European commercial real estate market – an anticipated pause in Q1

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The European commercial real estate market hit pause in Q1 2023. Tightening monetary policy, rising inflation and European and US bank crises weighed heavily on investment activity. While the current context is slowing down the pace of transactions and pushing some investors to adopt a wait-and-see attitude, it is also creating opportunities for equity-rich investors, who can create value through rental reversion or by improving the features – particularly the environmental characteristics – of assets and for opportunistic global investors.

Market segments characterized by a structural supply shortage or more immune to economic cycles are attracting investors' attention. These include healthcare, tourism and manages residential assets.

Investment volume down year-on-year

The European real estate market is experiencing a period of adjustment. Investors, eager to position themselves in the new macroeconomic and financial context, are necessarily trying to establish new benchmarks. In Europe, the volume of commercial real estate investment dropped 63% year-on-year, reaching 26.5€ in Q1 2023. In Q1 2023, the share of global investors (versus European investors), looking to take advantage of price levels, was on the rise.

Across the board, all asset classes and markets registered declining investment volumes. Nevertheless, diversification assets stood out, given their more defensive profile. For example, the volume of European healthcare real estate investment over the past twelve months ending March 2023 declined, standing at €9.5 billion, nevertheless above its long-term average.

The United Kingdom and Germany remain the most dynamic European real estate markets despite the respective drops in investment volume of 68% and 71% year-on-year. Ireland, Belgium and France on the other hand are the most resilient, registering declines of less than 30%.

Broadly stable prime office yields

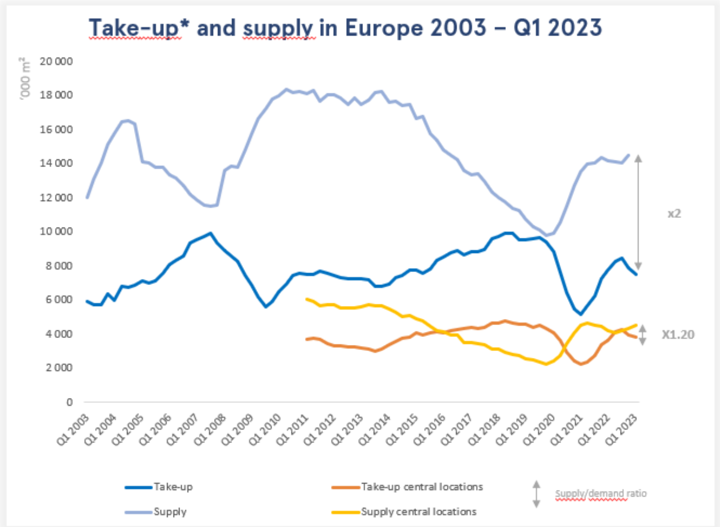
The upward trend in peripheral location real estate yields continued within a range of 25 to 50 basis points across Europe in Q1, while prime office yields remained broadly stable. Paris, London, and the main German cities (Berlin, Hamburg, Munich and Frankfurt) still offer prime yields below 4%, while regional cities (i.e., Lille) offer yields of around 4.5%.

High inflation and growth in rental values, supported by weak vacancy in central locations, should contribute to offsetting the effect of rising interest rates on prime real estate asset values.

Take-up and supply in European office markets

With businesses hit by rising energy costs, wage inflation and higher investment costs, the European letting market slowed in Q1 2023, with take-up* down by 4% over the past twelve months and immediate supply rising by 6%. Given the quasi absence of transactions exceeding 5 000 m^2, the transaction volume of the European office real estate market fell significantly. New ways of working and the subsequent rationalisation of office premises are contributing to an increase in supply, particularly of secondary assets.

Overall office supply in most of Europe's capital cities remains abundant, but of poor quality, falling short of occupier expectations in terms of centrality, adaptability and technical standards.



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

Market polarisation

The polarization of rental markets continues to accelerate. Users are leaning towards quality assets, particularly in terms of energy criteria. They favour central locations that allow them to benefit from new working arrangements and to retain and attract talent, while simultaneously improving their carbon footprint. The future of secondary assets in peripheral areas, abundant in supply, raises questions, whereas the concentration of demand in central locations, easily accessible to all, does not allow for the renewal of the already limited supply.

Overall, vacancy rates are on the rise across all European markets. However, the magnitude of the rise varies significantly across countries. The vacancy rate in Germany is manageable or even low while in peripheral countries such as Spain, Ireland and Italy, vacancy is above 10%. There is a large discrepancy in vacancy rates in Central Business Districts versus peripheral locations. Naturally, rents are falling in over-supplied peripheral locations and experiencing upward pressure in central locations.

User sustainability requirements are reflected in the levels of rent.

Sources: CBRE, Knight Frank, MBE, La Française REM Research
**demand in the 12 main European cities: Brussels, Lille, Lyon, Paris, Berlin, Frankfurt, Hamburg, Munich, Dublin, Milan, Amsterdam, Madrid*