Real Estate Research

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Scarcity: Navigating Supply-Constrained European Markets

IN A NUTSHELL

— DWS created a framework to assess the immediate and long-term supply outlook to identify supply-constrained markets with strong rent growth prospects in Europe.

— Residential sector remains most supply-constrained with chronic and increasing undersupply, especially in German top-7 cities and Copenhagen

— Logistics still has low availability of best-in-class product with high specifications, despite recent uptick in new supply in markets such as Belgium, the Netherlands and Paris

— Office sector shows big differences between (sub)markets and quality of stock, favouring markets such as London West End, Paris CBD and Munich

Since the beginning of the second half of 2024, we sense a shift in the mood and investor confidence. We've come a long way, from interest rates peaking in 2023, and recently the first set of cuts by various European Central Banks. This change heralds a new era of cautious optimism as the markets adjust to the easing monetary policies. With inflation nearing target, there's a palpable sense of relief that the tough measures taken by central banks have done their job. Looking ahead, now the interest rate storm has passed, we should turn our focus back to real estate fundamentals.

Predicting future interest rates, and ultimately property yields is difficult, especially given the wide range of factors influencing interest rates – and the elusive "neutral rate". Conversely, rent growth is a relatively easier component to forecast occupier demand, vacancy rates and expected new supply, as well as other structural and economic factors. Often the vacancy rate – and the change in vacancy – is the biggest driver of near-term rent growth. Barriers to future supply, development margins and the impact of regulations on future supply are a good gauge of medium-to-long-term rent growth. To identify markets with strong rent growth, we have developed a framework to assess the supply outlook.

Market Components of Supply Outlook

Source: DWS, August 2024

1.1 Vacancy vs. Supply Outlook

Analysis to identify the most supply-constrained European markets

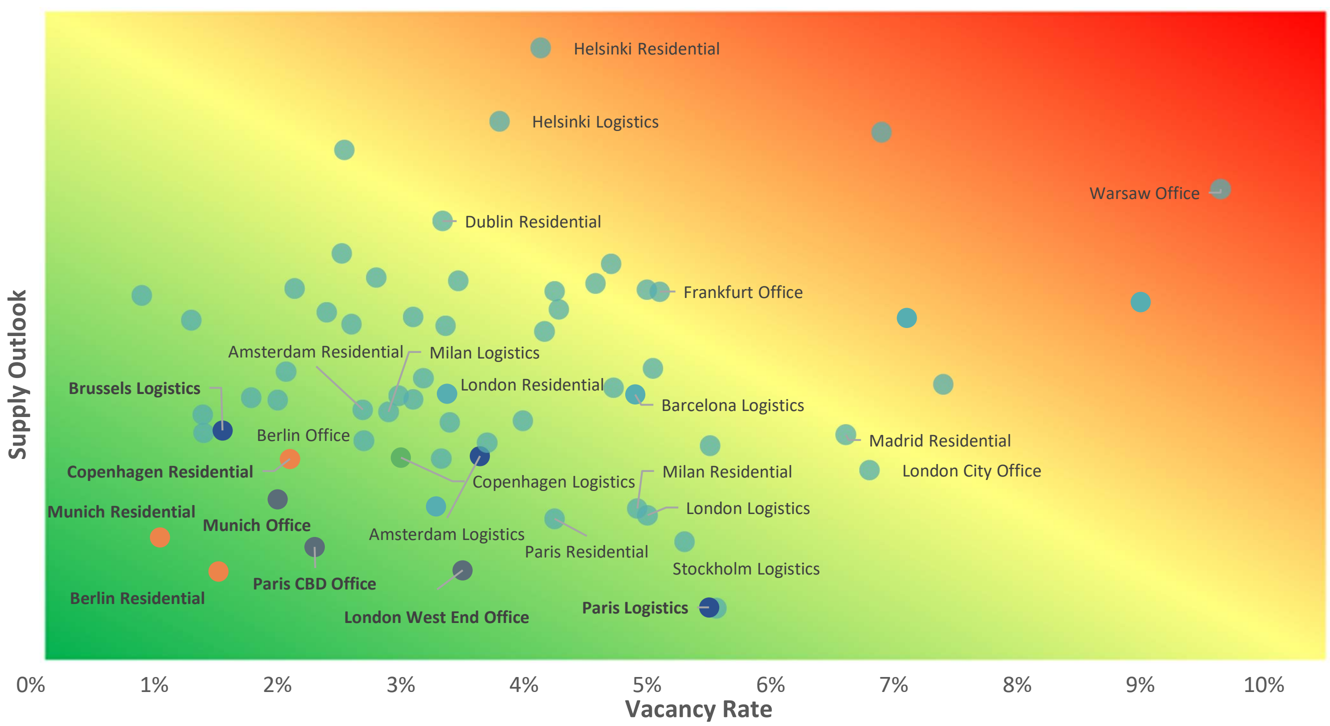
The current vacancy rate is a pivotal initial starting point for expected rent growth. The vacancy rate reflects the immediate availability of space but also influences future development decisions. Data on vacancy rates are generally widely available, and therefore immediate-term market rent growth is typically priced into property yields. Next, the expected change in these vacancy rates is a critical indicator of market trends, signalling near-term shifts in supply and demand dynamics. We estimate the change in vacancy rates based on the current supply pipeline and expected net absorption.

Growth in construction costs, estimated exit capital values and ultimately development margins impact the medium-term supply outlook. Low development margins can significantly limit future supply, as developers may be hesitant to embark on new projects if the expected return does not justify the investment, leading to a slowdown in construction activity.

Lastly, barriers to supply and regulation are poised to have a profound impact on the long-term supply outlook. Geographic constraints – such as limited available land – and legislative barriers like zoning restrictions substantially hinder the supply of new developments. New regulations, including sustainability-related factors, while important may also result in tighter supply if they increase costs or extend development timelines.

The chart below provides a tool for investors and developers to help assess market conditions and make informed decisions about property development, acquisition, and leasing strategies. A low vacancy rate coupled with a limited supply outlook suggests a landlord's market, where demand outstrips supply, potentially leading to higher rents and lower tenant incentives. We may see differences in rent growth between micro locations and quality of stock, and rent growth is not the only factor that determines an investment decision.

Figure 1: European Market Vacancy Rate vs. Supply Outlook



Note: Office vacancy refers to Grade A vacancy
Source: DWS, Broker Sources, Oxford Economics, Green Street, August 2024

1.2 The results

Where are the supply-constrained markets in Europe?

Our analysis looks at the attractiveness of a market based purely on supply-related metrics. We believe these markets could exhibit strong rent growth over the next 5 years, but also beyond (see figure 2).

Residential – Most supply constrained, with chronic and increasing undersupply

— **Berlin and Munich:** Exhibit virtually no vacancy, putting strong upward pressure on rent growth in the unregulated part of the market. Falling construction activity is enhancing demand-supply imbalances. Demand for housing continues to grow due to urbanization, a robust job market, and an influx of international residents.

— **Copenhagen:** A vibrant and competitive, reflecting the city's status as a desirable place to live. The demand for rentals remains high, driven by the city's growing international community and the preference among many residents for flexibility, whilst development starts have fallen sharply over recent months.

Logistics – Still low availability of high-quality stock, despite uptick in new supply

— **Netherlands:** Forecast to be one of our top-performing markets, with virtually no vacancy for modern units and a limited supply of zoned land constraining speculative development. However, demand remains high as a key logistics and distribution hub in Europe, thanks to the country's strategic location and advanced infrastructure.

— **Paris:** Demand for logistics space in the greater Paris region has outpaced the available supply, particularly for large-scale warehouses. This imbalance is exacerbated by the limited availability of land suitable for logistics use within the city's dense urban environment.

— **Belgium (Brussels/Antwerp):** Antwerp, with its bustling port, faces a high demand for logistics space, challenging the city's ability to expand rapidly enough to accommodate the growing needs. Similarly, Brussels, a pivotal logistics hub in Europe, grapples with the scarcity of available space due to its dense urban setting.

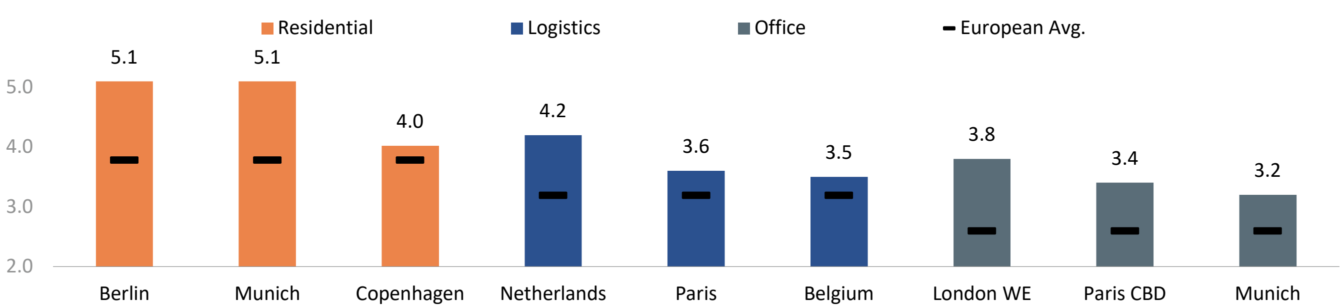
Office – Big differences between office (sub)markets and quality of stock

— **London West End:** Market conditions remain tight and upward pressure on prime rents persists. The scarcity is prompting developers to focus on refurbishing existing buildings and converting other types of spaces into offices, rather than constructing new ones, due to the historical and regulatory complexities of the West End.

— **Paris CBD:** With new planning laws prioritizing the conversion of office space to residential use to meet housing demands, the availability of office space is becoming increasingly limited. This shift is leading to a tighter market with fewer options for businesses seeking premium office locations in the heart of Paris.

— **Munich:** Remains a highly sought-after location for firms looking to capitalize on its economic strength and cultural appeal. Conversions in central locations are pushing up prime rents given the flight to quality and a smaller office footprint. Polarisation is visible as the vast majority of take-up is in the city centre.

Figure 2: Rent Growth (2023-2028F, p.a.)



Source: DWS, July 2024

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