European Real Estate Trends

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Higher inflation, monetary and fiscal stimulus, and economic reopening fueled a strong real estate market in 2021. Once a plain asset class with predictable returns, the sector is witnessing a dramatic repositioning within investor portfolios. Alternative assets and new sources of premiums complement traditional products with robust fundamentals and long-term trends.

How affordable is housing across Europe?

City Migration and Home Prices

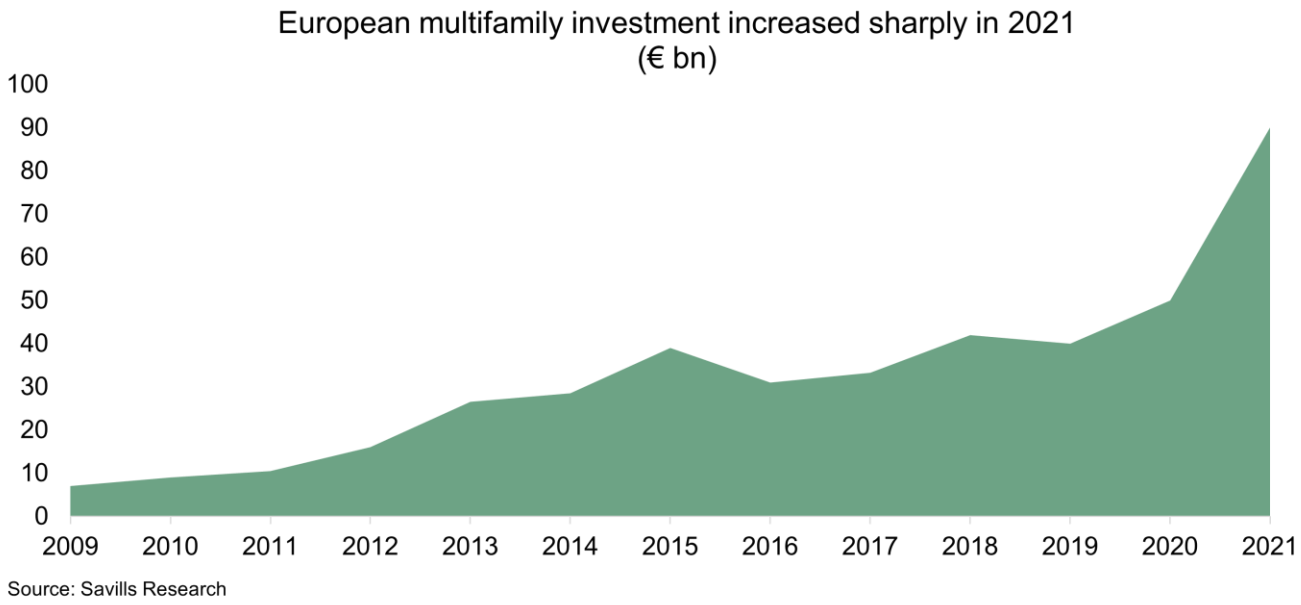
In the past two years, we have seen a strong city migration trend, which can be partially explained by the rising accommodation costs in inner cities. Since 2000, home prices have increased by an average of 3.4% per year, compared to a smaller 0.4% annual growth in wages. For a clearer perspective - while home prices have doubled, wages have merely grown by 9%. The variance has only grown larger in the past 5 years. Higher construction costs and mortgage rates are putting an extra burden on homebuyers.

Another reason for city migration is the COVID-19 workplace shift. Post-pandemic (and even with the larger share of workers returning to the office), a good percentage of Europeans are working remotely. The share of people working from home has more than doubled since pre-pandemic from 5% to 12.3%, with Finland, Ireland, and Luxembourg having more than 20% of their population working from home. This change has altered the way people look at housing.

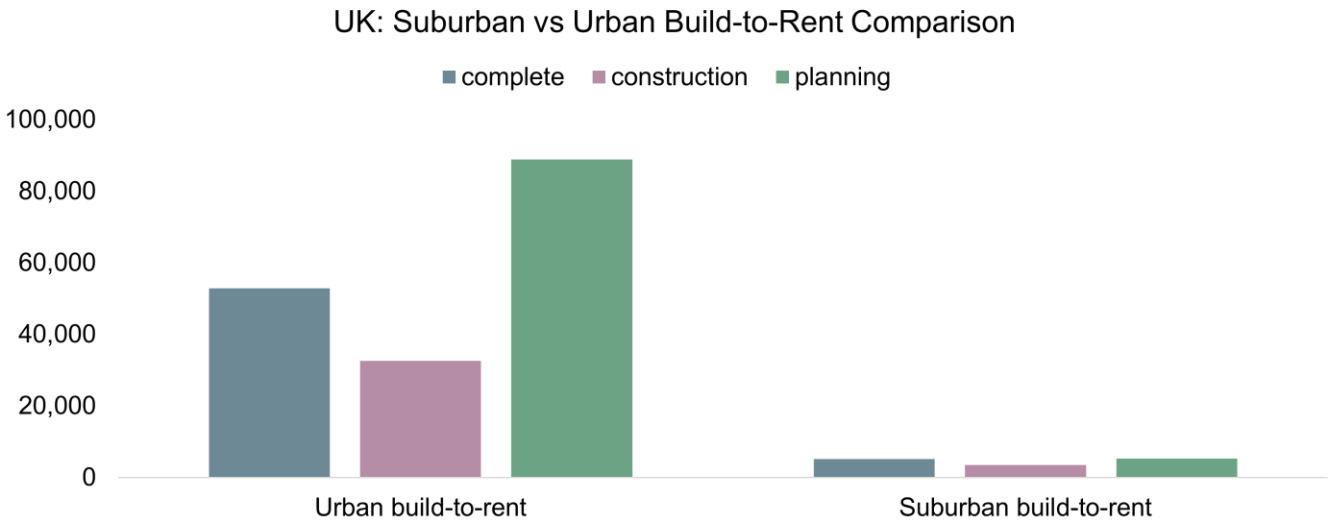
Instead of proximity to work and public transportation, work-from-home employees now look for larger homes in less populated areas, typically away from cities. But the city exodus has resulted in prices increasing in these areas as well, with prices in some outskirts rising more rapidly than those in inner cities. All of this means one thing: Fewer people can buy homes.

Rental Housing

With home ownership out of reach for a larger portion of the population, the need for rental housing has never been more dire. Asset managers are clearly capitalizing on this need, as European multifamily investment has more than tripled compared to 2013, with total investments reaching €92.3bn in 2021. The residential sector represented 29% of total European real estate investment compared to 19% in 2019, showing the growing attractiveness of the sector compared to the traditional sectors like office spaces, which have lost momentum since the pandemic.



Single-family homes in suburban areas are as likely to see strong demand in the coming future. Presently a small fraction of their urban counterparts, suburban single-family "built-to-rent" communities combine larger spaces, attractive locations, easier access to open space and nature, and cheaper rent. These properties offer workers what they need in times of uncertainty and unaffordable home prices while providing a new yield-generating product for asset managers looking to deploy a historic amount of dry powder.



Source: Savills Research

ESG in Real Estate

There is a growing emphasis on environmental, social, and governance (ESG) considerations within the commercial real estate industry, with investors and developers carefully considering the choice of materials, building designs, energy sources and consumption, as well as ways to operate. In a recent survey by PwC, 81% of asset managers cite energy efficiency as increasing in importance, with over 70% feeling the same towards reduction in operational and embodied carbon emissions. More managers tend to put more weight on community spaces (including green space), social impact, climate adaptation and biodiversity. And this is with good reason: Real estate is one of the top five sectors responsible for European emissions, with buildings generating 13% of total greenhouse gases.

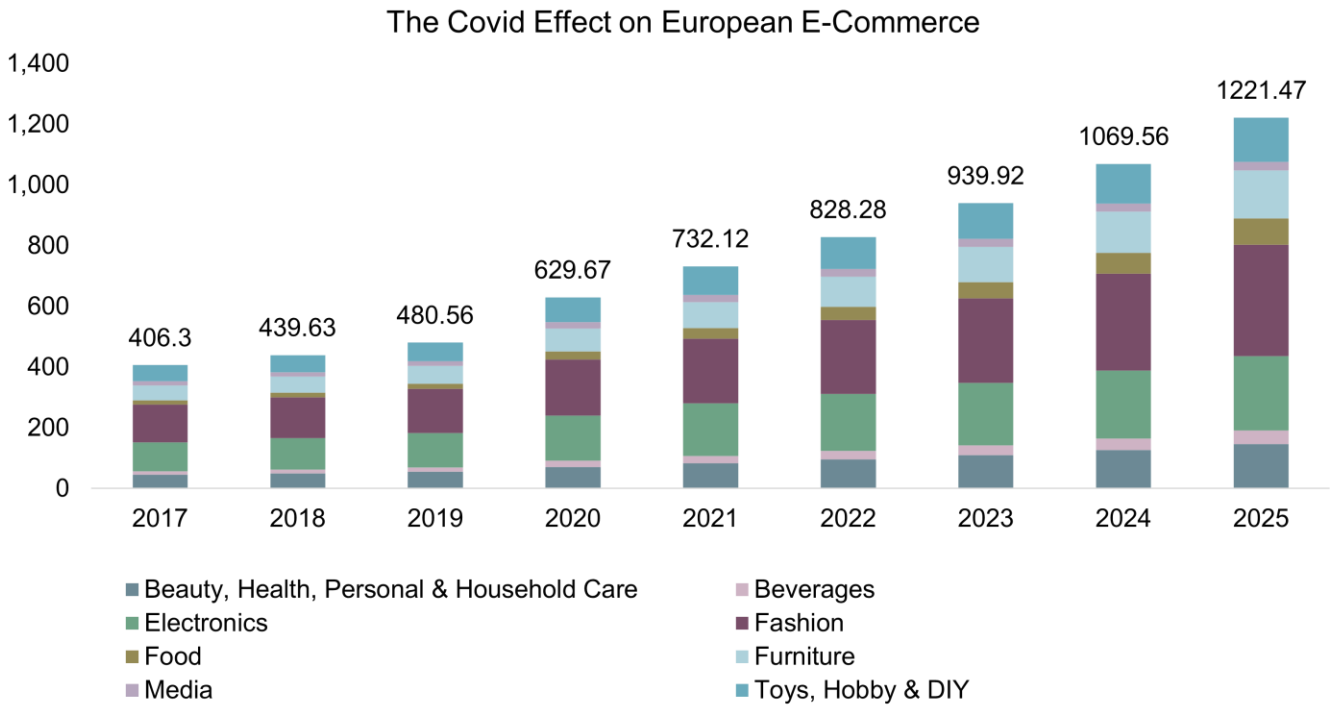
The incorporation of ESG initiatives can also be monetarily valuable. A recent study conducted by Knight Frank showed that environment-friendly rated buildings achieve up to 12.3% rent and 10.5% sales premium. More sustainable developments are becoming increasingly attractive to tenants too, with the recent inflation in energy prices steering occupiers to energy-efficient buildings where lower utility costs can play a significant role in lowering overall operating costs. In conclusion, and while the conversation about this green premium is still in its early stages to have global benchmarking consistency, sustainable buildings with solid ESG considerations could attract demand and liquidity over the long term as more investors screen for sustainable factors.

Long Term Effects of COVID on Data Centers, Healthcare, and Logistics

The pandemic has accelerated already visible megatrends and even spawned others, introducing investors to new or what was previously less-known real estate sectors.

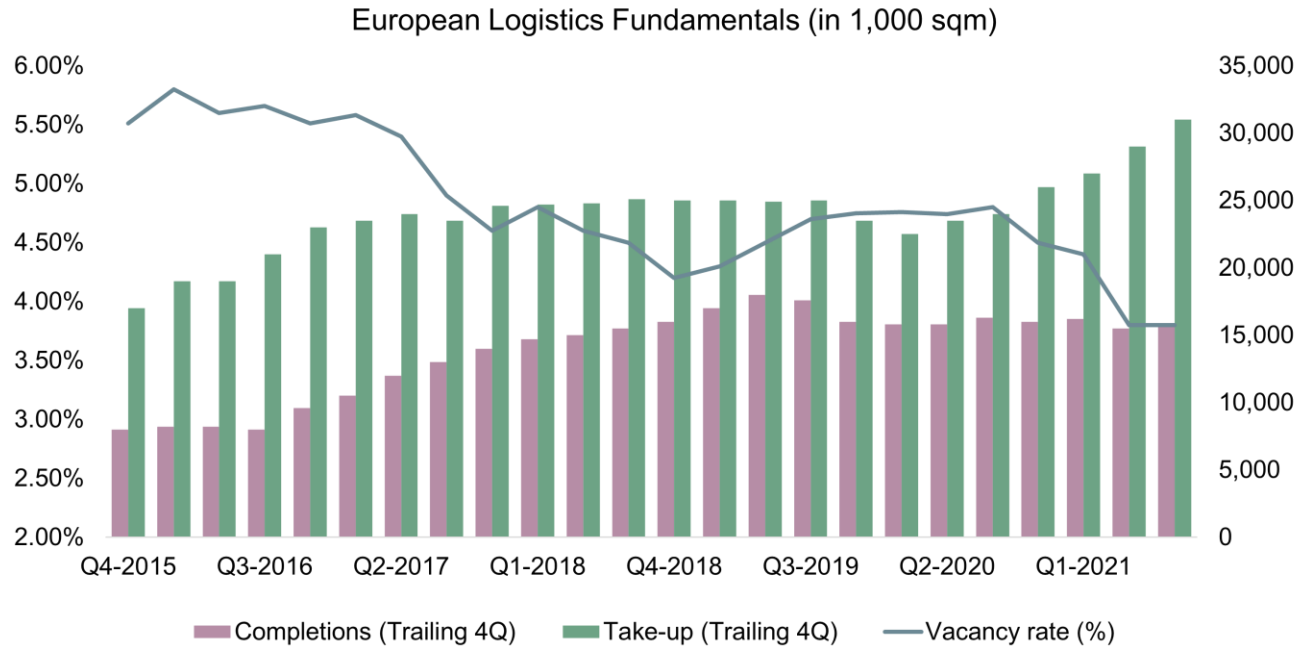
The healthcare sector, for instance, had been gaining traction prior to the pandemic, with the aging demographic structure fueling demand for senior living and assisted living communities. The expected increase in healthcare spending post-pandemic presents a strong demand for medical office buildings, particularly in northern Europe. Investors see familiarity in this asset class as it is comparable to the office sector, with long leases and sticky tenants. In southern Europe, the market for senior private housing catering to foreign residents is growing but still lacks institutional ownership.

Logistics is another sector seeing strong tailwinds partially supported by COVID-19. High consumer spending and widespread adoption of technology push for new tech-enabled facilities, as e-commerce continues to grow and supply chains get re-organized.



Source: Statista

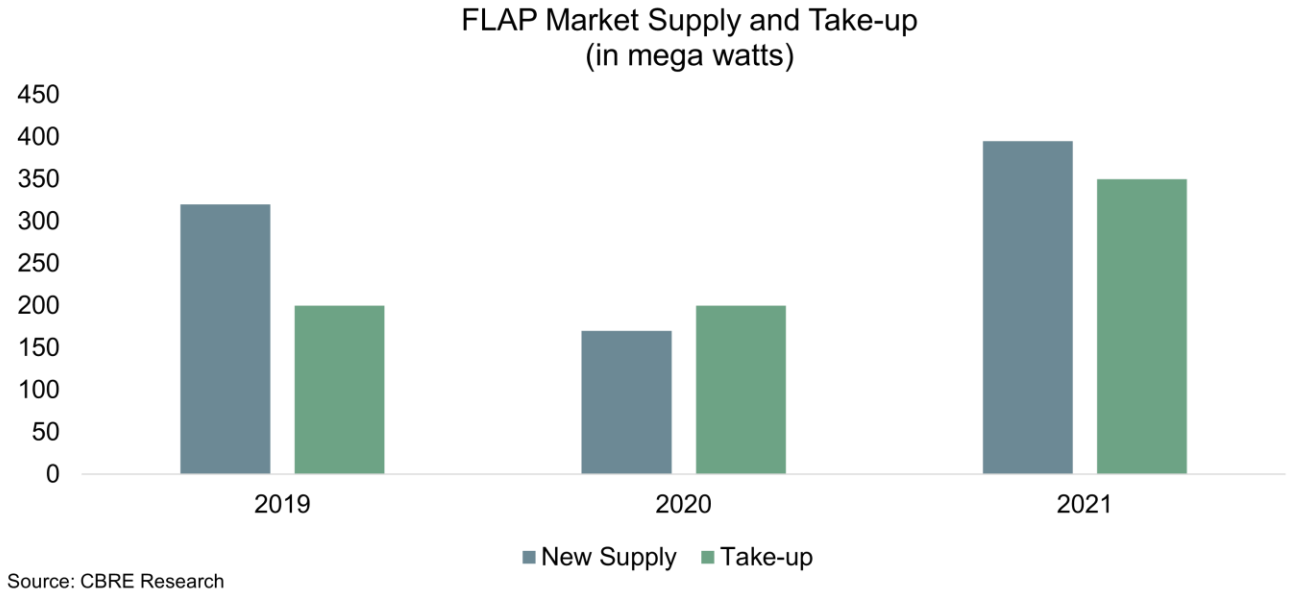
In the first quarter of 2022, logistics and industrial investment made up 23% of total commercial real estate (compared to 10% in 2016). Online penetration is still only at 11% of total retail sales and there's plenty of room to grow, with heightened demand and the obsolescence of old supply driving development in the years to come.



Source: CBRE Research

Data centers are also benefiting from the expanding technology sector. The increased adoption of cloud services (forced by the pandemic, in some cases) aggregates demand in FLAP markets (Frankfurt, London, Amsterdam and Paris) at a 77% growth in 2021. To handle the expected demand quickly, many cloud service providers are pressured to seek pre-lets. However, the availability of land near end users, unique fiber requirements, and planning restrictions still stand in the way of new supply.

Challenges Ahead



Source: CBRE Research

With the world heading into a possible recession, Europe is no exception. Historically, private real estate has been looked at as an effective inflation hedge, but a deeper dive shows that it is economic growth, not inflation, that drives private real estate returns. A study ran by Franklin Templeton shows that the annualized performance of private real estate in low-growth, high-inflation environments is less than a third of the annualized returns achieved in high-growth, high-inflation environments, and less than half of annualized returns achieved in a mid-growth, high-inflation scenarios. Strong economic growth is often associated with demand-pull inflation, which makes the latter look like the driving force for the average investor. What we have now is different: cost-push inflation, the risk of the economic fallout from the Ukraine war lowering consumption and growth, and rising interest rates putting downward pressures on valuation. This trinity can paint a very bleak outlook on European real estate over the short to medium term, and investors need to be carefully positioned to find value, unlike in the past decade.

Conclusion

Economic conditions, ESG awareness, and pandemic-induced changes are taking center stage in the European real estate sector. While short-term imbalances can provide opportunities to capitalize on market dislocations, investors need to look at megatrends that resiliently deliver through an increasingly uncertain world.

As part of Petiole's diversified private market investment programs, we have been investing in real estate to capture long-term growth trends in developed markets. As a PRI signatory, we use exclusionary and positive screening at our core Responsible Investing approach when making investment decisions while maintaining financial returns.

Contact our expert team today to find out more about how private real estate can be a valuable asset in your portfolio.

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