# Preparing For Value Add

September 2022

IN A NUTSHELL

– The European real estate market has entered a period of price correction. According to recent estimates, the average net initial yield on grade B office stock could increase this year by 100 basis points, equivalent to a 20% fall in value.

– With price correction should come opportunity. As the economy returns to growth, and as structural demand drivers continue to assert themselves, this looks to be an excellent time to prepare value-add-focused strategies. Given a constrained pipeline of new supply, we see future opportunities to purchase grade B assets at a reduced price, with a view to delivering high quality space that meets future occupier requirements.

– The vast majority of Europe's current real estate stock will still stand in 2050. Value-add strategies that focus on refurbishment could be a critical component in meeting real estate's carbon reduction goals, while also providing the added benefit of delivering assets that are in demand from occupiers, investors and regulators.

## Price correction

### Weaker quality stock is experiencing a far greater price correction than the market average

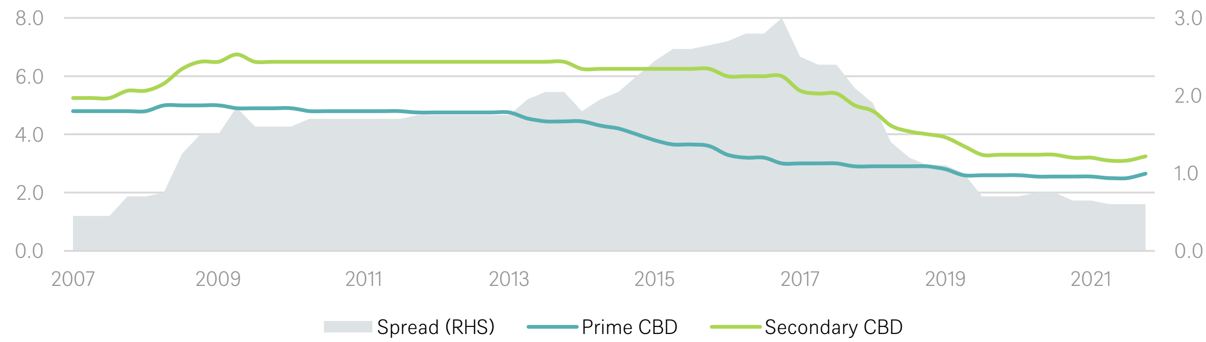
The European real estate market has entered a period of price correction. With financing conditions tightening, investment volumes falling, and economic growth slowing to the point of possible recession, there is a strong likelihood that we will see a material reduction in real estate prices over the coming 12 months.

Weaker quality assets are judged to be most at risk, and while valuation evidence is likely to lag for some months to come, we are already witnessing a notable pullback in pricing for assets that are currently on the market. This does not come as a surprise. At a time of reduced liquidity, uncertainty around future cashflows is leading investors to seek the safety of well-let, prime assets. And in addition, the various ongoing structural changes – from technology to ESG – and their associated capex requirements mean that over the coming quarters we expect to see far fewer investors willing to acquire poorer quality stock. This is laying the groundwork for a major price correction in stock judged to be grade B and below.

We have also witnessed over recent years a marked reduction in the risk premium applied to weaker assets. This has been most noticeable in the office sector, where despite a growing divergence in occupier performance, the prime/secondary spread for CBD assets in Germany was just 60 basis points in the second quarter of this year, 80 basis points below the historical average.[1]

[1] CBRE, July 2022

German Office Yield by Asset Quality (% / % points)




Source: CBRE, DWS, July 2022.

Taking into account all assets on the market, including those which have failed to sell, Green Street estimates suggest that repricing of grade B stock is well underway. Using this approach, the average net initial yield on grade B office stock is expected to expand by around 100 basis points in 2022, equivalent to a 20% fall in value. And while the impact may be less for other sectors, grade B logistics, residential and retail are still judged likely to see value declines in the range of 5-10%.[2]

Despite the pandemic, the occupier market has been in good shape, with shortages of new and high-quality stock reported across almost all sectors. Often reflecting a sustained lack of development, shortages span the entire spectrum of residential and logistics. Average office vacancy has risen in recent years, but even here the market is frequently struggling to offer the quality of assets sought by corporate occupiers.

However, as the economy slows, rising corporate insolvencies and job losses could lead vacancy higher. Given a relatively modest pipeline of development in all sectors outside logistics, this scenario suggests a more acute rise in secondary vacancy, as occupiers consolidate their space requirements. Grade B offices look particularly vulnerable. A typically pro-cyclical sector, higher average vacancy, and ongoing questions over remote working increase the risk of rental decline.

Clearly there is a huge degree of uncertainty to this outlook, and there will most probably be a wide range of outcomes across different assets. Nonetheless, given some of the recent estimates of current price correction, and with rental values vulnerable in the face of slowing demand, it would not be unreasonable to suggest that some secondary assets could see considerably more than 20% wiped off their value.

## Upcoming opportunities

Price correction and future economic recovery laying the groundworks for attractive value-add opportunities

With price correction should come opportunity. As the economy returns to growth, and as structural demand drivers continue to assert themselves, this looks to be an excellent time to prepare strategies that are focused on value-add investment. Even the worst recessions come to an end, and certainly very few economists are expecting this downturn to rank anywhere near events such as the GFC. This is important, as the success of value-add strategies will often be dependent upon growing occupier demand. While trend economic growth may be slower in the future, many cities, from London to Copenhagen, are projected to see population, employment, and GDP growth well in advance of the European average.[3]

As recovery emerges, this should support the letting of vacant space. While current repricing will help, unless other asset management initiatives are successfully executed, this approach is unlikely to provide sufficient returns to satisfy most value-add strategies. Additional return may be found by moving into smaller markets, where lower levels of liquidity could support

[2] Green Street, August 2022
[3] Oxford Economics, August 2022

an even greater price adjustment. However, we would generally caution against this approach, with the exception of the living sectors in a select number of smaller cities such as Valencia, Bristol and Leipzig, which are benefitting from population and employment growth more than the major markets.

## Structural drivers

### Value-add investors should seek to deliver space that meets the needs of ongoing structural demand drivers

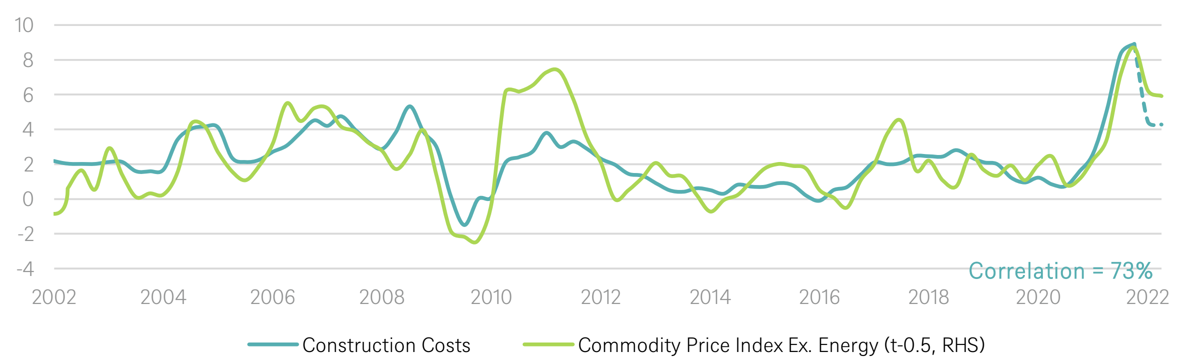
Perhaps more important than the cycle are the ongoing structural drivers that continue to influence and alter demand for real estate space. Whether it be technology, demographics or changes in the way we live our lives, these factors have the potential to lead to outsized demand growth across various parts of the real estate market – demand that the current stock of real estate will struggle to meet without significant active asset management.

With a constrained pipeline of new supply, which may well shrink further in response to today's market environment, this should open-up future opportunities for those investors willing and able to purchase grade B assets at a reduced price, with a view to delivering high quality space that meets future occupier needs.

In growing segments such as co-living, senior housing or self-storage, we also see opportunities for value-add investors to establish programmatic partnerships with specialist operators. Depending on the setup of this relationship, in addition to delivering stock that that meets the needs of a growing part of the market, investors may also gain from improvements in tenant covenant, net operating income growth and even through holding a stake in the operating company itself.

The recent increase in construction costs may make some investors nervous in committing to an active strategy that requires a large capex budget, although there are signs that supply chains are now starting to ease, with commodity prices well down from their recent peak. However, if construction cost growth does remain elevated, in time we would expect this to further weigh on new supply, particularly where replacement costs are running above that of current asset prices.

Euro Area Construction Costs and Commodity Prices




Source: DWS, Macrobond, August 2022.
Note: Dotted line reflects forecast based on historical relationship between construction costs and commodity prices.

## Impact and carbon reduction

### Value-add strategies that focus on refurbishment have the potential to have a significant impact of carbon emissions

One key structural driver in support of a future value-add strategy is the ongoing move towards a low carbon economy. Real estate is a major contributor to emissions, and to meet industry commitments, a large proportion of the current stock will require substantial refurbishment. It is important to stress refurbishment rather than new build here, given that refurbished assets not only reduce operational carbon, they are also estimated to save between a third and a half of embodied carbon.[4]

[4] London Energy Transformation Initiative, AECOM, DWS, August 2022

With tenants increasingly wanting space that meets their own environmental standards, and with environmental regulations becoming stricter, refurbished stock could achieve higher occupier demand while recording a lower risk profile. Not only would this help to provide additional returns, but it would also support investors looking to meet their own environmental and other impact objectives.

We believe this strategy could be most effective in high productivity cities such as London and Paris, where corporate and residential tenants are more likely to be able to afford the additional costs associated with high specification space. We also favour cities like Berlin and Hamburg where there are currently fewer environmentally certified (office) buildings,[5] and delivering high specification space into these markets could benefit from a scarcity premium.

## Preparing for Value Add

Price correction, recovery, high return expectations and positive impact support the case for future value-add investment

We're only at the beginning of this economic and real estate market slowdown, and therefore it may seem counterintuitive to be suggesting that now is the right time to be thinking about a move up the risk curve. However, for most, real estate investment is a multi-year process, and as such we must be prepared to look out into the future.

Market timing is important, but we do not believe it is a sufficient condition for ensuring investment success. Nothing is certain, but as explained in this note, the outlook for real estate, whether it be current repricing, prolonged undersupply, or major structural changes, all lend themselves to the view that investors should now be considering a future allocation to value-add strategies.

Source: Microsoft Stock Images; August 2022.

Successful value-add strategies won't be limited to just one sector. Whether it be the impact of remote working on residential, ecommerce on logistics, demographics on senior housing, or the push for net-zero on corporate office space, all these factors indicate the need for the real estate market to respond to changing occupier requirements.

Success also won't be limited to just one location. Structural changes are occurring across the globe and throughout Europe's real estate markets. While we do tend to favour fast growing and high productivity locations, where occupiers are more likely to be able to afford high specification space that meets the latest environmental standards, this should not be a limitation, with many smaller cities also seeing similar demand drivers.

Finally, the vast majority of Europe's current build stock will still stand in 2050, and as such we will not be able to build our way to lower carbon. Taking on refurbishments – retaining carbon while delivering operationally efficient assets – will be a critical component in meeting real estate's carbon reduction goals, while also providing the added benefit of delivering assets that are in demand from occupiers, investors and regulators.

In sum, we believe there is a strong case for investors to start preparing for value-add strategies. Not only due to improving return expectations in the years beyond the current market downturn, but also as a key element in meeting the industry's environmental goals.

[5] JLL, July 2022

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