RESEARCH BRIEF

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INVESTMENT STRATEGY
& RESEARCH

PATRIZIA's 2024 Real Estate Outlook: Cause for Optimism

PATRIZIA

While the global economy continues to face challenges, the anticipated decline in interest rates and the resilience of fundamentals in many sectors provide reasons for optimism: it's the time to protect core assets while actively pursuing opportunities in value-add strategies.

Despite a tumultuous 2023, the global economy showed surprising resilience. The US experienced growth in the face of monetary tightening, Europe reduced its reliance on Russian gas without economic disaster and worldwide inflation declined without a significant spike in unemployment. Optimists who predicted a ‘soft landing’ called it right.

However, the macroeconomic backdrop remains challenging – the slowdown is turning global as higher interest rates bite. Europe is particularly exposed due to the prevalence of variable-rate lending. While inflation has eased, it's unlikely to stabilize at 2% in wealthy countries without a cost to activity. Major central banks will likely hold off on further interest rate hikes, however, they're also cautious about rate cuts.

Growth in Advanced Economies should bottom out soon and recover from the second half of the year onwards. There are risks of a recession, although a fall in GDP of more than 2% is virtually off the table for now.

In our base case scenario, we anticipate that the ECB might cut rates as early as mid-2024. This rate cutting process, expected to take around 18 months, would eventually stabilise the deposit rate at approximately 1.5%. The Bank of England, facing more entrenched inflationary pressures, might follow later in 2024.

Real estate poised for gradual recovery amidst market shifts

The year 2024 stands as a pivotal one of transition and recovery for real estate. PATRIZIA projects a nuanced trajectory for the market, combining caution with optimism.

The steep rise in interest rates led to a significant repricing in real estate capital values. Since the process began in early 2022, capital values have adjusted between 10-20% on average in major markets across Europe. However, the momentum of the correction has slowed noticeably in the past few quarters, suggesting we may have seen the worst of it (see Chart 1).

Likewise, when Central Banks begin to cut rates, this will further alleviate pressure on real estate pricing. Public markets (equities/bonds) have already rallied in Q4 2023, improving the relative attractiveness of real estate to some degree.

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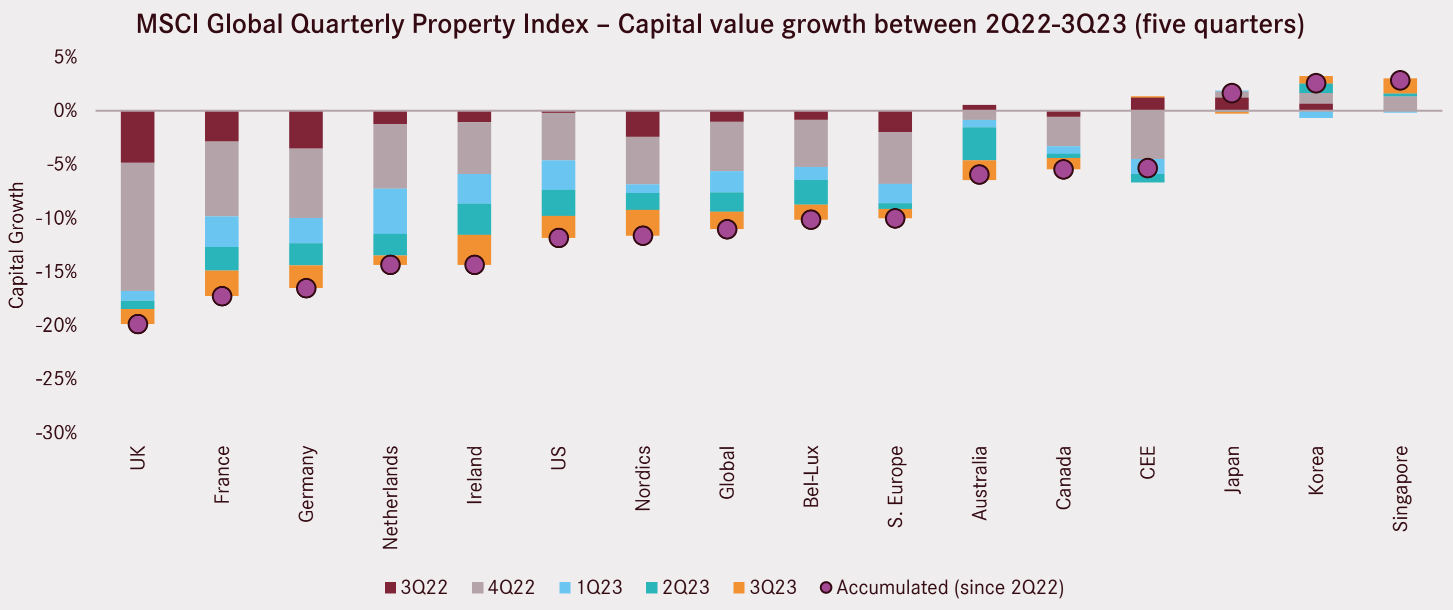
Chart 1: Significant repricing starting in 2022



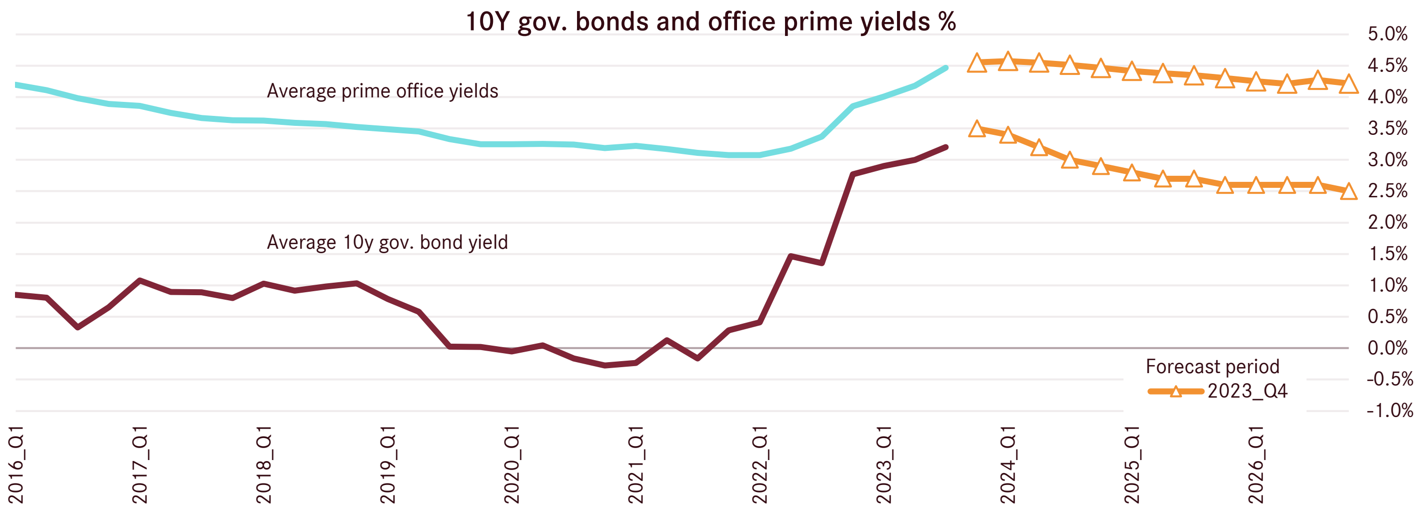
Source: : MSCI, PATRIZIA | December 2023

The implication is that real estate markets will recover, but gradually over time. Chart 2 illustrates what's in store for Office prime yields in Europe. Our research shows that interest rates are the most important driver of prime office yields. When bond yields shot up, office prime yields followed, with some delay characteristic of illiquid markets.

But now bond yields are projected to have peaked and are expected to embark on a steady decline. Using bond yield forecasts as a key input, our Vector Auto-Regression (VAR) model predicts office prime yields will decline gradually. However, unless we see a more material decline in interest rates, we don't foresee significant yield compression in prime markets.

Chart 2: Office prime yields adapt to the higher bond yield environment

VAR Model - We apply the Oxford Econ. forecast of the 10-year gov. bond yields as an input variable of our projection



Source: PATRIZIA, CBRE, Oxford Economics, Eikon.
We calculate the average 10 years government bond yield for the countries we observe markets. Model uses data since 1986 including: Frankfurt am Main, Munich, Barcelona, Paris, Amsterdam, Berlin, Dublin, London, Vienna, Brussels and Madrid.

> More tactical opportunities are emerging in 2024; sector and stock selection will matter more for performance.

Market players will also monitor transaction activity. The year 2024 is poised to witness a modest resurgence in transaction volumes from a sluggish 2023 (ca +25% y-o-y). This uptick is expected to gain momentum post-2024, propelled by stronger economic growth and a more accommodative monetary policy.

In essence, while the real estate market faces its share of challenges in 2024, the underlying trends point to a gradual journey towards recovery. More tactical opportunities are emerging; sector and stock selection will matter more for performance than in the past. Stakeholders in the industry are advised to stay informed and agile, ready to adapt to the evolving market conditions.

Offices: Rising headwinds and polarisation

The impact of recent macroeconomic shifts has been uneven across sectors; in particular, the office sector has been significantly affected. Cyclical (economic downturn) and structural factors (rise of hybrid/remote work) are both important drags on demand. On top of this, shifting preferences towards Grade A assets with ESG credentials are driving more dispersion of performance within the sector, with sustained relative outperformance for prime assets compared to other segments of the market.

On the bright side, Europe remains significantly supply-constrained, leading to lower vacancy compared to US and APAC. In Europe, the stock is also quite old (~2/3rds being built before 2000), which means demand will be quite concentrated in healthy, sustainable and tech-enabled offices, especially in central business districts and innovation hubs. Finally, high construction costs and restrained future supply are expected support occupier trends.

All in all, we've become more negative on offices on account of deteriorating fundamentals. Liquidity limited to core (and low/mid-size assets) and widening brown discounts means landlords will need to work harder to protect their investments. Finally, we reiterate our preference for Grade A quality in CBD locations, with Value-Add themes (e.g. develop to core, brown-to-green, conversions to other uses) challenging in the absence of very meaningful discounts.

Residential: Opportunities and challenges

The residential sector remains buoyed by the persistent imbalance between supply and demand. This dynamic is aggravated by the plummeting of new starts in several countries, and today's snapshot suggest a recovery is not imminent.

Investors seeking stable income and long-term returns that align with asset-liability matching (ALM) strategies find a natural fit in the multifamily residential sector. The correlation between the net return of these investments and the funds' long-term financial obligations is particularly strong. The current market dynamics, characterised by a supply-demand imbalance, further boost the attractiveness of investments.

However, looming challenges such as potential rent regulations and market volatility require a strategic and proactive approach from investors and managers alike. Future-proofing assets is also essential to mitigate stranding risks. Managers are encouraged to actively consider future capital expenditure needs and explore diversification into alternative sectors.

Purpose-built student accommodation (PBSA) stands out as a particularly promising opportunity driven by a need for modern facilities. The undersupply in this niche positions PBSA as a high-conviction investment for PATRIZIA in the alternative living space. Similarly, we believe that investors can capitalize on the critical need for affordable housing and take a long-term hold approach in markets where government support is sufficient.

Industrial: Signs of market normalisation

The star performer of the previous cycle, the industrial sector is experiencing signs of market normalisation. Tailwinds such as the surge in online retail and inventory expansion are moderating just as the sector grapples with challenges such as over-capacity and occupier cost pressures. Take-up in European logistics has significantly declined from the highs of 2021-22, now aligning with the more moderate levels observed in 2017-20. Vacancy rates have risen marginally, but generally remain below 5% in most countries. Consequently, rental growth, previously in double digits, is likely to taper down to low to mid-single-digit figures.

A similar picture applies to urban logistics, a highly sought-after segment due to its proximity to consumer markets and role in last-mile delivery. Here, developer activity has largely responded to the e-commerce boom, which at a time of slightly weaker demand, has resulted in rising vacancy in key markets such as London. This, combined with the truly exceptional levels of rental growth in the post-GFC cycle, underpins a softer rental growth outlook.

Overall, we adopt a slightly more cautious stance on industrial and highlight the need to be selective. Although long-term returns remain compelling, we hold a slightly less bullish view on urban logistics due to the weaker market and priced-in growth. Conversely, our outlook on out-of-town logistics has improved marginally compared to the past, fuelled by extensive repricing and opportunities to capture releasing spreads that drive Net Operating Income (NOI) growth. The performance outlook remains strong.

Retail: Consumer behaviour is driven by cost-awareness

The last few years have witnessed significant divergence among retail asset classes. The COVID-19 pandemic prompted a shift towards online and food retail, with retail parks, warehouses, and DIY (Do-It-Yourself) stores maintaining stability by catering to daily food and essential needs. In contrast, traditional high street retail and shopping/outlet centres faced challenges. The ongoing cost-of-living crisis is continuing to shape this landscape, favouring food and discount retail models.

However, it appears that the sector has crossed an inflection point following substantial declines in rental and property values. High street vacancy rates are now on the decline, and top-quality shopping centres owned by REITs are exhibiting improvements in rental income and releasing spreads.

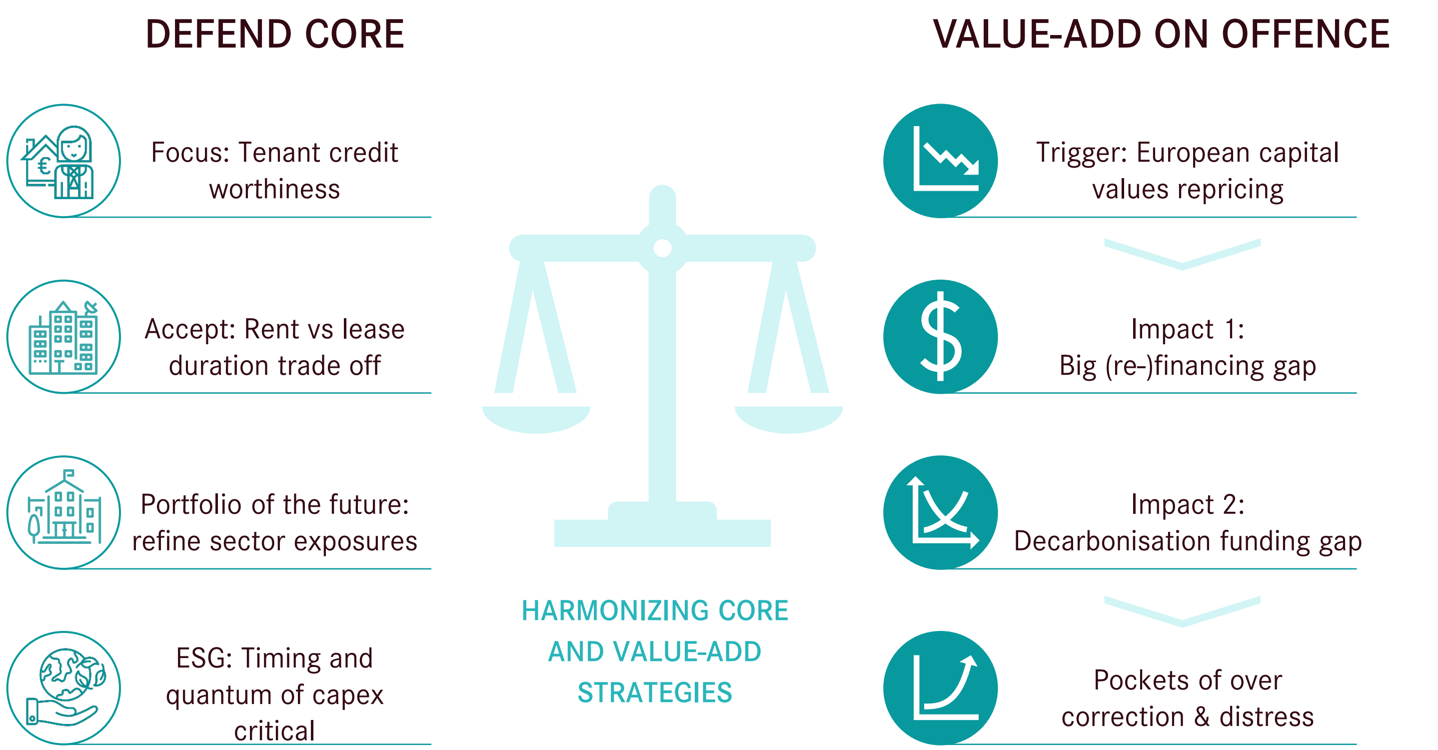
Our recommended route for 2024: Defend Core and double-down on Value Add

Confronted with short-term challenges, there is merit in revisiting medium-term fundamentals. We maintain the expectation that enduring structural drivers such as Demographics, Urbanisation, Digitalisation, and Decarbonisation will support allocations to real estate. 'Beds, sheds, and alternatives' continue as strong plays which capitalize on these megatrends.

In this environment emphasis must be placed on defending core assets. This includes strategies that enhance tenant retention, refining sector exposures, optimising operational efficiencies, and closely monitoring market trends to safeguard income. It also means paying particular attention to capex needs to ward off stranding risks.

While Core has a mind on defence, Value-add should go on the offence. The rise in interest rates has already triggered widespread repricing. Despite the recent decline in long-term interest rates and some green shoots in public markets, a significant debt funding gap persists. The situation is further aggravated by the need to finance decarbonisation or face stranding.

This dual funding gap presents a potential for overcorrection and distress, translating into double-digit return opportunities for those willing to provide capital solutions for broken capital structures and undermanaged assets in preferred markets and locations. In the meantime, fundamentals remain supportive for NOI growth across most sectors. Value-add is in vogue.



There will also be differences between sectors and markets. We expect the UK to bounce back quicker and France and Germany to lag. Banks and lenders will dictate the market tempo, but we expect a modest recovery in transaction volumes in 2024 (ca +25% on 2023 levels). Supply chain, student housing, and food & value retail emerge as our top sector picks supported by structural factors and fundamentals.

In conclusion, PATRIZIA's House View reflects a landscape of cautious optimism. While challenges abound, opportunities for growth and recovery exist. Investors and market players would do well to navigate this terrain with a blend of caution, insight and adaptability and be ready to capitalise on the shifts and turns of an ever-changing economic and geopolitical story.

Investment Strategy & Research:

Mahdi Mokrane
Head of Global Investment Strategy, Research & Investment Solutions

Marcelo Cajias
Head of Data Intelligence

Marcus Cieleback
Chief Urban Economist

Radu Mircea
Head of Int. Funds Research

Georg Kläger
Senior Associate

Juan Manuel Gotsis
Senior Associate

Anett Wins
Senior Associate

Julia Ashford
Head of Performance Analytics

George Baan
Associate

Gabor Van Meenen
Analyst

João Victor da Silva
Analyst

Rebecca Restle
Associate

Holman Latorre
Analyst

Alexander Fetzer
Associate