Real Estate Research

January 2023

Europe Real Estate Strategic Outlook

First Quarter 2023

IN A NUTSHELL

- European property prices have undergone a significant correction over the past six months. However, we believe that most of the expected decline has now happened, and we anticipate that the full extent of the price correction should be over by the middle of this year, with a recovery beginning soon after.
- Occupier fundamentals remain in good shape, and while a European recession looks increasingly likely, any downturn is expected to be mild. Interest rates continue to rise as inflation remains elevated at the start of 2023, but falling commodity prices provide some upside to the near-term outlook.
- The repricing of the market creates an opportunity for newly allocated capital to engage in real estate investment strategies. Investors should take advantage of the current market to buy attractively priced assets and prepare for a return to real estate funds as valuations converge with pricing in the first half of this year.
- We continue to favour the residential sector, including operational residential such as student housing and senior living. A significant revaluation of the logistics sector is now providing an attractive (re)entry point, while price dislocation between prime and secondary office assets should also provide strong opportunities for the refurbishment of ageing assets as part of a value-add or impact strategy.

1 / Market Outlook

After performing well in the first half of 2022, an environment of higher inflation and interest rates, together with slowing economic growth, finally took its toll on real estate performance in the second half of the year, pushing total returns into negative territory for the first time since the onset of the Covid pandemic. Among diversified pan-European core funds, quarterly asset-level total returns fell to -2.4% in the third quarter, the worst figure since the Global Financial Crisis.[1] Annual returns were still comfortably positive at +8.4%, although this represents a sharp slowdown since earlier in the year. Evidence from the fourth quarter also strongly suggests an accelerating decline in performance, with asset values in the MSCI UK Monthly Index down by a total of -15.6% in the final quarter.[2]

In response to inflation at a multi-decade high, higher interest rates are now putting the brakes on economic growth. As costs have rocketed, consumers have found themselves with significantly less cash to spare and have pulled back on spending, while governments have made significant interventions to help with the increased cost of living.

[1] MSCI, December 2022
[2] MSCI, January 2023

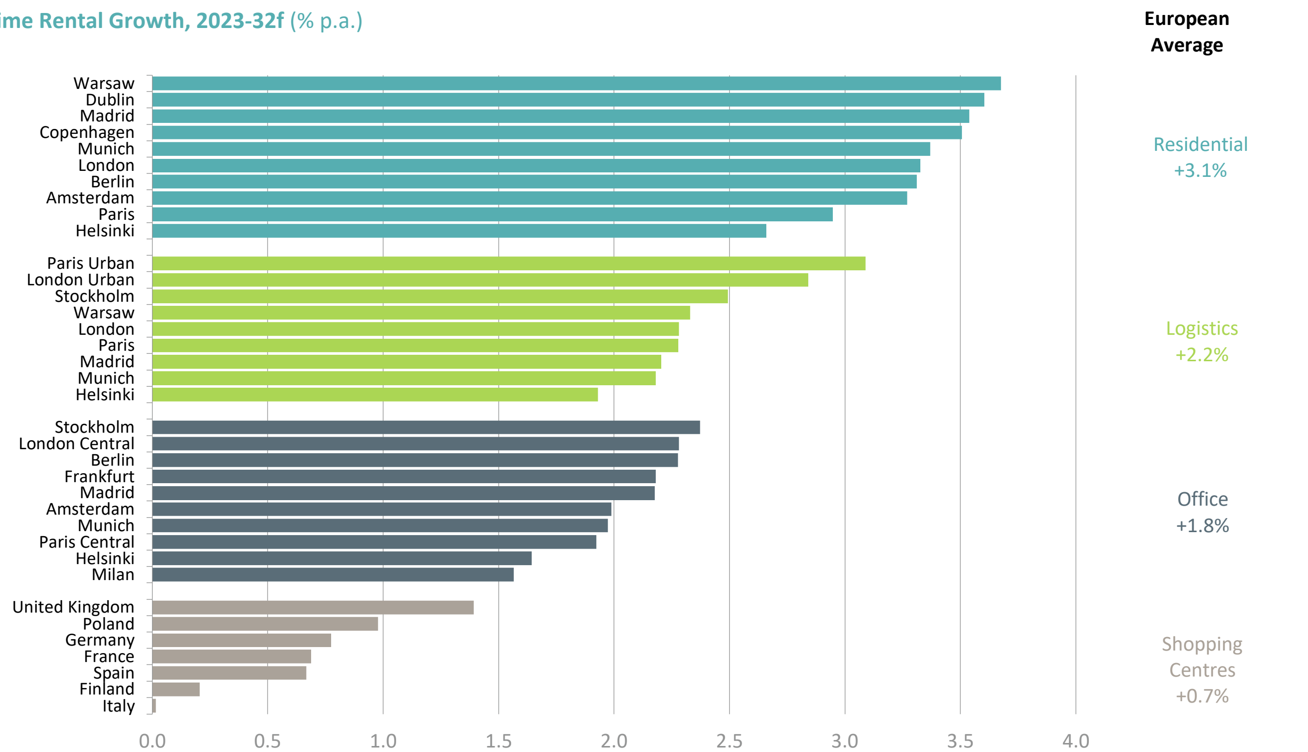
A tight labour market and accelerating wage growth mean inflation is anticipated to remain notably above target this year, with current predictions generally sitting in the 5–6% range, before falling back further in 2024 and 2025. As such, we expect that Europe could experience a mild recession early this year, although growth should remain marginally positive on average over 2023. However, the prices of energy and other commodities have already come down a long way since their highs last year, which could help to temper short-term inflation trends. This has already led to some improvement in European sentiment indices, while recent economic data has also surprised on the upside.

Real estate is often quoted as a good hedge against inflation, and while this certainly can be true, some parts of the market have been more successful than others at pushing through inflation into rents over the past year. In the residential market, for example, we expect European market rents to have grown by more than 7% in 2022, buoyed by higher wages, rising demand for rented accommodation in the face of higher mortgage costs for owner-occupiers, and the longer-term trends of undersupply and favourable demographics in major European cities.

At the same time, logistics rent growth has been equally impressive in mainland Europe, and stronger still in the United Kingdom. Logistics take-up trended downwards last year, yet weaker construction volumes meant that vacancy also continued to fall, reaching a new low of 2.9% by the third quarter, creating significant rental tension in the occupier market.

Nevertheless, this year, as inflation cools, we expect rent growth to weaken across all sectors. Retail, which after several years of decline appeared a step closer to turning a corner at the start of 2022, now looks to be in difficulty once more, as consumer spending will most likely be held back by higher living costs this year. The office sector could also struggle to record any meaningful rental increase in 2023, as both economic growth and the jobs market come under pressure. And with hybrid working looking increasingly like a permanent fixture in some measure, we expect office vacancy to move out in the short term.

Prime Rental Growth, 2023-32f (% p.a.)



Source: DWS, January 2023.
Note: f = forecast. Forecasts are not a reliable indicator of future returns. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

In the medium term, we do foresee some improvement for offices. Current market uncertainty, elevated borrowing rates, and much higher construction costs have meant that developers have taken a step back. Projects already underway will continue to progress, meaning that completion volumes will remain relatively strong this year. But from next year onwards we expect to see far fewer completions, and as economic growth picks up again, this should allow some breathing room for occupier fundamentals, leading to the return of positive rental growth. We feel this is particularly likely at the top end of the market, where well-located, modern buildings with strong ESG credentials are already in short supply and should continue to be in high demand.

So, while we anticipate some deterioration in the near term, for much of the commercial real estate universe, the occupier market remains in relatively good shape. However, investment market activity has taken a sharp turn downwards. Transaction volumes in the first six months of 2022 were very robust, surpassed only at the peak of the pre-GFC boom in 2007, but the brakes were firmly applied during the second half of the year. Final quarter volumes were down by around 65% year-on-year and represented the worst fourth quarter in the past decade. In terms of the number of properties transacted, the picture looks even more gloomy, with fewer buildings bought and sold than in any fourth quarter since data collection began in 2007.[3]

In part, declining investment activity has been down to significant uncertainty over pricing, a sizeable gap between buyers' and sellers' expectations, and a darkening outlook for the economy. And without significant distress in the market yet, there remains a lack of motivated sellers at the prices buyers are willing to pay. However, this may begin to change, as revaluation has happened quickly in Europe, and especially the United Kingdom. Certain parts of the market are also still in strong demand, with private residential, student accommodation and urban logistics, in particular, remaining at the top of many investors' wish lists.[4]

At the time of our previous update six months ago, long-term interest rates had already risen considerably, although there was relatively little evidence of property yields having moved out. We had seen some anecdotal evidence of price discounts on active deals, but valuers were not necessarily reflecting this.

Yet during the second half of the year, as expectations of higher inflation became more entrenched, interest rates continued to rise. Of course, fixed income yields, as we've seen recently, can move sharply from day to day, so pricing illiquid assets such as real estate against a daily spot rate should be undertaken with caution. But in the final quarter of the year, the German 10-year Bund settled within a range of 2.0–2.5%, representing an annual increase of around 250 basis points. As such, the real estate yield premium – which has remained elevated since the GFC – has been reduced dramatically. At the same time, the five-year euro swap rate stabilised at around 3.0%, meaning that together with increasing loan margins, borrowing costs rose by more than 300 basis points last year.

With this in mind, return requirements have risen, and the ultra-low yields of recent times are no longer viable for most investors. Although weaker deal flows make pinpointing current values more difficult, prime yields across different markets and sectors are estimated to have risen by anything from 30 basis points to as much as 170 basis points from their low point earlier in the year.[5]

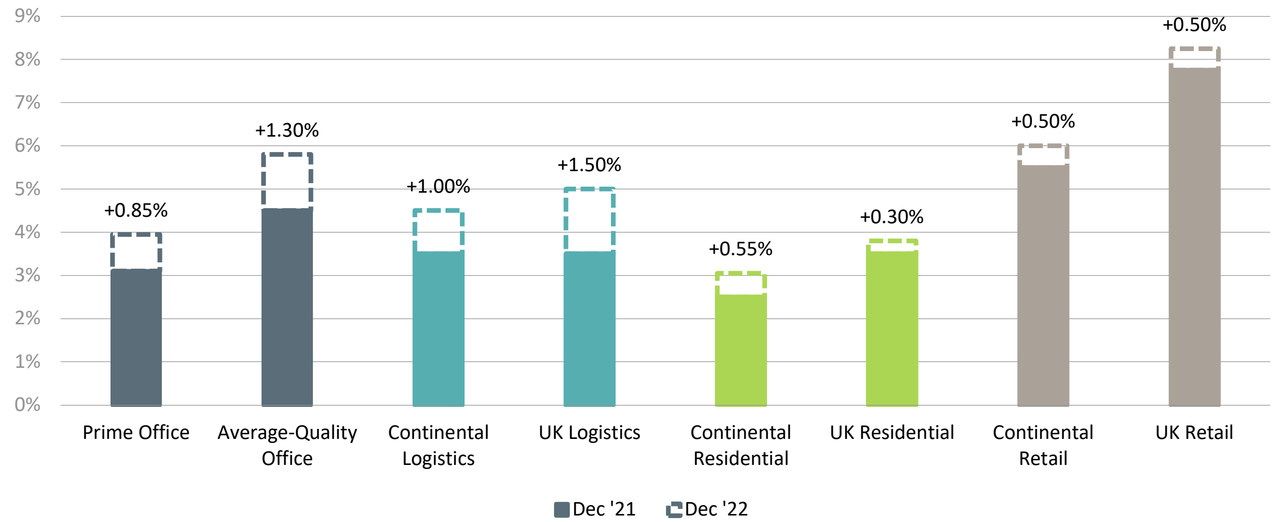
No sector has escaped unscathed, although the residential sector's appeal has meant that outward yield shift has so far been limited to an average of 60 basis points – a price reduction of less than 20% (excluding any positive effect from rental growth). Conversely, UK logistics has been one of the hardest hit segments, with a negative yield impact of up to -40% in London, while big box logistics yields on the continent moved out by close to 100 basis points on average – equivalent to a price cut of 20%-25%. Secondary offices across Europe have also seen yields move out by 100 basis points or more this year, with the long-term outlook for this part of the sector particularly affected by home working trends.

However, we now believe that the majority of the total expected correction has occurred. Central bank rates are likely to rise further this year, but this has already largely been priced into longer-term rates, and with some easing of inflationary pressures, the expected peak for policy rates has come down some way in recent months. Our view is that the ECB deposit rate will now reach 3% this year, with the Bank

[3] RCA, January 2023
[4] Savills, January 2023
[5] CBRE, December 2022

of England base rate rising to 4%.[6] With this in mind, we do anticipate further outward yield movement in some markets and sectors early in 2023, but this should be on a much smaller scale than the adjustments recorded last year.

Prime Yield by Sector (December 2021 vs. December 2022)



Source: CBRE, Savills, Green Street, DWS, December 2022.

At the all-property level, our current forecasts would suggest that prime yields will move out by only another 15 basis points this year, and we feel that yields in some markets may have already reached their peak. This means that out of a total expected capital value loss of 15–20%, around four-fifths has already happened. We anticipate that the full extent of the price correction should be over by the middle of this year, and that the market will begin its recovery phase during the second half of the year.

Importantly, if we also look at the long-term drivers of interest rates, there has been relatively little shift; demographic trends are similar, the outlook for productivity remains broadly the same, and long-term inflation expectations still suggest a return to target. So, despite short-term noise, the long-term interest rate outlook remains fairly similar to where it was this time last year, and as such, our long-term real estate yield projections have not moved significantly.

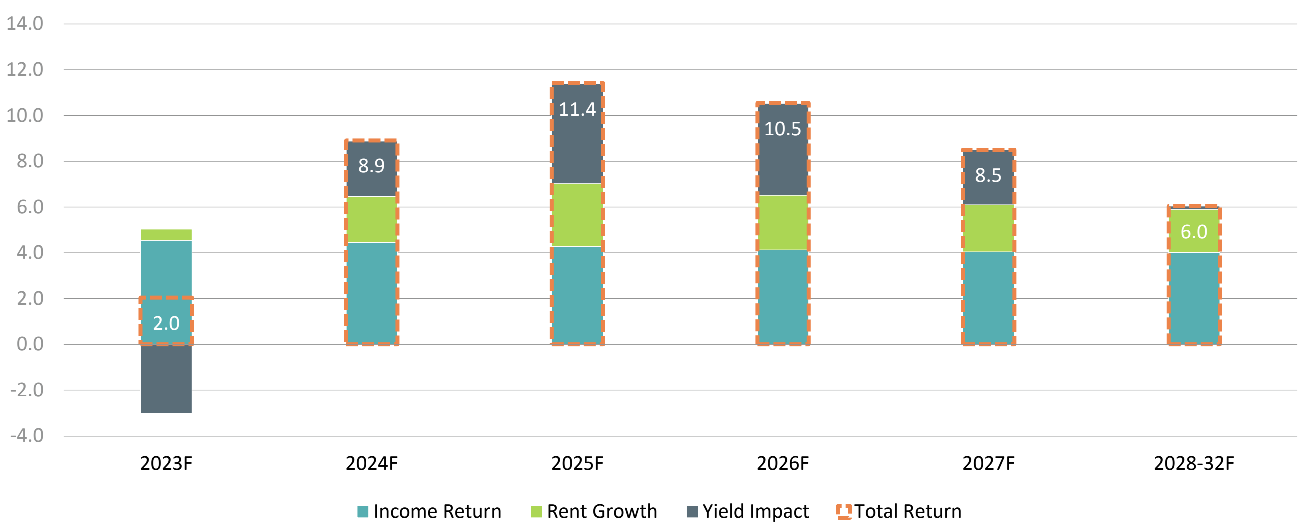
This long-term view does represent a tightening of the property yield spread compared to what we've been used to over the past 10 years, but for much of that post-GFC period, we saw constantly falling interest rates, eventually reaching levels never seen before. During that time property yields were always playing catch up, and there was also a constant expectation of rising rates, resulting in a consistently higher spread. Our forecast does see the spread narrow to a level some way lower than in recent years, but remaining higher than the pre-GFC period.

With yields having moved out rapidly and much of the predicted value adjustment now already behind us, our prime total return forecast has seen a marked improvement compared to six months ago. This year, with yields edging out further and rents remaining flat, returns are expected to remain subdued. However, as the European economy enters its recovery phase and construction volumes tail off, we anticipate a period of above-average performance from 2024 onwards, and an average all-property prime total return of 7.1% per annum over 10 years.
Overall, we still feel that residential will present the best opportunities looking ahead. Although affordability could be a concern and there is some risk around the potential for increased regulation in times of rapidly rising rents, we see strong occupier demand in the face of

[6] DWS Quarterly CIO View, December 2022

rising mortgage costs, while fundamentals will be supported by the ongoing shortage of rented accommodation in many major cities. High inflation has put pressure on wages as employees demand pay increases to meet rising prices and maintain purchasing power, and while household income growth is unlikely to keep up with inflation, it is expected to grow at a faster pace compared to historical norms. Copenhagen, Dublin, and the Spanish and UK cities continue to stand out as our top-performing PRS markets. Of the four main sectors, private rented residential remains our top performer over the 10-year outlook, although we also see the potential for strong risk-adjusted returns in other parts of the residential sector such as student housing and co-living.

European Average All-Property Prime Gross Total Return, 2023-32F (% p.a.)



Source: DWS, January 2023.
Notes: F = forecast. No assurance can be given that any forecast will materialise. Forecasts are not a reliable indicator of future returns. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

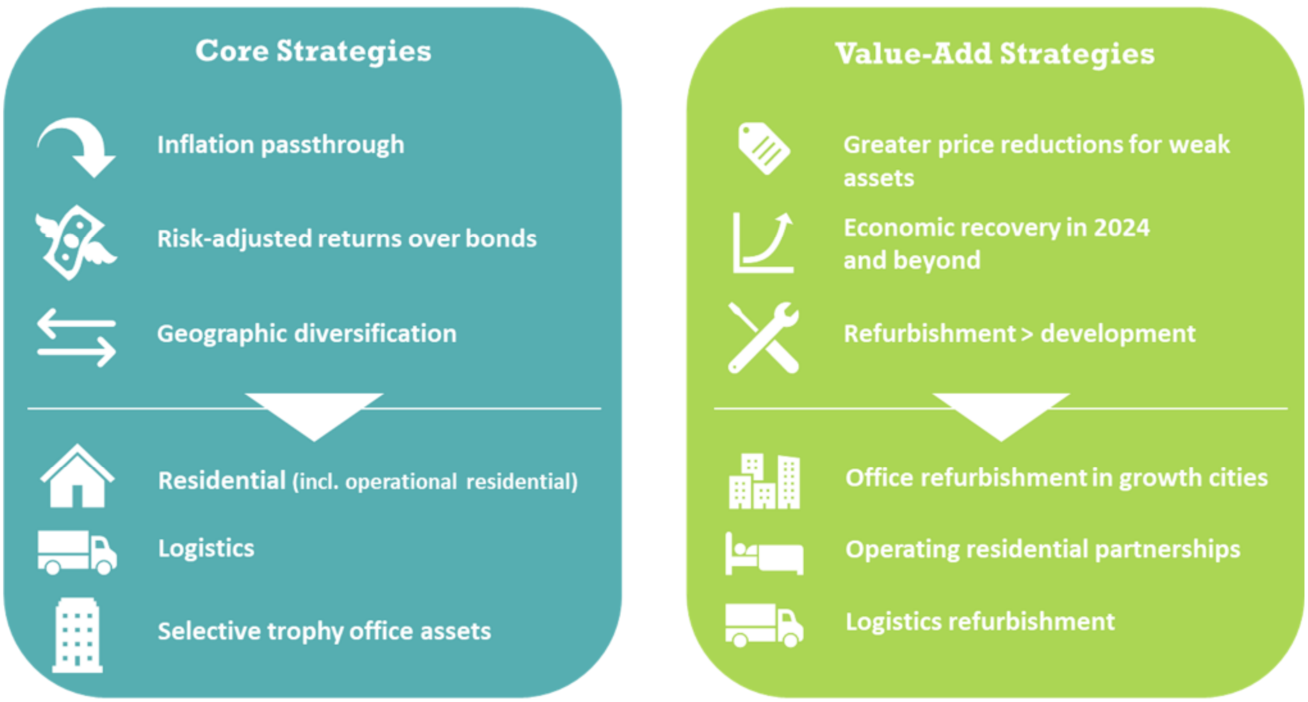
The other sector we expect to perform well is logistics. There are some short-term challenges here, as soaring inflation has led to increased costs and squeezed margins for occupiers, while also tempering demand by forcing consumers to cut back on spending. But with long-term fundamentals remaining in good shape, and having undergone major repricing over the past six months, the sector looks attractive. Urban logistics in particular is anticipated to be an outperformer, with rising online sales, a lack of existing stock and competing space use driving expectations of strong rental growth.

Offices are still likely to be an underperformer, but we expect that centrally located, Next Generation stock in major cities such as London, Paris, Amsterdam and the major German cities should outperform in terms of rental growth and remain highly desirable to investors. Creating such buildings through the refurbishment of older stock therefore presents a strong value-add investment opportunity. We foresee lower aggregate demand for office space in the years ahead, although we believe that poorly located, secondary stock will bear the brunt of this decline. Weaker construction activity should also help the medium-term recovery for the wider market, and higher entry yields mean our outlook for prime total returns has improved.

Retail returns continue to look relatively good on paper, but the sector remains unpopular due to high vacancy, structural changes and current consumer risks. Retail parks and supermarkets are still perhaps the only areas generating interest, and are likely to outperform within the sector, although even here the risks have increased. Shopping centre yields had already moved out quite some way before inflation took off last year, and have increased further since, making income returns look attractive relative to other sectors. This, together with the likelihood that yields will come back down in the longer term, is likely to prove tempting to some investors.

2 / Investment Strategies

The European real estate market is now well into a period of price correction, and while fundamentals remain generally healthy, the looming recession is a threat and will test the strength of occupier markets. However, ongoing structural changes and price dislocation may create attractive investment opportunities. Investors should take advantage of this climate to buy attractively priced assets and prepare for a return to core funds as valuations converge with pricing throughout the first half of this year. Price dislocation between prime and secondary assets provides an opportunity for the refurbishment of ageing assets as part of a value-add or impact strategy.



The ability to increase rents is key for investors in light of elevated inflation. However, there is a clear difference between contractual CPI-linked rent increases and market rent growth, with the latter ultimately the key driver of returns over the full ownership cycle. In our view, the residential and logistics sectors have the best prospects of passing through inflation to tenants given strong occupier fundamentals, while retail rent growth is expected to fall well short.

Total returns for European core real estate funds turned negative in the third quarter of last year,[7] and early indications are that NAVs are likely to have been revised down significantly further in the fourth quarter. Such repricing creates an attractive entry point in core strategies for newly allocated capital, from both existing and new investors. The ongoing price correction also provides an excellent opportunity for value-add investment strategies.

Additionally, the repricing of office assets also provides a tactical opportunity to acquire long-leased trophy assets with blue-chip tenants in markets such as London and Paris, which may trade at even higher yields this year given the lack of liquidity in the market. This tactical strategy often requires a “motivated” seller, who is either overweight offices or in need of liquidity, with European office REITs also potential sellers in order to reduce leverage and avoid equity issuances.

[7] MSCI, December 2022

In this environment sales will likely be difficult, however, and vendors will often be required to accept prices at substantial discounts compared to values 12 months ago. Liquidity is expected to remain limited in the first half of 2023. Dispositions of good-quality assets this year could potentially be at the bottom of the market, as we expect prices to recover in 2024, although there is an argument for selling weak or stranded assets to avoid further valuation declines, or to recycle capital into better and higher returning assets.

Return to logistics

Despite acknowledging the strength of occupier fundamentals, ultra-low yields have for several years forced us to take a cautious view of the logistics sector. However, the significant repricing of the sector is now providing an attractive (re)entry point. Following several years of sharp compression, prime logistics yields moved out by 100–150 basis points last year, bringing yields back to 2016 levels in the United Kingdom and 2019 levels in Continental Europe, and reflecting an average price correction of more than 20%.

The logistics sector has its challenges: low-margin distribution businesses face rising costs and retail sales are at risk. Nonetheless, occupier fundamentals look strong, with record-low vacancy across most logistics markets. Barcelona, the Netherlands, and the United Kingdom are our preferred markets for corridor logistics. The United Kingdom has seen the largest price correction, with yields expanding by 150 basis points compared to December 2021. The Randstad area in the Netherlands services multiple metro populations and benefits from tight land supply and strict planning regimes, while Barcelona is well positioned for rental growth based on geographic barriers to supply and e-commerce growth potential. Overall, tight planning controls and the shortage of high-quality space could also provide an opportunity for value-add strategies such as the refurbishment of old assets, including ESG-related upgrades.

We have a positive view on niche segments such as cold storage, while urban logistics in particular remains a key investment theme. Urban logistics yields have also moved out, yet we still expect strong rental growth from urban locations within markets such as London, Paris and Berlin, given supply constraints, strong occupier demand and low vacancy.

We also believe that recent geopolitical events support the need for long-term European transformation, including a reconfiguration of supply chains through nearshoring and alternative trade routes from Asia to Europe. Polish logistics – especially Wroclaw and Poznan – could be a key beneficiary of nearshoring given its proximity to Western European markets and the cheaper cost of land, labour, and rents, while the Czech Republic and Hungary may also benefit.

Meanwhile, investments in the logistics sector can meet specific ESG targets, including the utilisation of roof space for solar photovoltaic systems to generate renewable energy, the facilitation of electric vehicle charging stations and focus on social employee wellbeing to create people-centric environments.

Office refurbishments

We continue to see a divergence between best-in-class office buildings with green certifications and old, lower-quality grade B stock. Office occupiers are rethinking their office footprint in a post-Covid world, generally looking for less, but higher-quality space. The push by occupiers towards sustainability is driven by company net-zero targets and talent retention. Increasing competition for skilled labour is impacting employers' choice for asset quality and location, and as a result, the availability of grade A office space remains well-below historical norms, and in some cities close to zero.

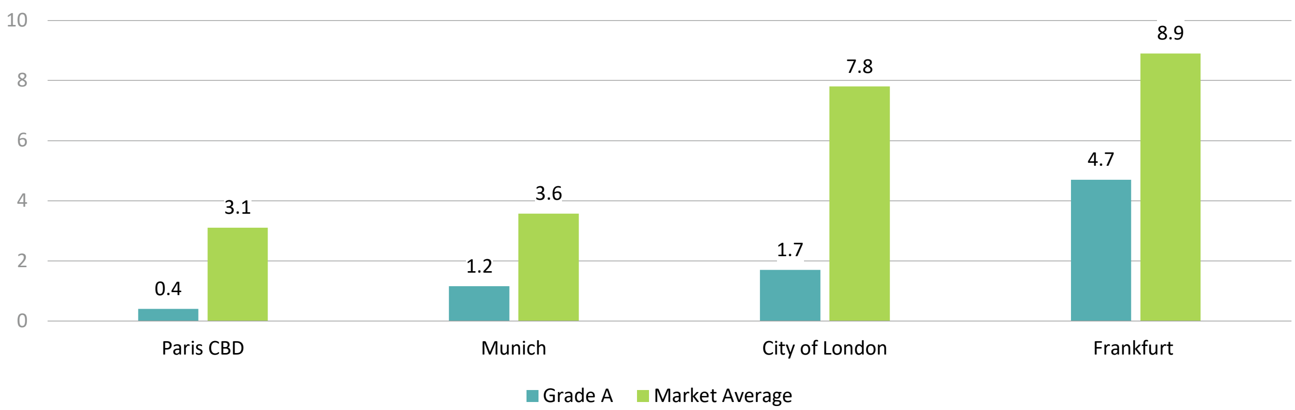
Grade B office assets without green credentials are out of favour with both investors and occupiers. The deterioration of demand for such assets could lead to rental declines and greater valuation discounts relative to best-in-class office. Initial evidence shows a widening of the yield spread between prime and grade B office yields. European prime office yields have expanded by an average of 90 basis points so far, reflecting a capital value decline of nearly 20%,[8] with possible further value declines to come. Conversely, yields for grade B offices have moved out by around 135 basis points.[9] Near-term rental decline and potential further yield expansion could result in a capital value decline of roughly 30% for grade B offices in Europe.

[8] DWS, January 2023
[9] Green Street, December 2022

We believe this presents a clear opportunity to refurbish existing, well-located, grade B stock in markets with low grade A vacancy. Such stock could be acquired at a significantly rebased price, and transformed into Next Generation space to meet investor and occupier needs, especially given the constrained pipeline of new supply. Creating such modern offices also plays a key role in supporting resilient urban areas and provides economic and productivity benefits as part of the European transformation.

A key structural driver in support of an office refurbishment value-add strategy is the move towards a low-carbon economy. A refurbished office will reduce operational carbon emissions, but also save an estimated 30–50% of embodied carbon relative to new build development. On the other hand, surging construction costs are among the main concerns for investors, although recent data suggests a slowdown in construction cost inflation as supply chain constraints ease and economic growth slows. Furthermore, we expect the economy to recover in 2024, which will support the letting of vacant space within newly refurbished offices. This is especially the case in high-productivity markets with growing occupier demand, such as London, Paris, Berlin, Amsterdam, and Stockholm.

European Office Vacancy by Quality (%, as of 2021)



Source: CBRE, DWS, 2022.

Operational residential and repriced PRS

Fundamentals for the private residential sector remain strong. Overall, we continue to favour commuter locations in and around major cities such as London, Paris, Berlin, and Madrid, but also centrally located residential in fast-growing regional cities including Bristol, Leipzig, and Valencia. That said, traditional multi-family residential becomes more of a tactical play at this point of the cycle, as yields remain below all-in financing costs. Nonetheless, investors might be able to enter the market at reduced pricing as developers need funding or vendors seek liquidity. Developments and active asset management strategies could potentially generate sufficient returns to meet investor hurdle rates.

Assets such as student housing, senior living and co-living typically offer a yield premium over multi-family residential, while having many of the same safe-haven characteristics, including low vacancy and a supply-demand imbalance. In addition, these residential subsectors are typically less exposed to regulation and rent controls.

Student housing sits high on our list of key investment themes, especially during a potential economic downturn. Student enrolment is typically inversely related to the economic cycle: the tougher the job market, the more likely the decision to study. With demand coming from both domestic and international students, there is still a shortage of good-quality purpose-built student accommodation (PBSA). As such, entering the PBSA market would most likely require a development strategy given the size of the sector and limited high-quality standing stock.

We see a strong case for both mid-range and high-end student housing. The mid-range segment offers relatively affordable accommodation, aimed at domestically mobile students in regional cities with good universities and low vacancy in the private residential market. High-end accommodation offers additional amenities, such as a cinema, gym or bar, with the target tenants predominately international students looking to study at the top universities in large cities.

Demographic trends are likely to be a significant demand driver for the European senior living market, The sector is emerging and still undersupplied, but is expected to expand over the next ten years as development meets future demand. We rate France, Germany, the Netherlands and Spain highly for senior living investments based on demographics, wealth and economic indicators, current and future supply, and operator landscape.

Co-living is another emerging segment that has gained traction in the previous two to three years. The number of operators continues to increase, although penetration rates remain very low, accounting for just 1% of rental stock in key European markets.[10] The sector has also seen a widening of tenant demand: typically, co-living attracts graduates and young professionals, but the pool has expanded to include “digital nomads” such as international students, ex-pats, or contingency workers, who particularly favour flexible housing solutions and simple movement processes. We prefer growing and resilient cities with tight housing markets and a high share of young population, graduates and single-person households, such as London, Amsterdam, Berlin and Copenhagen.

Highly affordable and social housing remains a key long-term strategy. Our experience in Spain has shown that through partnerships with local authorities, institutional investors can play an important part in the provision of affordable and good-quality housing, while also meeting risk-return requirements. A pan-European social housing strategy may be difficult to roll out as this sector is often exceptionally local, fragmented and with many different stakeholders.

Real estate is expected to play a key role in supporting resilient urban areas by delivering high-quality, professionally managed and affordable residential assets, given further urbanisation and population growth across Europe. Working alongside operational partners, investors may also be part of the solution to current demographic challenges, through student housing and corporate housing, as well as senior housing facilities to meet the needs of an ageing demographic.

[10] JLL, 2022

3 / Country Summaries

Germany	— The German economy has proved more resilient than expected but a mild recession is likely. Fiscal packages and weakening tension from the energy crisis should support demand. — Investment volumes slumped and property yields moved out sharply as financing sentiment reached an all-time low in 2022, but the market also provides opportunities ahead.	— The residential market – including micro-living, student and senior housing – is our top pick and is expected to outperform in terms of rental growth and returns. — Price corrections in the office and logistics sectors allow for both core and value-add strategies, with a focus on future-proof refurbishments as well as repriced core products.
France	— Our medium-to-long-term outlook for the French economy is positive, with GDP growth expected to outpace the Eurozone over the next five years. — Logistics yields have moved out by almost 100 basis points compared to the end of 2021, which could provide some tactical acquisition opportunities.	— Student housing is under-supplied relative to demand, particularly in Paris, while student numbers have recovered quickly following the end of pandemic-related restrictions. — Senior living is also a growing sector, fuelled by demographic growth in the over-70s cohort. Yield spreads to residential are still attractive.
UK & Ireland	— A weaker economic outlook, alongside higher financing costs, have had a profound impact on UK real estate, with rapid and significant repricing over the second half of 2022. — In the short term, challenges will likely persist, although the longer-term outlook is arguably more positive. London in particular should be a key driver of growth.	— The repricing of real estate should provide attractive opportunities in both core and value-add investments. Central London remains one of our top-performing office markets. — UK logistics is set to be a clear outperformer. Prices have corrected faster than almost any other market, while rental growth is expected to be ahead of the European average.
Southern Europe	— The return of tourists to the region has boosted economic growth for 2022, with a mild and brief recession expected in 2023. — Residential rents are proving resilient to the current crisis, and we expect the sector to outperform over the next five years as household growth outpaces supply.	— Logistics in supply-protected locations such as Barcelona remains a key focus. E-commerce continues to grow in the region and occupier demand is likely to be buoyant. — While rental growth in the office market is likely to be negatively affected by an economic slowdown, we see opportunity in retrofitting older stock to meet current needs.
Benelux	— Logistics markets look attractive based on recent repricing. Supply-demand fundamentals and ultra-low vacancy rates should support robust rental growth. — A severe shortage of student accommodation – especially in Amsterdam – and growing presence of international students bodes well for student housing investments.	— A rapidly ageing population and a lack of suitable and good-quality senior living establishments offer an opportunity for senior living investments. — Stricter office energy efficiency regulations could provide an opportunity to refurbish old, but centrally located office buildings.
Nordics	— Elevated inflation, tighter financial conditions and weakening economic growth present headwinds to the Nordic market, and the market has recorded a rapid price correction. — There are short-term challenges for the Nordic economies but over the longer term the outlook looks more positive. Stockholm and Copenhagen in particular should outperform.	— The affordable residential sector remains a top pick, with the Nordic capital cities supported by positive demographic trends, alongside supportive market fundamentals. — Stockholm's prime office market is expected to prove successful over the long term as high-productivity sectors encourage further growth.
Central Europe	— Falling real incomes and fading consumer demand are leading the way to a technical recession in Poland, but rising industrial output presented a silver lining at year-end 2022. — Supply in the office sector continues to decline, although demand is expected to slow as well against the weaker economic backdrop. Flight to quality remains an important driver.	— The residential rental sector continues to mature in the wake of an explosion in demand. Migration and the shift from owner occupation should remain key drivers. — Nearshoring trends and changing trade routes will have a positive impact on CEE logistics. Weak sentiment and a slim domestic investor base will open up opportunities.

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