January 2025

European Real Estate Market Outlook 2025

Key Takeaways

- 2025 appears set to be a promising vintage year for European real estate investors. Values have stabilised, and we believe there will be opportunities to acquire assets at or close to the bottom of the market.
- Fears of a prolonged higher interest rate environment have negatively impacted sentiment among allocators, but in our view, a narrow focus on yields overlooks the strong potential for rental value growth as a driver of performance.
- The supply of best-in-class assets is expected to remain limited due to various factors that continue to constrain new development. This is expected to support further rental growth in the sector

2024

A year for the optimists

Sentiment in the real estate market at this time last year was split into two camps: the optimists who were calling for investors to “do more in ’24” and the pessimists who were talking about “staying alive until ’25.” We were very much in the optimists’ camp.

Looking back, as we expected, values stabilised across Europe during 2024 as interest rate cuts helped put a floor under values. The UK market led the way into the down cycle in 2022 and led the way out in 2024. UK property-level total returns turned positive in January, gradually improving over the year, and by November, all sectors were recording month-on-month positive capital value growth. Full-year returns are likely to be 6.0%+, and 3-month annualised returns are running at approximately 10%.

On the broader European front, pan-European portfolios posted positive returns in Q2 (taking income into account) and positive capital value growth in Q3. The residential and industrial sectors have led the recovery, reflecting investor appetite and, therefore, market liquidity. However, retail warehousing has delivered good performance over the year, and while office markets have lagged, yields have stabilised and rental growth will help to drive positive returns.

Capital values fell less than 1% during H1 2024, so those placing money in the market during 2024 seem to have called the bottom of the market correctly, and 2024 should prove to be a good vintage for them. But what does 2025 hold in store for investors?

The macro environment is unlikely to be a tailwind for recovery

Economic performance does influence the performance of real assets in the long term, but in this cycle, we do not expect the economy to do much heavy lifting in the early stages of this real estate market recovery. As we enter 2025, growth projections for most European countries are being downgraded, reflecting concerns about potential tariffs once Donald Trump takes over the US presidency. In response, the European Central Bank is now expected to accelerate interest rate cuts to provide support for Eurozone economies. These cuts should support the real estate market, making the cost of debt cheaper and, consequently, providing additional liquidity.

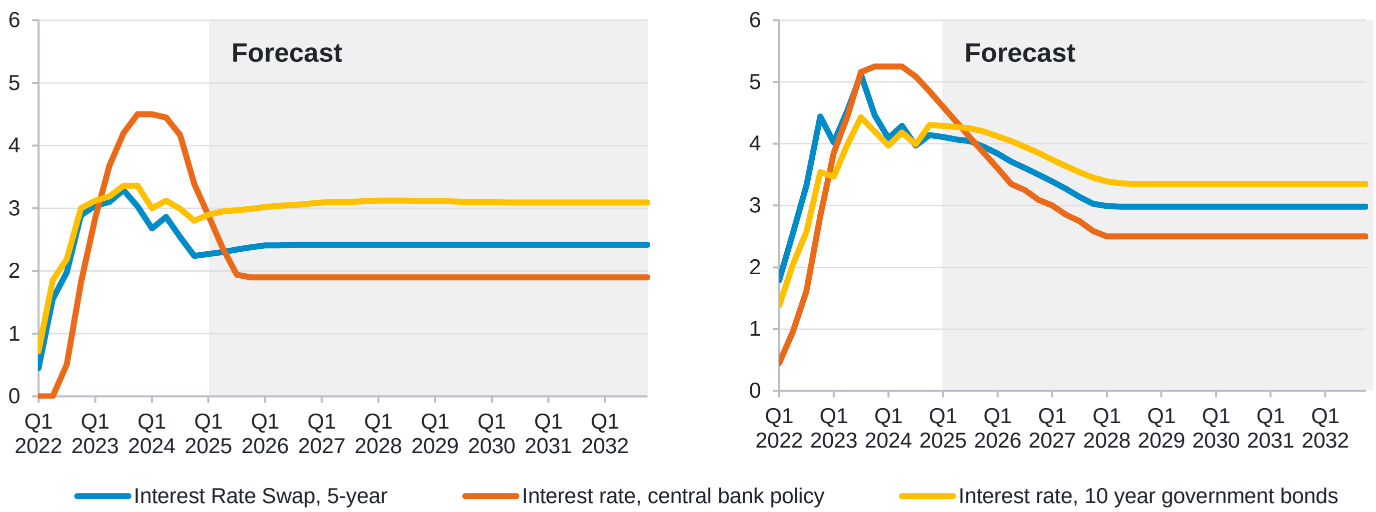
The relationship between interest rates and property yields is complex, and while a lower cost of debt provides liquidity, it does not necessarily place downward pressure on rental yields. Long-term yields also play a role. The 10-year government bond rate is often used as the 'risk-free rate,' and real estate is expected to be priced at a premium to that, reflecting the additional risk of obsolescence and depreciation. The premium also reflects the bond-like nature of the income stream received (credit risk from tenants). The required return for real estate then looks at both the opportunities for income growth through market rental value growth and indexation of leases, and the opportunity for capital growth through yield movements to see if these offset the risks.

Rising government bond yields in the first half of January have provided a bumpy start to the year for real estate. Market nervousness about stagflation pushed bond yields up 25-30 bps in the first two weeks of the year, creating concerns about a 'higher-for-longer' scenario, which dampened sentiment towards real estate. While nerves have settled following more positive inflation data, the outlook for 10-year government bond yields remains quite different from that of short-term rates (see Figure 1). This reflects that the interest rate curve has been inverted and is returning to a more normal pattern, with forecasts indicating it will be broadly stable over the next few years. Various 'fair value' analyses[1] suggest that European real estate is now fairly priced following the re-pricing of the past two years. Therefore, the scope for yield compression looks modest in the near term, with the UK possibly offering greater opportunities for yield compression given the expectations for more significant reductions in the 10-year government bond yield in the medium term.

Figure 1: The outlook for interest rates in the Eurozone and the UK

Eurozone interest rates

UK interest rates



Source: Oxford Economics, December 2024

[1] Cushman & Wakefield Fair Value Index, Q3 2024; Oxford Economics, October 2024.

There is a third factor at play in driving yields, and that is market sentiment and the liquidity it creates. Where demand outstrips supply, pricing pressures could emerge. We are seeing steady investor demand for industrial/logistics assets and residential assets across Europe. As there is little evidence of stress in the market driving forced selling, the amount of stock brought to market by sellers is limited. In the latter half of 2024, we saw some evidence of falling yields, particularly in markets (Spain) and sectors (industrials and residential) that investors are favouring. This trend is likely to continue into H1 2025 and should generate good returns in areas that are attracting capital such as hotels, multifamily, and industrial/logistics.

Politics remains a potential disruptor

Remarkably, in 2024, half the world had the opportunity to go to the ballot box. In many cases, voters voted for change. In 2025, we will begin to see the consequences of those votes. For real estate, the impact should be modest, although residential markets remain vulnerable to political intervention through policies like rent controls. There has also been some backlash against green policies put in place for countries to meet their commitments to the Paris Agreement. In the US, President Trump is likely to withdraw the US once again from the commitment, which is expected to slow progress in delivering green buildings and infrastructure in the US. By contrast, in Europe, the corporate commitment to reach Net Zero Carbon by 2050 remains strong despite some populist political backlash.

Europe enters 2025 with no government in place in its two largest economies, France and Germany. This political vacuum and consequent economic inertia are likely to remain in place throughout Q1 and may dampen cross-border investor sentiment towards the region in the near term. For European investors, this may provide an opportunity to invest in European markets while competition for assets remains relatively modest, particularly in the value-add space where US investors have been most active in the past.

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Generating alpha will require a return to real estate fundamentals

Limited macro growth does not neccesarily mean that real estate will see weak performance in the near term. In the UK, where monthly performance data is available, the best performing sector of 2024, retail warehousing, delivered a return of 12.5% in 2024[2]. Performance was driven by an attractive running yield, a small amount of yield compression (helped by good market liquidity), and low and stable vacancy levels (which generated modest rental growth).

Given yield compression is likely to be a smaller part of delivering performance in this cycle, driving alpha in core strategies will be focused on capturing rental growth through asset selection and active asset management. There is likely to be some differentiation in rental growth at a sector and country level as core portfolios continue to restructure away from traditional sectors such as high street retail and offices. However, the variation in the performance of individual assets within a market is much greater than the difference across markets. Strong stock selection and robust, proven processes in assessing risks and opportunities should help to deliver out-performance.

While macro fundamentals suggest that demand will remain muted in the near term, that doesn't necessarily equate to weak rental value growth, as it is important to also consider the supply side of the equation. We believe that shortages of supply will be a key driver of rental growth and performance, and there are a number of reasons why supply will remain constrained:

- New development failed to keep up with demand for good quality, well-located sustainable assets in the last cycle, largely due to limited availability of funding for speculative development
- Post-COVID, the cost of development has risen sharply as a result of high inflation in 2022/23, driven by higher materials costs and higher labour costs, with the latter exacerbated by a shortage of skilled construction workers.
- National government policies have allocated resources away from commercial development and, in some cases, even infrastructure. For example, in Italy, a €220 billion program subsidising energy efficiency enhancing residential renovations is believed to have crowded out investment in commercial sectors that would have had longer-term economic benefits.

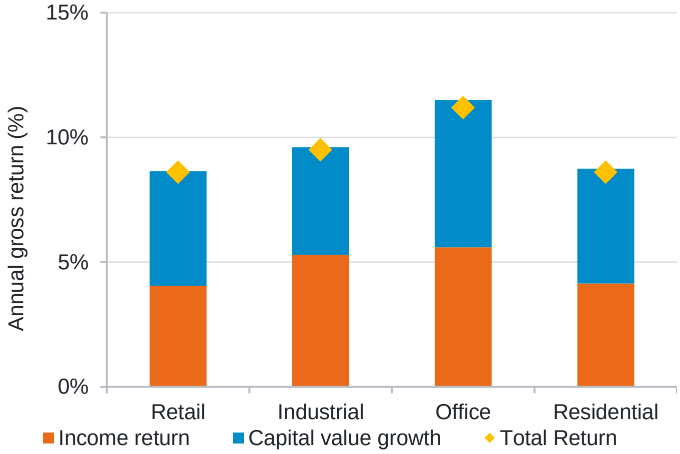
Due to increased construction costs, fewer new developments are viable unless higher rental growth is achieved, as developers need confidence that the rents will support the higher costs of the scheme. This will generally be true in larger cities and for good quality assets, and in these locations rental growth performance should be strong.

For value-add strategies, much of what has been said for core strategies remains true, but understanding the right risk levers to pull will be important. The shortages of new supply will support strategies focused on renovation rather than redevelopment. Such an approach not only delivers good quality space to the market more quickly than a full redevelopment, but also ensures that embedded carbon is not released. Delivering buildings that play a role in the energy transition will be non-negotiable.

Despite growing evidence that real estate values have stabilised, and that investors placing money in the market at this point in the cycle should see strong performance, there appears to be a disconnect between large asset allocators and the real estate market as they are reluctant to re-allocate to the sector. However, we are seeing private investors, such as property companies and family offices, become more active. The presence of these investor types, who are able to be more selective in when they place money in the market, is often a sign that markets are at or close to the bottom of a cycle.

Figure 2: Real estate should deliver attractive returns over five years, underpinned by strong capital growth

Forecast Pan-European Real Estate Returns 2025-2029



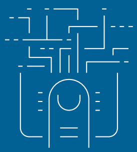
Source: Fidelity international, CBRE, Q4 2024

[2] MSCI UK Monthly Property Index, January 2025.

However, allocators at institutional investors remain concerned about relative pricing. With CBRE forecasting 5-year gross total returns of 9.6% at an all-property level for prime European real estate, driven by attractive running yields, good rental value growth, and modest yield compression, this suggests that returns in the asset class should compensate investors for the risk profile of the asset class (see Figure 2).

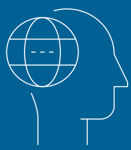
In the absence of short-term macro growth, lean into longer-term themes

We continue to believe there are four key themes that provide momentum for real estate investment:



Technological change

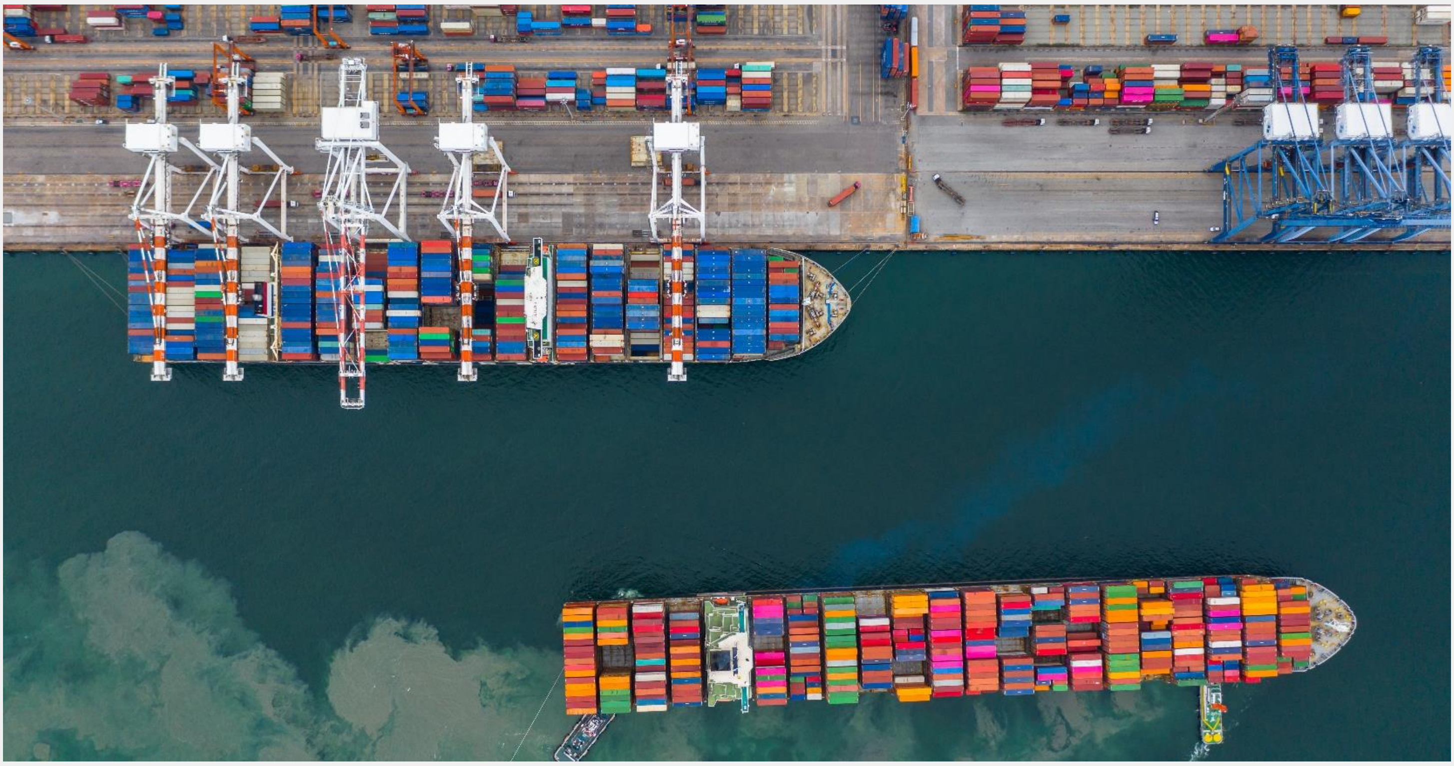
Demographic change



Geopolitics

Sustainability

As an asset class that benefits from long-term holds, ensuring that investment strategy is aligned with these themes becomes even more important. We explore how these themes apply to the key real estate sectors below.



Industrial & Logistics

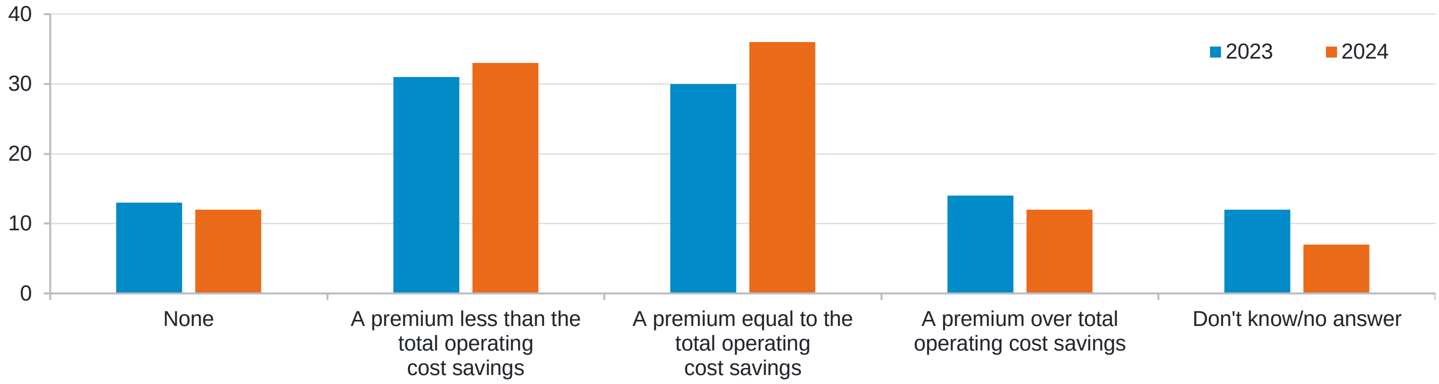
Increasingly driven by shifting global supply chains

Industrial/logistics assets remain on many investors' shopping lists as the sector continues to see good occupier demand driven by a number of longer-term themes such as technological change, geopolitics, and sustainability. Demand in the sector is being driven by two structural factors. Firstly, the pandemic and the Russia-Ukraine war have reshaped global supply chains, as companies shift from just-in-time to just-in-case models of supply chain management and seek to re-shore or near-shore some production to help limit disruption from geopolitics. This has resulted in strong demand from 3rd party logistics (3PLs) players and manufacturers. Secondly, sustainability factors have been rising up occupier priority lists, with a particular focus on energy efficiency, as it offers the opportunity for cost savings in a sector where margins are slim. The sector is well suited to the development of on-site power generation through photovoltaic panels, wind turbines, and heat pumps, helping companies meet their net zero carbon commitments. This can also help in the procurement of energy for energy-intensive processes such as robotics and warehouse automation, which are becoming increasingly important in managing total operating costs.

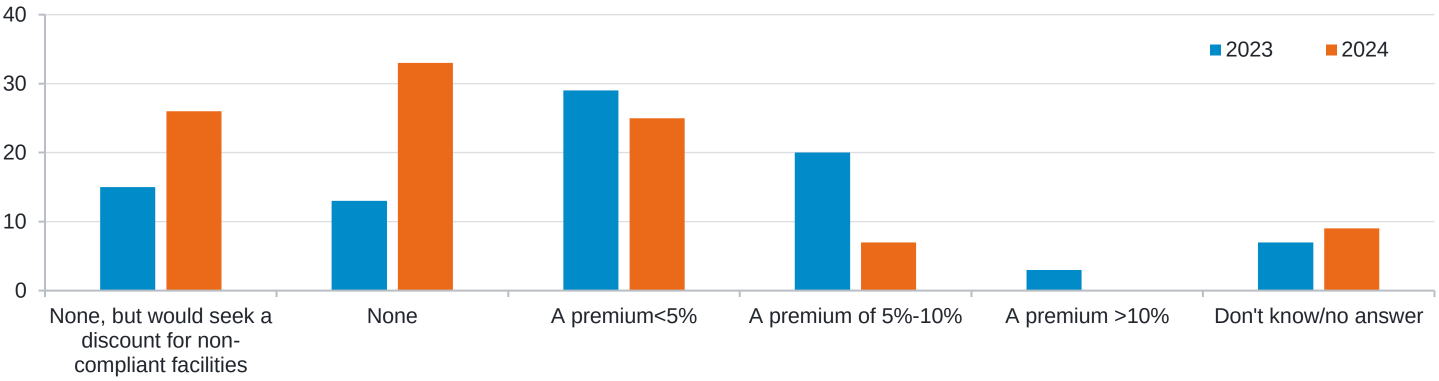
While the acute shortages of space seen in 2022 have been alleviated by development activity, demand is expected to remain sufficiently robust to drive rental growth of 2%-4% per annum over the next five years. Supply and demand are closer to being well-balanced, but increased planning regulation will help to limit new supply

Figure 3: Occupiers are willing to pay a premium for green energy, but green building certifications are increasingly non-negotiable

Willingness to pay a rent premium to switch to green sources of energy



Willingness to pay a rent premium for a green certified facility



Source: CBRE European Logistics Occupier Survey, July 2024.

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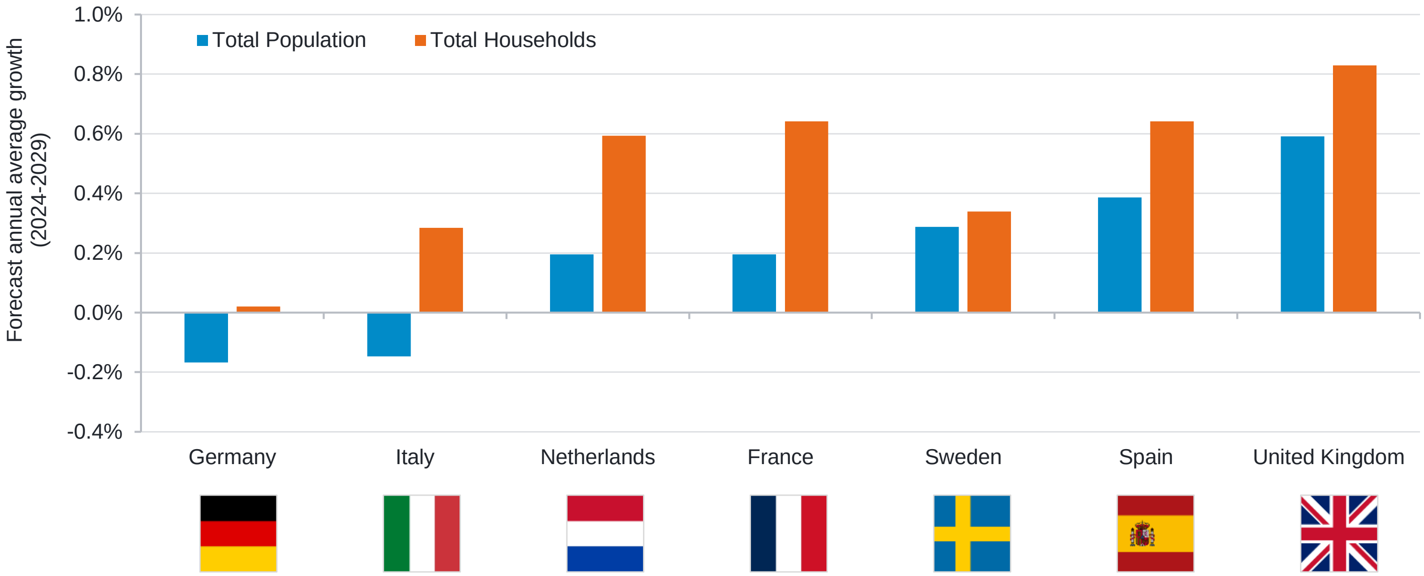
Residential

Falling supply of new developments at a time of soaring demand

The residential sector continues to benefit from demographic change (see Figure 4). Continued urbanisation across Europe is creating demand for housing, as is the changing structure of households, with both a growing number of households and fewer people per household.

Issues of housing affordability have affected a number of European markets, driving younger households to rent for longer, while demand from older households for senior living accommodation is also rising. In contrast, a number of developers have become insolvent as delays to construction, significant construction cost increases, and significant increases in the cost of debt made developments financially unviable. The knock-on consequence is that at a point where many European markets need to see more house building, house building activity is slowing significantly. This imbalance in supply and demand is expected to deliver good rental growth. While these macro trends are important at a market level, recent studies have shown that micro location qualities are key in delivering the best growth. These factors can differ from country to country, city to city, and even street to street, so good knowledge of local markets is important in delivering strong rental growth.

Figure 4: Household growth remains a driver of demand, even in markets where population growth is limited



Source: Oxford Economics, December 2024.

Offices

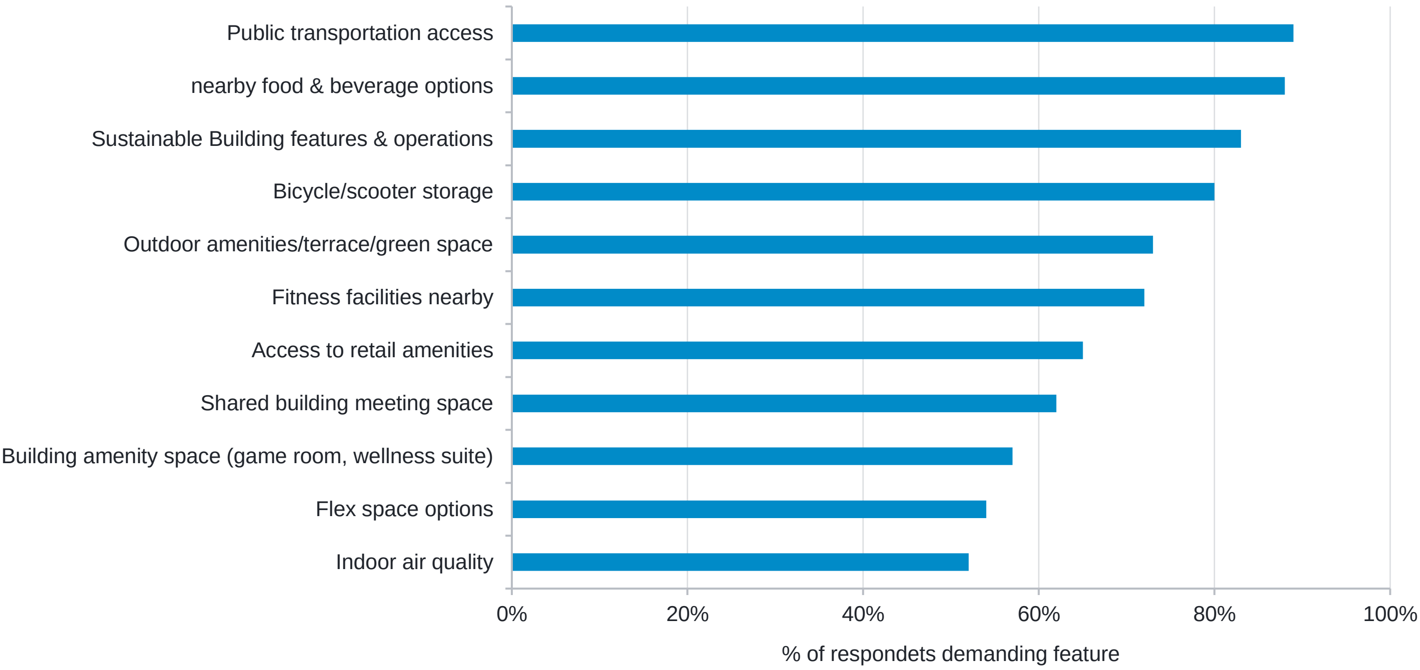
Building obsolescence, rather than hybrid working, of increasing importance to sector

For office occupiers, their building is often a significant contributor to their overall carbon footprint, and the quality of the office and its surrounding environment is key to attracting workers back to the office. Therefore, their focus is often on the highest levels of certification, with BREEAM excellent or its equivalent being a "must have". Other certifications relating to digital infrastructure and wellness are also growing in importance (see figure 5).

The shortage of space that meets occupier requirements has been responsible for headline prime office rental growth of 6.7% on average across major European markets[3]. Markets such as the City of London recorded rental increases of 12.8% in the year to the end of Q3, despite the overall vacancy rate exceeding 10%. For investors with good active asset management skills, this provides an excellent opportunity to deliver brown-to-green renovation projects in accessible amenity-rich locations. However, the cost of renovation needs to be supported by rental values, and in many second-tier markets, this may make such strategies uneconomical.

Despite the evidence of strong rental growth, investors remain wary of the sector. Concerns focus on the risks of obsolescence, the cost of renovation to the required green standards (and whether rental growth will be sufficient to support the renovation), and the continued shift in occupier requirements. While commentators have written much about how hybrid working is here to stay, and the 'ideal' model being two-to-three days per week in the office, recent headlines suggest that employers are beginning to think differently. Some companies are calling for a full return to the office, while others are enforcing office attendance more rigorously. Occupation rates are continuing to rise. Companies may decide to continue to extend existing leases to see how occupation rates change under more stringent policies, but with many having put off moving for some years already, the desire to upgrade their space and ensure they are able to recruit and retain talent may prove to be a bigger driver of demand.

Figure 5: Office occupiers are demanding flexible and sustainable space in amenity-rich locations



Source: CBRE EMEA Office Occupier Sentiment Survey, July 2024 - Most in-demand building/location features

[3] Cushman & Wakefield, December 2024.

Specialist sectors

Demographics and rapid technological change the driving forces

Drivers of demand for specialist sectors are particularly well aligned with some of the long-term themes driving performance. Life sciences, health care, and senior living should all see strong demand growth as a result of demographic change in Europe. Technological change is driving strong interest in data centres as generative AI spurs demand for space, but restrictions on grid capacity make identifying new locations challenging.

The life science sector has had a couple of quieter years. There was a post-pandemic drop in venture capital investment in the pharmaceuticals sector, but activity has picked up in 2024. This suggests a likely renewed interest in the sector with good demand from life science occupiers. Location remains very important to the sector, especially within clusters around universities, teaching and research hospitals, or major pharmaceutical hubs. Limited space in these clusters constrains supply for both occupiers and investors. We expect renewed interest in the sector will provide attractive returns.

Specialist sectors are likely to draw increasing interest from investors as they rebalance their portfolios away from office and retail assets where concerns remain about long-term demand. These trends will contribute to changing the shape of the typical portfolio in Europe over the next five years. These sectors are not only well-correlated with longer-term themes, but also provide further diversification benefits to portfolios.

Conclusion

2025 should be another good vintage for real estate. With pricing having stabilized during 2024, we believe investors can be confident that they are entering the market close to the trough.

For core investors, the opportunity to invest in a continuing story of rental growth, driven by shortages of space that meet new sustainability requirements, should help to deliver returns well above the 10-year pan-European average.

For value-add investors, current pricing also offers an attractive entry point into the market, and the focus of demand on best-in-class, operationally net zero carbon space provides the opportunity to deliver products that are in short supply into a market where demand is robust. Here, understanding exactly what occupiers are looking for will be important and, in particular, understanding the nuances of demand in different sectors and markets. As interest rates fall from recent peaks, debt should also become more additive to performance for those taking more investment risk. We expect returns of 12%-15% should be deliverable in both the office and industrial sectors.

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Important information