European commercial real estate market – the first signs of an imminent rebound?

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While European real estate markets have been adjusting to the new financial environment for several quarters now, some segments seem to have found a new equilibrium that could provide the basis for a rebound in investment volumes in the short term, and in terms of valuations in the medium term.

All real estate markets are affected by the rise in interest rates and financing costs, but some are adjusting more quickly than others. While real estate activity continues to fall overall, it is stabilising or even picking up again in some areas. Similarly, while yields continue to rise in most markets, a consensus seems to have been reached on several others, such as logistics in Germany and retail in the UK. France, which traditionally lags behind other markets, continues to exhibit signs of transition.

Investment volumes: the first signs of a recovery?

The wait-and-see attitude of investors and lenders at the start of the year was reflected in a sharp fall in investment volumes over the first three quarters. The decline was particularly marked in the large transactions segment, given the greater recourse to financing.

Over the past twelve months, European investment volumes on a downward trend, with an average drop of 55%: -50% for the United Kingdom, -52% for France and -60% for Germany. At the end of September, offices accounted for 30% of investment volumes in 2023, compared to 51% in 2019. The proportion of diversification assets has continued to rise, reaching 24% at the end of September 2023.

There are a few exceptions, notably in Germany and the Netherlands, where investment volumes are back on the rise, with a rebound of around 30% over the quarter. Slower than its neighbours in the price adjustment phase, the French market is suffering from competition from other European countries that are beginning to present interesting opportunities.

Prime office yields keep pace with rising interest rates

In the wake of the European Central Bank's tenth straight interest rate hike, real estate yields continue to rise across Europe. In addition, the high cost of debt results in negative leverage in many European countries. Prime office yields rose by between 10 and 50 bps over the last quarter, bringing the year-on-year increase to between 35 and 170 bps (Dublin 35 bps, London 50 bps, Paris 75 bps, Brussels 75 bps, Munich 150 bps). In logistics, prime yields rose by an average of 7 bps over the quarter, suggesting an attractive entry point for an asset class with good rental fundamentals.

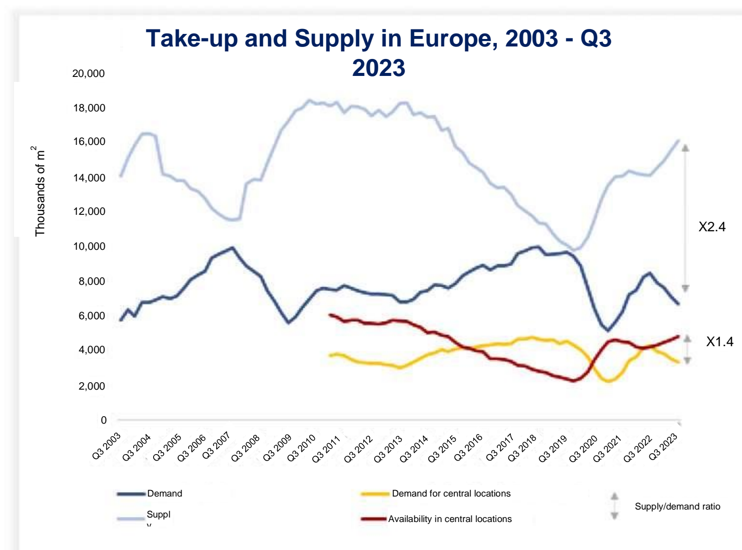
The rise in yields varies within a same market depending on the quality and location of the assets. An additional risk premium in excess of 150 bps is often expected by investors for assets located in

peripheral areas. The trend is the same for "obsolete" assets, in terms of both durability and functionality.

A rise in supply, difficult to control

Following the example of Germany and confronted with the economic slowdown, cost-cutting is a key issue for companies. Take-up* in Europe's main office markets fell by 21% year-on-year, mainly due to **a reduction in leased space**. However, some markets, such as Paris, Lyon and Amsterdam, saw demand stabilise or even increase in the third quarter. Companies are primarily looking for quality assets, offering smaller spaces with good accessibility.

In Europe, **office supply rose by 4% over the quarter, bringing the year-on-year increase to 14%.** Some markets stand out, such as Brussels, Amsterdam and Milan, where supply fell in the third quarter.



* Cumulative over 12 sliding months | Source: MBE, CBRE, LF REM Research

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Polarisation of rental markets with the emergence of a middle ground

The polarisation of rental markets is evolving in tandem with the emergence of a third segment. Until now, the rental market included:

- prime assets in central locations, where supply is becoming scarce, exerting upward pressure on rents. **Across Europe, with the exception of the UK, prime rents rose in the third quarter**; and
- secondary assets in peripheral locations, where the abundant supply continues to increase, driving down rental values.

As the economic environment darkens, an intermediate segment is emerging: prime and environmentally friendly assets which are available at competitive rent levels due to their peripheral location.

The rise in vacancy rates across Europe highlights a problem of inadequate supply, both in terms of location and quality. Supply continues to increase in peripheral locations but is declining in central locations. The central business districts of Paris and Munich have vacancy rates of 2.1% and 0.6% respectively, while peripheral locations have vacancy rates close to 20%. Two opposing trends will determine future supply. The high volume of vacancies over the next 24 months will increase the

supply of second-hand assets while new construction is falling sharply. In the Greater Paris region, for example, for every m² of good quality supply, there are 2.5m² of obsolete space.

Sources: CBRE, Trading Economics, MBE, La Française REM Research
**Take-up in the 12 main European cities: Brussels, Lille, Lyon, Paris, Berlin, Frankfurt, Hamburg, Munich, Dublin, Milan, Amsterdam, Madrid*

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