Europe: Stepping Up as a Pinch Hitter

April 2025

IN A NUTSHELL

– Resilient and growing cities, fiscal policy shifts to support growth, robust occupier fundamentals, repriced markets and compressing yields provide an intriguingly positive backdrop for European real estate investments.
– A pivotal shift in the new supply landscape due to declining development margins with an estimated 25-30% drop in new supply over the next five years, putting pressure on rents in low vacancy and supply-constrained markets.
– Compelling value-add opportunities in the living sector, capitalising on a rare convergence of improving fundamentals, pricing dislocation, new living solutions, and technology-driven operational efficiencies.

Why European Real Estate (Now)?

The term "pinch hitter" originates from baseball, where it refers to a substitute batter brought in to replace a regular player in a critical moment of the game. In the context of investing in European real estate, the term pinch hitter signifies a strategic pivot in response to market changes. Much like a baseball manager substituting a pinch hitter to seize an opportunity at a crucial time. Moreover, being a "pinch hitter" in the investment world emphasizes the importance of having a diverse portfolio. It is widely known that Europe is forecasted to exhibit modest economic growth. However, from a real estate perspective, Europe benefits from historically lower supply levels, lower land availability and stricter planning regulations, resulting in structurally lower vacancy rates. Countries such as the United States and Australia are experiencing much higher economic growth, driving demand for real estate. This is often coupled with a higher supply response, especially compared to Europe. Understanding these differences is crucial for investors seeking to navigate the nuances of each market and capitalize on opportunities.

Now, in our view, it becomes evident that this is a good time to focus our attention on the European real estate market, bringing in the “pinch hitter”. Europe is entering a promising new chapter, with robust occupier fundamentals, limited new supply, stabilized yields, increasing liquidity and an easing interest rate environment. We believe the year 2025 is set to be a standout vintage year in European real estate. European real estate, with its intrinsic benefits of diversification, stable income, could potentially lead to attractive risk-adjusted returns. Real estate also stands Real estate also stands out for its potential to foster positive impacts, such as the development of green(er) buildings and the provision of affordable housing. Also central to the attractiveness of Europe's real estate market are several key structural drivers, such as acute housing shortages, student mobility, ageing population, and increased healthcare and defense spending.

Why Europe despite the sluggish growth outlook?

As we look ahead, it's clear that Europe is on a path toward subdued economics growth, likely falling behind other major developed economies. The persistence of elevated energy prices creates enduring challenges, particularly for large industrial nations. Moreover, with an aging population, demographic trends could further limit the growth potential in the decade to come. But if we look beyond the headlines, a brighter outlook emerges. Higher European defence spending will likely boost economic growth over the next five year. But more importantly, fiscal policy is set to play a more pivotal role in Europe. Several European countries benefit from a relatively low level of public debt[1], including Denmark (32%), Sweden (32%), the Netherlands (43%) and Germany (62%) – compared to 125% in the United States[2]. European countries also benefit from lower a lower fiscal balance (-2.8% for the Eurozone vs. -6.9% in the U.S.[3]). The fiscal spending power could unlock further growth. For example, Germany recently proposed a €500bn fund for investment in infrastructure, financed by additional government borrowing. This would position Germany favourably for economic stability and ability to invest into growth sectors. European equity markets rallied in the first three months of 2025, suggesting renewed investor confidence and equity investors desire to diversify their holdings.

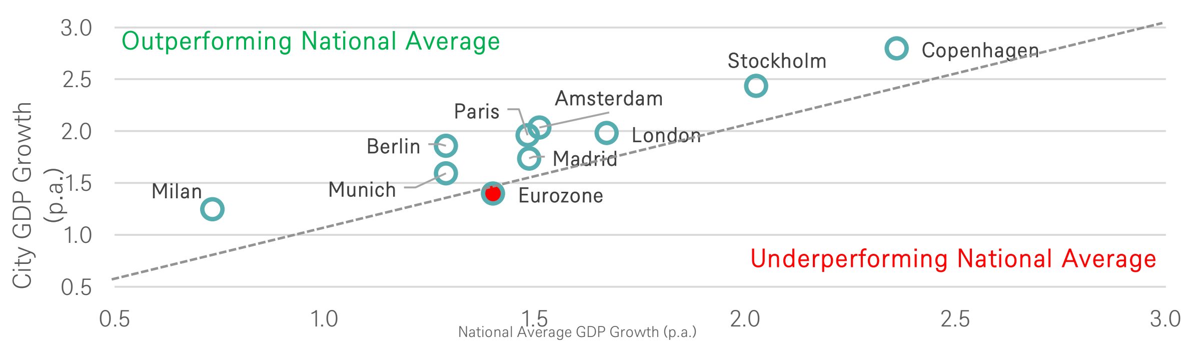
Urban resilience amid national slowdown

While Europe faces a slow growth outlook on a national level, key cities are displaying a much more promising trajectory, underscoring their resilience and vitality. These urban centres are thriving due to ongoing urbanization and the presence of fast-growing, high-productivity companies that appeal to a young, dynamic population. Europe's gateway cities–such as London, Berlin, and Amsterdam–are emerging as premier destinations for young professionals, high-productivity businesses, and rapidly growing companies. Over the next decade, these key cities are projected to see an impressive 8% growth in their working-age population, while the rest of Europe faces a 3% decline[4]. This compares to an average decline of 6% in Boston, Chicago and New York[5].

The silver lining of slow growth for real estate investors

Inflation is broadly under control in Europe as Central Banks implemented interest rate hikes to manage the money supply and curb spending. Interest rate cuts are now well underway across Europe, providing tailwinds for the real estate industry. The outlook for modest economic growth driven by the challenges of an ageing population and diminishing productivity growth suggests a lower "neutral rate," particularly when compared to the higher-growth U.S. For example, the European Central Bank has cut interest rates by 150 basis points since its peak of 4% in 2023. This sets the stage for European real estate markets to benefit from potential yield compression, unlocking potential for investors. The strong correlation between real estate returns and interest rates further underscores the opportunities present in this sector.

European GDP Growth Forecast for the Eurozone and Major Cities (2025-29)



Source: Oxford Economics, DWS, December 2024

[1] Gross government debt (as a % of GDP) Maastricht definition, Oxford Economics, March 2025
[2] DWS Macro and Market View, February 2025
[3] 2024 actual. DWS Strategic CIO View, March 2025
[4] Oxford Economics, March 2025
[5] Moody's Analytics, March 2025

Constrained Supply Outlook

Shift in development: What lies ahead?

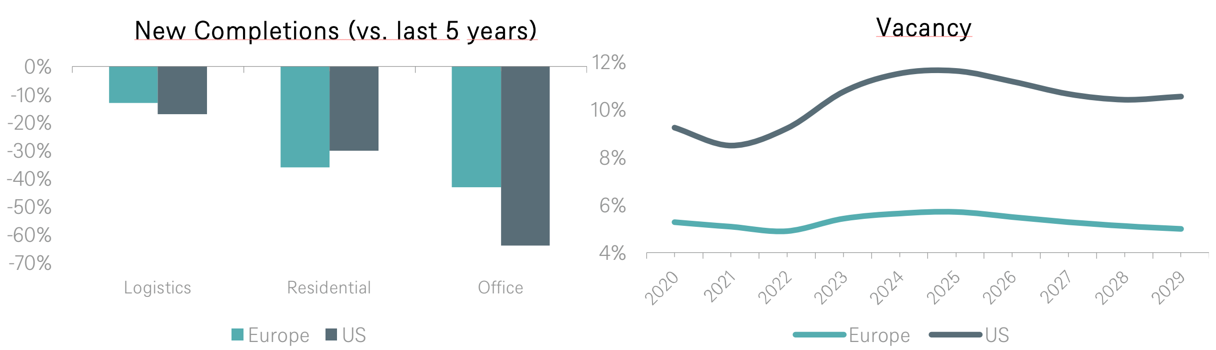
As economic growth remains modest, long-term structural drivers as well as the outlook for supply and vacancy are expected to be the primary drivers of rent growth. We are witnessing a pivotal shift in the new supply landscape, largely driven by declining development profit margins. Exit values have fallen by roughly 20%[6] while simultaneously construction costs have surged by more than 20% since 2021[7], creating an increasingly challenging environment for new developments. Looking ahead, we anticipate a 25-30% decrease in new supply over the next five years compared to the previous half-decade. This shift is expected to have notable implications for already highly tight markets, particularly in terms of vacancy rates. Despite the lingering supply overhang resulting from the end of the previous cycle – mainly in the U.S. when financing was cheap and development margins were very healthy. We estimate that vacancy rates will decline by 70-100 basis points over the next five years in Europe and the U.S[8].

Europe enjoys a notable advantage in its real estate market due to historically lower supply levels compared to the U.S., coupled with structurally lower vacancy rates, which stand at ~5.5% compared to the ~11.5% observed in the U.S[9]. This can be attributed to several factors, including land scarcity and the implementation of stricter planning regimes, which regulate development more tightly. Additionally, a higher proportion of urban residents living in city centres and the prevalence of denser urban planning contribute to this disparity, creating a market environment that fosters stability and higher demand for housing in European cities.

Structural drivers driving demand

We observe shifting lifestyle trends that necessitate new residential strategies, as individuals and families seek living spaces that better align with their evolving needs, or students looking for opportunities abroad. Simultaneously, the continent grapples with an ageing population, resulting in increased healthcare expenditure—a trend that underscores the importance of investing in senior living, healthcare facilities and life science.

Comparing New Completions and Vacancy Rates (Residential, Logistics and Office)



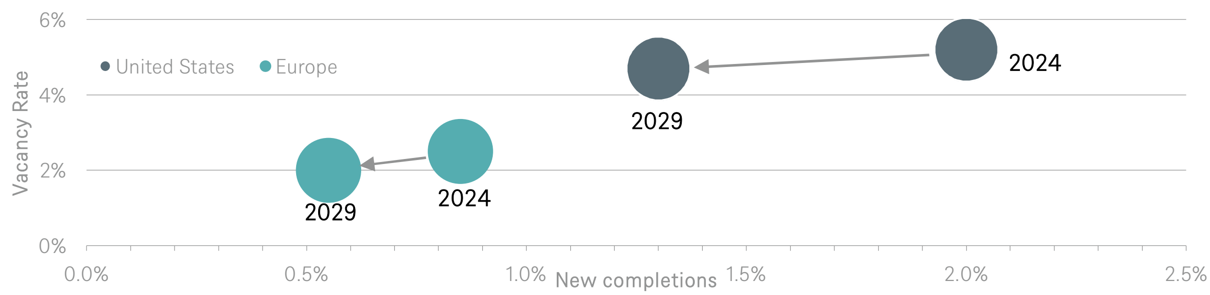
Source: CBRE, Green Street, PMA, DWS. March 2025

[6] DWS Europe Real Estate Strategic Outlook, December 2024
[7] Construction producer price and construction cost index, Eurostat 2024
[8] DWS Real Estate Research estimates, based on CBRE, PMA and Green Street data, December 2024
[9] DWS Real Estate Research estimates, based on CBRE, PMA and Green Street data, December 2024

Focus on European Residential

The European residential market highlights the acute supply challenges it faces with stark clarity. As the most supply-constrained sector, it is plagued by chronic and worsening undersupply issues. Vacancy rates hover around the mid-2% range, which is nearly half of what is observed in the U.S. market, and in certain German cities these rates dip below 1%. This persistent scarcity of available housing is exacerbated by new completions that remain significantly below 1% annually, resulting in a pronounced housing crisis. Housing delivery often fails to meet government targets, exacerbating the situation further. If we project that future supply would be approximately 35%[10] lower than needed, we can anticipate an even more severe undersupply crisis on the horizon, which could inevitably lead to escalating rent pressures and increased difficulties for potential renters.

Vacancy Rate and Supply Growth (p.a.)



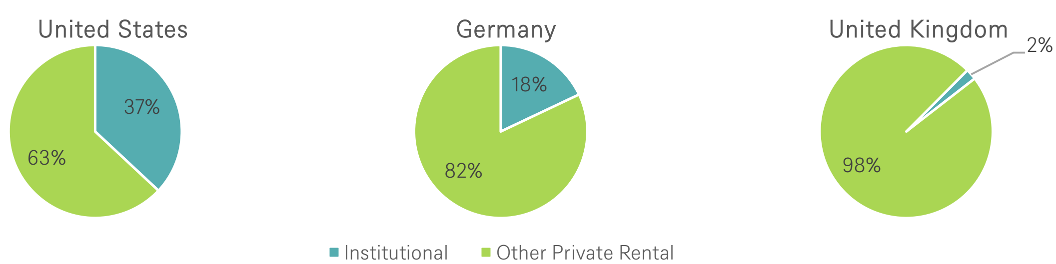
Source: CBRE, Green Street, PMA, DWS. March 2025

Unlocking growth in Europe's living sector

The European build-to-rent market presents an opportunity for growth, especially when we consider its current scale compared to the U.S. In the U.S., institutional ownership accounts for nearly 40% of the private rental market, demonstrating a robust and mature sector. In contrast, Germany, despite being the most institutionalised rental market in Western Europe, sits at just 18%, while the United Kingdom lags significantly at only 2%. This disparity highlights a clear potential for expansion and investment in Europe's living sector. Furthermore, operational residential sectors like student housing, senior living, and co-living are still in their infancy across Europe. The scalability of European living sector is robust and supported by favourable market fundamentals. On the operational residential side, expertise and knowledge acquired through traditional multi-family investments can often be leveraged effectively, as the sectors are akin to the build-to-rent.

Rent regulation is a critical factor to consider when investing in Europe, necessitating a strategic approach to operate effectively within a regulated environment, where understanding local laws, navigating compliance, and adapting investment strategies are essential. Over the long term, a well-designed rent regulation offers stability and may help reduce overall risk. Moreover, regulation (including higher transaction taxes) aggravated the supply demand misbalance and deterred less sophisticated capital from operating in regulated markets. Expertise to successfully navigate operationally in more regulated markets presents potential opportunity and a significant barrier to entry, thereby while it is for some a threat, it should be viewed as an opportunity.

Ownership as percentage of private rented sector



Source: Green Street, September 2024

[10] DWS Real Estate Research estimate based on CBRE, PMA and Green Street data, March 2025

Investment Strategy

The U.S. and Europe offer appealing investment strategies, each owing to their contrasting economic outlook. The U.S. market can be characterised by high (nominal) economic growth, but also higher supply growth. Investment strategies are focused on capturing growth trends, including garden-style suburban residential, high-supply/high-demand logistics markets and non-core gateway office markets (e.g. San Jose, Boston and Sunbelt markets). In stark contrast, in Europe, investment strategies focus on supply-constrained markets. We also observe a growing polarisation between locations and asset qualities. This intensifying divide is creating a landscape where the discrepancies across sectors and markets are more pronounced than ever. Location and asset selection are key as we see a greater dispersion between the "winners" and "losers" in Europe.

Focus on high-quality assets in fast-growing, supply-constrained cities

The overall macroeconomic weakness shouldn't necessarily deter investment in the European market. On the contrary, with many of the major cities growing substantially faster than the average, the headline reduction in national economic growth and subsequent cuts in interest rates to follow, and euro weakness could provide an intriguingly positive backdrop for real estate investment. This is particularly so, as many of these cities, with high barriers to supply, are exhibiting shortages of high-quality stock, shortages which we believe could only get worse over the coming few years.

Value Add Strategies in the European Living Market

The European real estate market also presents a compelling value-add opportunity, particularly in the living sector. Strong fundamentals, such as low vacancy rates, falling supply, and robust rent growth, coupled with a pricing correction, create a unique window for investment. A comprehensive asset management approach is essential to align properties with tightening regulations and to provide future-fit living solutions. This strategy not only helps ensure compliance but also can help position assets to capitalise on the high growth living sector. Key components of this strategy include living-to-living refurbishments, which focus on rent increases and unit size optimization, and (re)development of under-valued or sub-optimal sites and structures. These efforts are aimed at unlocking the full potential of permitted plots and potentially enhancing their value.

Repurposing existing structures, such as converting offices or parking spaces into living spaces like co-living, serviced apartments, or student housing, is another critical element of this strategy. Conversion to the highest-and-best use helps maximise the utility and profitability of the assets. Operational excellence and diverse living solutions further drive value creation for investors, ensuring that properties are not only future-fit but also aligned with market demands. Focusing on these strategies may help drive value and help create sustainable, high-performing living properties.

We also observe favourable conditions for value-add strategies, which are pertinent in Europe:

- High-density cities and scarcity of land
- Older property stock which is primed for modernisation
- The regulatory encouragement for property enhancements that not only comply with modern standards but also appeal to ESG-conscious tenants and investors
- Growing emphasis on green initiatives, with access to subsidised loans that make these upgrades economically viable
- Attractive financing to conversions with strong ESG certifications

Summary

Despite broader economic challenges, Europe presents a compelling investment landscape focused on high-quality, supply-constrained assets in dynamic cities. The favourable conditions for value-add strategies in the living sector may present attractive opportunities while aligning with sustainability trends. By capitalizing on location and asset quality discrepancies may help to navigate the European market, serving as the "pinch hitter" in their investment strategies.

Real Estate Research Team

Office Locations

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

London
45 Cannon Street
London, EC4m 5SB
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
15th Floor
Singapore 048583
Tel: +65 6538 7011

Tokyo
Azabudai Hills Mori JP Tower
1-3-1 Azabudai
Minssato-ku
16th Floor
Tokyo
Japan
Tel: +81 3 6730 1300

Sydney
Level 16, Deutsche Bank Place
Corner of Hunter and Phillip Streets
Sydney NSW 2000
Australia
Tel: +61 2 8258 1234

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 & Retail Research

Ross Adams
Industrial Research

Sharim Sohail
Self-Storage Research

Europe

Ruben Bos, CFA
Head of Real Estate Investment Strategy, Europe

Tom Francis
Property Market Research

Siena Golan
Property Market Research

Rosie Hunt
Property Market Research

Carsten Lieser
Property Market Research

Martin Lippmann
Head of Real Estate Research, Europe

Asia Pacific

Koichiro Obu
Head of Real Estate Research, Asia Pacific

Seng-Hong Teng
Property Market Research

Hyunwoo Kim
Property Market Research

Matthew Persson
Property Market Research

AUTHORS

Ruben Bos
Head of Real Estate Investment Strategy, Europe

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