LiGHTHOUSE

H2 2023 | EUROPEAN PROPERTY MARKET **OUTLOOK**

BNP PARIBAS REIM

BNP PARIBAS REAL ESTATE

Real Estate for a changing world

Talking Points

1

FINANCING CONDITIONS WILL DICTATE THE RECOVERY.
High inflation and the US banking crisis have not weakened the European economic outlook, but lenders and borrowers remain extremely risk averse. The flow of debt could diminish further and weigh on investment activity across Europe throughout 2023.

2

EUROPEAN REAL ESTATE STILL NEEDS TO PRICE IN SHORT-TERM RISKS.
Yields are rising quickly to account for higher debt costs. The UK is furthest into this repricing phase, followed by the rest of Europe. The timing and height of peak central bank interest rates is still unclear. The risk of large-scale refinancing and fund redemptions could cause the repricing phase for prime assets to be sharper and extend further.

3

REDEFINING CORE INVESTMENT TO AVOID THE STRANDED ASSETS AND SUBMARKETS.
Secondary assets are likely to see their pricing drift out for many years across all property types. Small, but significant, parts of the market may become stranded and never be core again. Meanwhile, core-plus and value-add investors could find many assets in strong markets worth improving and making sustainable.

4

WAITING FOR PRIME OFFICE RETURNS TO ADD UP.
The occupier fundamentals of European office markets are in a much stronger position than those of US office markets. But even within European cities, a strong micro location is essential. Buyers are waiting for debt costs and equity yields to return to feasible spreads. Pricing should stabilise in the next six to twelve months, but investment volumes would stay at extreme lows.

5

LOOKING FOR PROTECTION FROM FUTURE DOWNTURNS.
No property type is exempt from repricing, but healthcare and residential have been more resilient. They benefit from long-term macro trends, such as demographics, and, in turn, investors are committed for the long term. They are showing their credentials for reducing portfolio risk in a market that could see further volatility in the future. Operator risk remains a key consideration for healthcare and managed residential.

6

LOGISTICS INVESTMENT NEEDS CAREFUL ANALYSIS AND QUICK DECISIONS.
Logistics is our top performing sector over the next five years. E-commerce is, however, unlikely to maintain the double-digit rental growth seen recently. Investors, therefore, need to be confident on future rent reversions and that the building's design and function are sustainable. Strong competition among buyers is likely.

7

A RESURGENCE OF DISCRETIONARY SPENDING SHOULD BENEFIT HOSPITALITY.
Mid-to-high income households are spending more on experiences. The hospitality sector is close to a full recovery from the pandemic, although budget and midscale hotels, especially those reliant on business travel, may continue to struggle. Camping and nature-based holidays should remain popular, while upscale and luxury hotels also should perform well.

We are pleased to present the seventh edition of our European property market outlook. BNP Paribas REIM publishes its bi-annual House View in Q2 and Q4 of every year, providing our investment strategies in light of the expected macroeconomic and financial environment.

CONTENT

2 TALKING POINTS

4 THE ECONOMIC OUTLOOK

7 THE REAL ESTATE OUTLOOK

10 SUSTAINABILITY

13 INVESTMENT THEMES AND STRATEGIES

- 16 FINANCING CONDITIONS
- 17 MORE REPRICING
- 18 STRANDED ASSETS
- 19 WAITING FOR PRIME
- 20 DOWNTURN PROTECTION
- 21 LOGISTICS COMPETITION
- 22 MORE HOSPITALITY

THE ECONOMIC OUTLOOK

BY SAMUEL DUAH

The outlook for activity in the European economy has improved materially since the last quarter of 2022. In our last Lighthouse publication the expectation was for the European economy to enter a recession at the turn of the year, on the back energy supply issues and weakening sentiment. However, the economies of the region proved resilient, except Germany, reflecting a better situation than expected with respect to energy supply and improving sentiment indicators across sectors and countries.

The composite business sentiment PMIs have risen in the UK (5 points) and the Eurozone (4 points) since the turn of the year, alongside improving consumer confidence, even if the latter remains historically low. Consequently, there have been upward revisions to 2023 GDP growth forecasts for most European countries. We currently expect the Eurozone economy to grow by 0.6% in 2023. This compares to -0.5% in the H1 2023 Lighthouse report. In Germany (0.0%) and France (0.5%) growth is expected to be weak. However, in Spain (1.8%) and Italy (0.9%) with the support of increased tourism, we expect growth to exceed that of the core countries. The UK (0.4%) has seen the most improved outlook since our last update, driven largely by reduced political uncertainty and falling energy costs.

Although growth is less likely to be negative, it risks being extremely low in all countries. The main cause remains the continued squeeze on consumption from falling real income. Although the level of inflation is receding, price levels remain high. Additionally, some energy costs are still high. For the consumer, the price of energy in its immediate useable form (petrol at the pump) may have fallen, but not that of home heating, which is determined by contracts. Another factor that will slow growth in the second half of the year is the delayed impact of cumulative increases in key interest rates.

European economies are effectively in stagnation, and it is highly likely that this weakness will continue into 2024. BNP Paribas has lowered its 2024 GDP growth forecast for the Eurozone (from 1.3% to 0.5%). Conversely, it has slightly raised its assumption for the UK (1.0% instead of 0.8%).

> Upward revisions to 2023 GDP growth forecasts for most European countries.

From Headline to Core, inflation persists

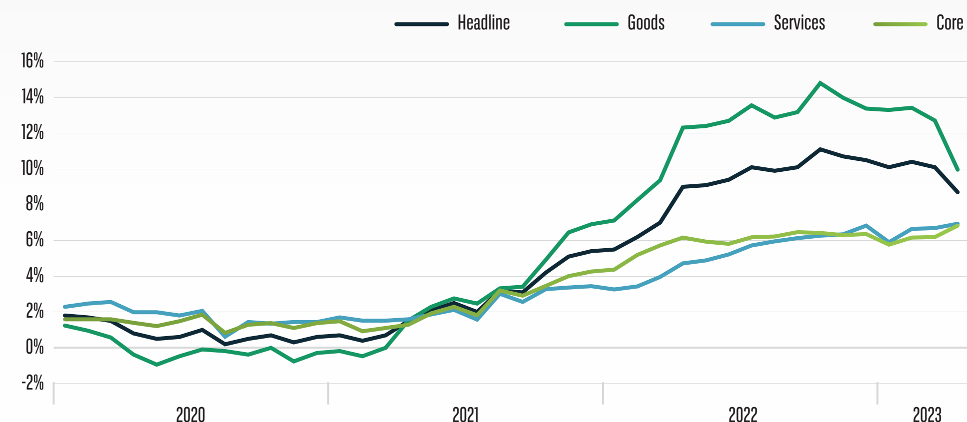
At the start of the recent inflation scare in Europe, the key driver was imported energy costs exacerbated by Russia's invasion of Ukraine. Inflation peaked in November in the Eurozone (11.1%) and the UK (10.1%). As the cost of wholesale energy keeps falling, the rate of inflation has also fallen steadily to stand at 7.0% and 8.7% in the Eurozone and UK respectively. As an inflationary factor, energy is being replaced by domestic components such as cost of services, food and wage increases.

Exhibit 1. UPGRADES TO THE ECONOMIC OUTLOOK Forecasts of European GDP and Inflation by date of forecast

FORECAST (% PA)	2023			2024		
GDP	PREVIOUS	CURRENT	DIRECTION CHANGE	PREVIOUS	CURRENT	DIRECTION CHANGE
Eurozone	-0.5%	0.6%	↑	1.3%	0.5%	↓
Germany	-1.0%	0.0%	↑	1.1%	0.5%	↓
France	0.0%	0.5%	↑	1.0%	0.6%	↓
UK	-0.9%	0.4%	↑	0.8%	0.7%	↓
INFLATION						
Eurozone	5.7%	5.4%	↓	2.3%	2.6%	↑
Germany	5.4%	5.8%	↑	2.0%	2.6%	↑
France	6.2%	6.1%	↓	2.7%	3.0%	↑
UK	7.4%	6.6%	↓	2.1%	2.0%	↓

Sources: BNP Paribas (forecasts as at May 2023)

Exhibit 2. UK INFLATION STARTING TO FALL UK consumer price inflation (% y/y)



Source: Macrobond (data as at May 2023)

Worryingly, core inflation is more persistent than headline inflation. The headline inflation figure in the UK has recently fallen, while core inflation has continued to rise. It is hard to see core inflation moving lastingly closer to the target level in the near term, with goods and wages still climbing. As such, we expect headline inflation in the Eurozone (5.4%) and the UK (6.6%) to remain above central bank target rates throughout 2023, driven principally by core rates.

Headline inflation may return to the targeted rate eventually, but we expect higher prices to persist as they become embedded in forecasts and wage negotiations.

Labour market both a support and hindrance

Monetary policy transmission takes a long time, such that the rate hikes so far are yet to percolate through to the economy. The main impact may manifest in the housing sector, as a large proportion of mortgages in Europe are on rates that are set to be renegotiated during this high interest rate period. Increased mortgage costs are likely to eat further into discretionary spending.

There is insufficient slack in European economies because labour markets remain historically tight. The IT sector aside, mass layoffs are still the exception. Yet even if these do occur, it may not solve shortages in the sectors worst affected by labour issues – construction, health and wellbeing, hospitality and leisure.

The structural problem of declining participation is unlikely to resolve itself over the short term. Labour markets are likely to remain strong, keeping wage growth elevated. The wage contribution to inflation may persist for some time, keeping pressure on central bank resolve. On the plus side, the high level of employment will sustain consumer

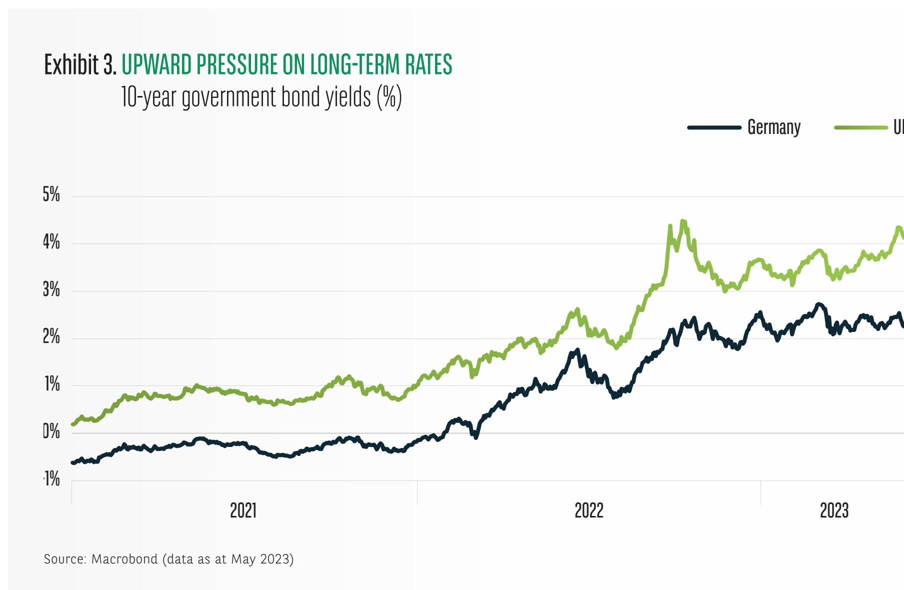


Exhibit 3. UPWARD PRESSURE ON LONG-TERM RATES
10-year government bond yields (%)

Source: Macrobond (data as at May 2023)

> Labour markets are likely to remain strong, keeping wage growth elevated

demand, acting as a floor for the housing market and economic growth. However, it will not create the conditions for growth acceleration.

Monetary policy: unfinished business

Persistently high inflation now poses a major obstacle to changing the direction of monetary policy across the European continent. Recent inflation trends, particularly core inflation, makes a pause in rate hikes more palatable than rate cuts. We doubt central banks will go into reverse at the first sign of weakening inflation. Rather, they will require substantial evidence to prove that the mission to tame

4.00%
EXPECTED PEAK ECB
DEPOSIT RATE

5.00-5.25%
EXPECTED PEAK BOE
BANK RATE

inflation has been successful. Such evidence is unlikely to emerge until the beginning of 2024.

Therefore, we expect further tightening by both the ECB and BoE throughout 2023. In the immediate months this could be as much as 25bps each in each of the next two meetings by the BoE, with a slower pace thereafter. We think the terminal rate for the BoE will be between 5.00% – 5.25%. For the ECB the pace of tightening may not be as rapid, given the various pace of inflation and economic growth in the different countries in the Eurozone. We see the terminal rate for its main policy refinance rate at 4.0%.

Yield rises, further to go

Ten-year government bonds stand at around 2.5% for Germany, 2.9% for France and 3.9% for the UK, having expanded by 50bps points since the start of the year. Rising inflation and short-term rates continue to put upward pressure on long-term rates. Yield rises may continue until the end of 2023, i.e. when monetary policy stops being tightened. The good news is that five-year swap rates remain steady, albeit at an elevated level, implying that refinancing is available even though it is more expensive than before.

THE REAL ESTATE OUTLOOK

The low liquidity of the real estate market is impacting our outlook: repricing is taking longer to materialise and activity might pick-up later than previously expected. However, market fundamentals remain positive as the demand from occupier is still strong enough to generate rental growth

BY BENOIT LEFEBVRE

Despite a brighter economic outlook, European real estate markets are still responding to the new environment implied by higher financing costs. The pricing adjustment that started at the beginning of Q3 2022 is still dampening real estate market activity. Indeed, most investors are adopting a wait-and-see approach: buyers are waiting to see where financing costs are heading (expecting for better pricing), while sellers are waiting for more information on prices. Consequently investment has now been falling since mid 2022, and reached only € 29bn in Q1, the lowest figure for a first quarter since 2012. As the current level of pending deals does not suggest that market activity will pick up in the short term, the price discovery phase could extend further into 2023.

Do not confuse short-term distress with long-term outlook

The low correlation between the economic outlook and real estate activity could be explained by the headwinds that the sector is currently facing. Not a single asset class seems to be immune from the negative impact on pricing, driven either by global or domestic uncertainties.

So far, logistics assets have experienced the sharpest and swiftest readjustment of yields (+80 bps since Q4 2021). Nevertheless, investors are still sitting on the fence. Indeed, the current slowdown in global trade, driven by the change in consumers' priorities, is affecting occupier demand. Some tenants are also now taking a slight pause to review their options, seeking price reductions or improved terms. However, the long-term prospects for the logistics sector remain bright and we still expect it to be one of the top performing asset classes over the next 5 years. The unprecedented levels of new tenant enquiries from a wide range of occupiers is expected to continue into 2024, underpinning demand. As long as take-up remains sufficient to prevent vacancy rising materially, then rental growth will remain strong, supporting returns.

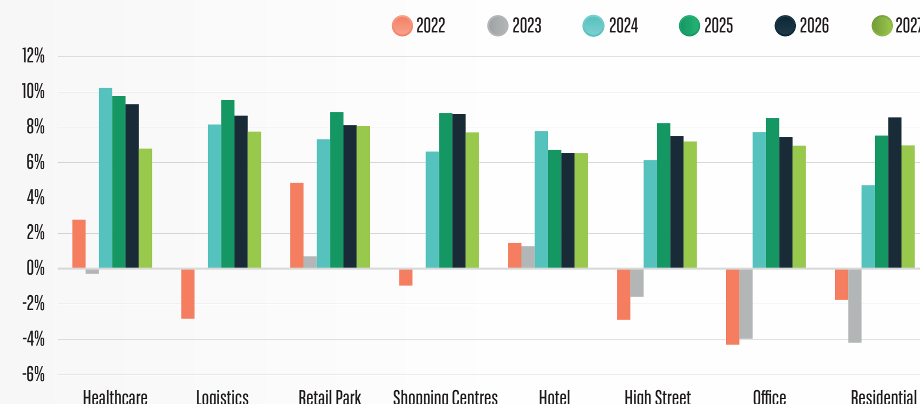
Real estate fundamentals remain positive over the long-run.

Uncertainties around the office market since the COVID-19 pandemic are more prevalent than ever. The pronounced slowdown in the US is now spreading in Europe as investors assess the future of offices in companies' strategy. Moreover, the increasing pressure around building obsolescence and their more rapid depreciation could squeeze office values. The latest official statistics suggest that doubts about the future of offices in Europe are unfounded, as teleworking has not been widely adopted. Central locations also appear to be more resilient in the long-term as most tenant demand is now concentrated in these business districts. Rental growth is expected to exceed 2% per year for these submarkets, supporting a sufficient level of returns for Core investors.

The retail sector is still assessing the impact of e-commerce and future consumer habits. Even though high street units and shopping centers have already been repriced, value creation prospects remain uncertain. Indeed, vacancy for these assets is still high and most of them need to review their positioning. The surge of prices and its impact on disposable income should also slow the pace of retail sales in the coming quarters. On the other hand, some retailers are still in robust health and high profile locations remain popular. The strong tourism rebound should also support consumption and the high street sector in Prime locations.

Finally, sectors such as healthcare and residential are also experiencing price and yield adjustments, mainly driven by the macroeconomic challenges. We are also seeing pressure on valuations from national regulations and operator risks. A growing number of healthcare companies face credit rating downgrades and potential defaults, increasing the risk for these properties. However, healthcare and residential still benefit from long-term macro trends that are immune to the current economic slowdown, such as the ageing population, urbanisation and smaller family units. As such, healthcare should continue to be our top performer over the next 5 years. Residential should have the lowest returns in the next 5 years, mostly due to a longer readjustment of yields and low capital growth expectations. However, on a risk-adjusted basis, residential is our second-best performing sector after healthcare.

Exhibit 4. A STRONG REBOUND AFTER THE REPRICING PHASE
European prime total returns by property type (% y/y)



Sources: BNP Paribas REIM (forecasts as at May 2023)

Different points in the cycle tend to reward different styles

In order to create value during this readjustment phase, we are particularly interested in understanding which market and sectors we should concentrate on, to optimise the risk/return. Style investing allows investors to choose the markets and sectors that are most likely to match their aspirations in terms of return and risk, but each factor needs to be considered carefully:

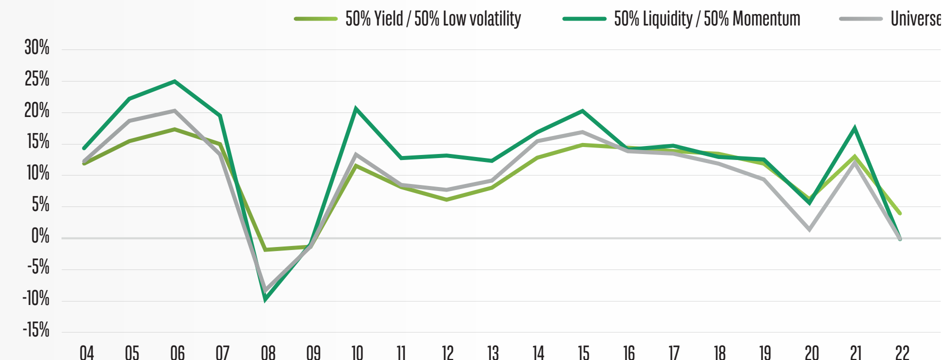
- **Momentum:** markets featuring strong supply/demand fundamentals tend to show relatively stronger rental growth and higher yield resilience in the medium run;
- **Yield:** higher yield markets might support performance in late-cycle markets;
- **Liquidity:** larger, deeper and liquid markets make the process of disposal quicker and less costly and tend to do well in up-cycles;
- **Low volatility:** relatively stable markets are more likely to deliver higher risk-adjusted returns, especially in less favourable phases of the cycle;
- **Quality:** sustainable, efficient and productive markets have better chances of outperforming in the long run;
- **Value:** under-rented, fast-growing markets tend to do well in the short-to-medium run. These markets are particularly suited for value-added strategies.

Depending on the phase of the cycle, investors should shift their strategy towards factors that will maximise their returns. **Exhibit 5** shows that during phases of market correction (2008 and 2022), a portfolio based on yield and low volatility outperformed the investment universe. Assets with low volatility (such as offices in Paris CBD, logistics in Belgium or Healthcare in the United Kingdom) or assets with high yields (such as offices in UK regional markets, logistics in the CEE, or Retail Parks) should be targeted. On the other hand, during the recovery and expansion phase, investors might want to shift their portfolios towards liquidity and momentum to maximise their returns. As such, markets such as offices in Central Paris or London, or logistics in Germany are highly liquid. To capture momentum, investors might want to focus on markets with the ability to capture performance trends, such as offices in Berlin, logistics in France or retail in Southern Europe.

Looking at a balanced portfolio that seeks low volatility, momentum and high liquidity, the current uncertainties are suggesting some adjustment compared to the market portfolio. As **Exhibit 6** shows, we are currently overweighting sectors and markets with higher yields (Logistics in Belgium or in the CEE) and higher momentum potential (residential in the UK or Logistics in France) to benefit from the recovery phase.

Risk/return optimisation is key in this market environment.

Exhibit 5. YIELD AND LOW VOLATITILY ARE OFFERING HIGHER RETURNS
Total return for different investment styles (% y/y)



Source: BNP Paribas REIM

Exhibit 6. PROPOSED OVER (↑↑) AND UNDERWEIGHTING (↓↓) ACROSS MACRO REGIONS*, BASED ON OUR FACTOR MODELING AND A BALANCED PORTFOLIO**

	OFFICE	LOGISTICS	RETAIL	RESIDENTIAL	ALTERNATIVES
Germany /Austria	↔	↔	↓	↔	↔
Benelux	↔	↑	↔	↔	↔
Nordics	↔	↔	↓	↑	↔
France	↔	↑	↔	↔	↑
CEE countries	↔	↑	↓	↔	↔
Iberia	↔	↔	↔	↑	↔
Italy	↓	↔	↔	↔	↑
UK/ Ireland	↔	↑	↔	↑	↔

Source: BNP Paribas REIM

*The original results are disaggregated at country level. The macro regions are as follows: Benelux: Belgium, the Netherlands, Luxembourg. Nordics: Denmark, Finland, Norway, Sweden. CEE countries: the Czech Republic, Hungary, Poland. Iberia: Spain, Portugal.
**Our balanced portfolio consists of the following factors: 15% Momentum, 10% Yield, 30% Liquidity, 15% Low vol, 30% Quality and 0% Value

SUSTAINABILITY

A CONSTELLATION OF RISKS AND OPPORTUNITIES

As the compounding effects of an accelerating climate emergency, ecological breakdown and social inequality become ever more apparent, the urgency of transitioning to a sustainable future has never been clearer, and real estate is at the core of this transformative shift.

BY MUNISH DATTA

Real estate absolutely underpins human society. It provides us with habitation, a place to gather, rest, learn, play, heal and work – in fact we spend most of our lives in buildings. However, for a sector that covers 1%[1] of the world's land, it has a hugely disproportional environmental footprint: 40% of global carbon emissions, 50% of all extracted materials, 33% water consumption and 35% of generated waste.[2] As our planet's finite resources become scarcer, user demand changes rapidly, in a challenging macroeconomic context with increasing regulatory demands, the economics of building and operating real estate are under pressure. To turn these risks into opportunities, real estate needs to focus on six urgent priorities:

1. **Energy Efficiency and Zero Carbon Emissions:**
   The International Energy Agency roadmap to Net Zero Emissions by 2050,[3] highlights the important role of buildings in terms of reducing energy consumption and carbon emissions. Incorporating energy-efficient heating, cooling, lighting systems, utilising renewable energy sources, and implementing smart technologies leads to substantial operational and long-term cost benefits. To have any chance of achieving the roadmap, 20% of existing buildings and all new buildings must be zero carbon ready by 2030. This means that we need to be retrofitting 2.5% of our existing buildings per annum and the financial return for energy efficiency has never been better.[4]

2. **Enhanced Resilience and Risk Management:**
   A recent survey of 1,000 built assets across Europe and the US[5] assessed their physical climate risk against a 'Business as usual', unabated emissions, climate scenario. As indicated in **Exhibit 7,** without mitigation, by 2025, most of these assets could face social and financial 'value at risk' because of heat stress, precipitation, and wind. By integrating resilient design principles, such as flood-resistant structures and green roofs for stormwater management, buildings can better withstand and recover from increasingly regular extreme weather events. This proactive approach to risk management enhances the long-term viability and attractiveness of real estate assets.

Exhibit 7. MOST ASSETS FACE SOCIAL AND FINANCIAL VALUE AT RISK

A global asset matrix by risk category and timeframe

Risk Category Distribution	Overall Cervest Rating by risk category and % of assets exposed to risk under a BAU climate emissions scenario		
	2025	2050	2100
Heat Stress	C 71% of assets	D 92% of assets	E 100% of assets
Precipitation Risk	B 46% of assets	C 60% of assets	D 86% of assets
Wind Risk	C 68% of assets	C 68% of assets	C 68% of assets

Source: Cervest (data as at April 2023)

Exhibit 8. GLOBAL CONSTRUCTION COSTS CONTINUE TO RISE

The S&P Global PEG Engineering and Construction Cost Index

	May 2023	April 2023	Difference	Direction	Rate of Change
Current Pricing					
Headline Cost Indicator	**54.4**	**65.2**	**-10.8**	↑	**Slower**
Materials & Equipment	52.7	63.7	-11.0	↑	Slower
Subcontractor Labour	58.3	68.6	-10.3	↑	Slower
Expected Pricing in Six Months					
Headline Cost Indicator	**73.2**	**72.8**	**+0.4**	↑	**Faster**
Materials & Equipment	67.6	72.9	-5.3	↑	Slower
Subcontractor Labour	86.5	72.5	+14.0	↑	Faster

Source: S&P (data as at May 2023)

To have any chance of achieving the roadmap, 20% of existing buildings and all new buildings must be zero carbon ready by 2030.

3. **Resource optimisation:**
   Escalating resource scarcity, energy constraints, and material shortages have put inflationary pressures on global construction costs.[6] In 2022, globally we consumed 100 billion tonnes of materials[7] and the real estate and infrastructure sectors used about half of these and wasted up to 60%. This inefficient use of resources not only contributes to environmental degradation but also influences the cost viability of real estate projects. Making the most of what already exists and prioritising circular economy principles are helping to reduce costs and enhance the overall financial viability of real estate development. Furthermore, the choice and efficient use of building materials used in construction and operation is an important consideration to reach whole life net zero carbon emissions.

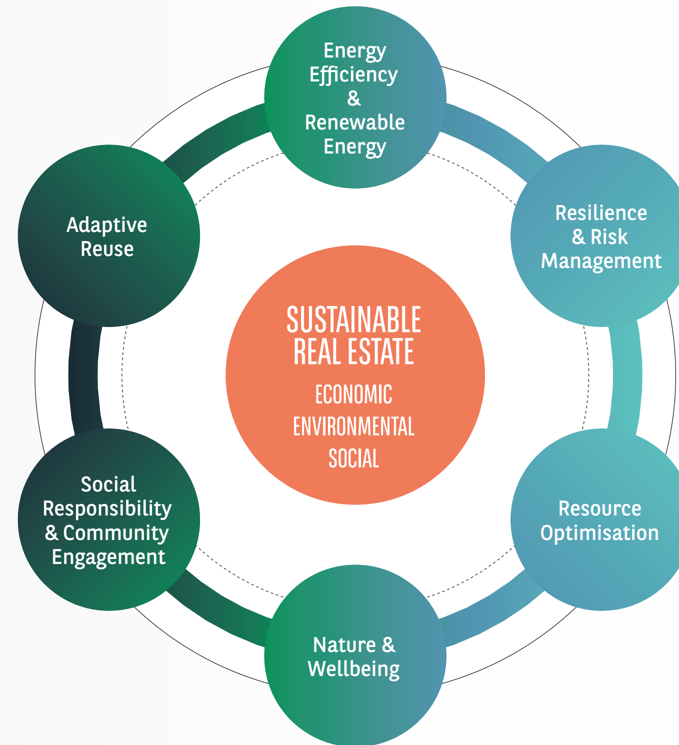
[1] https://ourworldindata.org/land-use#how-the-world-s-land-is-used-total-area-sizes-by-type-of-use-cover
[2] https://worldgbc.org/what-is-a-sustainable-built-environment/
[3] https://www.iea.org/reports/world-energy-outlook-2022/an-updated-roadmap-to-net-zero-emissions-by-2050#abstract
[4] https://www.iea.org/reports/energy-efficiency-2022/executive-summary
[5] https://cervest.earth/news/physical-climate-risk-earth-day
[6] https://www.spglobal.com/marketintelligence/en/mi/info/pp/ihs-peg-ecci.html
[7] https://www.circularity-gap.world/2023#download

4. **Nature and Wellbeing:**
The incorporation of nature into real estate projects provides numerous benefits to planet and people. Integrating green spaces, rooftop gardens, and urban forests into developments not only enhances aesthetics but also improves air quality, reduces the urban heat island effect, contributes to the health and well-being of occupants, and supports biodiversity. Studies[8] have shown that properties with access to nature command higher rental and sale prices, attract premium tenants, and experience increased occupant satisfaction. Nature-based solutions can provide up to 30% of the necessary emissions reductions,[9] making them a key part of achieving net zero carbon.

5. **Social Responsibility and Community Engagement:**
Shelter is a basic human need, yet the biggest problem for millions of people around the world is that housing is not affordable with income spent on rent going up. By incorporating affordable housing initiatives, mixed-income developments, and community spaces, sustainable buildings create inclusive environments that accommodate diverse populations. Furthermore, sustainable design principles prioritise accessibility, ensuring buildings are suitable for people of all abilities and ages. By offering affordable and equitable housing options, sustainable buildings contribute to mitigating housing crises, improving living conditions, and fostering social cohesion within communities.

6. **Adaptive reuse:**
For many real estate markets, the last three years have seen the biggest shift in the way we use buildings; homes as offices, offices as homes. And in the last six months, a rapid adoption of generative artificial intelligence, advanced robotics, and the metaverse are strong signals that the only constant is change.

Exhibit 9. **SUSTAINABLE PRACTICES ARE CONNECTED**
Economic, environmental and social factors for sustainable real estate



Source: BNP Paribas REIM

Though there are many social and governance considerations about the adoption of these technologies, they pose serious questions about the purpose and design of real estate. Assets that can easily adapt to these changes, thereby prolonging their lifecycle, should remain relevant and more valuable in changing market.

We are amid a reshaping of the real estate landscape: climate risk, resource scarcity, nature, wellbeing, social value and changing user needs are critical priorities for real estate investors. There is strong evidence that the market is responding. Analysis of prices paid by investors for offices in London and Paris in Q3 2022, shows a widening premium of up to 35% for buildings that have sustainability ratings versus those that do not.[10] Buyers in the UK are ready to pay a 9.4% premium on homes that sellers have retrofitted to be energy efficient.[11] More than a green premium, the threat of a "brown discount" or devaluation of built assets (or even of outright stranding) is far greater. By 2030, $21trillion worth of global real estate assets could experience major write-downs in value given climate risks and the economic transition.[12] Conversely, decarbonising the built environment is already a market worth up to $1.9 trillion[13] in new annual value, especially in resilient materials and systems, and in retrofitting existing assets.

Like all constellations, risks and opportunities cannot be considered in isolation, they are deeply connected. By incorporating sustainable practices into real estate projects, investors can unlock long-term financial benefits while simultaneously addressing the environmental challenges of mitigation and adaptation, solving social issues of improving occupant well-being and equity and future proofing assets for changing market demand and regulatory compliance.

[8] https://www.ons.gov.uk/economy/environmentalaccounts/articles/urbangreenspacesraisenearbyhousepricesbyanaverageof2500/2019-10-14
[9] https://knowledge.uli.org/en/reports/research-reports/2022/nature-positive-net-zero-the-ecology-of-real-estate
[10] https://www.msci.com/www/quick-take/london-and-paris-offices-green/03510893060?utm_source=Linkedin&utm_medium=social&utm_term=Real+estate&utm_content=100003547206449
[11] https://www.santander.co.uk/about-santander/media-centre/press-releases/a-green-premium-house-buyers-willing-to-pay-almost-10
[12] https://worldgbc.org/wp-content/uploads/2022/08/WorldGBC-Beyond-the-Business-Case.pdf
[13] https://www.mckinsey.com/capabilities/operations/our-insights/accelerating-green-growth-in-the-built-environment#:~:text=Decarbonizing%20the%20built%20environment%20can,for%20players%20in%20the%20ecosystem.

INVESTMENT THEMES & STRATEGIES

As investors pause and real estate prices continue to adjust, our thoughts turn to what the next opportunities might be and what actions investors could take in 2023 to benefit from their long-term views on the market.

BY GREG MANSELL

Low growth, high volatility

Strategic Take-Aways:

- A clear view on fair value is more important than predicting the next turning point
- A start-stop pattern to capital markets creates shorter buying windows
- Investment should concentrate on the more liquid markets

Russia's invasion of Ukraine ended any hope of strong post-pandemic economic growth and, instead, we find ourselves in a period of stagflation. That said, the European economy has been resilient. However, while most of the region should avoid recession in 2023, it is also likely to experience low growth thereafter. So we face the prospect of no rebound once stagflation ends and lose the chance to catch up on the economic boom we had hoped for as the pandemic eased.

The European economy has been resilient.

Ultimately, financing conditions should drive the recovery. However, an irony of Europe's refusal to lapse into recession is that the timing and height of peak central bank interest rates is still unclear. Further rises in interest rates could have consequences for real estate markets. There is a risk that large-scale refinancing and fund redemptions could cause the repricing phase for real estate to be sharper and last longer.

European real estate still needs to price in short-term risks. And once repricing is complete, what then? There is likely to be another event, in fact many events, over the next 10 years. The trigger could relate to climate, energy, trade, war, or finance. We should adapt to the possibility that central banks and governments will be very hands-on in their responses – bank rates could rise and fall quickly.

Redefine the core investment universe to avoid the stranded assets and submarkets.

The problem that investors face is not how to predict exactly when values will rise again, but in determining assets' long-term fair value given the market is likely to remain highly cyclical.

One outcome of continued volatility could be that buyer and seller price expectations diverge often and align only for short periods in each cycle. Just because a buyer has a fair price in mind for an asset, does not necessarily mean the seller is willing to accept that price.

Another consideration is that investors cannot take market liquidity for granted. The current dislocation in capital markets meant that the number of deals completed last quarter (653 deals, Q1 2023) was a third of the recent peak (1960 deals, Q4 2021). Moreover, if financing conditions continue to fluctuate, investors may have to accept real estate investment volumes could whipsaw from extreme highs to extreme lows.

European real estate still needs to price in short-term risks.

A narrow, competitive core market

Strategic Take-Aways:

- Consider which assets could become stranded due to a wide range of risks
- Core investors should not overlook assets that need only light improvements
- Be patient for now, but prepare to move quickly when competition among buyers returns

For some time it has been clear that some assets suffer in downturns but even a buoyant market cannot lift their values. Instead, their yields drift higher. The weakest shopping centres in the UK, for example, now have yields over 18%, over 12 percentage points higher than the strongest centres.

Financing conditions should drive the recovery.

Every country and property type could see some assets suffer the same fate. Different risks, particularly in combination, could cause assets to fall out of favour with institutional investors and effectively leave them stranded when the rest of the market recovers.

Investors may need to redefine the core investment universe to avoid the stranded assets and submarkets. Climate change is at the forefront of investors' minds as a cause of obsolescence, but locational, functional and economic obsolescence are still material considerations.

What level of credit risk is unacceptable? Which locations are too illiquid? How much capital expenditure on an old building is too much? The answer to each question sets a boundary for what is in scope for a core investor.

Assets that fall either side of this boundary could be more prone to mispricing. An asset that CRREM (Carbon Risk Real Estate Monitor) considers "stranded" might be overlooked by investors but only need a little capital expenditure to get back in line with energy efficiency targets. New lettings could reduce income risk. Refurbishment could avert functional or economic obsolescence, and so on.

> Waiting for prime returns to add up.

Investors naturally become more risk averse in market downturns. However, in this downturn the sharp rise in debt costs leaves many investors waiting for prime returns to add up. We forecast total returns for prime office markets, for example, to average -4% in 2023, but returns in 2024-2027 should average 7.7% y/y. As each quarter of poor performance passes, investors with a long-term strategy should become increasingly positive about the outlook for prime offices.

Such investors would need to move quickly in a market that suddenly appears good value but still lacks any depth in transactions. The wait for prime returns to add up could be short, but this part of the market could quickly become very competitive among potential buyers.

> Looking for protection from downturns.

Property types for resilience, property types for growth

Strategic Take-Aways:

- Healthcare and residential could reduce portfolio volatility
- Logistics and hospitality represent high risk-return options for investors
- Net operating income growth is a key metric for outperformance in the next cycle

Investors can use different property types to alter the risk-return profile of their portfolio. In the current environment, many are looking for protection from downturns. In this context, adding healthcare or residential could reduce portfolio volatility. It is no coincidence that healthcare and residential markets have been more resilient during the current repricing phase. Investors are often committed to these sectors for the long term. There has also been a sharp increase in demand for rental properties, and demand for healthcare services should continue to grow as our population ages and becomes more prone to acute and chronic disease.

At the other end of the scale, investors focused on the market recovery might prioritise logistics and hospitality. Logistics investment needs careful analysis and quick decisions. Logistics should remain a top performing sector in Europe and stay popular with core investors. Assets and portfolios are likely to go through fast and competitive bidding processes even in the current market conditions.

The main consideration for logistics investment is assessing the rent level the asset could revert to at its next lease event. Many logistics markets have undergone extreme rental growth in recent years. Nevertheless, this leaves a wide range of possible outcomes for the reversionary rent. In most cases, the new rent would be much higher than the passing rent, but a competitive bidding process among potential buyers could push some investors' assumptions ahead of what is realistic.

> Logistics investment needs careful analysis and quick decisions.

A resurgence of discretionary spending should benefit hospitality. Urban upscale and luxury hotels should benefit from the rise in discretionary spending on experiences and the return of non-European inbound tourism as the effects of the pandemic fade. Another area of interest is hospitality focused on health and wellbeing such as yoga, meditation or spa resorts and nature-based tourism, including camping.

Hotels with hybrid leases or full management or franchise agreements also offer exposure to the recovery in RevPAR (revenue per available room). This income stream is higher risk than leased assets but offers income growth that could at least partially hedge inflation, if not exceed it, over the long term.

In general, even prime rents for most office and retail markets would struggle to match inflation over the medium term. Logistics and hospitality stand out thanks to their stronger income growth prospects. Net operating income growth could be a key metric for outperformance in a low growth economy where the impact of yield movement may be less of a value growth driver than it has been in the past.

> A resurgence of discretionary spending should benefit hospitality.

Financing Conditions

by Benoit Lefebvre

Financing conditions will drive the recovery

The beginning of the year was affected by the failure of Silicon Valley Bank (SVB) and the near collapse of Credit Suisse in March. Although fears of a global financial crisis subsided with the rapid intervention of central banks, the flow of debt to the global economy will be impacted. On the other hand, while the US is expected to fall into recession in the second half of 2023, Europe should steer clear as energy prices have dropped and business sentiment seems more resilient. However, the recovery of the European real estate sector is linked to both financing conditions and investors' sentiment (both institutional and private) on the global economy.

The flow of debt should continue to diminish

Current financing conditions are impacted by restrictive monetary policies, but also by fears of bank failures. Indeed, the risk of contagion is prompting lenders to be more cautious, prioritising the need to maintain adequate liquidity and to conserve capital. The weaker economic momentum in Europe and in the US could also increase the risk of corporate defaults as their capacity to service debt diminishes. The trajectory of borrowing costs – and ultimately of funding costs – is also raising some concerns. Compared to 2008, when lenders often extended their borrowing facilities as interest rates were near zero, banks might be less indulgent towards struggling borrowers.

In this context, lenders and borrowers are currently reducing their exposure to new risks and the level of debt is expected to decrease significantly. As such, public and private investment will be constrained in the short-term, affecting global activity. However, compared to previous downturns, the balance sheets of the private sector are in good shape, which suggests a possible rebound once there are prospects of monetary easing from the central banks.

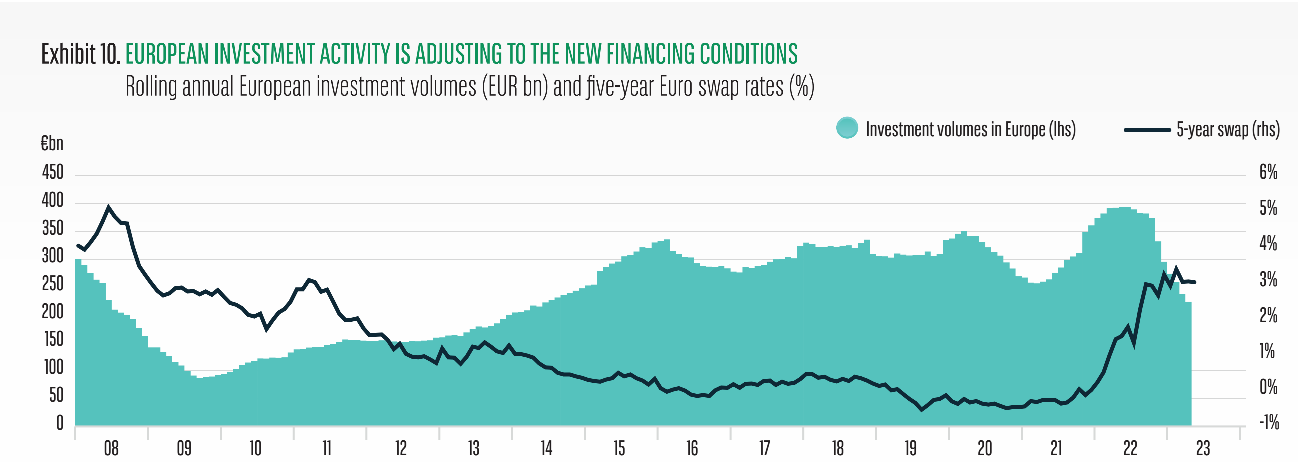
CRE investment activity is plummeting

The reliance of the real estate sector on borrowed funds makes it vulnerable to these changes in financing conditions. The higher cost of capital and the limited availability of debt will weigh on investment activity across Europe in 2023. Total investment in Europe is expected to fall by around a third, before a double-digit resurgence in 2024. The low level of activity will have a significant effect on price discovery and the repricing phase might take longer than expected for some sectors and locations in Europe.[1] Moreover, although real estate values have already fallen due to a global adjustment, we might see further pressure induced by defaults on loan repayments in the coming months. In this period of uncertainty, assets that can attract the best tenants with good credit scores are paramount to guarantee refinancing.

Stranded assets will then be the first to be hit by weaker demand, higher construction and maintenance costs, fewer potential buyers or lenders and higher costs of debt. Indeed, occupiers are now looking to move into better buildings, even if it means downsizing. The new energy efficiency standards will also require heavy investment for the oldest buildings. However, all the headwinds and uncertainty around future occupier interest in secondary locations are making it harder to both find investors with the confidence to repurpose these stranded assets and prevent significant discounts being demanded. Some landlords of obsolete assets may need cash injections to reduce their leverage, which could lead to forced sales.

During this period of high uncertainty, an asset's fundamentals will be key to determine its resilience and its future financial performance. Well-located assets that will be able to attract creditworthy tenants will be less affected by this stress, underpinning our assumption of a two-speed market.

Exhibit 10. EUROPEAN INVESTMENT ACTIVITY IS ADJUSTING TO THE NEW FINANCING CONDITIONS
Rolling annual European investment volumes (EUR bn) and five-year Euro swap rates (%)



Source: BNP Paribas Real Estate, RCA (data as at May 2023)

[1] Valuation in Europe are based on comparative transactions. When market activity is low, valuers are taking longer to reflect pricing changes.

More Repricing
by Greg Mansell

European real estate still needs to price-in short-term risks

Yields are rising quickly to account for higher debt costs. The UK is furthest into this repricing phase, followed by the rest of Europe.

More yield expansion to come

Yields rose in almost every European real estate market in 2022, across all property types. The extent of the rise was remarkable. **Exhibit 11** shows around half of all markets saw prime yields expand by more than 40bps. In fact, some markets saw an even more abrupt shift. London logistics posted the largest jump at 175bps.

However, high interest rates still form a barrier that every real estate market has yet to overcome, and yields are likely to continue widening until investors can see value. For most markets, yields should peak in 2023. For others, particularly residential markets, yield rises might stretch into 2024.

Although rising interest rates are a macro – almost global – driver of higher yields in all asset classes, European real estate markets are starting to show some dislocation from one country to the next.

The UK is further through in its repricing phase than other European countries. Most of its office and logistics markets repriced by 100bps or more in 2022 and we forecast them to need only 25bps-50bps more in 2023, most of which has already happened. This more urgent reset in values occurred around the time of the UK's political turmoil in October and November 2022, triggered by loose fiscal policies that have since reversed.

Yields in Germany also had to rise sharply at the end of 2022, but this was because they were very low in comparison to other markets and relevant debt costs. France and the other main Eurozone markets were a little slower to reprice, although the pace of yield expansion picked up at the start of 2023, a pace that should remain for the rest of the year.

An uncertain outlook

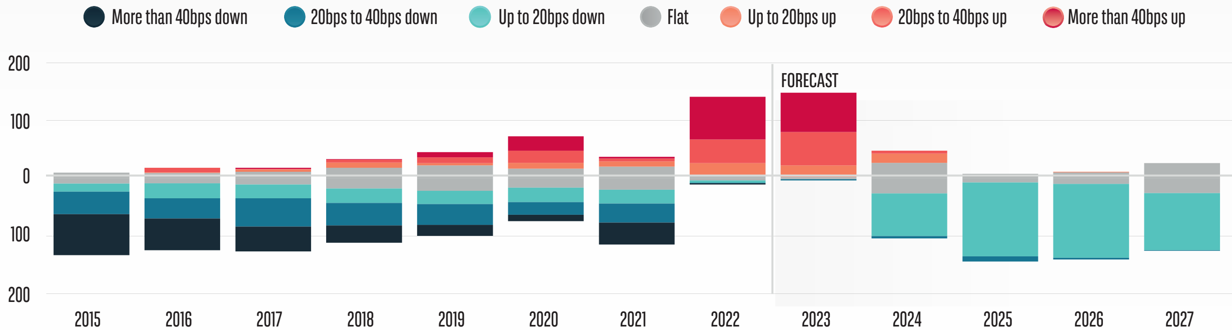
To give a guide for the extent of repricing to date, UK value loss occurred over a nine-month period, starting last summer, and totalled around 30% for logistics and 15% for other commercial property types. Average values were steady in March and April 2023 in the UK; in fact they increased slightly for most property types, giving some hope that the initial phase of repricing is close to complete.

For the rest of Europe, while we expect 2023 largely to be a repeat of 2022, yields should stabilise and fall thereafter. The decline in yields in our forecasts should be milder than the strong falls seen in the years before the pandemic began. Yields in all markets should be settling at higher levels than seen in the ultra-low and negative interest rate environment of the previous cycle.

There are risks to this base case. First, the timing and height of peak central bank interest rates is still unclear. Second, there is a risk of large-scale refinancing and fund redemptions (including retail funds) that could cause the repricing phase for prime assets to be sharper and extend to a second phase, or at least act as a drag on the recovery.

For now, therefore, our outlook remains conservative. However, the average spread between prime real estate yields and government bonds would be 300bps in the UK, 240bps in France, and 210bps in Germany by the end of 2027 in our base case. There could be an upside scenario where there is room for further compression of that spread if the risks we are concerned about today do not materialise by then.

Exhibit 11. WIDESPREAD PRICE ADJUSTMENTS CONTINUE IN 2023
Count of European markets, grouped by annual change in prime yield, includes all countries and property types



Source: BNP Paribas REIM (forecasts as at May 2023)

Stranded Assets

by Greg Mansell

Redefining core investment to avoid the stranded assets and submarkets.

Some assets are likely to see their pricing drift out for many years across all property types. Small, but significant, parts of the market may become stranded and never be core again.

Weakness at the core

Core investors hold stable, income-producing assets over the long term, which include most of the building stock, not just the best-in-class. Not all of that stock, however, is suitable for institutional, professionally managed real estate funds.

Despite European fund income returns falling to a cyclical low in recent years, below 4% y/y in 2022,[1] it has become more common to see some assets with far higher yields, indicative of their higher risks. Moreover, it has been concerning to see parts of the real estate market experience a structural shift toward higher yields, to the extent that they no longer fit the profile for core investment.

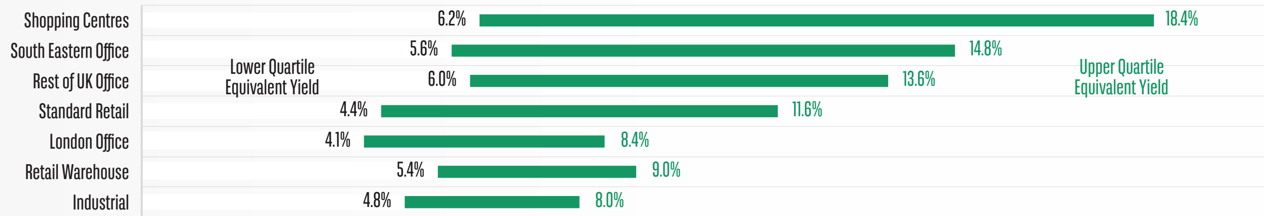
The MSCI UK Quarterly Property Index is one of the few indices in Europe that shows the full range of yields that core investors' assets are valued at (equivalent yields).

Exhibit 12 shows the latest interquartile range of yields for each segment of the UK market taken from a sample of £142bn of assets under management in Q1 2023.

The lower quartile of assets in each segment had average yields of between 4.1% for London offices and 6.2% for shopping centres – i.e., a similar set of yields across a diverse range of locations and property types.

In contrast, the upper quartile of assets in each segment had vastly different yields. The weakest shopping centres had yields of over

Exhibit 12. A WIDENING RANGE OF YIELDS Interquartile range of equivalent yields for each segment of the uk real estate market, Q1 2023



Source: MSCI UK Quarterly Property Index (data as at Q1 2023)

18% and an interquartile range of over 12 percentage points. Back in 2006, UK shopping centre yields were 5.2% for the lower quartile and 7.2% for the upper quartile – a range of just 200bps. Since then, the weakest shopping centres have seen their yields drift out more with each market downturn in a seemingly structural and permanent shift. The same has been true more recently of regional office markets.

The risk of stranded assets

UK shopping centres are a perfect example of how a large part of a segment institutional investors once considered core has no prospect of returning to that status. However, the reasons for the increase in yield ranges are varied and not unique to that segment.

CRREM (Carbon Risk Real Estate Monitor) introduced the idea that a market could have stranded assets, which it defined as the risk of early obsolescence due to climate change because the asset would not meet future regulatory efficiency standards or market expectations. Core investors should take on this mentality, but also apply it to a wider range of risks. In addition to environmental considerations, the core investment universe could shrink for other reasons:

- **Income:** Occupiers that no longer have a suitable credit rating
- **Location:** Submarkets with insufficient liquidity
- **Function:** Buildings prone to obsolescence due to their design and format
- **Economic:** Buildings that face excessive capital expenditure for improvements

All countries and property types are more or less susceptible to these risks. Core investors need to be more discerning about whether an asset or, at a higher level, a market is suitable for their risk-return appetite.

Fixed income investors, for example, divide their market into investment grade assets and non-investment (or speculative) grade. Real estate investors may need to divide their investment universe into what they consider core and non-core.

Framing a discussion about investment strategy around environmental, income, functional and economic risks could be an essential exercise to help avoid the stranded assets and submarkets of the future.

[1] MSCI European Annual Property Index, all property, 2022, income return 3.5% y/y

Waiting for Prime

By Olivier Denagiscarde

Waiting for prime office returns to add up

The occupier fundamentals of European office markets are much stronger than those of US office markets. Buyers are waiting for debt costs and equity yields to return to feasible spreads. Pricing should stabilise in the next six to twelve months.

A wait-and-see attitude

Office prices have been quick to react to the rise in interest rates. Yields increased on average by around 70bps between Q1 2022 and Q1 2023, with some markets exceeding 100bps, including Amsterdam, Berlin, Milan and Madrid. At the same time, investment in offices plummeted by 41% compared to the previous year, more than other asset types. The market is experiencing a marked flight-to-quality, as the very small fraction of the stock currently being transacted is essentially made up of prime offices.

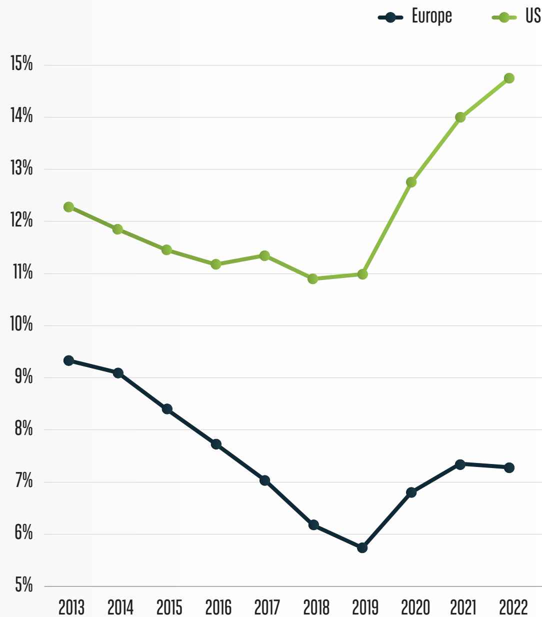
Office price adjustments should be limited by the end of the year, as long as investment remains lacklustre. This scenario is likely, as many investors and sellers prefer to wait and see in response to short-term financial constraints and further monetary tightening in the Euro Area in 2023.

Resilient and concentrated rental demand

Investors often use the US office market as an early indicator for other countries. However, the European office market is structurally less cyclical and has a relatively lower remote working propensity, as well as less exposure to the tech and banking sectors than the US.

The office occupier markets in Europe have proved resilient over the past two years despite economic turbulence. The aggregate vacancy rate stood at 7.4% in March 2023, following a relatively modest increase (190bps) since the pre-pandemic historical low. Furthermore, office availability is generally below 4.5% of the stock in the CBDs of the major European cities, especially in Berlin, Milan and Paris, which are all below 2.5%. Meanwhile, the vacancy rate in the top 15 US cities grew from 11% in Q4 2019 to 15% in Q4 2022 (with cities such as San Francisco or Atlanta topping 18%).

Exhibit 13. EUROPEAN OCCUPIER MARKET SHOWING RESILIENCE
Aggregate office vacancy as share of office stock



Source: BNP Paribas Real Estate, Transwestern

Timing the rebound

Most office markets are clearly experiencing a two-speed dynamic and recent developments have helped boost the premium for prime assets. The widening gap between prime and average rents reflects the preference for new, centrally located offices with good ESG credentials that offer an attractive working environment. Credit risk is another important consideration. Core investors might also focus on companies with critical mass and belonging to sectors that are relatively insensitive to business cycles (e.g. pharmaceuticals, telecommunications) or with promising long-term growth prospects (e.g. IT services).

Despite keen interest from occupiers, the expected returns for prime offices are still low in comparison to other property types (5.3% y/y on average from 2023 to 2027). However, the short-term distress in capital markets has heavily impacted these returns. Prime office returns should improve markedly after 2024, as pricing stabilises. This rebound could be postponed if investment activity fails to pick up, and yields continue to rise. However, total returns for 2024 should stay in positive territory so long as yields do not expand by more than 35bps compared to the end of 2023.

Given the heightened demand for prime assets, we also believe that great opportunities may arise from the refurbishment and modernisation of prestigious but ageing properties located in attractive areas. We believe that adapting spaces to new uses, by offering more services in larger shared areas, and enhancing energy performance by improving insulation and optimising consumption management, constitute key levers to create value.

Downturn Protection

by Clément Rabenandrasana

Looking for protection from future downturns.

In this gloomy environment, the residential and healthcare real estate sectors still have a resilient outlook. Indeed, these two property types are well equipped to face the headwinds raised by the ongoing momentum of the financial markets. Furthermore, as these investments tend to be long term, they are better able to weather real estate market cycles.

Income growth should attract investors

The low volatility of returns during previous downturns has increased investor interest in residential and healthcare assets. In today's environment, the structural fundamentals (such as the lack of supply, demographic growth and the shift in family structures towards smaller households) should continue to support income growth.

The upward trajectory of interest rates will fuel the need for buy-to-let properties. The number of transactions and prices of residential assets have started to decline in some locations and institutional investors should benefit from the loss of purchasing power by many European households. As such, we have seen a sharp increase in demand for rental properties as the numbers of rental dwellings listed on web platforms has shrunk dramatically. Rental values have jumped by an average of 8% across Europe over the past year.

In the healthcare sector, we still expect a significant increase in the need for healthcare services, and notably for care homes. Indeed, in addition to the impact of an ageing population, the rising prevalence of new types of pathologies (mental disorders, diseases of the nervous system, etc.) and chronic diseases (such as diabetes or hypertension) is affecting a growing share of the population.

Rental growth expectations for healthcare and residential assets should be around 3% per year between 2023 and 2027, higher than for any other property type. Therefore, the income component should continue to support and drive returns in the coming years.

On the other hand, national regulations and operator risk might play major roles in the future. Rental regulations for the residential market, introduced by governments to protect household purchasing power, may dampen the expected rental growth. Moreover, a growing number of healthcare companies have faced credit rating downgrades and potential defaults. The high levels of debt would limit the ability for operators to adapt to the changing macroeconomic environment, as well as to new legislation. This could also have a negative impact on income growth, and the choice of operator will be a key consideration. Targeting the most stable healthcare operators is the best way to maximise potential gains while reducing risks.

Reducing risk in a volatile market

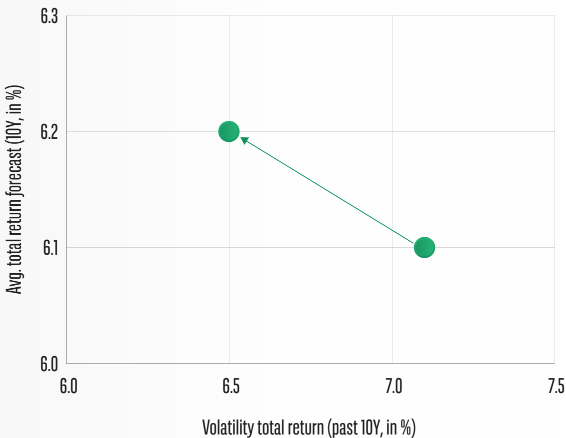
The general decline of interest rates and the defensive and resilient nature of residential and healthcare assets have attracted investors during the past decade. Indeed, in addition to having the best risk/return over the long term, the resilience of the sectors during economic crises offers interesting diversification opportunities. The financial occupancy rate of these properties has also contributed to their attractiveness.

The low correlation of residential and healthcare with the most traditional property types (offices, logistics and retail) is another argument for including residential in a balanced portfolio. The greater resilience of these sectors in economic downturns explains this low correlation. According to our forecasts, including a 15% mix of residential and healthcare in a real estate portfolio could reduce risk without altering the performance.

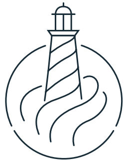
Healthcare and residential markets have been more resilient during the current repricing phase.

Exhibit 14. ADDING RESIDENTIAL AND HEALTHCARE COULD REDUCE PORTFOLIO VOLATILITY

European real estate portfolio, weighted by average investment volumes, 15% weighting to residential and healthcare



Source: BNP Paribas REIM (forecasts as at May 2023)



Logistics Competition

by Lucas Böller

Logistics investment needs careful analysis and quick decisions. Strong competition among buyers is likely.

Logistics: Former and future top performer

Logistics outperformed other property types by far[1] during the last cycle, despite strong performance across all asset classes. This remarkable trend came to an abrupt end in 2022, as capital market conditions changed. Logistics' low yields had to adjust faster than for other property types at the end of last year, as higher debt costs started to bite. Throughout Europe, based on recent market data, logistics prime yields have already risen by 85 basis points on average. We expect a further yield adjustment this year.

Although rising financing costs are distorting capital markets, the occupier market continues to enjoy strong fundamentals and has a good outlook. Logistics properties should have a significantly higher initial yield by the end of 2023 compared to 2021 coupled with a solid rental growth outlook. This implies total returns of about 7.0% y/y between 2023 and 2027. From this standpoint, it is one of the best investment picks.

Structural changes boost occupier demand

The increase in e-commerce sales and the restructuring of supply chains have led to the need to expand infrastructure (especially in urban areas) and rethink city layouts. Since the supply chain[2] disruption caused by the pandemic and Russia's invasion of Ukraine, there has been a shift in mindset from "just in time" to "just in case" and companies have therefore increased their inventories as a precaution.[3] The energy transition and climate change, both generators of volatility, are also causing a build-up of capacity in key industries, and in the supplier network, creating a need for more storage space in the short to medium term.

Currently, the supply of space is not keeping pace with demand. This has led to extraordinary rent increases in European markets in recent years. Even after record construction activity over the past two years, occupiers have absorbed space rapidly, which continues to indicate pent-up demand. The shortage of space, especially in urban areas, and competition from occupiers from a wider range of industries has increasingly shifted construction (and the resulting take-up of this new space) to peripheral areas.

The logistics market is unlikely to maintain the double-digit rental growth seen in recent years. For 2023, we expect rental growth of 3.9% y/y and long-term rental growth of over 2% y/y as a European average and, therefore, comfortably above the long-term trend GDP growth rate.

Careful analysis and quick decisions

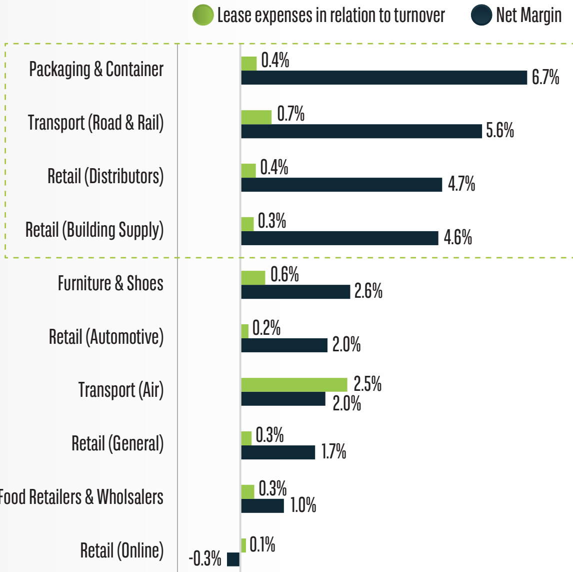
Buyers will compete fiercely for sustainable real estate that meets social requirements, at established intermodal transport hubs or urban locations with creditworthy, established logistics tenants. There will be few assets of this kind, so swift decision-making is crucial.

Governments may also want to divert freight traffic, which is predominantly by road, to the railways. Intermodal transport hubs could benefit most from this shift in transportation.

The changing tenant landscape now also includes start-ups, which need to be analysed more closely by landlords, especially in the current challenging financing environment.

The sustainability of current rent levels in a given location must also be carefully considered. Not all properties and tenants are able to keep up with prime rent trends. Property purchases with a solvent tenant at prime rent levels do not protect against downside risks in new or re-letting situations.Established occupiers and new entrants find themselves in different positions in this weak economic environment. Profit margins and therefore rent burdens differ significantly depending on the segment considered. **Exhibit 15** shows that purely transport sectors (with the exception of air transport) and building supplies retailers have relatively high profit margins and low rental burden in relation to turnover. Depending on the cost structure, one can calculate their ability to afford higher market rents.

Exhibit 15. HIGH DISPERSION IN PROFIT MARGIN AND RENT BURDEN
(Western Europe – averages per sector, 2022)



Source: Data collection by Aswath Damodaran, New York University, Stern School of Business, based on Bloomberg, Morningstar, Capital IQ and Compustat[4]

[1] MSCI Database, MSCI Europe Annual Property Index (Unfrozen; Weighting: Market Size) as of 09.05.2023
[2] (and partly relocation of production facilities)
[3] Eurostat Database, online code: NAMA_10_GDP__custom_5749404, Changes in inventories
[4] https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datahistory.html#sources

More Hospitality

by Victoria Groene

A resurgence of discretionary spending should benefit hospitality.

Travel is the only discretionary expense people are currently willing to maintain (59%) or even increase (16%) in light of current economic conditions.

The latest data indicates a recovery of 75% of 2019 travel volumes to Europe in 2022. This strong tourism rebound might continue into 2023. In H1 2023, 77% (up 16% y-o-y) of European travellers intend to take a trip but will cut their retail spending, according to the latest survey by the European Travel Commission. Summer travel demand could reach new heights in 2023 – fuelled by long weekends and leisure travel. Long weekend travel has seen an uptick of 30%-35% and leisure travel destinations have seen an uptick of 82%, compared to 2019. People prefer shorter, closer-to-home trips, according to industry experts.[1]

Unique experiences that contrast with everyday life

The hospitality sector is close to a full recovery from the pandemic. Historically low unemployment and a healthy labour market has generally kept consumers on a firm financial footing. The rebound has come with heightened cost awareness, with consumers paying close attention to the price-performance ratio or possible savings.

A few areas within the hospitality industry are doing particularly well. Staycations can save money and reduce a vacation's environmental impact. Camping and nature-based holidays are a great way to get back to nature and enjoy the outdoors and are also more affordable than staying in hotels or motels.

As more people prioritise their health and wellbeing, wellness travel is another area gaining in popularity, such as yoga, meditation or spa retreats that promote relaxation, mindfulness, and self-care. Many consumers still have savings intact from the pandemic. Mid-to-high income households are spending more on experiences. Due to their relatively higher disposable income and therefore resilience to the current economic situation, 74% of Europeans over 25 are keen to travel. This figure falls to 61% for younger people (18-24 years), who are still more reluctant to plan a vacation.

These areas of the hospitality universe offer travel experiences that contrast starkly with everyday life, which is exactly what consumers are looking for.

Consumers with a propensity to spend

However, inflation and the energy crisis have not led to a budget stampede. People set off on their travels despite rising prices, especially favouring higher quality locations. According to the second largest German tour operator Dertour, demand for hotels with higher star categories increased in the winter season. Eighty-two percent of its customers booked a four- or five-star hotel between November 2022 and February 2023. As such, upscale and luxury hotels should perform well.[2] The recovery should gather pace this year, as Asia/Pacific travellers return to the market, after the end of the pandemic lockdown of mainland China in January 2023.

For the real estate sector, this means a focus on leisure hotels from four to five stars that cater for wellbeing/ wellness experiences. Budget and midscale hotels, especially those reliant on business travel, may continue to struggle, as remote conferencing solutions increasingly replace business trips. This is partly due to stricter corporate carbon footprint regulations. To meet their 2030 sustainability goals, a recent survey found out that four in ten European companies and a third of US companies say they need to reduce travel per employee by more than 20%.[3]

Exhibit 16. TOURISM SPENDING FOR EXPERIENCES IS TAKING THE LEAD

Change (%) in inbound tourism spending for experiences vs. things vs same time in 2019

Source: Mastercard Economics Institute (data as at March 2023)

[1] Travel a 'top priority' for Europeans but retail spend to be reined in, says ETC (trbusiness.com)
[2] Leisure travel is back. Business travel is not. – Marketplace
[3] Deloitte's corporate travel study; Corporate travel study 2023 | Deloitte Insights

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The BNP Paribas REIM Research Team draws its conclusion using the local expertise of the 60 people working for BNP Paribas Real Estate Research. The teams are located in our offices in Paris, Munich, Hamburg, London, Brussels, Amsterdam, Milan, Madrid, Dublin, Warsaw and Prague.

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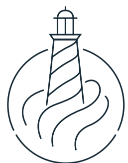

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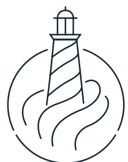

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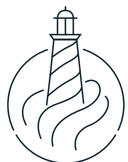

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