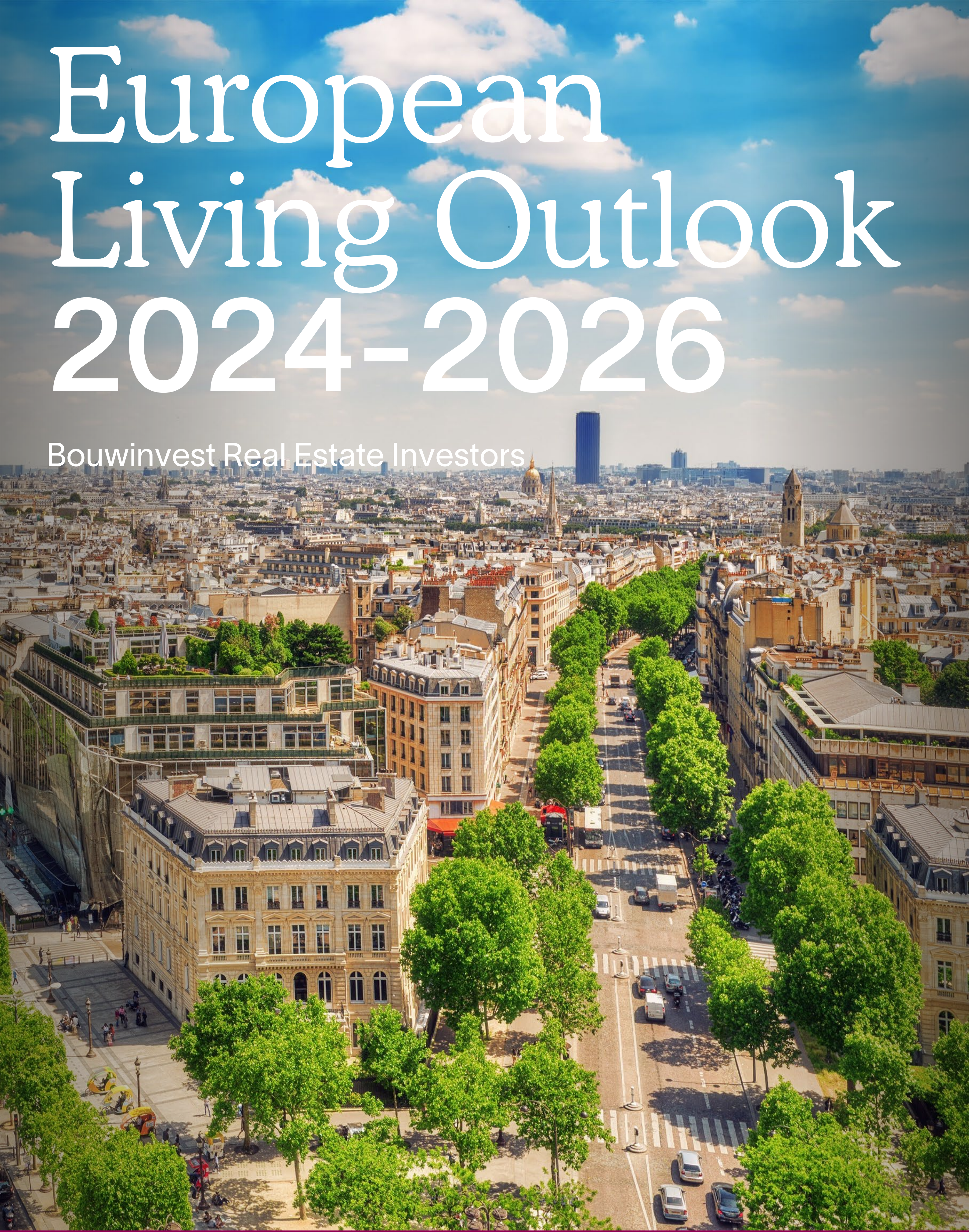
European Living Outlook 2024-2026

Bouwinvest Real Estate Investors



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Introduction

The share of living investments is set to grow significantly in institutional real estate portfolios. Not only traditional multifamily housing, but also upcoming subsectors like Purpose-Built Student Accommodation and Senior Housing are becoming highly sought after living investments.

Although the level of maturity and housing market structure differs between countries, the overall trend is that significantly more rental housing is needed, especially in the heavily undersupplied affordable housing segment.

While looking at the occupier market, macro-economic environment and investor market, we discuss key topics like migration, climate change and climate adaptation, regulatory change and social impact. We believe that institutional investors with strong ESG ambitions and a long-term investment horizon are in the position to tackle these challenges and support future housing demand.

In this Outlook, Bouwinvest discusses these developments with a specific focus on European living markets, each with its own characteristics, opportunities and challenges. We hope you find this informative. If you would like more information; please contact us at Bouwinvest.

Executive summary

Emerging living sector

- The European real estate landscape is reshaping, with living investments projected to become the largest real estate sector.
- The observed differences in maturity levels between markets can offer diversification benefits and cater to investors with different risk appetites.
- Driven by demographic shifts, ongoing urbanisation and evolving lifestyle preferences, demand for living properties continue to outpace supply, not only multifamily but also upcoming subsectors like PBSA and senior housing.

Strong market fundamentals

- The expansion of the 25-39 age group is expected to boost demand in some European markets, while ageing populations present opportunities in senior living.
- Home ownership is financially unfeasible for many European households, leading to additional pressure on rental markets.
- Investors, developers and occupiers are increasingly recognising the economic benefits of sustainable buildings to help reduce financial risks and increase long-term value.

Tailwinds become stronger

- Modest GDP growth is expected for 2024.
- Due to falling inflation, low unemployment levels, positive real wage growth, a recovery in consumer spending and the prospect of lower interest rates, a stronger growth is anticipated beyond 2024.
- ECB policy rates have currently peaked at 4.0%, with market participants now expecting interest rate cuts from mid-2024.
- The geopolitical landscape is changing, with important elections ahead, but more government incentives are expected to boost the new construction of homes.

Attractive entry moment

- To date, peak-to-trough capital value declines in Europe have been between 10% and 24%, with the majority of markets expected to have reached the trough.
- Improved attractiveness of yield spread levels, also in relation to other asset classes, but there is some way to go.
- Late 2024 and 2025 could prove highly profitable market entry moments.

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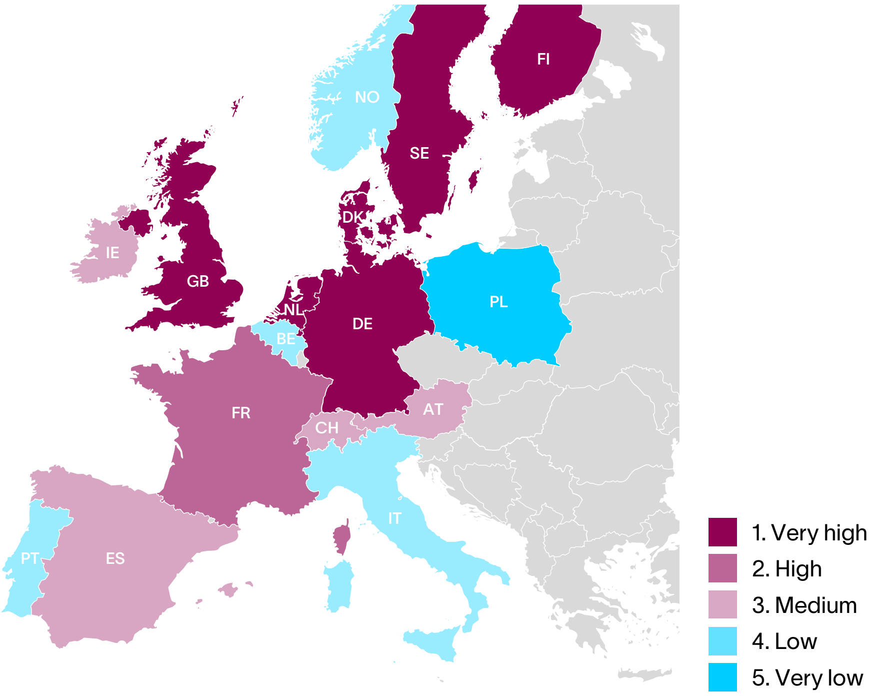
Setting the scene for Europe’s evolving living sector

A resilient asset class gaining more interest from investors

Living real estate has provided a compelling investment opportunity because of strong demand, undersupplied markets, relatively secure income streams, which sets it apart from commercial real estate. This distinction becomes particularly evident during economic downturns. While commercial real estate strategies may face immediate constraints or negative impacts, with higher vacancy and lower rent levels, owners of living properties benefit from enduring fundamentals driving demand, demonstrated by low vacancy and stable inflation-linked rent levels. Annual rent increases serve as a partial hedge against inflation and contribute to stable income returns. Also, surges in student enrolments and ongoing government spending on healthcare, regardless of fluctuations in economic growth, further bolster the case to invest in upcoming subsectors like Purpose-Built Student Accommodation (PBSA), senior housing and care homes.

Investments in living assets has been steadily gaining momentum, exhibiting strong growth in annual transaction volumes of 16.5% between 2011 and 2021. Even amidst current lower market activity, the resilience of living investments remains evident, with its share of overall real estate investment reaching 22% in 2023, compared with 26% for offices. The European real estate landscape is reshaping, with living investments projected to become the largest real estate sector, mirroring the trajectory witnessed in the United States. Living investments accounted for 28% of total real estate investment in the United States in 2023 and are expected to exceed 33% by 2030.

Figure 1: Level of maturity for European residential markets



Source: Bouwinvest Research (2024)

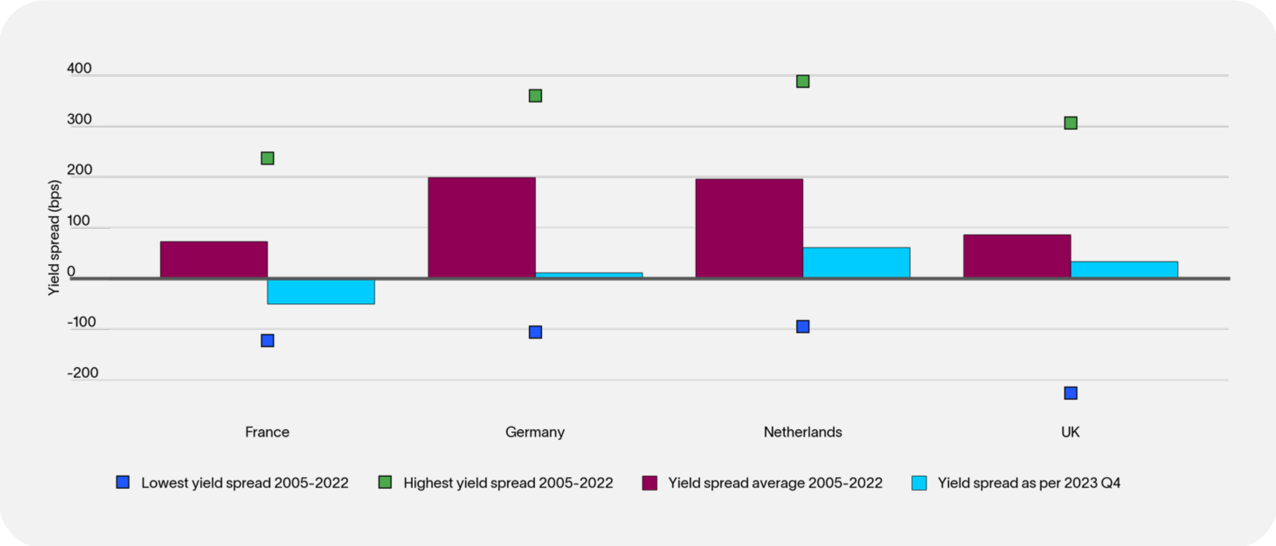
Despite the nascent stage of living investments in many parts of Europe, the living landscape is evolving rapidly, as emerging markets and subsectors gain more interest from institutional investors and are becoming more mature and transparent. The maturity levels of various European countries can be quantified by looking at transaction volumes, number of active (international) investors, number of deals, quality of stock, history of data availability and the size of the rental market. The observed differences can offer diversification benefits and cater to investors with different risk appetites. In the map above, we indicate the overall maturity level per country.

‘The European real estate landscape is reshaping, with living investments projected to become the largest real estate sector.’

Attractive entry moment ahead as yields stabilise and yield spread widens

The more mature living markets in Europe peaked around Q2 2022. According to the MSCI valuation-based index, capital values dropped by approximately 10% to 15% in the following 18 months. We expect modest further declines for some European living markets in 2024, after which we expect to see a gradual recovery. This would take the duration of the current (and ongoing) peak-to-trough close to around ten quarters.

Figure 2: Net Initial Yield spread to 10-year government bond rates



Source: MSCI, Oxford Economics (2024)

At 60 basis points, the Netherlands has the highest yield spread as per Q4 2023, when compared to France, Germany and the UK. If it were to revert closer towards the long-term average, as applicable for all markets, a further yield decompression is expected in the course of 2024.

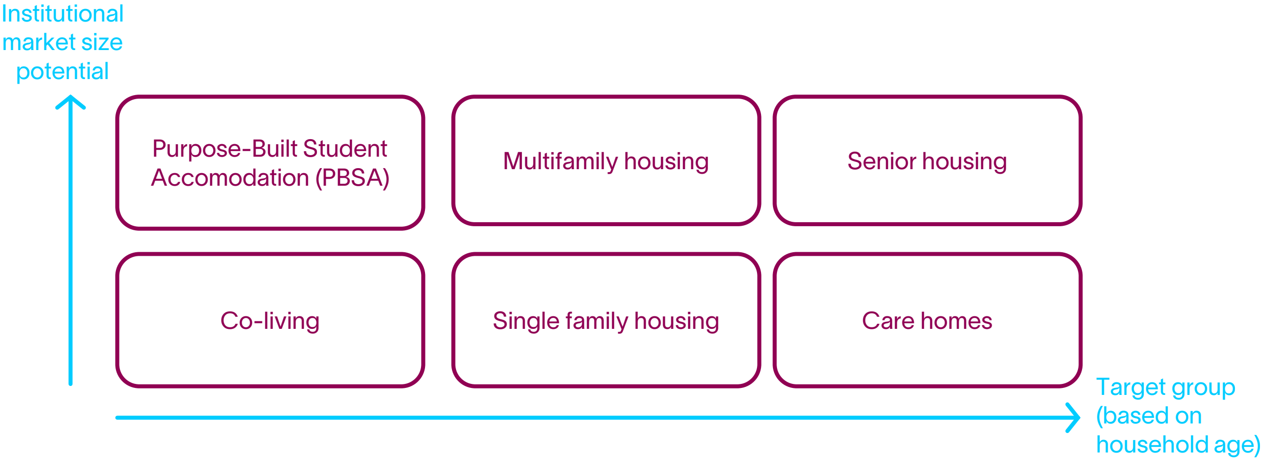
Once inflation and interest rates stabilise further, we expect living yields to follow suit. An expansionary monetary policy with lower interest rates will increase the yield spread for living investments, making them relatively more attractive from a pricing perspective in the course of 2025. Subsequently, increased investor appetite and improving financing conditions could drive yield compression and improving values.

Living sector more than just multifamily housing

Driven by demographic shifts, ongoing urbanisation and evolving lifestyle preferences, demand for living properties continues to outpace supply. The share of 80+ inhabitants in Europe is expected to increase from the current one in fifteen to one in seven in 2050, boosting demand for care homes, while significantly more senior housing is needed for people below that age group. Overall household growth is expected to be positive, at around 0.7% p.a. between 2024 and 2028, aided by an increase in the number of one-person households. Moreover, provision rates for student housing show a demand-supply gap as the number of student beds available compared to the total number of students is approximately 15% on a European level.

Across all target (household) groups, the overall trend is that significantly more rental housing is needed, especially in the heavily undersupplied affordable housing segment. The prime rental age cohort of 25-39 years old is expected to show sustained growth in selected markets in Europe and will boost demand for multifamily housing relative to single family housing as households become smaller. Subsectors like PBSA and senior housing are also increasingly becoming a standard part of institutional living portfolios, while investments in co-living concepts and care homes are still developing in terms of maturity from an operational perspective.

Figure 3: Living landscape*



Source: Bouwinvest Research (2024)

This European Living Outlook delves into the investment potential of the European living sector, focusing on multifamily housing and PBSA. We refer to our Dutch Market Outlook 2024-2026 for more details on senior housing and the Dutch healthcare market:

https://www.dutch-market-outlook-bouwinvest.nl/outlook/healthcare-market

** This overview is simplified, as we recognise that more living subsectors are available, including more shared living and healthcare concepts.*

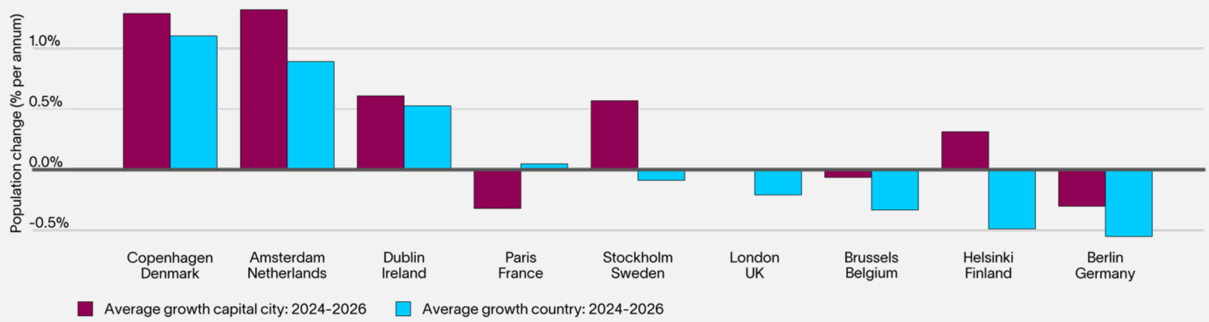
Demographic trends supportive of strong market fundamentals

Immigration and strong household growth main drivers for housing demand

We expect the number of people in most European countries, specifically individuals aged 25 to 39 (prime rental age group), to peak in 2024, followed by a modest decline in subsequent years. Notable exceptions to this pattern include Denmark, the Netherlands, and Ireland, which are poised to sustain growth within this age cohort throughout the whole forecast period. The expansion of this age group is expected to boost demand in respective for-rent markets, particularly in Amsterdam, Dublin, and the Nordic capital cities. Germany and Finland anticipate a more pronounced ageing of their national population in the period 2024 to 2026, which will create opportunities within certain living subsectors such as senior housing and care homes.

'The expansion of the 25-39 age group is expected to boost demand in some European markets, while ageing populations present opportunities in senior living.'

Figure 4: Population of 25-39-year-olds (% change)



Source: Oxford Economics (2024)

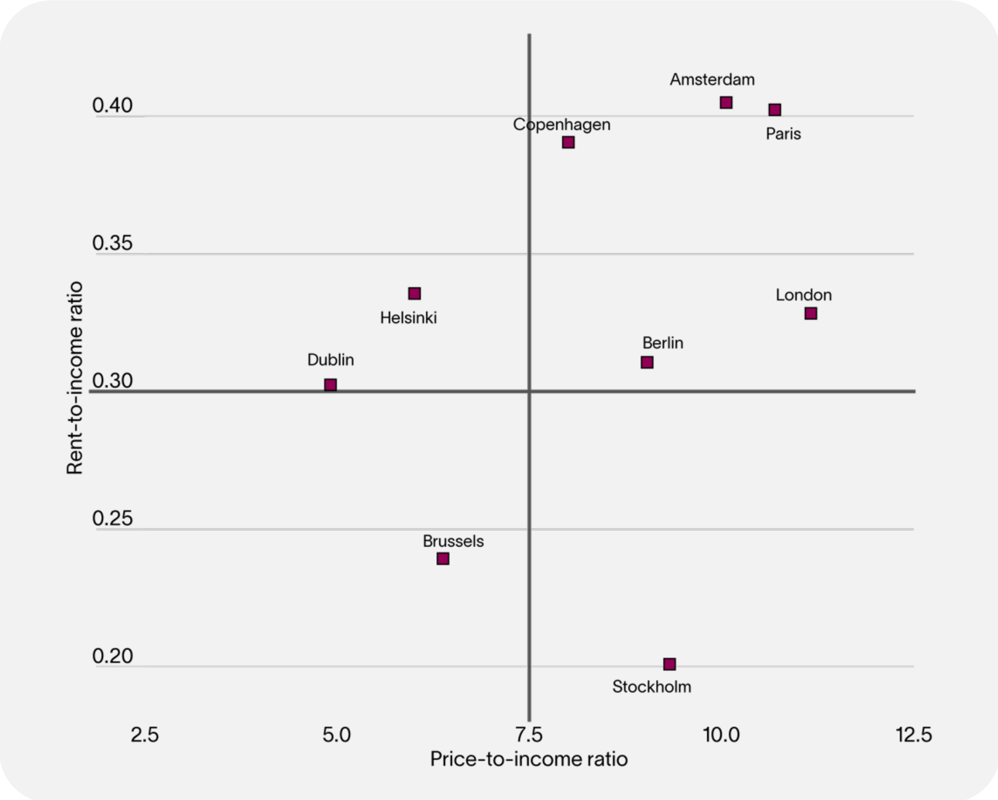
The figure above shows the annual growth of the prime rental age group of 25–39-year-olds, both on a national level (blue) and at capital city level (purple).

Ageing populations in Europe present economic challenges in the longer term, from a real estate perspective this presents opportunities in senior living, compounded by a decline in political backing for immigration in several countries. Migration continues to be the main driver of population growth across many markets in the region, with anticipated shifts in migration policies coinciding with upcoming elections in 2024 in the UK, the European Parliament and Belgium and other countries. Given the possible tightening of immigration laws post-elections, we anticipate a modest increase in migrant arrivals in 2024, as the impact of more restrictive policies could create a perceived final opportunity window for those considering migration to Europe.

Challenging affordability strengthens case for renting

The growing trend of European households entering the rental market can be attributed to the rise in mortgage costs, often exacerbated by substantial deposit demands, rendering home ownership financially unfeasible for many households. However, this influx into the rental sphere is intensifying an already tight market in most cities, pushing up rental costs. In the figure on the next page, we have defined affordable house prices as 7.5 times the nominal household income, or monthly rental costs as 30% of nominal household income. In our assessment of home ownership affordability across major European cities, Paris, Amsterdam, London, Stockholm and Berlin emerge as the markets in which home ownership is the least attainable given their respective average disposable incomes, followed by Copenhagen. In the rental market, Paris, Amsterdam, and Copenhagen stand out as the most expensive, gauged by the average apartment rent relative to the average disposable household income. Stockholm's effective rents are the lowest in the sample due to practically every single (legal) rental unit being regulated. This gives the country affordable but limited solutions for its inhabitants, which forces a portion of its tenants into the expensive grey segment of the market.

Figure 5: Affordability of a selection of European markets (80-square metre dwellings)



Source: Catella, Oxford Economics (2023)

Combining the rent-to-income ratio (average monthly apartment rents versus average monthly household disposable incomes) with the price-to-income multiple (average apartment price versus average annual household disposable income) gives us insight into the affordability landscape in European capital cities – and subsequently reveals whether the current market favours buying or renting a property. The figure's limitations include the consideration of income inequality, price levels and any miscellaneous market-specific forms of ownership costs/benefits. So, while home ownership looks to be relatively affordable in Dublin using these metrics, it is important to bear in mind the skewed nature of average disposable household income figures based on regional accounts.

Demand for multifamily remains significant due to limited new supply

As house prices have proven to be somewhat inelastic against elevated mortgage rates across many European markets, for-rent solutions are likely to remain a popular option. Vacancy is expected to remain below 3% for Amsterdam, Berlin, Brussels, Copenhagen and Stockholm over the outlook period of 2024-2026. With the exception of Sweden, the Netherlands, the UK and France, home completions are projected to outpace household growth on a national level in these markets (see figure next page), although we argue that persistent urbanisation and generally higher supply constraints in their respective (capital) cities will continue to drive demand.

One example is Belgium, where on a national level the country has seen a significant surplus in construction completions over the past decade. While Brussels remains a relatively affordable city in a European context, the familiar combination of elevated mortgage rates, persistent urban household and job growth, declining household size and limited completions of (rental) housing within the city limits will continue to drive rents up in the city going forward. Amsterdam and Berlin are characterised by a similar story, although the imbalance between supply and demand is much more pronounced in these cities, reflected in their poor affordability compared with Brussels. Our expectations for market rental growth (CAGR) for the period 2024-2026 lies just above 4% for Berlin, around 3.5% for Amsterdam and at roughly 3% for Brussels.

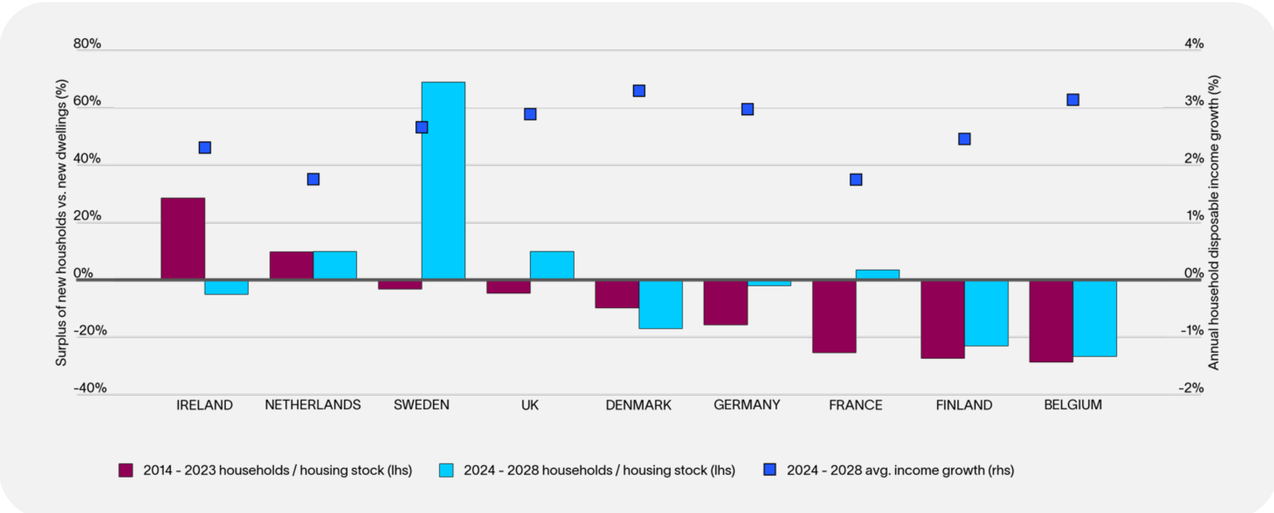
Occupancy rates have been slightly more volatile in Dublin in recent years (correlation with tech sector employment), Paris (migration to the suburbs) and London (post-Brexit uncertainty). For Ireland, national level data show that Ireland's home completions over the past 10 years have been the lowest when compared with household formations in our sample. This, combined with a steady flow of people aged 25-39 expected to migrate towards Dublin over the outlook period, suggests that its multifamily sector will see robust and consistent demand growth for the foreseeable future.

'As house prices have proven to be somewhat inelastic against elevated mortgage rates, for-rent solutions are likely to remain a popular option.'

Residential occupancy for Paris and London stood at roughly 96% at year-end 2023. For London, we expect multifamily demand to accelerate over the outlook period, as the UK is one of the few markets in our sample where household growth is set to outpace the addition of homes on a national level. Historically, the United Kingdom has maintained lower barriers to housing supply compared with many other mainland European markets, although London is a notable exception to this national characteristic. The city is grappling with more constrained land availability, and the absence of new rental supply in the London market prompts us to anticipate an exacerbation of the shortage of residential units at city level.

Shifting focus to Paris, the outmigration of its population aged 25-39 is expected to ease over the outlook period, although a reversal to positive migration appears unlikely after this. The supply of new residential units in Paris is expected to decline significantly, following a period marked by robust apartment deliveries from 2017 to 2019. While this is poised to exert some additional pressure on existing rentals in the city, our analysis does not foresee a substantial uptick in rents over the outlook period. We do expect market rental growth (CAGR) in Paris to outpace inflation at 2.5% annually during the outlook period, while we expect rents to grow at a faster pace for London and Dublin, i.e. between 3.5% and 4.0% per annum over the outlook period.

Figure 6: Household and supply growth of a selection of European countries



Source: Oxford Economics, Green Street, ABF (2024)

A ratio above 0.0% signals that household growth is projected to surpass housing starts in the designated market. Ireland and the Netherlands emerge as appealing occupier markets, as their historical demand/supply dynamic in both cities favours rental growth. Construction is expected to pick up in most markets versus household growth the coming 10 years, although notable exceptions are Sweden, the UK, the Netherlands and France. While Denmark, Germany and Belgium saw their national markets become less undersupplied, rental growth is supported by strong nominal income growth. It is also likely that the supply-demand imbalance is much more severe than the national level in certain sub-markets, mainly larger cities.

PBSA fundamentals look uniformly strong

In the past decade, international student numbers have generally surged across most European markets, oftentimes colliding with the capacity to host them. We have recently seen governments push back somewhat on the growth of their country's international student base, with examples being Finland raising fees for non-EU students, Denmark limiting the number of English language programmes, with the Netherlands likely to follow suit for its bachelor degrees, and the UK limiting options for students to bring dependents into the country, as well as raising the required salary for skilled-worker visas. France's proposed restrictions on international students were recently found unconstitutional, although negative sentiment is likely to result in the introduction of other restrictive measures in the near future. Part of this sentiment stems from a perceived pressure on available resources, such as educational facilities, healthcare capacity and of course pressure on the rental housing market. We want to make note of Ireland and Germany, as their sentiment appears less negative right now, which bodes well for their ability to attract talent going forward (with Ireland having the added benefit of offering (all) its courses in English, while English-taught undergraduate programmes in Germany are scarce).

While taking into account whether a country's government 'fears' or 'favours' international students is important when analysing the respective occupier markets, the existing shortage of student housing in many of the target markets is unlikely to see significant relief as a result of such policies. High interest rates impacted investment activity throughout 2023, as underwriting new developments has become problematic in some instances. As a result, the inadequate supply of PBSA beds versus the number of students has generally not changed by a significant margin in the period 2022 through 2023. Nor do we expect any significant relief of this imbalance soon, as development economics have deteriorated over the past period, limiting the number of realisable projects (though most definitely not making them impossible).

Markets such as Stockholm and Dublin have experienced a slight increase in supply relative to student numbers, while some UK cities (e.g. London, Bristol and Glasgow) saw a modest decline. Notably, UK-wide annual market rental growth came in at approximately 13% in 2023 according to Bonard, much higher than the European average of approximately 5.5%. For other markets in the region, the supply pipeline post 2023 is trending downwards, which adds further pressure to the limited number of student beds and adds a further push to rental growth.

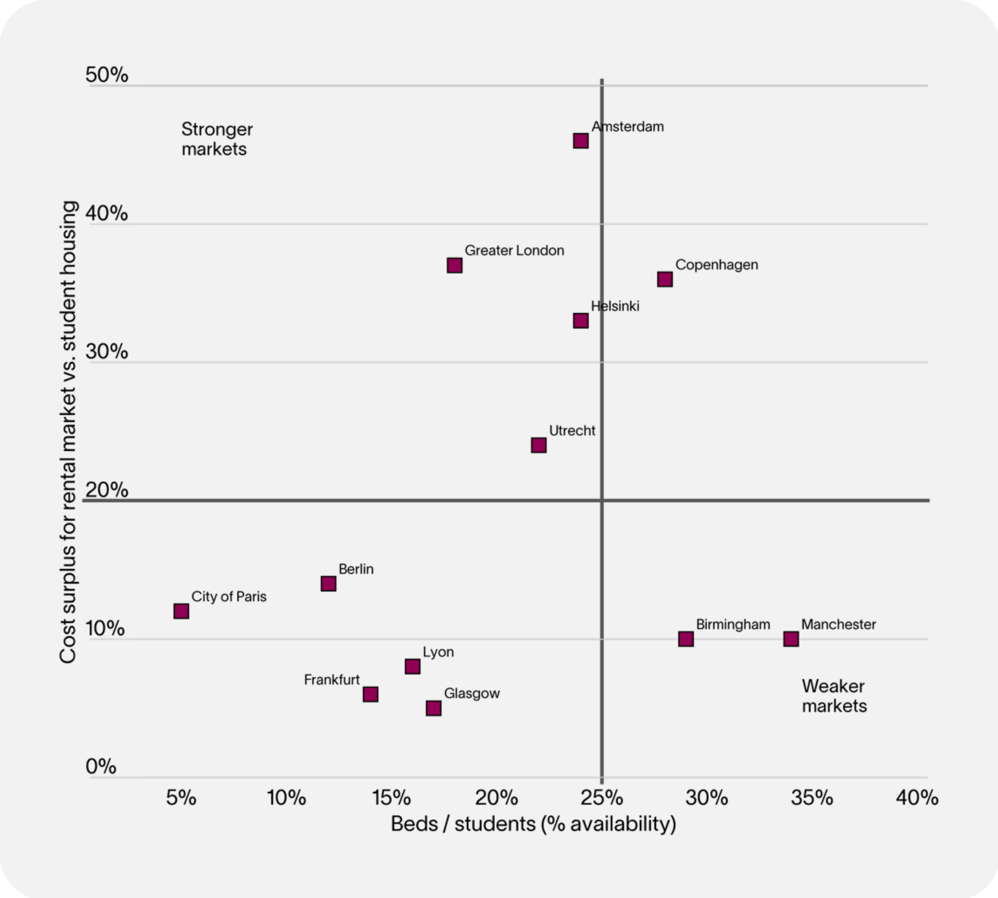
While cities with a lower provision rate (available beds per student) may appear more attractive for new student housing developments at first glance, we also take into account how the 'regular' for-rent market compares with student housing in terms of rental costs. Provision rates are higher in cities like Amsterdam, Helsinki and Copenhagen, but the high costs of renting a studio on their respective 'regular' for-rent markets will increase the demand for local student housing stock, as it is relatively cheaper. Most French, German and regional UK cities have more comparable all-inclusive costs between student housing and the 'regular' for-rent market. Students are better able to compete for rental apartments in these cities and are less dependent on the available student housing stock.

'We see the higher NOI margins that characterise student housing allowing for adequate and stable returns for investors.'

A substantial fall in rental listings after the university summer break in cities like Lyon, Manchester and Birmingham is in part a result of this heightened competition for 'regular' for-rent housing. The city where 'regular' for-rent listings declined the most after the summer break was Utrecht, which means that despite its 'regular' for-rent units being relatively expensive versus student housing units, the shortage of PBSA (despite its relatively higher provision rate) is probably still driving students to look for a studio (or shared apartment) on the 'regular' for-rent market.

Given the sector's increasing institutionalisation, we expect it to align even more closely with policy frameworks similar to the multifamily sector, although the potential for return diversification in a European living strategy remains potent. We see the higher NOI margins that characterise student housing over regular rental housing, combined with higher turnover rates, as positive attributes for navigating the stricter regulatory frameworks found throughout the region, allowing for adequate and stable returns for investors.

Figure 7: Availability of student housing beds versus relative cost of the 'regular-for-rent' market



Source: JLL, Bonard, Savills (2023)

Here we plot the provision rates of PBSA (Beds/Students) versus the affordability of PBSA versus PRS (cost of renting a studio in both segments). While cities with a lower provision rate appear more attractive at a first glance, we also take into account how the public rental sector competes with PBSA for tenants. While provision rates are higher in Amsterdam, Helsinki and Copenhagen, the high cost of renting a studio on the PRS market will increase the pressure from students on the existing PBSA stock.

ESG policies influenced by more regulation and increased focus on social impact

Investors, developers and occupiers are increasingly recognising the economic benefits of sustainable buildings to help reduce financial risks and increase long-term value. This is done by lowering operating costs, vacancy rates and financing costs, which ultimately leaves investors with a more attractive asset at exit. Increased regulation is an important driver behind the development and implementation of more ambitious ESG policies across Europe.

Environmental

Investors are increasingly prioritising decarbonisation to maintain asset value. Many managers are adopting science-based targets, like the CRREM tool, to assess and predict asset stranding risks. However, incomplete utilities data and lack of data collection systems in the living sector poses a challenge for effective decarbonisation strategies. While the focus has traditionally been on operational carbon emissions, there is growing recognition of the significance of embodied carbon, leading to increased tracking of whole lifecycle emissions, including investing in circular buildings that use renewable materials (e.g. bio-based and timber). Consequently, there is a shift towards brown to green initiatives, with retrofitting and repurposing buildings seen as valuable opportunities to enhance asset value and resilience.

Climate change poses systemic risks to the European housing market, prompting investors to integrate climate change risk assessment into their processes, focusing in particular on physical asset-level risks and the increasing impact of extreme weather events. Prioritising business continuity and mitigating financial losses through understanding asset vulnerabilities are essential strategies for ensuring real estate resilience in the face of climate change.

Social

The focus in Europe has been on environmental factors such as reducing CO2-emissions as a more tangible target, while the impact of social factors is more difficult to measure. Evidence of this is the EU social taxonomy, which has been shelved and is expected to remain shelved for the next couple of years. The policy focused on three objectives: i) decent work ii) adequate living standards and the well-being of end-users and iii) inclusive and sustainable communities and societies. Fortunately, developers are incorporating features such as accessible design, green spaces, and amenities that promote well-being and community engagement.

Within the living sector, affordable housing is an issue in many European Union member states. The high cost of housing has led to concerns about social exclusion, homelessness and an imbalance in housing markets. In response, the EU and EU member states have introduced several initiatives to stimulate developments by de-risking the sector. It is therefore an attractive real estate strategy, as it both addresses social needs and creates stable cash flows as a result of strong market demand, while the sector remains stable in challenging economic environments.

Governance

The European Union has been actively developing regulations and frameworks to promote ESG practices for the real estate sector, including the living sector. While EU regulations, such as the SFDR, EU Taxonomy and CSRD, etc. provide common frameworks for member states, each country has some flexibility in how they enforce specific ESG regulations in the context of their own national laws. As a result, there are variations in the strictness of regulations across various EU countries. France, Germany and the Netherlands are known to be the countries with the most rigorous regulations that should stimulate high ESG ambition levels.

The EU's Energy Performance Building Directive (EPBD), in particular, is expected to have a significant impact on the European living sector in the near future. EPBD version IV will likely take effect from 2025. As EPC label definitions can differ materially between countries, the EPBD proposes a rating scale for energy efficiency in which the 15% least efficient buildings are classed as 'G' and zero-emission buildings are classed as 'A', while residential buildings must achieve class F by 2030 and class E by 2033. The ultimate goal is that all buildings should be zero-emission by 2050.

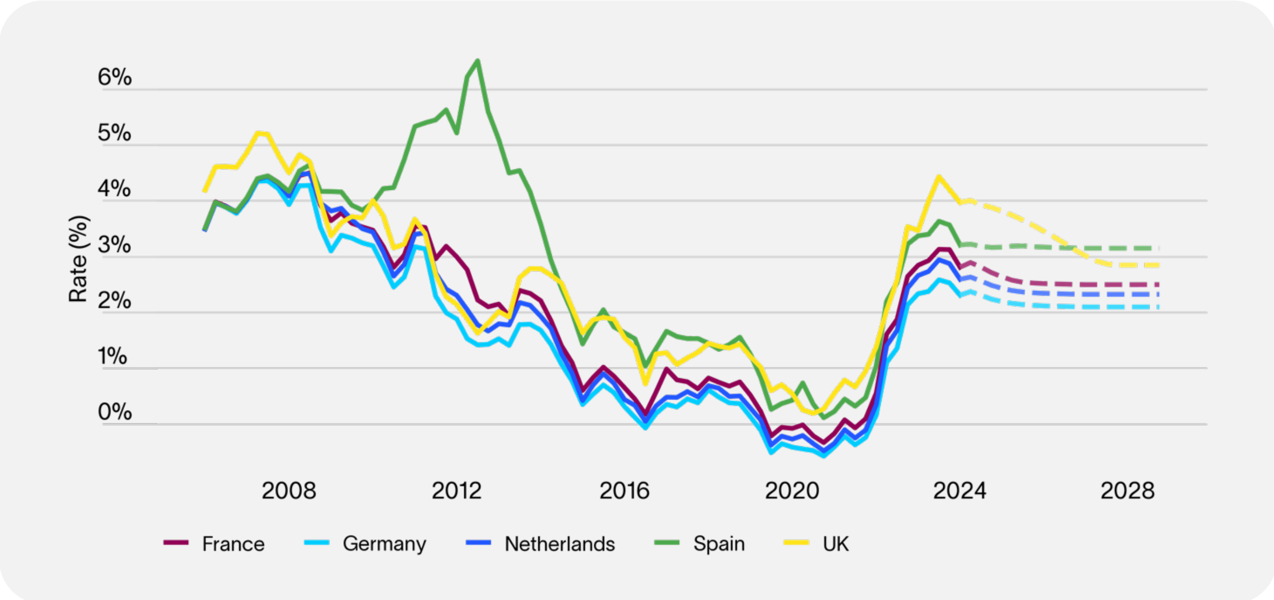
European economy preparing for pronounced recovery in 2025

Lower interest rates supportive of higher economic growth

The Eurozone economy grew modestly in the 2023 calendar year, trailing the economies of the US and the Asia-Pacific region. Geographical proximity to conflict and the resulting impact on energy prices has been a drag on Europe's economic performance. The largest economy in Europe, Germany, contracted by -0.3% in 2023 compared with solid real GDP growth in Spain (2.5%). A restrictive credit environment, negative sentiment indicators, as well as prolonged tight monetary and fiscal conditions, will inhibit the growth of the Eurozone economy in 2024. As of May 2024, Oxford Economics expects modest GDP growth of 0.8% this year. However, due to falling inflation, low unemployment levels, positive real wage growth, a recovery in consumer spending and the prospect of lower interest rates, stronger growth is anticipated beyond 2024.

The consensus view in the market is that ECB policy rates have peaked. The ECB has raised its deposit rate from minus 0.5% in early 2022 to the current 4.0%. Market participants now expect the ECB to start cutting rates from mid-2024 onwards, which should lead to a decline in risk-free rates and will have an impact on living yields and yield spreads.

Figure 8: 10-year government bond interest rates in Europe



Source: Oxford Economics (2024)

Geopolitical landscape changing, with important elections ahead

Important elections are due to take place in Europe, e.g. in the UK (no later than 28 January 2025) and the European Parliament (6 June 2024). Key topics in many European countries include migration patterns, poverty reduction, affordability of and access to the housing market and climate change and adaptation.

Many (Western) European countries are facing a huge challenge to house incoming migrants. These mainly include both highly skilled and low-skilled workers, but also refugees from (political) conflict. Rising numbers of international students are also putting pressure on various local housing markets. The vast majority of immigrants rent (and continue to rent) rather than purchase a home on arrival.

Faced with the challenge of reducing poverty and improving affordability and access to housing, many governments in different jurisdictions have introduced a range of rent control measures. While existing tenants may benefit, investors are worried that this will lead to a reduction in investment and the development of new rental housing, exacerbating the fundamental problem of a lack of supply.

The issue of climate change and adaptation covers a broad range of related topics, such as nitrogen emission problems and its impact on the built environment and infrastructure. Farmer protests in many European countries are demonstrations of societal unease. Resulting delays in zoning, planning and delivery of new-build homes are increasing shortages in various European housing markets. In addition, limited expansion options in electricity infrastructure are restricting the number of new construction projects.

Regulatory landscape defined by rent regulation and government incentives

Since its inception in the 1950s, the European Union has promoted an open investment environment through the harmonisation of national investment laws and regulations, many of which are also voluntarily applied by non-EU states such as Norway and Switzerland. The management of investment structures based in the European Union may be subject to the Alternative Investment Fund Manager Directive (AIFMD), which is designed to harmonise financial legislation throughout the EU. The UK has similar legislation, which has its roots in the AIFMD. The AIFMD is subject to constant review, with the aim of enhancing regulatory clarity and investor protection in the investment fund industry.

> 'Throughout Europe, governments are introducing more incentives to boost the new construction of homes.'

The European Union has limited authority over the residential housing policies of its member states and consequently there is no harmonised legal framework for residential housing in the European Union. Politically, European countries have a long-standing tradition of seeing residential housing as a basic need, resulting in a wide array of country-specific rental regulations with a high degree of tenant protection and rules governing both the tenant-landlord relationship and rent control mechanisms. Tenants usually have access to low-threshold and low-cost dispute resolution mechanisms. In the face of the structural housing shortage in major metropolitan areas throughout Europe and the resultant increase in rents, both local and national lawmakers have stepped up government regulation of the private residential housing market to counteract market excesses.

In the Netherlands, for example, the central government has proposed an affordable rent act, which is intended to regulate mid-market rents by capping the rent for these homes based on several points attributable to the home. In Germany, on the other hand, Berlin's local rent cap (Mietendeckel) was declared unconstitutional, testifying to the limited powers local governments have in terms of regulating their housing markets. Maintaining affordability while still having a viable business case to invest in rental homes remains the greatest challenge across Europe.

On the other hand, throughout Europe, governments are introducing more incentives to boost the new construction of homes. In Finland, the property transfer tax rate has been reduced to 3% from 4%, while the Belgian government is reintroducing the reduced VAT rate for new-build homes. In Germany, a number of relevant legislative changes have been introduced as part of the Growth Opportunities Act, including the increase of depreciation on residential properties to 5% per year. Additionally, apartments qualify for a temporary special extra depreciation. Governments are expected to introduce more incentives as European living markets need to stay competitive for institutional capital.

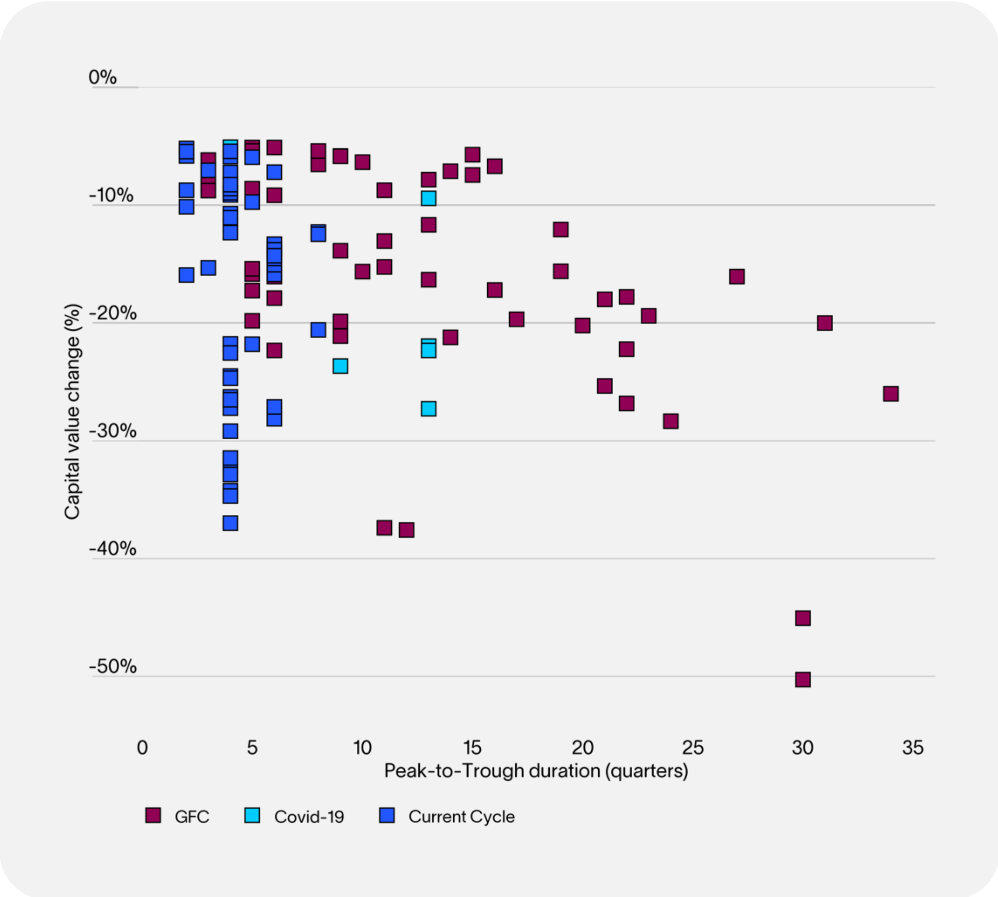
Attractive entry moment for investors as market conditions improve

Capital values expected to reach trough in course of 2024

As is the case in the US, the most mature residential markets in Europe peaked around Q2 2022. Based on the MSCI valuation-based index, since then residential capital values dropped by approximately 10% to 15% in the period to the end of Q4 2023. Capital value declines for transaction-driven and theoretical mark-to-market values, as measured by Green Street and PMA, were more pronounced, registering a cumulative decline of between 15% and 35% (depending on the local market).

Due to differences in valuation methods, lagging valuations (compared to transaction-based evidence) and the widely documented aspect of 'smoothing', differences in peak-to-trough capital value declines across the various European residential markets can be large. We expect modest further declines in capital values for some institutional European residential markets in 2024, after which we expect to see a recovery. This would take the duration of the current (and ongoing) peak-to-trough period close to around ten quarters.

Figure 9: Overview of historical capital value decline of European residential markets (peak-to-trough)



Source: Bouwinvest Research (2023)

Each square represents a city; the same city can be shown multiple times if affected by multiple crises.

Earlier peak-to-trough periods show that the longest duration of capital value declines happened during the GFC (Global Financial Crisis), as shown in the figure above. Many residential markets in Europe registered declines in capital value for 16 to 20 consecutive quarters. While it looks like the current duration of value declines might be shorter than during the GFC, cumulative value declines are similar. The time it took for the ECB to hike interest rates between June 2022 and September 2023 (by 450 basis points) was the fastest in its history and is the main reason for the aggressive correction in residential markets. However, compared to other asset classes, capital value declines are still modest (for instance, compared to offices, which have seen cumulative capital value declines of close to 40% to 60% over the same period). Therefore, as troughs in the market are notoriously difficult to predict, we think that 2024 and 2025 could prove to be excellent vintage years in the longer run.

European markets show different levels of price volatility

Belgium has the least non-listed institutionalised residential rental market of the markets that we analysed. However, over the last few years the country has seen more interest from investors. Investment volumes are still low but are picking up. The OECD also lists Belgium as one of the most stable property markets. The standard deviation in house prices since 1990 is much lower than in other countries. House prices have fallen in only two years since 1990, significantly fewer than elsewhere in Europe. According to our peak-to-trough data, even when prices decline, corrections are not as sharp in Belgium as elsewhere.

Ireland's institutional maturity level is also lower than in many other European countries and historically it has been characterised as very volatile due to its small and open export-oriented society. During the GFC, Ireland's housing market was one of the worst hit (together with Spain). However, since then its economy has shifted into the services and technology sectors (rather than construction and banking), which made the market more stable. Also, stricter mortgage loan-to-income ratios and managed new supply prevented subsequent housing bubbles. Cap rates have moved out by approximately 150bps and spread levels are now moving closer to their long-term average.

France is characterised as a stable residential market. Its institutional for-rent market is largely concentrated in its biggest metropolitan areas, such as Paris and Lyon. Infrastructure improvements as a result of the summer Olympics, being held in Paris in 2024, may prove beneficial for residential opportunities in that city comparable to the summer Olympics held in London in 2012.

'While it looks like the current duration of value declines might be shorter than during the GFC, cumulative values declines are similar.'

Furthermore, according to our historical peak-to-trough data in more mature markets, German, Swedish and Finnish residential assets in the larger cities displayed a relatively stable performance during the GFC and Covid-19 periods. Danish residential investments saw larger declines during the same periods, due to the rapid rise in house prices in the years prior to the crises. This pattern seen in Denmark during the GFC is now repeating itself in the German and Swedish markets due to the strong appreciation of residential values over the last few years (the impact of outward moving yields relative to very low starting levels is significant). However, we expect strong fundamentals to drive rental growth and thus capital values into positive territory again in the coming years.

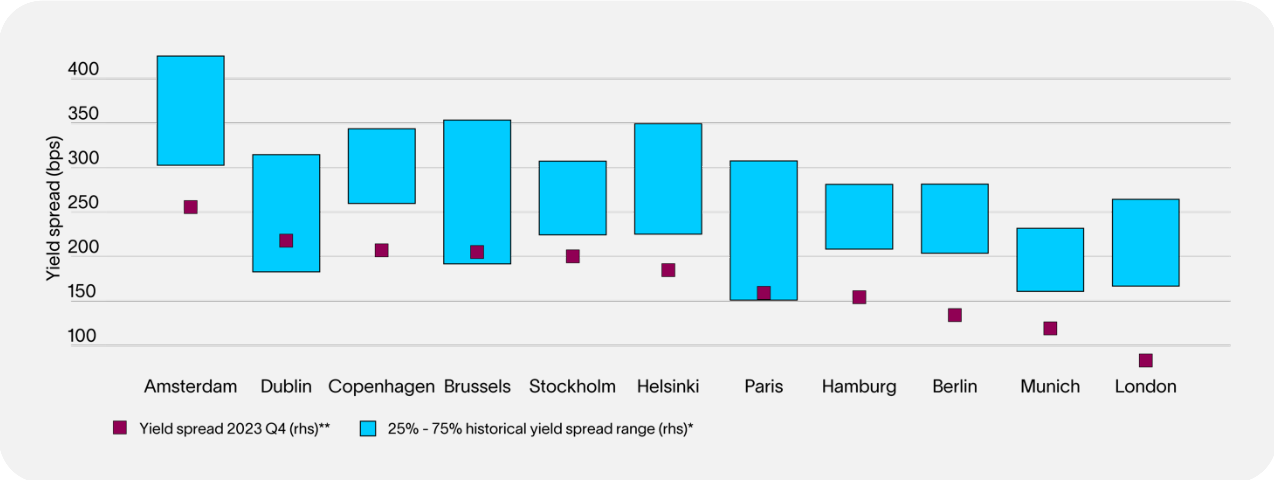
The Netherlands has one of the most institutionalised residential markets in the world, aided by broad availability of data and capital sources and a robust banking system. Based on the MSCI investable universe, Dutch residential real estate makes up more than half of the total investable universe in the Netherlands. Liquidity levels are therefore high. However, due to higher interest rates and an uncertain regulatory environment, real capital growth is not expected to pick up before 2025. You will find more details on our Dutch residential market outlook in our Dutch Market Outlook 2024-2026:

https://www.dutch-market-outlook-bouwinvest.nl/outlook/residential-market

Increasing yield spreads supportive of attractive entry moment

The graph below shows spread levels of key European residential markets. If we apply a historically conventional spread of approximately 200 to 250 basis points, we can see that Amsterdam and Copenhagen are close to this level, although still below their historical average spread. Other European cities have some way to go. At the same time, due to the institutionalisation of the residential sector and significant investor interest, future spread levels may be somewhat below the historical long-term average. For the aforementioned reasons of lagging valuations, smoothing, and differences in correction cycles, we recognise that it is challenging to compare markets.

Figure 10: Yield spread between Net Initial Yields and risk-free rates



Source: Oxford Economics, Green Street (2023)
**Based on historical Green Street Yields*
***Based on most recent Green Street Yield*

As we have already mentioned, markets expect the ECB to lower interest rates mid-2024 if inflation remains steady. Once yields have corrected further, pricing visibility and market sentiment have improved, and risk-free rates have continued to decline, we believe that spread levels will be attractive again (also relative to other asset classes, such as stocks and bonds).

However, some caution is warranted, as it is estimated that the debt funding gap for multifamily in Europe will be nearly € 60 billion[1] over the next four years. The peak of the debt funding gap is expected to occur in 2026, although it is not uncommon to extend loan terms during challenging market circumstances ('extend and pretend'). Eventually, borrowers will need to refinance their loans against significantly higher interest rates (or sell their property holdings to pay down the debt). This may dampen capital value growth in the near future, but also provides opportunities for investors with dry powder and non-bank subordinate debt providers.

Furthermore, listed European residential real estate delivered a strong performance in Q4 2023 (+24.0%). Even though some of those gains have diminished in recent months, overall improvement in listed performance points toward further recovery in private markets in late 2024 and early 2025.

[1] Source: CBRE Research, the debt funding gap for European real estate, December 2023. Estimates cover six countries: France, Germany, the Netherlands, Spain, Sweden and the UK.

Reach out for more detailed insights

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