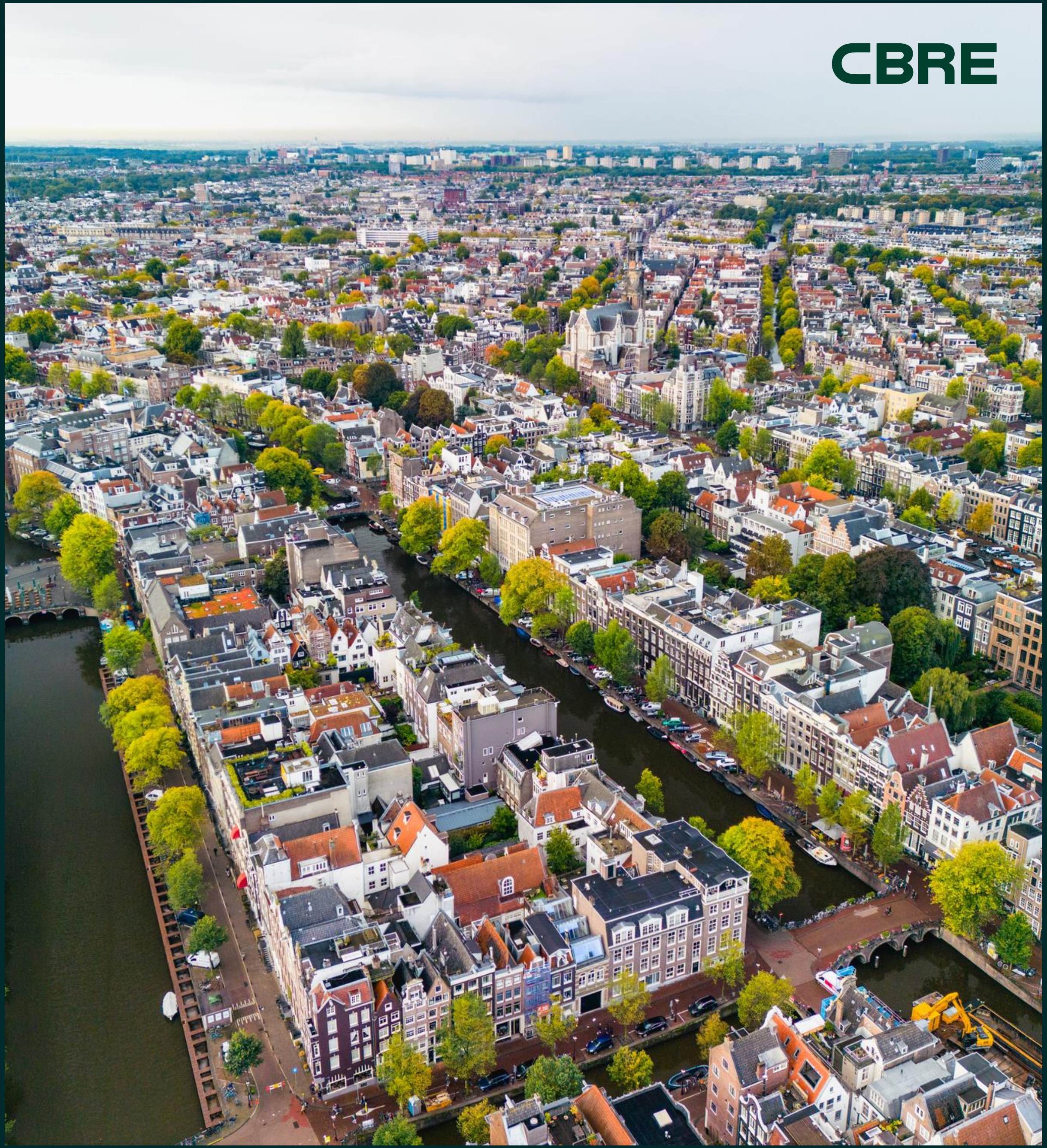
Depreciation of Real Estate almost at an end, Market dynamism returns

Mid Year Market Outlook 2023

REPORT

The Netherlands
REAL ESTATE

CBRE RESEARCH



Dear reader,

After a quiet spring, we are preparing for returning activity in the real estate investment market. Historically low investment volumes marked the market in recent months, and investors have had to cash in. Necessary and inevitable were the sharp downgrades of book values. But now, we are seeing realistic, market-based prices again.

Now that the band-aid is off, we can look forward and upward again. It is noticeable in the market: parties are moving again. In the past we have seen that decisive investors, who buy without delay after quiet periods, end up achieving the highest returns - provided the timing is right. And that time is coming: to reap the benefits of the increasing liquidity we expect over the next six months, now is the time to get in.

Kind regards,

Erik Langens
Executive Director Capital Markets

Content

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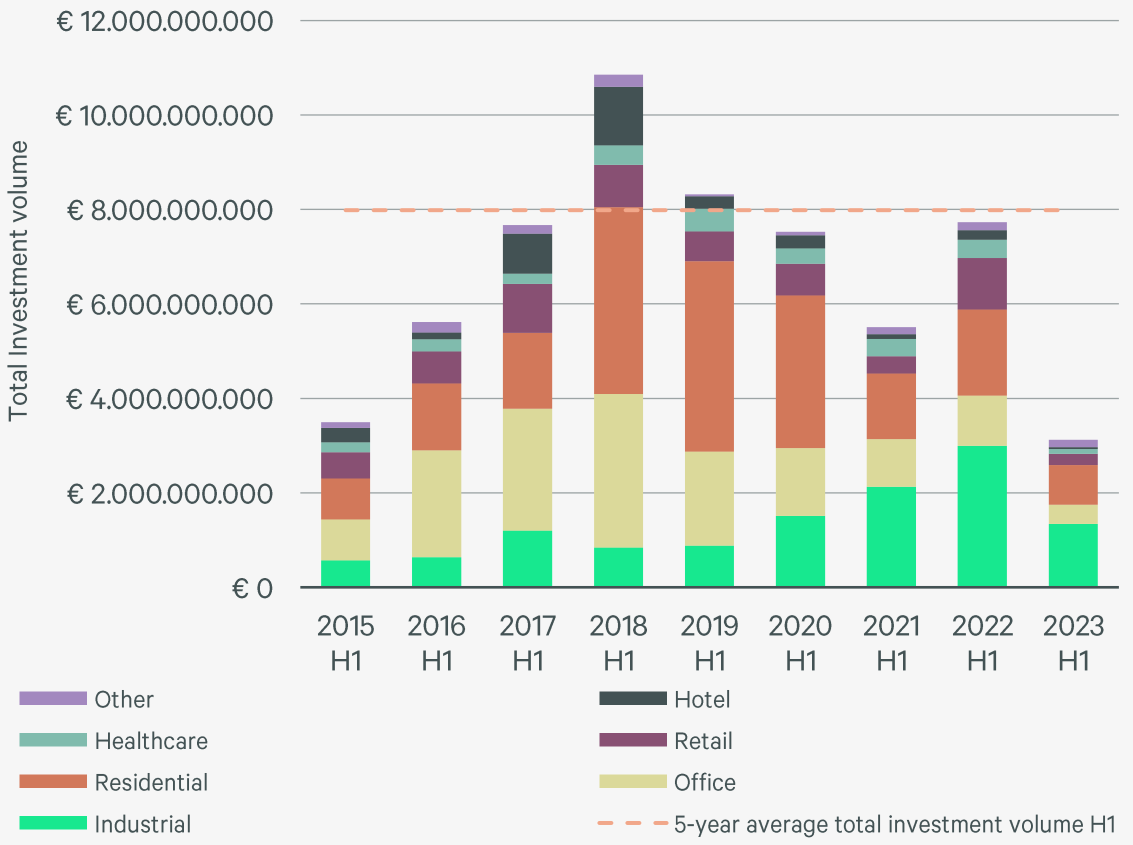
Introduction

01
INTRODUCTION

Like last year, the Dutch investment market this year looks set to be one of striking contrasts. The first half of the year was marked by depreciation, reassessment of investment strategies, and a search for the new price level. All this resulted in a historically low first-half investment volume of €3.2 billion. A 60% drop from last year. However, the second half of 2023 seems to offer more certainties that should lead to increased investment activity. The expected fall in inflation, stabilisation of interest rates and clarity and transparency about the new price level in the real-estate market means that parties are increasingly aligning to do deals. However, this is happening different speeds. Whereas in the logistics market and, to a lesser extent, the retail market, momentum is returning in leaps and bounds, this is still less the case in the office, residential, care and hotel investment markets. Nevertheless, CBRE expects momentum to pick up in these sectors too in the autumn.

Investment volume H1 (2015-2023)



Source: CBRE Research

02

Economy

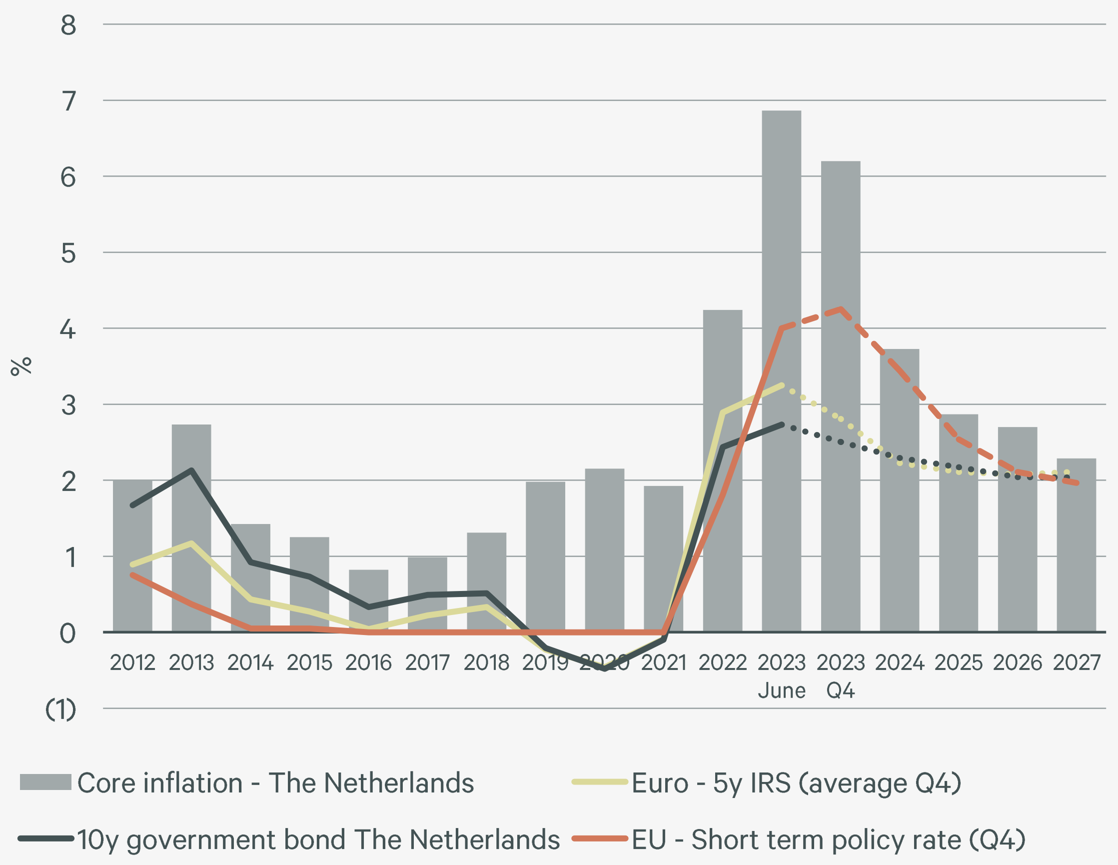
02
ECONOMY

Drop in inflation ahead, interest rates stabilise

After a year of interest rate hikes, a fall in core inflation is on the horizon. A drop in consumer spending is the first indication of a cooling economy, which could also bring inflation - albeit slowly - under control. Strong collective wage increases and measures to support purchasing power have caused a marked slowdown in the fall in inflation. Despite this, core inflation looks set to take its first downward steps in the autumn, after which it will fall to the desired level towards the end of 2024.

Due in part to the persistence of inflation, it remains difficult to estimate whether the July 2023 interest rate hike will be followed by another in September. Nevertheless, the general expectation is that policy interest rates will have peaked after that. And this is good news for the development of capital market interest rates as well as property prices. Since various capital interest rates seem to be reaching their peak, the vast majority of property market depreciations are a thing of the past. The fact that in the medium term slight compression may start to recur in initial yields in the property market, means that many investors see the coming period as the ideal entry point.

Development of key economic parameters



Source: CBRE Research, Macrobond, ECB

03

Investment Market

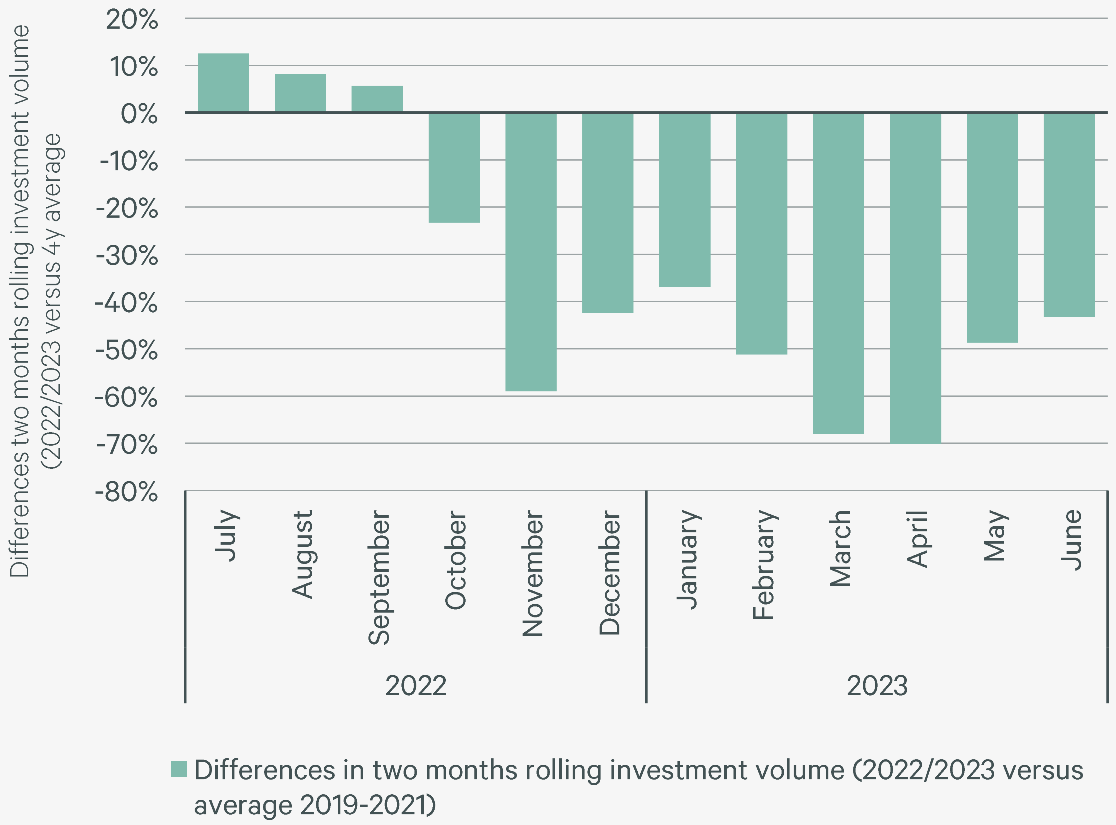
03
INVESTMENT MARKET

Recovery already visible in last few months

In the first three months of 2023 investment volume reached levels that CBRE had not recorded since 2015. Compared to the first quarter (€1.4 billion), investment volume in the second quarter was already a quarter higher at a level of €1.8 billion. Still significantly lower than that recorded by CBRE in recent years.

Nevertheless, the 2-month average investment volume provides the first confirmation that investors find the current market conditions attractive enough to re-engage in the buying market. And sellers are also willing to sell at the revised prices.

Difference in 2-month average investment volume 2022/2023 compared to 2019-2021



Source: CBRE Research

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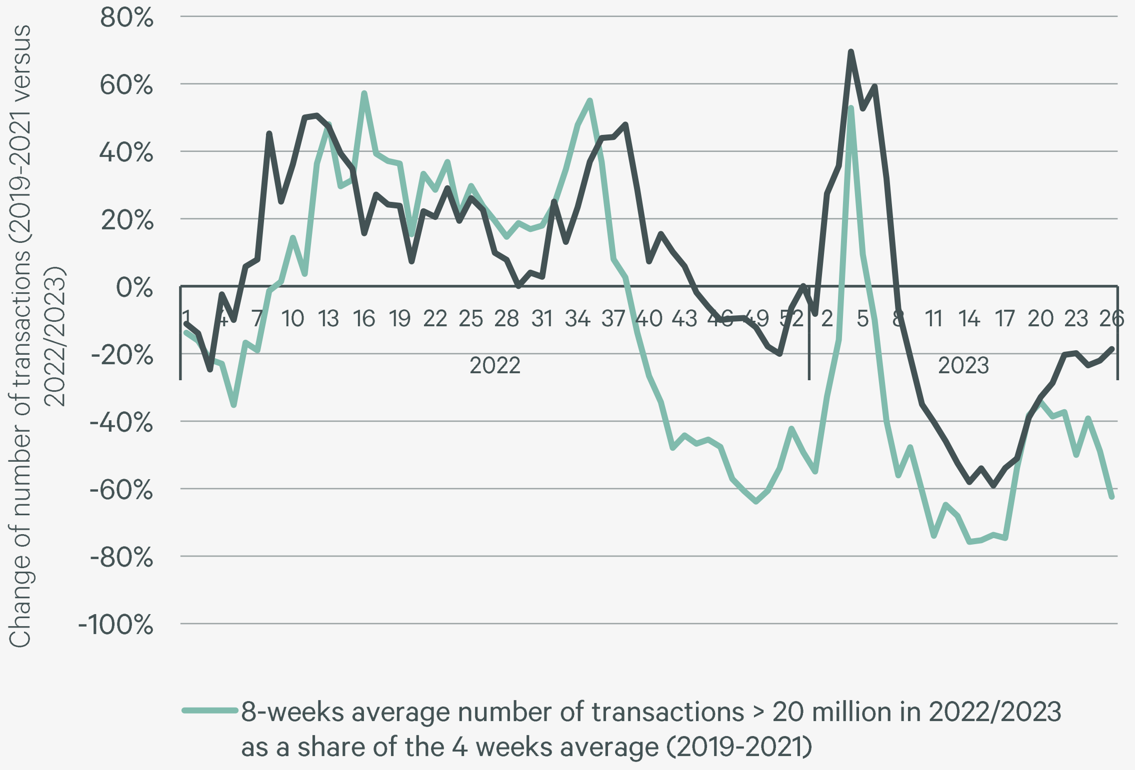
INVESTMENT MARKET

Consequently: momentum has been increasing for three months in a row. And the momentum is still 'only' 43% below the level of the period between 2019 and 2021. 'Only' because one needs to bear in mind that prices are around 7.5% to as much as 40% lower than in the period under comparison. Taking this into account, the momentum is still only 25% lower than in the heyday of the Dutch investment market.

This picture is confirmed when looking at the trend in the number of transactions in the last few weeks and contrasted with the same period between 2019 and 2021. This shows that the 'mid-cap' market (transactions < €20 million), in particular, but also the market with transaction volumes above €20 million, is again showing increasing dynamism. The main explanation for a lesser recovery of transactions above €20 million is that the recovery is actually less evident in the office and housing market, precisely the sectors where normally most transactions are above €20 million. Therefore, not every sector can be said to show the same rate of recovery. The main reason for this diffuse sectoral picture is two-fold: firstly, the fall in prices is not the same everywhere, and secondly, the fall in prices is not and cannot be accepted in every sector by every selling party.

Difference in number of transactions < 20 million & > 20 million 2022/2023 compared to 3-year average



Source: CBRE Research

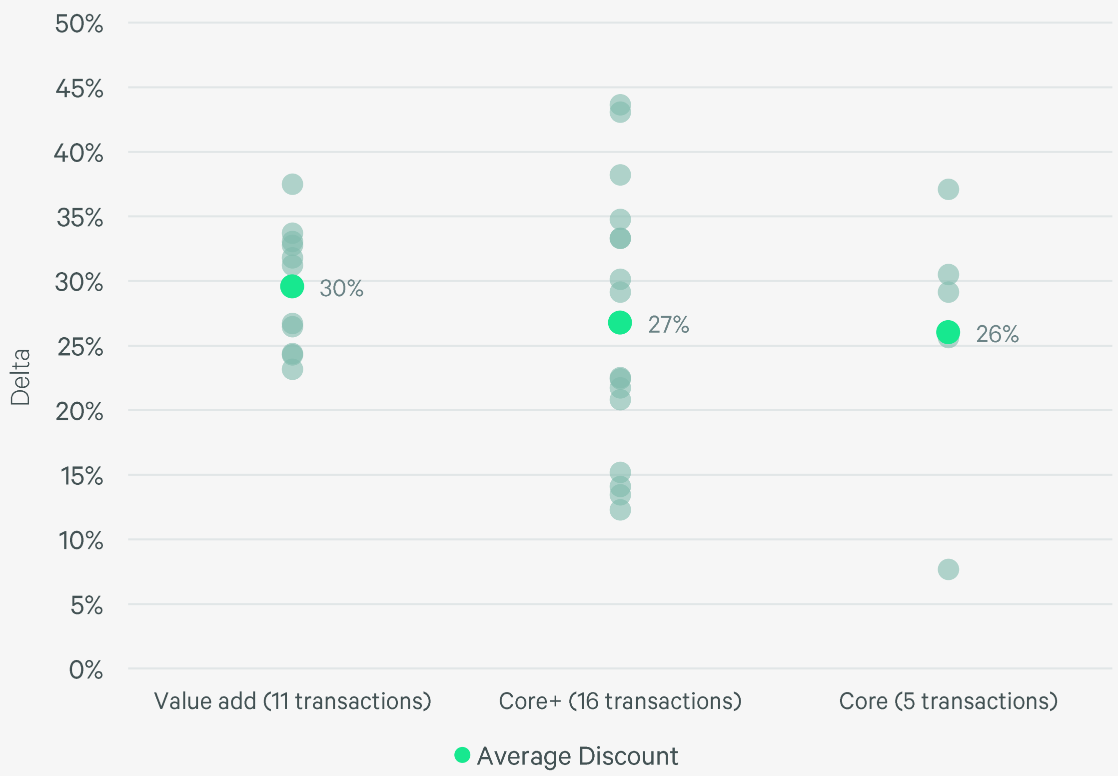
03
INVESTMENT MARKET

New price balance almost fully achieved

Looking first at the changes in pricing, one can conclude that across the breadth of the property market there has been a drop in value of between 7.5% and 40% in one year. A wide spread in depreciation that can be easily interpreted per sector. The most limited decline in value is visible in several retail segments. Here, decreases in value range from 7.5% to 15% depending on the type of retail segment and location. The fact that the smallest price decline was identified here has largely to do with the limited number of investors buying with financing. As a result, the negative impact of higher financing rates is less in this sector compared to other sectors. Furthermore, we see that - due to already relatively high initial yields - investors are actually allocating more money in retail properties again, as a result of which the demand for retail investments has increased.

At the other end of the spectrum: the office market. The office market is struggling firstly with sharply higher financing interest rates and secondly a change in risk perception partly prompted by the issue of sharply rising vacancy rates in the United States. To date, this has resulted in greater investor reluctance and, partly as a result, a larger price correction compared to the other property categories. Furthermore, it is apparent that future strong rental growth in the office market seems to be increasingly limited to the most modern office properties. Across risk profiles, office property values are now stabilising at 35%-40% lower than year-end 2021 values.

Price correction from historical high based on transactions and bidding processes H1 2023



Source: CBRE Research

03
INVESTMENT MARKET

The logistics market has recorded a price drop of 20-30%. However, it is now apparent that the capital value of logistics real estate is again stabilising. This is partly because initial yields have now been more or less stable for several months and partly because expectations regarding market rent developments now seem to be more positive than estimated more than a year ago.

In the residential investment market, there is a clear difference in depreciation particularly between existing construction and new construction. Future regulation reinforces the focus on sustainable homes and leads to a greater price reduction for older, energy inefficient homes. Many investors are reassessing their strategies based on these new 'rules of the game', which is expected to lead to a growing number of transactions for existing, older rental housing complexes in the coming year, as well as a higher number of sell offs of individual units. In the new-build market, transactions are now relatively low. Such transactions are the result of (lengthy) negotiations between developer, municipality and end investor on programming and yield value to arrive at a financially viable case.

The strong demographic and economic fundamentals are ensuring continued interest from investors in the new-build market. This does have the consequence that the decline in value in the housing market seems to be reflected most slowly in investors' book values so far. To date, we see a 15-25% drop in value based on transactions and bidding processes. However, we also continue to see some sporadic transactions at historically high pricing. These, however, are mostly small-scale and highly energy-efficient new construction sites on prime inner-city locations in the mid-priced rental segment, where the development risk for the investor has been completely removed.

In both the healthcare and hotel investment markets, there are opposite movements that - similar to the more positive rental growth in the logistics market - lead to a dampening effect of depreciation. In the healthcare investment market, demand for assests continues to grow from both domestic and foreign parties. Furthermore, the care home product is basically not affected by the proposed rent regulation, which only makes it more interesting for investors to allocate a larger part of investment volume to this area of the residential segment. All in all, for this very reason, CBRE has recorded a less steep 10-15% drop in value for extramural care homes compared to the start of 2022.

In the hotel investment market, the greatly improved operation - due to the faster recovery in overnight stays - is creating a softer landing. In addition, partly because of the Covid epidemic, the value changes in hotel properties had been adjusted earlier. As a result, the value impact on hotel properties remains relatively limited.

03
INVESTMENT MARKET

Expectations: a varied sector-based picture towards recovery

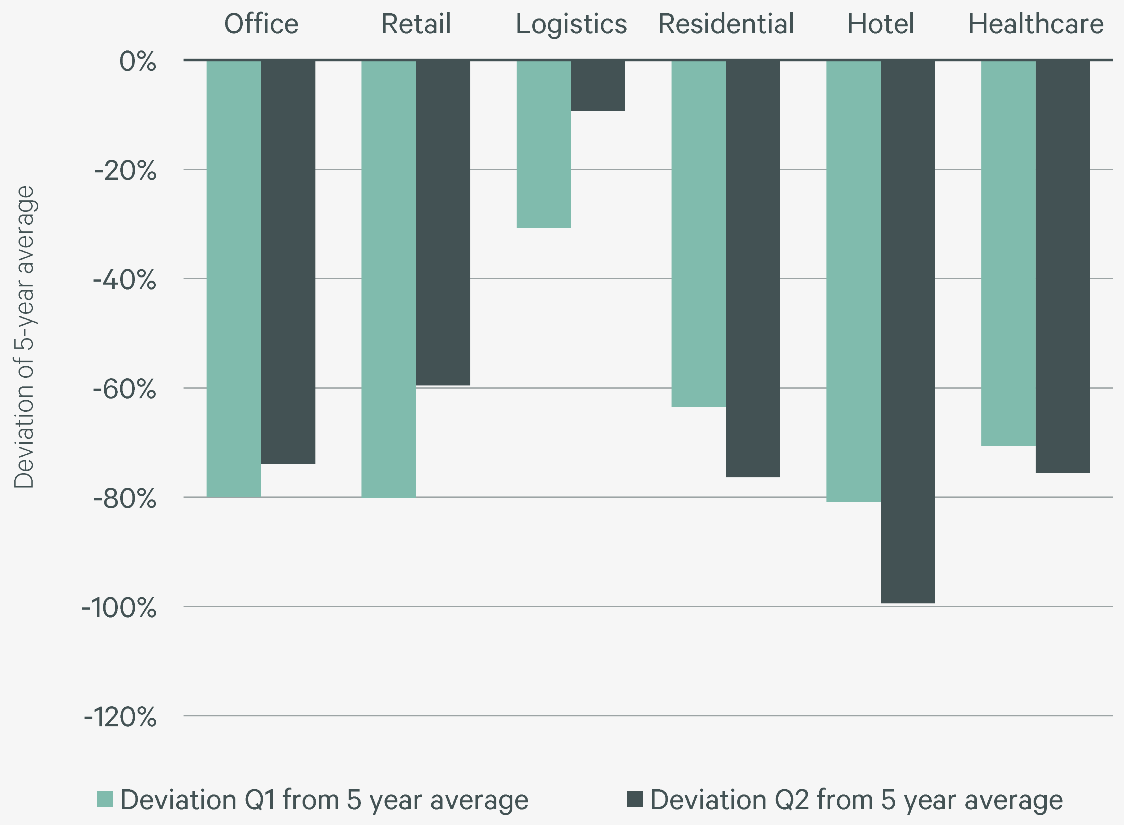
Against the backdrop of stabilising funding rates, CBRE sees uncertainty slowly ebbing from the market. The flattening trend in financing rates offers buyers and sellers greater certainty of a new price balance in the market. This is leading to a greater consensus on realistic price levels, and buyers and sellers alike are once again better able to come together as book values reach market price levels. And this situation is (still) without any forced sale in the case of the selling party.

To get a good sectoral picture of recovery, the 2023 transaction volumes have been set against the average quarterly volumes over the past 5 years. This shows that investment market dynamics are already growing strongly in logistics and retail properties, and to a lesser extent in office properties. By contrast, momentum remains very low in residential, healthcare and hotel investments.

Across the board, it can be said that the speed of recovery is determined by (1) the extent to which the market has accepted the new price equilibrium and brought it back on the books and (2) to what extent investment offers are (forced onto) the market that can be accepted by sellers at the new price levels.

All in all, over the next six to nine months, CBRE expects the momentum to grow and be more spread out across sectors with each month. The new price equilibrium looks set to be achieved in all sectors in the coming months, so the expectation of (slight) compression in initial yields in the medium term will strongly encourage boarding investors. However, the extent to which this is matched by willing supply varies by sector.

Investment dynamics Q1/Q2 2023 compared to 5-year average, sectoral



Source: CBRE Research

04

Logistics

04
LOGISTICS

Huge occupier market squeeze props up faster recovery of logistics investment

After a more challenging second half of 2022, momentum has clearly returned to the logistics investment market. In the first six months, investment volume stood at €1.4 billion, whereby 44% of investment volume in those six months was allocated to industrial and logistics properties.

The reason for the relatively faster recovery in momentum lies in the fact that the aforesaid price equilibrium for logistics real estate has already been achieved in the first few months of this year. Indeed, in parts of the market, capital value growth is a highly plausible prospect, which is contributing to investors becoming active in the market. What helps here is that even with the new (lower) prices for logistics real estate, new buildings - especially for large-scale developments - can often still be realised profitably. This is also related to the sharply lower steel prices over the past year, which are also bringing down the cost of realisation.

In addition, the occupier market for logistics remains good and demand continues to facilitate historically low vacancy rates. However, CBRE does see that a downturn in consumer spending means that 3PL's are now experiencing some degree of hidden vacancy, reducing their desire to expand. While this development somewhat curtails rental growth potential, the recovery is still expected to continue, albeit with weaker rental growth than in the last two years.

05

Office

05
OFFICE

Uncertainty of risk perception concerning office investment is still holding back some investors

With an investment volume of 400 million in the first six months, these six months in the office investment market can be characterised as very quiet. The recorded volume has not been this low since 2013.

The decline is largely the result of uncertainty about pricing and the decline in value per se. In addition, risk perception around hybrid working also plays a role. With increasing vacancy rates in the United States, several institutional investors in the Netherlands are also more uncertain about the exact impact of hybrid working. The main uncertainty here is the long-term structural demand and hence the impact on vacancy in the short term. This manifests itself partly through caution in the investment market and partly through a review of office investment strategies. Investors are choosing a narrower definition of a 'core' office investment, which means not all sales propositions are still seen as promising. Accordingly, fewer and fewer offices meet the criteria of a ‘prime location’ and, moreover, there are few offices in the Netherlands that also meet the strategy of institutional investors from an ESG perspective.

Nevertheless, there are arguments against investors' current risk perception regarding Dutch office properties. The developments in the Dutch occupier market contradict the market uncertainty felt by investors regarding the impact of hybrid working on the demand for office space. Despite the fact that corporates - in particular - need less office space, vacancy rates have fallen sharply in almost every city in the Netherlands over the past three years. Only in Amsterdam are vacancy rates rising, mainly due to the available new construction pipeline.

Furthermore, the limited expansion policy of municipal governments, combined with great experience in transforming office space, actually ensures a relatively low market risk, especially compared to other countries where this combination of factors is not present. In addition, companies in the Netherlands were already operating with a relatively low workplace per employee ratio (0.6 - 0.7) compared, for example, to the relatively high workplace per employee ratio (0.8 - 0.85) in the United States. This largely explains the much sharper rise in vacancy rates in the United States.

All in all, the end of depreciation will automatically ensure that more momentum returns to the market. Remarkably, the depreciation has now gone much faster - within 12 months - than in previous sharp depreciations, when it took mostly 2-3 years for price levels to bottom out. Thereby, the current market actually offers opportunities for less risk-averse investors who look at the Dutch office market with greater confidence now that some office investors are still taking a wait-and-see attitude.

06

Residential

06
RESIDENTIAL

The forthcoming elections will lead to more uncertainty and not help housing (investment) market

In the first six months, investment volume was stuck at €840 million. A decline to a level similar to that recorded in 2015. The rise in interest rates combined with future reantal regulation and a further increase in property transfer tax underlie this.

The drop in momentum compared to last year is considerably smaller for existing housing complexes (-41%), than for new construction complexes (-58%). This is largely explained by the fact that new-build transactions often fail to go ahead due to the insufficient net realisable value - and continuing high construction costs - to be financially viable as a project. It remains a quest by developers, municipalities and end investors together to find the right programming to achieve a financially viable housing project. The limited improvement in flexibility in this programming means that the new construction market is expected to remain very challenging towards the end of the year. The main opportunity here seems to lie in increased programming in new-build owner-occupied housing as purchase prices and confidence among individuals in that market segment are rising again. However, this does not contribute to a larger and affordable rental housing market in the medium term.

Existing housing complexes obviously do not have this problem, but here book values and bids are still often too far apart for agreement to be reached on price. Furthermore, there is a relatively high number of unsold portfolios in the pipeline as an outcome of the regulatory proposal. However, the strategic decision to proceed with a sale and what type of sale will also lead to possible delays for these parties due to the fall of the Dutch Government.

The coming months will show to what extent the announced regulatory measures from central government are not delayed or need adjustment. However, in order to maintain production of new buildings and labour market in the building industry, it is essential to get clarity on the policy to be formed in the housing market soon. With the current political uncertainty, construction output is expected to fall further and thus negatively affect the momentum in the housing (investment) market.

Should it still come to a decision around regulation, there also seems to be more support in the House of Representatives of the Dutch Parliament for at least a lighter form of regulation. This has everything to do with the critical stance that parties such as the DNB and the European Commission have already expressed about the regulatory proposal. A critical opinion from the Council of State could possibly be added here over the summer. On top of that, the wave of sell offs of individual units - previously predicted by CBRE - the drop in investment demand, and the sharp rise in rents as a result of this regulatory proposal are already being felt and seen. All in all, an increasing number of political parties seem to be concluding that the current regulatory proposal or further tightening of regulation is in fact not conducive to the goal of an affordable, available and investable housing market.

07

Retail

07

RETAIL

Confidence in retail investment despite falling consumer spending

With €230 million in transaction volume, momentum in the retail investment market also lagged sharply behind last year (-75%). That being said, we are now seeing quarter-on-quarter improvement. This improvement is mainly explained by the fact that in the retail market too the new price equilibrium has been achieved relatively quickly, showing a greater allocation of money to the retail market that is also less dependent on borrowed capital. All this also largely explains the relatively smaller price correction on retail properties described earlier.

Despite a decline in consumer spending, continued growth of e-commerce, rising costs due to rent indexation, repayment of financial support during the Covid epidemic, and higher procurement and labour costs for retailers, investors remain confident in the retail investment market. Indeed, the recent past has demonstrated the agility of the retail market, with almost all retailers successfully switching to an omnichannel strategy, making them more robust as they face the future. As a result, market risks have proved more manageable than previously thought, especially now that market rents are - much lower - and more in line with future structural market demand for retail space.

Fundamentally, this makes more money available for retail investment. This is the main reason why CBRE expects investment volume to show a significant increase in the second part of the year, especially as more retail investment product is being brought back on the market for sale.

08

Hotel & Healthcare

08
HOTEL & HEALTHCARE

Dynamic hotel and healthcare investments depend mainly on available product

Investment volume on healthcare (€100 million) and hotels (€40 million) has been very low to date. However, this is mainly due to the limited availability of investment product. The second part of the year sees more available product in the market for both sectors, which will also register recovery. For the hotel investment market, however, it is still noticeable that Covid epidemic risks sometimes still seem to be priced into the bids. However, this is at odds with the current historically strong operations of hotels in the Netherlands. To date, this is sometimes still leading to divergent bid and offer prices in the sales process.

For new construction sites for the healthcare investment market – although less so than for regular housing - the business case cannot always be made financially viable. Again, reprogramming to the current economic zeitgeist can help smooth both initial regular and care housing projects.

09

Conclusion

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CONCLUSION

A new beginning

All in all - like 2022 - a clear year with two contrasting facets. The revision of price levels, fall in inflation, and stabilisation of interest rates are adding significantly to the momentum of the Dutch property market into autumn. The outlook for initial yields ensures that there is a lot of investor appetite to tap into. With book values coming more in line with market values, transaction certainty in the market will begin again to increase. All this will result in a significant increase in investment volume compared to the first half of the year. For now, end-of-year investment volume is assumed to be between €8.7 and €11.5 billion. But, above all, this is a year in which the investment market made a fresh start at normalised interest rate levels.

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