has been in past recoveries and the desirability of the asset classes shifting in favour of the living sectors. Above all, real estate remains an attractive asset class.

Samuel Duah
Head of Real Estate Economics
Research & Insights

EUROPEAN REAL ESTATE PERSPECTIVE

NAVIGATING THE RECOVERY

by Samuel Duah

After a torrid two years for European commercial real estate (CRE), when annual transaction volumes halved in almost all markets, we are beginning to see the light at the end of the tunnel. Pricing has begun to stabilise, following a sudden and sharp increase in policy and market interest rates.

As the market emerges from this difficult period, we think that this recovery will differ from past recoveries in several ways. First, investors are turning increasingly towards operational real estate, such as the Living sector, at the expense of cyclical assets such as Offices. Moreover, with higher interest rates, debt fund is becoming more attractive. Second, long-term interest rates have risen and are unlikely to return to the lows of recent years. This has driven institutional investors such as pension funds out of the market, withdrawing the primary source of core money. Third, the new landscape is likely to be characterised by increased volatility, leading to shorter real estate cycles.

Recent volatility in Equity markets **(see Exhibit 1)** shows us that real estate investors will have to build multiple cycles into their strategy rather than the simple buy and hold structure they may have become accustomed to.

TENTATIVE RECOVERY IN INVESTMENT VOLUMES

Over the first half of 2024, investment in European CRE reached €74bn (+7%, compared to H1 2023), with the boost to activity coming mostly in the second quarter of the year. Although still lower on a rolling annual basis, the market appears to have bottomed out.

Sentiment has generally seen a marked positive shift with increases in activity in most of Europe. Italy recorded the largest growth, with transaction volumes reaching €3.2bn (+55%, compared to same period last year), albeit from a low base. The UK came in at €27bn (+8%), Germany €12.2 bn (+34%) and Spain €4bn (+3%). The only core market to see activity fall was France, at € 5.9bn (-29%).

Unusually, the early stage of the recovery has not been led by Offices. While transaction

EUROPEAN ALL PROPERTY: PEAK TO TROUGH FALL IN VALUE

-21%

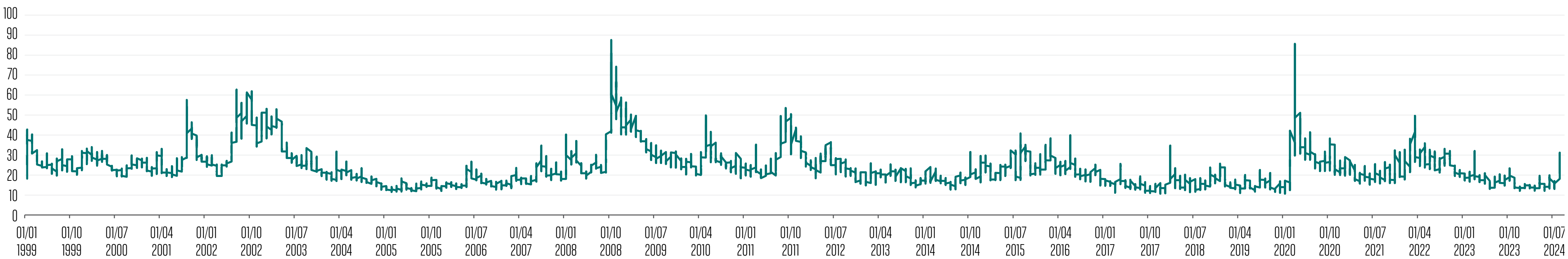
EXPECTED INCREASE IN ANNUAL EUROPEAN INVESTMENT VOLUME IN 2024

+22%

EXPECTED ANNUAL EUROPEAN ALL PROPERTY TOTAL RETURN OVER THE NEXT FIVE YEARS

+8.3%

Exhibit 1: STOXX 30 Volatility Index (VIX)



Source: Macrobond

volumes in the first half of the year fell in the Office sector (-11%), they rose in Retail (+6%), Logistics (+6%) and substantially in Hotels (+56%). The poor performance in the Office sector can be attributed to two key factors. First the ongoing structural change around remote working has made investors cautious about investing in the sector. Second, the high cost of debt makes leverage (a key component of deals in this sector) expensive.

For 2024, we are forecasting volumes to rise to €170bn (+25%, compared to 2023). A similar level of growth is expected in 2025, when volumes are expected to reach € 210bn **(see Exhibit 2).**

Risk-free rates have repriced in recent years, alongside the sharp increase in policy rates. Although we are now at the foothills of a policy easing cycle, we doubt a return to the lows of post GFC. This implies risk-free rates will also remain elevated and attractive to core institutional investors, who have lately found refuge in real estate in order to meet their liabilities. As such there is a meaningful pool of investors who have withdrawn from the real estate market for now, which will have a negative impact on the level of activity that can be achieved over the next few years. We don't see the overall volumes of European CRE transactions reaching their pre-COVID highs in the near term.

STABLE YIELDS IN 2024

The shift in sentiment seen in 2024 comes on the back of broader stability in the macroeconomy, with high inflation receding. As a result, the European Central Bank (ECB) cut its policy rate in June 2024, followed by the Bank of England (BoE) in August. These encouraging actions are positive for assets classes sensitive to interest rates, such as CRE.

"We expect European property yields to remain broadly stable until the end of the year."

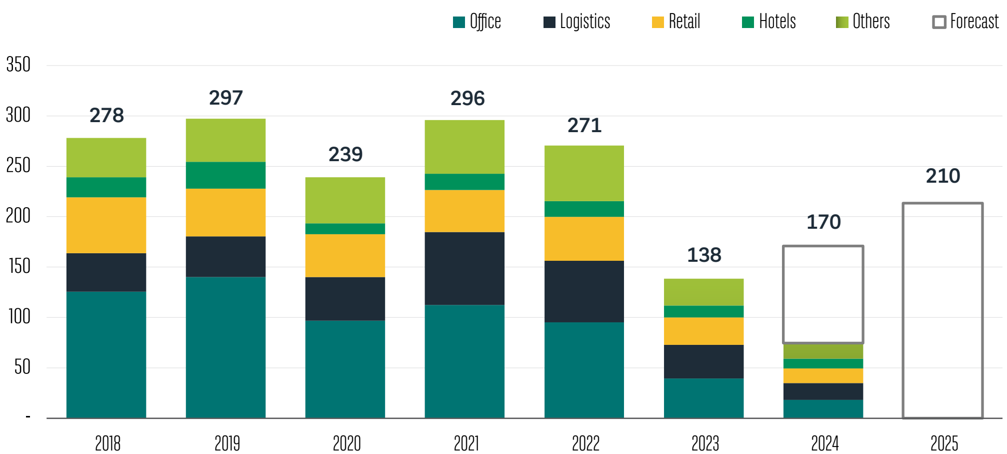
Despite these moves, market participants are unclear on the pace and magnitude of interest rate cuts, particularly in 2024. As such they remain cautious and the gap between buyer and seller expectations on price remains significant. The remainder of the year is shaping up to be a period of stasis for yields on prime assets in European markets. Conversely, yields on secondary assets could continue to decompress. At the end of H1 2024, the composite European prime yield for Retail stood at 4.40% (3.6% in 2022), Logistics 4.7% (4.2% in 2022) and Offices 5.0% (3.8% in 2022). These yields have been stable since the start of the year and are likely to remain so until the end of 2024.

We expect yields to start declining from the end of 2024 and through the five year forecast period, as the easing in policy and market interest rates gathers pace **(see Exhibit 3).** It is unlikely that yields will return to their recent lows with core investors staying out of the market and risk-free rates remaining higher.

NORMALISATION OF LOGISTICS RENTAL GROWTH

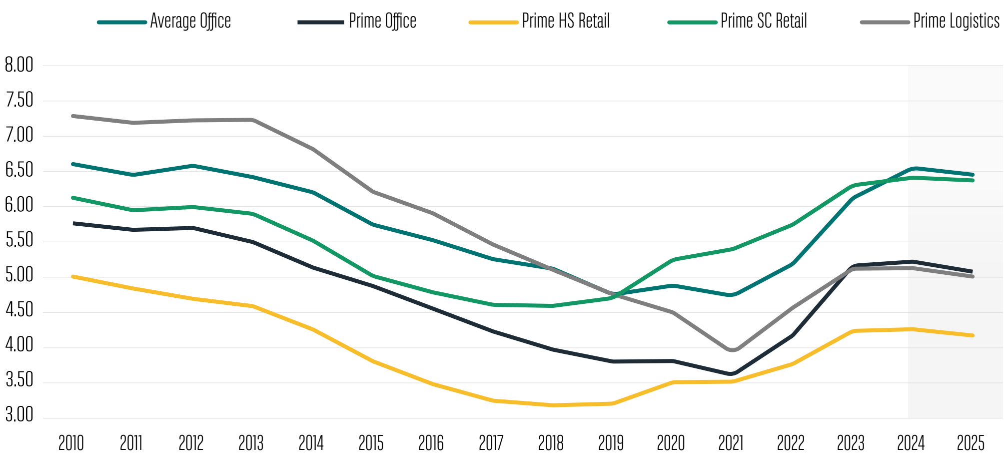
Logistics take-up reached 8.8million sqm over H1 2024, which was 5% down on H2 2023 in the six main European markets. The sector remains

Exhibit 2: European Investment Volume (€bn)



Source: BNP Paribas Real Estate August 2024

Exhibit 3: Average European Yields by Sector (%)



Source: BNP Paribas Real Estate August 2024 some way off the exceptional volumes seen in 2021 and 2022. A return to these levels may not be readily forthcoming.

Although demand for space remains strong in most markets, rental values have grown significantly over the past three years, in some cases leading to affordability constraints for occupiers. This is one reason why we expect future rental growth to be slower.

We are beginning to see evidence of this with average European rental growth of 5.2% y/y in Q2: slower than the 6.3% seen at end-2023. The need for more energy-compliant buildings may also start to make inroads into this sector over the forecast period.

At the European level, we expect rental growth to average 2.6% over the five-year forecast period. It is highest in Benelux (+3.8%), UK (+3.0%) and Southern Europe (+2.6%).

STORE EXPANSION PLANS MAY AID RETAIL RENTAL GROWTH

Unsurprisingly, headline inflation, with the long glide down from its peak in 2022 to its target rate, left consumer sentiment trailing in its wake. In the EU, consumer confidence bottomed out in late 2022 and the recovery has been slow. As of July 2024, the balance of consumer confidence in Europe, as reported by the EU Commission, stood at -12.2%, still below the long-term average of -10%. This suggests that, even with strong wage growth, it may be some time before consumers perceive they have more money to spend. This is a classic example of hysteresis, when effects linger after the causal factors have dissipated.

> *"Real estate debt has become attractive on the back of structurally higher interest rates."*

Consequently, much of the dynamic that has shaped retailing over the past two years is likely to run for another year. Central here is that price levels remain high, especially for food. Even though inflation rates have fallen substantially, high prices may continue to dampen discretionary spending. Discounters are likely to continue reaping the benefits of this situation, although gradual improvement over 2025 will see the midmarket segment improve across goods categories. The edge came off growth in the luxury market over H1 2024. The Luxury Goods Worldwide Market Study 2024 report by Bain & Company indicated record sales of € 1.5 trillion in 2023, driven by luxury travel. The fall back this year reflects macroeconomic uncertainty in China (a key source of demand) and geopolitical tensions.

For all categories of retailing, the immediate pathway is likely to be innovation, with retailers increasingly seeing physical space as an essential part of their strategy. Controlling prices (bearing in mind hysteresis effects) plus brand leverage and an optimum omnichannel delivery model are key to the success of their strategies. This is positive for the Retail sector.

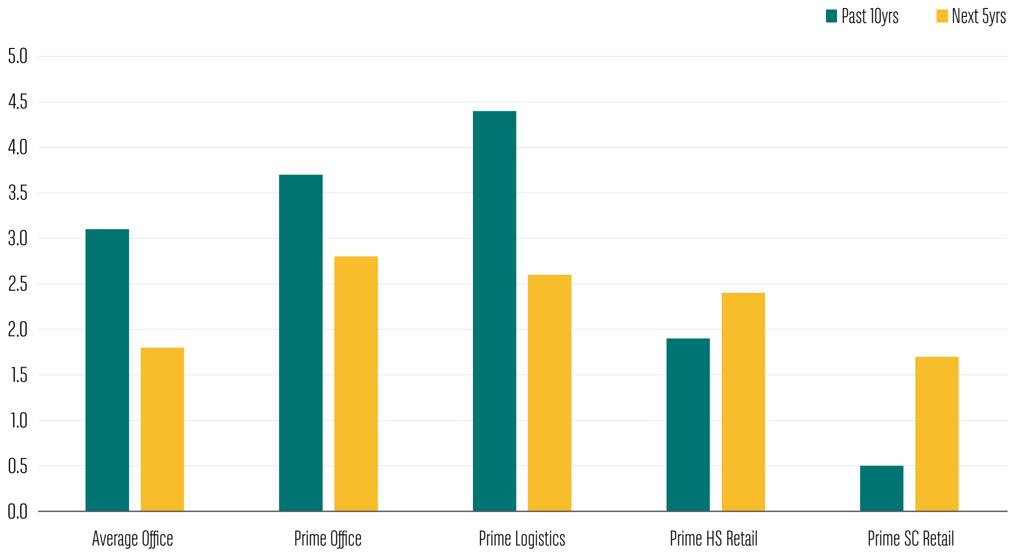
We think that getting the store right may end up being a unique feature of this cycle. Consequently, we anticipate that High Street rents will expand by 2.4% per annum over the next five years in Europe. All regions are likely to see growth, with the strongest in the Nordics (+4.1% per annum) and lowest in the CEE (+0.7% per annum). The rental growth of Shopping Centres may also turn positive, but at a slower pace of 1.7% per annum across Europe. Only in Portugal (+2.6%) and France (+2.3%) do we see rental growth exceeding the long-term expected inflation rate of 2.0% **(see Exhibit 4).**

OFFICE RENTAL GROWTH FACES STRATIFICATION BY AGE

Quality remains a key factor to commanding the best rent for Offices. Over the next couple of years, the scarcity of modern units may intensify at a time when big floorplate requirements reactivate. These are likely to drain the market of its existing space until new supply catches up. New supply varies considerably by city across Europe. In cities with particularly weak construction pipelines, many large requirements may take longer to realise.

The outcome of such intense focus on the best assets is that the rest of the Office stock will become increasingly defined by its age. Tied to this is the fact that the Office market is becoming increasingly operational as developers move into the flexible office segment. Together with a greater focus on ESG compliance, the amplitude

Exhibit 4: Average European Rental Growth (%, per annum)



Source: BNP Paribas Real Estate August 2024 of the Office cycle is becoming more intense. The most modern units will see the strongest rental growth, followed by the rest of prime. It is likely that "prime" may become more tightly defined by age. Secondary property faces a more mixed outlook as much depends on how easy it will be to adapt. Many old buildings are not designed to be adaptable and may have to either change purpose or alter their core tenant base.

Despite increased demand for prime space at a time of limited construction, the average rental growth for prime Office space in Europe is expected to be lower over the next five years (averaging +2.8%) than the last ten years (+3.7%). Naturally there are differences at the granular level, with the UK bucking this general trend at 4.6% per annum vs. an average of 4.0% over the past 10 years.

For secondary assets, rents in Europe may post growth of 1.8% per annum over the forecast period, 100bps lower than in the prime segment. In practice, age stratification may lead to a vast range of rental outcomes with an increased level of obsolescence and repurposing of some Office stock. This may become an important issue in the sector across Europe.

REAL ESTATE RETURNS MAY PERFORM WELL RELATIVE TO OTHER EUROPEAN ASSET CLASSES

As the market recovers, European real estate returns look set to strengthen from end-2024 onwards. We continue to think that the asset class could gain from capital value growth early in the forecast period, resulting in double-digit returns in several markets.

Values have stabilised in recent months, and we expect them to grow over the forecast period. Together with meaningful income growth, returns for European direct real estate could exceed those of other asset classes **(see Exhibit 5).** UK direct real estate may perform particularly well, along with European REITs.

At European level, prime Offices are likely to see average returns of 9% per annum between 2024 and 2028. Returns in the overall market may be lower at 7% per annum, in our view, as weakness in the secondary segment weighs on the whole market, with limited growth in rental and capital values. The age of units strongly influences the outcomes of both metrics. Age inflates the CAPEX required to meet energy regulation and makes it more challenging to meet tenant demand for easily adaptable units. These cost hurdles will accelerate churn in stock, by removing old units entirely over the new cycle.

European Logistics may post a similar level of returns to that in the prime Office market, averaging 9% per annum over the forecast period. The sector still looks likely to see early gains from capital growth with yield compression. However, returns are unlikely to outperform the prime Office sector, at least not markedly, as has been the case in the last five years. That reflects a slightly cooler occupational market with more selective tenant demand taking the heat out of rental growth.

We forecast High Street Retail returns to come in at 7.8% per annum over the forecast period. The sector performance increasingly seems to have left behind a troubled period, with returns possibly

Exhibit 5 . Annual Total Return of Various Asset Classes (%)

2021	2022	2023	5yr Average (2024-2028)
UK REITS (+25.7)	UK Equity (+0.9)	Europe REITS (+14.8)	UK Equities (+9.8)
Europe Equity (+22.9)	Europe CRE (-0.9)	Europe Equities (+12.1)	UK CRE (+9.2)
UK Equity (+14.3)	UK CRE (-2.4)	UK REITS (+5.8)	European CRE (+8.2)
Europe CRE (+14.2)	Europe Equity (- 4.4)	UK CRE (+3.9)	European REITS (+5.8)
UK CRE (+ 14.2)	Europe Bonds (- 15.4)	UK Equities (+3.8)	UK REITS (+5.4)
Europe REITS (+ 8.5)	UK Bonds (-16.8)	European Bonds (+3.3)	UK Bonds (+3.8)
Europe Bonds (-1.2)	UK REITS (-34.4)	UK Bonds (3.3)	European Equities (+4.7)
UK Bond (- 6.2)	Europe REITS (-39.1)	Europe CRE (-6.1)	European Bonds (+3.1)

Source: BNP Paribas Real Estate/ Oxford Economics

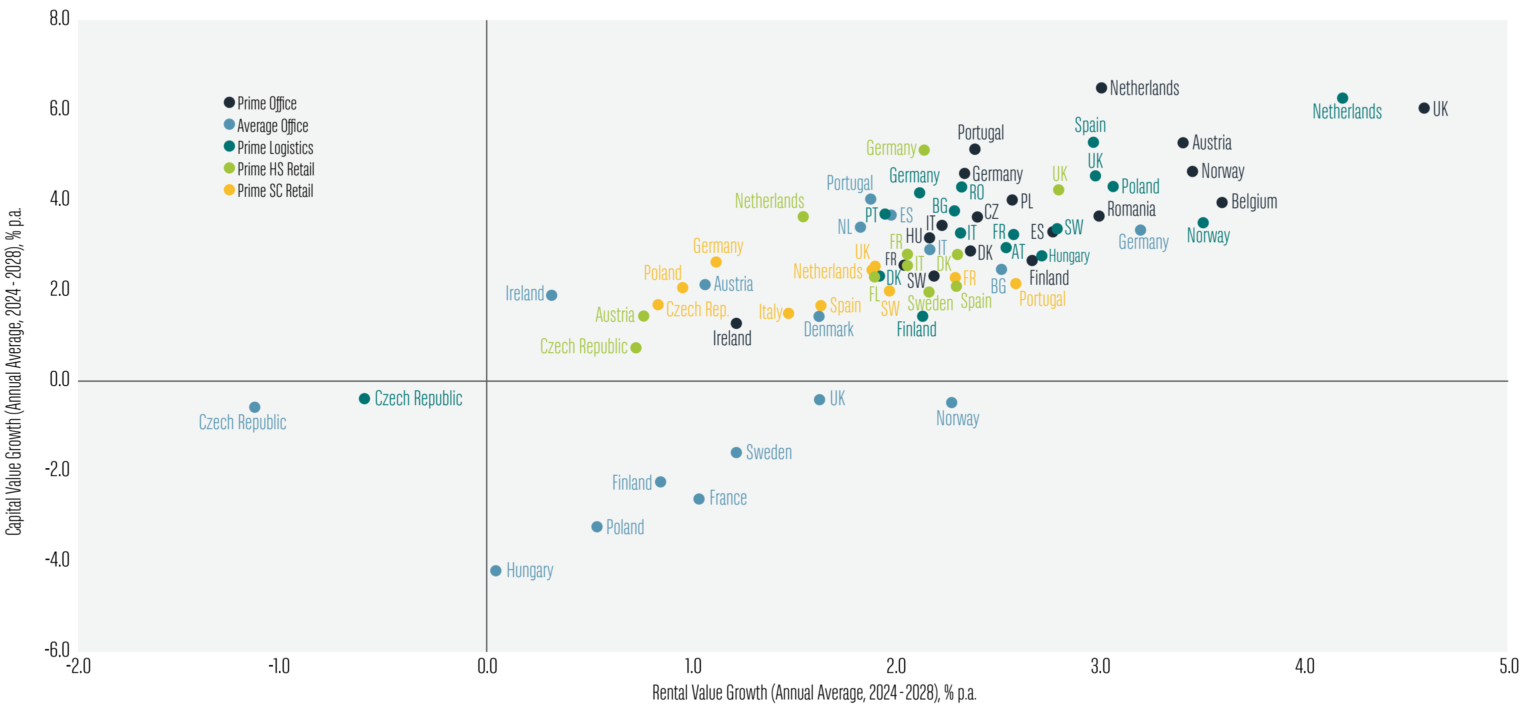
positive for all locations across the entire forecast period. Nonetheless, these forecasts are for city centre locations, which benefit considerably from wider catchment and tourism especially. The latter has normalised and in some locations, such as Spain, achieved record highs. Luxury benefits the most from this, as do more premium mid-market brands. The rest of the mid-market, even in these locations, remains challenged, driven as much by business model weakness as issues of reduced consumption. Discounters continue to benefit from the selective spending that comes with higher prices – these still linger even though the headline rate of inflation has reduced. For Shopping Centres, total returns may average 8.4% per annum over the forecast period. This is slightly above the figure for high streets, due to a higher yield and therefore income return.

REAL ESTATE MARKET MOMENTUM

Despite a pickup in investment activity and the repositioning of Retail as the European economy recovers, the sector is only at the early stages of a recovery. Over the forecast period it is unlikely to generate higher capital and rental growth than prime Offices and Logistics. Like most sectors it will outperform secondary Offices; the weakest performing asset over the forecast period.

We continue to believe that Retail remains an opportunistic play rather than an asset for a core strategy. This is predicated on the challenges that online retailing continues to present for physical stores, even though the situation is improving as domestic consumer demand strengthens.

Exhibit 6: Real Estate Momentum



Source: BNP Paribas Real Estate August 2024

"Institutional investors, such as pension funds, will stay out of the market as long term rates remain elevated."

The assets that may fare best in terms of both capital and rental growth include prime Offices and Logistics, albeit at slower paces than in the previous cycle. Although not measured here, there is strong momentum also in the alternative asset types (Data Centres, Residential, Senior Living, and Student Accommodation).

Age stratification for secondary Offices will exert increasing downward pressure on rents and capital values in all cities across Europe over the forecast. Prime rental growth in Logistics is normalising, after significant growth over the past three years. This is likely to slow its momentum of recent years.

Exhibit 6 shows the spectrum of performance outcomes that may occur across the markets and sectors covered in this report. Those that offer the best balance of capital and rental growth over the five-year period include prime Offices and Logistics. For Offices, these include the UK, London especially, historically a leading city in cycles. For Logistics, the Netherlands is the leading market. For Retail, UK and German High Street lead the pack.

ECONOMIC OUTLOOK

A NEW ECONOMIC CYCLE

by Sam Hall

ECONOMIC RECOVERY UNDERWAY

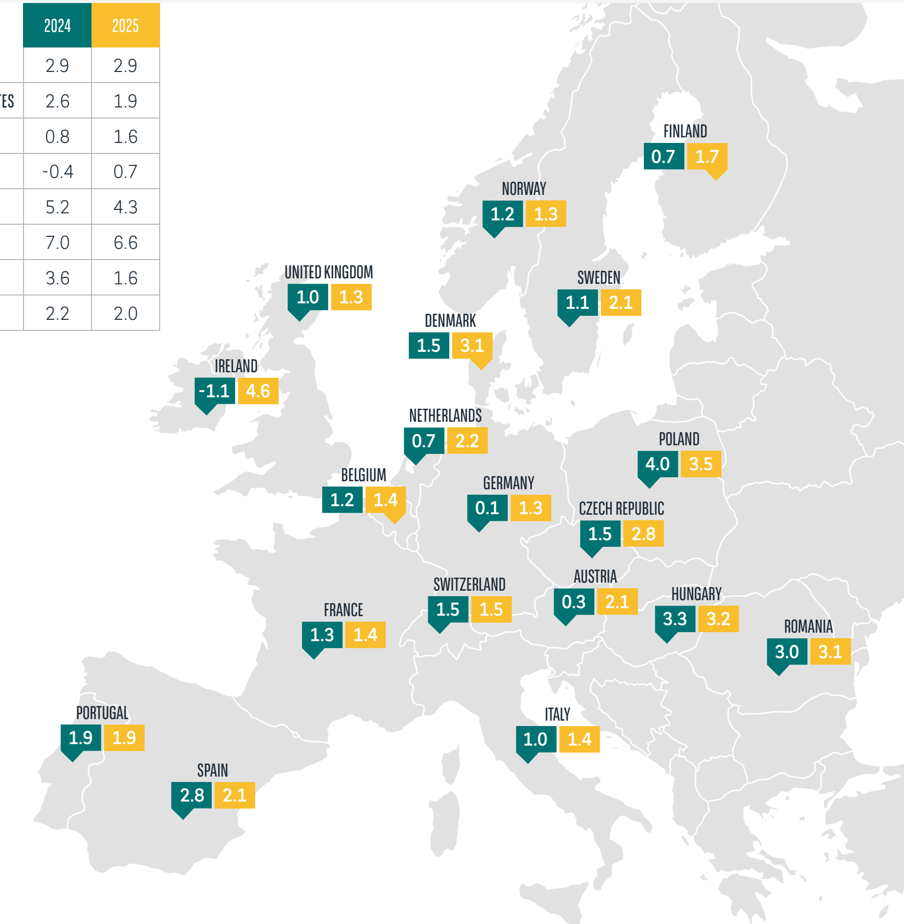
Broadly speaking, European economies returned to growth in the first half of 2024 after stagnating in 2023. The increase in economic activity has been in part driven by declines in inflation, which have boosted household purchasing power and consumer confidence. In turn, this has helped to underpin demand in the services sector, which continued to expand at a steady pace.

However, there is still a high degree of economic uncertainty which has dragged on activity. Indeed, households remain cautious about making major purchases and have increased the share of their income channelled to savings. Alongside high interest rates and heightened geopolitical uncertainty, this has weighed on the demand for goods and therefore activity in the manufacturing sector.

The relative strengths and weaknesses in the services and goods sectors has been reflected in the economic growth rates of Europe's largest economies. For example, Spain has seen the fastest growth since the start of the year, as record tourism levels have driven expansion in the services sector. By contrast, a weak manufacturing performance has weighed heavily on economic growth in Germany, where the recovery to date has been less convincing.

EXHIBIT 7: GDP Expectations for Monetary Blocks and Selected European Countries (%)

	2024	2025
WORLD	2.9	2.9
UNITED STATES	2.6	1.9
EURO AREA	0.8	1.6
JAPAN	-0.4	0.7
CHINA	5.2	4.3
INDIA	7.0	6.6
RUSSIA	3.6	1.6
BRAZIL	2.2	2.0



Source: BNP Paribas, Oxford Economics

EUROZONE GDP GROWTH

2024 +0.8% | 2025 +1.6%

EUROZONE HEADLINE INFLATION RATE

END 2024 2.4% | END 2025 2.0%

POLICY RATES BY END 2025

ECB 2.5% | BoE 3.5%

ECONOMIC GROWTH ON AN UPWARD TRAJECTORY

We expect economies to recover over the next couple of years, even if they will remain below their pre-pandemic trend **(see Exhibit 8),** driven by a combination of factors supportive to economic growth. In the near term, consumer spending will benefit from real wage gains as inflation falls faster than the still limited moderation in wage growth. This will directly increase household purchasing power. It is also likely that when economic uncertainty starts to clear, households will normalise their saving rate, which currently stands at its highest level in over two decades (aside from the Covid period). A reversal of this trend should help boost consumer spending over the next year.

We also expect various economic stimuli, including dissipation of the energy price shock, buoyant tourism, less restrictive monetary policy, continued strength in the labour market, investment in the low-carbon transition and support from public policies such as Next Generation EU disbursements. Admittedly, fiscal policy is set to weigh on economic growth. Amid rising concerns about debt sustainability, the EU's fiscal rules will be reimplemented this year, following a multi-year suspension. In addition, several countries have been identified as not meeting the EU's deficit criterion, which is a prerequisite for launching an excessive deficit procedure. There is uncertainty around the nature and scope of this upcoming fiscal consolidation. However, in our view it is unlikely to derail the economic recovery. We assume that much of the consolidation this year will be delivered automatically through the expiry of energy support measures. Further ahead, we expect a gradual path of consolidation, without a return to post-GFC-style austerity. The inclusion of mitigating factors such as defence spending should allow for some flexibility.

Overall, we expect the eurozone economy to grow by 0.8% y/y in 2024 and 1.6% y/y in 2025, which is a faster pace of growth than in 2023 **(see Exhibit 7).** Of the five largest European economies, we expect Spain to see the swiftest growth this year and next, supported by a strong labour market and investment fuelled by Next Generation EU funds. While Italy will benefit from similar tailwinds, the phasing out of the 'Superbonus' scheme means that residential investment will drag on growth. We expect Italy, France and the UK to underperform Spain in 2024, but still recover steadily over the next couple of years. Meanwhile, Germany's industrial sector now faces stronger headwinds than in the past, which is likely to slow its recovery.

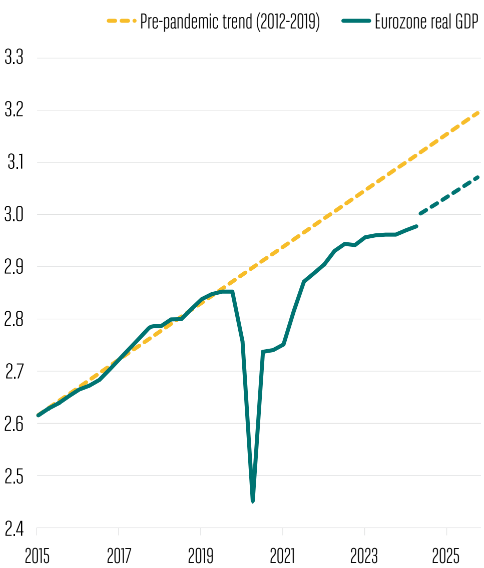
LABOUR MARKETS ARE KEY TO THE INFLATION OUTLOOK.

Inflation rates have fallen significantly from the highs of late 2022. In most European countries, headline inflation has eased back to central bank targets, or close to them. However, almost all of the decline to date has been due to energy, food and goods. These components are typically driven by global factors and therefore have weak links to local supply-and-demand conditions. Meanwhile, there has been relatively little progress on the more domestically generated parts of inflation, such as the service sector. So as long as these domestic price pressures remain elevated, concerns that inflation rates may not lastingly settle at central bank targets will persist.

"Central banks start their interest rate cutting cycle, but the pace is likely to be cautious."

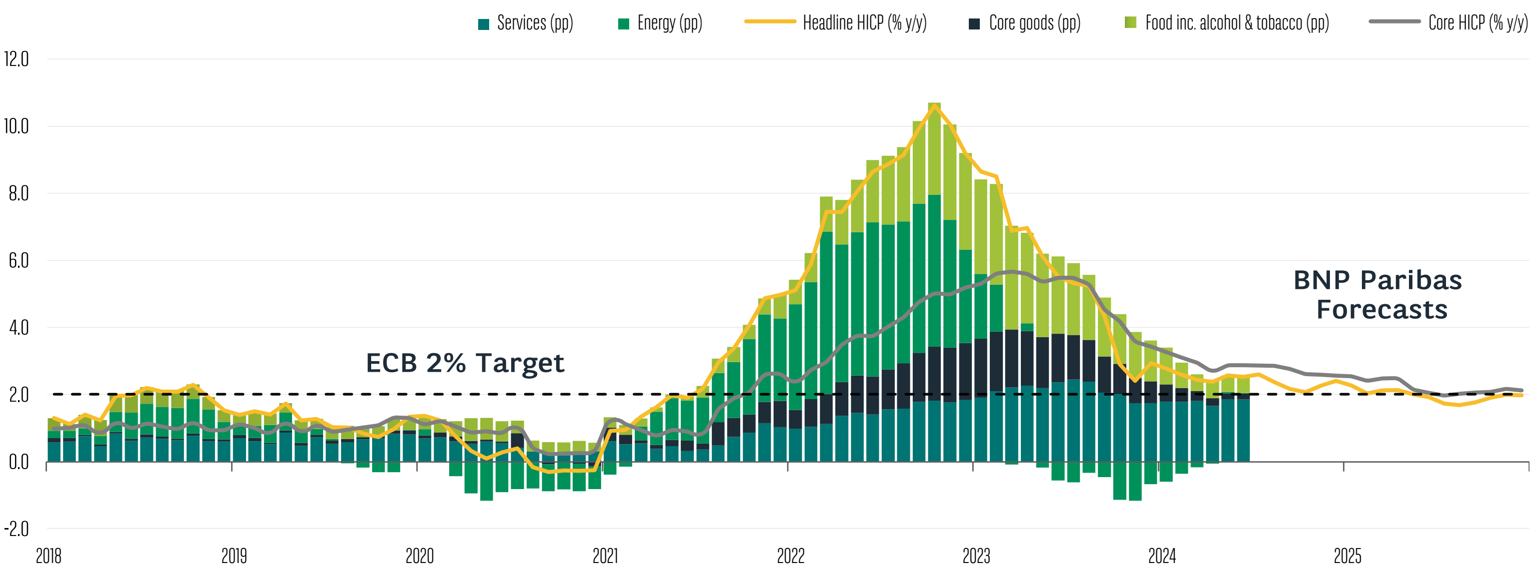
Looking ahead, global factors will offer less support to the disinflationary process. For example, goods disinflation has been driven by past improvements

Exhibit 8: Eurozone Real GDP (€ trillions)



Source: Macrobond; BNP Paribas

Exhibit 9: Contributions to Eurozone Inflation (%)



Source: Macrobond; BNP Paribas

in supply chains and energy prices, which have likely run their course. In fact, core goods inflation could edge higher in the coming quarters, given higher energy prices and shipping costs.

Inflation in the service sector is closely correlated to labour costs due to the relatively high share of labour in the sector's total costs. While tight labour markets led to a surge in labour costs and therefore services inflation, this trend has partially unwound. Labour market conditions have loosened considerably over the past couple of years which has shifted wage bargaining power away from workers. This has started feeding through to slower wage growth, albeit gradually. Alongside measures of labour market tightness, various forward-looking indicators such as inflation expectations and PMI services output prices also point to slower wage growth in the coming quarters. We also expect limited demand to weigh on companies' profit margins and their ability to pass higher costs on to prices. Therefore, as the pass-through from wage pressures cools, we expect services inflation to trend downwards in 2025.

Pulling all this together, the near-term outlook for headline inflation may be bumpy. Nevertheless, we expect the headline inflation rate in the UK and eurozone to hover around the 2% central bank target over the next couple of years. Meanwhile, core inflation will only grind down as the slowdown in services inflation progresses **(see Exhibit 9).**

CENTRAL BANKS LOWER INTEREST RATES WITH CAUTION

The significant progress of inflation towards central bank targets has led to both the European Central Bank (ECB) and Bank of England (BoE) starting their interest rate cutting cycles. Indeed, the ECB delivered its first rate cut in June and the BoE in August. It is worth noting that despite the step down in interest rates, they continue to restrict economic growth.

"Improving economic conditions will provide increasing support to the real estate market."

Looking ahead, there is still significant uncertainty around the pace of future interest rate cuts. On the one hand, monetary policymakers have made progress towards the medium-term inflation target. But on the other hand, strong underlying price pressures have cast doubts over whether inflation will remain at target on a sustained basis. As a result, some policymakers are not yet confident enough in the inflationary backdrop to vote for interest rate cuts and there is still caution around committing to a future path for interest rates.

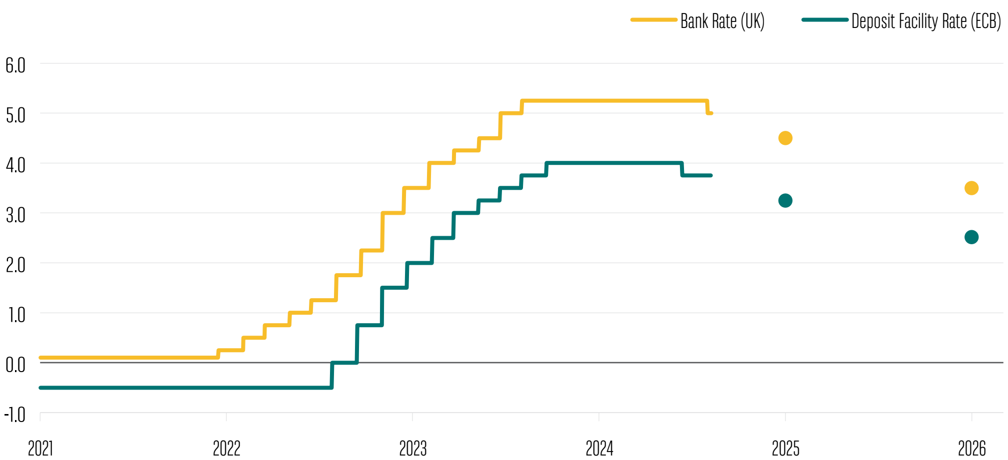
It is widely expected that interest rate decisions will remain on a meeting-by-meeting basis and in line with data developments. That said, it also appears that central banks are becoming more forward-looking in their assessment of inflationary pressures. For example, ECB President Lagarde has emphasised the importance of studying the drivers of inflation, which include wages, productivity and profits, when setting monetary policy.

Taking this into account, we generally expect central banks to gradually ease monetary policy. One reason is that the economic recovery appears to be underway, which makes the case for front-loaded interest rate cuts less compelling. It also means that central banks are likely to normalise monetary policy rather than shift to an accommodative stance. Further, we expect to see some stickiness in the more wage-sensitive parts of inflation such as in the services sector. In our view, developments in wage growth and services inflation will be key to the timing of future interest rate cuts.

Overall, we expect the ECB to lower the Deposit Facility Rate to 2.50% by end-2025 and the BoE to lower the Bank Rate to 3.50% over the same time period **(see Exhibit 10).** Beyond 2025, the outlook is more uncertain, although it is widely expected that interest rates will not return to their post-GFC lows in the medium term. Rather, we think that central banks will be forced to grapple with stronger underlying inflationary pressures than before the Covid pandemic.

For example, after the pandemic exposed the fragility of supply chains, we think that some firms may prioritise supply chain resilience over efficiency, leading to higher costs and therefore prices. Similarly, governments may opt for greater self-sufficiency in strategically important sectors, reversing some of the disinflationary impacts from globalisation. It is also likely that the pandemic has left scars on the supply side of the economy through depressed investment, misallocation of capital and labour and disruptions to education. As a result, we think that central banks will need to keep interest rates at higher levels than in the previous decade if they are to achieve their inflation targets.

Exhibit 10: Central Bank Policy Rates (%)



Source: Macrobond; BNP Paribas

SECTOR PROSPECTS

CHANGING OF THE GUARDS

by Samuel Duah

After a difficult two years for European commercial real estate, with investment activity across the continent down 51% in H1 2024 compared to the same period in 2022, we are beginning to see the early stages of a recovery. The key driver is improved sentiment among investors on the prospects for inflation, monetary policy, and cost of debt. However, this recovery will look different from those that we have seen in the past. Structurally higher levels of inflation will continue to drive capital into sectors such as Logistics and Living (Residential, Healthcare, Student Housing and Hotels), resulting in a faster recovery in those sectors over cyclical sectors such as Offices. A recovery is also emerging in the Retail sector.

OFFICES – WORK IN PROGRESS

Although Offices remain the most challenged sector, the outlook is brightening. However, the pace of recovery in the investment and occupational segments are polarised. Pricing in terms of yields has stabilised in most European markets over the past six months, even though there remains a gap between what investors are willing to pay and sellers are willing to accept for assets. This has contributed to a slower recovery in the volume of transactions. Meanwhile, demand in the occupational market remains strong for well-located, prime and ESG-compliant buildings. Prime rents in this segment of the market are rising, and we expect double-digit cumulative growth over the next five years in most markets. That said, we also see challenges in secondary markets, where some assets appear obsolete in the current marketplace and need repurposing.

LOGISTICS – A NEW PLAYER IN TOWN

Demand for Logistics space remains strong in European markets, even though leasing activity has eased somewhat on the back of weaker economic conditions. We see continued strong demand in the medium to long term, on the back of continued growth in E-commerce. The penetration rate for on-line shopping, at 11%, remains low across Europe, offering potential for future growth and hence demand for warehouse space. Rental growth remains strong and above inflation, but we expect this to slow in the long term as supply begins to come online. In most markets, rental growth in Logistics will remain the strongest of the real estate sectors. The investment market has sufficiently repriced and offers a compelling opportunity in the long term, albeit with notable geographical differences that need to be navigated carefully. Increasing supply chain re-orientation is keeping the focus on Central and Eastern European markets, however the traditional storage and distribution play continues to be dominant in the core western European markets of Germany, France, and the UK.

RETAIL – RENAISSANCE

The Retail sector continues its recovery, with capital values edging up for the first time since 2015 in several markets in H1 2024. This is supported by rental uplifts in key markets and in some cases double-digit growth. Improved sentiment and bottoming out of the market also led to a compression in yields across Europe for prime High street assets. Nonetheless, we remain cautious on the pace of any recovery and point to the continued differentiation in this broad sector. We see the most compelling opportunities in the Retail Warehouse, Supermarket, and niche High Street segments, most probably as an opportunistic play in a wider real estate strategy.

OFFICE

by Stephen Ackroyd

YEAR ON YEAR FALL IN EUROPEAN INVESTMENT VOLUMES, H1 2024

11%

PEAK EUROPEAN VACANCY RATE (2025)

9.7%

PEAK EUROPEAN CAPITAL GROWTH (2025)

6.1%

WORK IN PROGRESS

Gradual improvement is already occurring in the Office market as it moves into the second half of 2024. The sector may initially run at two speeds with a more active occupational than investment market.

Investment volumes for European offices came in at €18bn for H1 2024, down +11% on H1 2023. The pace of decline has slowed considerably, and a few markets are now posting increases. Those showing gains include Italy (+99%), Spain (-46%) Norway (+190%) and Poland (+190%). In the major markets such as Germany (-31%), the UK (-26%) and France (-55%), volumes are still falling. Apart from France, the rate of decline has almost halved since the start of 2024.

Macroeconomic stability helped investment to regain traction, particularly in the second quarter, and it may pick up pace over H2. This is not to suggest that Office investment will return to Pre-Covid volumes – repricing and greater selectivity are still acting as brakes. Nevertheless, 2025 could see buyers re-enter the market seeking assets capable of generating sustained income.

MARKET RECOVERY TO STRENGTHEN TOTAL RETURNS.

Total returns in Europe may benefit from the improved macroeconomic backdrop across the forecast period (2024 to 2028). Many locations may see the reappearance of double-digit returns, albeit front-loaded, thanks to the bounce back in capital

growth as the real estate market goes into the first stage of its recovery.

We have revised up our European prime Office total returns to 8.6% in 2024 compared to 7% in our previous report. We think the prime Office segment may hit double-digit growth in 2025 (11.3%) before dropping back to 7.8% by 2028. Better capital growth at the front end of the forecast period drives some of the gain **(Exhibit 11).** Capital growth may turn positive in 2024 at 3.4% compared to -16.4% in 2023. A small number of markets (Paris La Défense notably at -11.7%) may still see declines in 2024. Over the next five years, most markets should see capital growth peak in 2025.

The UK may be the best performer in 2024 at 14.5%, driven by strong rental growth, particularly in London. The improvement means all regions may now see positive returns for 2024. Most regions are set to peak in 2025 except France (9.2% 2026) and Benelux (14.3% 2024). Germany may peak at 13.5%, the UK 15.5%, Southern Europe 10%, CEE 14.3%, and Nordics 9%.

At the city level,the best returns come from Bristol (24.4%), Amsterdam (17.2%) and London City (15.8%). The best performing city by 2028 could be Berlin at 10.5%.

Overall market returns may have a much weaker outcome with 0.4% projected for all European Offices in 2024. This is forecast to peak at 9.6% in 2026 before dropping back to 6.9% in 2028. The strongest performing region may be Southern Europe (9.2% in 2024 and 10% by 2028). Lisbon (13%) is the best performing city by 2028.

A POTENTIALLY EXPANSIONARY OCCUPATIONAL MARKET IN 2025

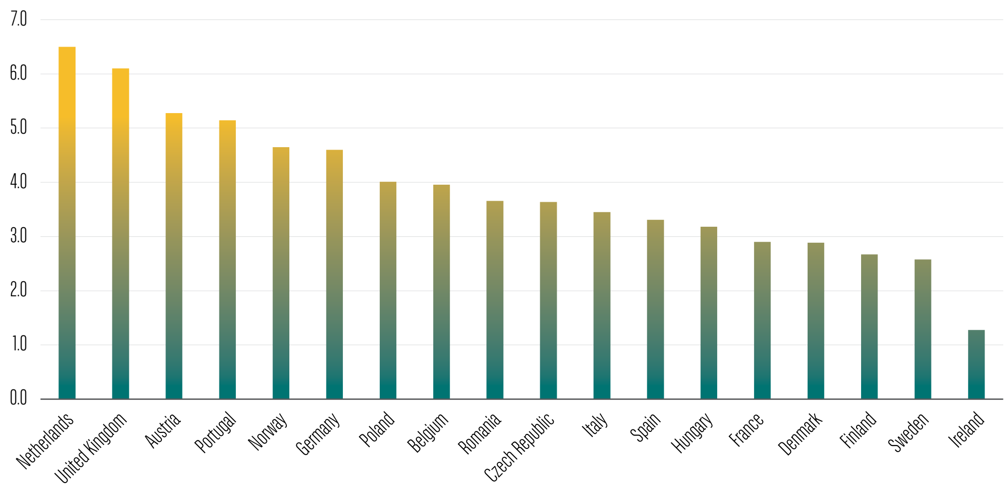
Sustained letting activity over 2024 comes from the small to mid-sized segment. The 18 main European markets (as covered in our CRE180 report) posted take-up of 3.72 million sqm over H1 2024; i.e. no change vs. H1 2023. Letting volume expansion is highly sensitive to large transactions. As anticipated at the start of the year, large scale transactions have not been a market feature in 2024 although they are returning. With greater economic stability in 2024, the last quarter of absolute decline was in Q1 2024 when take-up fell 5% y/y. Take-up in the 18 markets increased by 4% over Q2 2023.

Large moves take longer to complete partly because finding big enough units is challenging. Given the short supply of modern space in city cores (the overwhelmingly preferred space type), informed occupiers may voice their requirements in H2. Aside from the economy, sustained expansion depends on the availability of modern space. Competition amid reduced choice may be a key theme for the occupational market and intensify over the forecast period.

"In 2025, we see a more active occupational than Investment market."

Even though not many are moving, large space occupiers remain active in the release of spare

Exhibit 11 . Average Capital Value Growth (% per annum, 2024 - 2028)



Source: BNP Paribas Real Estate

floor space. Net absorption for 2024 for the whole European market may come in at -174,000 sqm. The return of big occupiers to the market could cause net absorption to increase across the forecast from 1.9 million sqm in 2025 to 2.8 million sqm by 2028 **(see Exhibit 12).**

BETTER TAKE-UP MAY OFFSET VACANCY INCREASES.

The net absorption dynamic is set to be determined by the balance of two factors: the delivery of modern supply and quantum of space released as companies exit leases. The latter has some way to go although as we suggested in the latest BNP Paribas Real Estate Occupier Survey the pace is slowing.

Complete exits from leases will continue to add more space that in most cases will be considered old. The unusual prospect for Offices is that as take-up increases, it will offset but not decrease vacancy.

The focus on securing modern space leaves a growing, ageing and stratified secondary tier behind. Stratification is by age and upgradeability with the top bit easiest to let because it requires less capex to modernise. The rest forms the core of structural vacancy that may take many years to reduce. For the 32 largest city markets, the average vacancy rate stood at 8.4% in H1 2024, up 100bps over H1 2023. The magnitude of vacancy change varies between cities and is hugely influenced by how dynamic construction is at local level.

Across 2024 to 2028, second hand space will form the bulk of structurally higher vacancy. Europe's aggregate Office vacancy may increase to 9.4% by end 2024 before reaching 9.7% in 2025, then dropping back to 9.1 % by 2028. Again, vacancy varies from city to city and depend on construction.

"As interest rates, and subsequently yields, begin to fall capital growth will drive returns over the next two years."

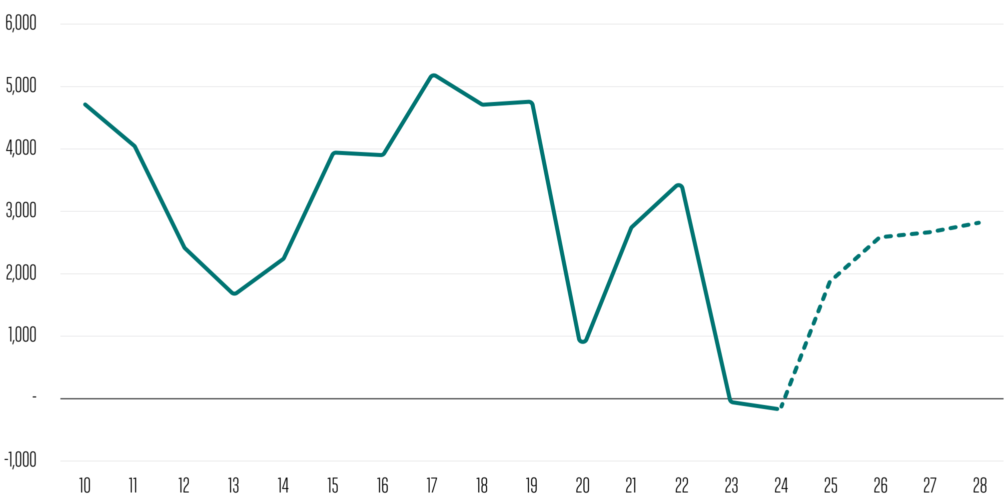
We still expect French and German cities to have the lowest vacancy rates over the forecast period. Paris CBD vacancy remains the lowest in Europe at 2.7% in 2024 and 2.9% by 2028e. The highest by 2028 are expected to be Helsinki (15.5%), Dublin (14.4%) and Paris La Défense (14.3%).

RENTAL GROWTH TO BE CONCENTRATED IN CITY CORES

The quality over quantity dynamic that has shaped letting for the last two years remains influential on European rental growth pattens. Prime rents in the 36 leading cities increased by 3.8% over the year to H1 2024. Brussels led in H1 (+18%), followed by Warsaw/Madrid (+11%), and London/Central Paris (+10%).

Rental growth is derived almost entirely from central locations. Rental growth here shows little

Exhibit 12. Net Absorption in Europe (000's sqm)



Source: BNP Paribas Real Estate (as at August 2024)

sign of slowing, particularly if improved take-up comes up against the existing supply dynamic (low availability of best units).

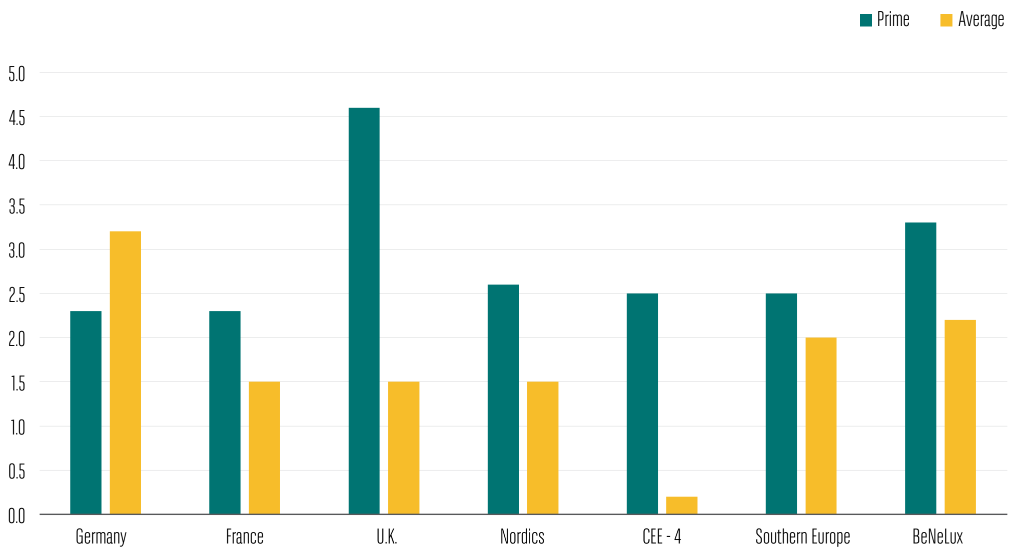
The prime rent trajectory is determined by the pace of construction in meeting demand. Currently, modern modular space in the Office stock (units under 10 years old) is a minority in most cities. Development and refurbishment mean that 2024 may see a net addition to European stock of around 3.8 million sqm, double that of 2023 and around 2.0 to 3.0 million sqm per year over the rest of the forecast.

With the inflation push to rents fading, increased construction may suffice to taper rental growth over the forecast. At European aggregate level, prime Office rental growth averages 2.6% per annum over the 5yr forecast period.

Revised forecasts suggest Bristol (UK) may see the strongest growth in 2024 at 18%. Over the forecast period, cities with stronger rental growth include UK cities and Berlin at over 3% each year. Copenhagen (4.3%), Central London/Stockholm (3.9%) and Berlin (3.8%) have strongest growth by 2028.

Rents for average assets are still heading in a different direction. Age stratification may intensify with the effective rent disguised by ever greater incentives. CBD locations and new units may better resist the effective rental markdown overall. Market rents in Europe are projected to grow 2.4% in 2024 and 1.4% by 2028. We see the strongest prime rental growth in UK, averaging 4.5% per annum over the forecast period. With the exception of Germany, most European regions will see a stronger rental growth in the prime segment than the market as a whole **(see Exhibit 13).**

Exhibit 13. Rental Value Growth (%, per annum, 2024 – 2028)



Source: BNP Paribas Real Estate

PRIME YIELD PRICING AT MARKET BOTTOM

The average yield seems to have settled at 4.7% for the 18 key city markets in H1 2024 compared to 4.6% at the end of 2023. Since the low point of 3.2% in 2022, Office yields have expanded 150bps. The aggregate yield is unlikely to expand much further given the direction of monetary policy. It is 45bps above the ECB main refinancing rate of 4.25% and still below the BoE rate at 5%.

The average European prime yield may end 2024 at 5.22% (vs. 5.25% as stated in our last report.) and 5.08% for 2025 (vs. 5.06%). We see a gradual compression beginning from 2025, to end at 4.98% by 2028. The lowest yield by 2028 may occur in Munich (3.5%), Berlin (3.8%) and Hamburg (3.8%).

The gap between market and prime yields has widened. The European average for 2024 may be 6.55% compared to 6.35% and 6.57%, as reported in our Q1 and Q2 2024, respectively, forecast releases.

RETAIL

by Philippe Guardiola

INVESTMENT IN EUROPEAN RETAIL ASSETS IN Q2 2024

€7.0bn

TOURISTS ARRIVALS IN EUROPE IN 2023

710M

EXPECTED EUROPEAN REAL PURCHASING POWER GROWTH IN 2024

+1.3%

RENAISSANCE

EBBING INFLATIONARY TIDE SHOULD BOLSTER SALES GROWTH

The first half of 2024 brought hope that the battle against inflation might be won. After +5.4% in 2023, the Eurozone CPI posted growth of less than +2.5% in Q2 2024. Although core inflation is more tenacious (+2.8% over the same period), projections point to a fall below the 2% target over the next 12 months. This drop should enable household purchasing power to recover, after contracting by -0.8% over the past two years. It is expected to increase by +1.3% in 2024, which will fuel consumer spending in Europe. Real retail spending, down by -2.0% in 2023, should start to rally in 2024 (+0.4% expected) and could reach +2.3% in 2025. Moreover, tourism continues to recover which should support economic activity, especially in Southern European countries. According to the UN World Tourism Organisation, the number of tourist arrivals in Europe in the first quarter of 2024 exceeded the 2019 level for the first time since the pandemic, driven by the Iberian Peninsula and Greece. France could also see a record number of international arrivals with the sporting events in Paris this summer. Asian tourist numbers remain below pre-crisis levels, especially from China and Japan, but their gradual return could be a source of future growth **(see Exhibit 14).**

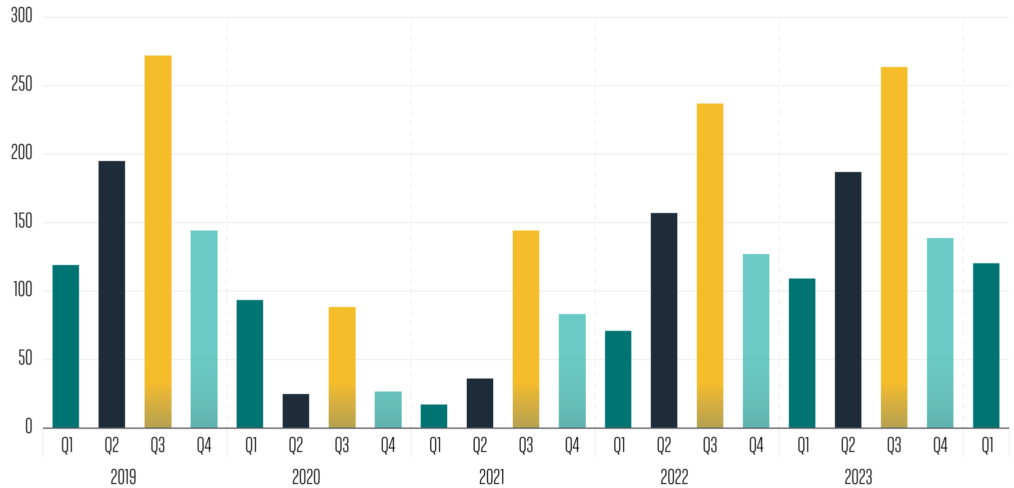
The recovery of tourism benefits the luxury sector, which has proven very resilient as its consumer

base is less sensitive to rising prices. However a recent report, by fashion network, has shown that the slowdown in China is beginning to have an impact on the sector. As such some key players have been opening flagship stores to maintain their dominant positions in the most prestigious streets in Europe. At the other end of the segment, discounters also enjoyed a rapid increase in market share as prices became increasingly important to European consumers. The middle segment has been the hardest hit, with frequent receiverships, liquidations and restructurings among historic names in the past two years. However, those that manage to reassess their business model and reduce costs could benefit from stronger consumption over the next few years.

RENTS COULD FINALLY PICK UP

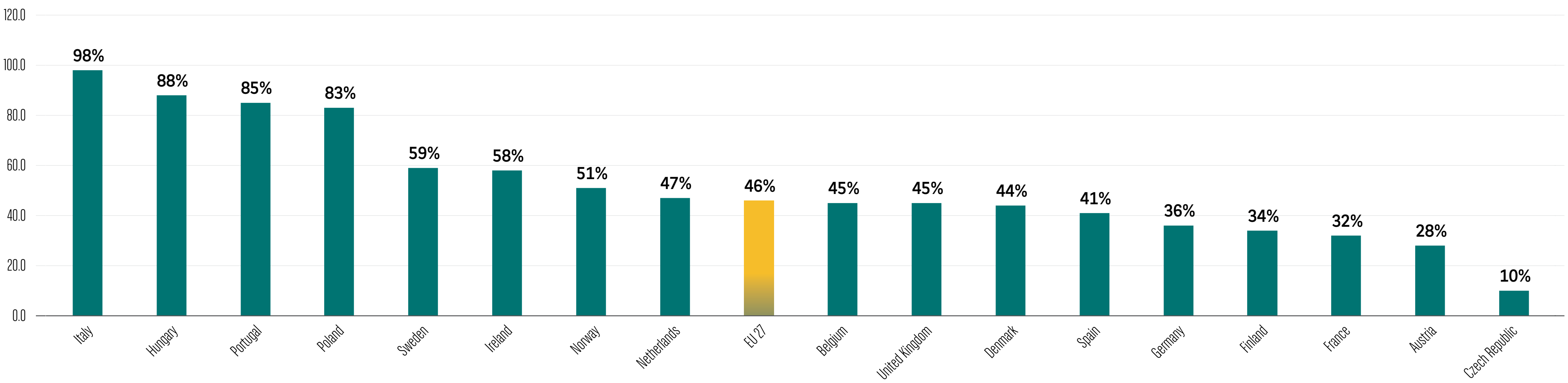
The improvement in sales figures should eventually trickle down to rental growth. European High Street rents have been relatively stable over the past three years and are finally expected to exceed their 2019 level this year. Prime locations remain attractive, especially luxury thoroughfares that show very low vacancy and thus exerting high pressure on rents. However, mass market retailers have been facing rising costs and lower real sales, creating strong resistance to rent increases and a rise in incentives. For Shopping Centres, although 2024 should be the first year with positive rental growth, it will likely take a few more years to overcome the Covid impact on rents, when the surge in online sales cast doubt on the future of Retail. However rental growth in Retail Warehouses has been significant in recent years.

Exhibit 14. International Tourist Arrivals in Europe (millions)



Source:UN World Tourism Organisation

Exhibit 15 . Growth of Online Sales of Goods per Capita (%, 2023 vs 2019)



Source: BNP Paribas Real Estate

That said, e-commerce is no longer perceived as a threat to physical stores, as the lines between them have become blurred. Online penetration is growing strongly across Europe, even if the tempo is slowing in recent months **(see Exhibit 15).** Reduced sales and excess returns have upset the business models of some e-commerce pure players, especially when compounded by stock management issues and complex supply chains. Already before the COVID-19 crisis, many retailers were looking to strengthen their online sales by implementing omnichannel experiences. Robust digital development has proven a significant hedge against the health crisis, and retailers are looking at Click & Collect as an additional revenue stream.

RETAIL INVESTMENT IN EUROPE MIGHT HAVE BOTTOMED OUT

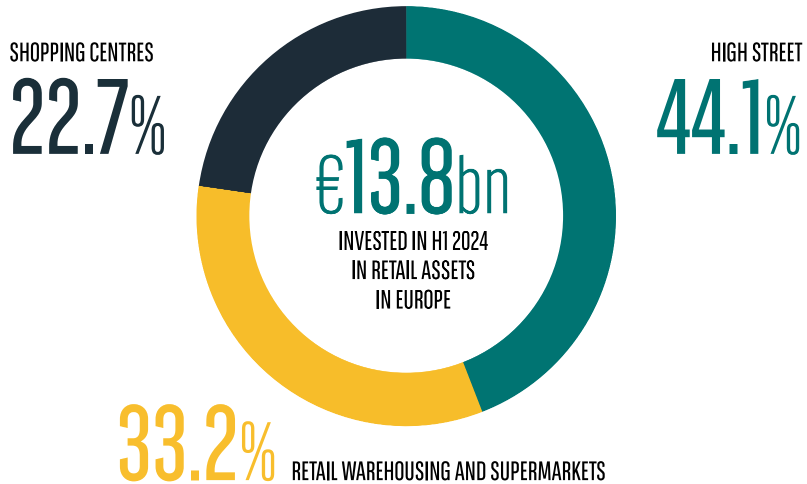
After four consecutive years of sliding investment in Retail premises, the rebound seen in 2022 (+6%) was short-lived. Indeed, the €14.6bn invested in Retail assets in 2023 represented a 31% drop compared with the year before, as the rapid increase in interest rates dampened investors' appetite. However, Retail investment seems to have bottomed out, as suggested by the improvement in H1 2024 vs. H1 2023 (+6.0%). Although the High Street sector seems to have regained the dominant position in terms of average investment volumes **(see Exhibit 16),** the geographical picture is more nuanced. Germany accounts for over 60% of all High Street investment, while in most other countries, Retail Warehouses and supermarkets account for the lion's share. The accessibility and value-for-money brands of Retail Parks, as well as their ability to operate as hybrid last-mile delivery hubs and low occupancy costs, makes them attractive to both customers and investors.

Owner-occupier deals, which had been muted for a while in Europe, are now weighing heavily in total Retail investment in Europe, especially the High Street segment which has regained its dominance in the sector. They are mainly driven by the luxury sector, with LVMH and Kering allocating considerable resources to bolster their real estate portfolios on the most prestigious streets of Paris and London's West End. The number of retailers buying properties to occupy themselves or for investment is on the rise, with transactions by the Rolex family, Swatch in London and INGKA in France. Additionally, value-add and opportunistic investors acquisition of Shopping Centres, driven by an already deep price adjustment and supportive bank finance. The excellent operational results in recent years has been the main catalyst for the return of lending activity, albeit at a higher rate. However Core and Core+ investors remain on the sideline.

"Tourism arrivals in Europe in 2024 could top 2019 levels."

As Central Banks begin to cut their interest rates, investors should enjoy more favourable financing conditions, which should boost volumes in the coming semesters. Nevertheless, the second half of the year may remain sluggish as yields are still stabilising. We expect small expansions in Austria, Czech Republic, Spain, and the Nordic countries. Investors are likely to remain on the fence until the first signs of compression that could occur in 2025. We see a 10bps compression on average for prime High Street assets next year, and a delay for Shopping Centres until 2026. Overall, between 2021 and 2024, Retail assets should experience lower yield expansion (around +75bps on average for high streets) than offices (+160bps) and logistics (+120 bps), as the sector had already begun repricing before the COVID pandemic. The higher net initial yields coupled with a small compression in the coming years should create attractive total returns: around 8% yearly on average for prime High Streets in Europe between 2025 and 2028, and 9% for Shopping Centre, which together with Retail Park offer the best risk premiums in the sector.

Exhibit 16. Volume of Investment in Retail by Asset type (%)



Source: BNP Paribas Real Estate

LOGISTICS

by Thomas Glup

AVERAGE TOTAL RETURN IN EUROPE OVER THE NEXT FIVE YEARS

PER ANNUM

+9.0%

PRIME RENTAL GROWTH IN EUROPE OVER THE NEXT FIVE YEARS

+2.6% p.a.

AVERAGE EXPECTED FALL IN YIELDS IN EUROPE (2023 - 2028)

30bps

A NEW PLAYER IN TOWN

IN A NUTSHELL

Demand for Logistics space in Europe remained high in the first half of 2024, although take-up declined both due to the economic situation. This lack of suitable space and buildings is one of the biggest challenges facing the Logistics sector. As in previous quarters, demand in many markets clearly exceeded supply, on the back of limited developments. From the point of view of the Logistics industry itself, the biggest challenges are increased energy and wage costs, shortage of labour and available land.

Rents have surged over the past two and a half years. The pressure on rents due to the shortage of space should remain, but future rental growth will slow.

European industry is increasingly near-shoring and reshoring activities for strategic reasons. The focus is on Eastern and Southern European locations with advantages such as low wage costs or stable economic conditions. These trends are pushing up local rents. We therefore forecast a somewhat higher rental growth potential for these markets in the coming years.

While rental growth is expected to slow from 2025 at the latest, yields could further contract moderately over the same period.

WEAKENING ECONOMY DAMPENS DEMAND FOR SPACE

At 8.8 million sqm, Europe-wide Logistics take-up in the first half of 2024 was 5% lower than in the same period last year. The boom generated by e-commerce during the pandemic has come to an end, although online retail remains one of the most important drivers of demand for Logistics space. Take-up also came in short of the five-year average for H1. In addition to the general uncertainty and weak economy, the decline in take-up also reflects the scarce supply of space, especially in the top regions. For example, the fall in demand was particularly marked in France (-25%). However in Spain demand was almost stable (-3%), on the back of a strong tourism driving retail sales.

"Yield compression expected from 2025."

Third party Logistics and the outsourcing of supply chains are expected to remain key components of demand for Logistics space in Europe. The manufacturing sector is suffering from both weak domestic demand and slowing exports. On the other hand, newly optimistic retailers have expansion plans as the post-pandemic landscape has become clearer and physical retail performance has improved considerably. If physical retail sales rebound across Europe, it could support future demand for Logistics space.

VACANCY RISK STILL LIMITED

Construction activity declined in the first half of 2024, hit by weaker demand and sharply increased costs. As such, completion volumes are likely to fall in the coming quarters. Vacancy rates, which are still low, should remain manageable, even though they have been increasing in some markets. Overall, the figure remains low at 6.0% in most European countries. The pressure on rents should therefore continue.

RENTAL GROWTH EXPECTED TO CONTINUE BUT SLOW SIGNIFICANTLY

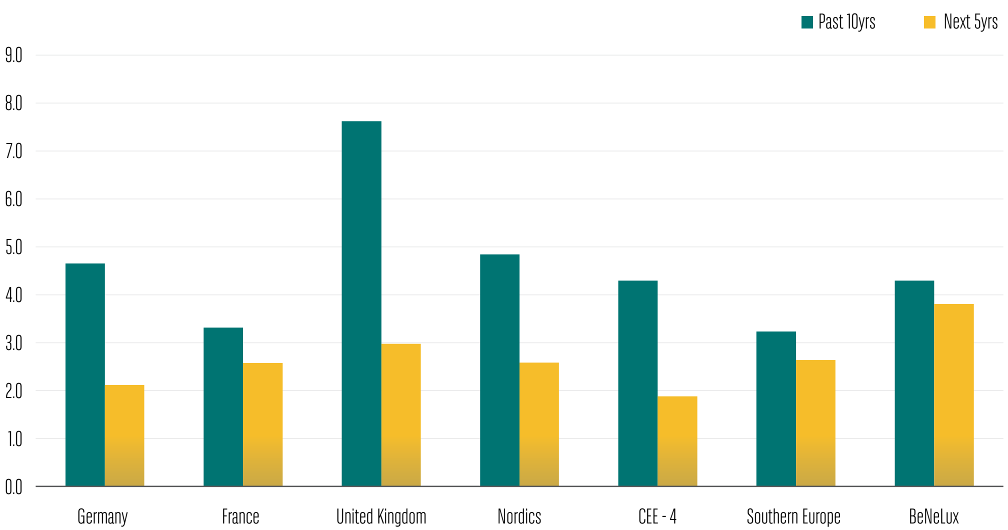
The lack of new developments may continue to underpin rental growth in prime sectors, although weaker demand could detract from the momentum.

Prime rents rose by 5.2% (y/y) in Q2 2024 across a panel of 49 markets covering 22 countries. Rents are still rising in some cities but overall, the market slowdown in Q2 2024 resulted in limited rental growth of only 0.9% for the quarter. Strong increases were seen in Paris (15%) and Venlo (11%).

An increasing share of Logistics occupiers are willing to accept higher rents on existing buildings to switch to green sources of energy. In the future, this could not only mean further potential for increasing rents, but also spur the owners of existing buildings to carry out renovations for greater energy efficiency.

Rents will continue to rise, but at a much slower pace, also because of dissipating inflationary pressures **(see Exhibit 17).** Our rental growth forecast for

Exhibit 17. Prime Rental Value Growth in European Regions (%, per annum)



Source: BNP Paribas Real Estate

"Take-up set to stabilise, also from 2025."

Europe in 2024 is still good at 3%. However, from 2025 this growth could slow significantly to just over 2%, accompanied by stabilised inflation rates.

SLIGHT INCREASE IN INVESTMENT

The decline in investment seems to have slowed in H1 2024 and was just under € 17bn. This even corresponds to a slight increase of 6% compared to the same period last year. The low point may have been crossed in 2023. Demand is gradually picking up again in some countries including France, the Netherlands, and Germany. This trend is expected to spread to more countries throughout 2024.

The Logistics share of overall commercial real estate investment has risen markedly in recent years. In 2017 it was 16%, rising to 24% by H1 2024 in Europe. Nevertheless, we expect investment for the full year 2024 to be significantly lower than in previous years. A material recovery in investment is not expected until 2025.

YIELDS STABILISING IN 2024

The yield correction is complete in most countries and encouragingly they have been stable for the last two quarters.

Prime yields stabilised in the first half of the year. Interest rate pressure and the associated rising yields on long-term government bonds gradually eased again somewhat. The resulting expansion of prime Logistics yields over the past two years also seems to be coming to an end. Prime yields should therefore continue to stabilise throughout Europe until the end of 2024. However, there would also need to be a stable or slightly falling key interest rate in H2 2024 for this to happen.

Prime yields could fall slightly again from 2025. In Europe we expect average compression of around -10bps for each of the next three years. The projected yield compression in 2025 fluctuates between 5bps and 25bps, as in Bucharest, for example. Over the next five years we expect yields to compress by an average of 30bps in most European regions **(see Exhibit 18).**

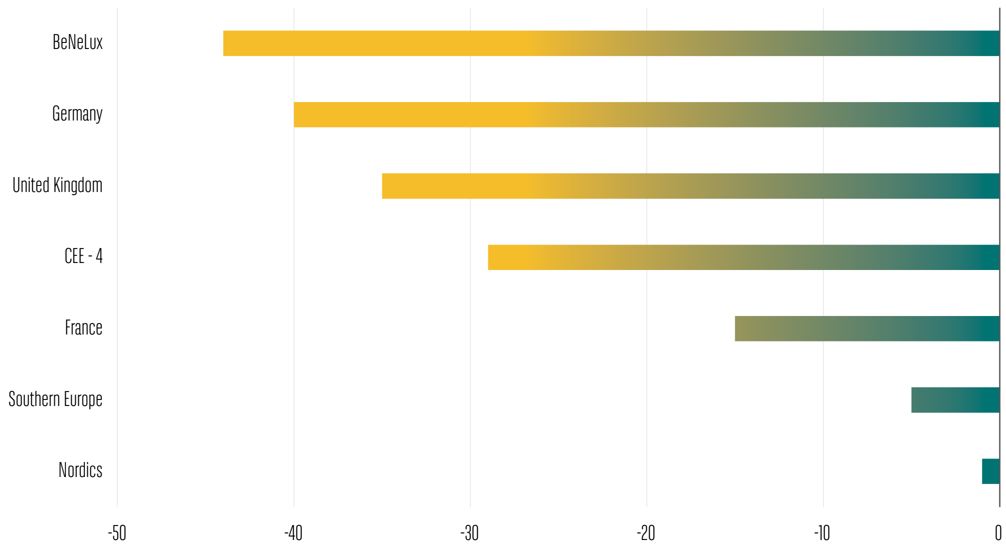
LOGISTICS TOTAL RETURNS ON AN EQUAL FOOTING WITH OFFICES

Increased rental income, continued positive rental outlook (albeit slower) and declining yields in the future suggest a robust overall capital growth and total return outlook until 2028. The Logistics asset class, which has benefited from structural change in recent years, could achieve an average total return of 9.0% per year in Europe **(see Exhibit 19).** This puts it almost on a par with the Office sector, which is estimated at 9.2%.

FUTURE CHALLENGES

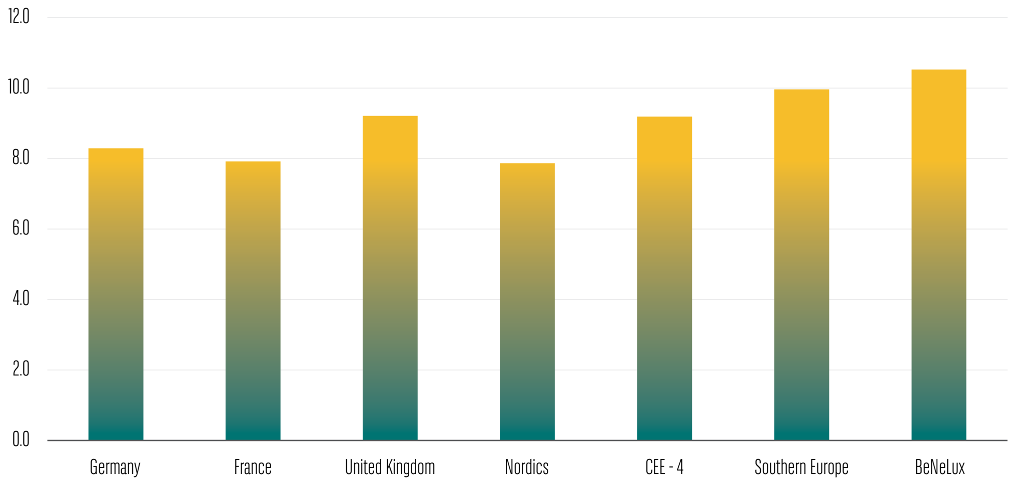
The biggest current risk factors for the Logistics industry are still at the global economic and political level. The ongoing – and in some cases escalating – geopolitical conflicts have the potential to endanger world trade. However, the fundamentals for European Logistics markets remain relatively good, especially on the demand side. As such, the prospects for Logistics investment look bright, at least from 2025 onwards.

Exhibit 18. Expected Yield Shift by European Region (bps, End 2023 – End 2028)



Source: BNP Paribas Real Estate

Exhibit 19. Expected Total Return by Region (% per annum, 2024 – 2028)



Source: BNP Paribas Real Estate

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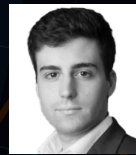

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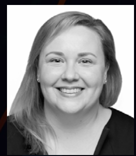

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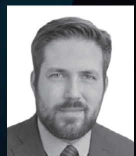

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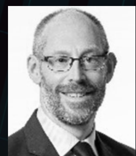

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