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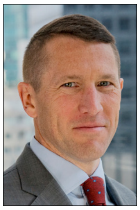
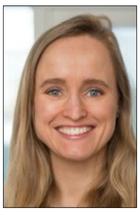
A Capital Markets Conversation: What Is EMEA Thinking?



Matt Hershey
Hodes Weill & Associates



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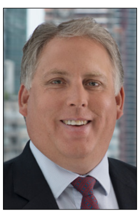

Jonathan Read
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Matt Hershey: Barbara, Rima, Jonathan, it's been a year since I moved to Amsterdam, and the world is in such a different place. When I arrived, Europe was easing out of COVID-19 travel restrictions. The EU and UK were on track to deliver GDP growth of 3.4% and 4.1%, according to Trading Economics. Those GDP numbers were second best in 20 years, behind only 2021. Property markets were strong. In the year through 2Q2022, Europe and the US delivered core returns of 11.6% and 28.3%.[1]

Now things are upside down. In the EU and the UK, inflation is high but easing at 5.3%[2] and 6.3%,[3] respectively, and GDP growth is 0.9% and 0.3%,[4] respectively. The Bank of England increased rates to more than 500 basis points (bps),[5] and the European Central Bank increased rates to more than 400 bps.[6] In the year to 2Q2023, European core property markets delivered a 10.3% loss.[7] You three speak with EMEA investors daily. What are they thinking?

Barbara Maltha: European investors find the current environment challenging. Existing portfolios and relationships have been prioritized as a result of this uncertainty. Some current assets pose challenges because of potential leverage issues during refinancing. Nonetheless, most asset owners learned hard lessons in the past and went into this cycle with lower leverage, thankfully.

Low liquidity in the real estate fund market is because of stagnant asset transaction markets with the mismatch between bid and ask prices. Inefficient financing and regulatory hurdles, especially in the housing sector, are putting development projects on pause and hindering new investments.

Jonathan Read: Expanding on Barbara's comments, European commercial real estate transactions in 2Q2023 were down 54% compared to a year earlier.[8] However, investors are getting comfortable that the end of the tightening cycle is nearing, and European occupier fundamentals are strong in certain sectors, particularly industrial and residential. Some investors are starting to put their heads above the parapet to look for new opportunities.

Matt Hershey: The 2023 INREV Investment Intentions Survey (INREV Intentions Survey) reports that European investors still have 33% office exposure and North American investors have 19%. In contrast, Europeans have only 15% logistics and North Americans have 27%.

Jonathan Read: Office assets worry and perplex European investors today. That 33% allocation is a big reason, and occupancy is another. In its Spotlight on European Office Occupancy, Savills reports, "European office occupancy rates have increased from 43% in June 2022 to 55% in February 2023, behind the pre-pandemic average of 70%." Anecdotally, leasing activity for prime, grade A office is still positive, but everything else is slow. The market needs the product it wants, including ESG-compliant stock. Logistics remains a big growth area, driven by e-commerce, where most European countries lag the US.

Matt Hershey: Rima, turning to the Middle East, oil started at $80 a barrel in January 2022, rose to $113 in the middle of 2022, dropped to $68 in 2Q2023, but is back up again recently, according to the US Energy and Information Administration. The US dollar strengthened beyond parity with the euro by September 2022, only to lose about half those gains. Yet it's done the opposite with the British pound. How are your investors seeing the world these days?

1. INREV European ODCE Quarterly Index and MSCI/PREA US Property Fund Index (ACOE).
2. Inflation and Consumer Prices, European Central Bank.
3. Consumer Price Inflation, UK: July 2023, Aug. 16, 2023.
4. Economic & Financial Indicators, *The Economist*.
5. Official Bank Rate History, Bank of England Database.
6. Key ECB Interest Rates, European Central Bank.
7. European ODCE Quarterly Index, INREV, Aug. 23, 2023.
8. UK Real Estate Investment Figures Q2 2023, CBRE, Sept. 4, 2023.

Rima Batal: They are cautious and thinking carefully about investing given the market turmoil, especially after the post-COVID buoyancy. Throughout COVID, investors remained active and opportunistic. Some invested in deals that have performed very well. This time around, they have continued conversations but have been slower to commit capital.

Matt Hershey: The 2023 *Institutional Real Estate Allocations Monitor* (2023 Allocations Monitor), jointly conducted by Cornell University's Baker Program and Hodes Weill, found EMEA respondents' actual real estate exposure largely in line with their target allocation levels, whereas respondents from the Americas were 50 bps overallocated. How has that affected European investors?

Jonathan Read: Many European investors have cited the denominator effect for their lack of activity. Private market portfolio write-downs and rising public equity markets will rebalance this, but there is a lag. The numbers will look better over the next couple of quarters with more room to add real estate.

Matt Hershey: The INREV Investment Intentions Survey 2023 showed that European investors had a global portfolio mix of 82% core and 18% non-core. For US portfolios, the mix was even more pronounced, with 90% core and 10% non-core. How does that affect their outlook these days?

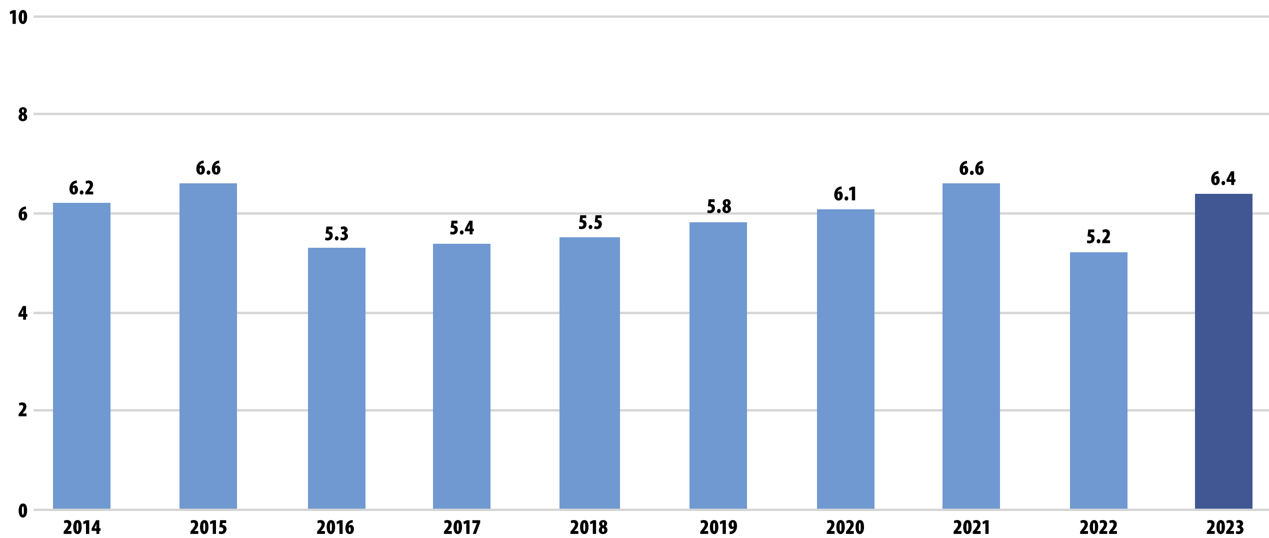
Barbara Maltha: European core investors with limited leverage exposure are well-prepared for new investments. However, the core fund market is slow because of capital market stagnation and uncertain portfolio valuations. As a result, core investors are making few new investments, awaiting market recovery and entry-pricing comfort.

Jonathan Read: European investors are generally more risk averse than their US counterparts. These numbers aren't surprising. Some US core funds haven't been immune to market turbulence and haven't provided the safe harbor investors sought. Consequently, risk appetite is even lower today. That can mean more focus on "home" markets with no cross-border complications and currency risks.

Matt Hershey: Good point, Jonathan. Which markets are Middle Eastern investors focused on, Rima? I was thinking US or Europe, but *The Economist* wrote about "The New Middle East" (Sept. 9, 2023). Are Middle Eastern investors focused on home markets too?

Rima Batal: There has been an increase in Middle East investments from regional institutions. Strong opportunities are available in residential and logistics, especially with e-commerce growth since COVID. Globally, however, Middle East investors are still keen on residential, logistics, and private credit opportunities with a strong current yield component and a minimum net return of about 12%.

Exhibit 1: Conviction Index of EMEA Institutions



Source: Hodes Weill & Associates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Matt Hershey: In the 2023 Allocations Monitor, the Conviction Index (Exhibit 1) showed a significant rebound of EMEA institutions, from 5.2 in 2022 to 6.4 this year, the second best over the past eight years. What does it look like on the ground?

Rima Batal: Sentiment is starting to improve, with interest rates leveling and 2024 approaching. Continued resilience at an operating level in target sectors is reassuring too.

Matt Hershey: Switching gears, I was amazed by a statistic in the INREV Intentions Survey that 91% of European investors are committed to becoming net-zero carbon emitters, and the statistic was 0% in North America. Net zero is a lot more than changing to efficient lightbulbs. How is the net-zero goal shaping Europeans' investment decisions, Barbara?

Barbara Maltha: European investors are highly focused on achieving their net-zero goals spurred by the 2015 Paris Agreement. They are using CRREM pathways backed by the EU to set targets for assets and portfolios. This is significantly impacting existing manager relationships and guiding new manager selection globally. Managers don't need to be experts, but they should have a strong willingness to work with these goals to widen their access to European capital.

Matt Hershey: There's a severe housing shortage in the UK too, Jonathan. In its *Big Six Residential Development Report* (Summer 2023), JLL reported the number of UK homes to let was down 17% and rents were up more than 14% in the year to June 2023. We've heard a lot of talk about the UK's "build-to-rent" market growing to resolve that supply-demand imbalance. How does that translate into capital deployment?

Jonathan Read: The UK is following the US trend, with a growing number of people opting to rent. The private rental sector has increased from about 10% of the market in the early 2000s to more than 20% by the end of 2020.[9] Institutionally owned build-to-rent units account for only 3% of the private rented residential sector, and the penetration rate of UK households living in build-to-rent units is less than 1%.[10] This has attracted institutional investment activity.[11]

Yet occupier fundamentals are strong, and investable assets are scarce. This has kept yields lower than in the US, leading to investor caution but possibly a fair reflection of risk. Demographic tailwinds are definitely behind this sector.

Matt Hershey: Finally, Barbara, North American investors seem to have found some safe harbor from the recent market volatility in alternative property types such as student housing, life sciences, and data centers. Is it the same for European investors?

Barbara Maltha: The US leads in the life sciences and data center markets, but Europe is catching up, notably post-COVID. Investors are increasingly interested in these assets because of their defensive characteristics and long-term tenant appeal alongside their core portfolios in mature asset classes.

Matt Hershey: Thanks, all. What a year. Best wishes on a soft landing into the year end. ■

Matt Hershey is a Partner and Barbara Maltha is a Principal in the Amsterdam office; Jonathan Read is a Managing Director and Rima Batal is a Principal in the London office of Hodes Weill & Associates.

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9. *The Size & Structure of the UK Property Market Year-End 2020 Report*, Jan. 2022.
10. UK Build to Rent Market Update, Q2 2023, Savills, July 24, 2023.
11. Families and Households in the UK: 2021, Office for National Statistics, March 2022.