EUROPE
CRE 180

ECONOMIC OUTLOOK

REAL ESTATE PERSPECTIVES

GLOBAL RESEARCH
July 2023

BNP PARIBAS REAL ESTATE

Real Estate for a changing world

EUROPE CRE 180

CONTENTS

EXECUTIVE SUMMARY

IN A NUTSHELL

SLOWER GROWTH

European economic conditions remained favorable over the first quarter in 2023. Yet many components of GDP are slowing as interest rate increases bite.

Nonetheless, a receding energy crisis and labour market stability underpins improved corporate and household confidence that likely means Europe will see low positive growth going into 2024

DISINFLATION IS A SLOW PROCESS IN EUROPE

Headline inflation slowed in June (5.5% YoY, after reaching 8.6% in January). Core inflation remains sticky, having gone back up to 5.5% in June (5.3% in January). Its persistence may mean the ECB is likely to continue rate increases at its next meeting

INVESTMENT STILL PLUMMETING

Persistent inflation means the cycle still has further to run and consequently, many investors are wary of committing to acquisition at existing prices using debt until stability is seen in financing costs.
Overall, between Q2 2022 and Q2 2023, investment decreased by 57%. All asset classes experienced a reduction.

YIELDS STILL EXPANDING

The principal factor behind yield expansion is the change in the macro-financial environment. Persistent inflation is prompting more robust response from central banks. Normalization of monetary policy still has further to go and that implies yields may continue to decompress in 2023.

OFFICE: LETTING ACTIVITY SLOWED IN H1 2023

The contraction noticeable in the European office markets from the end of 2022 accelerated in Q2 2023. Take-up at the end of H1 2023 shrank 25% relative to H1 2022. This decline is mostly due to a reduced number of very large transactions. Occupiers are looking for space optimization to meet hybrid working patterns and reduce costs.

THE FLIGHT TO QUALITY CONTINUES

While hybrid work models are here to stay, workplace plays a key role in attracting and retaining talent, both in terms of space quality and location. Demand is also high for energy-efficient and sustainable buildings.
These increasing quality requirements drive values up for modern buildings located in the most established districts.

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ECONOMIC OUTLOOK

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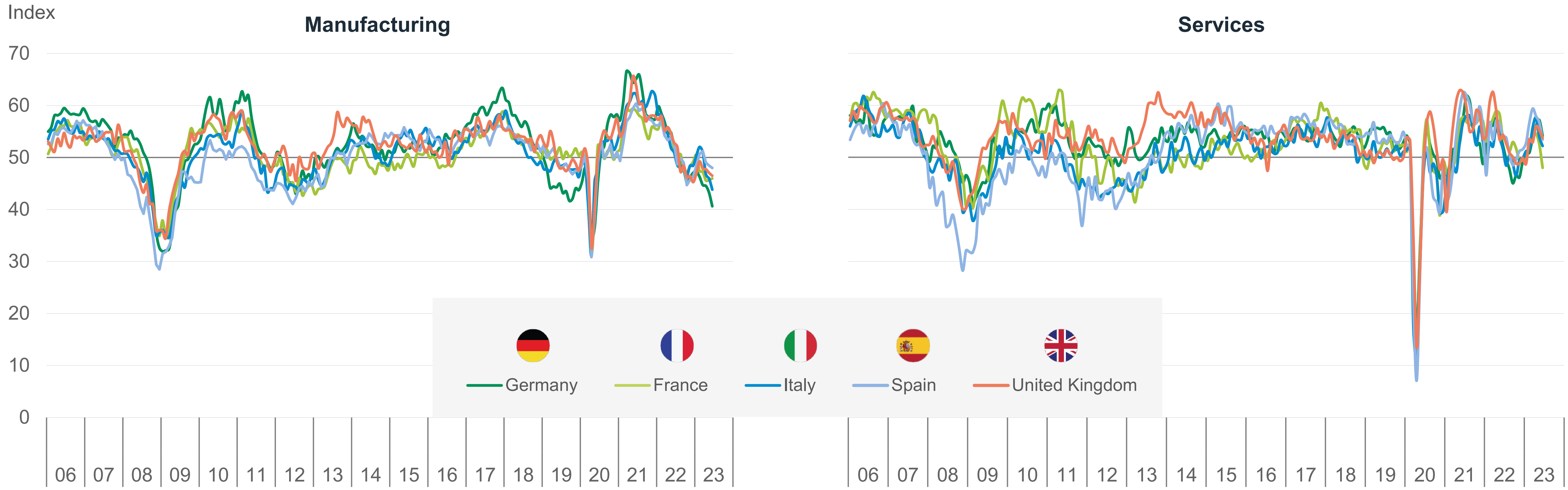
PURCHASING MANAGER INDEX SURVEYS

ACTIVITY IS LOSING MOMENTUM



Sources: Markit, BNP Paribas Economic Research.

Global economic growth is losing momentum

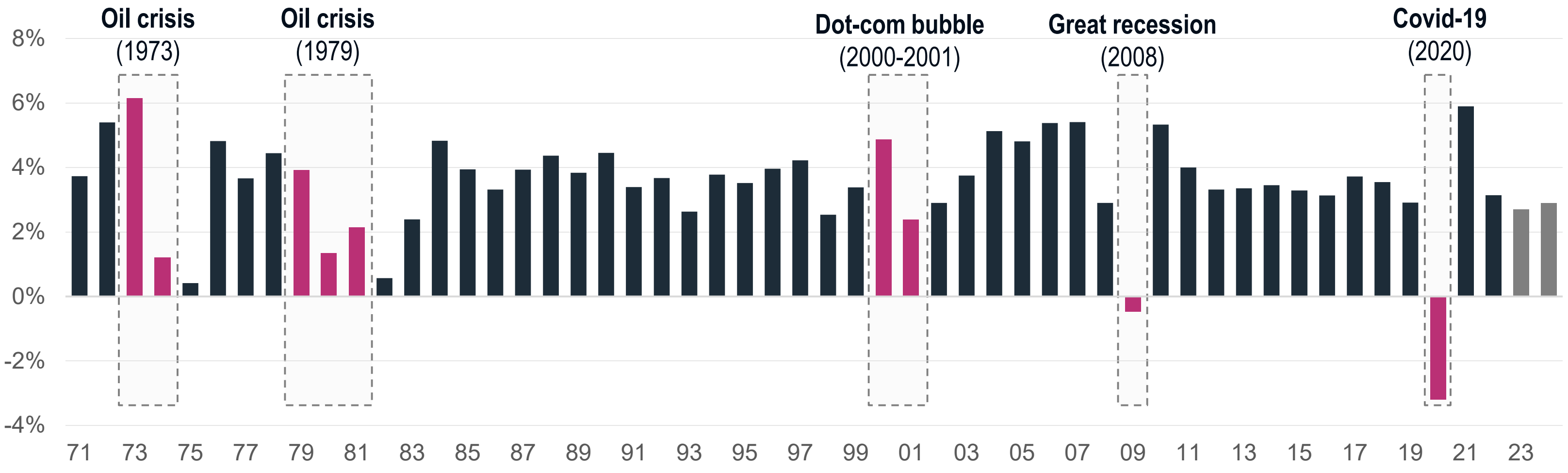
The global composite PMI index stood at 52.7 in June, the lowest in four months, reflecting slowing global growth at end Q2 2023. The service sector is still expanding, with the exception of France whose index contracted for the first time in five months.

Services remain buoyed by the increase in new contracts, new export orders, and employment. However, the expansion is losing momentum in light of the drop in these various indices in June compared to May.

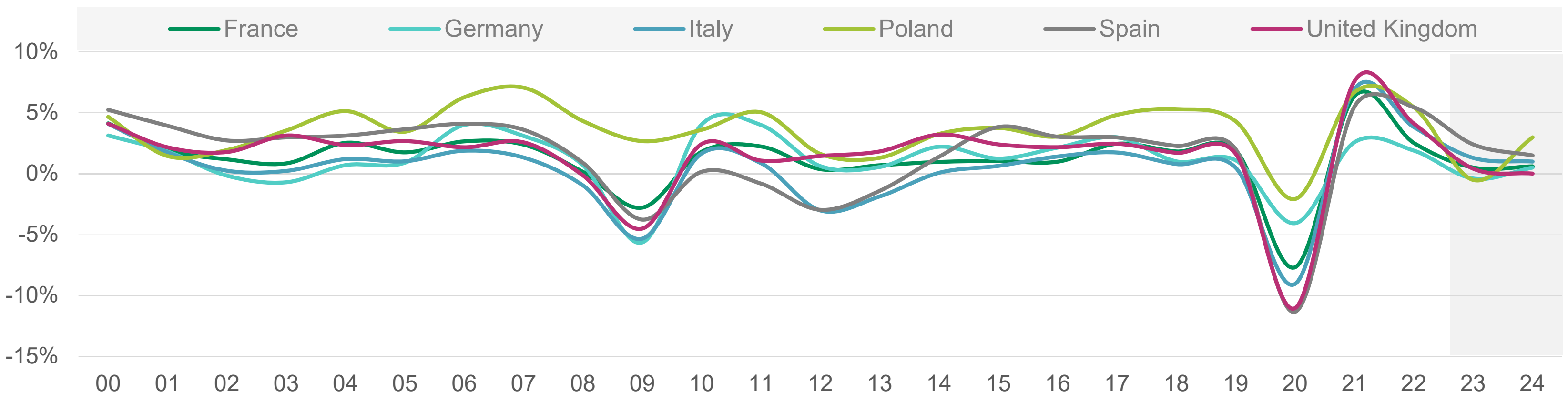
ECONOMIC OUTLOOK

WHAT OUTLOOK FOR THE MAIN ECONOMIES?

World GDP



GDP Growth in European countries



Sources: BNP Paribas Real Estate, OECD.

Stagnation is emerging

- The combination of higher absolute prices and interest rates is squeezing economic activity meaning 2023 looks set to post slower growth, if not recession. Roll over factors from 2022 continue to complicate the outlook:
  - The Ukrainian war continue to shape energy and commodity prices. It imposes energy transition costs that may act as a drag on output. Continued disruption to grain exports injects volatility into global food prices
  - The reopening of the Chinese economy following abandonment of zero-Covid is not yielding growth. Unlike Europe and the US, China faces a situation of deflation
  - Monetary tightening from the main central banks is sustaining over 2023 with no loosening

Low growth outlook for Europe

- Despite the current uncertainties, we expect weak growth in Europe. Recession remains deflected by the limited rise in unemployment (labour shortages characterize most countries). Additionally the support from fiscal policy still exists placing a floor under demand.
- After three quarters of stagnation (Q2, Q3 and Q4 2023), a limited recovery may occur in 2024.
- Overall, both the Euro area and the United Kingdom should have weak growth in 2023 at around 0.4%.

GDP GROWTH IN EUROPE

SLOWING TO A CRAWL

FORECAST (%):

	2022	2023	2024
World	3.1	2.7	2.9
United States	2.1	1.5	-0.1
Euro area	3.5	0.4	0.6
Japan	1.0	1.5	1.0
China	3.0	5.6	4.5
India	7.0	5.7	6.0
Russia	-2.1	-0.2	1.8
Brazil	2.9	2.5	0.5

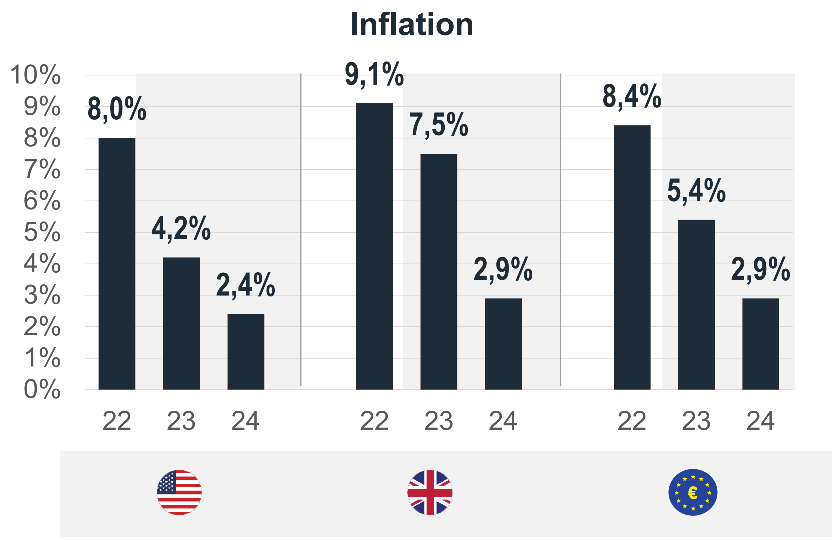
Source: BNP Paribas Real Estate Research.

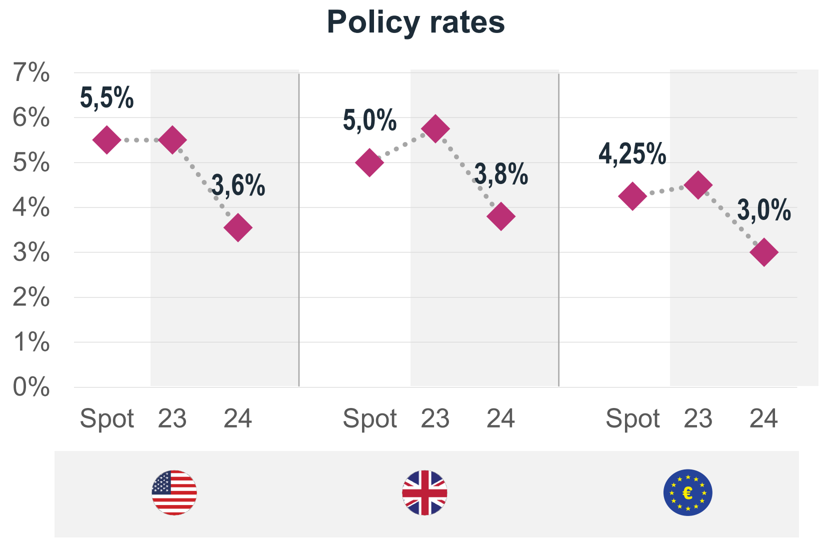
Growth is slowing globally

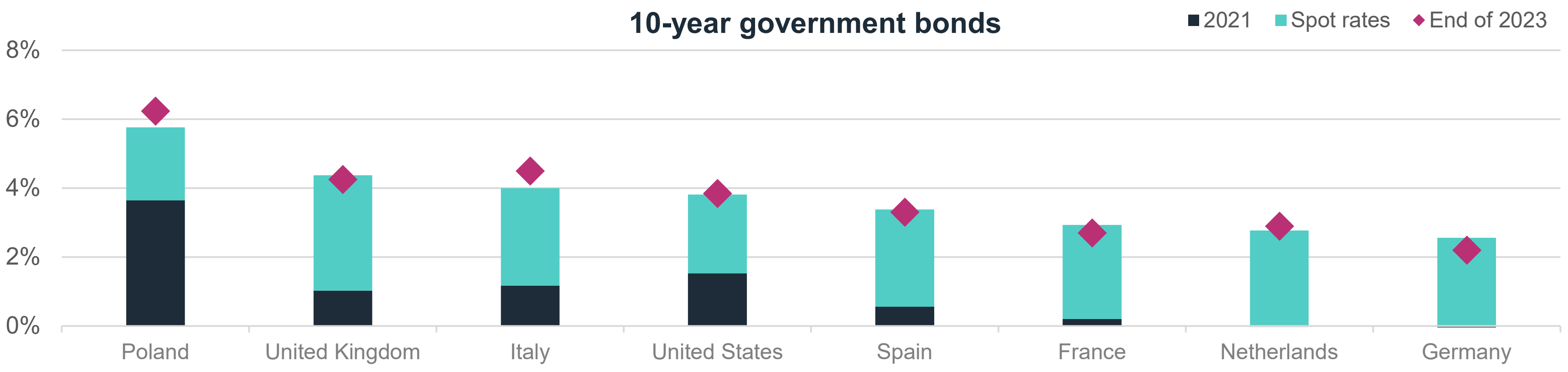
- The squeeze on global activity from monetary tightening may lead to a shallow recession in the United States and stagnation in Eurozone.
- The US economy continues to grow and create jobs, albeit at a gradually slower pace. We continue to anticipate a “growth recession” (where jobs are largely unaffected), from Q3 2023 until Q1 2024, under the effect of monetary tightening.
- China’s economic growth recovered rapidly following the abandonment of the zero-Covid policy, but it is also running out of steam faster than expected.
- Several demand factors should support European economic growth in 2023: good dynamics for the tourism sector, strong labour markets and wage increases. On the supply side, falling energy and commodity prices are aiding the corporate sector. Companies have been largely successful in passing on increased costs of production to consumers; profit margins remain mostly in-tact.
- Growth in 2024 should also be limited; cost increases may still be undergoing absorption dampening demand. Monetary policy is unlikely to give much leeway either as it may remain restrictive to ensure that inflation is firmly back under control near the 2% target.

FINANCIAL OUTLOOK

ECONOMIC AND FINANCIAL INDICATORS







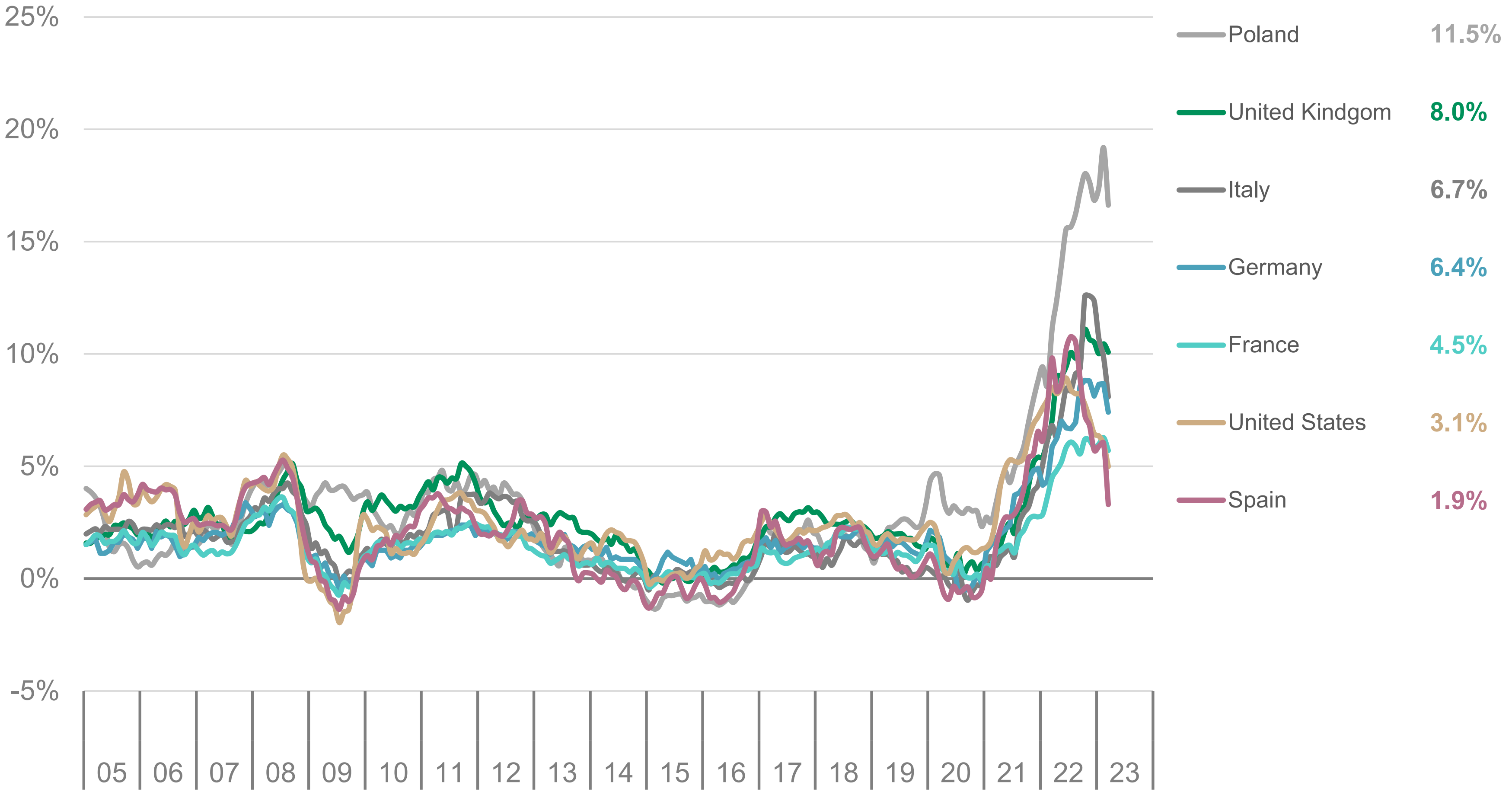
Sources: BNP Paribas Economic Research, OECD.

The end is near for monetary policy tightening

- Both headline and core inflation are slowing, but remain at a high level. We are not expecting headline inflation fall back to 2% before the end of 2024 or even the beginning of 2025.
- Core inflation is now key to central bank monetary policy decisions. All banks have indicated their concern about its persistence and need to see a clear path of reduction before ending their current stance.
- Consequently, the US Federal Reserve, after pausing at 5.25% in June, increased again its rate by +25bps at the July meeting, to its highest level in 22 years.
- The ECB increased the main refinancing rate by 25bps in July to 4.25% and more is to come. The ECB does not consider disinflation sufficient enough to end the tightening cycle. We expect the terminal rate for the refinancing rate to be at 4.5% in Q3.
- Financial markets have already priced in the terminal interest rates. That means the peak in long-term yields is likely to have been reached already. Bonds should subsequently move lower as the inflation outlook improves and the market moves towards anticipating monetary easing.

INFLATION IN EUROPE

DISINFLATION SLOWED BY CHANGES IN DRIVERS



Sources: Macrobond.

Disinflation is proving a slow process

- The world faced multiple inflationary shocks since 2020 with the COVID-19 pandemic and the energy crisis following Russia's war on Ukraine.
- Now that some of these shocks are fading, the rise of inflation is starting to slow.
- However, the pace of disinflation is slow as emphasis switches between the drivers of inflation. Goods based inflation has slowed considerably with the improvement in supply chains, whereas services now lie at the heart of persistent core inflation.
- The European Union's annual inflation rate dropped to 6.4% in June 2023 from 7.1% in May, according to Eurostat.
- Luxembourg registered the lowest European annual rate at 1%, followed closely by Belgium and Spain, both recording a rate of 1.6%.
- Disinflation in the US is further along than the Eurozone, in part because it was less exposed to energy driven increases and has slowed food price rises to a greater extent than Europe.
- Persistent inflation in the United Kingdom stems from reliance on imported gas, elevated food costs and difficult-to-fix labour market shortages.

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REAL ESTATE PERSPECTIVES

BNP PARIBAS REAL ESTATE

Credit: AdobeStock_142998563_Jamestechart

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REAL ESTATE PERSPECTIVES

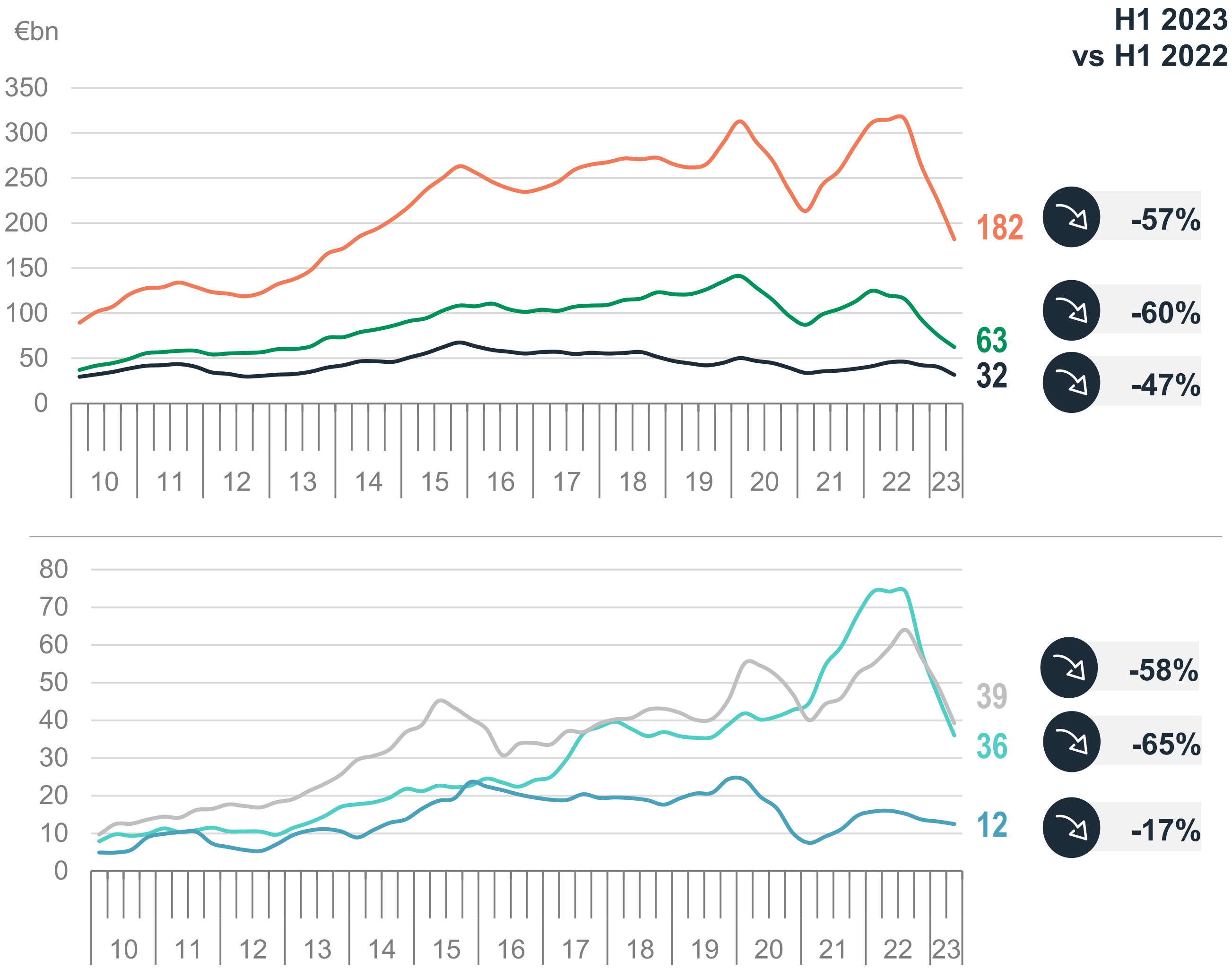
COMMERCIAL REAL ESTATE INVESTMENT MARKETS

BNP PARIBAS REAL ESTATE

Credit: AdobeStock_594221259_Emanuel Corso

INVESTMENT IN COMMERCIAL REAL ESTATE IN EUROPE

BREAKDOWN OF INVESTMENT BY ASSET CLASS



Investment at a decade low as buyers and sellers assess pricing

- Investment continues to scale back over 2023 with the ongoing pricing impasse triggered by the fastest acceleration in interest rates in twenty years. Over the 12 months ending with Q2 2023, investment reached €182bn, below Q1 2021's low point (€213bn). Investment is back to levels seen in 2014.
- The rapid acceleration in financing costs from mid-2022, destabilized pricing in the market resulting in investment plummeting by Q4 as buyers and sellers pulled back. Many were expecting the interest rate cycle to draw to a close by early summer with a final increase. Persistent inflation means the cycle still has further to run and consequently, many investors are wary of committing to acquisition at existing prices using debt until stability is seen in financing costs.
- Overall, between Q2 2022 and Q2 2023, investment decreased by 57%. All asset classes experienced a reduction. Logistics (-65%) was the most affected as prices were already expensive before problems arose. Offices (-60%) suffered as well as complicated pricing adds difficulties to a sector where structural change seems to be underway. Hotels (-17%) and retail (-47%) incurred the least declines.

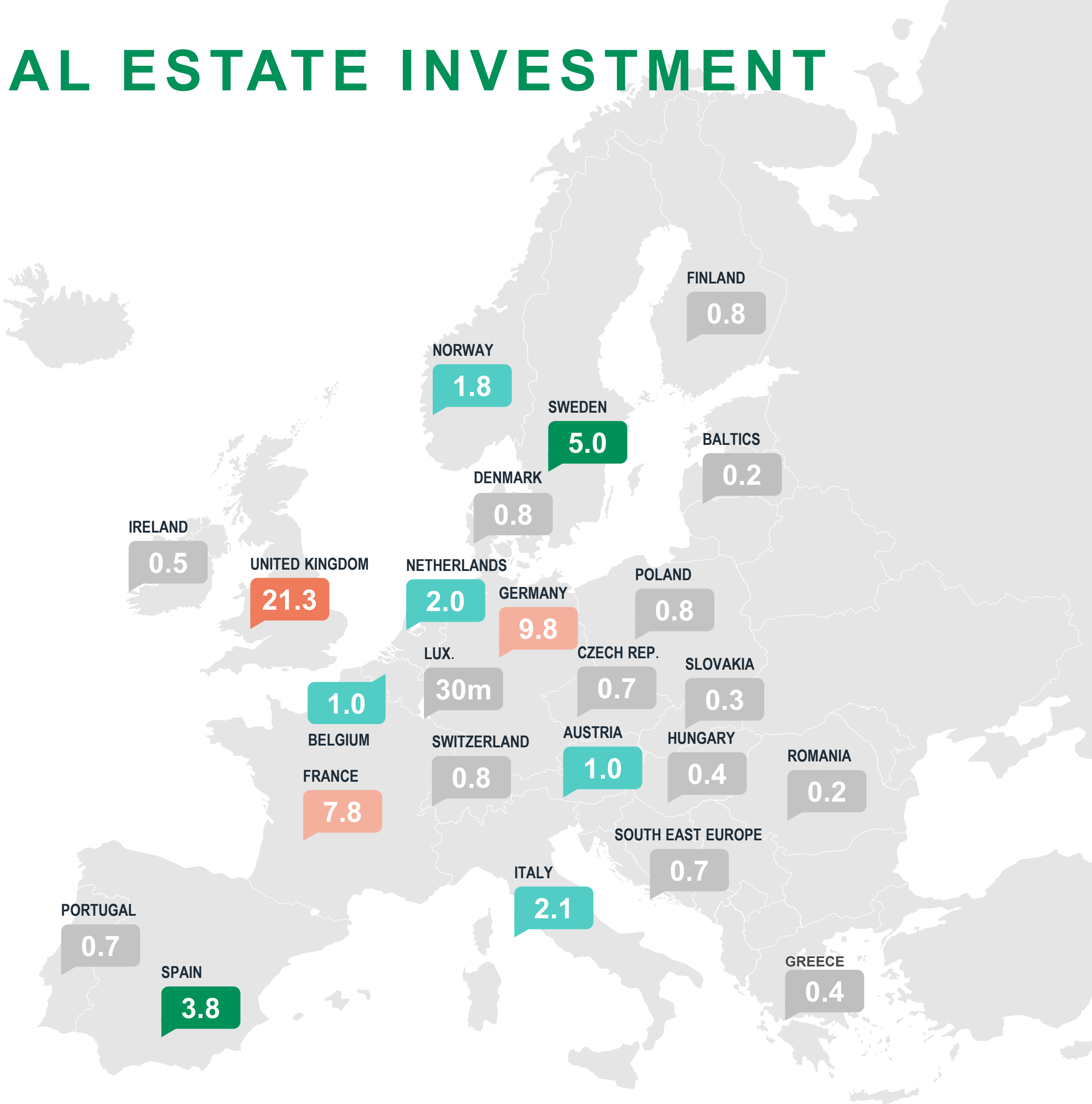
Commercial real estate
Office
Retail
Industrial & logistics
Hotel
Other

This excludes residential investment.

COMMERCIAL REAL ESTATE INVESTMENT

H1 2023 vs H1 2022

GERMANY	-68%
UNITED KINGDOM	-52%
FRANCE	-42%
NETHERLANDS	-69%
ITALY	-62%
SPAIN	-41%
POLAND	-71%
IRELAND	-77%
BELGIUM	-70%
CZECH REPUBLIC	-46%
LUXEMBOURG	-95%



- ≥ €15bn
- €6-15bn
- €3-6bn
- €1-3bn
- < €1bn

(excludes residential investment)

Source : BNP Paribas Real Estate

EUROPE – H1 2023

€62.4bn

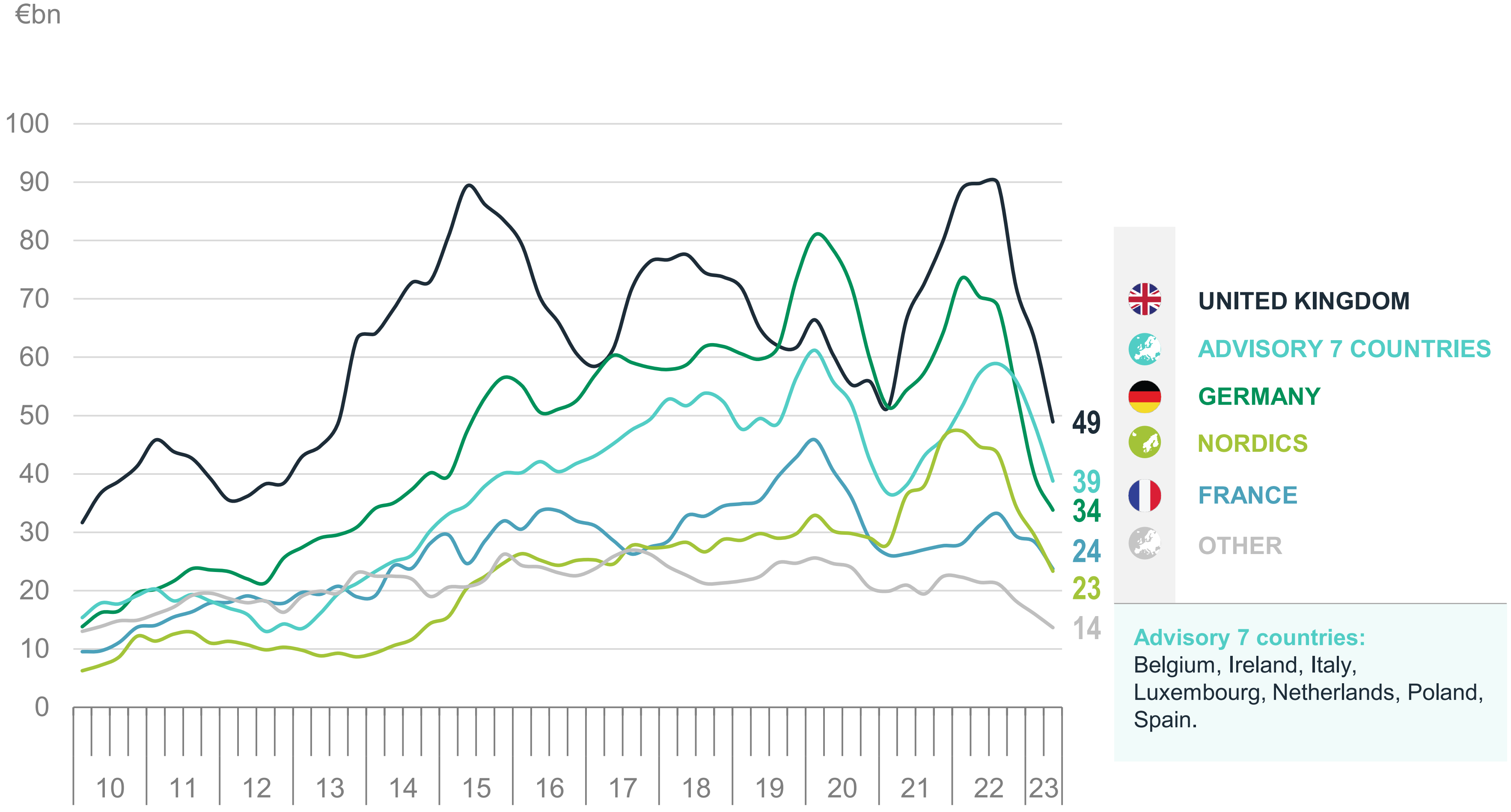
-57% vs H1 2022

- €62.4bn were invested in Europe over H1 2023, which represents a 57% decrease vs H1 2022.
- Some countries experienced strong declines: Germany (-68%), the UK (-52%), the Netherlands (-69%), Italy (-62%), Poland (-71%), Ireland (-77%) and Belgium (-70%), while declines in France (-42%) and Spain (-41%) were of lower magnitude.

COMMERCIAL REAL ESTATE INVESTMENT VOLUME

INVESTMENT VOLUMES ROLL BACK A DECADE

CRE Investment volume (€ billion)



Advisory 7 countries: Belgium, Ireland, Italy, Luxembourg, Netherlands, Poland, Spain.

Source: BNP Paribas Real Estate Research.

- No country has escaped from investment pull back over 2023, though the character of it differs between countries.
- High inflation and subsequent acceleration in monetary policy tightening has led to rapid bond yield expansion. This makes the rate of return from real estate less acceptable for the risk involved. Added to this is more expensive debt where the rate of return often now does not cover the cost of servicing loans.
- The outcome is a switch from a sellers market to a buyers one. Sellers remain unwilling to shift prices enough (given occupational fundamentals are still good) to meet buyers' revised requirements. Buyers remain reluctant to commit while debt costs remain in flux. Volumes indicate property acquisition has become far more specific over 2023.

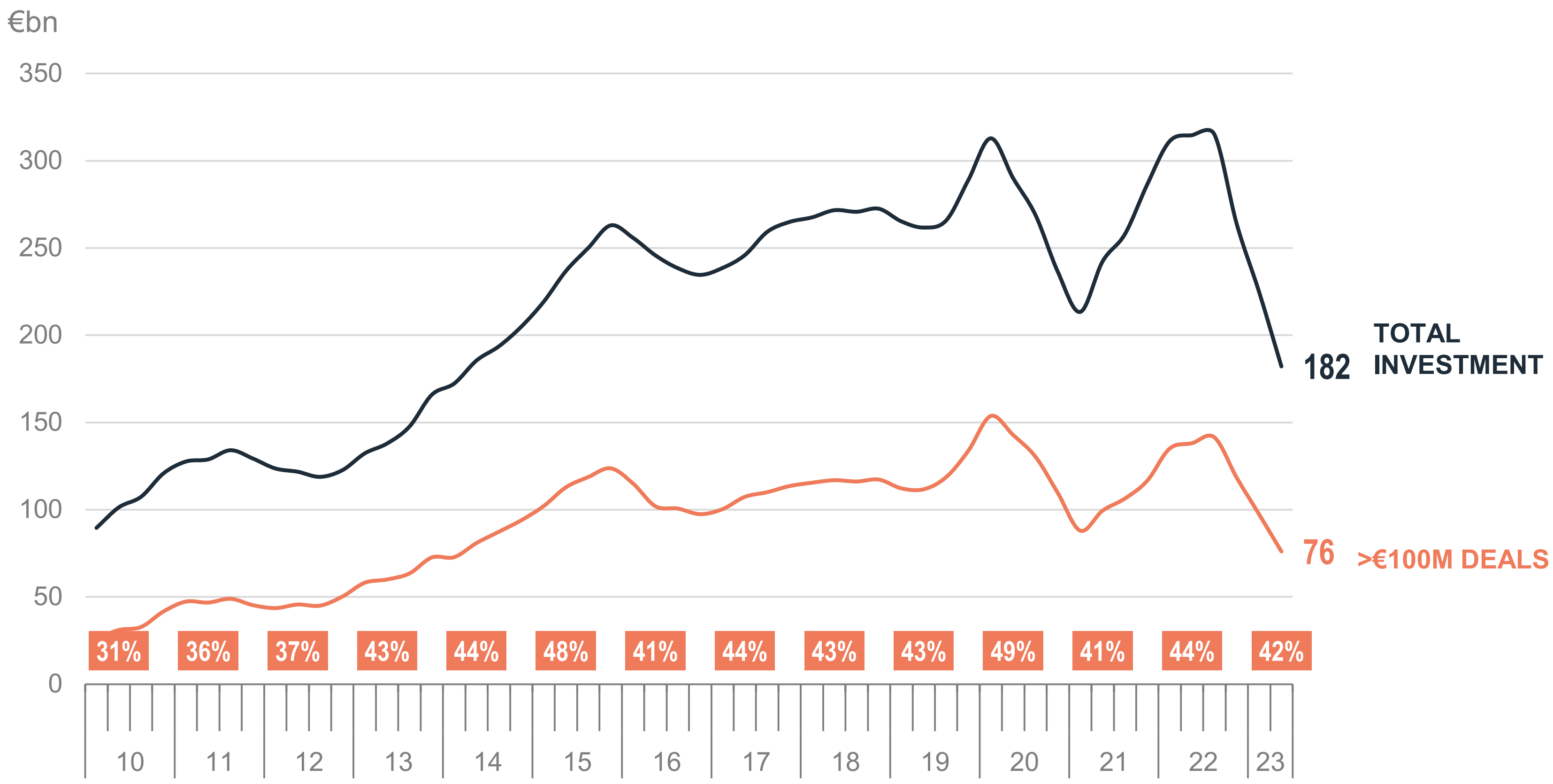
INVESTMENT BY SIZE BAND

Mega deals also at a decade low

- Mega deals are also now at a decade low. The peak in mega deals (>€100m) occurred in Q1 2020 with a record figure of €154bn (on a rolling-year basis). That is 49% of the total investment, an unusually big share for a Q1 and may not reappear for the time being.
- The pandemic-induced low point of €89bn occurred in Q1 2021 (€88bn). This was down 43% over Q1 2020 figure. Prior to global interest rate cycle tightening, the segment was regaining momentum reaching €142bn at Q3 2022.
- The mega deals volume dropped over Q4 2022 but to a lesser extent than other size bands of deals. The delayed response to interest rates may be a timing issue as these sort of deals take a long time to complete. Now the share of mega deals has decreased (42%).

Commercial Real Estate Investment in Europe

Total and >€100m size band - volume and share



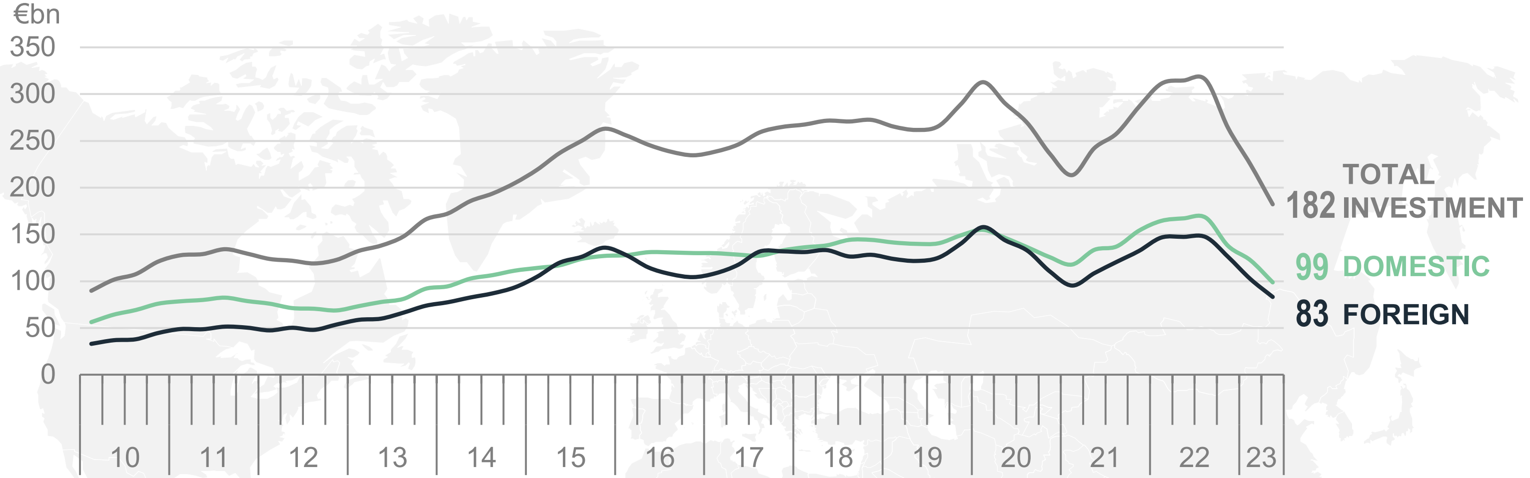
Source: BNP Paribas Real Estate.

CROSS-BORDER INVESTMENT MARKET

- Foreign investment continues to be negatively affected by the interest rate cycle and pricing mismatch The sharp decline started in Q4 reached €83bn in Q2 2023 (-43% vs Q2 2022).
- Within foreign investment, **European cross-border investment declined in line with the overall reduction in activity (-45%).** It represents 40% of foreign investment, a smaller share than during the Covid-19 years, but still above pre-pandemic times.
- Investment from other continents shows contrasting developments. **American investors** showed less interest in the European markets (-48%) but are still very present with 33% of foreign investment.
- Investment from Asia Pacific was also very important over the 12 last months. **With more than €11bn invested, (-31%),** Asian investor share increased slightly (13%).
- Middle East investors are less interested in the European markets compared to Americans and Asians. **They only represented 5% of the last 12-month foreign investment with €4.4bn invested (-27%).**

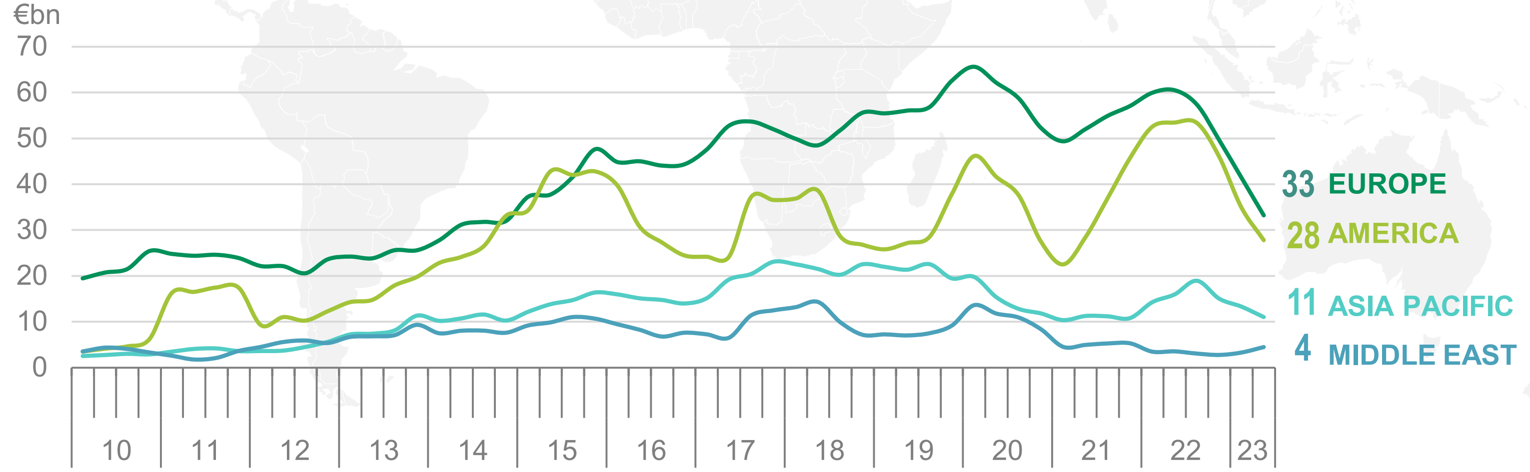
Commercial Real Estate Investment in Europe

Total, foreign and domestic investment



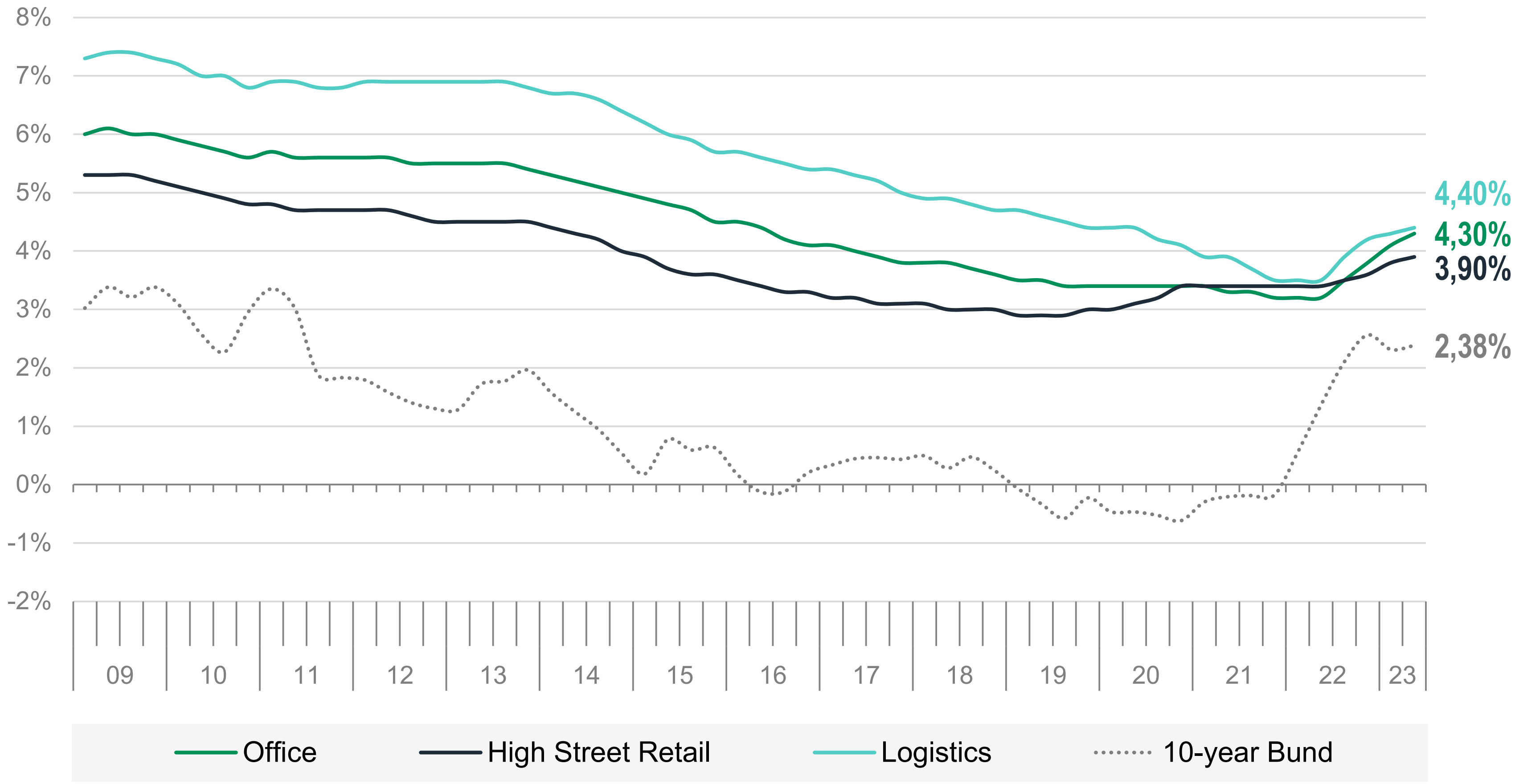
Commercial Real Estate Investment in Europe

Foreign investment detail



AVERAGE PRIME YIELDS IN EUROPE

BASED ON 16 MARKETS



Source: BNP Paribas Real Estate Research.

- Prime yield decompression characterizes 2023.
- Mid-2022 showed the first signs of expansion that have strengthened since. Decompression is affecting all the main sectors of real estate.
- The principal factor behind yield expansion is the change in the macro-financial environment. Persistent inflation is prompting more robust response from central banks. Normalization of monetary policy still has further to go and that implies yields may continue to decompress in 2023
- Bond yields have subsequently expanded, reducing the yield gap with real estate and prompting rethinking about the prices being paid for assets.

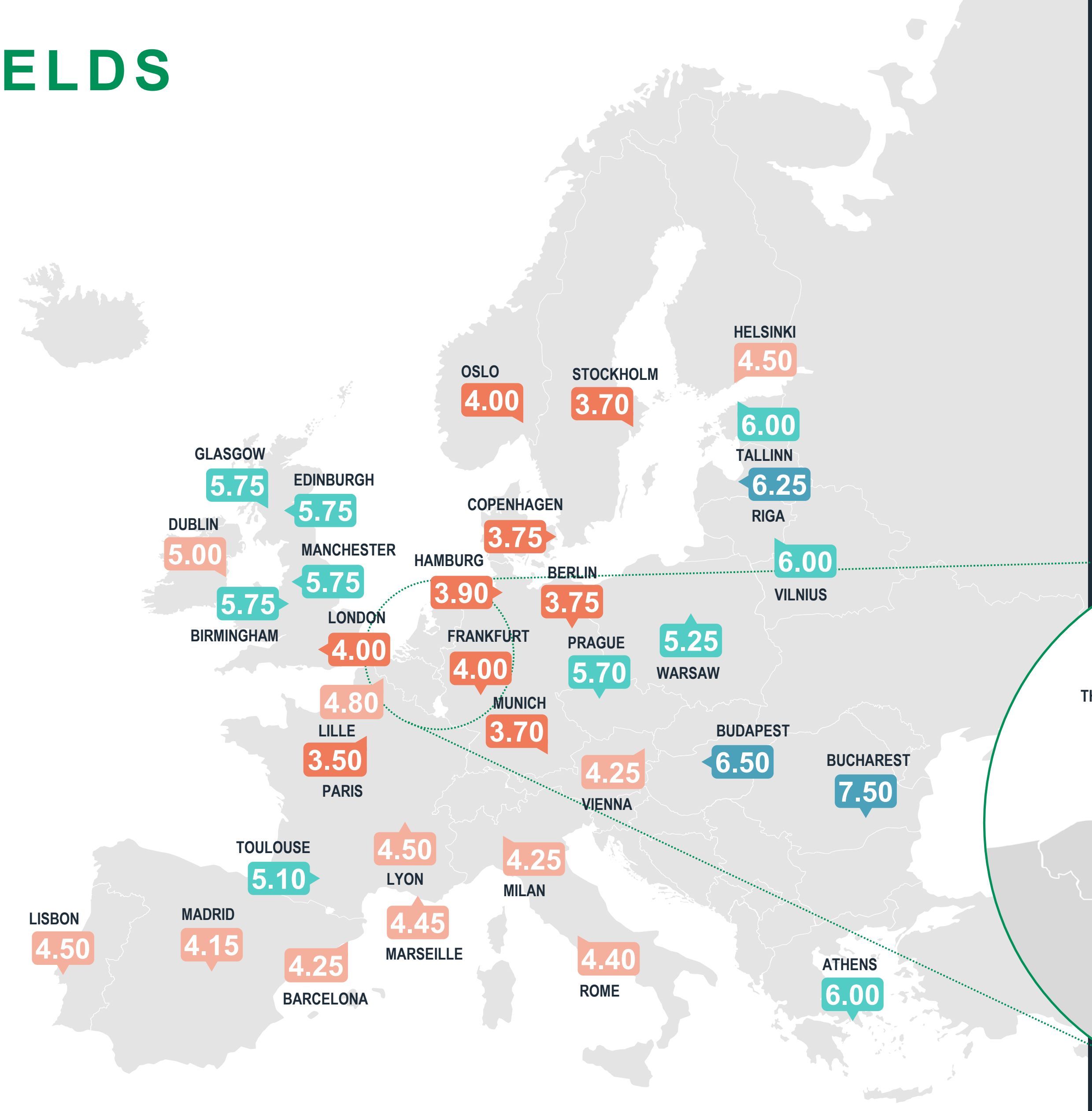
Based on 16 cities: Amsterdam, Berlin, Brussels, London, Paris, Dublin, Frankfurt, Hamburg, Lisbon, Luxembourg, Madrid, Milan, Munich, Prague, Vienna and Warsaw.

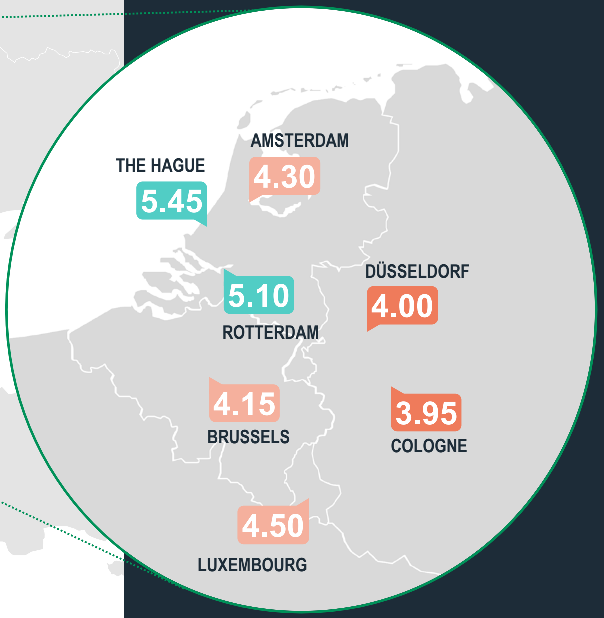
PRIME OFFICE YIELDS

Q2 2023 vs Q1 2022

BERLIN	+120bp
PARIS	+80bp
AMSTERDAM	+130bp
MADRID	+90bp
MILAN	+125bp
LONDON	+75bp
LUXEMBOURG	+110bp
BRUSSELS	+90bp
DUBLIN	+100bp
PRAGUE	+170bp
WARSAW	+75bp

≤ 4%
4-5%
5-6%
>6%





Source : BNP Paribas Real Estate

- Office yield compression effectively ceased in Q1 2022. By Q2 and Q3 2022 the first signs of yield expansion were occurring, becoming strong and universal by Q4. Expansion has rolled forward into H1 2023.
- Several markets experienced a 100bp or more expansion such as Amsterdam (+130bp), Milan (+125 bp) or Dublin (+100 bp).

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REAL ESTATE PERSPECTIVES

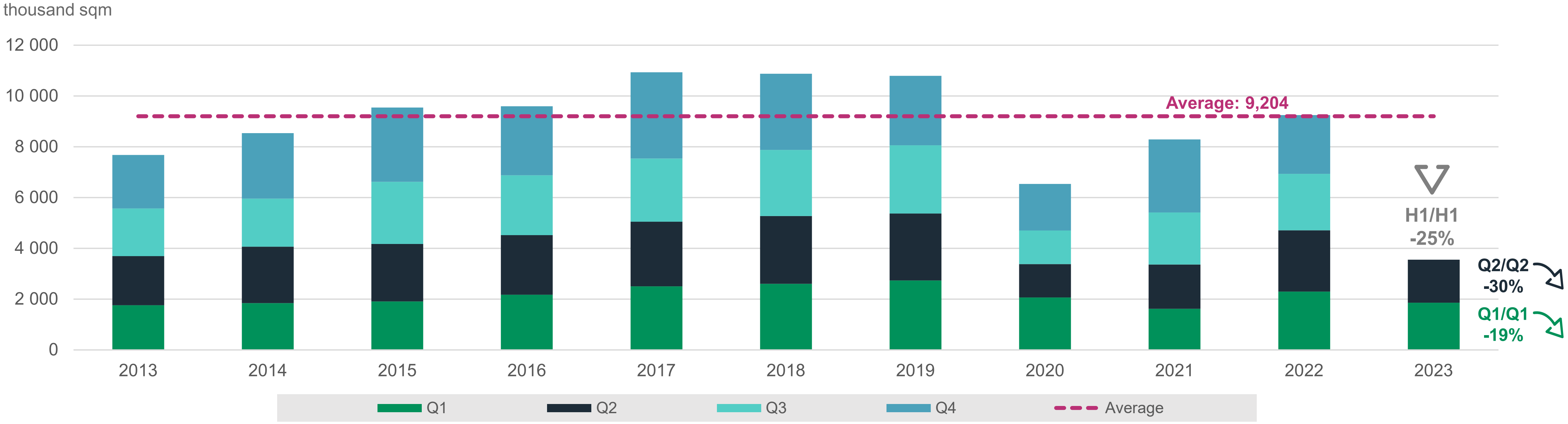
OFFICE MARKETS

BNP PARIBAS REAL ESTATE


Credit: Ooshot-Xavier Alexandre Pons

OFFICE TAKE-UP IN EUROPE – H1 2023

17 MAIN EUROPEAN OFFICE MARKETS*



Letting activity slowed in H1 2023

- While 2022's overall take-up returned to its long-term average in Europe, the contraction noticeable in few markets at the end of 2022 extended across Europe in H1 2023.
- Around 3.56 m sqm was transacted over H1 in the 17 main European markets, down by 25% vs H1 2022.
- H1 volumes are consequently below their 10-year average (-18%).
- Most European markets experienced significant declines in volumes in H1 including Barcelona (-38%), Central London (-30%) and the six main German markets (-35%).
- Rome, Brussels and Madrid stand in contrast accelerating by 88%, 25% and 8% y.o.y respectively.

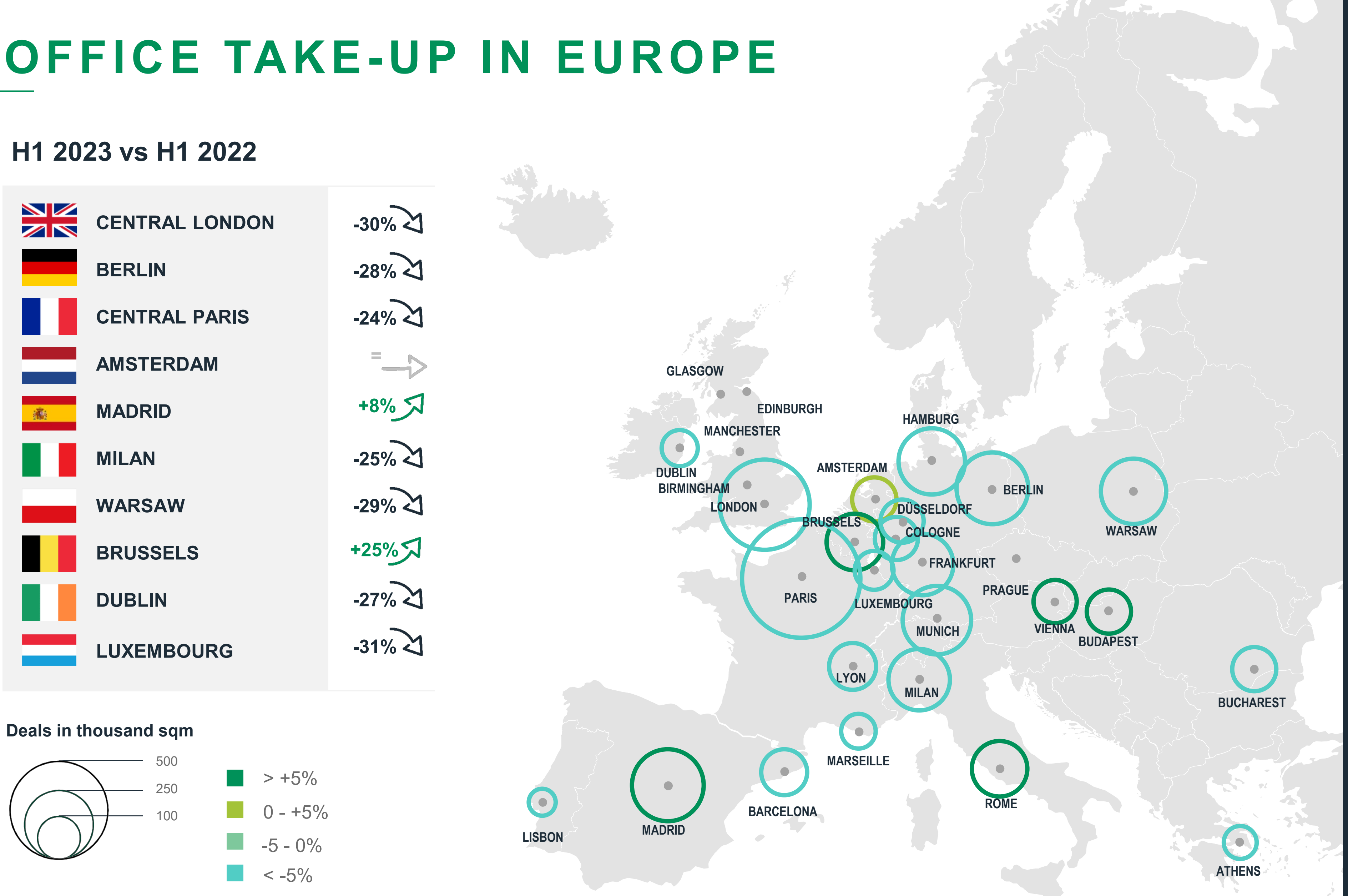
Source: BNP Paribas Real Estate Research.

* Berlin, Cologne, Düsseldorf, Frankfurt, Hamburg, Munich, Central Paris, Central London, Brussels, Barcelona, Madrid, Dublin, Milan, Rome, Luxembourg, Amsterdam, Warsaw

OFFICE TAKE-UP IN EUROPE

H1 2023 vs H1 2022

CENTRAL LONDON	-30%
BERLIN	-28%
CENTRAL PARIS	-24%
AMSTERDAM	=
MADRID	+8%
MILAN	-25%
WARSAW	-29%
BRUSSELS	+25%
DUBLIN	-27%
LUXEMBOURG	-31%



Source: BNP Paribas Real Estate Research.

EUROPE – H1 2023

4.28m sqm

26 markets

-25% vs H1 2022

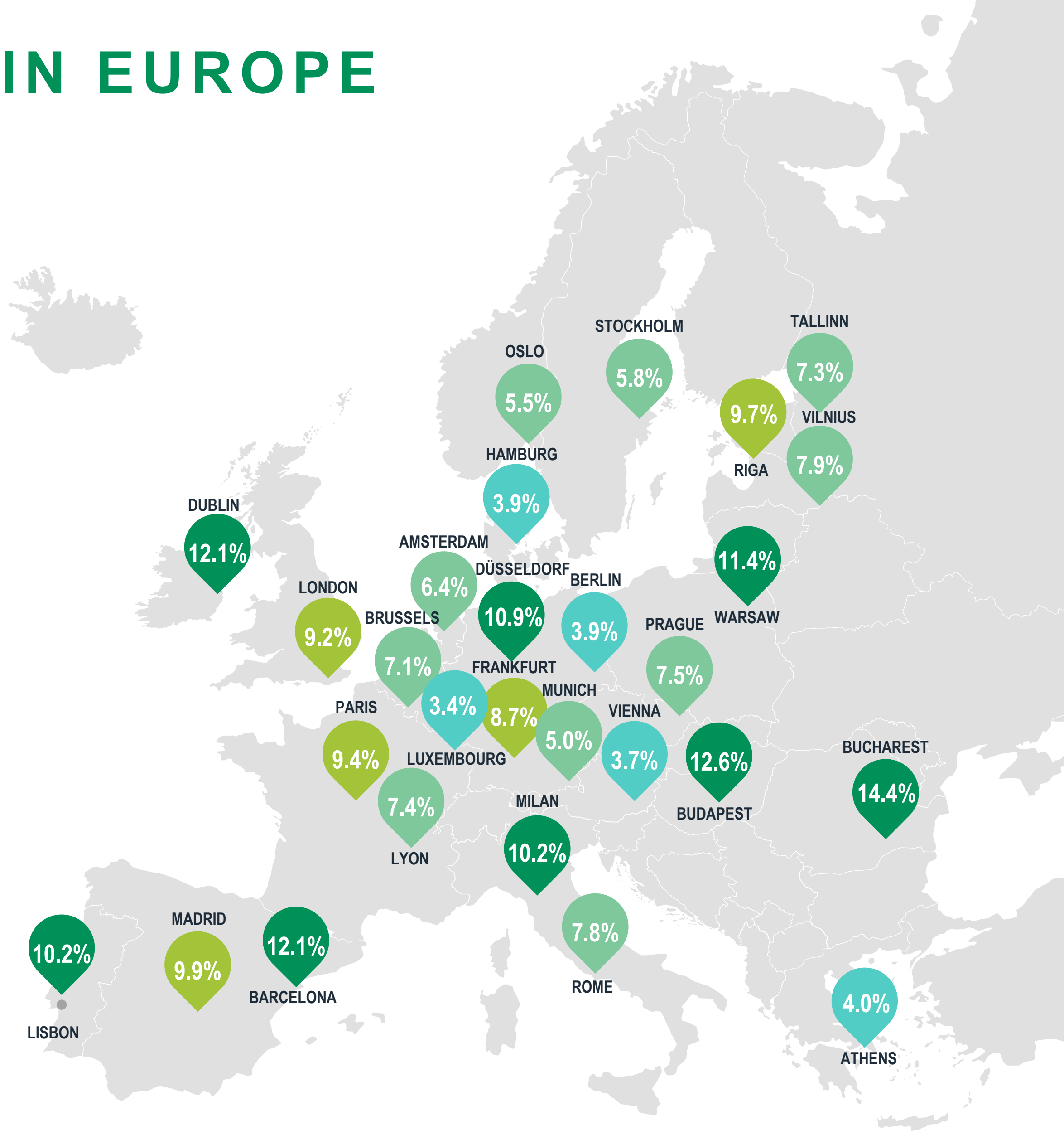
Take-up down in H1 2023

- Take-up at the end of H1 23 shrank 25% relative to H1 22.
- Most markets have experienced a decline in volumes, mostly due to a reduced number of very large transactions (over 10,000 sqm).
- However, a few markets have seen an increase in letting activity. This occurred with Rome (+ 88%) where the volume was driven by the closure of a very large transaction to a public sector tenant. Madrid continues to show a good momentum with H1 volume over 14% the 10-year average.

OFFICE VACANCY IN EUROPE

Q2 2023 vs Q2 2022

CENTRAL LONDON	-130 bp
BERLIN	+70 bp
CENTRAL PARIS	+80 bp
AMSTERDAM	+10 bp
MADRID	+10 bp
MILAN	+20 bp
WARSAW	-50 bp
BRUSSELS	-90 bp
DUBLIN	+70 bp
LUXEMBOURG	-40 bp



> 10% 5 - 8%
8 -10% < 5%

Source: BNP Paribas Real Estate Research.

EUROPE – Q2 2023

7.6%

29 markets
+30bp vs. Q2 2022

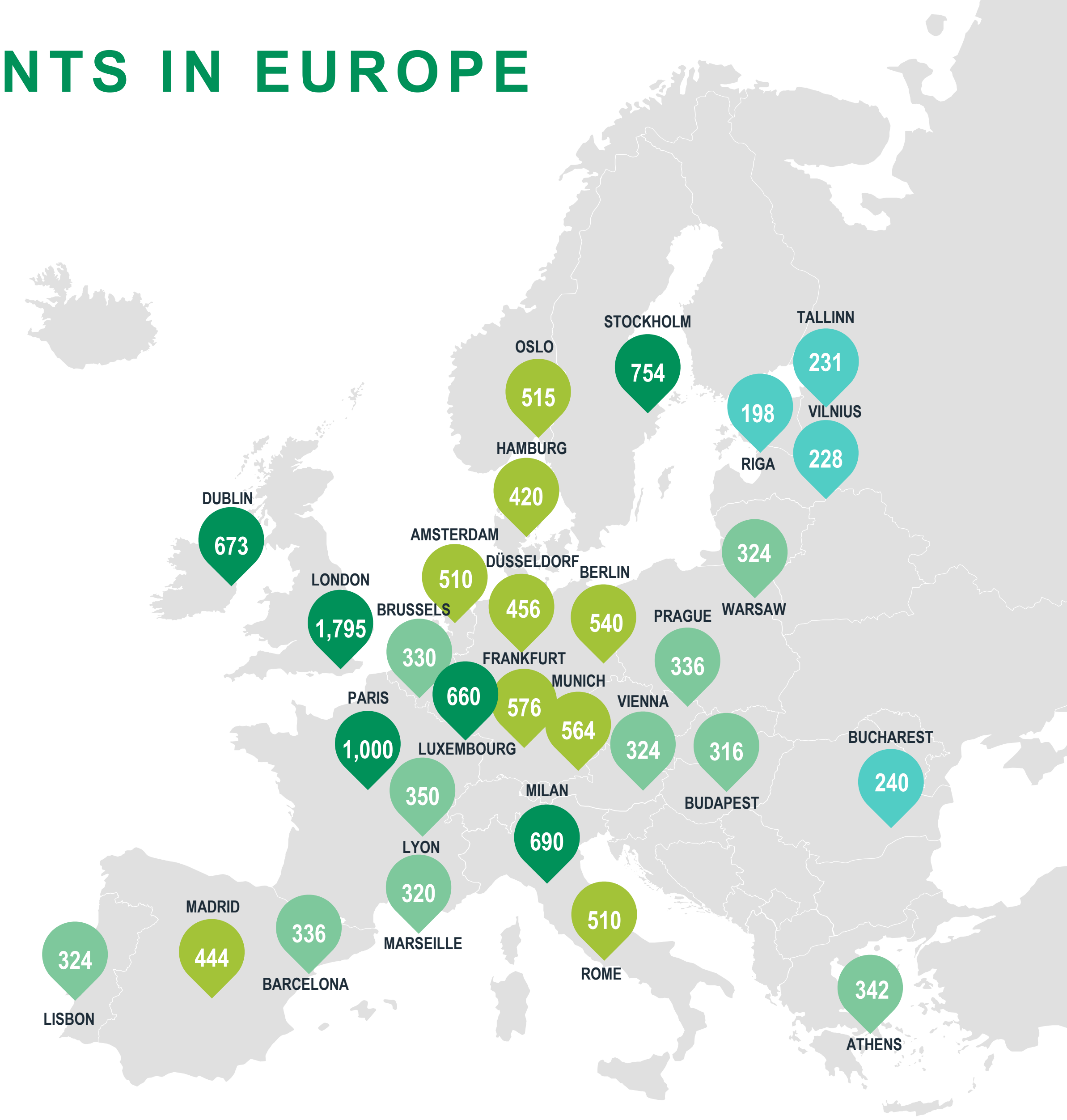
Vacancy remains under control in Europe

- The overall vacancy rate in Europe stood at 7.6% at Q2 2023 (+30bp vs. Q2 2022).
- Trends vary between markets: a sharp increase occurred in Barcelona (+300 bps vs. Q1 2022) due to numerous completions in 2022 while Berlin and Central Paris experienced more moderate rise. In Central London, the vacancy rate markedly declined.
- Most markets are seeing two-speed dynamics, with low availability in central submarkets and in new buildings, and much higher vacancy rates in peripheral office districts.

OFFICE PRIME RENTS IN EUROPE

Q2 2023 vs Q2 2022

CENTRAL LONDON	+12%
BERLIN	+5%
CENTRAL PARIS	+4%
AMSTERDAM	+5%
MADRID	+1%
MILAN	+6%
WARSAW	+4%
BRUSSELS	+3%
DUBLIN	=
LUXEMBOURG	=



Rents are in €/sqm/year

- > €600
- € 300 - 400
- € 400 - 600
- < € 300

Source: BNP Paribas Real Estate Research.

Prime rents still driven by high demand for top space

- The very low availability of prime assets and the appeal of high quality buildings located in the most sought-after districts continue to drive values up.
- With the widespread uptake of hybrid work models, companies are seeking attractive and modular workplaces.
- Workplace plays a key role in attracting and retaining talent, both in terms of space quality and location.
- Over the past 12 months, London (+12%), Milan (+6%), Amsterdam (+5%) and Berlin (+5%) have seen the most significant increases in values.

LOCATIONS

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