RESEARCH · REAL ESTATE

The real estate market in Europe: what effect from rising rates?

Where the pressure is greatest, which segments resist, and why 2024 may offer an entry point

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> *To counter inflation, the world's central banks have not ceased to raise their policy rates since the middle of 2022. Does the slowdown and then the decline of the real estate market in Europe that followed give reason to fear a continuation of the trend for 2024?*

Signs of overvaluation

It is true that there are growing signs of overvaluation in real estate markets across Europe, of the order of 10 to 15% in most countries. The risks of a fall are amplified by the growing pressure on household balance sheets due to higher mortgage rates and lower real incomes, because of high inflation in the prices of energy, food and other goods, which has reduced accessibility to property ownership.

In France, for example, according to Crédit Logement CSA, the borrowing capacity of households has diminished by 12.6% since the beginning of the year. The IMF estimates that the rise in the cost of living and in interest rates tends to put household finances under severe strain, and that more constraining financial conditions will bring one consumer in four to reduce their spending because of real income losses.

In their most pessimistic scenario, 45% of households could find themselves financially stretched on average, holding more than 40% of mortgage debt and 45% of consumer debt. A third of consumers could be constrained to reduce their consumption of non-essential goods in order to face their basic expenditure, which represents 30% of overall consumption.

We estimate that debt service repayments have increased by a third on average, and by up to 70% in the United Kingdom. In that country, most mortgage loans are at a fixed rate for five years and will have to be renewed at much higher rates, which will reduce the purchasing power of consumers. To maintain monthly payments at 2021 levels, the purchasing power of borrowers would be reduced by 40% in the United Kingdom, and by more than 20% on average in European countries.

Commercial real estate under cyclical headwinds

The commercial sector also faces powerful cyclical headwinds, as the strong increase in interest rates remains a major source of concern. The tightening of credit standards and of the general conditions of banks, in particular in the real estate sector, has brought about a contraction in the annual growth of loans this year across the whole euro zone, but in particular in Germany, France and Italy, amplifying the negative impact on the commercial real estate market. According to the estimates of Allianz analysts, weak economic momentum is bringing about an increase in corporate bankruptcies, which could lead to a rise in rental defaults. The principal users of offices recorded the strongest resumptions of corporate bankruptcies in 2022. Analysts foresee a rise in bankruptcies in France, Italy and Germany, and that real estate prices could continue their decline next year. A strong increase in construction costs arising from stricter conditions has also discouraged investment and has increased the expenditure linked to the maintenance and modernisation of buildings.

Which segments resist

Despite the pessimism, certain segments of the market resist better than others. Data centres and logistics in particular are the positive sectors, with an increased dependence on cloud services, on online communication and on data-storage companies requiring a robust infrastructure to support their operations. Consequently, the data-centre industry has experienced a strong demand for space, which has brought about the expansion and construction of new installations to answer the growing needs of businesses.

Hotels are also recovering from the blow dealt by the pandemic, while the retail sector remains the most fragile. Before the pandemic, hotels had experienced a period of robust growth and prosperity: even the great cities of the euro zone had seen a strong increase in the construction of hotels, or in their conversion, and occupancy rates had remained consistently high, even with the rise of competitors such as short-term rental platforms. After the spectacular fall in tourism during the pandemic, occupancy has progressively recovered, in particular in Spain and France, and the outlook remains positive as the sector adapts to technological changes and to the changing preferences of travellers.

Reasons to hope for better days

Many other reasons to hope for better days in 2024 also exist. Construction costs, already, reached a peak during the first half of 2023, allowing developers to determine their profit margins with more certainty. This is a crucial point, because the banks, which strongly reduced their real estate lending in 2023, represent an essential point of blockage before any restart of the real estate market. No bank likes to lend to a developer for a loss-making project. We have observed since September, in Germany notably, a restart of real estate lending by certain large banking lenders, which are often the first to resume service.

There are also several signals of a return to economic normality in Europe for 2024, which would give a little air to the European real estate market, with growth that should recover 0.5% to establish itself at 1.3% in the euro zone, and a NextGenerationEU recovery plan that should continue to support growth next year.

Moreover, historically, when blockages on bank credit last too long, it is frequent to see politicians intervene to remind our dear bankers of their primary duties, for fear of electoral sanction. Governmental policies of support for the real estate market, fiscal incentives for the purchase of houses, or increased financing for housing construction, are usual in these market conditions.

Finally, euro zone inflation passed below the symbolic bar of 3% in October, at 2.9%, its lowest level for two years. Even if central bankers do not yet want to speak of a rate cut, betting on an inflection of the curve for 2024 seems to us coherent, and by the same token an interesting entry point on the European real estate market. Did Powell not deny for more than a year after the Russian invasion that he would raise rates?

Enough to imagine a future that is not radiant but better for the European real estate market in 2024? It is a step we are ready to take, and a progressive re-entry during the first half could prove beneficial for dynamic diversified investment portfolios.

A Spanish case study with a social dimension

Spain has an ageing population, with nearly 20% of people over 65 and a regressive pyramid typical of developed countries. But 90% of this population owns its property, in the finest districts of Barcelona and Madrid. Following the fundamental economic data of the market, there are numerous opportunities to acquire apartments. A demographic and actuarial study was carried out with doctors in economics from the University of Barcelona, and an exhaustive analysis was conducted using data from the Instituto Nacional de Estadística and the Agencia Tributaria Estatal in order to produce mortality tables and projections.

Due to the rise in energy prices, after an already difficult Covid period, and to the rise in rates on account of inflation, the increase in the cost of living tends to put the finances of these people under severe strain. More constraining financial conditions will bring these people, who wish to remain in their districts, to act.

Structures of a life-interest type answer this problem with a social approach, allowing the current owner to obtain a supplementary income to improve their quality of life and to remain in their district until the end of their life. The commitment towards the former owners, after the purchase, is not only to provide a solution to a situation of financial need, but extends also to a commitment to protect them and to take care of them.

Investors obtain an attractive profitability with quality assets by acquiring this real estate in districts such as the Eixample, Sarrià-Sant Gervasi, Chamartín, Chamberí and Salamanca, a niche investment with fiscal advantages and a social impact in Madrid and Barcelona.

— Luxembourg For Family Office.

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