WHEN WILL BE THE REPRICING TURNING POINT?

This edition of Living Thoughts analyses the downward trend in pricing of European real estate market that characterised the market recently and identifies when the potential turning point will be reached. This is a key aspect for investors especially when investing in private markets such real estate. Indeed, investors ideally need to anticipate market turning points to optimise investment timing. And it seems that 2024 looks to be a good timing to invest in real estate.

PRICING DRIVERS IN REAL ESTATE

The real estate market, as much as other private markets, has prices which are harder to define due to its level of transparency. Indeed, compared to public markets where a specific asset is generally priced at any given time during the opening hours of the markets, a specific real estate asset is usually traded only a few times in a decade and mark-to-market valuations are done every quarter at most.

To make it simple, the exercise of pricing real estate involves a combination of the expected income generated by the investment and of the cost of equity for the investors (and the cost of debt for lenders) at the time of the investment. The income expectations can be impacted both by micro features (e.g. assets specification) and by macro factors (e.g. megatrends), while the required cost of equity and of debt is mainly driven by financial markets dynamics. The latter impact was extremely evident during the last decade.

BOND RATES IMPACT

It was not a coincidence that meanwhile the government bond market recorded a period of unprecedented low rates, real estate yields reached low levels in 2018 – 2022 that the industry never witnessed before. Out of the 45 markets considered for this analysis,[1] all of them except two reached the historical lowest yields level in that five-year period.

However, just like how the drop in government bond yields was the main driver of value rises in 2018-2022, the rise in bond yields since 2022 has been the main cause of value losses in all European real estate markets, regardless of rental trends.

Analyzing from a different angle this trend: the downward pressure on real estate yields started when the spread between government bond rates and real estate yields reached an historical high in 2015 above 400 bps on average and changed direction when the spread was around only 60 bps at the end of 2022.

1 Office, logistics and high street retail in 15 countries (Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Netherlands, Norway, Poland, Portugal, Spain, Sweden. United Kingdom)

LIVING THOUGHTS

A BNP PARIBAS REIM RESEARCH PAPER

FEBRUARY 2024

THE CORRELATION BETWEEN REAL ESTATE YIELDS AND BOND RATES

The correlation between bond rates and prime real estate yields have been analysed on quarterly data from 2007 to 2023 for a total of 68 data points for each of the 45 markets considered.

At a first glance, the outcome shows a correlation not as clear as expected. The average for all markets shows a positive correlation coefficient (meaning that bond and real estate yields should move in the same direction), but the level of the coefficient is somehow modest (0.65 for the average of all markets) and with limited variance among sectors.

However, the picture changes when these correlations are recalculated with an additional time lag on the real estate yields (correlation of bond rates with prime yields recorded x quarters after).

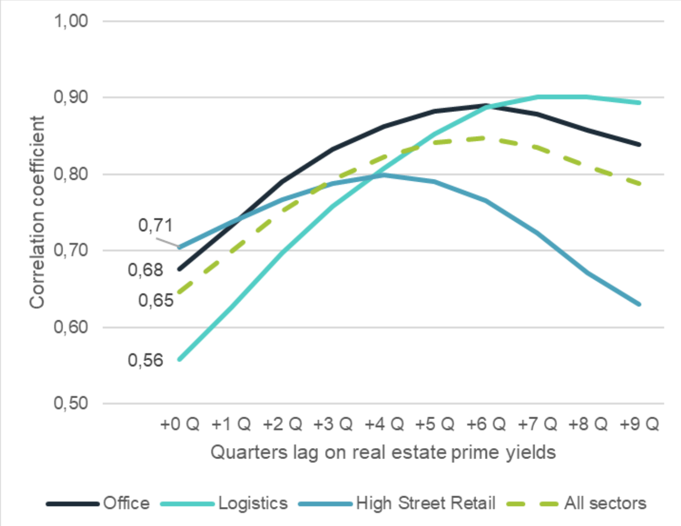
This exercise provides consistent results among most of the markets: the correlation increases, reaches its maximum with a time lag of four to six quarters and gradually decrease with longer time lags. The impact of bond rates changes needs some time to be reflected on the real estate market.

Why is there this time lag in the correlation? This is due to the length of the decision and acquisition process of a real estate asset. Sourcing an asset, negotiating, running a due diligence process, and potentially structuring and financing the deal, could easily make the transaction price to be defined even months before closing.

Moreover, investors not investing directly will analyse the offering of different managers and have a due diligence on them and on the funds. Finally, investors, especially when the cycle are at a turning point, will be cautious and reach the sufficient comfort that markets are indeed changing direction.

FIGURE 1: CORRELATION BETWEEN BOND RATES AND REAL ESTATE PRIME YIELDS WITH DIFFERENT QUARTERS LAG

Correlation on quarterly data between 2007 and 2023; average correlation of 15 markets by sectors



Why is this topic of interest today? Because in Q4 2023 there were evidences that the bond rates could be changing direction. Indeed, in Q4 2023 bond rates recorded a steep fall of ca. 80 bps in major markets such as Germany, France and UK. These were among the largest quarterly falls in the last decade.

The start of 2024 recorded a minor bounce back. Inflation has not yet demonstrated to be fully under control and, consequently, there is still some uncertainty on when and how quickly the ECB will decide to start cutting interest rates. Though, Q4 2023 could have provided the first evidence that also real estate yields will reduce soon, according to the usual time lag described in this paper.

Source: BNP Paribas REIM calculations, BNP Paribas Real Estate Research, Macrobond (data as at February 2024)

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FUNDAMENTALS ARE KEY

This paper is focusing on the relation between bond rates and real estate yields, however there is a missing variable in the equation: rental growth. Indeed, even assuming that the monetary policy is close to a turning point and bond rates recent correction will consolidate, the real estate pricing dynamics will for sure be driven by yield movements but expectations on rental growth will be part as well of the equation. On the one hand, a positive rental growth can push values upward even with stable yields, on the other hand investors could be more willing to accept lower yields if they expect future rental growth.

The rental outlook is based on the fundamentals. E.g. demand and supply of space. This varies among the different real estate asset types. Among commercial real estate we expect logistics, hotels and healthcare to overperform. Therefore, we expect those property types to be the first to experience a decline in yield levels.

WHAT IS NEXT?

Our latest expects that real estate values should stabilise in 2024 and rise in 2025.. Though, bond rates adjustment has proven so far to be quicker than our expectations and if this would be confirmed it may translate in an earlier than expected turning point. The spread between government bonds and real estate yields was at the end of 2023 already close to 200 bps on average. A much healthier level than in 2022 and earlier 2023.

In all cases, 2024 looks to be a good timing to invest in real estate: clarity on monetary policy direction should improve (providing investors confidence) and real estate values should have reached their trough. However, given the time needed to deploy capital in the real estate market, this would mean that investors should start to make decisions today to scan the market in coming months and take advantage of the best investment timing for this cycle.

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