Real Estate Research

July 2023

DWS

Europe Real Estate Strategic Outlook

Mid-Year 2023

IN A NUTSHELL

— European property yields expanded rapidly, but have shown early signs of stabilisation. We still believe that prime pricing will reach a trough during the second half of this year if investment markets and investor sentiment improves.
— Occupier fundamentals remain robust, whilst the European market is expected to return to growth in 2024 driven by strong rental growth. A higher entry yield, strong fundamentals, and an expectation of yield compression when inflation wanes, all suggest a robust medium-term outlook.
— The price correction provides an excellent opportunity for refurbishments strategies given the polarisation between prime and secondary assets. Core investors can also take advantage as market prices could be nearing a low point.
— A value-add office refurbishment strategy could prove successful in high-productivity cities with low grade A vacancy. Repriced core logistics and urban redevelopments attractive given robust demand, limited land availability and tight planning regimes. Operational residential offers better risk-adjusted returns relative to multi-family residential.

1 / Market Outlook

At the start of this year, we made the bold prediction that by mid-2023 European real estate prices would be at a cyclical low. Here we are six months later, and so, were we correct? The pace of price correction has certainly slowed sharply, and in some markets, we have seen the return of price growth. But for Europe as a whole, our projections may have been premature – although this is not to say we have significantly extended our expected period of price correction.

There are several reasons for this delay in price correction. The most notable being inflation and interest rates. While inflation peaked some months ago, it has proven stickier than originally expected. In part the result of a stronger economic growth – allowing us to upgrade our outlook for 2023 rental growth – central banks are now forecast to push interest rates higher. Add to this the ongoing uncertainties in the banking sector, there has been no relief in real estate financing costs. With investment activity running at decade lows, property yields have moved higher, with a forecast peak approximately 25 basis points higher than we had at the start of the year.

We still believe that prime pricing will reach a trough during the second half of this year, with growth resuming across all sectors in 2024. For this to occur, it is important that we see an improvement in the investment market. There is so far little evidence of this, but there may be signs of stabilisation. Investor sentiment is edging higher, yields are rising more slowly, while rents continue to grow at a robust pace.

The revaluation of real estate should also provide relief for those investors burdened by the denominator effect. Not only could we have seen a 15-20% peak to trough reduction in European real estate values, given the recent rally in global equity markets, it is quite possible an increasing number of institutional investors may find themselves at or even below their target real estate allocation by the end of this year. Quite different from 12 months ago. Add to this the prospect of peak interest rates, pricing clarity, and greater access to product, there are certainly reasons to believe that investment activity could now gain in momentum.

Recovery, Return and Risk

European market expected to return to growth in 2024, entering a period of above average returns

Beyond 2023 we expect a period of strong returns. Not only do we see prime yields stabilising and then start to fall, but the occupier market is also in a strong position. And while the exceptional rent growth of this year and last is unlikely to be repeated, prime property may remain in short supply for several years to come. Major cities are not only reporting a lack of housing and logistics units, even the much-maligned office market is recording a lack of good quality space. With development activity trending lower – a function of pandemic, costs, and correction – occupiers looking for best-in-class space are unlikely to be inundated with options.

Current Vacancy Rate by Sector

Source: DWS, PMA, Savills, Green Street, Cushman & Wakefield, June 2023
Note: Green = Below 10-yr historical average, Orange = Close to historical average, Red = Above historical average

We should not be complacent about the occupier market. Overall vacancy is up, and there is far less of a shortage of grade B stock, particularly office and retail. Should economic conditions deteriorate, not only could we see reduced occupier demand, but business insolvencies may also increase - UK business failures are already up by more than 13% on last year.[1] It's important that real estate investors understand the potential income risk to their portfolios.

Access to debt is likely to remain a challenge, and all equity investors may be some of the first movers back into the market. Not only have borrowing costs increased, but lenders are also more cautious, particularly in the aftermath of recent banking issues. This is not to say we expect a wave of forced sales. Real estate is less levered than in the run up to the GFC, while private debt is proving a useful alternative to traditional sources of lending. Nonetheless, weaker, and poorly located assets may struggle to gain access to finance, forcing owners to bring these assets to market, potentially at a considerable discount.

These two factors suggest we may see polarisation between prime and secondary over the coming years. We already see evidence of this – mostly in office – creating opportunities for value add, particularly with a view towards long-term demand dynamics as well as future regulatory requirements, particularly regarding environmental standards.

The recovery is expected to build in strength over the coming two years. Initially led by rental growth, we expect from 2025 onwards, moderating borrowing costs and the return of investor demand will lead to lower real estate yields and a period of double-digit return. We are not expecting yields to return to the ultra-lows of 2021, but neither are we expecting them to remain at cyclical highs. Where two years

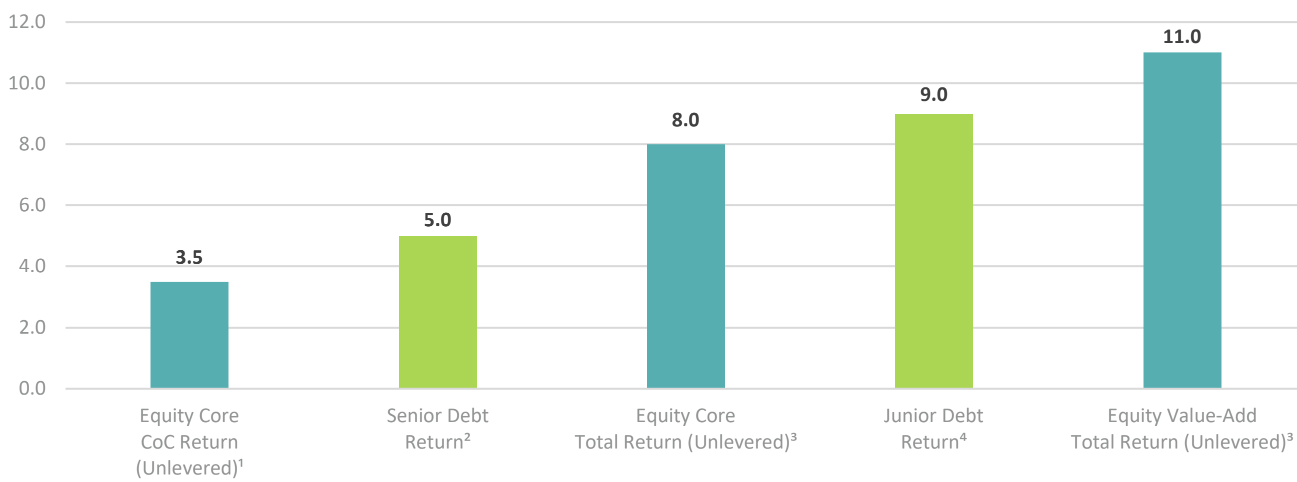
[1] ONS, July 2023

ago we had been expecting a gradual increase in real estate yields over the coming decade, today we expect the reverse, as we anchor our long-term bond and real estate yield assumptions to the economic fundamentals of demographics, productivity, and inflation expectations. It is impossible to accurately predict the real estate return for each of the next ten years. Experience would suggest that once momentum returns to the market, we may be surprised at how quickly capital values increase. This was the case for mid-90s London office, the mid-00s following Dot.com and to a lesser degree the years following the Eurozone Debt Crisis.[2] Our modelled outlook is most likely a smoothed representation of the final outcome, so it's important to keep this in mind when considering investment vintage.

Nonetheless, we strongly believe that unlevered real estate returns over the coming five years should be higher than their historical average. A higher entry yield, strong fundamentals, and an expectation of yield compression, all suggest a robust medium-term outlook. Indeed, given today's higher risk-free rate, investors should be demanding higher total returns from their real estate investment.

Levered cash returns may be less attractive, with all in borrowing costs often still higher than real estate yields. Real estate is no longer the cash alternative it was in the second half of the last decade, but it is important to remember that during a period of ultra-low interest rates, this should be viewed as an anomaly. There is still a place for leverage, but for investors focused on cash, private real estate debt may prove to be the preferred option.

Expected 5-year Unlevered Debt and Equity Real Estate Returns (Net of Taxes, Fees and Capex Reserve)



Source: DWS, July 2023

Note: 1) Average all-property (ex. retail) net initial yield minus capex and maintenance. 2) 6-month EURIBOR Swap Rate (5-yrs) + 200 bps margin + arrangement fee. 3) Average all-property (ex. retail) unlevered return minus estimated capital costs, but before taxes and fees. 4) 6-month EURIBOR Swap Rate (5-yrs) + 6500 bps margin + arrangement fee. 4) Average all-property (ex. retail) unlevered return minus estimated capital costs, but before taxes and fees.

[2] PMA, JLL, CBRE, July 2023

Sector performance

Recovery expected to be led by logistics, with residential, select prime office, and even some retail doing well

We expect the recovery to be led by logistics. Not only has this sector experienced a material increase in yield, but it also continues to have some of the strongest occupier fundamentals. Vacancy rates are running at 3%, and while current constraints on consumer spending and manufacturing output may curb demand in the short-term, long-term demand drivers persist, alongside a growing backlash from local government and communities against new supply. Rent growth for the sector is projected to be well above inflation for the rest of the decade, with cities such as London, Paris, and Stockholm well in advance of the European average, with CEE markets also doing well as Europe's supply chains move further towards the east.

Residential has faced challenges over the past twelve months, particularly highly regulated, low yielding parts of the market. With the prime yield on rental stock averaging just 2.7% at the end of 2021[3], the lowest of the four main sectors, the sector has certainly been exposed to the changing interest rate environment. Nonetheless, residential remains one of our top picks. Housing shortages plague Europe's major cities, with many reporting close to zero vacancy. This trend shows no sign of reversal, with less new supply and a squeeze on mortgage affordability sustaining above inflationary rental growth for some years to come. Not only has the sector repriced, if economic conditions deteriorate, stable residential income is likely to be highly sort after. Across the markets we cover, fast growing cities such as Dublin and Copenhagen stand out as long-term outperformers, while Stockholm and the German cities, having suffered major price corrections, look well set for a rebound from next year onwards.

Our view on office is broadly unchanged. We have a strong conviction that Europe lacks high quality office across many major cities. Grade A vacancy in places like Berlin, Paris and Madrid is running at less than 3%[4], supply is moderating and could turn negative if EPC regulations and changing occupier demand results in poorly located stock being withdrawn from the market. Today there are few investors willing to purchase even prime buildings, but in time, we see fast growing and high productivity cities such as Paris, Berlin, and London, alongside the ongoing emergence of Warsaw, offering attractive risk adjusted returns.

Retail remains a challenge, but the outlook is less negative than it has been in the past. While the cost-of-living is making life difficult for many non-grocery retailers, the real estate sector has been less exposed to higher interest rates, given already elevated property yields. We are still some ways from a broadly positive outlook, there are chinks of light in places such as the UK where prime shopping centre yields are close to 10%. We have little doubt though that this is a complicated sector, often requiring elevated levels of capex and specialist skills. High yields and signs of rental recovery in the UK, Ireland and Iberia may tempt some investors back into the market, but as ever it will be important to understand quality of income, long-term demand and, if necessary, an asset's alternative uses.

Sector Headlines and Expected Outperforming Markets

Top Performing Sector	Strong After Correction	Polarisation	Recovery But Risky
Urban Outperformance	Fast growth C'hagen & Dublin	Next Generation Focus	Food Focused & Dominant
London, Paris, Stockholm, CE	Repriced Germany & Sweden	Paris, Berlin, London, Warsaw	Uk, Ireland, Iberia

Source: DWS, July 2023

[3] Various broker sources: June 2023
[4] JLL, June 2023

Country performance

Most attractive risk-adjusted returns expected across Germany, London, Paris, Amsterdam and Warsaw

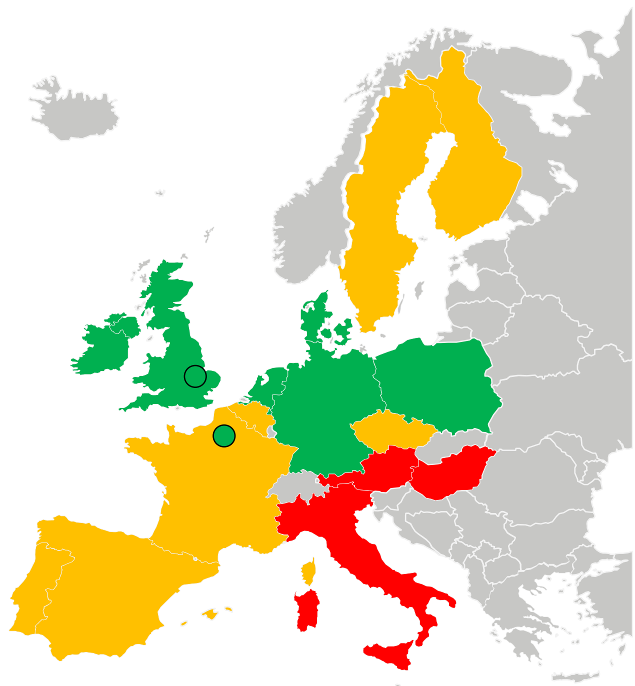
No market has been immune to price correction over the past twelve months. And while different approaches to valuation may be creating a divergence in the performance indices, we expect almost all markets to have seen on average a double-digit percentage reduction by the time they reach their trough.

Different approaches to valuation are likely to be an important factor in determining future liquidity and the pace of recovery. In the UK, where appraisal values fell swiftly and sharply, we have already seen evidence at the start of this year of a both competitive bidding and rising prices, particularly for logistics. However, there is clearly more to our outlook than appraisal values and compared to six months ago we have moderated our short-term outlook for the UK, reflecting the persistence of inflation, and a reappraisal of peak interest rates.

Taking a longer-term perspective, today we see the most attractive opportunities across Germany, the UK, the Netherlands, and Poland, with the fast-growing cities of Dublin and Copenhagen also doing well over the coming five years.

The German cities may still need until 2024 to reach their low point. However, across office, logistics, and residential, major markets continue to lack good quality space, while recent waves of migration have certainly helped to improve to country's demographic profile.

Market Calls



Source: DWS, July 2023
Note: Based on DWS in house real estate return five-year forecasts for office, logistics, residential and shopping centres. Green = Positive, Orange = Neutral, Red = Negative

Despite the recent concerns over further rate rises, the UK remains one of our top performers over the medium term. Having looked relatively cheap in the run up to this downturn, London in particularly looks attractively priced from both a European and global perspective. Paris also stands out as strong performer, with CBD office and logistics showing returns well in advance of the European average.

Away from the three largest markets, some of the greatest price corrections to date have been recorded in the Netherlands, pushing yields above the Core European average, and with cities like Amsterdam expected to continue to grow strongly, the market is well set for recovery. Other fast-growing cities such as Dublin and Copenhagen are also expected to perform, supported by both population and employment growth. Residential in the Spanish cities looks well placed, with Barcelona logistics also positioned for strong rental growth. We have an underweight call on the Italian market, having so far seen less price correction in Milan and Rome. Milan though could offer opportunities for value-add investment.

Finally, cities such as Warsaw are projected to outperform. Not only is the Polish economy in the process of converging with Western Europe, but the outlook for supply is finally starting to moderate. Across all CE countries we see the potential for the ongoing transformation of Europe, with a greater focus on self-reliance and changing supply chains in the aftermath of war in Ukraine, boosting economic growth and demand for real estate facilities, especially logistics, across CE markets.

2 / Investment Strategies

The ongoing price correction, robust occupier fundamentals, moderating supply pipelines and attractive unlevered returns make a good case for (re)allocating capital to European real estate. Price correction provides an excellent opportunity for value-add investment strategies, as the polarisation between prime and secondary assets creates an opportunity for active refurbishment. Weaker quality assets are deemed to be most at risk as uncertainty around future cashflows is leading investors to seek the safety of well-let, prime assets, especially at a time of reduced liquidity.

Core investors can also take advantage of the price correction as market prices could be nearing a low point as yield expansion is stabilising and rent growth is (partly) offsetting any future yield movement. Valuations – which are often lagging – are converging with market pricing. Looking ahead, we expect attractive core returns based on today's higher in-going yields and the expectation of lower exit yields in 5-10 years based on stabilising inflation and long-term interest rate estimates.

Alternatively, real estate senior debt could provide an excellent alternative to core real estate investors based on current benchmark rates and lending margins, especially from a cash-on-cash perspective. An investment in senior debt could be expected to provide a 100-150 basis point additional cash return over the coming five years, compared to a core equity investment. See our recent Real Estate Debt Strategic Outlook, dated May 2023.

Investment Strategies

Core

Repriced logistics
- Top performer
- Strong occupier fundamentals
- Low vacancy rates

UK
Netherlands
CEE (Poland)

Operational residential
- Yield premium
- Growing subsectors
- Undersupplied

Student housing
Senior living
Co-living

Value-Add

Brown-to-green office refurbishments in markets with:
- High-productivity
- Low grade A vacancy
- Substantial green premium

Target cities:

Amsterdam
Berlin
London
Madrid
Munich
Paris
Stockholm

Debt

Senior debt is an attractive alternative for cash-on-cash focused core investors

Junior debt provides enhanced returns at modest risk (compared to equity investments)

Multi-family residential
Operational residential
Corridor and urban logistics
Green / certified offices
Supermarkets & retail parks

Source: DWS, July 2023

Brown-to-green office refurbishments

Structural changes to the way we work, alongside environmental pressures, present a clear opportunity to transform existing, well-located, grade B offices into Sustainable Next Generation Office space in markets with low grade A vacancy levels. The deterioration of demand for grade B assets could lead to rental declines and greater valuation discounts relative to best-in-class offices. Grade B office assets historically traded at circa 100 basis points yield spread compared to prime office buildings in Europe. Initial evidence shows a widening of this yield spread, with grade B office assets trading at a more than 200 basis point spread relative to prime office assets.[5]

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 and save an estimated 30–50% of embodied carbon relative to new build developments. Rising construction costs is the main concern for investors for such a strategy, but recent data suggest a stabilisation here as commodity prices have declined and supply chain constraints eased.

A value-add office refurbishment strategy will prove most successful in dynamic, high-productivity, and sought-after cities, such as London, Paris, Berlin, Amsterdam, and Stockholm. The availability of grade A office space remains well-below historical norms in these markets, coupled with moderating new supply pipelines.

Return to logistics

Logistics stands out as a core investment strategy based on an attractive (re)entry point due to the material yield expansion and strong occupier fundamentals supporting rental growth. Rent growth is expected to outperform inflation over the next 10 years, especially in markets with low vacancy and high supply barriers, while expected inward yield movement over the next 5 years would encourage healthy risk-adjusted returns. The Netherlands, United Kingdom, Barcelona and CEE are our preferred markets.

We also see an opportunity for a logistics redevelopment strategy in Western European markets such as the UK, Spain and the Netherlands, where existing logistics stock is typically much older compared to Central and Eastern Europe. Micro-location is key, with good existing infrastructure, access to electric power and a large labour pool all important for successful implementation. With that in mind, we particularly favour the redevelopment of warehouse stock in urban locations.

The topic of ESG has not been as prominent as it has been for offices, but demand for sustainable and high-quality warehouses is growing. Major logistics operators are increasingly committing to net-zero emission targets and consequently their suppliers and third-party operators are equally looking to improve their environmental credentials.

Like other sectors, the European logistics sector increasingly must comply with stricter energy efficiency standards given increased backlash and regulation towards greenfield development. As well as having environmental benefits, such as through the retention of embodied carbon, the upgrading of older logistics stock will also have economic benefits for both occupiers and investors. Energy-efficient warehouses will enable occupiers to enhance operational efficiencies and reduce running costs. For example, on-site energy production using solar photovoltaic systems (PV panels) can greatly reduce more expensive energy consumption. From an investor’s perspective, environmentally sustainable assets will likely achieve both rental and sales premiums and prove more liquid at exit.

[5] CBRE, July 2023

Focus on growing operational residential sector

Fundamentals for affordable multi-family residential remain strong, however, the sector becomes more of a tactical play at this point of the cycle as yields remain below all-in financing costs. Instead, we focus on operational residential assets, such as student housing, senior living, and co-living. These assets typically offer a yield premium over multi-family residential and provide robust and often unregulated rental growth.

Student housing can be viewed as a counter-cyclical sector and is typically inversely related to the economic cycle: the tougher the job market, the more likely the decision to study. Student demand is coming from both domestic and international students, given the lack of good-quality purpose-built student accommodation (PBSA) and tight for-rent residential markets. Entering the PBSA market would most likely require a development strategy.

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 levels 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. We would focus initially on the bigger university cities in France, Italy, the Netherlands, Spain, and the United Kingdom.

Senior living is an emerging and undersupplied market in Europe, and we expect the sector to expand over the next 10 years as investor interest grows. Senior living – consisting of independent and assisted living – is akin to the private rented sector and can be seen as a diversification and expansion of existing residential strategies. The demand from an ageing population and lack of suitable accommodation bodes well for rent growth. The Netherlands and Spain are our top picks based on demographics and proof of concept given the modest existing supply and active operators.

Co-living is another emerging segment as the number of operators continues to increase, although penetration rates remain very low, accounting for less than 2% of rental stock in most European markets. 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.

Dispositions

Selective disposition with a focus on liquidity and performance

Launching any sales process will likely be difficult in this environment given the uncertainty of market pricing and the volatility of swap rates. Vendors could be required to accept substantial discounts compared to values 12-18 months ago, and risk of selling near the bottom of the market. If near-term liquidity is required, we would advocate to stagger sales throughout 2023 and 2024, if possible. Nonetheless, selling weak or stranded assets to avoid further valuation declines, and recycling capital into better and higher-returning assets should also be considered.

We understand that the decision to sell is highly dependent on asset and investor-specific considerations. Nevertheless, we suggest adopting a framework to assess disposition strategies by considering ease of execution, achievable pricing, market liquidity and long-term fund performance.

Above average but non-prime quality assets may offer the best mix between ease of sale, valuations discount and impact on long-term fund performance.

Small-and-medium-sized assets are likely the most liquid given the type of buyers and availability of debt. Equity-only investors and smaller local investors are typically targeting these smaller lot sizes. Smaller loans (below <€100m) and loan-to-values below 50% exhibit much greater debt availability and offer more competitive margins. Conversely, larger assets would likely attract the deepest discount given limited liquidity and difficulty to secure financing.

Investors with near-term liquidity needs could also look to sell assets with short-term future capex requirements. Moreover, assets that require some capex investment or asset management initiatives are likely to generate higher returns to meet current hurdle rates. Finding a balance between selling assets with near-term capex requirements and keeping assets with the greatest upside potential. The pool of buyers for these assets, including value-add or private-equity capital, might be larger than for core assets.

As mentioned, we expect the recovery to be led by logistics, given strongest investor interest and occupier fundamentals. The yield expansion is slowing and offset by strong rental growth. A disposition of logistics assets would likely have the highest probability of success, followed by residential assets. Residential yields in some markets continue to face upward pressures due to the sensitivity to interest rates, but robust rent growth should provide a cushion for further value declines. Non-prime office and retail dispositions remain difficult given structural headwinds and limited investor interest.

Framework for Disposition Strategies

Asset Quality	Asset Size	Capex Requirements	Sector Focus
Sell average-to-good quality assets as a balance between discount and ease of sale	Sell small-and-medium-sized given highest liquidity and lower discounts compared to large assets	Balance between selling assets with capex requirement and keeping assets with greatest potential	Logistics likely to have highest probability of successful sale Weaker office & retail difficult

Source: DWS, July 2023

3 / Country Summaries

Germany	— Bifurcation between manufacturing and service sector goes on, with business sentiment pointing to weaker growth in the short-term. — Investment activity is weak and repricing continues given the further shift of the yield curve. Fundamentals remain healthy but the recovery may be delayed to 2024.	— The residential market – including micro-living, student- and senior housing – experiences a historical shortage and expected to outperform in terms of rental growth. — Office markets offer value-add potential with increasing discounts for grade B while occupiers focus on prime assets. Logistics sector allows for both core and value-add strategies.
France	— Economic reforms continue despite protests. Modest outperformance for the French economy relative to the Eurozone over the next five years. — New planning laws in Paris likely to suppress office development, raising prospects for rental growth in central locations.	— Logistics rental growth surprised to the upside in southern France due to chronic shortage of space, an issue which is unlikely to improve in the next two years. — Student housing remains undersupplied in regional France. While yields have not adjusted significantly, rental growth is likely to outperform.
UK & Ireland	— Stubbornly high inflation and the threat of more interest rate hikes have stalled market recovery and increased the likelihood of a recession by the end of this year. — Risks around pricing are on the downside in the short-term, but over the medium term, a greater repricing than elsewhere in Europe presents opportunities.	— A significant price correction and attractive rent growth prospects support the UK logistics sector. Tight supply and constrained land bolster London's urban logistics in particular. — The UK remains one of Europe's few residential markets with limited rent regulation, allowing stronger uplifts. The living sectors are further supported by a notable undersupply.
Southern Europe	— GDP growth outperformed expectations in early 2023 due to a rebound in tourism numbers while inflation has fallen faster than the rest of the Eurozone. — Logistics are an outperformer again after the capital value declines, particularly for core product, making entry pricing attractive.	— Residential continues to be a focus although new regulation in Spain reduces opportunities in the private rented sector. — Brown to green office refurbishments could be successful, esp. in gateway cities, where grade A vacancy is low, and the pipeline of new/refurbished stock is limited relative to demand.
Benelux	— Logistics redevelopment of old, but well-located stock looks attractive based on robust demand, low vacancy and strict planning regimes. — The Amsterdam office market screens attractive for brown-to-green refurbishments based on robust macro-economic factors, low grade A vacancy and barriers to new supply.	— 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.
Nordics	— Nordic economies continue to surprise on the upside, supported by robust labour markets. Short-term risks remain elevated, particularly in an over-leveraged Sweden. — The Nordic cities are expected to outperform over the longer term, supported by healthy employment growth and strong urbanisation. Copenhagen residential remains a top pick.	— Rent growth in the logistics sector is expected to outperform the European average, supported by tight supply and strict planning laws, particularly around urban centres. — Stockholm remains a key target city for value-add office refurbishment. Demand for best-in-class, sustainable space will come from innovative firms within fast-growing sectors.
Central Europe	— Weaker domestic demand remains a drag on economic activity. GDP growth in H2/2023 is expected to be moderate, ending the year in line with the Eurozone average. — Industrial production is likely to normalise to pre-pandemic levels, despite strong foreign direct investments. Demand for logistic space remains elevated, putting pressure on rents.	— The office occupier market is set to profit from weakening supply, with net completions heading towards their lowest level on record. Flight to quality persists. — Residential sector is losing steam after the strong migration push. Short-term government support for first time buyers is shifting demand, but rental markets continue to mature.

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