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Global Real Estate Outlook Mid-Year 2024: A New Cycle of Contrasts

Introduction

After a challenging couple of years for global real estate, there is a greater sense of optimism associated with the rest of 2024 and beyond. For the majority of markets, this year will likely mark the bottom of the cycle and the end of significant capital value falls. With stabilisation already emerging, investors are cautiously dipping their toes into the waters once again.

With the prospect of better days ahead, investing in real estate at this point in the cycle could offer attractive return potential. However, there remain a number of risks which need to be navigated.

If the era of 'lower for longer' interest rates represented a tide that lifted all boats, we see the beginning of the new cycle as a cycle of contrasts. In our opinion, performance is likely to be largely driven by income generation and preservation, over capital growth, and while occupier demand for most sectors should remain robust across the board there are some notable exceptions. At the same time, rate rises have revealed cracks in the system, especially relating to high – and now costly – leverage, but also assets with structural challenges, such as sub-standard secondary offices.

Investors will therefore need to be more selective about asset qualities and specifics to help ensure their investment decisions tap into what could be a fine vintage for real estate.

The value of investments will fluctuate, which will cause prices to fall as well as rise and investors may not get back the original amount they invested.
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Section 1

A fine vintage for investments

While expectations for fast and furious interest rate cuts globally have been dialled back, an increased risk premium for property, combined with improving rental growth prospects given a brighter economic outlook, supports the view that yields may have moved out by far enough. In our view, with few exceptions (such as Japanese offices), entry pricing now also looks attractive, providing a significant opportunity for new capital, and setting the scene for what could be a fine vintage for investments.

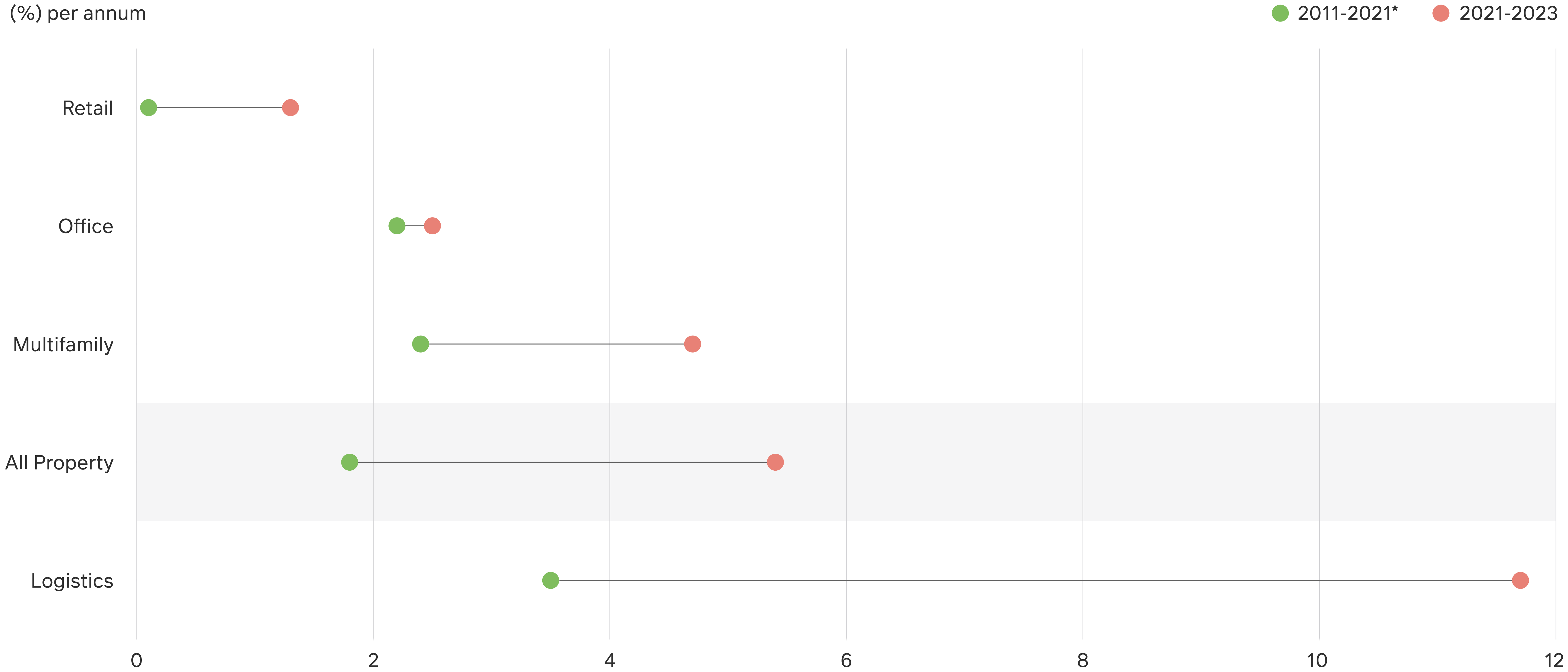
An emphasis on income to drive performance

Yet with yield compression likely off the table for now, due to 'higher for longer' interest rates, investors will have to rely on income as the main route to achieving target returns. Significantly, we believe income fundamentals for most global real estate is in a relatively strong position today, thanks to a limited supply of modern, high-quality assets. As such, occupational markets have proven stronger than expected, despite muted economic growth and in some markets, outright recession. Rents have continued to rise, beating forecasters' conservative expectations even as structural headwinds blow. An improving global economic backdrop opens the door for accelerating rental growth to drive performance, albeit with sector and geographic differentials.

Prospects for stronger economic growth in Asia Pacific position the region to lead this stage of the occupational and rental cycle, in our view. Continued business expansion and rising wages alongside moderate inflation support the potential for buoyant occupier demand and rental growth. Tokyo multi-family housing and retail rents are surprising on the upside, for example, while Seoul offices are benefiting from stronger (export-led) economic growth.

Looking to Europe, economies are also showing signs of recovery, spurring occupier demand. However, rental growth trajectories are poised to diverge, given distinct economic cycles and market dynamics. Despite Spain projecting the region's healthiest economic outlook, the country could see elevated levels of supply curb future rental rises, while the reverse could be true for larger, core markets like Germany, France, the Netherlands and the UK. Nordic markets – most challenged by economic weakness in the last couple of years – may be slowest to recover but, when the time comes, a severely constrained supply pipeline means the potential for a sharp rebound in rental growth could be significant.

Rental growth has exceeded expectations despite economic headwinds



*Multi-family and All Property rental growth covers 2014-2021 only. Source: PMA, April 2024.

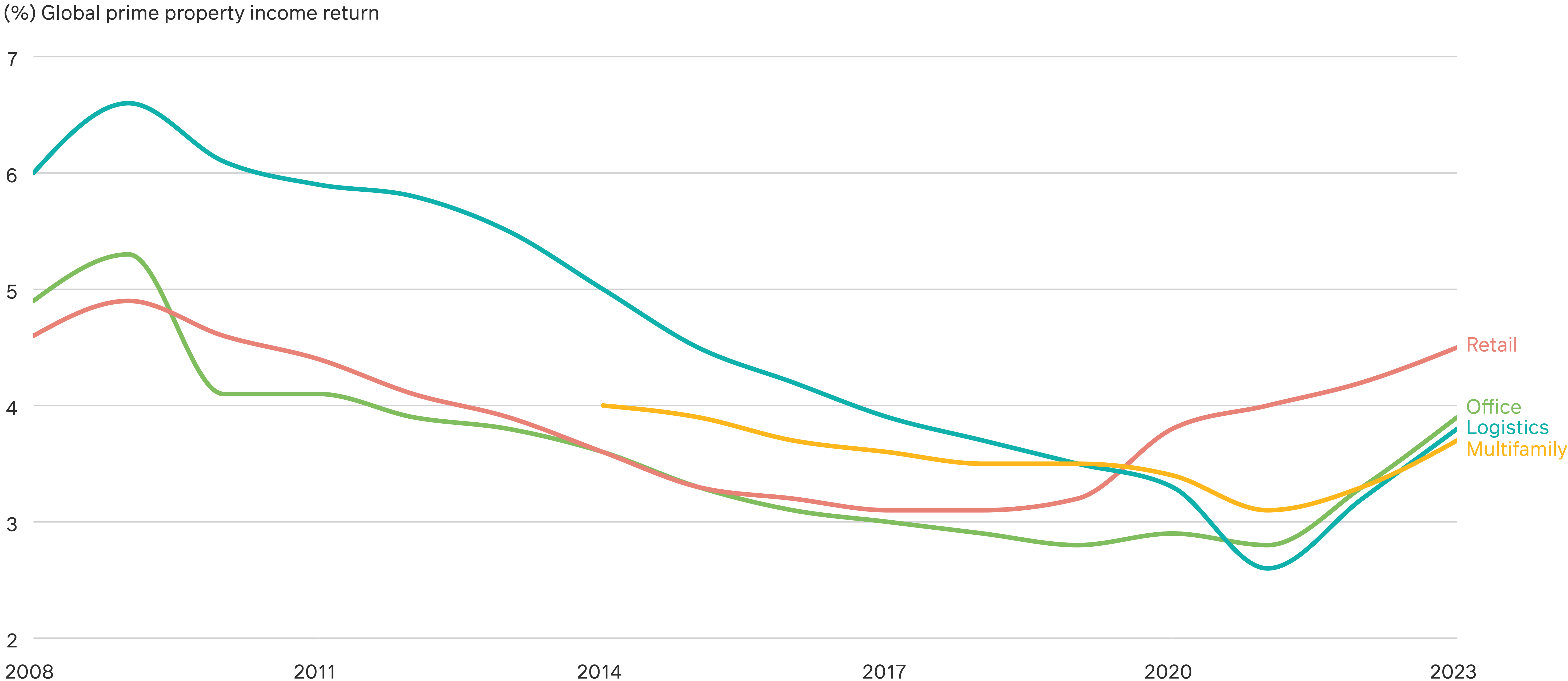
Rental growth prospects are nuanced

However, the interplay between a recovering economy and longer-term changes in occupier needs means that rental growth will be nuanced and asset and location specifics could override wider regional and sector trends. The stereotype of 'beds and sheds' as rental outperformers versus structurally-challenged retail and offices will broadly hold true, we believe. Yet the path to Net Zero will also play a vital role in determining the outlook for rental growth, potentially contravening sector-based views. Best-in-class office assets could well see a better rental return than older logistics assets in markets where recent double-digit rental growth has led to a large supply response.

Rental growth is not the only route to potential outperformance. With capital values lower and occupational markets largely resilient, income returns have risen significantly, rewarding in itself, even if yield compression looks less certain. Where assets have repriced by enough to reflect heightened occupier and ESG risks, a higher income return – especially from the newly rebased retail sector – should also pay performance dividends in the medium term.

While risks for the asset class remain, real estate's recent repricing, combined with significant income growth potential and cash flow resilience, we believe sets the asset class apart as the global economy starts its new cycle. With rates higher than they have been in more than a decade, and the prospect of 'sticky' inflation, the reward for owning property, as a real asset, offers both attractive return potential and risk mitigation.

Higher income returns set the scene for attractive performance



Source: PMA, April 2024.

Section 2

A lack of future supply creates gaps and opportunities

Historically, downturns have tended to coincide with periods of high supply, leading to rising vacancy rates, falling rents and a slow rebound. In contrast, this downturn began with minimal new supply, as pandemic uncertainty, tougher financing conditions and higher construction costs delayed or terminated development projects, supporting occupational markets even as capital values fell. With continued economic uncertainty and rising ESG standards, Gross Development Values and therefore development feasibility has declined. Already limited supply pipelines are shrinking as a result.

For ever-popular 'beds and sheds', undersupply has driven significant rent rises in recent years, therefore development in the face of growing demand should continue to support further growth over the medium term, albeit at a more moderate pace.

For retail and offices, an undersupply shock may have come at the right time. Now largely challenged by structural oversupply, both sectors could benefit from shrinking development pipelines, helping to mitigate vacancy – and rental weakness – even as occupiers reduce their space requirements.

Building rental pressures as a lack of development bites

Germany's private rented residential sector stands out as a market where a stark supply/demand imbalance has meant record rises in rents, with no end in sight. Vacancy rates in major cities have now dropped to below 1% and yet no supply response is forthcoming, driving strong future growth expectations as well.

Seoul offices are at the extreme end of the spectrum: despite offices being a sector beset by concerns around structural oversupply, vacancy rates here have dropped to their lowest levels since 2008, at sub-2%. With limited new space in the pipeline, occupiers have had to revise their rent expectations upwards to secure space that meets their needs. This is fuelling a growing trend of corporates acquiring assets for owner-occupation, helping to support capital values despite rising interest rates in the last two years.

Meanwhile, a lack of recent shopping centre development in Australia[1] is starting to support a burgeoning recovery in rental levels, as the worst of the structural impact in the retail sector fades. Even in the UK, where obsolete retail space is widespread, half a decade of little to no new development is finally supporting rising rents for better quality assets, as demand recovers from pandemic lows.

[1]The pipeline of incoming regional and sub-regional shopping centre space in 2024 is estimated to be less than 10% of the historical 10-year average. Source: JLL, Q1 2024.

New supply looks set to be restrained in most markets...but not everywhere

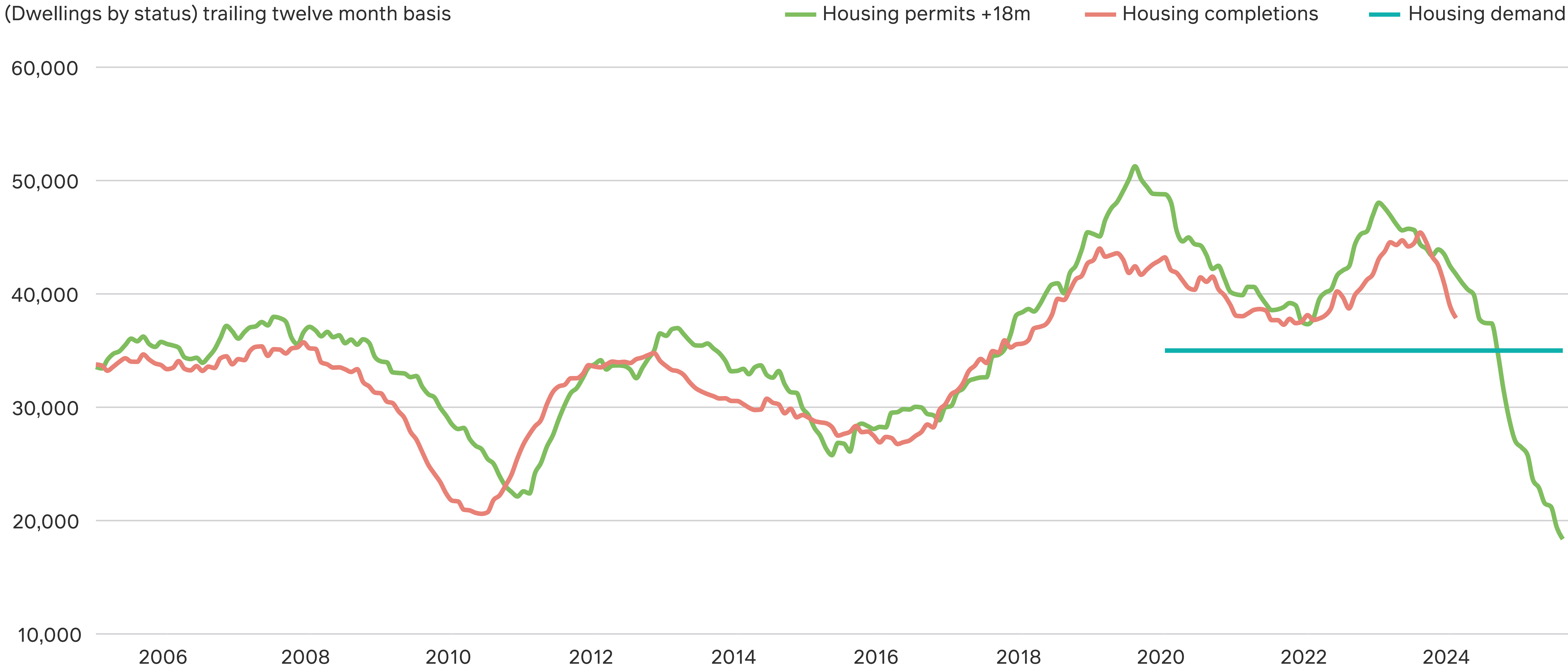
Source: PMA, Spring 2024.

Bucking the undersupply trend

While these trends may broadly hold true, there are markets that do not conform to the status quo. Thanks to a strong policy backdrop, Finland (with the notable exception of Helsinki's metro area) has seen consistently high housing delivery in recent years, limiting the country's rental growth even as it hit double-digit levels elsewhere in Europe. Stronger growth may be on the horizon, however, with five years' worth of oversupply set to be absorbed in the space of just 24 months as new construction falls back to minimal levels.

The Dublin office market is bucking the undersupply trend too, with high levels of space set to be delivered this year. Moreover, less than half of the space coming through is pre-let, suggesting that even the most discerning occupiers could be spoilt for choice – a stark difference to Europe's other Central Business Districts, where prime supply is severely lacking. This is likely to mute Dublin's rental growth

Finnish residential delivery has been high for the last few years, but looks set to fall dramatically



Source: M&G Real Estate based on Statistics Finland, latest data Feb 2024.

potential this year and next. Yet once this space is delivered, development looks set to fall back to levels not seen since the Global Financial Crisis. In the next couple of years, super-prime space will instead be in very short supply, creating the potential for sharp rental rises for the best quality assets.

The logistics markets in Australia, Korea and Japan still have elevated levels of supply to work through in 2024 and 2025, having increased to meet high demand for modern assets. However, higher costs of construction, labour and finance have already impacted new starts from 2023, giving confidence that supply beyond 2025 could be lower than demand, and rents could be well supported.

A lack of new supply in many markets means significant challenges may be ahead for occupiers, especially given the narrowing of focus to best-quality space. However, for investors, the imminent dearth of development at a time when demand looks set to recover bodes well for rental growth, and ultimately, performance for the 'right kind' of stock.

Section 3

Refinancing risks are now well understood, but borrowers still face tighter credit conditions

While we believe the coming quarters could well prove to be a fine vintage for global real estate investment, investors should be aware of leverage issues and refinancing challenges. These could hinder the recovery for certain asset types within selected parts of the property market as we enter a new cycle.

Still limited sign of a wave of distress

Though there has been some growing evidence of stressed sellers in the market over the last two years, including developers becoming insolvent and property owners defaulting on loans, the dramatic shift in policy rates globally has not as yet caused a larger wave of distress.

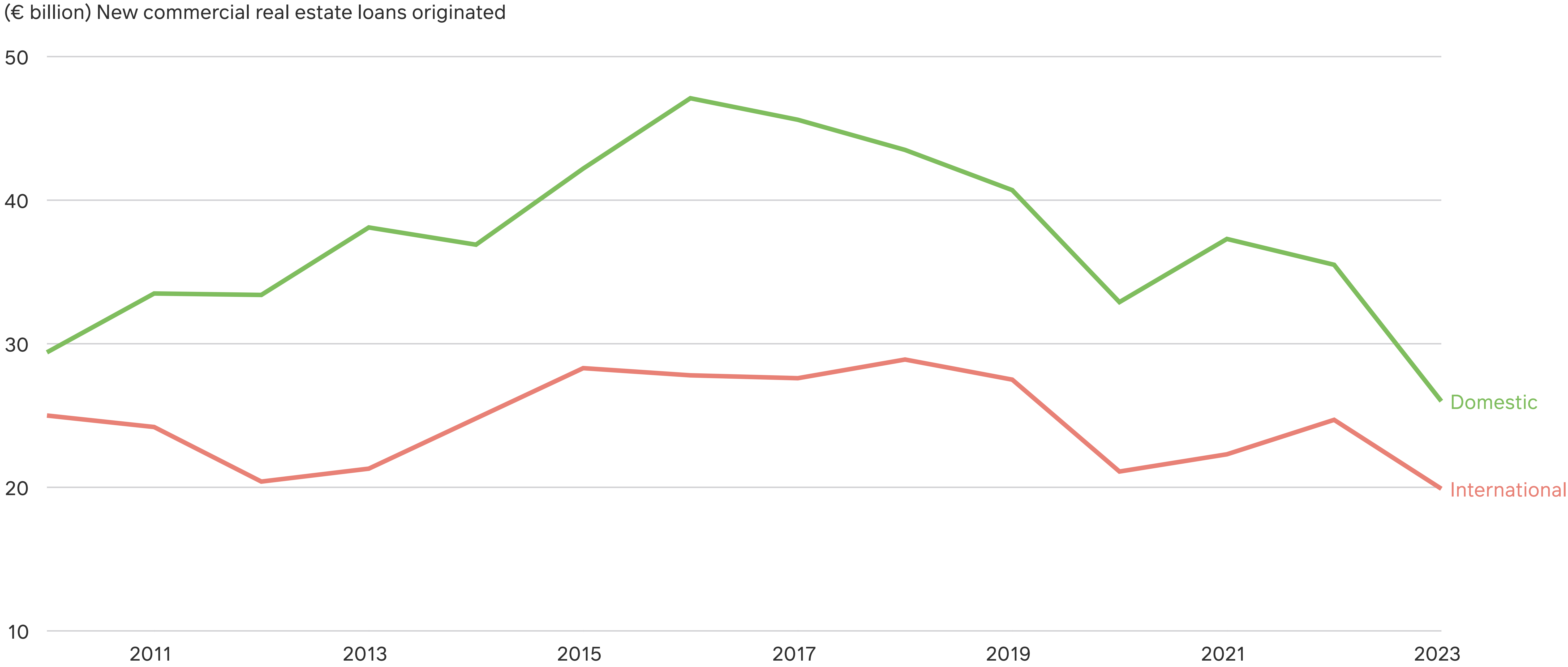
This is largely a result of lenders' continued willingness to compromise. In the US, over $200 billion of commercial real estate (CRE) loans due to expire in 2023 were neither sold nor refinanced, according to MSCI (adding to the large volume of loans maturing from 2024 onwards). Further, strong occupational markets and associated net operating income growth – particularly for the best assets and structurally favourable sectors – have, to an extent, also protected borrowers.

Some stress does appear to be surfacing in the system, however. Loan loss provisions among many lenders have risen in recent quarters, reflecting elevated risks faced by lending made against certain types of property. This is particularly true for the globally significant US office sector. Around 15% of German banks' loan books are backed by US properties[2], including in gateway office markets – and their loss provisions now top €2.5 billion according to a Bloomberg survey[3]. Further, over a year on from the collapse of SVB, there are lingering concerns over the lending characteristics and loan performance prospects of smaller, regional US banks with a high concentration of assets within the CRE sector. By contrast, Asia Pacific banks have less than 2% of loan book exposure to US properties, according to Fitch data.[4]

Crucially, given much more is known about problematic loan exposures and lending behaviour, we are cautiously optimistic that systemic risk to the real estate market remains an unlikely scenario. As an indicator, non-performing loan (NPL) ratios for CRE have risen only modestly over the last few quarters, and remain low. Across the Eurozone, the ratio is 4.3%[5], while it is just 1% in the US[6] and 0.65% in Australia[7].

[2]Based on a sample of 15 larger banks. Source: Borsen-Zeitung (2024), https://www.boersen-zeitung.de/english/how-german-banks-are-involved-in-the-us-real-estate-market'.
[3]For German Pfandbrief banks (which have a c.60% national market share), Scope analysis suggests the largest German lenders have manageable NPL ratios of under 3-5% across their CRE loans, some as low as 1%. Source: www.refire-online.com /api/amp/investment/banks-see-commercial-property-still-sliding/
[4]Based on analysis of banks that disclose this data. Source: https://www.fitchratings.com/research/banks/us-commercial-real-estate-exposure-generally-modest-for-fitch-rated-apac-banks-08-02-2024
[5]Source: EBA, Q4 2023, https://www.eba.europa.eu/sites/default/files/2024-04/70635613-edf4-495a-b9ce-42af51e93244/press_release_rdb_q4_final_embargoed_until_04042024_1100_cet.pdf
[6]Source: BankRegData.com, Q1 2024, https://www.bankregdata.com/allLD2met.asp?loan=F161&met=NPL (note – includes Owner Occupier CRE, Non-owner Occupier CRE and Multifamily
[7]Source: APRA, September 2023, https://www.apra.gov.au/sites/default/files/2023-12/Quarterly%20authorised%20deposit-taking%20institution%20property%20exposures%20statistics%20-%20highlights%20September%202023_0.pdf

German Pfandbrief Banks have a high loan exposure to international real estate, including the US



Source: vdp research, 2024.

The risks and opportunities in this recovery cycle

Refinancing needs are, however, still likely to grow this year and next. And there could be challenges as more loans expire, even if rates do come down.

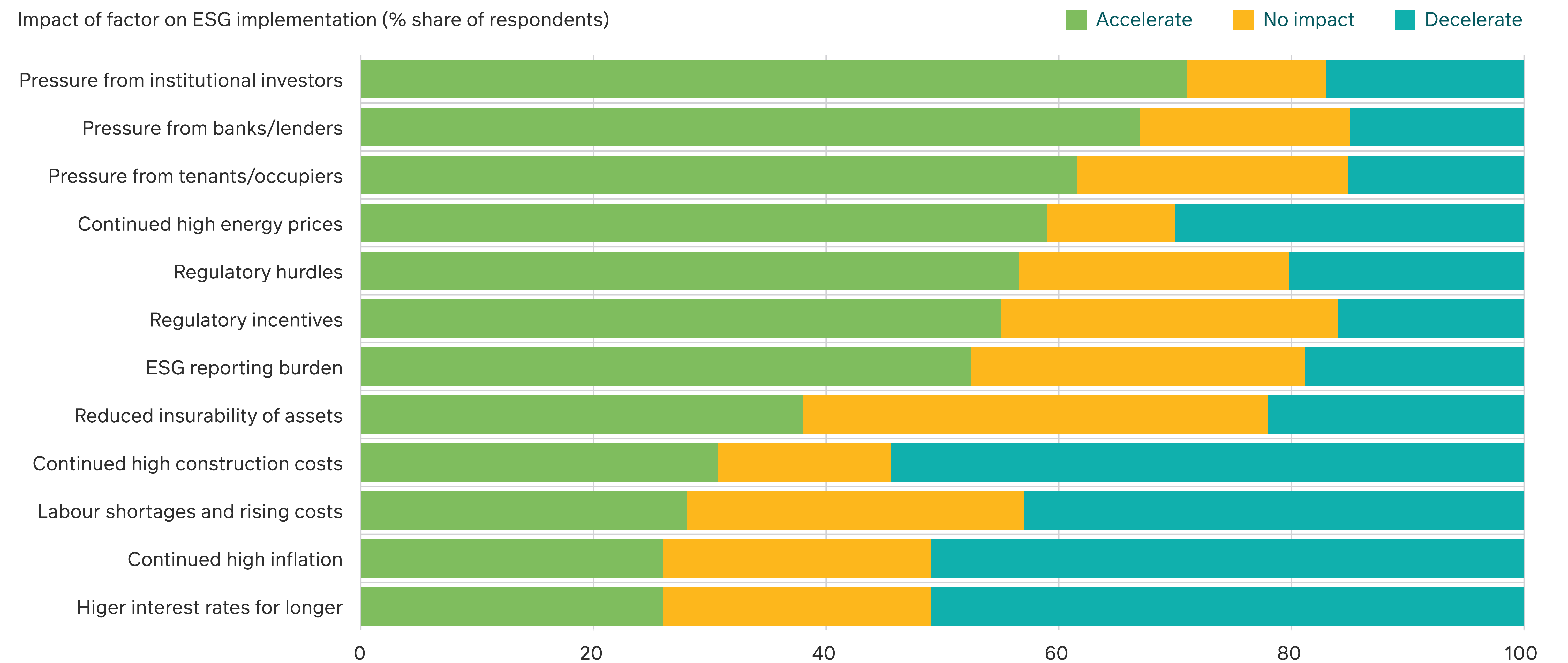
This could result in forced sellers offering properties to market at steep discounts; the need for equity injections by existing (or new) owners; or bridge/mezzanine financing needs from agile, potentially non-bank lenders. Sales of assets in distress typically, however, take a few years to work through the system. MSCI points to a peak of distressed European property sales[8] in 2012 following the Global Financial Crisis, and currently identifies a significant uptick, into 2024, of publicly-reported properties in distress but not yet transacted.

[8]As a proportion of total deal volumes (circa 8%), rather than total € value of distressed sales (which was registered in 2014).

Perhaps a bigger risk to the market's recovery is a cautious approach to new lending among traditional lenders, which could dampen deal activity. This will likely impact assets in different ways, leading to contrasting performance potential between those in, and out of favour.

Banks have scaled back appetite for new loans and have also become more selective in underwriting new deals. This includes providing more conservative Loan to Value ratios, scrutinising ESG criteria more thoroughly, and avoiding weaker assets without viable transformation plans. Green credentials are now considered in much more detail by virtually all lenders compared to a few years ago, creating the possibility for an acceleration in asset obsolescence, or material pricing discounts. Some are even offering margin step downs for the highest calibre ESG strategies, but overall ESG requirements (and any incentives) vary between lenders.

Lender pressure is the second most important factor in accelerating ESG strategy implementation in Europe



Source: ULI/PwC, Emerging Trends in Real Estate, Europe 2024.

Given banks represent the majority of the CRE lending market globally, their retreat coupled with the markdowns property valuations is likely to create a sizeable debt funding gap over the coming years – globally estimated at over $250 billion by 2026[9] – though it is an evolving picture, with changing rates and values rebounding. This is both a cause for concern of real estate equity investors, who may face challenging financing events, but also an opportunity for alternative lenders to step into the gap.

While some future credit losses on loans secured against CRE cannot be ruled out, wider systemic risk in any global region remains an unlikely scenario, in our view. The risks to the market's recovery are more centred around a cautious traditional lending market which dampens new transaction activity and creates performance divergence, coupled with expiring loans introducing some stresses to an already challenged ecosystem.

[9]For the period 2024-26 inclusive. Source: CBRE (Q4 2023).

Investment convictions

With the turning of the cycle and a more positive outlook for real estate moving forward, investment performance is likely to be generated by income qualities, rather than yield compression-driven capital appreciation. We see attractive investment propositions reflecting one or more of the following income characteristics:

- Income Growth: Largely stimulated by strong supply-demand imbalances, owning these properties enables landlords to benefit from positive market dynamics and grow real rents between (and sometimes within) leases
- Income Return: Characterised by higher yielding property types (ie, where income constitutes a greater proportion of an asset's value), coupled with sustainable rental levels
- Income Preservation: Resilient cash flows with low risk of vacancy or decline and which have an ability to keep pace with inflation; may include longer leases backed by strong tenant covenants

Top investment picks

Source: M&G Real Estate, 2024.

Income Growth

PBSA, Australia

Demand is robust with international student inflow growing at 4-5% annually and PBSA provision currently below 10%, well below international norms. Shortage of new supply in the next four years is supportive of strong rental growth.

Build to Rent, UK

Plunging Multifamily Housing starts combine with the ongoing reduction in small landlords to exacerbate the existing undersupply of good-quality private rented accommodation.

Warehouses Europe: Distribution Warehouses, Europe's 'Blue Banana'

Strong structural tailwinds support occupier demand along Europe's prominent logistics corridor which stretches from ports in the Benelux region, through western Germany and into northern Italy and the south of France, touching some of Europe's wealthiest regions. Strong rental growth is likely to come through for high-quality assets in connected locations.

CBD offices Europe: Ultra Prime Offices, Core European Cities

A low availability of high-quality space is meeting discerning tenant demand for ESG credentials and A-locations for office occupation across major capitals and international hubs in Europe. Above trend rental growth is likely to occur in markets with the most acute supply-demand imbalances and where tenant demand is diverse and dynamic.

Multi-let industrial, UK

Despite demand returning to pre-pandemic norms, the focus on last-mile delivery indicates strong growth prospects for major urban hubs, with the undersupplied London/SE region set to benefit.

Income Return

Shopping Centres, UK: Dominant Shopping Centres, UK

With yields at record highs of 8.25% and the occupier market showing signs of life after years of distress, the best quality shopping centres in the UK look poised to outperform in an income-driven environment.

Income Growth and Return

PBSA, Southern Europe

Spain, Portugal and Italy have the lowest national provision rates of student accommodation in Europe (at 8%, 5% and 3% respectively), with internationalisation and growing domestic enrolment driving demand. These are also higher yielding markets compared to the rest of Europe and the UK, but may have more limited market-entry opportunities.

Income Preservation and Return

Grocery-Anchored Retail, Australia

Yields rose to c.6% even for dominant shopping centres in Sydney and Melbourne and have stabilised in Q1 2024. Rents are rising on the back of positive population inflow, gradual improvement in retail sales and limited new supply.

Leading Retail Warehouses Parks, European Metros

Limited supply of big-box retail space combines with a growing and diverse tenant demand pool in many European countries, notably Germany, Denmark and Spain. Vacancy rates are reducing from COVID-highs, re-based rents are growing modestly, and yields in excess of 6% are available for even the most prime schemes in the market.

Income Growth and Preservation:

Suburban Malls, Singapore

Tight labour markets and rising wages support robust retail sales while supply of new regional and sub-regional malls in the pipeline is highly restricted.

Regulated PRS, Nordics

Growing urban populations in Denmark and Sweden create a large, captive pool of renters, with regulated units exhibiting strong occupational profiles coupled with index-linked or negotiated annual rental increases. The lagged pass-through of higher inflation is likely to generate above-trend rental growth in the coming years.

Conclusion

Following a challenging couple of years, we expect global real estate markets to be on a better footing through the rest of 2024, with capital value stabilisation and largely positive rental growth prospects. A focus on income and asset quality will be important in the new cycle, as investors and lenders become more selective, and investment performance differentials become apparent between assets of higher, and lower quality. We believe new investments made in the next 6-12 months are likely to be recognised as a robust vintage in the long term, benefiting from high entry yields and strong occupational profiles.

Rental increases are expected to be driven by a stronger economy – particularly in Asia – or at least an uptick in economic growth, which will spur occupier demand. Challenged development viabilities have limited the supply pipeline in most geographies – though there are some examples of the converse – which should help to stimulate rental growth over the next few years, in light of acute supply-demand imbalances.

Though refinancing challenges remain, the risks within banks are largely well understood and appear modest. The risk of wider systemic stress is unlikely, in our view, but lender behaviour and financing availability will be a key determinant of asset bifurcation and performance moving forward.

Despite some challenges and risks on the downside, with investment market stabilisation having arrived, or at least in sight, and the global economy look set to recover, we are increasingly optimistic about the outlook for real estate. As such, 2024 may present the most attractive buying opportunity that has been seen for some time.

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