No boom, but no crash either

Due to the rise in interest rates, transaction momentum in the real estate investment markets is declining. However, letting markets remain stable. The current environment offers opportunities for investors with a strong equity base.

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The boom on the real estate markets is taking a break. And not just since the start of the Ukraine war. The coronavirus pandemic already ended one of Europe's longest real estate cycles at the beginning of 2020, despite the still chronically low interest rates at the time. It lasted a record 11.5 years. With rising vaccination rates and declining travel and access restrictions, real estate investors were already becoming more optimistic again at first - until Russian troops invaded Ukraine in February 2022. The long era of ultra-low interest rates ended abruptly at the start of the second quarter. This has not left the real estate markets unscathed.

Transaction momentum in the real estate investment markets is declining. This is because, when interest rates rise, investors using debt capital have to recalibrate their yield calculations. However, many sellers are currently still asking yesterday's prices for tomorrow's products. That's why negotiations are taking longer. The real estate investment market is balancing itself between the changing financing conditions, the prevailing price expectations of sellers and the increasing capital pressure in the market. In theory, a combination of rising interest rates and declining demand should cause real estate prices to fall significantly. But that has not been the case across the board, at least up to mid-2022. European real estate investors are evidently still in a pricing phase.

No evidence for general doom and gloom

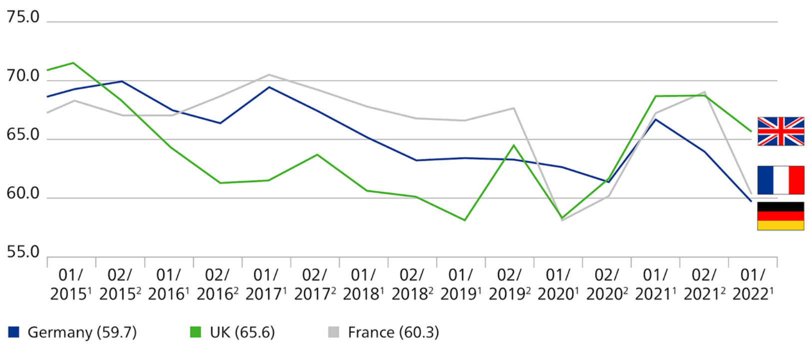
Certainly, some investors are thinking about investing the capital they would have used to buy real estate in other asset classes, such as government bonds, in the short term. On the other hand, against the backdrop of high inflation, many investors also accept a lower risk premium for real estate. After all, real estate is a tangible asset, and rents are often linked to inflation through indexed contracts. Fifty per cent of European real estate investors are sticking to their investment strategy despite the marked rise in interest rates, according to a recent survey of 150 property companies and institutional real estate investors in Germany, France and the UK by Union Investment. Some 39 per cent of respondents intend to invest less in real estate over the coming 12 months. However, there is no evidence for general doom and gloom: Only 3 per cent of survey participants plan to stop purchasing property altogether. The current adjustment period offer a great opportunity for equity-rich, long-term investors to secure high-quality properties now.

Positive trend in rental markets

Attractive spaces in well-connected locations that are both sustainable and modern and can be flexibly designed remain in high demand. This is also reflected in the rental markets: In Germany for instance, prime office rents continued to rise in the second quarter of this year. Despite slowing economic momentum and heightened uncertainty about future developments, this positive trend on the rental markets is likely to continue. This is because many companies that postponed their leasing decisions during the coronavirus pandemic are now returning to the market and, in the wake of back-to-office regulations, are increasingly looking for high-quality, flexible office space in which modern working environments can be implemented. As the supply of suitable space is likely to remain scarce in the future, a further upward trend in prime rents can be expected. In addition, many building materials have become scarce as a result of the pandemic and prices for these have risen accordingly, which is having a stabilising effect on rental levels via higher construction costs.

The real estate market segments in which rental income can be reliably generated and which accordingly offer extensive protection against inflation - provided a corresponding rent adjustment clause has been agreed in the lease - include office, residential and logistics properties.

Investment climate index – property investors



Source: Union Investment, real estate investment climate study I/2022 (survey of 150 real estate investors in Germany, France and the UK). [1]Survey period: Summer. [2]Survey period: Winter.

Yields are increasing

Purchase yields on the real estate markets are generally coming under moderate upward pressure in the wake of higher financing costs. In some cases, they have already risen slightly. For existing portfolios, however, yields are currently still stable despite the interest rate turnaround and rising inflation rates, construction and energy costs. This is also confirmed by the Union Investment investor study: A total of 37 per cent of the 150 real estate investors surveyed expect to see returns of 2 to 3 per cent on their existing stock over the coming 12 months, with 32 per cent even anticipating growth of between 4 and 5 per cent. One advantage of rising interest rates is that the cash positions in the portfolio are again yielding returns.

Investment climate in a downward trend

Uncertainty about the future direction of interest rates, energy costs and the economy is dampening sentiment among European real estate investors. The Real Estate Investment Climate Index compiled by Union Investment in Germany, France and the UK has fallen in all three countries. The mood in France has deteriorated the most: here, the barometer dropped by 8.8 to 60.3 points in the first half of 2022. In Germany, the index currently stands at 59.7 points, a fall of 4.3 points. In the UK, the barometer declined by 3.2 to 65.6 points.

Looking into the future is difficult at present. In principle, the real estate markets move relatively in line with the national or global economic cycle. Inflation, supply bottlenecks and war are currently limiting economic growth. Nevertheless, the economy is still growing. The European Commission forecast growth of 2.6 % for 2022 and 1.4% for the coming year in the Eurozone.

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