Invesco Real Estate

European Strategic Outlook

H2 2024

Alumno - Manchester, UK

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In our view, European real estate valuations have troughed. With GDP recovering and rates reducing the outlook for real estate is positive

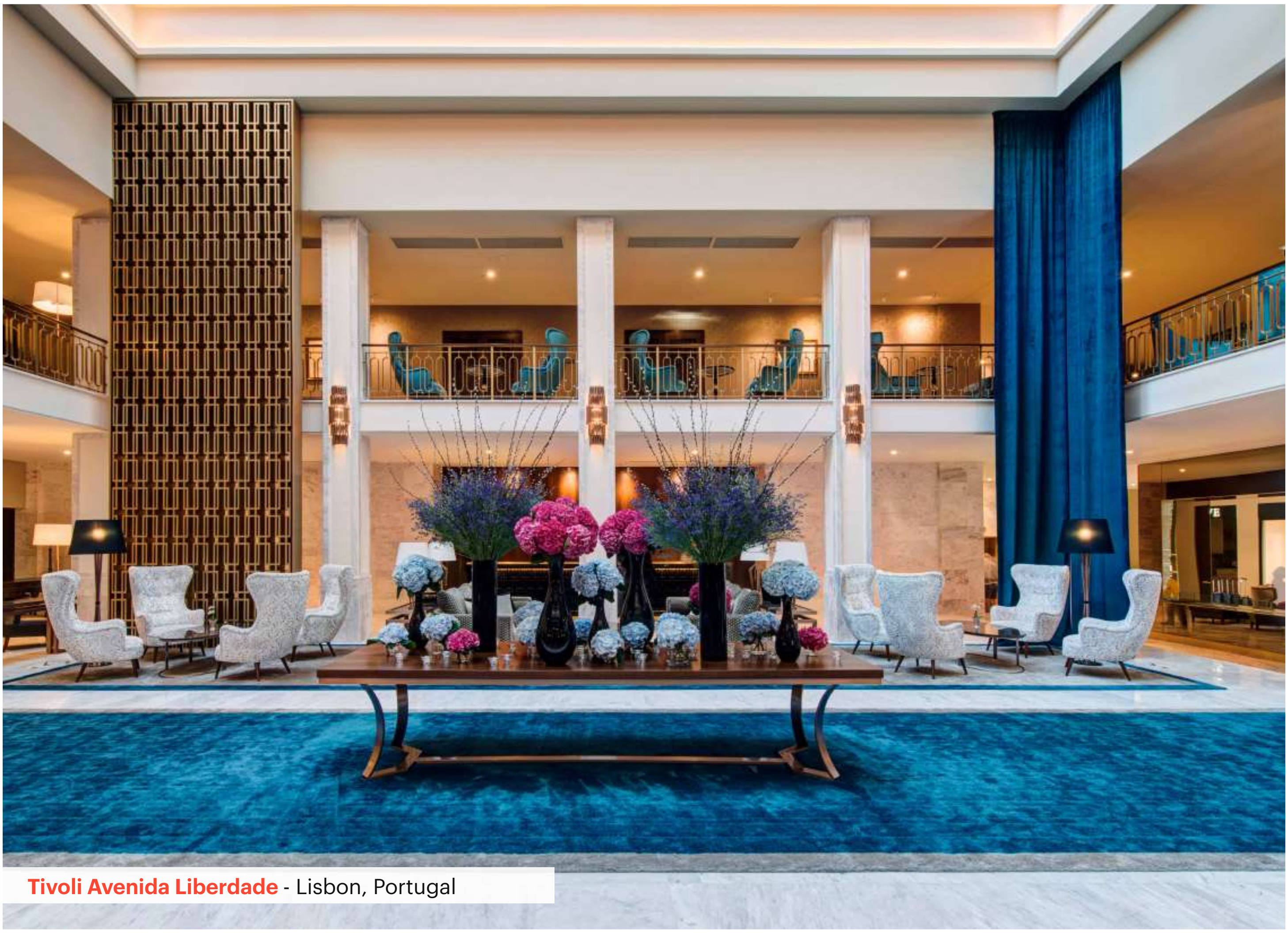
European economic growth is showing clear signs of recovering through H2 2024 and into 2025, and the European Central Bank made its first interest rate cut at the start of June. While market expectations of the number of ECB rate cuts has reduced through 2024, at least one more cut is expected in H2 2024, with further cuts in 2025. From a real estate perspective, what matters most is that the medium-term outlook for rates has remained largely unchanged.

In Europe, real estate capital markets have now adapted to the increased interest rate environment, with real estate yields largely showing as stable through Q2 2024. In addition, real estate fundamentals for most sectors remain robust, with rental pressures driven by ongoing occupier demand meeting limited supply. Our strategic outlook is focused on real estate assets which benefit from robust long-term drivers of demand to support occupancy and drive real rental growth. Our conviction themes target asset-specific opportunities to supply space into constrained occupier markets.

Positive data shows Eurozone GDP is recovering from the broad stagnation in 2023, picking up through 2024 and into 2025, though growth remains uneven across countries limiting the overall recovery. For real estate, this environment of steady but varied growth will drive differential tenant demand. Our investment strategies seek to identify those opportunities which we believe will benefit from stronger occupational demand and ongoing investment market liquidity. We therefore continue to focus on those real estate sectors where demand is supported by **three key long-term secular growth drivers**:

- Target demand driven by demographic changes and urbanisation.
- Position assets for tightening efficiency and sustainability requirements.
- Embrace technological changes.

In addition, we continue to look to exploit opportunities to capture deep value as market values stabilize after the recent dislocation.



Tivoli Avenida Liberdade - Lisbon, Portugal

H2 2024 investment guidance

European real estate yields saw a significant correction between the start of 2022 and Q1 2024, but market evidence suggests that the repricing has now played out, with real estate yields showing far greater stability in Q2 2024. For the markets covered by IRE's investment focus, CBRE's published market yields show an average outward shift of 107bps between January 2022 and June 2024, though almost 10% of markets have started to show some tightening, indicating a degree of over-correction. The markets that have seen 100bps or more of yield widening are variously those that were tightest priced to start with, secondary assets, or sectors where the income profile has materially changed – e.g. residential markets where rent caps have been introduced or adjusted.

While prime yields saw negative valuation driven yield shift during 2023, rents in most sectors have remained remarkably robust. Occupier activity has remained strong as demand for the best quality space has seen prime rents continue to grow or, at worst, remain stable.

Looking forward

Our House View guidance is underpinned by the expectation of a period of real estate yield stability after the recent market correction.

While current real estate pricing is in line with historic ranges in European markets, it is at the tighter end of that range. As a result, we expect cap rate compression will play a lesser role for real estate value growth, certainly until long-term rates fall further than currently expected, enabling spreads move closer to the long-term average.

European real estate capital markets have been through a significant shock over the past 24 months, but the occupier fundamentals have been robust in most markets and sectors. This is the result of demand remaining solid and generally hitting limited supply. Increasing confidence, as evidenced by e.g. the OECD Composite Lead Indicator, will further support demand for quality space, and hence support rent levels and rental growth. Furthermore, we would note that over the past two years, rental value growth across Europe has been less than headline inflation (or construction cost inflation), even for the best spaces, and therefore occupier affordability is maintained in real terms.

As a result, achieving the best real estate returns, relative to the respective local market, will require a focus on property income growth and reliance on secular demand drivers that can mitigate an easing of the economic cycle. It also elevates the need to seek differentiated performance through market selection, because of the large historical gap between top- and bottom-performing markets. **Our House View going into 2025 therefore has four key tenets:**

01 **Yields have adjusted to financing costs, but capital demand remains an area to watch.** Our base case is for yield stability after the recent correction, though we note that the adjustment to date reflects the movement in debt costs rather than any longer-term imbalances in capital availability. Further price correction may result if we see a mismatch between the profile of capital looking to invest in real estate versus the type of assets being brought to market.

02 **Flat yields require income growth as the driver of returns.** A period of low economic growth means not all sectors will see the same demand, so we will lean into the structural tailwinds noted above to drive income. While consumer confidence remains weak we will lean away from industries / sectors exposed to mass-market discretionary spend.

03 **Growing regulatory pressure around sustainability presents both threats and opportunities.** Demand for energy-efficient, sustainable spaces is growing while supply is weak, and we will seek to deliver into shortages. Risk of stranding will drive distressed priced opportunities over the medium term, particularly with asset owners that are also impacted by increased debt costs, creating opportunities to acquire assets for repositioning.

04 **Opportunity arises out of volatility. Historically, forward investment returns have been strongest for vintage years coming out of a market correction.** We expect to see continuing opportunities for those able to execute on their conviction strategies in current market conditions.

Changes in lending activity will drive two areas of opportunity

The current market correction has resulted in banks taking a more cautious approach to new lending, increasing the focus on fully-leased, core real estate. While this stance is slowly softening, we continue to see two key areas of opportunity for IRE over the medium-term: the first is for alternative lenders to step into the funding gaps left where banks retreat and the second is pressure on existing owners around refinancing deadlines, which will result in assets being brought to market for sale.

IRE's debt investment team underwrites opportunities based on real estate fundamentals, backing strong sponsors and partners by providing whole loans and mezzanine finance for a wide variety of assets including less traditional property sectors and those with an element of redevelopment or repositioning. As such, we believe the current retrenchment of the banks away from higher leverage and away from more alternative real estate sectors will continue to provide attractive opportunities. Recent examples include a mezzanine loan secured on pre-let logistics assets in Poland and a whole loan financing the development of a cold storage facility in Italy. Both examples demonstrate the benefits of combining of our pan-European debt expertise with our on-the-ground regional real estate knowledge.

Meanwhile, the increased costs of refinancing existing assets will continue to drive owners to review their current investments, and we believe in many instances this will combine with increasing capex needed to meet efficiency requirements. It is our conviction that such opportunities will come to market over the next four to five years, as interest rates fixed at low rates gradually roll off.

Two key areas of opportunity for IRE over the medium-term

01

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02

pressure on existing owners around refinancing deadlines

which will result in assets being brought to market

DL Invest - Warsaw, Poland

Magazzino - Trieste, Italy

Setting strategy to capture this outperformance

The previous decade saw persistent trends in the relative performance between real estate sectors. Our conviction is that sector allocation as the dominant driver of returns will break down, and instead investors need to focus on identifying winners within each sector. Over the longer-term the relative risk premia between real estate sectors fluctuates, both globally and within individual markets. A key driver of these variations is changes in the outlook for income growth between the sectors, where those with a more positive growth outlook will trade more tightly than other sectors, all else being equal. However, the recent market correction and related illiquidity has led to a greater variation both in terms of current pricing and also in terms of the rental growth outlook by asset.

Our outlook for property sector income growth is based on each sector’s exposure to long-term secular demand drivers, sensitivity to the economic cycle, and exposure to new supply within its local market. As forward-thinking real estate investors, we have stopped thinking in terms of four large sectors. Instead we think about sub-sectors and how assets are positioned within micro-niches. For example, the ‘industrial’ sector sees a huge variation in the return outlook between R&D space versus cold storage versus urban distribution. In other words, the details matter.

Asset specific returns will be driven in part by clear business plans and a disciplined approach to delivering these. But NOI growth is also strongly shaped by secular trends which drive changes in the relative demand patterns over time, including shifts in the tenant landscape which are further exacerbated by changes in financial markets. We are focusing on four key trends which will shape real estate investment over the shorter- and medium-term.

Conviction investment drivers 2025-26

Short term: Exploit opportunities to capture deep value in market dislocation

- Acquire from motivated sellers of assets which align with our longer-term convictions
- Partner with developers and platforms to deliver new stock where supply has been disrupted by capital market conditions
- Utilise our real estate expertise to provide financing in situations being overlooked by mainstream lenders

Target demand driven by demographic changes and urbanisation

- Continuing undersupply of single family and multi-family housing versus household formation
- Increasing congestion in urban transportation and delivery networks

Position assets for tightening efficiency and sustainability requirements

- Pro-actively acquire older assets in strong locations for repositioning to Grade A and modern efficiency standards
- Invest in existing IRE assets to improve efficiency and maximise values

Embrace technological changes

- Life science facilities to accommodate increasing healthcare investment
- Increasing shifts in all real estate types towards more operationally intensive utilisation

Capital 8 - Paris, France

Exploiting the current market dislocation

The first of these arises out of the current market volatility. We are already seeing opportunities to capture deep value appearing, and we are seeking motivated sellers of assets which are aligned to our long-term conviction goals. These opportunities typically arise as existing owners face refinancing deadlines or pressures from fund expiries, and pending ESG investment often increases the motivation to sell.

Related to this, we are also seeing opportunities to partner with developers or operators who are seeking to deliver new space into undersupplied markets, and where the tightened capital market conditions are limiting their sources of funding. We will utilise IRE's on-the-ground networks in our key markets to access off-market opportunities, both acquiring standing stock from owners needing a quick or discreet divestment, or from special situations including the distress already seen in the market.

Demographic shifts

Demographic changes, including urbanisation, are key drivers of changing real estate demand. The most obvious sectors that this theme covers are residential, but these structural shifts do have significant real estate impacts beyond just beds.

European countries continue to suffer from a historic, and continuing, undersupply of housing relative to household formation. In addition, recent increases in mortgage rates continue to keep many would-be buyers in rental accommodation, while residential developers remain under financial pressure. As a result, residential is a real estate sector where there is consistent demand, which drives robust occupancy and stable cash flows. There are some concerns in this space regarding the affordability of rents in certain cities, and this is manifesting in increased markets deploying rental regulations while policymakers at the same time will have to ensure that the delivery of new supply does not stop. We therefore continue to seek opportunities in this space, but with a primary focus on open-market rented assets which are at an affordable point of the local demand curve and unencumbered by rent regulations.

However, the impact of demographic and urbanisation trends on real estate are not limited to residential assets. For example, we see significant congestion in urban delivery networks, as ongoing urbanisation increases demand density at the same time as the growth in online retail increases the volume to be delivered. Fulfilment of online orders requires around double the warehouse space of a traditional retail sale, and in addition connectivity into transport networks is key, as for a distribution or delivery tenant, a 1% saving in transport costs justifies paying more than 10% extra in rent. Our key focus for this strategy is the European mega-cities of Paris and London, though we also see opportunities in high wealth locations such as Munich and Amsterdam.

Holloway Head - Birmingham, UK

ESG

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More sustainable buildings can be proven to drive higher rents and lower vacancies, and price at tighter cap rates. As a result, our focus on sustainability is fundamentally aligned with seeking to maximize investment performance.

Across the European real estate market, Environmental, Social, Governance (ESG) credentials are an increasingly important consideration for both real estate investors and occupiers. ESG+R (ESG and Resilience) investing is a fundamental commitment at Invesco Real Estate. Increasingly stringent regulations on the Energy Performance Certification are required when leasing assets, and result in opportunities for institutional investors to reposition less efficient assets to the highest sustainability standards.

Our strategic response to the ESG challenges is to ensure the sustainability of our assets and, in doing so, we seek to maximise investment returns. More sustainable buildings can be proven to drive higher rents and lower vacancies, and price at tighter cap rates. As a result, our focus on sustainability is fundamentally aligned with seeking to maximise investment performance.

We continually monitor all existing IRE assets for sustainability, and our business plans ensure that all assets meet all relevant standards in advance of the regulation timeline. The resulting capex requirements are assessed against expected future value impacts, accepting that some capex will be defensive (i.e. to maintain values) and some will be accretive. And we also look to accelerate disposition plans for assets which may struggle to adhere to relevant regulations.

We are also looking to acquire assets for repositioning to Grade A standards. Opportunities are arising from existing owners unable to invest to meet increasing efficiency requirements, particularly when combined with financing / refinancing pressures. We will continue to target core assets in gateway cities where investor and occupier demand remains most robust through cycles, utilising IRE’s on-the-ground expertise in our key markets, also securing access to attractive returns on super-core assets that do not normally transact.

Brent Cross - London, UK

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Technology changes

Technological developments are driving significant changes across the modern world. In real estate, we see the impact in both direct demand and also indirect changes. Within the former, we see for example demand for life science assets to meet growing healthcare investment, or the rise of data centres to meet growing data storage needs. Both of these categories of real estate remain in strong demand from both occupiers and investors, though transaction volumes remain limited.

We are also seeing indirect impacts of technological changes on real estate, in particular enabling a shift for almost all real estate sectors towards more operational utilisation. There is an increasing focus on the breadth of amenities in locations, requiring real estate to adapt increasingly to more integrated live-work-play uses, and this requires landlord involvement in amenity provision and wider placemaking. The increasing demand from tenants for lease flexibility places pressure on landlords to manage assets accordingly, which is increasingly enabled by technology solutions, while we are also seeing many examples of tenants seeking partnerships with landlords to support expansion, which requires a high degree of operational involvement for the real estate operator.

Conclusion

We head into Q4 2024 expecting values to start to recover after 24 months of correction. However, the recent slight downward adjustment in European interest rates has possibly come a fraction too late, so will likely keep the pace of transactions subdued through year-end. We have growing confidence that transaction activity is likely to re-accelerate in early 2025, and that the start of a new real estate value cycle is close at hand.

Real estate continues to offer significant diversification benefits versus other asset classes, and these diversification benefits exist across real estate markets and sectors. Opportunities in the real estate market today are across the capital stack and across the risk spectrum. In our experience, many asset allocations retain a home bias towards real estate exposure as well as targeting a specific risk segment, and we believe all investors should be considering whether they are appropriately diversified.

Geopolitical considerations remain key risks to the outlook, but overall we believe that the recent correction in values offers attractive entry points into the sector. Also, recent reductions in development pipelines are expected to shift the supply/demand balance more into the favour of the asset owner landlord. While global and macro factors are continuing to drive real estate returns, we believe that over the next couple of years local knowledge will be particularly important for driving relative outperformance.

Investment risks
The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. Property and land can be difficult to sell, so investors may not be able to sell such investments when they want to. The value of property is generally a matter of an independent valuer's opinion and may not be realised.

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