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Real estate market cycle – exploiting yield opportunities

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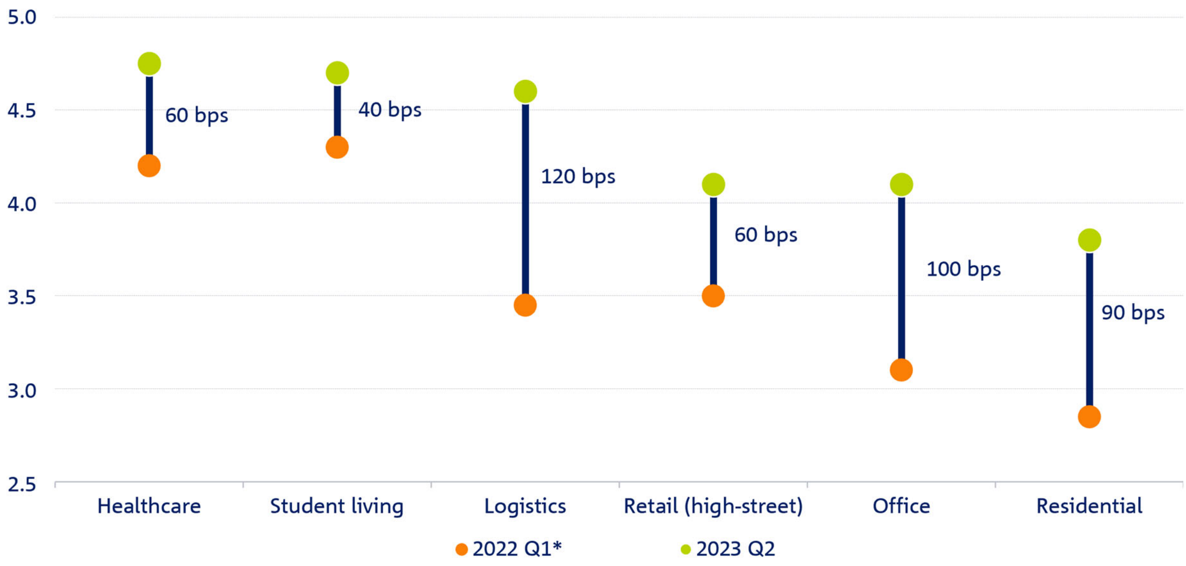
Increase in interest rates leads to market correction

The capital market environment has changed significantly since the end of 2021. Long-term interest rates have increased by 320 basis points, from -0.5% to the current level of 2.7%. This has been the biggest jump in interest rates in over 30 years. The sharp and rapid rise in interest rates is putting a strain on the real estate markets at present. The yield premium (risk premium) for property compared to risk-free government bonds has declined. In addition, the financing costs for real estate have risen sharply, thus reducing expectations for the performance of a property investment. As a result, residential and commercial property prices are falling. The price level is not expected to stabilise until 2024. At that time, however, attractive market opportunities will arise in the real estate markets. Due to the price decline, the expected returns on property investments will rise significantly again. From a historical perspective, market opportunities of this type are very rare, most recently in the aftermath of the financial market crisis in 2008/2009, i.e. 15 years ago.

Strong upsurge in yields for logistics properties

Depending on the type of use, the dynamics of the current price correction on the real estate market differ. Comparing the initial yields at the beginning of 2022, i.e. before the start of the rise in interest rates resulting from the Russia-Ukraine conflict, with the latest data from Q2 2023, a sharp rise in yields of 120 basis points can be seen, particularly in the European logistics sector (see Figure 1). According to brokerage firm Jones Lang LaSalle, net initial yields currently average around 4.6%, compared to 3.4% at the beginning of 2022. Although the correction in the other types of use was somewhat weaker, the office and residential segments also posted a significant rise in net initial yields across Europe. Residential hybrids such as healthcare properties and student accommodation saw a moderate price correction, but continue to offer the highest net initial yields at 4.8% and 4.7%, respectively. The price correction in the retail sector was less marked. This is due to the repricing that has already been applied in recent years.

Figure 1: Net initial yields of different real estate segments in Europe, in % and change in bps



*Data source: JLL; Graph: Real I.S. *2021 was the end of the yield compression of the previous years in most market segments*

Taking the security of the rental markets into consideration

In addition to the initial yields on the investment market, the trend in the rental markets and thus the trend in market rents plays a crucial role in the medium-term performance of a property investment. The basis for strong performance in the rental market is solid economic growth as a driver of demand. Based on the forecasts for real GDP growth in 2023 and 2024 (on average), the trend particularly in Ireland, Spain, Portugal, Luxembourg, and Belgium is positive.

In addition to GDP growth in the country, factors specific to the type of use are also important drivers of rental market performance. There are currently major differences in the attractiveness of each of the types of use in the rental markets.

Office real estate

Economic weakness and the increased use of home offices are the drivers behind the current decline in companies' need for space. Vacancy rates are tending to rise, while rental growth has slowed or come to a standstill. Basically, however, vacancy rates are still at low levels by historical standards. The location and property attributes of an office building are becoming increasingly important for companies. Prospective tenants prefer central locations with good public transport links as well as adequate local amenities and shopping facilities in the surrounding area, so that they can offer their employees an attractive alternative to the home office. The flexibility of the office space and the energy efficiency of the building are also key decision-making criteria. Going forward, office space in central locations will be more sought after than office space in peripheral locations with regard to rental growth than in previous years.

Logistics real estate

The market for logistics properties remains attractive in view of low vacancy rates and sustained rental growth. Nevertheless, a certain normalisation of the excess demand can be seen as a result of declining take up for space from large online retailers such as Amazon and Zalando, etc.

Hotel real estate

The figures for overnight stays in the European city hotel industry have recovered much faster than expected. Hotel occupancy rates in many cities are now back to pre-Covid levels.

In addition to tourist travel, business travel has also increased significantly again, with high demand triggering a rebound in room rates. This makes the hotel sector highly profitable again.

Retail real estate

Shopping centres and high street shops are seeing a sustained recovery in footfall, but sales are still weak. As a result, shops are still closing down and rents remain under downward pressure.

Residential real estate

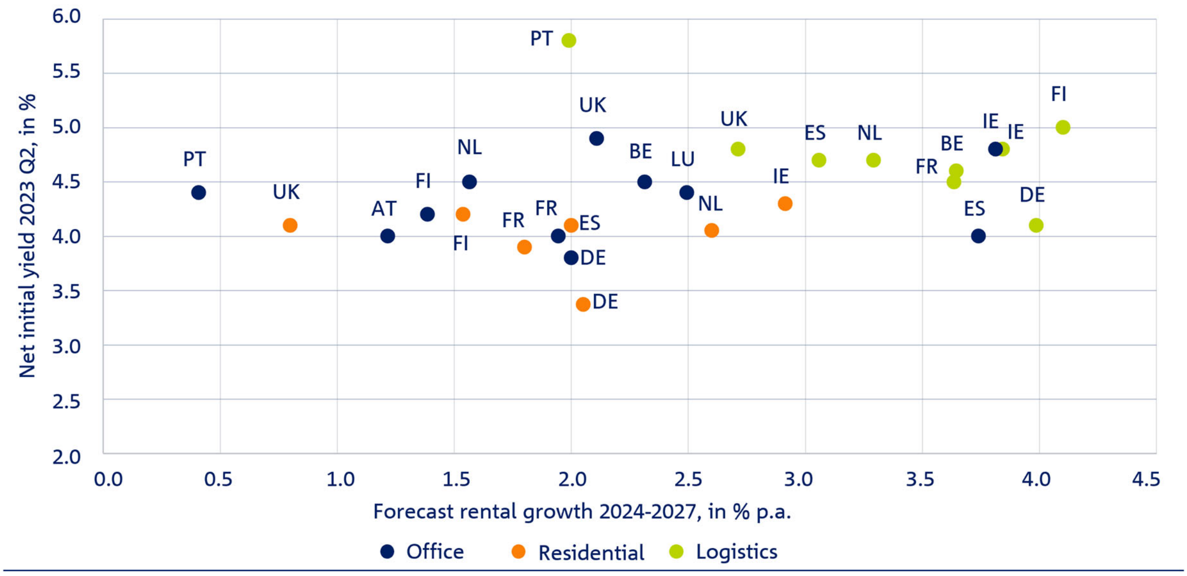
The residential real estate market is benefiting from the continuing low unemployment rates in the Eurozone. The lack of qualified employees has prompted many companies not to reduce their workforce, despite a weak economy. As a consequence, rents in most major cities continue to trend upwards. In addition to high demand, this is also due to the shortage of supply and the increased cost of buying an apartment as a result of higher borrowing costs. In addition to traditional housing, residential hybrids such as student accommodation, micro-living concepts and assisted living also have high occupancy rates, thus offering stability.

Rental growth forecasts favour logistics real estate

The fundamental situation in rental markets is also reflected in the rental growth forecasts. Over the short to medium term (2024-2027), data provider PMA forecasts the highest rental growth for the European logistics sector, with annual rental growth of around 3.4%. For European office markets, annual rental growth of 2.1% is expected, while rents in the residential market are forecast to increase by around 1.7% p.a.

An attractiveness matrix was compiled in Figure 2, using the rental growth forecasts per country and type of use, along with the initial yields for 2023 Q2 presented earlier in the text. This matrix shows the net initial yield on the y-axis and the rental growth expectation in the coming years on the x-axis. For example, an initial yield of 4.7% and rental growth averaging 3.3% p.a. can currently be expected for the Dutch logistics market in the years ahead. From a market viewpoint therefore, those country/type of use combinations that lie in the upper right-hand corner of the chart tend to offer higher expectations of performance.

Figure 2: Investment matrix by market segment* (country and type of use)



*Data source: PMA, JLL; Graph: Real I.S.; *Market segments by data availability, residential: rental growth of average rents*

Conclusion:

The rise in interest rates has led to a decline in prices on the property market. As soon as this, in all likelihood, comes to a standstill in 2024, attractive re-entry opportunities will be available at higher initial yields. In this respect, it is important to take advantage of yield opportunities in the investment market, but not to neglect a high degree of stability in the rental markets. The focus for an attractive risk/return mix is currently on countries such as Spain, Portugal, Ireland, Luxembourg and Belgium, as a complement to the large markets of Germany and France. The logistics, residential and hotel types of use in particular have highly stable demand and rental growth. In the office segment, energy-efficient buildings in central locations are especially attractive.

Kind regards

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