PRIMONIAL REIM
VALUE FROM VALUES

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REAL ESTATE PERSPECTIVES

By Primonial REIM Research & Strategy

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"Although considerable uncertainty persists in the short term, given the inflationary context and geopolitical tensions, the real estate market offers solid fundamentals. The market has strong sources of support that will drive demand: demographic shifts, with challenges of an ageing population; urbanisation as a vector of economic dynamism and net job creation; and the energy transition task that the real estate industry must tackle."

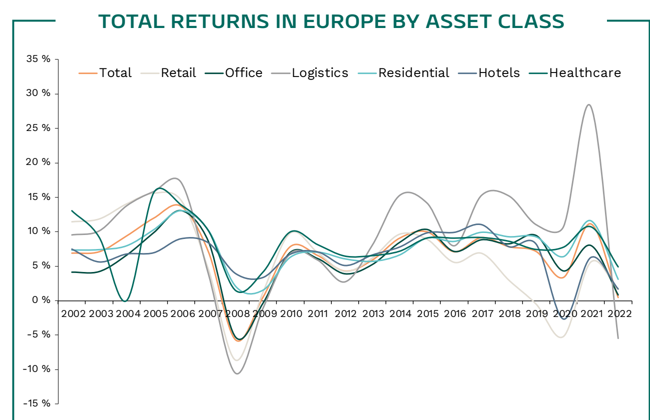
Whilst the risks to Europe's economic prospects are real (geopolitical tensions, high levels of inflation), GDP growth in the euro zone is still expected to be positive in 2023 (+0.8%) and 2024 (+1.2%). However, several indicators suggest that the trend remains fragile, particularly as financial and credit conditions are growing increasingly tight, and monetary and fiscal policies ever stricter. Significant divergences have emerged between countries that are outperforming and those which have gone into a technical recession.

With each successive month, the euro zone Consumer Price Index has confirmed the slowing of inflation. Because of this, it seems reasonable to believe that the ECB's interest rates are approaching their peak. But we cannot rule out the possibility that July's additional increase will be followed by further, albeit limited, rises in the coming months. Paradoxically, this could be made even more likely if excessive economic resilience leads central banks to seek to make bigger adjustments to their policy rates. For the time being, the consensus remains that the cycle of rate rises is reaching its end and that inflation will gradually fall back towards 2% over the next few years.

High inflation, low growth and high bond rates have had their consequences for real estate valuations in the short term. We believe that over the first six months of 2023, the market has already made the bulk of the corrections expected for this year – although there may still be some adjustments in store, before beginning a new cycle, that will bring opportunities. The value corrections that might occur in various European markets will create attractive entry points for investors once the level of yields on acquisition has stabilised. The advantage will lie with investors who have the liquidity to seize market opportunities.

One of the main risks we have identified is the liquidity risk. Some actors in the market, mainly real estate companies, have built up significant debt, which could force them to sell if they encounter complications when they look to refinance. One should also take account of persistent inflation as another risk. If inflation does persist, central banks could be obliged to continue to raise interest rates and/or hold them at high levels for longer. Lastly, the inversion of the yield curve will need to be watched. The ECB's action on interest rates has created the conditions for slowing the economy and thus stopping the inflationary spiral. The inversion of the yield curve for short-term and long-term rates is generally considered as an advance indicator of the triggering of a recession over the medium term. Although the European economy is still expected to see a soft landing, the risk of recession cannot be entirely ruled out.

TOTAL RETURNS IN EUROPE BY ASSET CLASS



THE REAL ESTATE PERSPECTIVES IS A BI-ANNUAL REPORT PUBLISHED BY PRIMONIAL REIM RESEARCH & STRATEGY. THIS REPORT HIGHLIGHTS PRIMONIAL REIM'S 5-YEAR PROJECTIONS FOR ALL MARKETS AND ALL ASSET CLASSES IN EUROPE. IT COMPLEMENTS OUR QUARTERLY REAL ESTATE CONVICTIONS.

REAL ESTATE ASSETS: SECTOR FUNDAMENTALS AND THE MAJOR CHANGES AHEAD

We have identified new sources of support for the real estate sector and the major changes that lie ahead: demographics, urbanisation and the energy transition.

Demographics

The ageing of Europe's population is the major factor in the demographic trends that lie ahead. Over the past few years, the most popular assets amongst investors have been in offices, retail and to a lesser extent logistics. However, diversification strategies brought a shift towards residential, senior healthcare and services sector real estate such as hotels.

Demographic pressure linked to the ageing population is likely to have various effects, including an increase in demand for residential real estate and, of course, for healthcare real estate. Moreover, the same phenomenon will put the labour market under pressure. The ageing population will gradually result in a shortage of labour due to the rising number of retirements and the reduction in the working-age population. The quality of office real estate will become a factor in the competition to retain talent. This could stimulate investment in assets considered as attractive to users.

Urbanisation

European cities have traditionally shown economic growth above their national average. According to Eurostat, this has held true during the recent crises we have experienced (financial crisis, recession, recovery, etc.). By sector, we expect IT, services, retail, hotels and the energy transition to be the main drivers of growth in cities over the next five years. Meanwhile, demographic growth in most European cities will also exceed national averages.

Energy transition in response to the climate crisis

We have assumed that governments will in fact adopt the policies to which they have committed to address climate change (Paris Accords from 2015).

Under current standards and at the current state of knowledge, in our view it is necessary to take into account the risk of repricing from decarbonisation and adaptation to climate change, which we estimate at between 50 bp and 300 bp depending on the asset and the market. This "climate risk premium" corresponds to estimated renovation costs..

PROSPECTS IN THE MAIN EUROPEAN MARKETS (EURO ZONE)

	Features	Short term 2023	Medium term To 2028
OFFICES	Central markets	Wait to selective	Selective
RETAIL	Depending on format and zone	Selective to positive	Selective to positive
LOGISTICS	Class A, urban logistics	Wait to selective	Selective to positive
RESIDENTIAL	Cities and suburbs	Wait to selective	Positive
HEALTHCARE	National, recent or new assets	Positive	Positive
HOTELS	Business and leisure	Selective to positive	Selective to positive

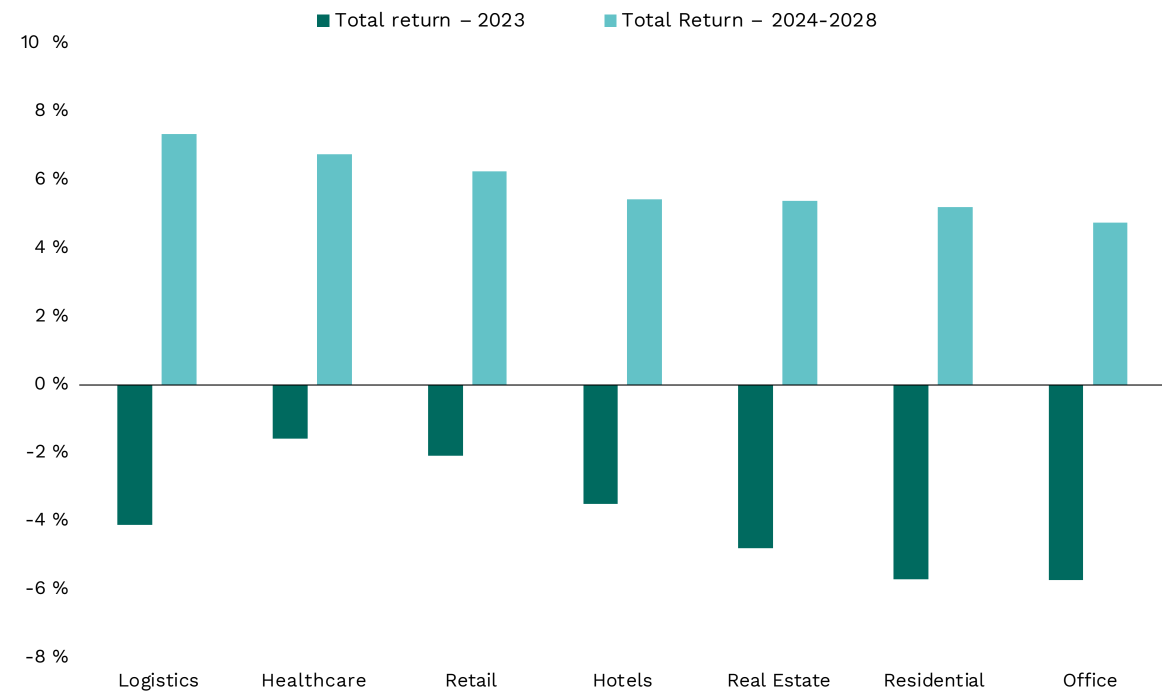
Primonial REIM Research & Strategy uses statistical models to apply the latest official macroeconomic forecasts to all classes of real estate assets. Clearly the findings are indicative and do not represent advice.

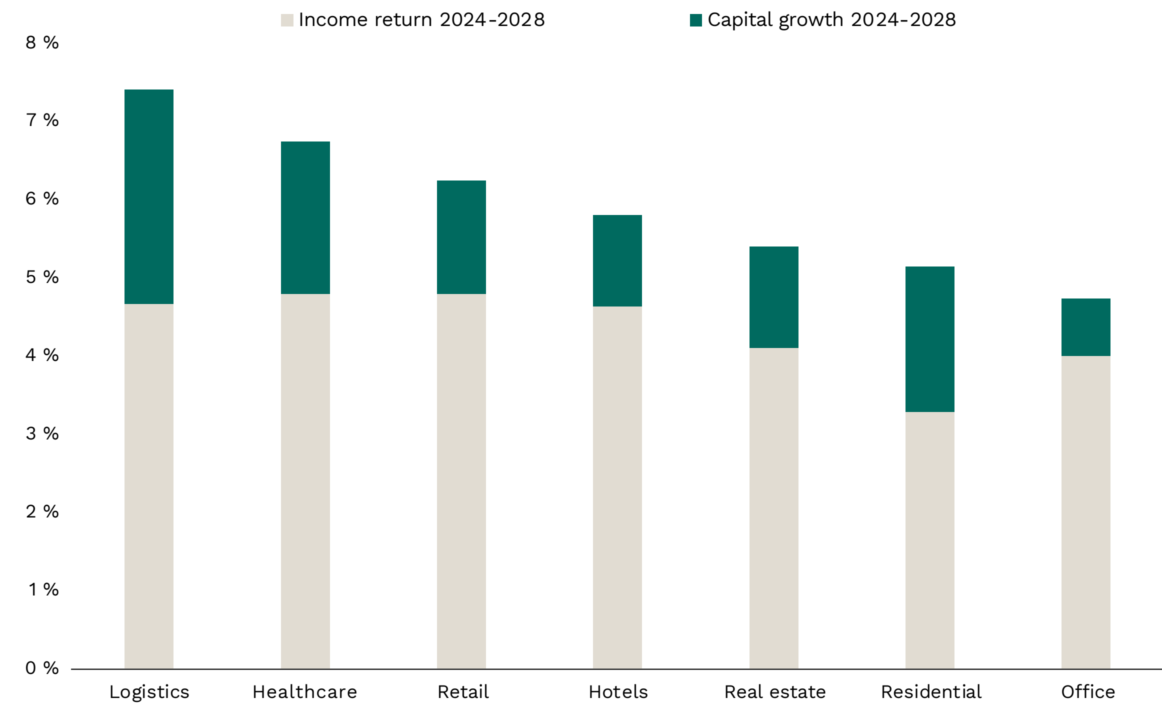
We expect real estate values to see adjustments for as long as the ECB continues its monetary tightening policy. The consequences of this situation create a risk for the prospects for capital growth in the short term. Over the medium term, we expect capital growth to be less significant than income return, which will drive overall performance. Thus, well-located assets with the potential for added value and solid tenants are likely to produce the best performance over the period. Across all real estate assets, we estimate that income return will be around 4% between 2023 and 2028. When it comes to capital returns, these are likely to drop off in 2023 (between -6% and -8%), but we are expecting a recovery between 2024 and 2028 (+1% to +3%). We predict an average total return for all asset classes of between 4% and 6% per year between 2024 and 2038. This projected performance is thus fairly close to the +7.0% seen over the past decade.

In the short term, we are expecting total returns to be less severely affected in the healthcare, retail and hotels real estate sectors. In **healthcare,** income return are resilient. Moreover, regulations in the sector could generate costs but also a degree of protection for the value of healthcare assets. Having seen significant value corrections during the pandemic, the **retail** sector will be less affected by adjustments in value. However, there are significant differences between formats. The performance from **hotels** is also likely to prove resilient in 2023, being driven by income return. The continued recovery in international tourism and operating performance argue for a positive trend over the coming years. Business tourism still faces difficulties and is unlikely to see a rapid return to pre-pandemic levels. We would therefore expect the sector as a whole to see a mixed performance. In **logistics,** the asset class is in a position to deliver a level of income return that will offset the value corrections seen in 2023. Let **offices** that are well located, meet tenants' new requirements and respect ESG (Environmental, Social and Governance) standards will be highly prized by investors as they are likely to enjoy the best yield prospects over the coming years. Lastly, in the **residential** segment, although adjustments are expected due to rising interest rates, the market has favourable fundamentals. Strategic positioning should be anticipated once rates have reached a plateau, in order to seize the best opportunities for the new cycle that will begin in this asset class.

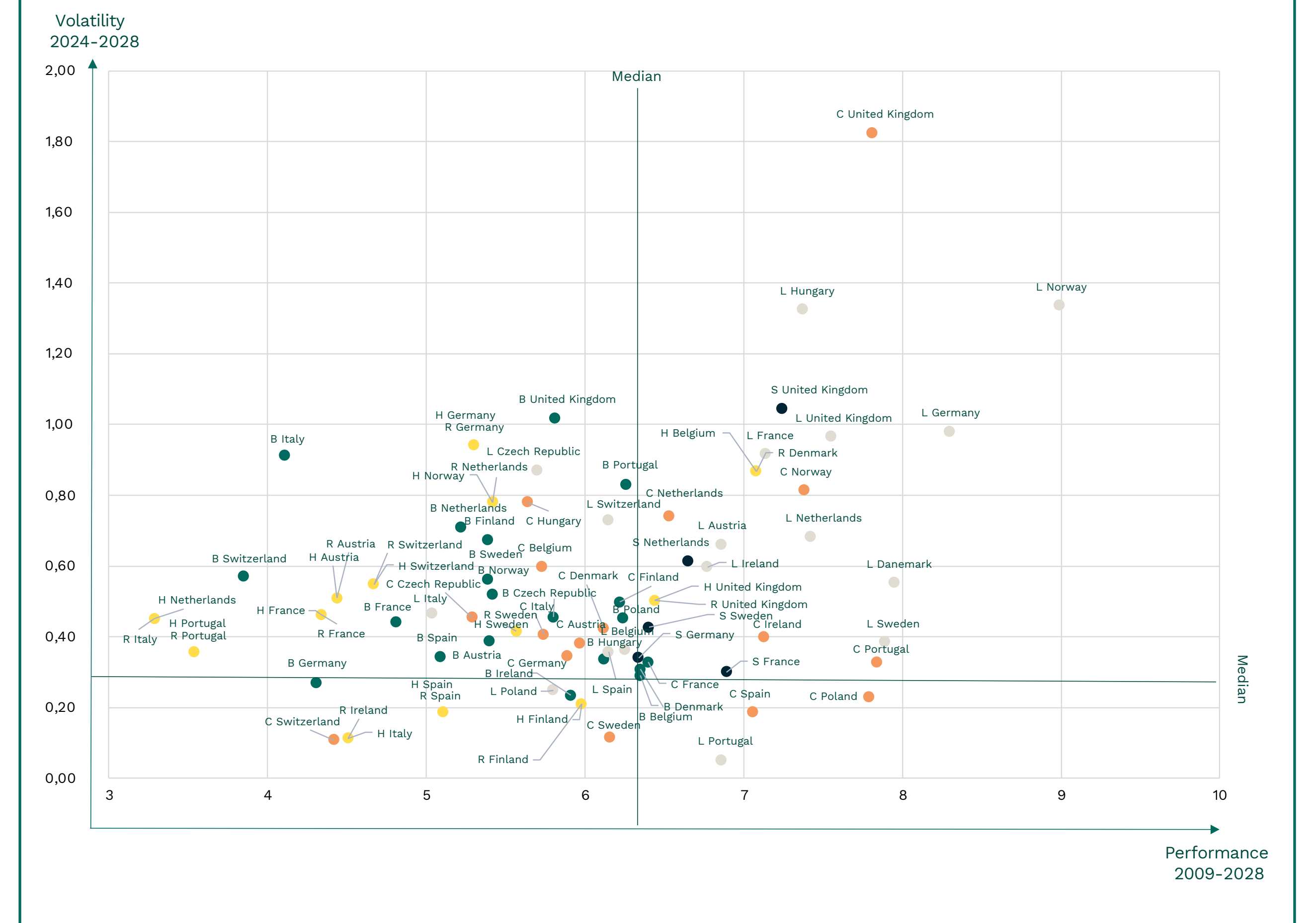
It is important to note that the gradual introduction of restrictive regulations and the shift in investment strategies will work in favour of assets meeting ESG criteria, which will have a negative impact on the overall performance of energy-hungry, high carbon footprint assets: assets not meeting ESG criteria could, over time, face a reduction in liquidity and thus corrections in their resale value.

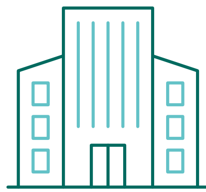
PROJECTED TOTAL RETURNS IN EUROPE BY ASSET CLASS 2023 TO 2028





PROJECTED REAL ESTATE MARKET PERFORMANCE/RISK IN EUROPE 2023-2028





OFFICES

Turning to our forecasts for 2023 to 2028, we believe that total returns for offices in Europe (euro zone) are likely to average between 2.5% and 5.0% per year. In terms of the contributions to performance, income return will be between 3% and 4% due to the fundamentals of the letting market over the period. This performance can be explained by healthy growth in rents and low vacancy rates. Capital growth is likely to be hit in 2023 but return to positive territory in 2024, with average annual growth of between 0.0% and 1.5% between now and 2028. As far as individual markets are concerned, we think that cities including Paris, Madrid, Munich, Frankfurt, Berlin and Hamburg will be amongst those least affected in 2023 and have the capacity to generate strong total returns through to 2028.

Returns are likely to see adjustments in 2023 due to higher borrowing costs, requirements for energy renovation of buildings and higher construction and renovation costs. One of the other challenges is the impact of hybrid working on demand. However, given the rising trends in job creation and office work between now and 2028 and the pressures from increases in retirement ages, we expect that these factors will boost demand for space from users.

RETAIL

We forecast average returns from retail assets in the euro zone of between 4% and 6.5% from 2023 to 2028. Income return, which we estimate at between 4% and 5%, will drive the retail sector's performance between 2023 and 2028. Although capital returns are likely to come under pressure in 2023, we expect that they will bounce back from 2024. Between now and 2028, we expect that increases in capital value will run at between 0% and 1.5% on average. Street-level shops in cities such as Berlin, Rome, Milan, Brussels, Munich and Paris have relatively strong prospective total returns between now and 2028. In shopping centres, Madrid, Lisbon, Milan, Vienna and Berlin offer attractive prospective returns.

Thanks to the good health of the euro zone labour market, wage growth and continued robust savings levels, consumer spending will help bolster retail sales. However, some risks persist given the level of economic uncertainty. In the event of a reversal of growth, the labour market could be affected, encouraging households to build up precautionary savings at the expense of consumer spending. This would affect retailers and could therefore have knock-on effects on rents. However, there are also balancing factors for retail. We believe that the winning cities in the future will be those that are highly attractive to international travellers and those organising major international events such as the Paris Olympics in 2024. Forecast revenue growth at retailers in these markets is already seen as a future support to income return. In general terms, "bricks and mortar" retail will need to continue to manage the balance with on-line sales.

LOGISTICS

We forecast average returns from logistics in Europe (euro zone) of between 5.0% and 7.0% from 2023 to 2028. Income return will drive performance over the whole period, with capital growth likely to see a marked correction in 2023. However, the logistics segment has good fundamentals for a recovery. We think that markets including Lyon, Vienna, Marseille, Barcelona, Madrid, Brussels, Berlin, Milan, Paris and Rotterdam have prospects that will allow them to show good resilience in 2023 and provide good levels of performance over the next few years.

In addition, European and national authorities have expressed their desire to relocate certain 'strategic' industries to make supply chains more resilient in the event of crises, by diversifying suppliers, raw materials, production and transport. This strategic repositioning will feed into demand for logistics assets. Meanwhile, retailer users are still likely to benefit from the strength of e-commerce even though the growth in penetration rates is likely to be less strong following the peak seen during the pandemic. The logistics sector will face different challenges over the coming years. First, investments will have to be made in digitisation and robotics in order to improve supply chain efficiency and optimise the use of space. The obsolescence of those buildings that have not made the transition will accelerate. Secondly, the ESG transition in logistics is a challenge as the sector is cost-driven, which could rapidly become a negative point for obsolete buildings.

RESIDENTIAL

Our forecasts for 2023 to 2028 suggest average total returns of between 3% and 5% in Europe (euro zone). Monetary tightening policies at central banks will have an effect on the residential market, which will result in pricing adjustments in certain markets in 2023. We already know that other markets will be flat or rising over the year as a whole. Indexation makes an automatic contribution to the rental performance of residential real estate, helping guarantee recurrent income. By country, we believe that in the short term Italy, France, Ireland and Belgium are likely to show better resistance than other countries. Over the longer term, the most economically solid of the countries that see substantial corrections in value have attractive recovery potential; Sweden and Denmark would be two examples. The Netherlands, Germany, Spain, Italy, Austria and France are amongst the markets which offer a reasonable risk-return profile between now and 2028.

The residential market has positive fundamentals. The imbalance between demand for housing and its supply will rapidly fuel a return to price growth as part of a marked uptick in transactions under the combined effect of an easing of borrowing conditions, a reduction in inflationary pressure on real household incomes and the stagnation or even reduction in borrowing rates. The continued growth in the number of households is another factor in favour of European residential real estate. This situation helps underpin demand in both the rental and home purchase markets, in line with household resources. Regarding ESG issues, the residential sector faces tighter regulations to meet energy consumption standards and carbon reductions (with a ban on letting apartments where the energy performance audit is below a certain level). Lastly, under national or local legislation, the European residential market is regulated to provide protection to tenants. Indexation, which is generally linked to the consumer price index, provides total or partial protection against inflation.

HEALTHCARE

Turning to our forecasts for 2023 to 2028, we believe that total returns for healthcare assets in Europe (euro zone) are likely to average between 4.5% and 6.5% per year. Total returns will be driven by income return and to a lesser extent by capital growth. Within the euro zone, we believe that France, Germany, Spain, Italy and the Netherlands are the deepest and most liquid markets and will have the ability to deliver high levels of performance. Looking at the risk-return profile, it is worth noting that healthcare is an attractive inclusion in a portfolio, in order to achieve optimum diversification in terms of both volatility and the reduction of the portfolio's exposure to economic cycles.

The imbalance between supply and demand in care and residential provision will persist over the coming years. We know that demographic pressures will remain strong and will continue to increase well beyond 2028. In many European countries, a significant share of healthcare expenses is covered by public and/or private sector insurance. The sector therefore has solid fundamentals on its side. The obsolete segment of care homes will need renovation to meet ESG criteria and protect their occupants, particularly during heatwaves. Lastly, the shortfall of supply in the market represents a powerful driver of investment in recent, well-located assets with a solid operator.

HOTELS

We forecast average returns from hotels in Europe's euro zone of between 3.5% and 5.5% from 2023 to 2028. Although capital performance will see adjustments in 2023, a gradual increase is expected between now and 2028. We think that a mix of leisure and business hotels, once the recovery in the latter is confirmed, will allow diversification of risk and generate a better level of performance. The global travel industry had recovered to 95% of its 2019 level by the first quarter of 2023, according to the World Travel & Tourism Council. For our part, we still expect growth in international visitors to be higher in 2023 than in 2022, despite inflationary pressures. On top of this, low levels of unemployment and the strength of employment will help support tourist demand. Between now and 2028, major international events and the return of tourist numbers to pre-pandemic levels will help drive the sector.

We believe that the indicators of hotel performance will improve further still. Thus we expect occupancy rates, average prices and RevPAR to rise relative to 2022 in those markets least affected by geopolitical tensions. When it comes to ESG issues, a selective and patient approach should guide investors' allocation strategy. The sector will need draconian changes to reduce its high levels of energy consumption, and its decarbonisation challenges are amongst the greatest in the real estate industry. An extra-financial risk premium could therefore emerge as sustainability considerations are included in valuations.

EFFICIENT REAL ESTATE PORTFOLIOS – THE SMARRT© MODEL FROM PRIMONIAL REIM RESEARCH & STRATEGY 2023-2028

The chart below shows the overall allocation recommended by SMARRT®, our allocation model that allows the management of real estate investment in accordance with changing macroeconomic conditions.

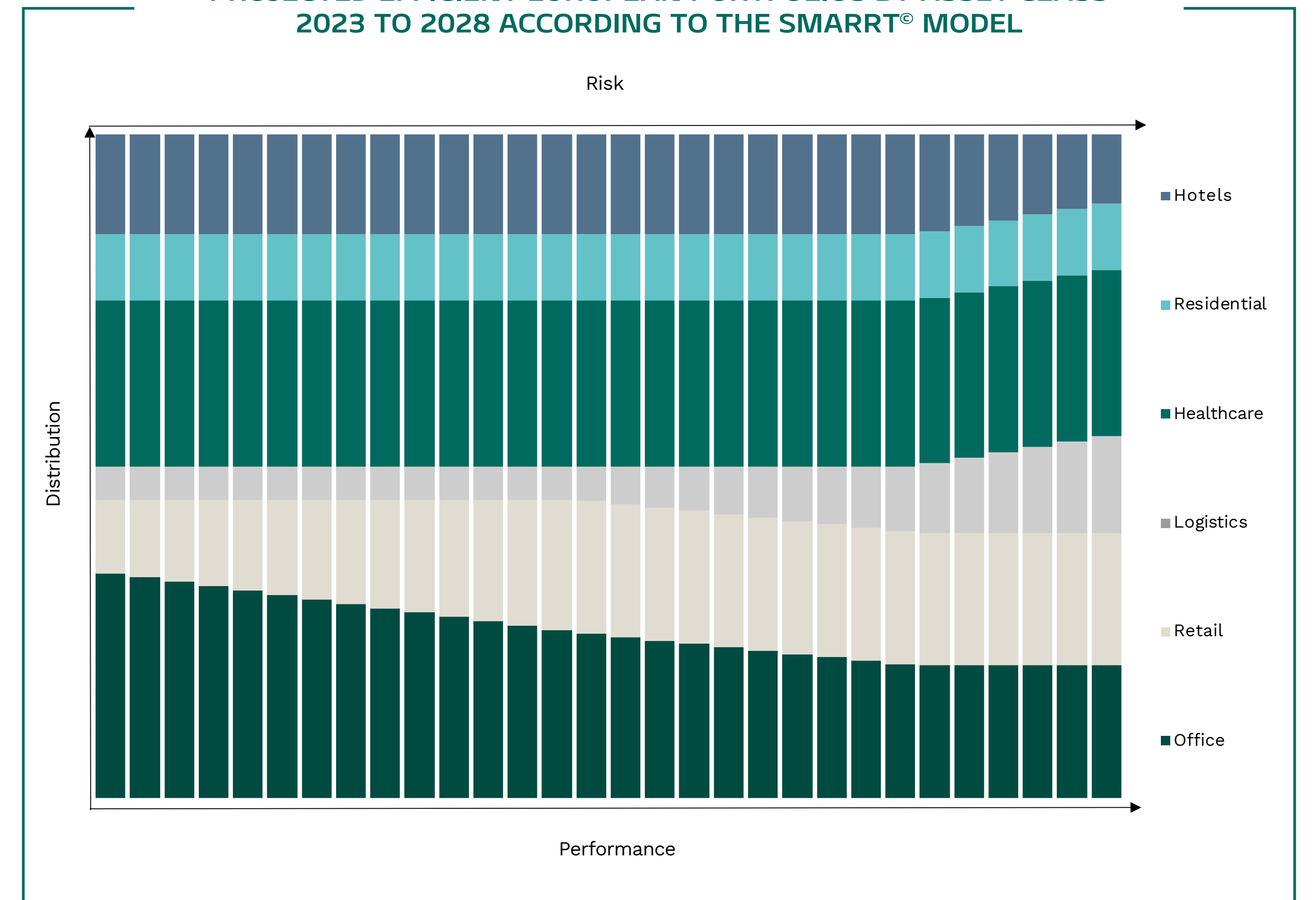
Our model has identified various efficient portfolios with a total return of between 3.5% and 5.0%. It favours geographical and asset class diversification at the European level.

When analysing future results and projecting real estate returns for the period from 2023 to 2028, the model allocates constant shares to healthcare (around 25%), residential (10%) and hotels (15%) irrespective of the strategy considered. In a defensive approach, the model favours the office segment because of its liquidity (30%). This share tends to reduce in favour of retail and logistics for a more aggressive strategy, with allocations to the latter two sectors rising from 11% to 20% and 5% to 15% respectively. These adjustments increase potential returns, but also risk.

It is interesting to note that the allocations suggested by SMARRT share a common denominator in the form of the shares of healthcare, hotels and residential. The algorithm believes that these three asset classes offer an attractive risk-return profile between now and 2028. Moreover, under an aggressive strategy SMARRT increases the share of logistics, historically a volatile asset class, and retail, an asset class that has seen sharp corrections and thus has recovery potential in the coming years.

These findings are those of a specific moment and must not be viewed as fixed over time. An allocation policy must take into consideration the real estate cycle for each market in order to invest at the most opportune time. The model will need to be adapted to each new situation, adjusting the allocation to ensure that the desired risk-return profile is maintained.

The structural risks identified are as follows: worsening instability in Europe that would reduce economic prospects; persistent inflation over time, such that central banks maintain high levels of interest rates and thus a narrower spread against real estate; the emergence of new conflicts which could affect the international value chain; or a financial crisis triggered by an abrupt economic downturn in response to rapid rises in interest rates, to the extent that such a policy could have economic consequences over the next two years.



Sources used throughout this document: Primonial REIM Research & Strategy statistical models, CBRE, Savills, BNP PRE, JLL, Knight Frank, MSCI, Oxford Economics, Eurostat, OECD, FMI, Stabel, NSI, CZSO, DST, Destatis, Stat, CSO, Statistics, INE, INSEE, DZS, ISTAT, CSB, Statistics Lithuania, Statec, KSH, CBS, Statistik Austria, Stat Poland, INE, INSSE, Statistics Finland, SCB, SSB, BFS, ONS.

About Primonial REIM

Primonial REIM has a workforce of 450 employees in **France, Germany, Luxembourg, Italy,** au **United Kingdom** and **Singapore.** Its values of conviction and commitment as well as its expertise on a European scale are used to design and manage real estate funds for its national and international clients, whether they are individuals or institutions.

Primonial REIM currently has **€42 billion** of assets under management.
Its conviction-based allocation breaks down into:

- **47%** healthcare/education,
- **35%** offices,
- **8%** residential,
- **5%** retail,
- **4%** hotels,
- **1%** logistics.

Its pan-European platform manages **61 funds** and has more than 80,000 investor clients, **55%** of which are **institutional** investors and **45% individual**. Its real estate portfolio consists of more than 1,695 properties (offices, healthcare/education, retail, residential, hotels) located in **10 European countries.**

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Primonial REIM, a key player in property asset management in Europe

The Research & Strategy Department's role is to formalise Primonial REIM's real estate investment strategies, based on continuous monitoring of the French and European markets. Although collective real estate accounts for a growing share of institutional portfolios and household savings, it is at the crossroads of financial (hierarchy of rates), economic (tenants' business models), demographic (the metropolisation phenomenon) and societal (changes in usage) factors. This is why a cross-cutting analysis is needed, which is also long term and therefore in keeping with the horizon of most real estate investors.

Real Estate Convictions Europe offers Primonial REIM's quarterly view of its markets of choice, i.e. offices, retail outlets and healthcare and residential real estate, in the Eurozone.

NOTES

Ref: Real Estate Perspectives – **072023** – Photo credits: Primonial REIM France, Adobe Stock – Primonial REIM, société par actions simplifiée au capital de 10 000 euros, immatriculée au RCS de Paris sous le numéro 884 030 842, dont le siège social se situe 6-8, rue du Général Foy – 75008 Paris. www.primonialreim.com

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