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US vs. European Real Estate: Why Europe is poised to outperform

Fidelity International Real Estate

Introduction

Is negative sentiment to European real estate justified or is contagion from the US spreading?

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Given the close relationship between the performance of the US and European real estate markets in the 21st century, it is common practice in the industry to seek insights from one market and apply it to the other, especially taking from the US and applying to Europe. The US has been a leading indicator on several key trends over the last cycle, including the rise of ecommerce and the commensurate boom of the logistics sector/decline of retail, so there can be demonstrable merit in this approach.

Today, the inflation challenges on both sides of the Atlantic and consequent increase in interest rates has flattened sentiment towards real estate globally. This has been compounded by turmoil in the banking sector, which has in part been traced back to real estate exposures. However, based on the current backdrop, taking insights from the US and applying them to Europe may prove to be a misleading exercise, for these primary reasons:

- Europe has already seen a rapid yield driven repricing of capital values, while North America is yet to see as significant capital value write downs despite the weaker fundamentals.
- Europe enters this downturn with record low vacancy rates across many markets, while US vacancy rates are 2.6x higher on average.
- Net absorption of office space in Europe is positive and has been for the last seven quarters. US net absorption has been negative since the pandemic began.
- Standard lease incentives in Europe (average 10.3%) are much lower than the US, ensuring net effective rents are slowly growing, while incentives equivalent to 30% of lease value are common in the US, eroding net operating incomes.
- Europe is much further ahead of the US in terms of hotdesking/reducing desks available per worker having started the transition before the Covid-19 pandemic. Therefore, office utilisation is already more efficient in Europe heading into a period of space rationalisation due to home working.

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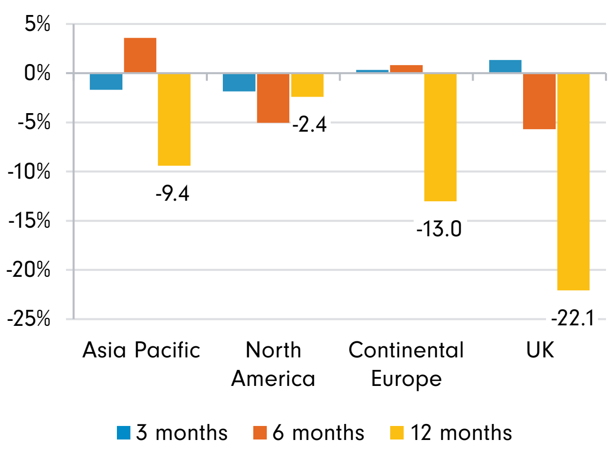
Rebased European values are close to trough

North American values do not reflect fundamentals yet

Despite a marked slowdown in European transaction levels since the summer of 2022, valuers have not opted for the material valuation uncertainty clauses that were put in place during the Global Financial Crisis and the initial phase of the pandemic. Instead, they have increased prime yields and discount rates to account for the interest rate rises we have seen. This 'mechanical adjustment' has caused pricing to reset in record quick time, and although dealmaking remains subdued, there is reasonable evidence available that deals have been agreed at or close to book values. This inspires confidence in the accuracy of current valuations, aiding market transparency and efficiency.

All Property capital value growth



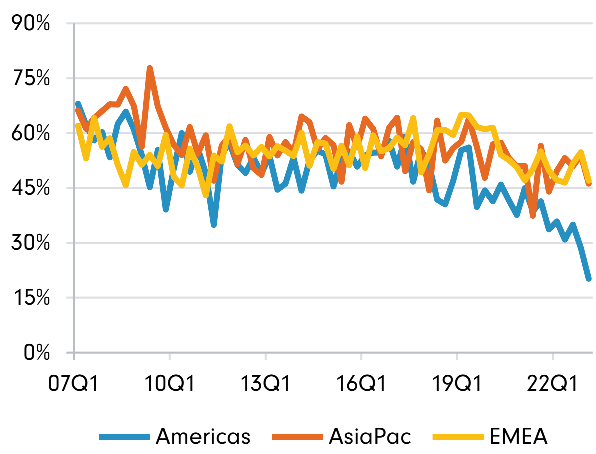
Source: MSCI, Q1 2023

North America by contrast has been much slower to adjust capital values to reflect the seismic changes to the macro economy and the end of the 'lower for longer' goldilocks era. In the 12 months to the end of March, North American property values were down 2.4%, compared with Continental Europe where they were down 13%. The UK repriced even more aggressively, with values down 22% in the same period. While the repricing for US offices has been more significant, down by 14.1% over the year to Q1 2023, this is still short of the 16.5% seen across European offices. A natural rebuttal might be that North America is more resilient and values are not as overpriced as they were in Europe, but the data does not substantiate this view, as we demonstrate in the following sections.

Transaction data illustrates investors are sceptical about US offices

Office investment is out of favour on both sides of the Atlantic Ocean, but in relative terms, it is at a much lower point in the US than it is in Europe (see chart below). Typically, office investment accounts for about 50% of commercial real estate investment activity in the US, but this has been trending down since the pandemic and reached just 20% in Q1 2023. The office share of investment activity meanwhile has remained relatively stable in Europe and Asia, despite the decline in overall investment activity that has also happened in those regions. This is likely symptomatic of weak investor sentiment in the US but could also be a sign that investors do not believe the valuations currently attributed to US office buildings.

Office investment as a % of total commercial real estate investment



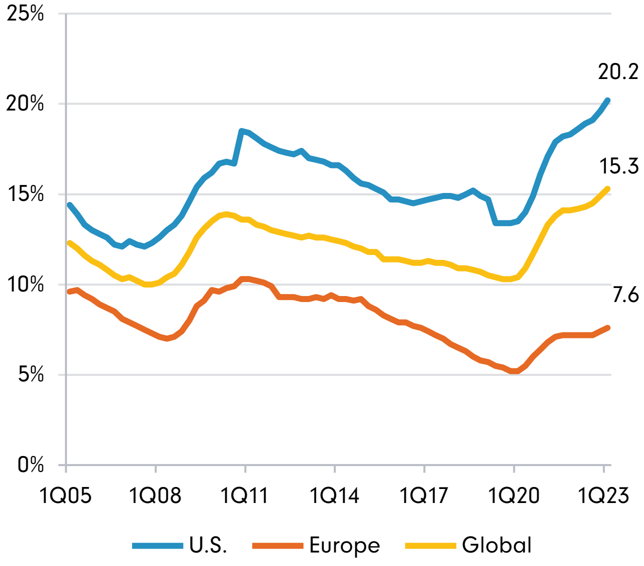
Source: RCA, Q1 2023

The fundamentals highlight Europe's relative strengths

The basis for rental growth

A key indication of the balance between supply and demand in real estate is the vacancy rate. A low vacancy rate is a prerequisite for sufficient tension between supply and demand to deliver rental value growth. Europe has the lowest vacancy rates of the major global regions for offices at 7.6% which puts the European market in an enviable position at the outset of what will be a long-term change in how office space is used thanks to more frequent working from home.

Vacancy rate



Source: JLL Q1 2023

Some of the major US markets, e.g. New York and San Francisco by contrast have seen vacancy rates spiral since the beginning of the pandemic. The latter's office vacancy has risen from 3% before the pandemic, to over 30% of office space today seeking new occupiers. These trends have catalysed a wave of concerns about obsolescence of large swathes of US office properties. The high-rise office towers common in these markets are generally difficult to repurpose into alternative uses such as residential, particularly when compared with predominantly low-rise European equivalents, exacerbating the problem in America.

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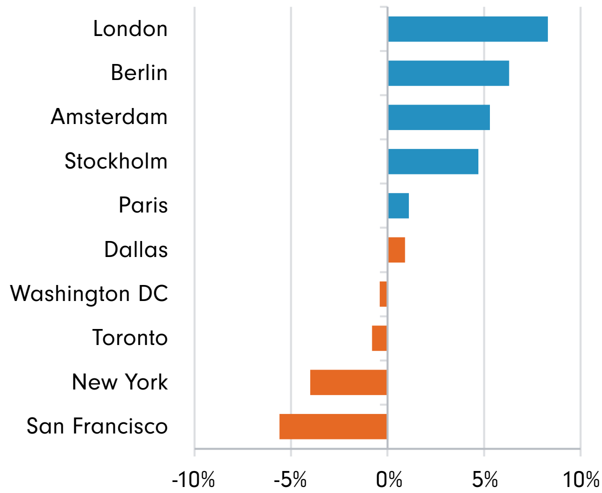
Despite the current fundamentals, 1.9% growth is forecast by JLL for prime US office markets to 2027. Part of the issue with traditional forecasting models is that they are not well suited to accounting for the structural changes that are taking place across the globe in how offices are used, and the local factors that will influence future demand. This inefficiency should put high conviction investors at an advantage when navigating global markets.

Prime office rental change Q1 2023



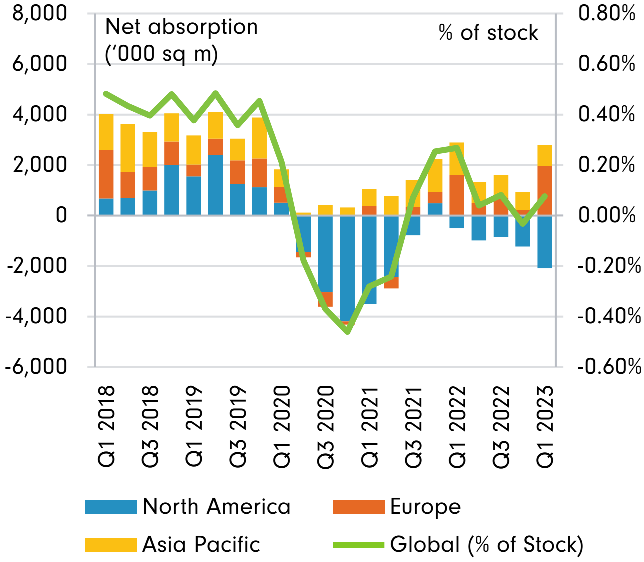
Source: JLL Q1 2023

Net absorption of space

The latest trends on net absorption[1] illustrate that Europe is gaining strength each quarter, despite the challenging growth backdrop, as the number of leases being signed outweighs the amount of space coming back to the market and new supply coming on stream. The US occupier market is still following its post pandemic trend downwards however, as the combination of more development and weaker occupier demand take effect.

[1] Net absorption is the sum of space that became physically occupied, minus the sum of space that became physically vacant during a specific period.

Net absorption vs. % of stock



Source: JLL Q1 2023

These trends suggest that the current differential in vacancy rates between the US and Europe will continue for another while yet, albeit some further weakening in occupier demand in both regions should be anticipated as Fidelity expects the US and European economies to enter a cyclical recession in the next 12 months.

Lease incentives

According to Savills, the average incentive package for new office leases is equivalent to 10.3% of lease value in Europe. In 2019 the average incentive granted was worth 7% of total lease value, indicating that lease incentives are still meaningfully above pre-pandemic levels. There are some notable outliers to this average, with Paris La Défense for example seeing incentive levels closer to 35% of lease value. La Défense is similar to US markets in more than just its appearance, dominated by high rise towers, as high lease incentive packages also characterize major US office markets. Standard incentives in Chicago are equivalent to 30% of lease value according to Avison Young, while they are 27% in LA, and 22% in Manhattan.

This is a useful indicator of the strength of occupier bargaining power in the US and highlights the weak position that many asset owners are in if they are trying increase the net operating income of their assets to help mitigate the rapidly rising cost of financing. With incentives at a much more contained level in Europe, and vacancy still in single digit territory, the prospects for boosting net operating income levels should be more robust.

Europe is a global leader in flexible working

American perceptions that Europeans are rarely in the office is partly true!

With more generous holiday allowances and shorter working days, the American vision of Europeans spending little time in the office does hold true in one important respect. The number of desks available per worker is typically far lower in Europe compared to the US or Asia as firms have adopted hotdesking long before it has become mainstream elsewhere.

> As a result of the greater prominence of hotdesking coupled with more fulsome return to offices post pandemic, European offices are being used much more efficiently than they are in the US.

Data from Colliers shows that there are as few as 60 desks available per 100 workers on average in cities such as Brussels, with 70 in Paris, and 80 across Amsterdam, London and Madrid. In the US, it is still far more common to have fixed desks for employees, so the desk to worker ratio is much closer to 1:1.

There is further nuance to the story however, as although European offices are more frequently specified for a flexible approach to home and office working among employees (and have been since before the pandemic), the return to office post pandemic has been much swifter in Europe (and Asia) than it has in the US. JLL data shows US office occupancy is at 40-60%, versus 70-90% in Europe and 80-100% in Asia. The possible explanations for the US trend is that homes there tend to be larger, and better suited to home working compared to smaller European/Asian apartments, and longer car based commutes in the US.

As a result of the greater prominence of hotdesking coupled with more fulsome return to offices post pandemic, European offices are being used much more efficiently than they are in the US.

At a time of structural concern over long term demand for office space, it should bring comfort to investors in Europe that the capacity of occupiers in Europe to rationalise their space is significantly more limited than counterparts in the US, based on current trends.

Summary and outlook

Europe, like the US, is a highly heterogenous network of localised markets, as distinct as the languages and cultures that weave across them. Therefore, it is important to complement the top down style of analysis above with a rigorous bottom up approach to accurately identify the winning locations.

That being said, there are some striking nuances in the fundamental positioning of US and European markets.

These nuances set the respective regions up with contrasting levels of vulnerability as the global economy battles the many economic and geopolitical issues it is facing.

The substantial repricing already seen in Europe, coupled with low vacancy, positive net absorption, and more efficient utilisation of office space should inspire confidence that European real estate is in a relatively strong position to outperform the US market over the medium term.

Financial instability, oversupply, and lofty valuations create a gathering storm at time of increasing distress for US real estate. Europe is not immune from these challenges and will likely see some further value corrections but its darkest days for this cycle may already be behind it.

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