Morgan Stanley
INVESTMENT MANAGEMENT

European Real Estate Credit

Safety Amid Fluid Backdrop

MORGAN STANLEY REAL ESTATE INVESTING | August 2026

Europe's macroenvironment is proving to be relatively resilient despite higher energy prices, elevated geopolitical risks and ongoing political fragmentation. Interest rate policy has shifted from dovish to hawkish to combat elevated inflation fueled by energy price spikes, leading to higher base rates. Real estate debt continues to screen attractively against other alternatives given re-pricing of ~25%, durability of income flows in sectors aligned to structural trends and a meaningfully lower supply environment, exacerbated by even higher construction costs. While Morgan Stanley Real Estate Investing (MSREI) remains constructive on the overall environment, the ability to build a diversified portfolio, dynamically shift capital between countries and/or asset classes and "stock pick" lending opportunities against assets with specifications and locational attributes that fit new occupier demand preferences, remains critical.

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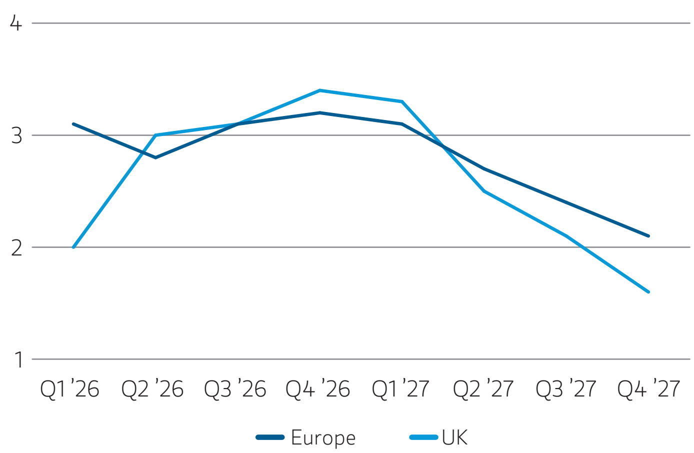
Macroeconomic Environment

European growth has moderated to below-trend levels as higher inflation has weighed on real household incomes and consumer spending. While headline inflation has been elevated by higher energy prices, these pressures are viewed as largely transitory, and core inflation remains relatively contained. As a result, the European Central Bank (ECB) has continued to normalize monetary policy, raising interest rates by 25bps, with additional tightening possible if inflation remains above target. Looking ahead, increased government spending and private investment in defense, infrastructure, and strategic industries should support a recovery in economic activity in 2027 as inflationary pressures ease.

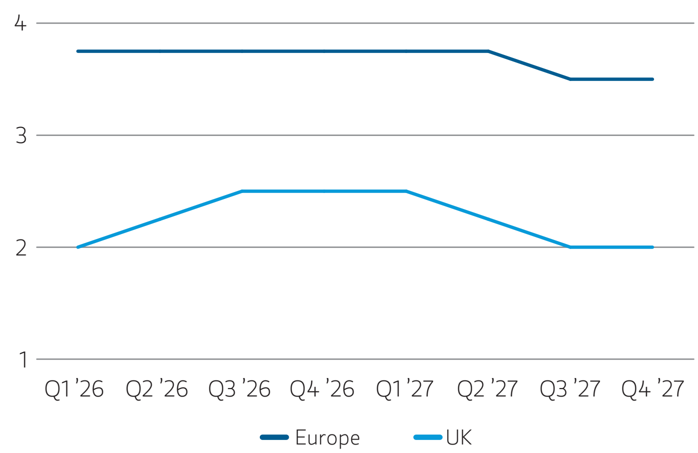
Despite significant volatility in energy markets driven by geopolitical developments, the impact on the broader economy has been less severe than initially anticipated. Global energy supply chains have proven more flexible, limiting both upward pressure on energy prices and the pass-through to core inflation. Economic growth has also remained resilient, supported by consumers temporarily drawing down excess savings to offset pressure on real incomes. In addition, manufacturing activity has benefited from the global capital expenditure cycle, while defense spending is increasingly translating into awarded contracts and investment activity, providing further support for growth.

DISPLAY 1
Inflation Expected to Moderate
Headline Inflation Forecast (Annual YOY %)



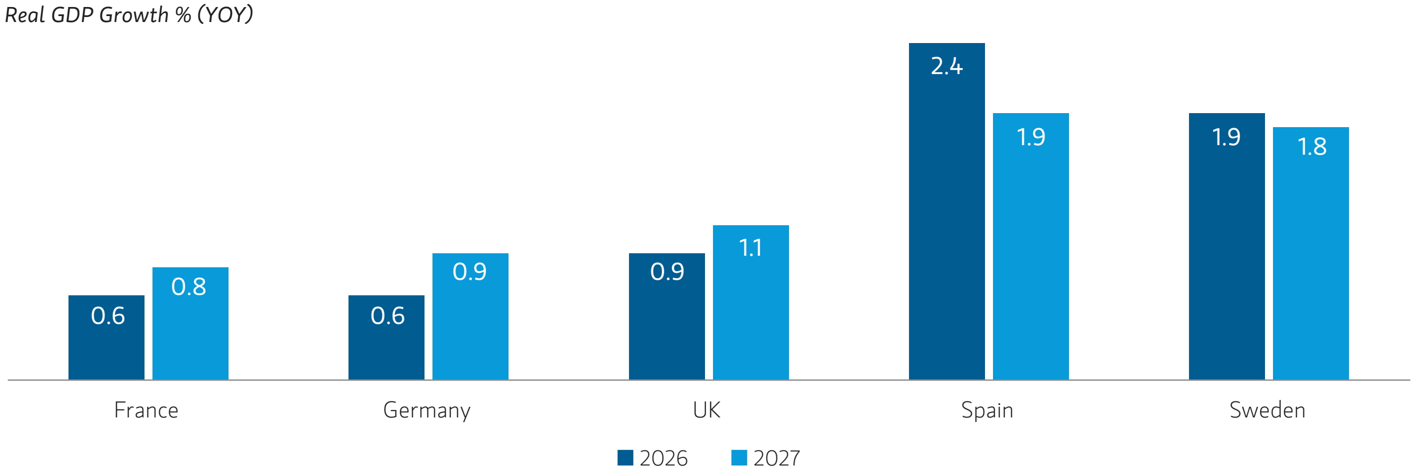
Source: MS Research, data as of August 2026

DISPLAY 2
Supporting Lower Policy Rates in 2027
Policy Rates (%)



Source: MS Research, data as of August 2026

DISPLAY 3
Growth Outlook Improving in 2027
Real GDP Growth % (YOY)



Source: MS Research, data as of June 2026

Commercial Real Estate Market

Real estate capital markets have softened following geopolitical uncertainty in the Middle East and the resulting shift toward higher-for-longer interest rate expectations. EMEA transaction volume declined 7% year-over-year to approximately €100 billion in 1H 2026, with the largest reductions in industrial (-28%), hotels (-20%), retail (-15%), and office (-7%). Apartments were among the few sectors to record growth, with transaction activity increasing 15%.[1] Despite the pullback in new transaction activity, the demand for refinancings and bridge financing remains high as investors look to address debt maturities and refinancing gaps.

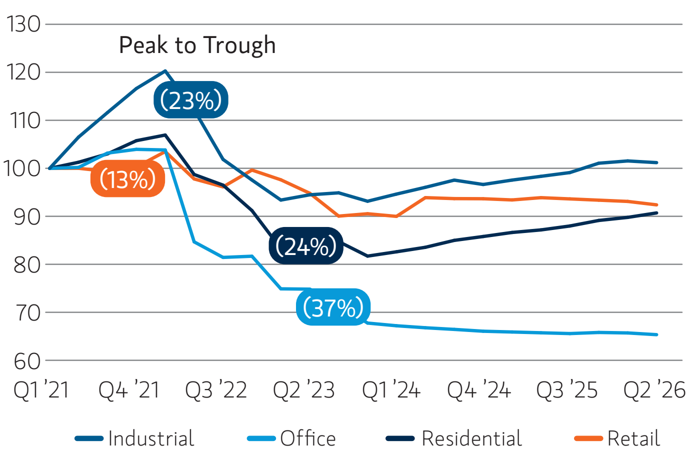
Alternative lenders continue to increase their overall market share given the pullback from banks who have become more risk-averse and tightened their focus on capital requirements.

Following a 20-25% decline in values and a meaningful expansion in yields, real estate is increasingly attractive relative to other asset classes, many of which continue to trade at record valuations or historically tight credit spreads. However, the most compelling aspect of the European investment thesis remains the structural shortage of supply. Outside of parts of the industrial sector, development pipelines were already constrained, and elevated construction and energy costs have further curtailed future

DISPLAY 4

Europe Values Have Begun to Inch Up

Commercial Property Price Index (Q1'21 = 100)

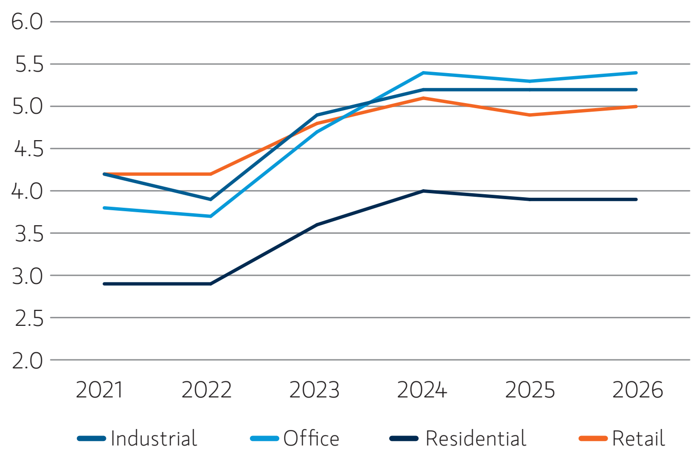


Source: Greenstreet August 2026

DISPLAY 5

Cap Rates at Highest Point in Five Years

Cap Rates for Stabilized Properties (%)

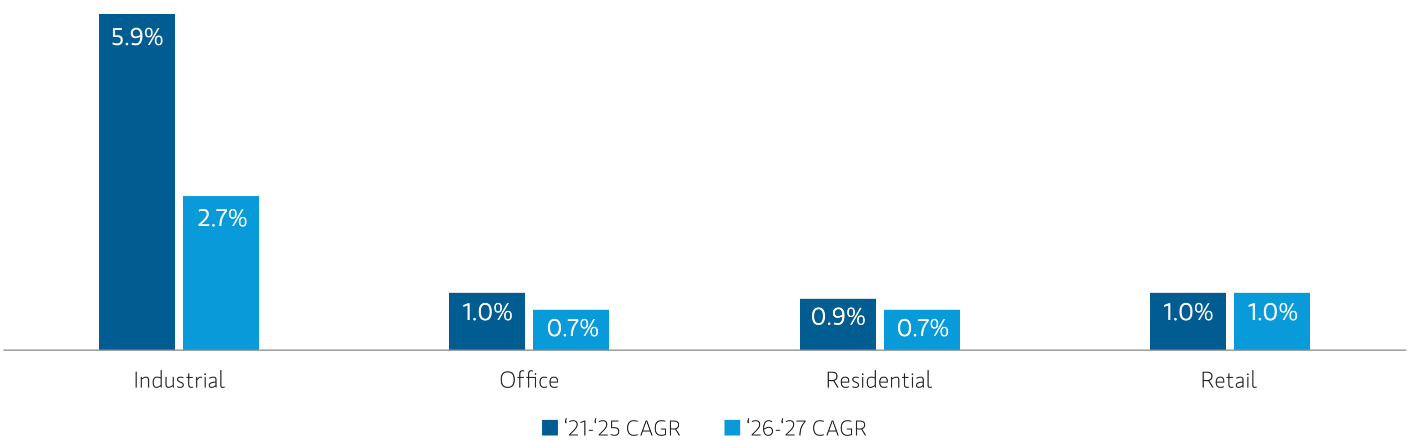


Source: Property Market Analysis, MSREI Strategy, June 2026

DISPLAY 6

Reduced Supply Supports Fundamentals

Annual Supply Growth (%)



Source: MS Research, data as of June 2026

[1] BlueGamma July 30, 2026

development activity. As a result, new supply is expected to remain limited for several years, supporting occupier fundamentals and rental growth even in a more moderate demand environment.

Investors are gravitating to safer asset classes and more resilient, downside protected capital structures with contractual income streams. Additionally, while lending margins have compressed or stabilized for preferred assets and sectors, higher base rates are supporting attractive all-in debt yields (euribor five-year swap rates have widened by 70bps since March).

Real Estate Investing Strategies

As discussed above, the ability to lend against tangible real estate aligned with long-term structural trends is a critical driver of outperformance, particularly in an environment where cyclical volatility, geopolitical risks and political fragmentation are becoming more frequent. Morgan Stanley Research highlights four key themes that have historically generated outsized returns: AI and technology diffusion (+108% LTM equity returns), deglobalization (+104%), societal shifts (+7%), and the future of energy (+56%). Despite this strong performance at the equity level, valuations for real estate linked to these same themes have largely remained flat, creating a notable disconnect. This divergence presents a compelling opportunity to lend capital into real assets at an earlier stage of repricing, with the potential for higher income growth as these structural tailwinds increasingly translate into physical space demand.

MULTIPOLAR WORLD

While tariffs, reshoring, and deglobalization continue to support industrial real estate demand, rising defense spending across Europe, particularly in Germany, is emerging as an additional tailwind. Heightened geopolitical tensions are driving increased investment in defense manufacturing, aerospace, and advanced technologies, generating demand for specialized industrial and R&D facilities. Established innovation hubs such as Munich and Paris are expected to be key beneficiaries, with defense-related occupiers becoming an increasingly important source of industrial space demand over the coming decade.

AI/TECH DIFFUSION

AI spending in the U.S. and globally continues to grow at an exponential pace, with nearly $3 trillion in AI-related infrastructure investment expected to flow through the global economy by 2028—over 80% of which is still ahead. Europe is benefiting directly through accelerated investment in data centers (MS Research expects the European DC market to grow +21% pa, until 2030) and indirectly given its

DISPLAY 7

MS Research Structural Themes, Equity Returns and Real Estate Strategies

		L12M Equity Returns	
Multipolar World	▪ Global defense ▪ Manufacturing reshoring ▪ Critical minerals ▪ Tech localization	104%	+ Industrial R&D + Manufacturing + Logistics benefiting from supply chain shifts
AI/Tech Diffusion	▪ AI enablers ▪ AI adopters ▪ AI infrastructure ▪ Humanoids/Robotics	108%	+ Data centers and derivative industrial + R&D innovation clusters/infill industrial + Prime office and resi
Societal Shifts	▪ Aging population ▪ AI-driven employment disruption ▪ K-shaped economy ▪ Shifts in demographics/consumer preferences	7%	+ Senior living + Class A Residential + High-end retail/hotels
Future of Energy	▪ Powering AI ▪ Nuclear renaissance ▪ Energy security and independence ▪ Clean energy	56%	+ Heavy powered solutions (industrial) + Micro grid value-add (batteries, NG conv.) + Value-add to improve energy efficiency

Source: Bloomberg Morgan Stanley custom ETFs, June 4, 2025, to June 4, 2026 export-oriented manufacturing base and global leadership in semiconductor equipment and other capital goods and industrial products. This dynamic creates a compelling opportunity to invest in real estate and markets that disproportionately benefit from AI enablement and physical deployment. The larger data center markets (Frankfurt, London, Amsterdam, Paris and Dublin) should generate incremental industrial leasing opportunities and innovation clusters in Munich, Paris, and London, should generate opportunities to lend to advanced manufacturing assets focused on the physical adoption of AI.

SOCIETAL SHIFTS

Persistent housing shortages, urbanization and for-sale affordability pressures are key forces shaping residential fundamentals in Europe. Stable cashflows, indexed-linked income and defensive demand make the opportunity even more compelling for debt investors. Given housing undersupply remains particularly acute (for example, only ~1,000 multifamily units commenced construction in London in 2025, down from an already low annual average of 5,000, for a population of 9 million),[2] the opportunity to lend to assets valued below replacement cost with

SECTOR	RELATIVE ASSESSMENT	CYCLICAL DEMAND	CYCLICAL SUPPLY	SECULAR BACKDROP	RENT GROWTH ('26-'30)	CONSIDERATIONS
Apartments	●	↑	↓	↑	3.5%	+ Unaffordable for-sale housing supports rentership. Rental affordability improving + Chronic undersupply – Higher inflation and energy costs may challenge lower income households – Regulatory risk in some markets
Student Housing	●	↑	↔	↑		+ Growing enrollment growth in preferred colleges. Higher share of international students + PBSA shortage in most markets + Margin premium over traditional residential + Counter-cyclical
Industrial	●	↔	↓	↑	3.0%	+ eCommerce, AI, defense spending and onshoring are demand accelerants + Construction starts down significantly off already low supply base – Higher fuel/transportation costs compress tenant margins + slower economic activity = weaker near-term demand
Retail	●	↔	↓	↔	3.1%	+ Higher personal savings rate cushions pull back impact on real incomes + Limited new supply, retail stock has shrunk in most markets – Discretionary spending may slow given higher inflation
Hotels	●	↔	↓	↑	2.3%	+ Continued preference for Europe over other regions driving international demand – Slowdown in travel from higher inflation and jet fuel costs may impact some markets without diverse demand
Data Centers	●	↑	↓	↑	4.2%	+ Accelerating hyperscaler capex driving demand + Industrial and advanced manufacturing opportunities leveraging AI expansion – Obsolescence risk, uncertainty over residual value and concentration risks remain challenging
Office	●	↑	↔	↓	2.3%	+ Improving office utilization (for prime locations) + Negligible new supply – Job growth slowing in line with growth + AI disruption risk (secondary locations challenged) – Capex remains elevated
Life Science	●	↓	↔	↑	2.3%	+ Aging demographics, AI aiding drug discovery, growing VC and govt funding off low base – Small market, pockets of excess supply

[2] Knight Frank, Multifamily Market Report, 2026

embedded rental upside remains compelling, despite regulatory headwinds. Additionally, purpose-built student housing assets in core Western European markets continue to attract strong bids. More broadly, the K-shaped economy is favoring residential assets that cater to higher-income households, while also supporting hospitality demand in key markets that benefit from multiple demand drivers, including both tourism and business travel.

FUTURE OF ENERGY

The availability, cost and security of energy remain top of mind. Higher costs, initially driven by the rapid build out of data centers, have been further compounded by energy price spikes stemming from the Middle East conflict and closure of the Strait of Hormuz. At the same time, demand is accelerating sharply, fueled not only by data centers, but also by the physical adoption of AI (e.g., robotics), defence spending and broader industrial and manufacturing activity. In this environment, investment strategies focused on assets with surplus or secured power capacity are likely to continue commanding rent and valuation premiums. Similarly, markets characterized by abundant, reliable, and lower-cost power are positioned to capture a disproportionate share of incremental demand.

Conclusion

Overall, real estate fundamentals remain supported by resilient demand, limited new supply, and favorable long-term trends. Although volatility in interest rates, inflation, and geopolitics is likely to persist, it further strengthens the case for real estate credit, particularly for alternative lenders who are not capital constrained.

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