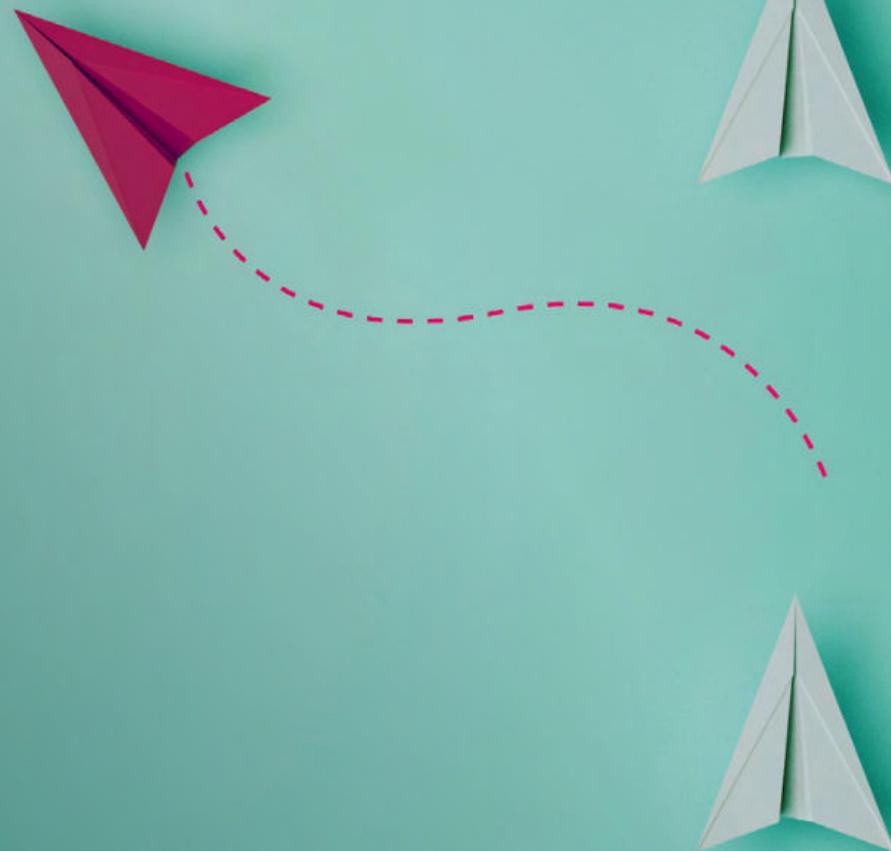


EUROPEAN PROPERTY MARKET

EMBRACING CHANGE

OUTLOOK H1 2024



RESEARCH & INSIGHTS



BNP PARIBAS
REAL ESTATE

Real Estate for a changing world

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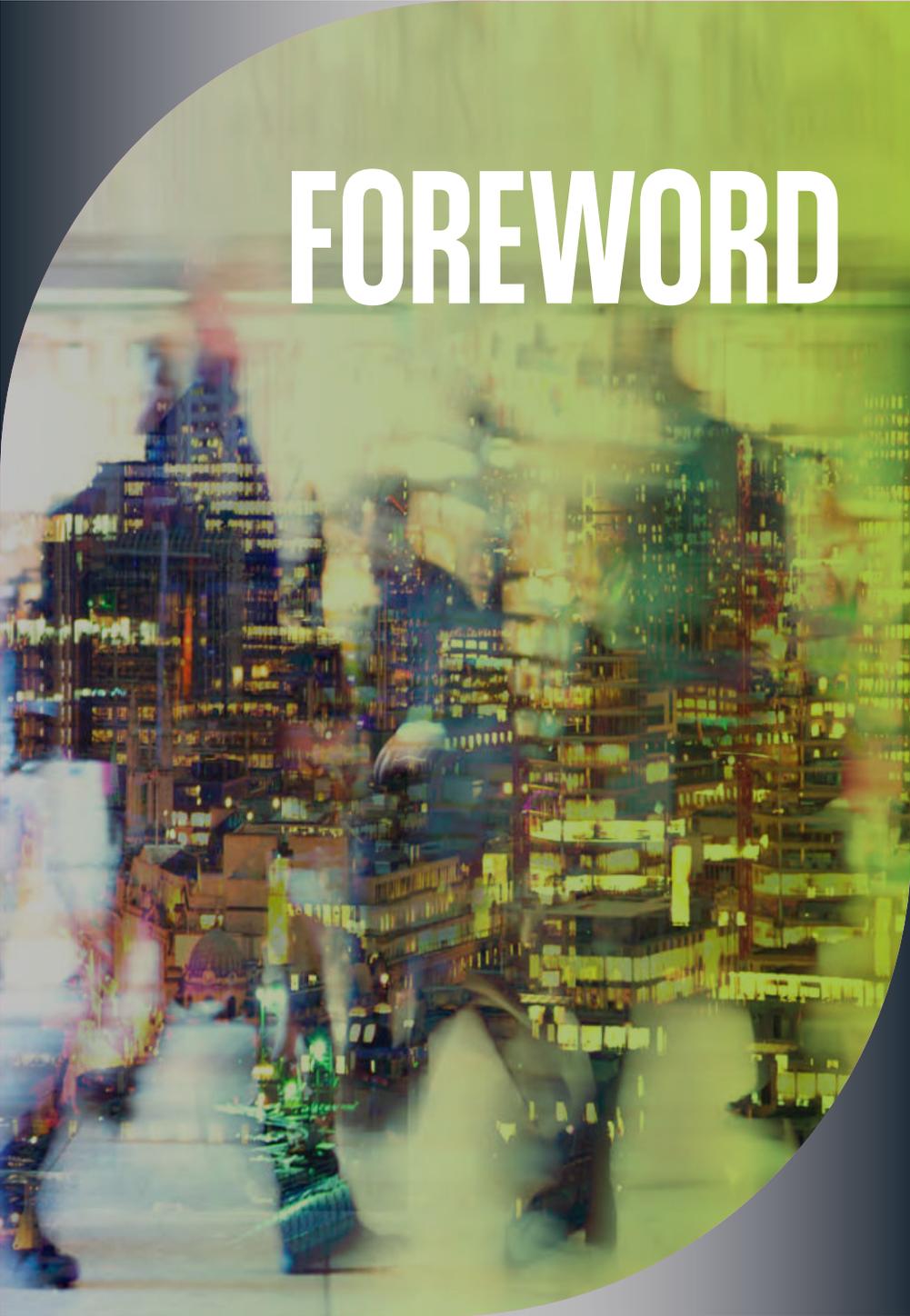
**BNP PARIBAS
REAL ESTATE**

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FOREWORD

RELATIVE CALM APPEARS TO HAVE DESCENDED ACROSS EUROPEAN ECONOMIES. ALTHOUGH SOME ECONOMIES HAVE ENTERED INTO A TECHNICAL RECESSION, THE THREAT OF EVER-INCREASING INFLATION RATES SEEMS TO BE FADING, WITH IMPLICATIONS FOR INTEREST RATES, DEBT COSTS AND REAL ESTATE MARKETS.

As we start the new year, the data flow on the European economy has been mixed. Thus far, we have seen deterioration in economic activity and the labour market in Q4. But we have also seen forward-looking indicators such as the Purchasing Managers' Index (PMI) strengthen, suggesting potential improvement in the economy going forward. On the inflationary front, headline figures continue to fall across, but the underlying rates remain sticky, particularly in the services sector due to rising labour costs. These developments continue to shape central bank decisions and the general view is that policy rates should begin to fall from the middle of the year.

The read across to the real estate market is that we may now be at the trough of the downturn and at the foothills of a new cycle. One that will be dominated by income and asset management as a driver of performance. There is likely to be bumps in the near term, so investors should focus on their long-term strategies and value creation and should not attach undue importance to short-term market stress. There is further yield decompression to come in the near term, but the clouds could begin to part in the second half of the year. This means different things for different sectors. The narrative on net income as a driver of return will become louder, and sectors able to generate superior rental growth will be better protected from further value falls. In this

regard, logistics stands out, but investors need to be selective to avoid lease events on assets that are already charging high rent. And the living sector is set to continue its upward march.

In this report, we discuss how European markets are shaping up for the short and long term amidst a changing investment, occupational and regulatory environment. The market has clearly been in flux over the past year. Although punditry remains bearish, we think there is a light at the end of the tunnel from the second half of 2024. For offices, consensus is emerging on the durability of hybrid working. This helps us to better understand the effect of this structural change on demand for space. Alongside a fall in the long-term take – up of space, demand is now more skewed towards modern and efficient buildings. In logistics, there has been significant rental growth in most European markets over the past 5 years. We see this continuing but at a much slower pace. The positive story is in retail, where we are now seeing rental growth and stable yields, after years of upheaval in the sector. We think investors should revisit this category, which could now offer an attractive entry point for an opportunistic play in a wider real estate portfolio.

Samuel Duah

Head of Real Estate Economics
Research & Insights



EUROPEAN REAL ESTATE **PERSPECTIVE**

A NEW CYCLE BEGINS

by Samuel Duah

'Every new beginning comes from some other beginning's end.' SENECA

The real estate cycle that began with the GFC in 2008 explicitly came to an end in 2023. What was notable about the end to this cycle was its elongated nature: drawing the cycle to a close took an entire year. This reflects the protracted nature of monetary policy, whereby it has taken central banks a full year to get on top of persistent inflation. However, they remain cautious about the current inflation trend and may be slow to normalise key interest rates. Consequently, real estate may also take longer to pick up as this new cycle begins.

REAL ESTATE INVESTMENT BOTTOM OUT IN 2023

European investment figures for 2023 were sobering, hitting a decade low of € 133bn, down 51% on 2022 (Exhibit 1). In the big 5 markets, the UK led with € 43.5bn (-43% y-o-y), followed by Germany with € 23.3bn (-57%), France with € 14.3bn (5.4%), Spain with € 7.1bn (-45%) and Italy with € 6.4bn (-49%).

Volatile financing costs in 2023 took a toll on European investment activity. The elongated nature of the monetary policy cycle has made it difficult to establish suitable pricing against bond yields and acceptable lending costs. At the heart

of this is ongoing price discovery rather than lack of liquidity.

Going forward it is likely that investment volumes will pick up, although this may be more apparent towards the end of 2024. The great unknown of the investment market is the extent to which it may be driven by distressed sales because of the funding gap. Like residential mortgages, many commercial loans are on fixed rates and due for refinancing in the coming years. This is mostly likely to occur at a higher interest rate.

It is unlikely that the high volume of transactions seen in the past five years will reappear any time soon, reflecting two aspects of the cycle. The first is the scale of repricing, which means more assets will have to be transacted to attain similar volumes. That seems very unlikely in the short term. Secondly, the cost of finance is likely to stay expensive in the short term, which may inhibit some transactions going forward.

YIELD DECOMPRESSION HAS ALMOST RUN ITS COURSE

Instead of ending the interest rate tightening cycle in early 2023 as had been hoped, central banks maintained the tightening bias into the

third quarter. Given the nature of valuation systems in different European countries, this has meant an almost constant catch-up process all year: 2023 will be regarded as the year of yield decompression. European markets are now characterized by protracted price discovery processes across all asset types, albeit at different speeds. The European composite yield for retail stood at 4.0% (3.6% in 2022) and logistics 4.6% (4.2% in 2022). The composite office yield stood at 4.6% (3.8% in 2022) for the 16 top markets. While we see further yield decompression expansion in 2024, albeit marginal, we acknowledge that this is the tail end of this process.

Although yields have repriced broadly, investors' appetite for the various asset classes varies. No asset commanded a substantial risk premium (over bonds) at the end of 2023. That alone suggests for some classes, offices especially, there may be some more expansion to come.

FALL IN EUROPEAN INVESTMENT VOLUME
2023 VS 2022



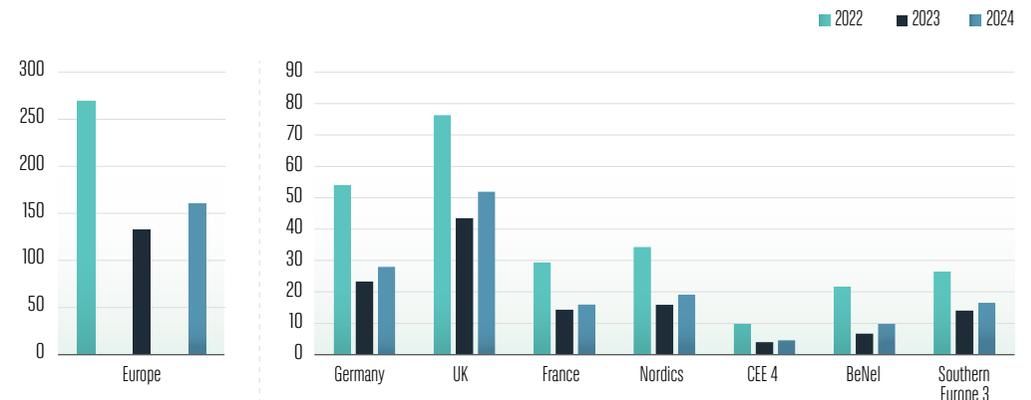
INCREASE IN AVERAGE EUROPEAN
PRIME OFFICE YIELDS



EXPECTED ANNUAL EUROPEAN ALL PROPERTY
TOTAL RETURN OVER THE NEXT 5YRS.



Exhibit 1: Investment Volume (€bn)



Source: BNP Paribas Real Estate

The attractiveness to investors therefore depends greatly on the asset's location, occupational dynamics, tenant demand and rental growth potential most of all.

This leads us to think that the market will reactivate selectively by asset type first, followed by location, with strong tenant demand and rental growth as the main drivers of performance. This points to investor demand for the alternative sectors such as residential with strong demand, ultra-low vacancy, and robust rental growth prospects.

As the new cycle develops, landlords must look more to rental growth to generate returns than yield compression. We continue to anticipate divergence in rental performance between sectors, with those characterised by low availability and high demand – like prime offices and logistic – outperforming in rental growth (**Exhibit 2**).

That inevitably means greater focus on tenant retention with increased incentives and the cost that implies. Retail, though not generating the magnitude of rents seen historically (luxury is an exception here), is likely to expand after years of decline.

COOLER LOGISTICS RENTAL GROWTH

Demand for logistics space cooled in 2023, in the wake of the economic slowdown. Take-up decreased by 35% in the leading European markets, though the decline came after exceptional years in 2021 and 2022. Take-up mirrored levels seen in 2016, so was still strong but considerably more selective. This partly reflected weaker tenant demand and the cost of constructing new units. This is still likely to be more expensive than in the past even with more accommodative monetary policy. The latter should help to stabilise the cost of financing construction, though the design and

“We expect strong rental growth in prime office and logistic assets, driven by scarcity, high construction and financing cost.”

RETAIL RENTAL GROWTH TO TURN POSITIVE

Although the European economy did not enter recession and inflation moderated over 2023, consumers remained cautious about spending. Price levels remain high, especially for food, which discourages the sort of discretionary spending on which retail thrives. The cost-of-living crisis produced a classic consumer substitution response; reduce, replace, and remove with the emphasis on necessities. This behaviour mostly benefited discounters at the expense of the midmarket segment. Immune to this phenomenon is the luxury segment, which continues to chart its own path of relentless growth.

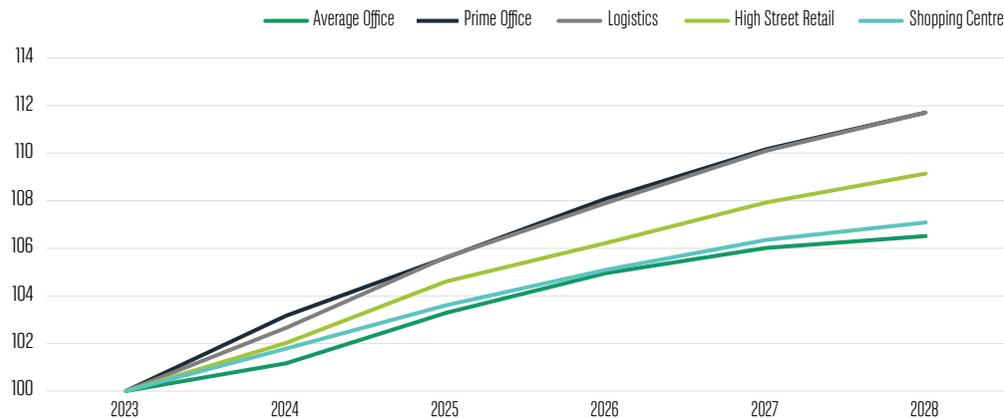
The prospects for retail recovery are good. The structural challenges that retailing has faced over the last twenty years means that many companies have learnt to cope. What made for a successful retailer over the slowdown was the ability to adapt pricing, leverage the brand and adopt an optimum omnichannel delivery strategy. The latter is important because many companies that stumbled either overinvested in e-commerce at the expense of stores, or underinvested. Getting the balance right may end up being a defining feature of this cycle.

Although an abundance of retail units remains, they increasingly do not fit with the innovation strategies of the mass market or are not located in the right places for luxury. We think that select retail locations are set to recover with brand expansion. **Consequently, we anticipate that high street rents could begin to grow again, starting with 2.2% growth on average across Europe. All regions are likely to see growth with the strongest**

build side of supply will still be affected by high construction prices. Material prices have been on a rollercoaster in the last two years and although key commodity prices may fall over the forecast period, the absolute price levels are likely to remain above those seen from 2015 to 2019.

The outcome is that scarcity is unlikely to disappear anytime soon, even with more selective demand. Rental levels, already high, increased by an average of 6.3% over 2023 against a backdrop of weaker take-up, highlighting the supply distortion. We continue to think that further rental growth may challenge some occupiers to find more cost-effective units. Added into the mix is the need for more energy-compliant buildings. The combination of more selective demand and a reactivated pipeline suggests that the pace of rental growth may slow over the next few years. **At European level, we see rental growth over the 5yr forecast period at 2.2% per annum.** It is likely to be strongest in 2024 for markets like Southern Europe (3.8%) Germany (3.5%) and the United Kingdom (3.4%).

Exhibit 2: Outlook for Rents by Sector in Europe (Index, 2023 = 100)



Source: BNP Paribas Real Estate

in CEE (3.7%), Germany and Southern Europe (2.3%). The best performing cities by 2028 may be Paris and Oslo (2.8%). Rental growth in shopping centres may also turn positive in 2024, with 1.8% at the European level and strongest in the UK (3.1%) and Benelux (2.4%) in 2024. Shopping centres and retail parks are of key interest to retailers seeking omnichannel options, especially “click and collect”.

CONSTRUCTION MAY SEE OFFICE RENTAL GROWTH TAPER OVER THE FORECAST

The new cycle underway for the office market may embed the quality factor as key to commanding the best rents. Supply is characterised by a scarcity of modern assets and an abundance of secondary ones. Yet this binary dynamic is now in flux as owners decide what to do with buildings. It is a slow process to alter the built environment, yet the two drivers of tenant demand and energy

regulation mean more development is rolling forward, even if at a high construction cost.

Take-up of large-scale floorplate units was particularly weak in 2023. With a clearer economic outlook for 2024 and especially from 2025, larger scale requirements are likely to reactivate. We continue to think that this will focus on the most modern units. However, we see future demand for large units being lower than in previous recoveries because of the impact of hybrid working. Yet many companies are still exploring how this style of working operates. It is not as simple as applying the same density ratios used pre-pandemic in a smaller space, as the hybrid working concept is a rethink of how space is used.

The office sector therefore continues to face a confluence of structural changes that favours prime and modern units, and less space. The combination may mean that prime assets

“Our forecast total return is driven by strong income return, reflecting the fact that prime yields have now corrected significantly upwards in most markets.”

albeit narrowly. The value collapse triggered by repricing that led returns to drop has mostly worked its way out of the market.

Relative stability is emerging in the macro financial environment, which ought to translate into resumption of yield compression from H2 2024, and hence capital value growth. We have downgraded our outlook for capital value growth in most asset classes to below 4% per annum (Exhibit 3). This will be supportive of total returns even if rental growth, and hence income return, will be the key driver of total returns going forward. All property return in Europe will average 8.1% over the 5yr forecast period.

At European level, prime and average offices are likely to see returns of 8.9% p.a. and 7.0% p.a. respectively, over the forecast period. The sector now faces a combination of short-term (weaker demand), midterm (hybrid working) and long-term (energy regulations) factors that make office selection complicated. Weaker demand will resolve itself with stronger economic growth. Hybrid working represents organisational change and that needs viewing as a ten-year adjustment period. Energy regulation is likely to become a tightening ratchet on the sector over the next 20 years as it is closely linked to stock quality and age.

Logistics returns are likely to average 8.8% p.a. This sector stands to gain the most from capital growth as it may see yield reduction earlier than any other. There is no ambiguity about tenant demand or rental prospects so total returns may stay positive across the whole forecast period.

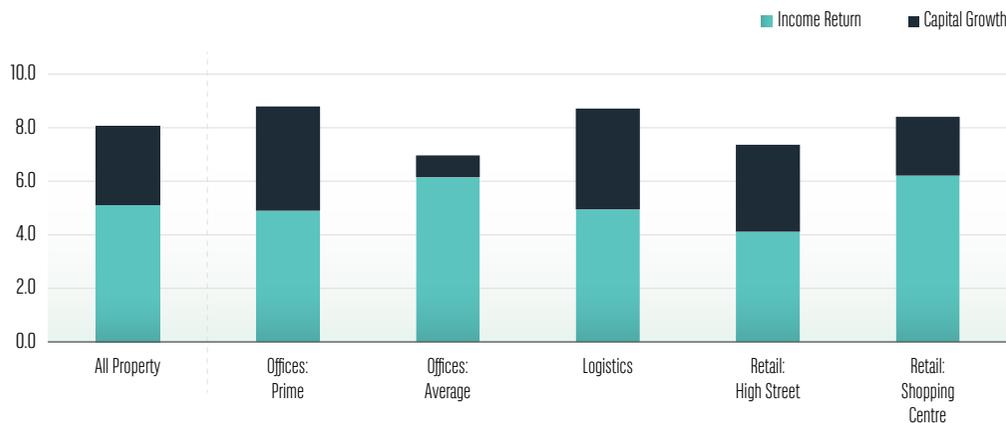
experience declining rental growth over the forecast (2.6% on average) compared to the last 5 years (3.9% on average). There is sufficient momentum behind development of prime units in CBDs to take the edge off rental growth even if requirements stay unaltered.

For secondary assets, especially those located outside the CBD, prospects are murky. There is considerably less demand, which could result in excess supply as vacancy increases. These types of assets may record an even slower rate of rental growth on average, at 1.3% over the forecast period. The ever-increasing performance gap in rents between old and new offices is likely to dominate the new cycle.

TOTAL RETURNS EXPAND TO INCORPORATE STRONGER INCOME BUT GREATER RISK

European real estate is at a point of recovery in terms of returns following two years of declines. Only logistics escaped negative territory in 2023,

Exhibit 3: Average European Total Return (% pa, 2024 - 2028)



Source: BNP Paribas Real Estate

The challenging environment in retail is mostly receding now with the best places holding value. Considerable growth opportunities exist for retailers and investors. Luxury benefits from inflation (it boosts brand exclusivity) and discounters gain from consumers seeking cheaper alternatives. Both these segments are taking on more space.

For the mid-market, the slowdown exposed business model flaws. Specifically, inadequate attention was given to store portfolios. Many retailers seem to have regained a taste for innovation and it looks likely that the retail

environment will witness much store-based experimentation tying into the online offer. Much of this will focus on retail parks and shopping centres especially, so that the sector's rental prospects are improved. We think European high street retail and shopping centres may see total returns of 7.4% p.a. and 8.5% p.a. respectively.

REAL ESTATE MARKET MOMENTUM

Each property cycle builds upon what has happened before, so the new one at the beginning will still feature assets that were already performing

well. Yet it remains the case that the assets best positioned to gain from market reactivation are those that already have the right combination of capital and rental growth prospects. This means assets that may still perform well include offices and logistics, although they may not excel as in the previous five years. New cycles are also periods when different assets start to generate momentum. In the coming years, the alternative asset types (residential, senior living and student accommodation) will become mainstream and old ones, such as retail, will come back as an opportunistic investment.

"A new cycle begins. One in which active management strategies that reduces obsolescence risk and priorities tenant retention will drive performance."

We continue to think that logistics and modern offices in CBDs may retain premiums. Sustained pressure on secondary office stock is likely to occur because of poor tenant demand and inadequacies in the building fabric. Logistics may come under increasing pressure from environmental standards. Sheer scarcity though will mitigate against serious downward pressure, so long as a unit is well placed and large enough.

We believe that retail is on the cusp of generating longer-term value for investors. Absolute rental and capital values have shrunk significantly over the years. We continue to stress that the sector presents a value-add opportunity rather than a core strategy product.

Exhibit 4 shows the spectrum of performance outcomes that may occur. The sectors and markets that offer the best balance of capital growth and rental performance over the 5-year period include offices and logistics. For offices, these include the Nordic markets led by Norway, and the UK, London especially, historically a leading city in cycles. For logistics Sweden is promising, but high street retail in Norway also looks good.



ECONOMIC OUTLOOK

ROAD TO RECOVERY

by Sam Hall

EUROZONE NARROWLY AVOIDS RECESSION

Looking back over the past year, our broad view was that most European economies would enter a mild technical recession in the second half of 2023. It is important to note that GDP data are often revised, although, the first estimates suggest that the eurozone narrowly avoided a recession, while the UK did not.

Generally, economic activity has held up well in the face of higher interest rates, particularly in the services sector. This could reflect a combination of factors including structurally tight labour markets, savings buffers, and the EU Next Generation fund disbursements.

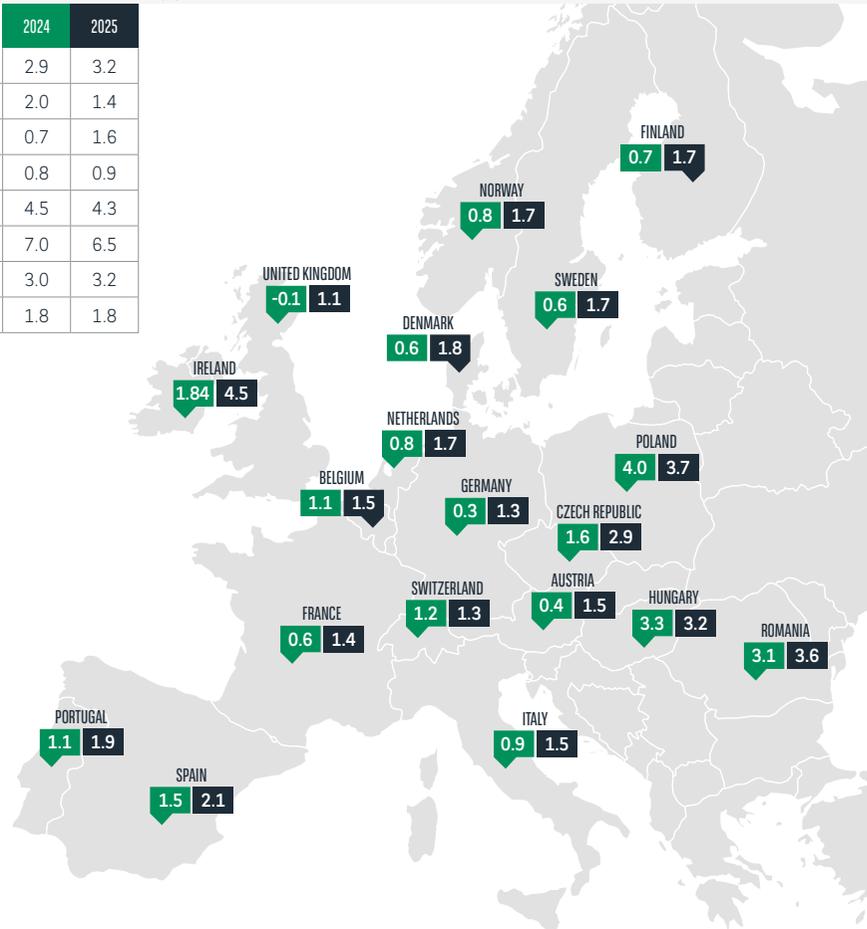
At a country level, the peripheral markets remained the key source of strength, with Italy and Spain growing by 0.2% and 0.6% q/q respectively in Q4. Meanwhile, France stagnated, and Germany contracted by 0.3% q/q on the back of a sharp drop in investment.

PRIMED FOR ECONOMIC GROWTH

The challenging interest rate environment will continue to weigh on economic activity in the near term. As a result, we expect the stagnation narrative that has taken hold over the past year to carry into the start of 2024.

EXHIBIT 5: GDP (%) EXPECTATIONS FOR MONETARY BLOCKS AND SELECTED EUROPEAN COUNTRIES

	2024	2025
WORLD	2.9	3.2
UNITED STATES	2.0	1.4
EURO AREA	0.7	1.6
JAPAN	0.8	0.9
CHINA	4.5	4.3
INDIA	7.0	6.5
RUSSIA	3.0	3.2
BRAZIL	1.8	1.8



Source: BNP Paribas, Oxford Economics, IMF

EUROZONE GDP GROWTH



INFLATION RATE BY END-2024



10 YEAR BOND YIELD BY END-2024



However, the worst is behind us. Indeed, there are a couple of reasons why we expect domestic demand to pick up from the second quarter of this year. For one, the outlook for consumer spending will begin to brighten. The combination of resilient nominal wage growth, stemming from tight labour markets, and a continued deceleration in inflation means real wages are likely to grow this year. Consumer spending could also benefit from sizeable cash buffers and an elevated saving ratio, which we think will moderate gradually as consumer confidence recovers.

Second, the squeeze from monetary policy tightening will lessen as cuts to interest rates draw closer. This is already starting to filter through to the economy, because expectations of rate cuts have led to lower borrowing costs. We think financial conditions will ease further in the coming quarters, which should support real estate investment growth.

Admittedly, fiscal policy is set to tighten. However, we doubt it will be a major drag on activity in most economies since most of the withdrawal of support will come from the expiration of energy subsidies. The biggest risk to this view is a more significant fiscal consolidation in Germany.

Overall, we expect the eurozone economy to grow by 0.7% y/y in 2024 and 1.6% y/y in 2025, with the peripheral markets continuing to outperform. Indeed, we forecast growth of around 2% p.a. in Spain and between 1% and 1.5% p.a. in Italy. Performance in Germany is likely to lag behind, with growth expected to be broadly flat this year and meagre in 2025. We see the UK economy following a similar trajectory, while France will fare slightly better (see Exhibit 5).

INFLATION RATES CONVERGE TOWARDS TARGET

In recent months, sharp declines in inflation rates across Europe have largely been driven by the unwinding of previous energy shocks. That said, there is also evidence of a broader cooling in price pressures as demand-supply imbalances normalise. Indeed, firms are increasingly citing weak demand as a factor limiting production, rather than supply chain challenges. At the same time, fewer firms have reported difficulties hiring and retaining staff, which should limit the risk of a wage/price spiral (see Exhibit 6).

Looking ahead, we expect goods disinflation to continue in the first half of the year in line with leading indicators. From there, supply chain snags stemming from conflicts in the Middle East may

represent an upside risk. Most recently, attacks in the Red Sea have led to ships taking longer and more costly routes. However, unless these disruptions last for a prolonged period of time, we see limited evidence to challenge our forecast of continued disinflation. After all, pressures on energy markets have remained contained. Also, the breadth and magnitude of shipping price increases have been relatively limited and, against a backdrop of subdued consumer demand, it will be more difficult for firms to pass rising costs through to prices.

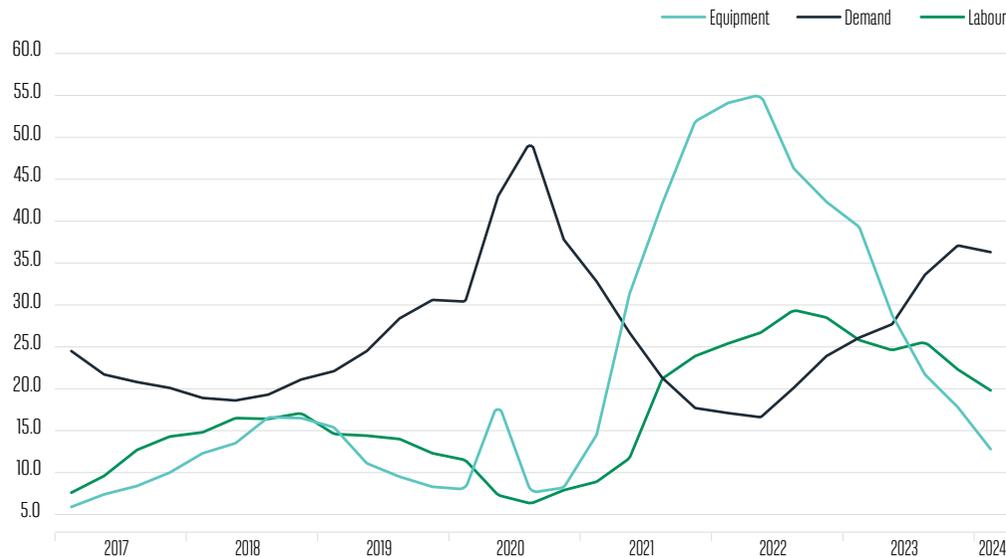
In addition, we expect further declines in services inflation. The annual rate is being propped up by large price increases at the start of 2023. By contrast, more recent price rises have been smaller. Therefore, as these large increases drop out of the annual

“Rising real income will help economies return to growth.”

calculation, the annual rate of services inflation will continue to decline.

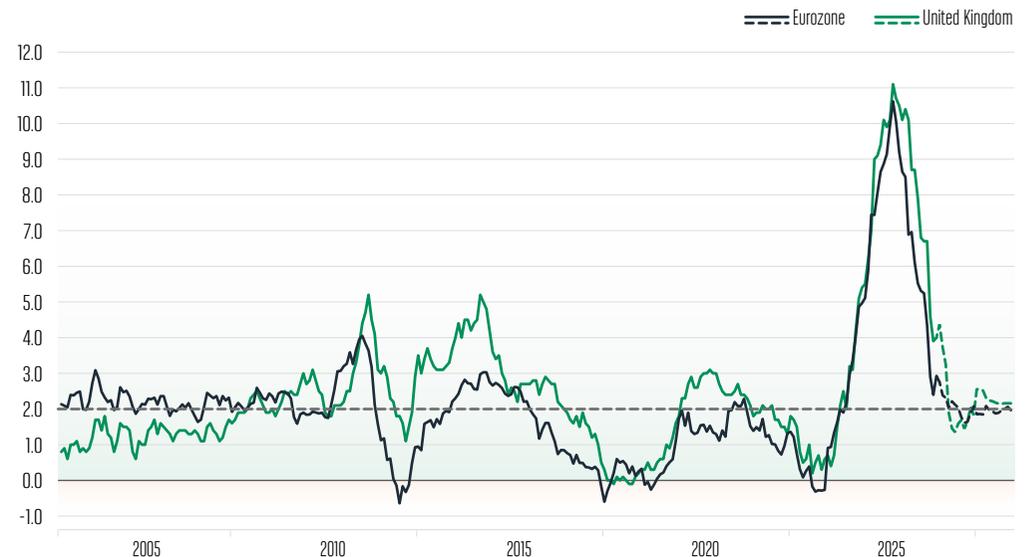
Overall, we forecast inflation will fall to 2% by mid-year in most European economies, even in the UK where tighter labour markets will mean that core inflation falls more slowly. Most countries will see inflation rates dip below 2% at some stage this year. However, the bigger picture is that inflation will return to target – or close to it – on a sustained basis (see Exhibit 7).

Exhibit 6: Factors Limiting Euro Area Industrial Production (%)



Source: Macrobond

Exhibit 7: Headline inflation Rate in Europe (% y/y)



Source: Macrobond, BNP Paribas

INTEREST RATE CUTS ON THE HORIZON

Recent declines in inflation towards the 2% target mean that the question around interest rate cuts has become a matter of “when” rather than “if”. The ECB has avoided sending signals about the timing of rate cuts, but the general tone of speakers seems to have acknowledged the progress made in cooling inflation.

In its January meeting, the ECB made clear that rate cuts were data- (not date-), dependent. At the same time, President Lagarde seemed to downplay the idea that the ECB is waiting for evidence of slower wage growth in the official data as it believes from the timelier measures that it is already happening. Therefore, all eyes will be on the February and March inflation prints.

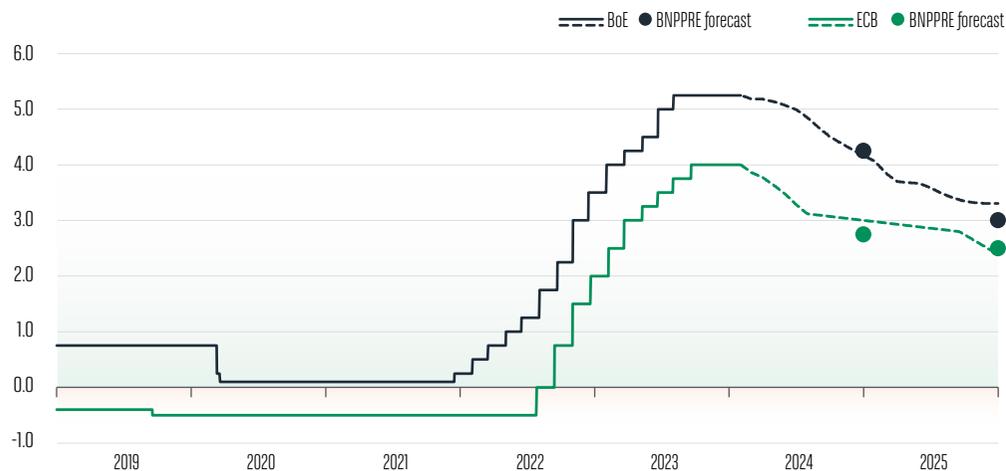
It appears that what was once a perceived preference for the first rate cut to be in June is now a more balanced debate between April and June. Given our

view that inflation will undershoot the ECB’s current projections over the coming months, we think the ECB will need to reassess the outlook at the March meeting, which should pave the way for monetary policy normalisation to begin in June.

We expect a cumulative 125bp of cuts this year, taking the Deposit Facility Rate to 2.75% by the end of 2024 and 2.50% by the end of 2025. In the UK, we forecast the Bank of England to start cutting rates in June, taking the Bank Rate to 4.25% by end-2024 and 3.00% by end-2025 (see Exhibit 8).

If central banks cut interest rates in line with these forecasts, long-term government bond yields will trend lower over the course of this year. By end-2024, we forecast the 10-year bund yield to be 2.20% and the 10-year gilt yield to be 3.55%. Thereafter, we expect a small rise to 2.50% and 3.65% respectively by end-2025.

Exhibit 8: Expectations for Policy Rates (%)



Source: Macrobond



The background features a dark blue, futuristic digital landscape. On the left, a large globe is rendered with glowing circuit board patterns. To the right, there are several financial charts, including a line graph with a red line and a candlestick chart. The floor is a grid of glowing blue squares with circular nodes. The overall aesthetic is high-tech and data-driven.

SECTOR PROSPECTS

CHALLENGES AND OPPORTUNITIES

by Samuel Duah

2023 has been an “annus horribilis” for commercial real estate. In fact, the numbers for investment activity across Europe are indeed sobering: activity fell by 51% on average across the market, reaching €133bn, the lowest since 2010. Property values fell by 30% on average across Europe as the cost of debt rose sharply and demand for occupational space fell meaningfully, particularly in the office sector. These challenges may seem daunting but look deeper and there are pockets of opportunities now emerging for investors.

OFFICES – TURNING POINT

The uncertainty in the real estate market is most acute in this segment, which is going through profound changes on multiple fronts: price adjustment after the sharpest increase in debt cost in decades; working patterns that continue to suggest reduced demand for space; and a regulatory framework that will increase obsolescence. These issues continue to weigh on the performance of the sector. But we believe there is light at the end of the tunnel now and most upheavals is now priced into the sector. Nonetheless, increasingly investors are growing averse to offices and are therefore reducing their exposures. Going forward, this means we are likely to see a reduced share of offices in the overall investable commercial real estate universe.

LOGISTICS – INFLEXION POINT

Over the past few years, factors such as online spending and supply chain disruptions have boosted demand for logistic space across Europe. In 2023, growth in demand slowed in response to a more challenging global economy. However, rental growth sustained as high-quality, energy efficient buildings were in short supply due to scarce land and low development finance. These rent hikes have been substantial in some markets and are affecting tenants unevenly. Going forward investors will have to reflect in their appraisals the possibility, at lease events, that tenants may seek a more affordable space and thereby creating a risk of void, even if temporarily.

RETAIL – RENAISSANCE

The retail sector has seen one of the most prolonged declines on record, driven by profound structural changes in shopping habits. The share of retail in European investment activity has fallen meaningfully over the years and consequently pricing has adjusted significantly. The effect has been uneven in this broad sector. We think the down cycle may have reached the bottom as evidenced by the limited effect of the current interest rate

cycle on pricing. Moreover, we are seeing pockets of rental growth again, which could be consistent with a recovery for the sector. This leads us to wonder whether the sector is now worth an opportunistic play in a broader real estate portfolio.

RESIDENTIAL – CATCH ME IF YOU CAN

This is a sector where movements in interest rates present a double edge sword. On the one hand, increasing debt costs make purchasing a home more difficult. As such, transaction volumes have fallen

significantly on the back of the sharp rise in financing rates. The flipside to this is increased demand for rental. This is one reason for growing institutional interest in residential allocations; demand for rental properties is increasing significantly across Europe. However, the rental segment faces two key challenges that investors need to consider; both are in the regulatory space. Increased regulation on both rental controls and ESG requirements will heighten the operational risk that investors will need to factor into their expected return.



OFFICES

by Stephen Ackroyd

FALL IN EUROPEAN OFFICE INVESTMENT
2023 VS 2022

-59%

EXPECTED PEAK IN VACANCY RATE
IN 2024

9.2%

AVERAGE PRIME TOTAL RETURN IN EUROPE
OVER THE NEXT 5YRS

+8.3%

TURNING POINT

The 2023 market can truly be defined as the end of a cycle with the office sector the biggest casualty, posting the steepest declines in transaction volume and value. However, we see a market turning point occurring in 2024.

Investment volumes for European offices came in at € 39.0bn for 2023, down 59% on 2022. Every single market bar Austria (+5%) witnessed declines. Of the big markets, Germany experienced a 73% fall, the UK -45%, France -56%, Italy -68% and Spain -33%. The markets that fell furthest were Belgium (-87%) and Poland (-80%)

Although, there remains a lot of mist around the sector, one thing becoming clear is that the pricing impasse that stymied activity is dissipating. The process began in Q4 when central banks decided to pause tightening of monetary policy. Consequently, the scale of repricing needed to encourage investment into the sector is much reduced. We are seeing increased activity as investors search for opportunities.

The new cycle for offices is likely to begin with a search for value, particularly for durable units with the potential for increased income. This will require more work from owners but will come with the benefit of lower entry cost.

TOTAL RETURNS TO TURN POSITIVE

Two terrible years for office returns are now behind us. European total returns posted -3% in 2022 and -11% in 2023. Over the 2024 to 2028 forecast period, European prime returns are likely to return to positive territory, driven mostly by income but also



with the return of some capital value growth. In the new cycle, it is more than ever the case that good asset management of offices makes all the difference between positive and negative return outcomes.

We anticipate European office prime returns to average around 7% in 2024 compared to 6.4% in our previous report. Total returns may reach double-digit growth in 2025 (11.1%) before dropping back to 7.4% by 2028. Improved returns in part reflect the greater emphasis on income compensation for the greater risk of holding offices. Nevertheless, some capital growth may start to emerge (**Exhibit 9**). At European level the forecast is for 2% in 2024, peaking at 6% in 2025. Many cities are still likely to see a fall in office values in 2024, albeit marginal.

France may be the best performer in 2024, with capital growth of 5.4%. It may also be the strongest performing region by end of the forecast period, at 5.1%. The UK is now likely to peak in 2025 with capital values up 9% before dropping back to 2.3% by 2028. Germany may post 2.7% in 2024 and 4.6% in 2028. Southern Europe may post 0.4% for 2024 and 0.5% for 2028.

At city level, it is a mixed performance with a large number posting negative returns for 2024, ranging between Madrid (+8.6%) and Milan (-4.9%).

We expect the performance difference between prime and non-prime assets to widen over the forecast period, driven by investors' desire to future-proof their portfolios. In our current forecast, the gap between average capital growth (over the forecast period) between the prime segment and the market is 3.4%; this was 2.5% in our previous forecast.

LARGE SCALE LETTINGS MORE LIKELY TO RETURN IN 2025

Economic torpor resulted in the occupational market bottoming out over 2023. **Take-up for the year reached 7.54 million sqm in Europe's 17 main markets**, down by 20% over 2022. Nevertheless, the reduction was front-loaded, with 23% y-o-y decline in Q1, -29% y-o-y in Q2 and -17% y-o-y in Q3. The last quarter witnessed 10% y-o-y drop off.

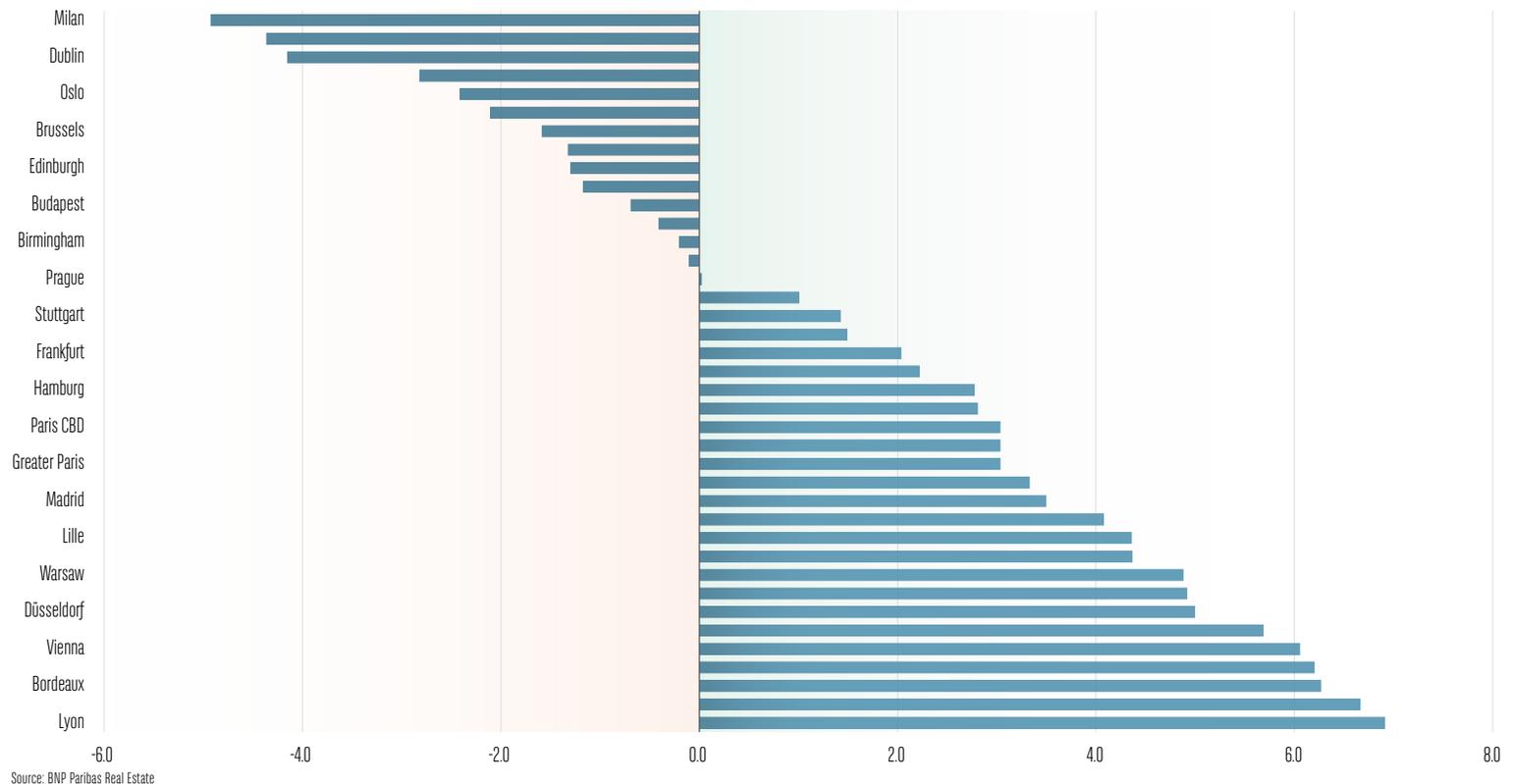
"The investment market is approaching a turning point with increased activity expected in 2024."

The year is notable for the absence of large-scale deals (units over 10,000 sqm) rather than reduction

in small to mid-sized lettings, where activity was solid over 2023. This is unsurprising, as big lettings represent a major financial commitment and fixed cost to large organisations. As such, these are decisions made when companies have operational clarity. 2022 and the early part of 2023 were distinctly uncertain in economic terms.

With that phenomenon mostly working itself out of the numbers by Q4 2023, some improvement to volumes in

Exhibit 9 . CAPITAL VALUE GROWTH IN EUROPEAN MARKETS (2024, %)



“Prime rental growth may slow as new construction improves supply of modern units.”

the large unit segment is likely. Nevertheless, activity may still be subdued over 2024. Budget planning for large space acquisitions took place at the end of 2023. Although the economic outlook at that time was more stable, it still posed enough questions for businesses to err on the side of caution. **This is likely to mean that any expansion in 2024 market take-up may derive from the mid-sized segment again, albeit with larger organisations making greater appearance.** Aside from large organisations moving because of necessity, we may see more adventurous occupiers who are financially secure and looking for units simply to improve their business. This would mark a return to a more expansionary market.

With all the office market problems of 2023, net absorption remained positive 406,447 sqm at

European level. This is about 0.1% of the total stock. Net absorption may now bounce along the bottom for part of 2024 before picking up pace to 2 to 3 million square metres across the remainder of the forecast. Much depends on the delivery of modern supply and the quantum of “grey” office space released as companies formally exit leases.

STRUCTURALLY HIGHER VACANCY STILL LOOMS OVER EUROPEAN OFFICES

The downward trend in net absorption over 2023 also reflects a commonality with a relocation-driven take-up: it has the propensity to reduce the amount of space needed. **A reduction in corporate estate footprint may become the new normal.** A similar process occurred after the GFC in 2009

with companies reducing space and opting to take advantage of reduced rents on modern buildings. What differs now is that companies are already lean in their use of space (densities prior to Covid were at all-time highs) so there is less space to reduce. Hybrid working arrangements will determine scale of reductions.

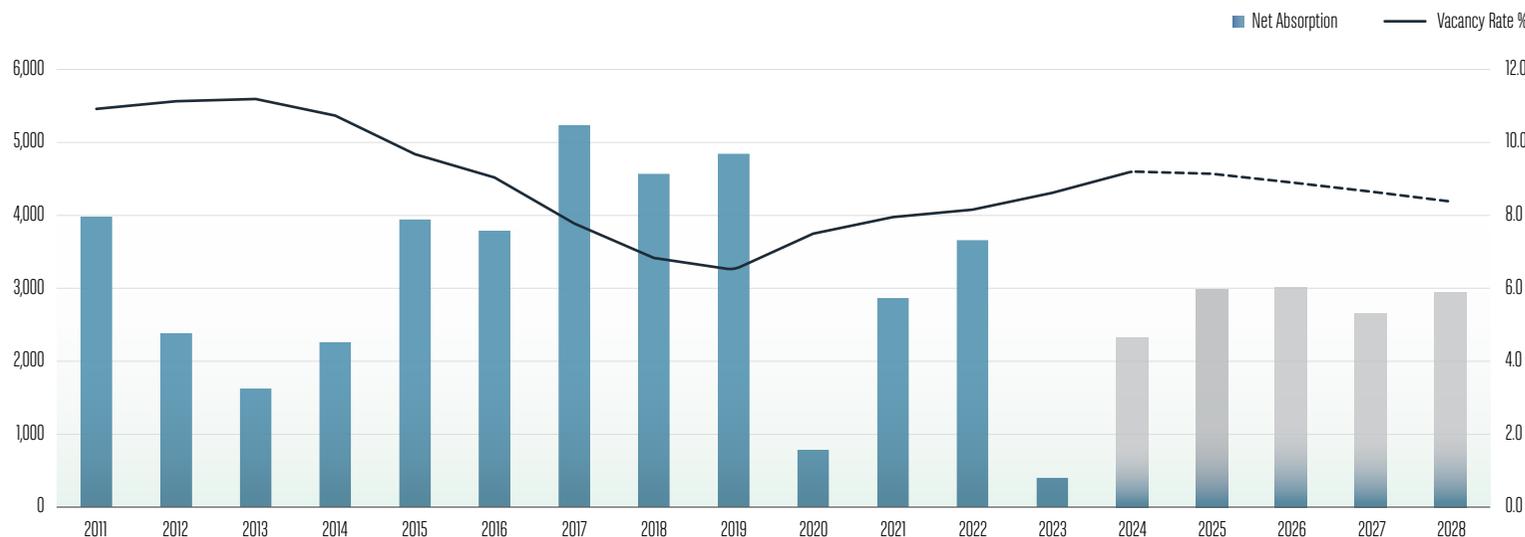
Relocation is creating a combination of completely empty floors and whole buildings, plus grey space that is difficult to sublet. Consequently, vacancy is still gradually building up in Europe. **For the 28**

largest city markets, the average vacancy rate in 2023 was 8%, up 40bps over 2022 and +210 bps over Q4 2019. The magnitude of vacancy change varies a lot between cities and is hugely influenced by how dynamic construction is at the local level. Though lower than the double-digit levels of the post GFC period, vacancy may be far harder to reduce without demolition, given occupational preferences for state-of-the-art adaptable space.

The current trend continues to affirm our viewpoint that Europe is looking at a period of structurally higher vacancy composed of low-quality space. Our forecast is revised upwards to reflect this. **Europe’s aggregate office vacancy may increase from 8.8% in 2023 to 9.2% in 2024** before dropping back to 8.4% by 2028. The drop back reflects the net absorption of good space by large requirements (Exhibit 10).

French and German cities may see the lowest vacancy rates over the forecast period. Paris CBD vacancy remains the lowest in Europe at 2.4% (2023). It ended the year slightly higher than our previous forecast suggested. Nevertheless, we still think it may decrease across the forecast period to 2.2% by 2028. Hamburg (3.8%), Berlin (4.0%), Cologne (4.1%) and Vienna (4.5%) have the lowest vacancy rates in Europe by 2028 in our forecast, while the highest by then may be Birmingham (13.6%) and Helsinki (14.5%).

Exhibit 10. Net Absorption (000’s sqm, LHS) and Vacancy Rate (% per annum, RHS)



Source: BNP Paribas Real Estate

PRIME RENTAL GROWTH MAY SLOW AS NEW CONSTRUCTION COMES TO MARKET

City-wide vacancy is increasing across Europe. Yet, CBD vacancy remains squeezed with many centres below 5%. This geographical split lies at the heart of a situation truly unique to this property crash – accelerating prime rental growth. **Rents in all the leading cities increased over 2023, led by Amsterdam (8%), London/Central Paris/Warsaw (+7%), Brussels (+ 6%), and Madrid (+ 4%).** Nevertheless, pace of growth slowed over the year, resulting in Berlin (2%) and Milan (1%) falling back. Dublin’s rental growth flatlined.

The CBD influence on prime rents reflects their concentration of modern modular space in the office stock. They are also where much of the refurbishment and development are occurring. This marks another difference with the post GFC market as this activity has not ceased. At the time of the GFC, many CBD developments, particularly in the gateway cities, were frozen. Now, existing tenant demand for best-in-class premises supports some activity. Energy regulations and the likelihood of reactivated requirements for large floorplates over 2024 provide the remaining rationale for development. Net addition to European stock in 2024 may come in at around 4 million sqm, double that of 2023, and then

“Office return may improve sharply from 2024 onwards, driven by income return.”

YIELD DECOMPRESSION NOW ENDING

The average yield for the 16 key city markets stands at **4.6% for 2023 compared to 3.8% at the end of 2022**. Since the low point of 3.2% at the start of 2022, office yields have expanded 140bps.

The office yield spread over base lending costs remains extremely thin, perhaps still too thin for many buyers to feel they have enough freedom to take on the risk of debt.

Signals from the central banks seem to indicate monetary policy has now peaked. This allays concerns that office yields will have to rise significantly further, as the cost of debt is now beginning to fall. However, it does not suggest that liquidity will come flooding back: price gap expectations continue to hamper activity. Yet it is likely to create some arbitrage opportunities over 2024 that will see deals roll forward. **We continue to think some further prime yield expansion is likely. The European prime average may move from 5.1% in 2023 to 5.2% in 2024, a much smaller magnitude of expansion than already seen.** From 2025 the European yield may resume gradual contraction to 4.78% by 2028. **The lowest yields by 2028 may occur in Stockholm (3.5%) and Munich (3.75%).**

Market yields also have further repricing ahead and have been revised upwards. The forecast European average of 5.91% for 2024 has been bumped up to 6.35%. Yields may eventually reduce to 5.98% by 2028.

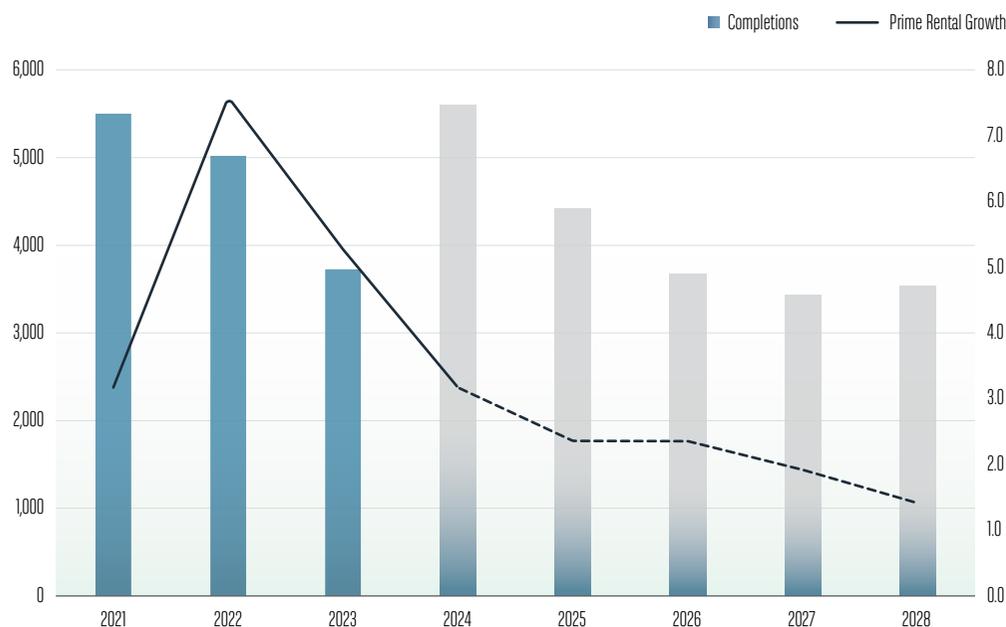
around 2.5 to 3 million sqm per year over the rest of the forecast.

This may dampen prime rental growth (Exhibit 11). The last of the inflationary push to rents will fade over 2024. **We think European office rents overall may show prime rental growth of 3.2% in 2023 (down from 5.3% in 2022). Rental growth eases across the forecast to 2.4% in 2025/6 and 1.4% in 2028.**

Madrid may see strongest growth in 2024 at 12%. The cities with strongest rental growth include Central London and UK regional cities, along with Stockholm and Berlin, which may post over 3% each year. Dublin (4.7%) Berlin (3.8%) and Oslo (3.4%) are projected to have the strongest growth by 2028.

Rental prospects for average property remain murky. It may be that as prime rental growth stabilises over the forecast horizon; the existing polarization will intensify with ever greater incentives applied to older property: paint over the cracks of a reduced rent. The average market may see polarization within itself. The best (if well located and new) may benefit from “halo” effects from modern units. This is already occurring to some extent in CBDs. Market rents in Europe may reach 1.2% in 2024 and 0.5% by 2028 with the strongest in Frankfurt at 3.9%.

Exhibit 11. Office Completions (000’s sqm, LHS) versus Prime Rental Growth (% per annum, RHS)



Source: BNP Paribas Real Estate

RETAIL

by Philippe Guardiola

FALL IN EUROPEAN RETAIL INVESTMENT
IN 2023

-40%

EXPECTED RETAIL SALES GROWTH
IN EUROPE IN 2024

+1.2%

AVERAGE TOTAL RETURN IN EUROPE
OVER THE NEXT 5YRS

+7.4%

EASING INFLATION SHOULD BOLSTER SALES GROWTH

After a challenging year in 2023 when inflation took a toll on households' purchasing power across the world, resulting in a slight decline (-1.8%) in real retail sales, projections suggest a modest rebound of +1.2% in 2024. This anticipated resurgence is fuelled by expectations of a much lower inflation rate, which would buoy real wages and consumer confidence. Moreover, the projected recovery in tourism bodes well for retail sales in the coming year. According to the UN World Tourism Organisation, Southern Europe has restored pre-pandemic tourism levels, with Western and Northern Europe following suit. While Asian tourist numbers remain below pre-crisis levels, their gradual return offers promising prospects for future growth (see Exhibit 12).

The high impact of inflation on purchasing power has not slowed the luxury segment, as its consumer base is less sensitive to rising prices. However, mass-market brands have tighter margins that force them to reflect the rise of materials and logistics costs in their prices. This price increase prompted consumers to shift towards discounters, perceived as bulwarks against inflation. While both the luxury and mass markets have performed strongly, mid-market players will have to work on their business models to control their costs and support consumption.



RETAIL INVESTMENT SHOULD PICK UP IN THE SECOND HALF OF THE YEAR

After four consecutive years of decreasing investment in retail premises, the rebound seen in 2022 (+10%) was short lived as the € 26bn invested in 2023 represented a -40% drop year-on-year (see Exhibit 13). However, owner-occupier deals, which have been rather uncommon in Europe, featured heavily in the total volume of transactions, amounting to 50% (€2.9bn) of total retail investment in France. The luxury sector was very active in 2023 and drove up the total, with LVMH and Kering allocating considerable resources to establish themselves on the most prestigious Paris and London West End streets. 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 or INGKA in France. Warehouse stores and supermarkets represented almost half of retail investments, driven mainly by Germany and the United Kingdom.

With interest rates having peaked in 2023 and central banks poised to lower them this year, investors should enjoy more favourable financing conditions, which should boost volumes in H2. However, the first half of the year should remain sluggish as retail yields stabilise. Investors are likely to stay on the fence until yields show signs of contracting again. Overall, between 2021 and 2024, retail assets should experience a lower yield expansion (around +90bps on average for high street) than offices (+160bps) and logistics (+120bps), as the sector had already begun repricing before the COVID pandemic.

Asset classes are affected unevenly. Prime high street locations remain attractive, especially luxury

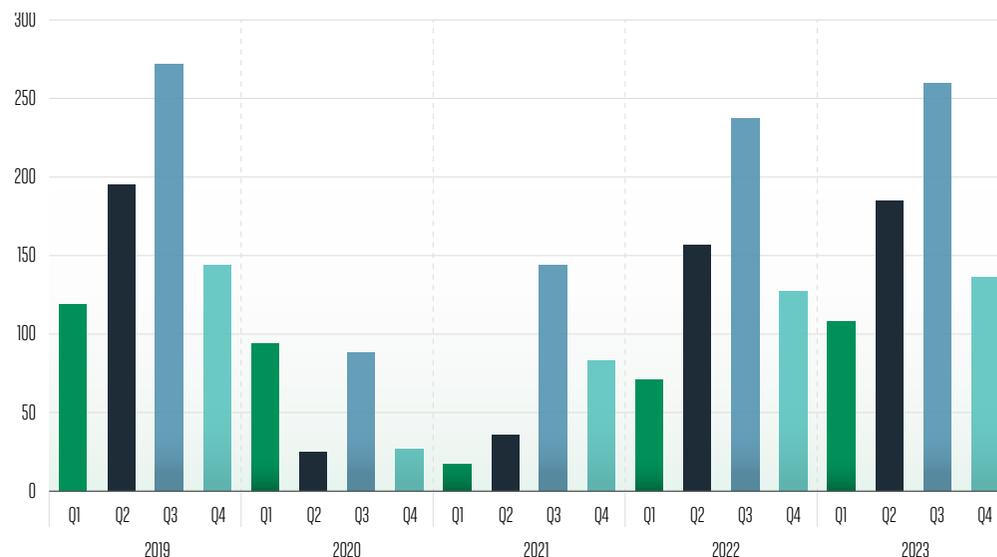
thoroughfares that have very low vacancy and therefore a high pressure on rents. Yet mass market retailers have been facing rising costs and headwinds, resulting in higher incentives. Shopping centres on a value-add or opportunistic basis are also becoming attractive. Prime rental values should increase in all countries except Norway, pulling capital growth back into positive territory this year. The higher net initial yields (Income Return) coupled with a small compression (Capital Growth) in the coming years should create attractive total returns of around 8% yearly on average for prime high streets in Europe.

LUXURY AND DISCOUNTERS ARE SQUEEZING RETAILERS IN THE MIDDLE

Consumers reduced their spending to focus on necessities during the pandemic. As the rise in prices has eroded purchasing power across Europe, we are seeing the same behaviour, with households favouring cautious savings in times of uncertainty. According to a study from l'Observatoire Cetelem in 2023, the main criterion for Europeans buying food products remains quality (43%) but this is now very closely followed by price (42%). The main beneficiaries of this trend are discounters, who have seen their market shares rise quickly in the last 5 years. The same study points out that 39% of Europeans intend to increase their discount consumption, while only 16% plan to decrease it. Discounters usually offer a reduced product range, 10 to 15 times fewer KPIs than traditional supermarkets and hypermarkets, enabling bigger orders to suppliers with better prices and reduced logistics costs.

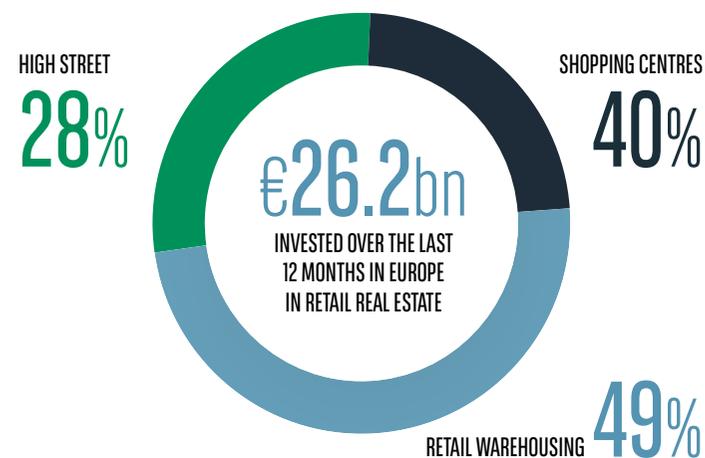
At the other end of the spectrum, luxury players have been busy in terms of both owner/occupier

Exhibit 12. International Tourist arrival in Europe (millions)



Source: UN World Tourism Organisation

Exhibit 13. Retail Investment Volume by Segments, in Europe:



Source: BNP Paribas Real Estate

purchases and rentals to maintain their dominant positions. There was a succession of flagship store openings in 2023 on the most popular streets of Europe, while remaining rare enough to be synonymous with exclusivity. These places are becoming tools of communication, power and influence for luxury brands, making it possible to develop their offer and the customer experience in larger units. They become destinations, where the brand's values are displayed. They are also "Instagrammable" formats, capable of attracting new generations to this segment.

2023 has been more difficult for the middle segment. Receiverships, liquidations, and restructurings of historic brands have been frequent. Many of

these brands' problems have their origin in flawed business strategies. Some concentrated all their investment in e-commerce expansion rather than developing an effective omnichannel strategy. Peek and Cloppenburg (Dusseldorf), which filed for protection from creditors in March, admitted that it had overinvested millions in the expansion of online activities in 2021, which led to its current financial difficulties. The protection it seeks will allow its restructuring process to focus on the core business in bricks-and-mortar retail and physical stores in its home market of Germany. Conversely, brands that underinvested in digital are now experiencing difficulties. French fashion brands have been hit since mid-2022, with the liquidation of Camaieu and Cop.Copine and the receivership of Go Sport,

Kookai, André, Kaporal and San Marina. The mass-market fashion brands that stand out are those with superior customer experience, such as the Fast Retailing company opening a Uniqlo-Theory store in London where customers can recycle, repair or remake their Uniqlo items.

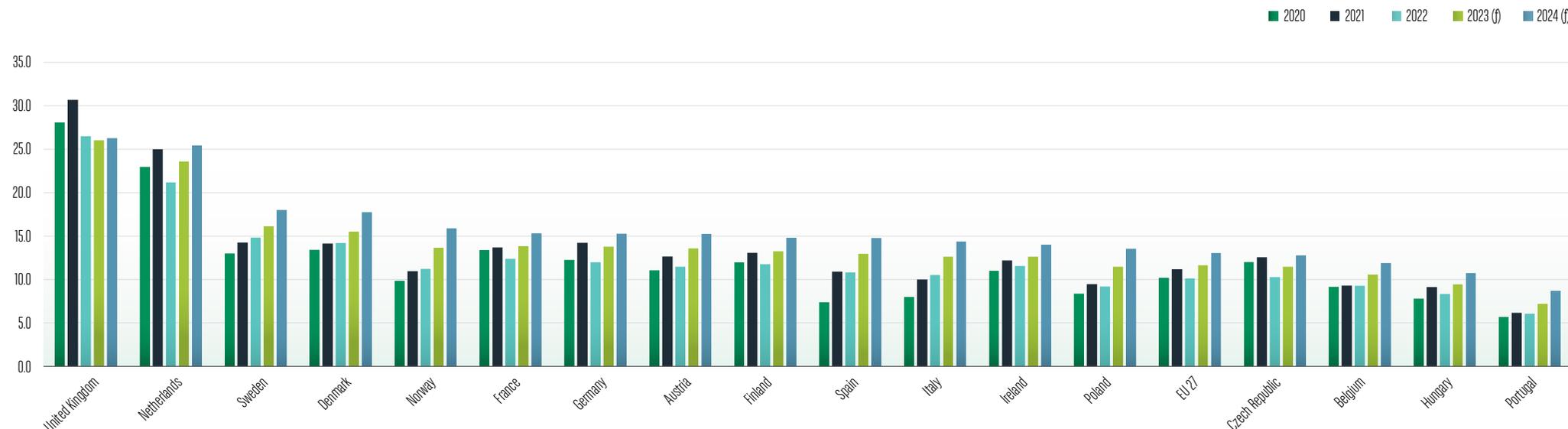
ONLINE PENETRATION IS STILL PROGRESSING BUT AT A SLOWER PACE

Even though e-commerce is still on an upward trend, its pace has slowed and is stabilising (see Exhibit 14). Online retail is no longer seen as a threat to physical stores, as differences are blurring. Reduced sales and excess returns have destabilised the business models of some e-commerce pure players,

"Luxury and discounters are outperforming the middle segments."

especially as they are already fragile, being sensitive to the management of their stock and the complexity of their supply chains. Already before the COVID-19 crisis, many retailers were looking to strengthen their online sales by introducing omnichannel experiences. Strong digital development has proven an effective hedge against the health crisis, and brands are looking at click & collect as an additional revenue stream.

Exhibit 14 . Online Retail Penetration (%)



Source: PMA, Mind Retail, Trade Associations

LOGISTICS

by Thomas Glup

TOTAL RETURN IN EUROPE P.A. OVER
THE FORECAST PERIOD

+8.8%

AVERAGE PRIME RENTAL GROWTH
EXPECTED IN EUROPE

+2.2% p.a.

PRIME YIELDS
EXPECTED IN 2024:

STABLE

INVESTMENT MARKET ON THE VERGE OF REACTIVATION

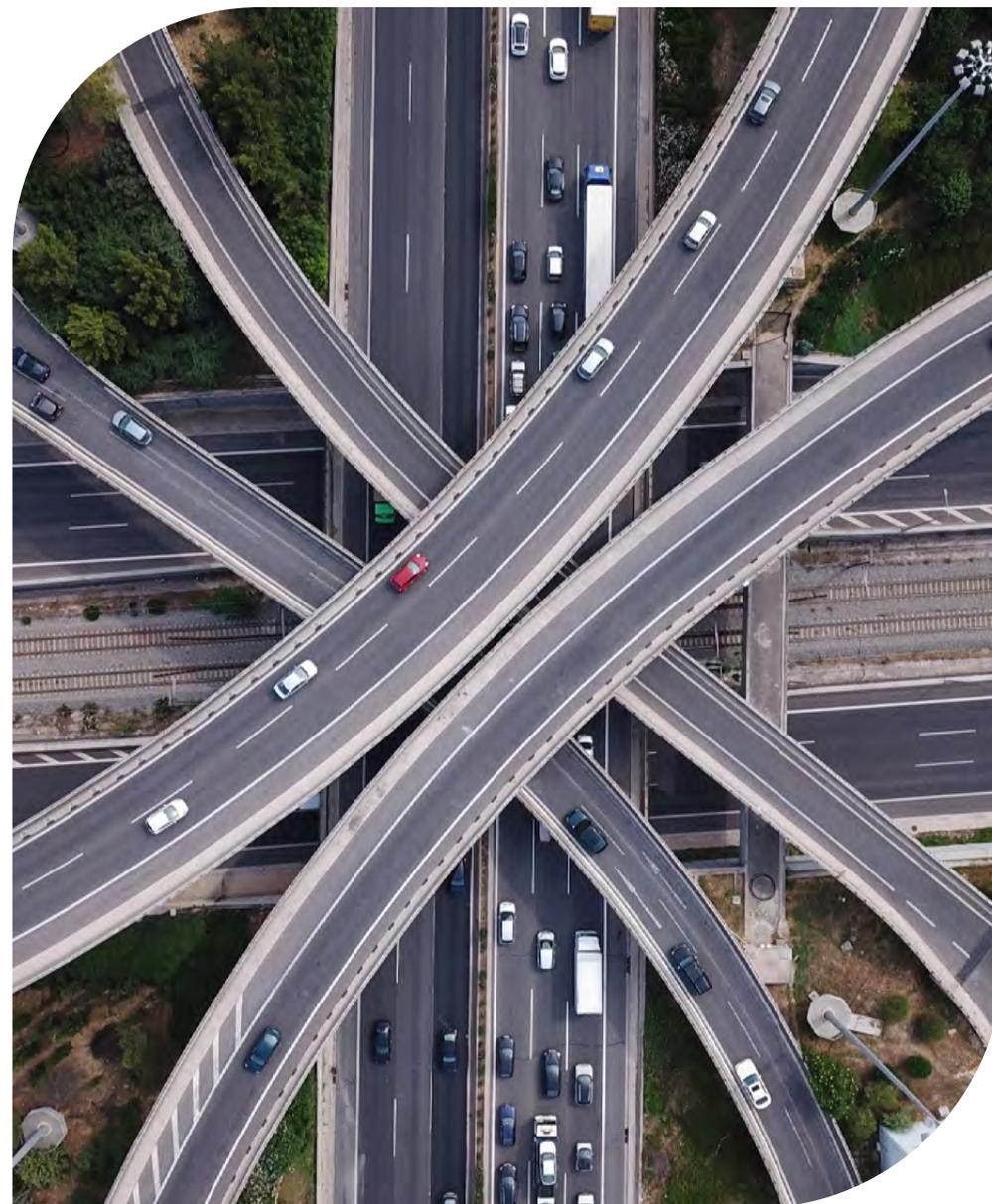
Global supply chain reorganisation through near shoring in Europe and the paradigm shift from “just in time” to “just in case” are gaining momentum. In the short term, there is sufficient growth potential from e-commerce and the core business (grocery and manufacturing) to support expansion and carry the sector through the weakening economic cycle.

Demand for logistics space remained relatively high in 2023. This is partly due to supply shortages, although take-up declined.

Rents have been rising for three years. Geopolitical upheaval has seen an even greater focus on securing supply chains. Some production is already being relocated back to European countries. With low supply, this extra demand is likely to put some pressure on rents, although it is likely that rental growth over the forecast period will slow.

We expect an end to yield expansion by 2024, with rental growth prospects encouraging investors back after the hiatus of 2023. Overall, European yields may peak at 5.2% in 2024 before resuming some minor contraction from mid-forecast (2025) to end at 4.8% by 2028.

Returns for logistics are likely to be among the strongest of all sectors in Europe over the forecast period. From a low of 0.3% in 2023, returns may increase to 11.2% by 2025.



DEMAND SCALED BACK AS HIGHER INTEREST RATES REDUCE OWNER/OCCUPIER DEVELOPMENT

The economic slowdown finally caught up with the European logistics market in 2023. Having expanded over the pandemic period, demand for space has scaled back sharply. In 2023, take-up decreased by 32% in the leading European markets. This is compared with the exceptional volumes recorded in 2021 and 2022. Although below the ten- and five-year average, volumes are in line with those seen pre pandemic (2016 to 2019). Yet the main cause lies with the XXL segment. Many of these units are loan-funded, owner-occupier developments. They require large capital outlays, and the current environment is less accommodating because of higher borrowing and construction costs.

The share of e-commerce in retail spending in the EU skyrocketed because of the pandemic. In 2022, customers were keen to return to stores and the online share fell again somewhat, but only temporarily. In our view, however, this was not a trend reversal. E-commerce will continue to grow, albeit at a slower pace.

SUPPLY LIKELY TO STAY OUT OF SYNC EVEN WITH SLOWER DEMAND

With lower but overall steady demand, the main inhibiting factor for take-up remains the lack of available space. Construction activity is still subdued. Development in the large European hubs has lagged. Conversely, there has been increased construction in peripheral regions and secondary

“The greatest risk factor for the logistic sector continue to be economic and geopolitical uncertainty.”

markets. This discrepancy is mostly due to the lack of suitable land for construction in the top markets, increasingly prompting developers and users to turn to secondary markets along the international transport corridors.

Minimal speculative development means that the risk of oversupply is limited. Consequently, the vacancy rate remains safely below 5% in most European countries. The current economic environment is likely to maintain the low supply of space: lack of land, rising construction costs and expensive financing all hamper projects.

STRONG RENTAL GROWTH IS INCREASINGLY A CHALLENGE FOR OCCUPIERS

With demand still outstripping supply, rental growth prospects for logistics are robust. Prime rents in the 48 European city markets covered by BNP Paribas increased by 6.4% on average from 2022 to 2023. Particularly steep increases were seen in Oslo (18%) and Paris (19%).

Rents will continue to rise, but probably at a much slower pace than over 2022-2023 as the inflationary boost to rents eases. Our rental growth forecast for Europe is just 2.7% for 2024 (down from 8.1% in 2023). From 2026, growth in our forecasts slows to 2.2%, and by 2028, it may be 1.5%. The strongest rental growth over the forecast period maybe seen in the UK (3.2% p.a.) and France 2.8% p.a. (see Exhibit 15)

LOGISTICS INVESTMENT LIKELY TO RECOVER IN 2024

Investment in logistics premises in Europe fell sharply in 2023, by 48% to € 32bn. Logistics, already perceived as expensive, was highly vulnerable to the sort of financial market volatility created by rising interest rates. Tougher pricing negotiations have resulted in a retreat from the market by buyers especially, and by sellers.

We expect investment to stay subdued until mid-2024. The sharp rise in interest rates has taken the wind out of the sails for investors reliant on debt

Exhibit 15 . Rental Dynamics in European Regions by period (€)



Source: BNP Paribas Real Estate

capital. This leaves the market open to investors with strong equity capital, who have the upper hand in a difficult environment.

YIELDS MAY CONTRACT AGAIN OVER THE FORECAST PERIOD

Part of the reason for a more rapid recovery lies in yield repricing. In addition to the drop in investment, logistics yields have also expanded quickly (Exhibit 16). Average European yield compression came to a halt in H2 2022. Subsequently, prime yields expanded by about 100 bp on average to 5.1% at the end of 2023.

In our assessment, price corrections were mostly complete by 2023. By the end of 2024, we expect average yields to stabilise at around 5.2%. It is possible that the sector will teeter on the edge of compression again in 2025; this has already begun in some markets, such as the UK.

STRONG TOTAL RETURNS TO CHARACTERIZE LOGISTICS

Over the entire forecast period from 2024 to 2028, the logistics sector has the second highest average total returns (8.8%), only surpassed by offices (8.9%) at the European level. The strongest region for returns in 2024 is likely to be the United Kingdom

“The fundamentals for the logistic market remains good, especially from the demand side.”

(10.3%). By the end of the forecast period, all regions are likely to be in the 7% to 8% range (Exhibit 17).

FUTURE CHALLENGES

Despite its importance, the logistics sector often gets shunned when it comes to obtaining land compared to other types of use, especially in urban locations. The difficulty in securing planning permission is unlikely to improve going forward. As part of comprehensive plans to achieve climate and biodiversity goals (to restore damaged ecosystems), the European Commission is advocating restrictions on the amount of land allocated for construction.

Exhibit 16. Average European Logistics Yields (%)



Source: BNP Paribas Real Estate

Exhibit 17. European Prime Total Returns (%)



Source: BNP Paribas Real Estate

RESIDENTIAL

by Alexis Pourcelot

AVERAGE MORTGAGE RATE
IN THE EURO AREA

4.0%

FALL IN MORTGAGE LENDING
IN THE EURO AREA

-31%

FALL IN HOUSE PRICES
IN EUROPE (Q3 2023 VS Q3 2022)

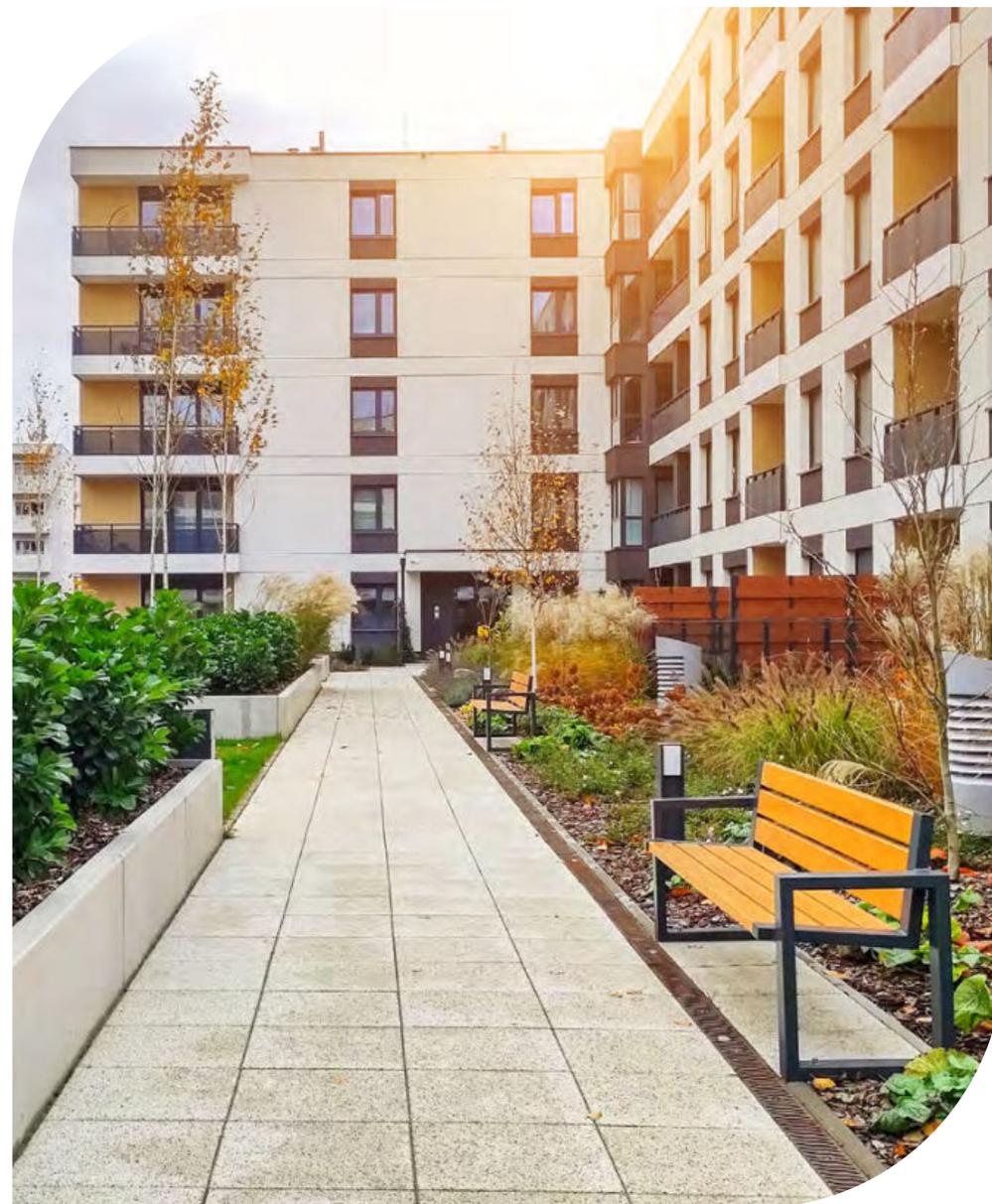
-1.0%

POSITIVE FUNDAMENTALS SHOULD BOOST RESIDENTIAL INVESTMENT

Due to tighter borrowing conditions and the lack of visibility on when rate hikes will end, investors have stepped back from the market. European residential investment plummeted by 46% in 2023 vs 2022 and was 52% below its five-year average. Investment fell more dramatically in Nordic countries (-70%) and France (-60%) while it seems to have been more resilient in the United Kingdom (-17%), Germany (-28%), Spain (-29%) and the Netherlands (-38%).

Hikes in mortgage rates and government bond yields have challenged investors by reducing the risk premium and the risk-adjusted return of real estate. However, we have seen prices adjust significantly due to the current economic and monetary context. Further price adjustments are still to come in some countries, but the coming rate cuts and the contraction of government bond yields should restore the risk premium and boost investment by the end of the year.

Moreover, investors continue to show a keen interest in the residential asset class, illustrated by certain office conversion transactions and the stable market share as part of total commercial real estate investment. The reason for this growing interest in residential is the boom in rental growth. This has been driven by plunging affordability for buying homes as both mortgage rates and prices have surged. Furthermore, we see severe housing shortages and obsolescence in big cities, while household formation will continue to rise in the medium term.



A TURNING POINT FOR THE HOUSING MARKET

The housing market is losing momentum. Credit production declined by 31% in 2023 vs 2022. As consequence, housing transaction volumes fell 13% on a rolling year basis in Q3 2023.

House prices in Europe declined by 1.0% in Q3 2023 vs the same period in 2022. The most affected countries were Luxembourg (-13.6%), Germany (-10.2%), Finland (-7.0%), Sweden (-4.4%), the Netherlands and Slovakia (-3.8%). The drop is even larger compared to the peak of the last two years.

The continuous growth in house prices, inflation and mortgage rates, and the fall in real household disposable income, are the main factors behind the steep fall in housing affordability and therefore the ongoing slide in European house prices. The price-to-income ratio hit a record level in Europe in Q2 last year and remains very high in numerous countries.

At the city level, our affordability ratio suggests that all markets (except Rome and Seville) are overvalued or significantly overvalued (**Exhibit 18**). Consequently, in Q3 2023, house prices were in decline in 17 cities out of the 28 we cover compared to last year and in 25 cities since the peak of the last 2 years. House prices fell by over 5% in Frankfurt (-13.5%), Munich (-12.9%), Amsterdam (-12.8%), Rotterdam (-8.1%), Hamburg (-7.1%), Lyon (-6.7%) and Paris (-5.3%). Southern European cities are the most resilient, as house prices have not yet adjusted and continue to grow. However, the trend could reverse moderately by the end of the year.

Given the underlying factors cited above, second-hand house prices should rise by +9% on average

over the next 5 years for the 20 markets in our forecast (**Exhibit 19**). House prices are likely to have declined in 2023 (around -1%) and should remain stable in 2024 (+0.3%). The recovery process should start gradually in 2025 (+2.0%), 2026 (+3.5%) and 2027 (+4.0%).

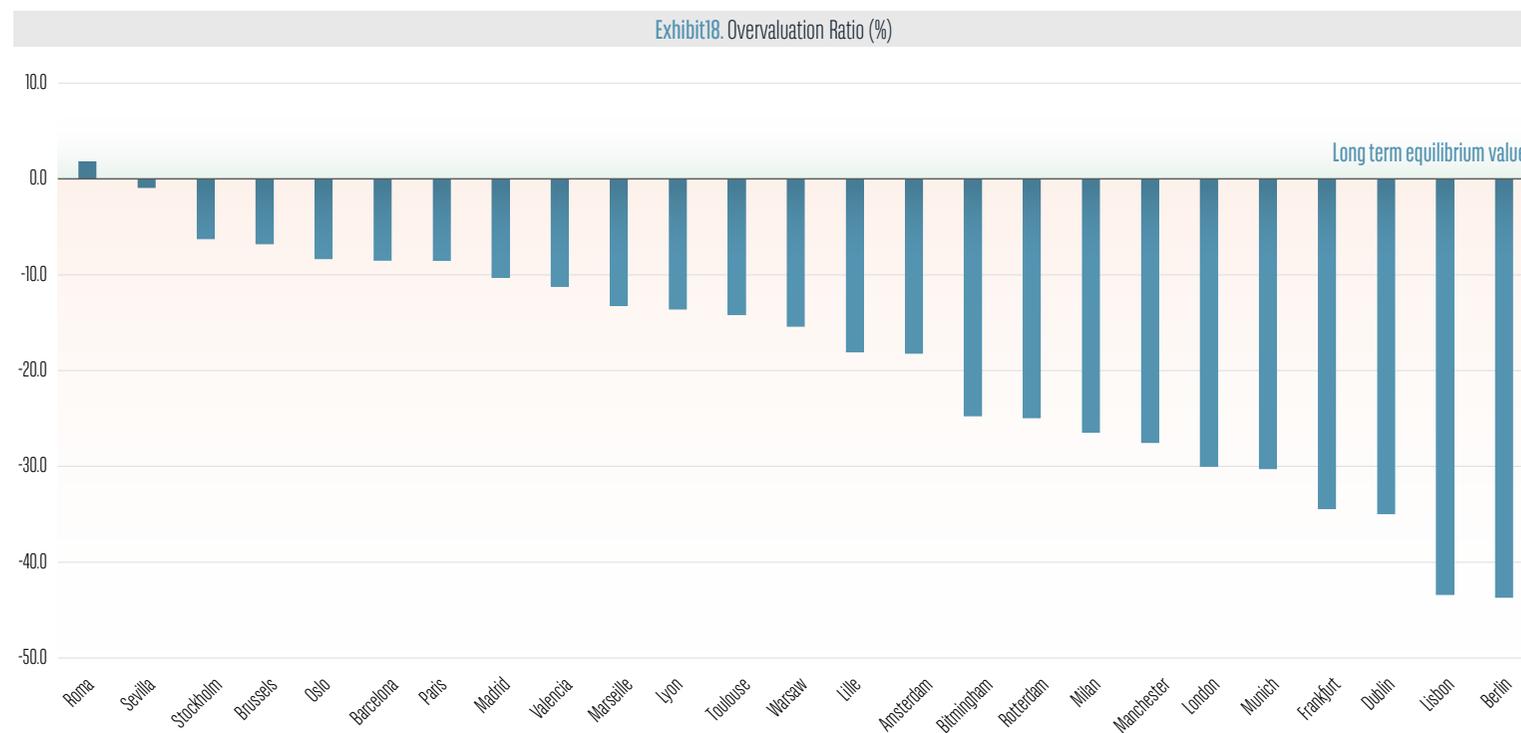
A HOT RENTAL MARKET

The change in financial conditions greatly increased demand for rental housing in big cities. Rental growth reached +7.8% y/y in Q3 2023, i.e., one of the highest average year-on-year growth figures recorded since

2010. We see a significant imbalance between demand and supply in the rental sector owing to legal uncertainties related to housing regulations that have contributed to a dramatic reduction in the rental stock, as is the case in Berlin, Barcelona, and Valencia. Moreover, the regulation of rent increases at around 2-3% to avoid indexation to inflation has prompted landlords to pass the loss of revenue onto new leases or sell their dwellings. Demand from tenants has also shifted toward more efficient homes to avoid soaring energy bills. The next challenge may be the ban on leasing any home with a low energy-efficiency score, as is already the case in some European countries.

This regulation will significantly increase the pressure on rental availability.

The buy-vs-rent ratio indicator shows that in most markets, renting is the best option for households that want to optimise space. In Stockholm, Munich, Hamburg, Lyon, Paris, Copenhagen, Frankfurt and Oslo, renters can afford twice the space of buyers. It also explains why these markets are the deepest in Europe. Since the pandemic, it has become better value to rent than to buy in several Southern European markets, such as Barcelona, Madrid, Milan, Rome and Seville.



Source: BNP Paribas Real Estate

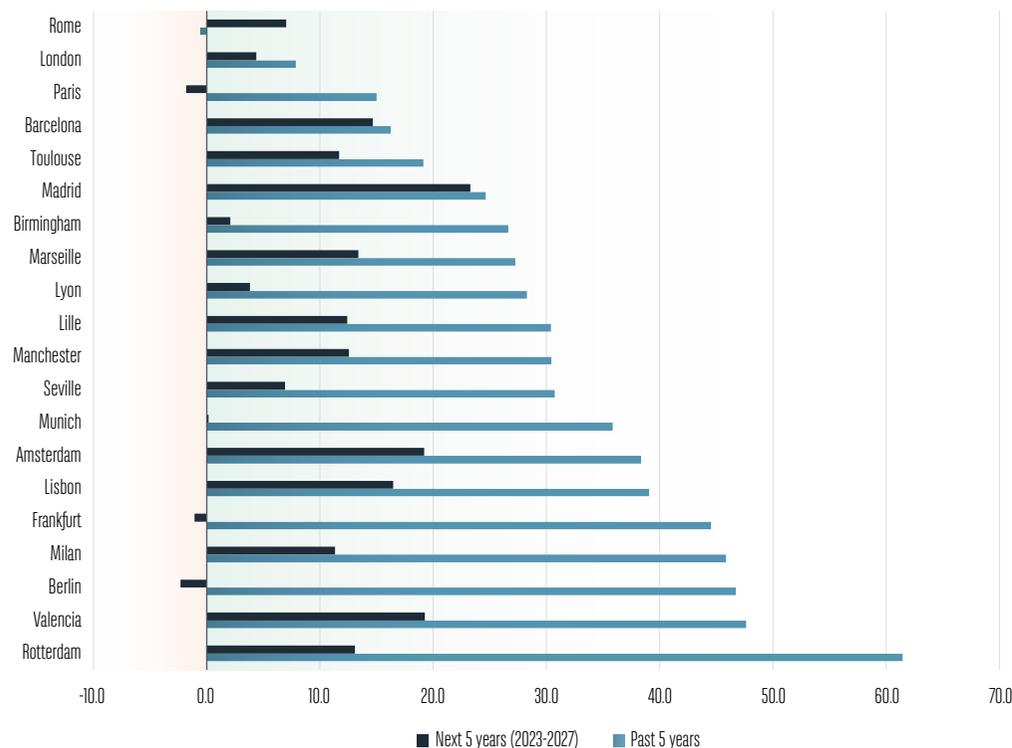
Unlike house prices, we expect rental values to continue rising, driven by inflation, resurgent real household disposable income, and the lack of supply relative to the rental demand. Southern Europe rental markets should continue to expand and see major increases in rental values driven by improved labour markets, strong income growth expectations and a strong potential in rental market depth. Moreover, the rental affordability remains fairly moderate, which should support growth in rental values.

We expect housing rents to continue rising over the next 5 years, by around 18% on average for the 20 markets we cover, driven by increasing rental demand due to the current economic context and households' ability to become homeowners (**Exhibit 20**). Likewise, current energy efficiency regulations being pushed by the European Commission could have a significant impact, reducing the quantity of available units for rent and improving the rental stock, thereby pushing up rents. Furthermore, the

rebound in tourism could prompt some investors to put their dwellings on the short-term lease market, putting even more pressure on rental housing availability.

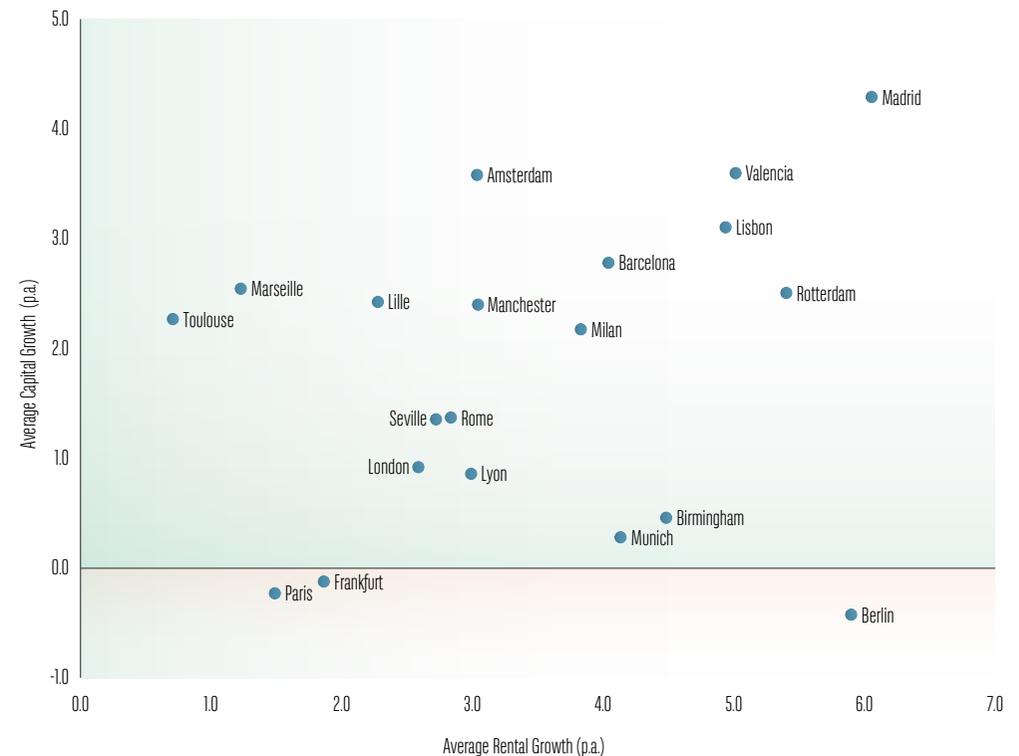
“Rental regulation, strong rental growth, low mobility, weak construction and the shift in the monetary policy are factors triggering the drop in rental supply.”

Exhibit 19. Cumulative House Price Growth (%)



Source: BNP Paribas Real Estate

Exhibit 20. Average Capital Growth vs Rental Growth, 2023 - 2027 (%)



Source: BNP Paribas Real Estate

RESEARCH & INSIGHTS



Benoit LEFEBVRE

DEPUTY GLOBAL HEAD OF RESEARCH

Tel: +33 (0)6 70 05 75 93
benoit.lefebvre
@realestate.bnpparibas



Guillaume JOLY

DEPUTY GLOBAL HEAD OF RESEARCH

Tel: +33 (0)6 87 05 53 91
guillaume.joly
@realestate.bnpparibas

ECONOMIST TEAM



Samuel DUAH

HEAD OF REAL ESTATE ECONOMICS

Tel: +44 207 338 42 07
samuel.duah
@realestate.bnpparibas



Stephen ACKROYD

SENIOR ANALYST - UK

Tel: +44 207 338 4328
stephen.ackroyd
@realestate.bnpparibas



Sam Hall

EUROPEAN ECONOMIST
- UK, IRELAND & NORDICS

Tel: +44 207 338 4328
sam.hall@realestate.bnpparibas



Alexis POURCELOT

EUROPEAN ECONOMIST
- BENELUX AND SOUTHERN EUROPE

Tel: +34 649 874 624
alexis.pourcelot
@realestate.bnpparibas



Thomas GLUP

ECONOMIST - GERMANY

Tel: +49 40 348 48 109
thomas.glup
@realestate.bnpparibas



Philippe GUARDIOLA

ECONOMIST - FRANCE

Tel: +33 7 85 70 71 21
philippe.guardiola
@realestate.bnpparibas

LOCAL RESEARCH



FRANCE Lucie MATHIEU

RESEARCH & DATA DIRECTOR

Tel: +33 (0)6 75 61 59 94
lucie.mathieu@realestate.bnpparibas



GERMANY Inga SCHWARZ

HEAD OF RESEARCH

Tel: +49 40 348 48 103
inga.schwarz@realestate.bnpparibas



SPAIN David ALONSO-FADRIQUE

HEAD OF RESEARCH

Tel: +34 914 54 99 80
david.alonso-fadrique@realestate.bnpparibas



UNITED KINGDOM Vanessa HALE

HEAD OF RESEARCH

Tel: +44 (0) 7557 912782
vanessa.hale@realestate.bnpparibas



ITALY Susan TREVOR BRISCOE

HEAD OF RESEARCH

Tel: +39 335 1718 200
susan.trevor-briscoe@realestate.bnpparibas



BELGIUM & LUXEMBURG Pascal MIKSE

HEAD OF RESEARCH

Tel: +32 2 290 59 23
pascal.mikse@realestate.bnpparibas



NETHERLANDS Dirk DEN HOLLANDER

HEAD OF RESEARCH

Tel: +31 6 15 64 67 20
dirk.den-hollander@realestate.bnpparibas



IRELAND John McCARTNEY

HEAD OF RESEARCH

Tel: +353 1 661 1233
john.mccartney@realestate.bnpparibas



POLAND Bolesław KOŁODZIEJCZYK

BUSINESS & DATA DIRECTOR

Tel: +48 664 982 486
boleslaw.kolodziejczyk@realestate.bnpparibas

LOCATIONS

(FEBRUARY 2024)

EUROPE

FRANCE

Headquarters
50, cours de l'Île Seguin – CS 50280
92650 Boulogne-Billancourt cedex
Tel.: +33 1 55 65 20 04

GERMANY

Goetheplatz 4
60311 Frankfurt am Main
Tel.: +49 69 29 89 90

UNITED KINGDOM

110 Harewood Avenue
London NW1 6AA
Tel.: +44 20 7338 4000

BELGIUM

Avenue Louise 235
1050 Brussels
Tel.: +32 2 290 59 59

SPAIN

C/ Emilio Vargas, 4
28043 Madrid
Tel.: +34 91 454 96 00

IRELAND

57 Adelaide Road,
Dublin 2
Tel.: +353 1 66 11 233

ITALY

Piazza Lina Bo Bardi, 3
20124 Milano
Tel.: +39 02 58 33 141

LUXEMBOURG

Kronos building
10, rue Edward-Steichen
2540 Luxembourg
Tel.: +352 34 94 84

Investment Management

Tel.: +352 26 06 06

NETHERLANDS

Antonio Vivaldistraat 54
1083 HP Amsterdam
Tel.: +31 20 305 97 20

POLAND

Prime Corporate Center
Grzybowska 78
00-844 Warsaw
Tel.: +48 22 653 44 00

PORTUGAL

Avenida da República, 90 Piso 1,
Fracção 1
1600-206 Lisboa
Tel.: +35 1 939 911 125

MIDDLE EAST / ASIA

DUBAI

Emaar Square
Building n° 1, 7th Floor
P.O. Box 7233, Dubai
Tel.: +971 44 248 277

HONG KONG, SAR CHINA

63/F, Two International
Finance Centre
8 Finance Street, Central,
Hong Kong, SAR China
Tel.: +852 2909 8888

SINGAPORE

20 Collyer Quay, #17-04
Singapore 049319
Tel.: +65 681 982 82

ALLIANCES

AUSTRIA | CZECH REPUBLIC | GREECE | HUNGARY | JERSEY | NORTHERN IRELAND | PORTUGAL | ROMANIA | SLOVAKIA | SWITZERLAND | USA



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