Europe Real Estate Strategic Outlook

January 2024

IN A NUTSHELL

— We believe that the correction is all but complete at the prime end of the market, with values around 20% below 2022 peak levels.
— The European real estate market looks poised to recover after the recent period of price correction, with interest rates moving beyond their peak, solid occupier fundamentals and diminishing development pipelines.
— We expect 2024 to be an exceptional vintage year for real estate investment. With rental growth and the return of yield compression, prime property-level returns could reach double digits across all major sectors from 2025 onwards.
— European logistics and residential – including student housing and co-living – remain our key core investment strategies. We also see attractive, higher return opportunities in development, including office-to-best-use conversions.

1 / Market Outlook

It may seem like we've been living in a constant state of crisis for the past fifteen years. Financial, political, epidemiological crises, buffeting the world from all directions, ending what was to some a golden age of tranquillity. But for real estate investors this was far from the reality. From 2010 onwards allocating capital to real estate seemed almost like a one-way bet. Investment volumes surged, capital values doubled and the market convinced itself that lower for longer was the new normal. Yes, there were times of stress, but overall, life was good. Eighteen months ago, that all changed, as the market entered one of the most severe downturns since the Global Financial Crisis.

Today, as we sit surveying the damage, we must ask ourselves: is that it, or is there more to come? The answer is not that simple. With the correction now well advanced and lower interest rates on the horizon, there is a strong case to made that we are now at a turning point, and that the market will enter a recovery phase in 2024. This is indeed our expectation. Already we see a small number of segments returning to growth, laying the foundations for a broader upturn throughout this year.

But in no way does this suggest that 2024 will be easy. Recession stalks the global economy, with Europe no exception. And while we may not be expecting a deep downturn, businesses are likely to fail and jobs expected to be lost, putting upwards pressure on vacancy and dampening the exceptional rental growth we've experienced over recent years.

Financing will also remain challenging. Having so far proven something of a Phoney War, the refinancing battle may have only just begun. And while we may not be seeing systemic risks or a widespread shortage of debt finance, the ending of grace periods, higher debt costs, additional equity requirements and a general unwillingness to lend outside of favoured sectors, all suggest we should see a steady increase in defaults well into the period of recovery.

However, prime European real estate is currently pricing at around 20% below 2022 peak levels and for some investors this will be enough to bring them back into the market, no longer burdened by the denominator effect, seeking out opportunities for higher returns. We strongly believe that parts of the market now look attractively priced, particularly in the face of recession, where a solid income return from good quality real estate could once again pique investor interest.

Challenges also bring opportunities. An overcorrection of good quality assets in unloved sectors, deep discounts on secondary stock ripe for redevelopment, and the provision of whole loans during periods of elevated refinancing all have the potential to provide excess returns over the years to come. Navigating this will not be easy, and therefore it will be important that we enter this period with a deep understanding of our markets, focusing not just on what looks cheap, but on fundamentals, on space that works for occupiers now and into the future.

Above average returns

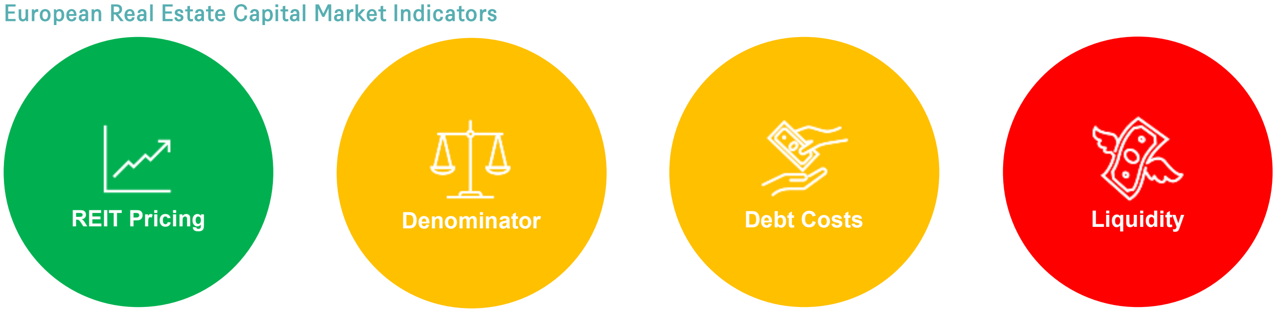
Peak interest rates, solid fundamentals and a diminished pipeline

The global run up in bond yields through summer and early autumn caught many by surprise, souring the mood across the real estate industry. European REITs sank 10%,[1] any signs of emerging optimism evaporated and eventually the market capitulated, pushing prices to new lows. With just €140 billion of transactions in 2023 (50% below the ten-year historical average),[2] the all-property prime yield in Europe ended the year more than 80 basis points higher at 5.2%.[3]

However, as we enter the new year, we sense a slight shift in the mood. The most notable driver of this has been a sharp improvement in debt costs. Five-year Eurozone swap rates fell from an October peak of 3.5% to around 2.4% by the end of the year,[4] with debt markets pricing in a series of rate cuts throughout 2024.

With an increased acceptance amongst real estate buyers, sellers and appraisers that values across almost all parts of the market are considerably lower than they were 18 months ago, alongside a recent rally in both debt and equities, this suggests that institutional investors considering real estate are no longer significantly burdened by the denominator effect. And while some may consider cutting back on target allocations to the sector, on balance this suggests a period of improving liquidity.

European Real Estate Capital Market Indicators



Source: DWS, Macrobond, MSCI, December 2023
Note: Green = positive impact for real estate performance; Orange = neutral impact; Red = negative impact

[1] Gross total return between 1-Jan 2023 and 25-Oct 2023 based on FTSE EPRA index. Macrobond, December 2023
[2] MSCI, January 2024
[3] Weighted average of office, logistics, residential and retail. DWS, January 2024
[4] Macrobond, January 2024

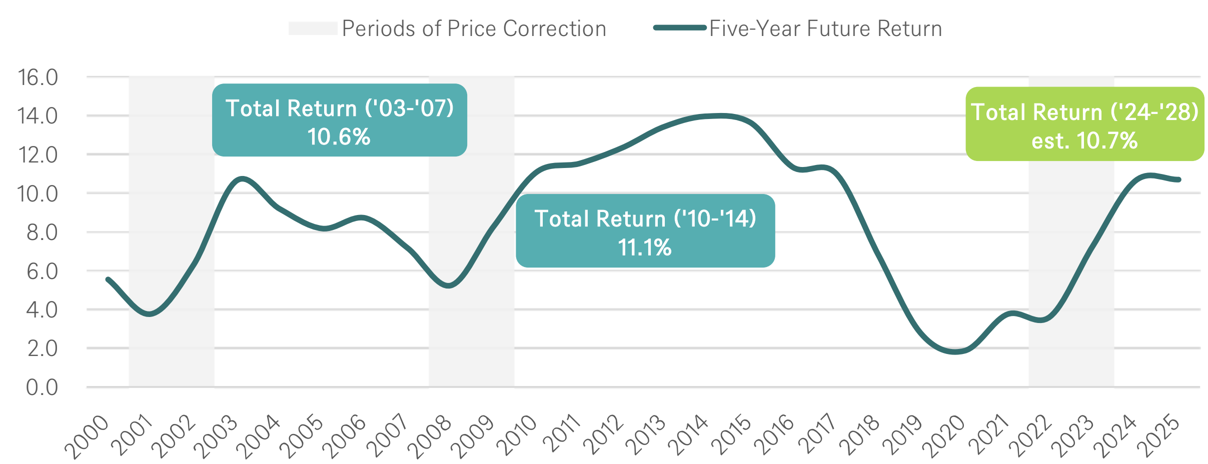
We may still be a few months away from reaching the low point in valuations, but overall, we believe that at the prime end of the market, the correction is all but complete. This is unlikely to be the case for poorer quality assets in weak locations, where we see a risk of further price correction. Not only are these assets more vulnerable to the economic downturn, but it is also likely to be some time before we see liquidity return, with debt finance both expensive and in short supply for this type of product.

As we move into the second half of the decade, we expect the recovery to accelerate and broaden. The return of economic growth and the current reduction in new starts should both help to reduce vacancy, boosting rental growth. Indeed, we believe some real estate markets could face acute shortages of new space over coming years. Many of Europe's largest cities already lack sufficient rental housing as well as good quality logistics, while even the unloved office sector across many prime locations is reporting low single digit grade A vacancy. With residential development in places like Germany or Sweden currently running around 25% below required levels,[5] European logistics starts down 30% on 2022,[6] and office net additions projected to turn negative in the second half of this decade, we see plenty of reasons to suggest rents could continue to grow well in excess of inflation for the rest of the decade.

We expect 2024 to be an exceptional vintage year for real estate investment. With rental growth and the return of yield compression, prime property-level returns could reach double digits across all major sectors from 2025 onwards.

There will of course be challenges. CBRE estimates the debt funding gap may not peak until 2026[7] – although price recovery should help to reduce some of the risk – while looking back to the financial crisis, loan defaults in the UK didn't peak until 2011.[8] We also shouldn't forget that structural drivers have certainly not gone away and will continue to shape and disrupt real estate demand for years to come. As such, a wide range in the return performance of sectors and subsectors, markets and submarkets, assets, and strategies, looks like a probable outcome.

Forward Looking Five-Year Core European Gross Property-Level Total Return



Note: Based on an unweighted average of office, logistics, residential and shopping centre forecasts. Pre-2010 reflects just the office sector.
Source: DWS, December 2023

[5] Destatis, November 2023 (2022 completions in Germany 25% below target), GDW, Swedish National Board of Housing, July 2023 (estimation of 40% below German target, 23% for Sweden)
[6] European logistics starts (over 10k sqm) Q1-Q32023 vs. Q1-Q3 2022, Property Market Analysis, December 2023
[7] CBRE, December 2023
[8] Bayes, July 2023

Sector performance

Residential and logistics set to outperform, office may become oversold in some locations

Our new forecasts show very little difference in the outlook for residential and logistics returns over the coming five and ten years. With both forecast to record annual double-digit returns through to 2028, we marginally favour residential on a risk-adjusted basis. Not only is the sector typically resilient to economic downturns, with just 3% vacancy[9] and future supply unlikely to meet demand, we project rent growth of near 4% per annum for the next five years. Add to this the bond-like nature of its income, repriced residential should be a key beneficiary of peak interest rates. Having experienced one of the most severe price corrections, German cities look good value, and are by far our top-performing markets. Fast-growing cities such as London, Amsterdam and Dublin also look well positioned, while the emergence of an institutional rental sector in Warsaw offers long-term opportunities.

Growing investor interest is already being seen across logistics, with some markets providing the first evidence of yield compression - notably in the UK, where transaction volumes for 2023 are currently running ahead of the ten-year average.[10] Notwithstanding the potential negative impact of a recession on occupier demand, we see a favourable occupier environment, particularly in urban areas where low vacancy and competition for space continues to drive rent growth. On average we see rents growing at around 3% per annum, rising to near 4% in urban areas. We favour high-barrier markets such as London and Amsterdam, while shifts in global supply chains could support the performance of Central European markets such as Czechia and Poland.

Office sentiment has weakened further over recent months. Heavily exposed, and facing ongoing uncertainty over future occupier demand, investors and lenders are often shying away. Despite over 10% rent growth, prime values have fallen by more than 30% over the past two years, with weaker assets in non-central locations seeing an even greater correction. There is certainly a risk of further decline, but also a growing possibility that some assets will become oversold. Many European cities continue to face shortages of good quality stock and given our expectation that net additions are projected to fall close to zero by 2025, we think it possible that best-in-class space across cities such as London, Paris, Berlin and Stockholm will continue to see record high office rents being achieved over the coming years.

We've been somewhat surprised by the resilience of the retail sector. Despite concerns that living costs would negatively impact retail sales, a post pandemic surge in tourist numbers, alongside elevated savings, and low unemployment, saw prime rents increase in 2023. These drivers may lose strength over the coming twelve months, but there is a growing sense that following several years of correction, prime rental levels may have reached a more sustainable level. Despite this, many investors continue to avoid the sector, wary of the complexities and capex required to keep schemes relevant. But with prime yields at 7.50% in Spain and over 9.00% in the UK, for those with the skills to manage these risks, we see the potential for an attractive income-led return.

[9] Green Street, December 2023
[10] MSCI, December 2023

Country performance

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

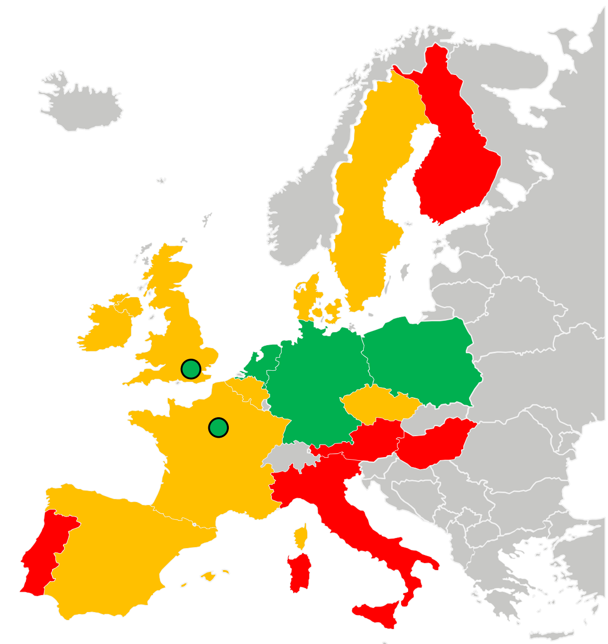
Having been through an overwhelmingly capital-markets-led correction, indiscriminately reducing prices across all sectors and markets, we must now turn our attention back to real estate fundamentals.

We may see differences between the timing and performance of sectors, but we expect greater divergence across cities: an earlier return of liquidity to the global gateways of London and Paris; faster population growth in centres of migration such as Stockholm and Dublin; stronger economic growth in converging markets such as Warsaw and high productivity clusters such as Amsterdam; and the effect of supply constraints in areas of acute physical or political barriers such as Barcelona.

Our key market calls remain little changed from our previous house view as we continue to favour targeting major cities in Germany, alongside London, Amsterdam, Paris and Warsaw.

We said six months ago that relative to other markets the correction in Germany had further to run. This indeed turned out to be the case, but today the market is starting to look more attractively priced. And while the economy does face the prospect of recession, low vacancy and moderating Bund yields both point towards a period of strong performance across the German Big-7.

Market Calls



Source: DWS, January 2024
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

London and Paris stand out within their respective national markets. History and recent evidence would suggest that both should see liquidity return more quickly than other cities, with international capital often seeking an opportunity to acquire unique stock at discount prices at this point in the cycle. The return of migration and students are supporting demand for already supply-constrained residential markets, while competition for space should also drive the performance of urban logistics. There is nervousness around the London office market, given a vacancy rate in the City of around 12%, but for the right stock we feel this concern may be misplaced. New record rents are now being set, and at a prime yield of close to 6.00%, City office pricing looks increasingly attractive.

Likewise, having suffered greater than average price corrections, the Netherlands now holds greater appeal, with logistics rents in Amsterdam forecast to grow an annual rate of near 4.5% over the coming five years. We see the Nordics performing broadly in line with the European average, with a more favourable outlook for Copenhagen and Stockholm over Helsinki, where we expect to see a slower pick up in liquidity alongside less robust economic drivers. Residential rental growth across Spain is expected to be some of the strongest in Europe, while Barcelona logistics will continue to be constrained by the sea and the mountains. Having been slower to accept a change in valuation, the recovery in Italy may be a little delayed. Nonetheless, with the market now adjusting, and rental growth in Milan expected to be in line with the European average, opportunities should arise.

Finally, Warsaw is projected to outperform. It may take longer for international capital to be comfortable returning to the region, particularly with the war in Ukraine. But with an arguably more market friendly government, reduced supply pipeline, economic convergence and the prospect of nearshoring, Warsaw and other parts of Poland look well placed, particularly logistics assets along major supply chain corridors.

2 / Investment Strategies

In today's market, investors are setting higher return requirements for core real estate, especially given the yield levels of fixed income. While core real estate typically offers stable cash flows, it also carries an inherent illiquidity premium. Historically, levered net IRRs for core real estate have provided a 200-300 basis point spread over 10-year BBB-rated corporate bond yields. Currently the spread sits close to the bottom of the range, but a further decrease in interest rates may increase the relative attractiveness of core real estate.

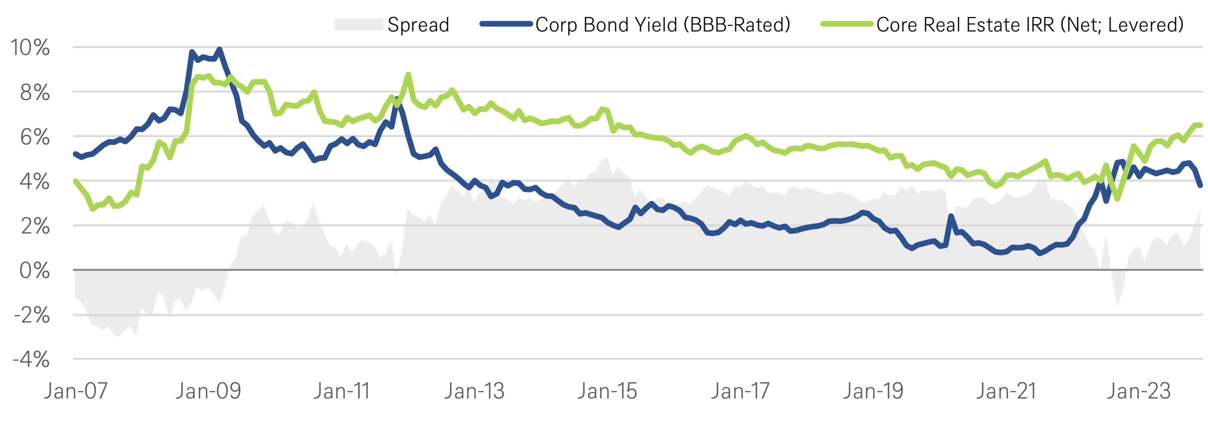
We strongly believe that real estate returns over the coming five years should be higher compared to their historical average. A higher entry yield, strong rent growth and expected yield compression all suggest a solid medium-term outlook. Indeed, given today's higher yield on alternative fixed-income investments, investors should be demanding higher total returns from their real estate investment.

Core investors may currently acquire prime real estate at a circa 20% discount compared to peak values in 2021. Of course, all-in financing costs have more than doubled, therefore reducing the impact of adding leverage. Predicting future interest rates, and ultimately property yields is difficult, especially given the wide range of views on the neutral rate. Conversely, rent growth is a far easier component to forecast by assessing occupier demand, vacancy rates and expected new supply, as well as other structural and economic factors. Therefore sector/market allocation and asset selection will be key to achieving excess returns over the fixed-income benchmark.

Given the supply outlook, we also see attractive opportunities to achieve higher returns through development. Value-add strategies could deliver double-digit returns in the mid-to-high teens. At the lower end of the risk spectrum, higher risk-adjusted returns versus typical core returns can be achieved by partnering with developers and taking moderate construction and leasing risk.

Levered cash returns may be less attractive, with all-in borrowing costs often still higher than real estate yields. There is still a place for leverage, but for investors focused on cash, private real estate debt may prove to be the preferred option. Private real estate debt continues to look strong in a multi-asset setting, as rising margins have pushed up the premium over other fixed-income investments. For senior debt, the return spread over similarly rated corporate bonds currently sits close to its highest level for 10 years, while junior debt has also seen an increase in spreads since the start of the year, despite margins remaining relatively stable.

Historical Expected Returns by Asset Class



Source: Macrobond, DWS, December 2023

Residential

Fundamentals for multi-family residential remain strong, especially given the sharp reduction in new starts. Chronic – and increasing – undersupply in many major markets is likely to continue pushing up rents, especially in unregulated markets. We prefer new-build residential given the ability to increase rents in line with the market and meet ESG-related goals including energy efficiency ratings, air quality and carbon emissions.

Student housing is once again proving its resilience through an economic downcycle, with strong rental growth and below-average value declines compared to other sectors. 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. In deploying capital in these markets, it will be important not to compromise on micro location and operator selection as these two elements can define the operational performance of the asset on a long-term basis.

Co-living is an emerging segment as the number of operators continues to grow, 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.

Logistics

European logistics remains a key investment strategy, supported by robust market fundamentals and healthy rent growth prospects. Given the continued growth in e-commerce, the fall in new starts and the importance of the logistics sector going forward, we anticipate further strong rental growth. In addition, the significant price correction in logistics over the last 18 months supports our strong call on the sector. We also see the opportunity to achieve higher returns through logistics development, including value-add strategies that comprise potential planning risk.

Dispositions

Any sales process could still be difficult in this environment, with a risk of selling near the bottom of the market. Dispositions of logistics assets would likely have the highest probability of success given the strong investor interest and occupier fundamentals, followed by residential. Office and retail dispositions remain difficult given structural headwinds and limited investor interest.

Investment Strategies

Residential	Logistics	Office	Dispositions
New-build residential	Repriced prime markets	Office-to-best-use conversions	Logistics
Student housing	Urban logistics	Green offices, residential, co-living, student housing, hotels	Residential
Co-living	(Re)development		Niche sectors

Source: DWS, January 2024

Office-to-best-use conversions

Structural changes in the office sector, including hybrid working and environmental pressures, present a clear opportunity to convert (soon-to-be) obsolete office buildings. There is a growing consensus that the office market is expected to shrink over the next ten years. The deterioration of demand for grade B office assets from occupiers, investors and lenders is expected to result in a peak-to-trough capital value decline of more than 40%. We still believe in a value-add strategy to convert grade B offices in the CBDs of high-productivity cities – where grade A vacancy is often very low – into sustainable Next Generation Office space. However, not all office buildings are suitable for such brown-to-green conversion. Office buildings in the inner city, suburban or commuter locations could have a higher and better use than office, including build-to-rent residential, student housing, co-living or hotels. The best alternative use is typically dictated by the distance to the CBD or city centre (see chart below).

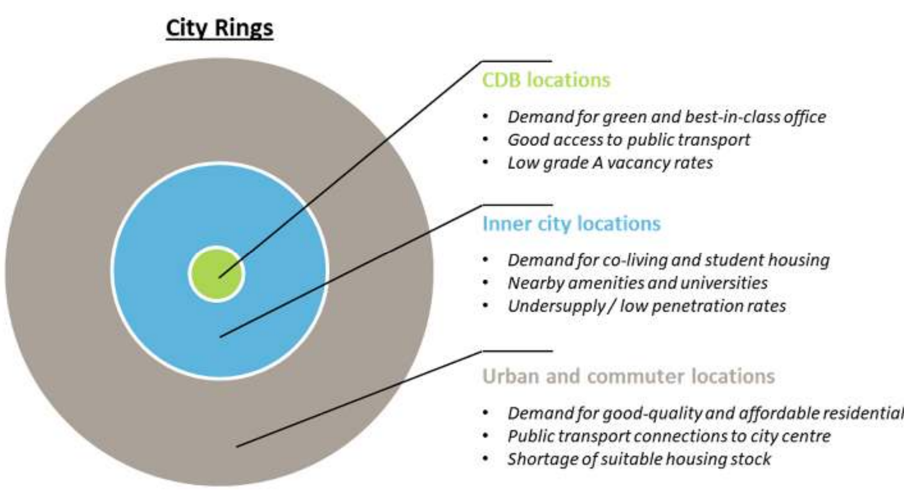
Build-to-rent residential: Office buildings in peripheral markets, but in desirable urban locations, have the potential to be converted into multi-family residential buildings. The existing foundations, plumbing and utility systems can be efficiently utilised, therefore streamlining the conversion process by reducing costs and embodied carbon. For example, narrower office buildings allow for more windows and are typically easier to convert than deep, rectangular-shaped office buildings.

Student housing: Non-CBD, obsolete office buildings near large universities offer a sought-after alternative use given steady demand from students and the undersupply of high-quality student accommodation across Europe. The technical adaptions required for student living, such as high-speed internet and study-friendly spaces can be integrated into the building's design.

Co-living: The rise of remote work and the digital nomad lifestyle has increased the demand for co-living spaces. These are communal living areas where residents share certain spaces, like kitchens and living rooms. Office buildings could be well suited for this, given their open-plan layouts and the provision of co-working space across some concepts.

Hotels: While the challenge of low ceiling heights in obsolete office buildings might seem like a limitation, it can be turned into a unique opportunity when converting them into hotels. The limitation can be creatively addressed through innovative design solutions that prioritise functionality and aesthetics. Hotels often thrive on creating intimate and cosy atmospheres.

Office-to-Best-Use Conversion Based on Location



Source: DWS, January 2024

3 / Country Summaries

Germany	– Weaker economic outlook in the short term. Poor business sentiment and headwinds from possible fiscal tightening in the wake of abolished unconstitutional off-budget vehicles. – Moderation in supply across sectors, but most pronounced in residential. Increasing pressure on unregulated rents as well as spill-over effects into operational residential offerings.	– Strong market fundamentals in logistics. Demand is entering a soft patch, but supply is also moderating. Strong long-term prospects around rent growth, especially for urban logistics. – Ongoing polarisation in the office market with a positive outlook for new or refurbished prime assets. Key markets with low vacancy like Berlin or Munich expected to outperform.
France	– Île De France appears set to continue to outperform, despite slower population growth, due to the dominance of the services sector in the regional economy. – Lyon also a strong regional performer thanks to its life sciences and R&D sectors, expanding office employment and population growth in excess of the national average.	– Low availability of office space in Central Paris coupled with high rents support the investment case for value-add strategies in this sector. – Current momentum in logistics demand has tailed off but long-term prospects for rental growth and yield compression remain convincing.
UK & Ireland	– Economic indicators highlight short-term challenges to the UK economy; however, price pressures are easing and the medium-to-longer-term outlook remains more positive. – A higher entry yield and healthy prime rent growth suggest a robust medium-term outlook for UK property, with returns forecast to outperform the European average.	– We see the best opportunities for outperformance in urban and Last Hour locations. Redeveloping aging stock into modern, energy-efficient logistics could capture higher returns. – In London's central submarkets, such as West End and City, we still favour the comprehensive refurbishment of secondary office stock to best-in-class, highly sustainable offices.
Southern Europe	– Tourism-led GDP recovery slowing down as higher interest rates feed through into lower consumer spending and investment. – Milan and Barcelona logistics vacancy highly constrained and supply pipeline insufficient to meet demand, so strong rental growth likely to continue.	– Operational residential (student housing and flex living) is now the focus in Spain and Italy given promising rent growth potential and attractive entry capital values. – Potential for further investment in affordable housing in Spain due to supply/demand imbalance, high initial yields, and stable income stream on offer.
Benelux	– With stringent planning controls, such as the limitation of greenfield development, and a scarcity of high-quality space, there is a potential for development-led strategies. – A swiftly ageing population and a deficiency of suitable, high-quality senior living options create an opportunity for investment in this sector.	– The pronounced scarcity of student accommodation, particularly in Amsterdam, coupled with the increasing presence of international students, make investments in student accommodation highly promising. – Opportunity in repurposing old, but well-located office spaces into residential units in Amsterdam, Rotterdam and Utrecht.
Nordics	– Interest rates weighing on the Nordic economies. However, the medium-to-longer-term outlook is brighter. Sweden and Denmark expected to outperform. – Logistics fundamentals remain solid. Given the constrained supply picture, brownfield redevelopment could offer an attractive opportunity for sustainable market entrance.	– Copenhagen remains a target city, supported by solid demand fundamentals and low vacancy. Operational residential, such as co-living, offers stronger risk-adjusted return potential. – Stockholm's office market supported by strong employment growth and a constrained supply pipeline. The city is a target for a brown-to-green office redevelopment strategy.
Central Europe	– Strong economic outlook for Poland due to a rebound in domestic demand. Further push from renewed inflows of EU funds after a change in government. – The logistics market maintains strong fundamentals. Long-term trends remain key drivers for the sector in CEE. Polish logistics seen as direct beneficiary of EU funding.	– Polarisation and a growing supply gap for prime offices are leading to increased rent growth. Renewed medium-term yield compression on the return of international investors. – Ongoing maturing of the residential sector with a focus on operational residential. Increasing attractiveness of Poland as business destination is driving demand.

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