Nordics Real Estate Strategic Outlook

First Quarter 2023

IN A NUTSHELL

— A short, shallow recession is expected over the first half of 2023 as high inflation and increased interest rates weigh on consumer spending. Over the longer term, however, the Nordic economies look well placed for growth.
— A significant price correction in the logistics sector offers an attractive entry point. We see the best opportunity in a value-add approach, redeveloping older, urban stock into energy efficient, last hour warehouses.
— The residential sector is expected to prove resilient, supported by positive demand and supply fundamentals. Stockholm's office market looks particularly well placed to withstand wider structural challenges, given its position as a high-productivity city.

The Nordic region, like elsewhere in Europe, faced growing challenges as 2022 progressed. Elevated inflation, tighter financial conditions and weakening economic growth all presented headwinds to the real estate market, and investment activity slowed significantly over the second half of 2022. The sharp increase in borrowing costs also contributed to a rapid repricing of the real estate market. Headwinds persist in the short term, but over the longer term we continue to have a more positive view on the outlook for the region. Given the extent of the recent price correction, we believe attractive opportunities will arise in both the core and value-add investment space. The logistics and residential sectors remain our top picks going into 2023, but we also see opportunities in Stockholm's office market.

Shallow recession expected in 2023

Over the second half of 2022, Europe battled with significantly increased inflation, falling household incomes and greatly reduced consumer confidence.[1] While the Nordic economies held up relatively well, supported by strong labour markets, we do anticipate a shallow recession in the first half of this year. While we expect that inflation has now peaked, it is set to remain well above target over the course of 2023. In response, the Nordic central banks, alongside the ECB, increased interest rates throughout 2022 and further monetary tightening is expected in the short term.

The outlook over the longer term is more positive, as inflation eases and stronger rates of economic growth are expected to resume. At the national level, with the exception of Finland, all Nordic economies are forecast to outperform the Eurozone average over the coming decade. The major Nordic cities have been among the strongest performing in Europe during the last decade and we anticipate this trend to continue in the coming years. Stockholm and Copenhagen in particular are well placed to see stronger-than-average GDP, employment and population growth.[2]

[1] Oxford Economics, January 2023
[2] DWS, December 2022

Real estate price corrections have been rapid and widespread

Alongside the weaker near-term economic outlook and significantly higher inflation, borrowing costs increased sharply and sentiment towards real estate shifted substantially over the second half of 2022. With investors adopting a 'wait-and-see' approach, transaction activity fell sharply. Provisional figures suggest all property investment volumes totalled €10.4 billion in the six months to December 2022, a fall of 60% compared to the first half of the year. Annual investment amounted to just over €36 billion, a 37% decline on the previous year, although still comfortably above the ten-year average. The residential sector continued to drive the bulk of investor demand, accounting for 34% of total invested capital in 2022, the highest share on record. In contrast, the office sector accounted for just 29% of the total, well below the longer term average of 37%.[3]

Alongside the fall in investment activity, a notable price correction was evident in the second half of 2022, with all core sectors recording an outward shift in yields. The residential sector saw the largest correction, driven largely by a substantial repricing in Sweden. Indeed, prime residential yields in Stockholm moved out by close to 100 basis points, leading to a capital value decline of over 20%. Prime logistics yields also moved out by 100 basis points on average and capital values fell by around -17.5%, while the office and retail sectors saw notable corrections as well, with secondary, unsustainable and poorer quality assets likely to have seen far greater value declines than prime stock.[4]

We anticipate that the majority of the total price correction has now been observed in both the logistics and residential sectors. While some further repricing is expected in both the office and retail sectors over the coming months, prime yields are expected to have peaked by the second half of the year. Over the longer term, as the economy recovers and interest rates stabilise, all-in financing costs are expected to fall and investment activity should return, prompting a recovery in prime real estate yields over the medium term. Ultimately, the outlook for property yields at the end of the ten-year forecast period has not changed significantly though. Compared to our previous forecasts, a slightly higher outlook for interest rates and 10-year government bond yields has added just 10-15 basis points onto exit yields in 2032.[4]

Nordic Prime Capital Value Growth by Sector (% p.a.)

Source: DWS, January 2023.

Sharp logistics repricing offers attractive entry point

Following several years of compression, prime logistics yields in the Nordic markets moved out sharply over the second half of 2022, returning to pre-pandemic levels. The resultant correction in values offers an attractive (re)entry point into the sector. Importantly, despite economic headwinds, the occupier market remains solid, as healthy demand has driven down available supply, and vacancy is tight across most markets. That said, while market fundamentals should support further strong rental growth in the short term, the sector is not immune to wider economic disruption, and soaring inflation has led to substantial cost increases, squeezing already thin tenant operating

[3] RCA, January 2023
[4] DWS, December 2022

margins. With that in mind, we see less impetus behind logistics rents over the longer term and expect rental growth to be more in line with long-term inflation.[4]

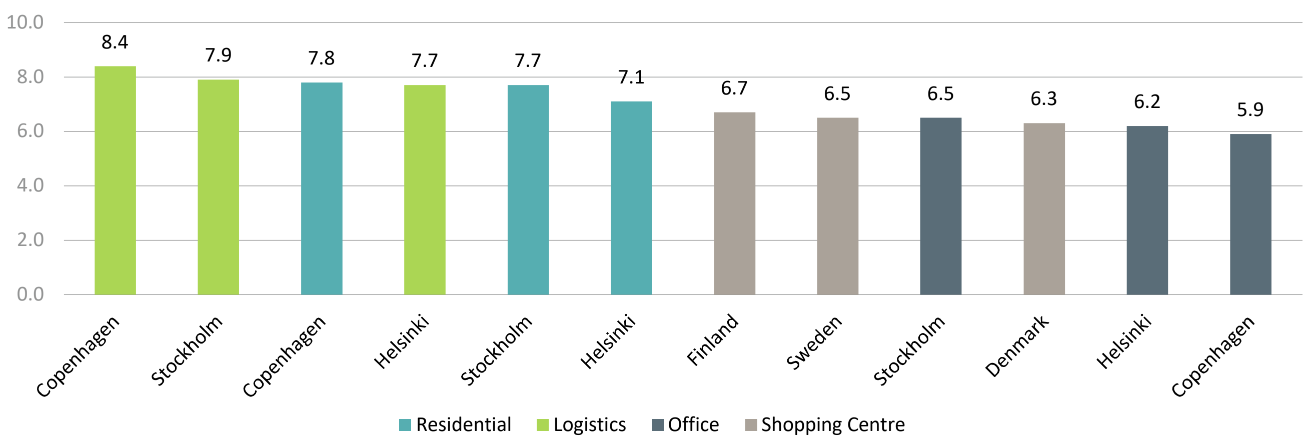
Urban logistics remains an outperformer, supported by extremely tight supply and competition from other land uses. These solid fundamentals should continue to drive strong rental growth over the forecast period. In particular, we see the best opportunities to achieve higher returns through the redevelopment of ageing logistics assets in urban locations around Stockholm and Copenhagen. With planning laws in Nordic markets becoming increasingly preventative of development on greenfield land, this value-add approach provides a more sustainable opportunity for market entrance. In addition, last hour and urban warehouses can meet specific ESG targets through the provision of electric vehicle charging stations and a focus on social employee wellbeing.

The residential sector remains well placed for resilience

Despite economic headwinds, residential markets in the Nordic capital cities are largely still supported by solid fundamentals. The high quality of life helps to attract young and well-educated workers, and a strong urbanisation trend across the region will continue to bolster demand for affordable private rental schemes. In our view, Copenhagen should remain a top-performing residential market in Europe over both the five and ten-year forecast period, benefitting from population growth comfortably ahead of the European city average.[3] Given rising the cost of living, we continue to favour more affordable accommodation on the outskirts of the city centre, in well-connected commuter locations such as Herlev and Rødovre. However, we also see opportunities in Denmark's largest regional cities, such as Aarhus, which is supported by a large university presence and solid employment prospects.

In many of Sweden's major cities, a structural undersupply of housing has created an exceptionally low-vacancy environment. Stockholm's residential market, for example, is defined by long queues for rental properties and minimal void periods, ensuring a low-risk and stable income for investors, which typically offers some protection against inflation. However, extremely strict rental regulation in residential stock built since 2006 has restricted entrance to this segment. Regulation in older, existing stock does allow for higher rent increases, although this has translated into significantly lower yields, typically well below 2% in Stockholm.[5] Until now, reaching target returns has therefore not been possible and investment opportunities have often been unviable. Going forward, however, an adequate level of repricing could allow entry to the market. We see the best opportunities in acquiring and refurbishing older stock, with a focus on improving energy efficiency in order to fully realise rental uplift potential and access attractive returns.

Prime Total Return Forecast, 2023-2032f (% 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.

[5] Newsec, January 2023

The office sector faces several structural challenges and therefore remains an underperformer overall. The occupier market will likely be hindered by weaker output and employment growth in the short term, as well as the longer-term trend of remote working. That said, we anticipate that Stockholm will prove to be one of the better performing European office markets over the forecast period, supported by fast-growing, high-productivity industries that typically favour best-in-class office space with the highest energy performance certifications. Furthermore, reduced construction activity over the medium term should limit supply and we anticipate that vacancy will trend down over the coming years. Prime supply in particular is in short supply. With that in mind, as price corrections are realised across grade B stock, the refurbishment of older, but well-located office stock into 'Next Generation' office buildings could lead to greater risk-adjusted returns. A value-add approach, with a focus on environmental sustainability and employee wellbeing, would have a more positive carbon and social impact than investments in lower-yielding, new-build stock.

Real Estate Research Team

Office Locations

Chicago
222 South Riverside Plaza
34th Floor
Chicago
IL 60606-1901
United States
Tel: +1 312 537 7000

Frankfurt
Mainzer Landstrasse 11-17
60329 Frankfurt am Main
Germany
Tel: +49 69 71909 0

London
Winchester House
1 Great Winchester Street
London EC2N 2DB
United Kingdom
Tel: +44 20 754 58000

New York
875 Third Avenue
26th Floor
New York
NY 10022-6225
United States
Tel: +1 212 454 3414

San Francisco
101 California Street
24th Floor
San Francisco
CA 94111
United States
Tel: +1 415 781 3300

Singapore
One Raffles Quay
South Tower
20th Floor
Singapore 048583
Tel: +65 6538 7011

Tokyo
Sanno Park Tower
2-11-1 Nagata-cho
Chiyoda-Ku
18th Floor
Tokyo
Japan
Tel: +81 3 5156 6000

Teams

Global

Kevin White, CFA
Global Co-Head of Real Estate Research

Simon Wallace
Global Co-Head of Real Estate Research

Americas

Brooks Wells
Head of Research, Americas

Liliana Diaconu, CFA
Office Research

Ross Adams
Industrial Research

Joseph Pecora, CFA
Apartment Research

Sharim Sohail
Property Market Research

Europe

Ruben Bos, CFA
Property Market Research

Tom Francis
Property Market Research

Siena Golan
Property Market Research

Rosie Hunt
Property Market Research

Carsten Lieser
Property Market Research

Martin Lippmann
Property Market Research

Asia Pacific

Koichiro Obu
Head of Real Estate Research, Asia Pacific

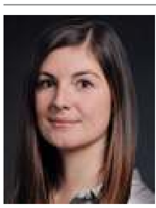
Natasha Lee
Property Market Research

Hyunwoo Kim
Property Market Research

Seng-Hong Teng
Property Market Research

AUTHORS

Simon Wallace
Global Co-Head of Real Estate Research



Rosie Hunt
Property Market Research

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