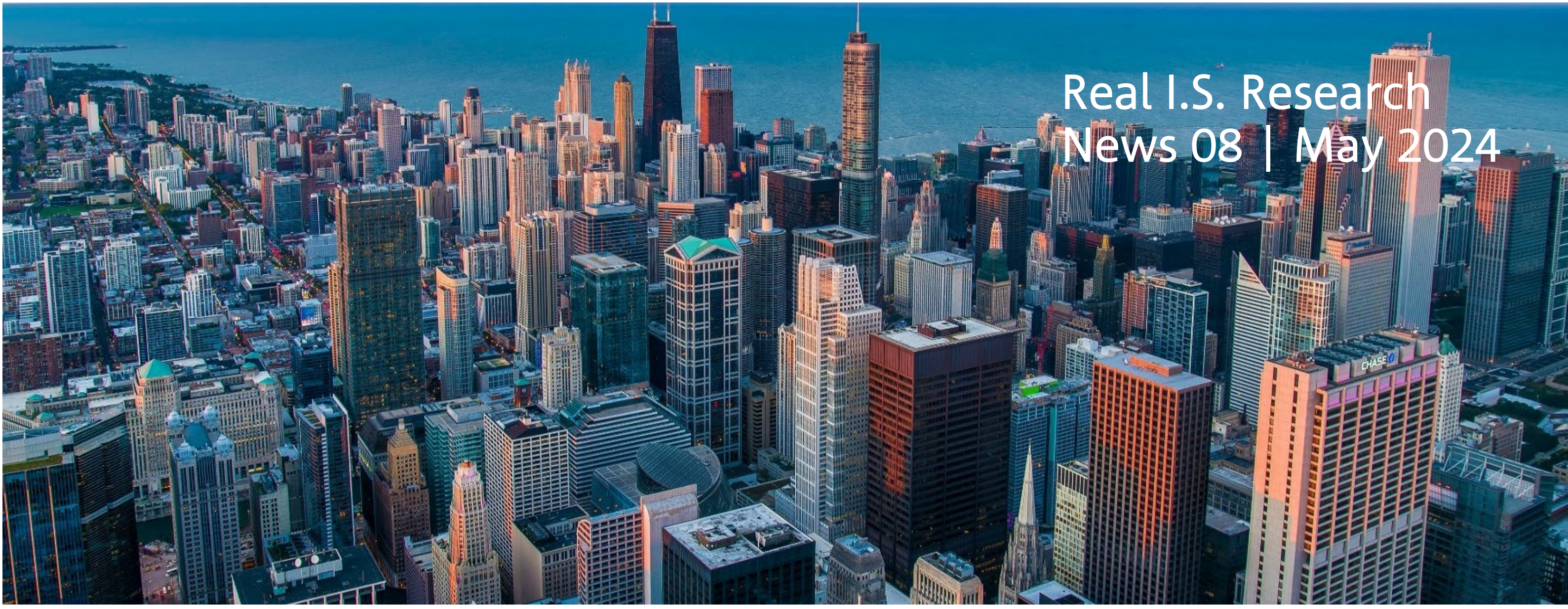
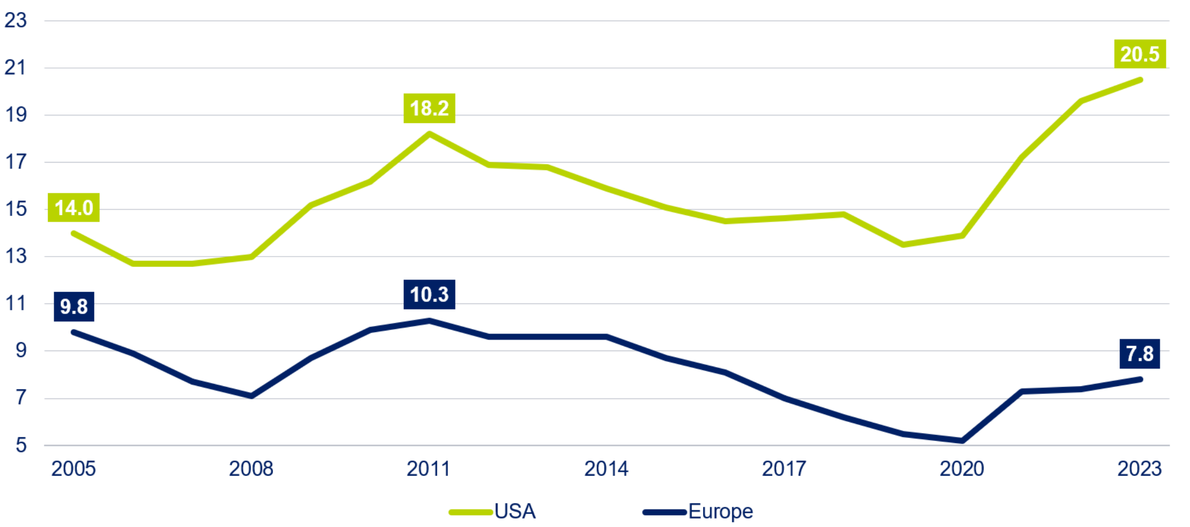


Crisis in the US real estate sector – Europe shows more resilience

The US office property market is in the eye of the storm. The interest rate hikes by the Federal Reserve Bank (Fed) have led to a slump in demand on the investment market. In addition, rents in the office market in major American cities are falling as more people work from home, combined with high vacancy rates. As a result, purchase prices for office real estate are on a sharp downward slide, with many market observers talking about a property crisis in the United States. Does this mean that the USA is a herald of developments in Europe? The following are arguments against this conjecture.

Rental market – The vacancy rate for office properties in the USA has now risen to 20.5% (see figure 1), positioning it above the previous peak in 2011 (18.2%). In Europe, the vacancy rate currently stands at 7.8%, which is well below the high of 10.3% in 2011. The impact of the COVID-19 pandemic is a major cause of this trend. In the United States, office workers have relocated from big cities, such as New York, Los Angeles, Chicago or San Francisco, to more rural regions to take advantage of remote working opportunities to a greater extent than in Europe. As a result, demand for office space has fallen more sharply. Moreover, existing buildings, taken as a whole, are older in the USA than in Europe and thus consume more energy. Given tenants' increased requirements for their office space, the structural office vacancy rate is therefore higher than in Europe and has risen more sharply in recent years. The high and increased vacancy rate is putting pressure on the rental market, thus also driving the price drop in the investment market.

Figure 1: Office vacancy rates USA vs. Europe, 2005 to 2023 (%)



Source: JLL, chart: Real I.S. AG

Investment market – The rise in interest rates was more drastic in the USA than in Europe. The Federal Reserve Bank (Fed) has raised the key interest rate by 525 basis points to 5.25%; the European Central Bank (ECB) increased its key interest rate by 450 basis points to 4.5%. The trend in capital market interest rates was similar (yields on 10-year benchmark bonds): they rose by 410 basis points from their low point in the US to their current level of 4.6%; in Germany, as benchmark for Europe, they grew by 330 basis points to 2.5% at present (see figure 2). This development has led to a stronger fall in prices on the investment market in the USA, as compared to the European market.

As real estate is financed at variable interest rates in the USA to a much greater extent than in Europe, the more significant rise in interest rates compared to Europe also has a much faster impact on the property-related cash flows of real estate holders. This has resulted in distress selling on the market, which has accelerated the fall in prices.

Figure 2: Capital market interest rates USA and Germany, 2020 to 2024 (%)

Source: investing.com, chart: Real I.S. AG

Valuation process – In the USA, it is common practice to use a market-based procedure, the discounted cash flow method, to determine the value of real estate portfolios. As a result, the values of real estate portfolios in the United States have fallen more sharply. The earnings value method is widely used in Europe. This method basically determines a sustainable fair value. As a result, values for real estate portfolios in Europe rise more slowly during a market upturn than market prices in the investment market; conversely, they also fall more slowly during a market correction.

The larger value corrections for office real estate portfolios in the USA versus Europe are also reflected in data from MSCI: in the United States, the aggregate change in capital values for real estate portfolios in the office segment was 27% for 2022 and 2023, while in Germany it was 11% on aggregate (2023 MSCI data for Europe is not available yet).

As a result of the larger capital value corrections in real estate portfolios in the USA, financing covenants from loan agreements tended to be breached more often. This has led to distressed sales, which accelerated the price decline in the investment market.

Risk not yet averted

The office property crisis in the US could, however, also have implications for Europe. European banks that need to set aside higher provisions for expected losses on loans in the United States may possibly reduce their loan commitments for real estate in Europe. This will also cloud the financing environment in Europe. Moreover, news about the property crisis in the USA continues to fuel uncertainty in the media about how the market will develop in Europe, thus dampening the mood on the investment market.

Conclusion: European market is more resilient than the US market

There are clear differences in the market trends of the rental and investment market for office properties in the United States versus Europe. Higher vacancy rates and the sharper rise in interest rates are having a greater impact on the US market, the fall in the value of real estate portfolios and the drop in prices for buying and selling on the investment market are more drastic than in Europe. Europe's office property market is, however, not a pillar of strength. Vacancy rates are also trending upwards in Europe, and prices have fallen. However, Europe currently presents a much more solid picture, particularly in the rental market. In most major European cities, this market still has comparatively low vacancy rates and is seeing growth in prime rents. This puts Europe ahead of the United States in the office property market.

Kind regards

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