Research Institute
European Transformation

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Marketing material

Europe’s investment appeal

The investment routes to express European Transformation


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IN A NUTSHELL

— Europe has been at the forefront of sustainability policies for years, illustrated by rapid decarbonization and the deployment of renewables.[1] Europe also leads on most dimensions of economic inclusion and social progress.[2]

— The U.S. election, the continuation of the Russia-Ukraine conflict and broader geopolitical and strategic risks simply fuel the impetus for Europe to transform and unlock capital investment to finance transformation.

— Action such as public-private finance partnerships to de-risk and scale-up breakthrough technologies as well as regulation to make it easier for start-ups and small to medium-sized enterprises (“SMEs”) to access capital markets demonstrate this transformational agenda.[3]

— We view Alternatives as the best route to capture transformative investment opportunities. Alternatives occupy a place in the risk-return spectrum between traditional lower-risk rates and investment grade credit on the one hand and risky equities and high yield credit assets on the other.

— One of the most attractive asset classes within Alternative is infrastructure, which now forms around 20% of assets under management in European alternatives.[4] We expect its appeal to continue given European infrastructure has three crucial benefits relative to other regions namely policy, diversity, and value.

— Real estate investment is pivotal in supporting Europe’s transformation and can play an important role in achieving economic, social, and environmental goals. Structural drivers for the asset class include Europe’s aging population, increasing healthcare spending and advancements in artificial intelligence.

— Similarly, private investments via direct lending offer investors a unique chance to finance SME transformation. Given the floating nature of direct lending loans, the prospect of further monetary easing in Europe should, in our view, provide an additional fillip to this asset class.

Introduction

In this paper, we explore the case for Europe as an investment location. We show how the policy and regulatory environment across the continent is increasingly being tilted to address structural challenges such as weak competitiveness as well as towards unlocking capital investment to finance sector transformation. We then delve into the characteristics of Alternatives as an asset class. Finally, we assess specific investment opportunities within the infrastructure, real estate, and direct lending sectors.

[1] European Commission (2023). JRC Science for policy report. GHG emissions of all world countries; EDGAR (October 2024). JRC Science for policy report. GHG emissions of all world countries 2024
[2] McKinsey Global Institute (January 2024). Accelerating Europe: Competitiveness for a new era
[3] Zeidler group (March 2024). Guide to Germany’s Future Financing Act for Startups and SMEs
[4] Preqin (2024)

1 / Europe as an investment location

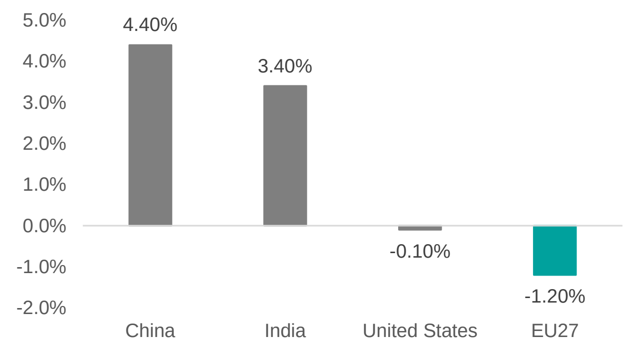
Europe has long been a leader in sustainability policy, but the re-election of U.S. President Trump, with his commitment to trade tariffs, poses a significant risk for Europe. Additionally, ongoing geopolitical risks, including Russia's invasion of Ukraine, further drive the need for European transformation. Major issues were identified, and recommendations made in important reports from former Italian Prime Minister Letta[5] and former European Central Bank President Draghi.[6] These reports echo the findings and efforts of DWS from our European Transformation initiative since December 2022.[7]

1.1 Europe's strong environmental and social credentials

Europe stands as a global success story in sustainability and social inclusion, two of the world's most critical issues. Europe has more ambitious climate targets compared to the U.S. and China, i.e. a 55% reduction from 1990 levels by 2030,[8] compared to the U.S.'s 50-52% reduction from 2005 levels, which translates to about 43-45% from 1990 levels,[9] and China's target focuses on peaking emissions prior to 2030 and improving carbon intensity.[10]

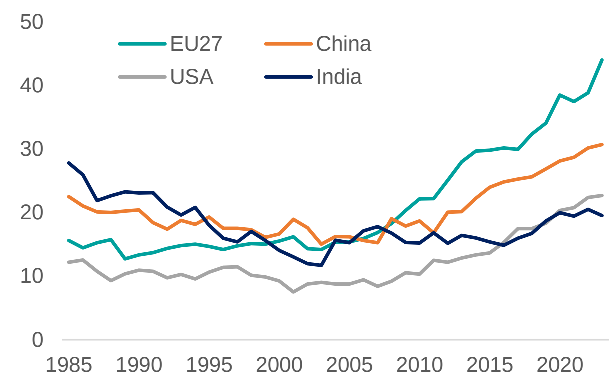
Since 1990, Europe has seen its greenhouse gas emissions decline by 33.9% or -1.2% on a compound annual growth rate (CAGR). This compares to a CAGR decline of just 0.1% CAGR in the United States and a rise of more than 3% for China and India. Figure 1a.[11] When it comes to the adoption of renewables, Europe has achieved 44% of its power generation stemming from this source.[12] The equivalent share in the United States is just 23%, Figure 1b. Europe also leads on most dimensions of economic inclusion and social progress, including income inequality and life expectancy.[13] The missing piece to the region's appeal as an investment location is the continent's performance in terms of economic growth and productivity. This has become a central pillar of the European Commission's efforts to addressing the region's competitive position.

Figure 1a: Greenhouse gas emission reduction by country/region



Source: EDGAR (October 2024)

Figure 1b: Share of electricity generated by renewables (%)



Source: OurWorldInData (October 2024); EMBER: 2023 data for EU27

1.2 Decarbonization, digitalization and defense are Europe's key priorities

Three strategic priorities to address Europe's competitiveness were well summarized in the recent report by a former Italian prime minister Mario Draghi: Europe needs to digitalize and decarbonize the economy and increase its defence capacity.[14] Digitalization should address Europe's productivity problem, fostering innovation and efficiency. Decarbonization is crucial not only for meeting ambitious greenhouse gas (GHG) targets but also for transitioning to secure low-cost clean energy sources. In an era of rising geopolitical tensions, reducing dependencies and increasing security by diversifying suppliers of critical raw materials and minimizing reliance on imported digital technology should strengthen Europe's resilience and strategic autonomy.

[5] European Commission (April 2024) Enrico Letta's Report on the Future of the Single Market
[6] Report by Mario Draghi for European Commission (September 2024) Future of EU competitiveness
[7] DWS (2022-24) European Transformation Research Hub
[8] European Commission (September 2020) Communication on the 2030 Climate Target Plan
[9] Congressional Research Service (January 2023). U.S. Greenhouse Gas Emissions Trends and Projections from the Inflation Reduction Act
[10] Climate Action Tracker (September 2024). Countries – China
[11] European Commission (2023). JRC Science for policy report. GHG emissions of all world countries
[12] EDGAR (October 2024). JRC Science for policy report. GHG emissions of all world countries 2024
[13] McKinsey Global Institute (January 2024). Accelerating Europe: Competitiveness for a new era
[14] Report by Mario Draghi for European Commission (September 2024). The future of European competitiveness

To achieve these objectives, European governments need to implement targeted policies and incentives tailored to the needs of both established, medium and large industrial companies on the one hand and young, innovative start-ups on the other. The former can benefit from sector-specific industrial and trade policies, which focus on enhancing competitiveness and sustainability without picking individual winners. In contrast, the emphasis for the latter should be on creating a dynamic ecosystem through more flexible regulations and improved access to venture capital. Over the past decade, the EU's venture capital investments have averaged just 0.3% of gross domestic product, significantly lower than the U.S. average.[15] This gap is particularly evident when many European start-ups choose to relocate overseas during their rapid growth phases.

Towards this goal, Germany, for example, passed the Future Financing Act (Zukunftsfinanzierungsgesetz) to make it easier for start-ups and small to medium-sized enterprises ("SMEs") to access the German capital market.[16] It introduces changes to existing laws with the goal of making Germany more appealing to international investment companies and investors, including measures to digitalize the capital market, reduce regulatory bureaucracy, and allow the use of English in certain documents and communications with the Federal Financial Supervisory Authority ("BaFin"). The minimum capital needed for an initial public offering ("IPO") has been reduced from EUR 1.25 million to EUR 1 million. In August 2024, a draft of the Second Act on the Financing of Future-Securing Investments was published by the Federal Ministry of Finance providing further measures, including tax incentives to support investments in renewable energies and infrastructure and the increase in the maximum tax-free reinvestment amount for profits from share sales from EUR 0.5 million to EUR 5 million.[17]

1.3 Governments need to activate private capital

European transformation requires unprecedented capital deployment, of which private capital is vital. It requires European governments' to facilitate private capital inflows through all available levers, from completing the Single Market to making capital market more attractive to retail customers.

Full implementation of the Single Market is one of the critical aspects for enabling growth and competitiveness of European companies across the continent and beyond. The single market allows companies to sell their products in all member states and achieve cost advantage but while the single market already covers many areas, it is not yet complete. It is estimated that ongoing trade frictions in the EU mean that Europe is leaving up to 10% of potential GDP on the table.[18]

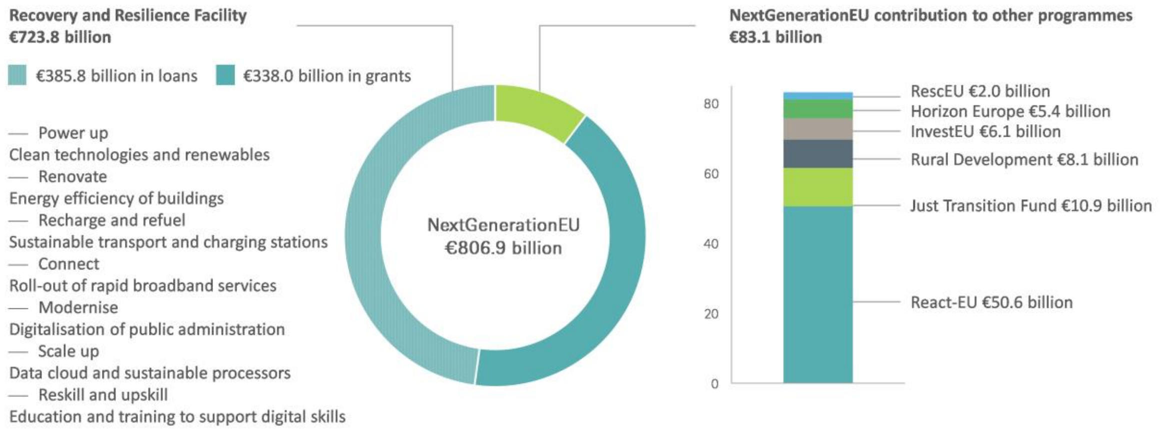
A genuine Capital Market Union (CMU) that would integrate Europe's capital markets into a single capital market able to rival Wall Street does not appear to be feasible in the near or medium term. However, some measures can be adopted, including the revitalization of the securitization market, the creation of an EU-level regulatory body ("European SEC") and the harmonization of the relevant aspects of insolvency, contract and tax law.

Public-private finance partnerships are important to de-risk and scale-up of breakthrough technologies. The InvestEU program is currently the largest risk-sharing instrument. However, the public-private investments scale is constrained by a small EU budget, fragmented across close to 50 spending programs, preventing EU financing from reaching sufficient size for larger pan-European projects.

The Next Generation EU fund, launched to assist member countries in recovering from the COVID-19 pandemic, also aims to achieve additional objectives such as the green transition and digital transformation in order to build a more sustainable and resilient future for the European Union, Figure 2. While €800 billion is available to compete with the Inflation Reduction Act (IRA) passed in the U.S., the incentives are distributed through different mechanisms. In the U.S., the IRA gives tax credits to a variety of projects and investors, who can pick where they want to direct the flow of funds. In contrast, there is less flexibility in Europe because the policy framework and incentive for each investment type is quite different.[19] With the IRA, the U.S. government targets mobilizing almost US$7 of private capital for every $1 of federal funds, ensuring that each public dollar is leveraged for significant private-sector investment.[20] European governments need similar incentives in order to close the financial gap needed for the transformation. In mid-2025, the European Commission is expected to set out proposals for the next long-term EU budget, known as the Multiannual Financial Framework (MFF), covering the seven years 2028-2034.

[15] Arnold, N.G. et al. IMF Working Paper, No 2024/146 (2024). Stepping Up Venture Capital to Finance Innovation in Europe
[16] Zeidler group (March 2024). Guide to Germany's Future Financing Act for Startups and SMEs
[17] Regfollower (September 2024). Germany unveils Future Financing Act II to boost capital market
[18] European Commission (February 2019). Quantifying the Economic Effects of the Single Market in a Structural Macro-model
[19] S&P Global (September 2023). Renewable Energy Funding in 2023: A "Capital Transition" Unleashed
[20] U.S. Environmental Protection Agency, EPA (April 2024). Biden-Harris Administration Announces $20 Billion in Grants to Mobilize Private Capital and Deliver Clean Energy and Climate Solutions to Communities Across America

Figure 2: NextGenerationEU: €806.9 billion for Europe's recovery



Source: European Commission. The 2021-2027 EU budget – What's new?

Some EU countries will strengthen their public investment policies partially in reaction to the policies likely to be implemented by incoming U.S. President Trump. For instance, since 2009, Germany has maintained a balanced budget policy (debt brake: Schuldenbremse) meaning that Germany's debt level is lower than other major European countries. An important aspect that will be debated in the leadup to a new German election is changes to the debt brake policy and increased fiscal spending for infrastructure investments. The potential for more public investment into productive assets in Germany, is a positive point for investors to consider.

Moving from unfunded public pension systems to better-funded, market-based schemes will also help European capital markets to get closer to other major economies in terms of the availability of long-term capital. In 2022, the level of pension assets in the EU was only 32% of GDP while in the U.S. and the UK total assets amounted to 142% and 100% of GDP respectively.[21] This difference reflects the fact that most European pension systems are based on pay-as-you-go social security systems. Countries with more developed private pension systems such as the Netherlands, Denmark and Sweden comprise 62% of the EU's total pension assets. To increase the flow of funds into capital markets, Europe should encourage retail investors through the offer of second pillar pension schemes.

[21] Report by Mario Draghi for European Commission (September 2024). Future of EU competitiveness

2 / The properties of Alternatives

2.1 Transformative investment opportunities exist in private markets

The long-term nature of transformative investment means that some of the most appropriate opportunities are in private markets, where investors can take the long-term view. Given their significant contribution to greenhouse gas emissions, we identify buildings, transportation, and energy as the three primary sectors that could drive the radical transformation of the continent's sustainability and digitalization ambitions.

Touching almost all parts of the economy and society, real estate will play a pivotal role in European transformation. Around 35% of all European commercial property with a total value of EUR 2.7 trillion+ is held as an investment.[22] This includes private real estate funds, real estate companies listed on stock exchanges and buildings directly owned by institutional investors. In addition, there are 100 million residential buildings in Europe that in total are worth in excess of EUR 17 trillion. Renovating these buildings is the largest part of the EU green-investment gap and vital for Europe's energy security and the goal of reducing energy prices, as buildings use 40% of Europe's energy.[23]

Real estate can also be an important part of economic growth and supply chain resilience. In addition to the economic and productivity benefits of modern offices, life science, data centre and high-tech workspace, investors in real estate could have the opportunity to support supply chain resilience with the delivery of modern logistics facilities, in emerging locations that are supportive of nearshoring trends.

The transformation of Europe can also not occur without the foundational infrastructure that the economy and wider society relies upon being at the heart of that change. Capital requirements span across energy, industry, mobility, and social infrastructure where old assets need transitioning and new assets need building. As the largest contributor to emissions in the European region, infrastructure offers a multi-billion-euro opportunity for example in shifting the electricity generation profile of Europe from thermal sources and towards renewable energy.

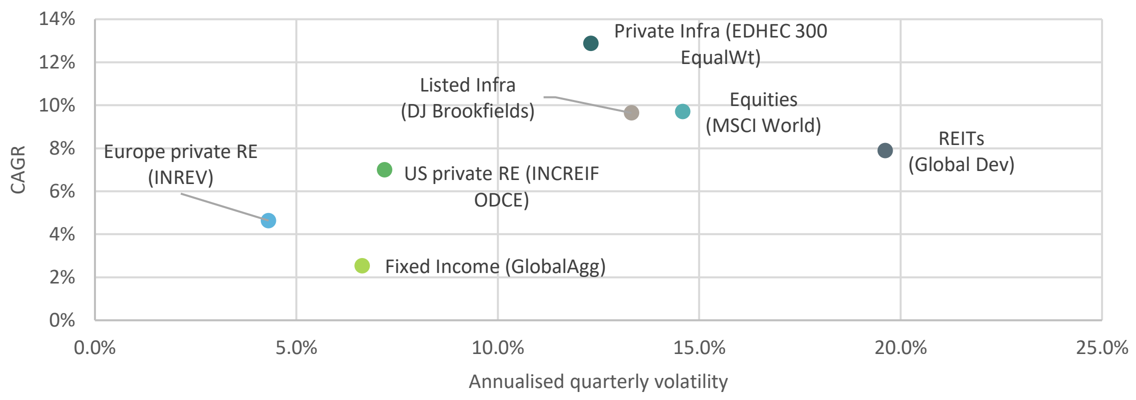
2.2 The cross-asset perspective: Alternatives in strategic asset allocation

Alternatives, especially its private/unlisted variants, occupy a place in the risk-return spectrum between traditional lower-risk (rates and investment grade credit) and risky (equities and high yield credit) assets. Figure 3 illustrates this, based on cumulative returns and volatility over the past two decades. Note that the risk-adjusted returns of both private real estate equity and private infrastructure equity were above those of equities or fixed income – although this needs to be taken with some caution since 1) this data is based on unhedged returns (and fixed income investors in particular would typically hedge away the currency risk of foreign Treasury and IG exposures, reducing their volatility further), and 2) the results are based on quarterly returns (typically the most granular reporting frequency of private assets). This may understate total mark-to-market risk somewhat and not fully capture liquidity risk of private assets. Nonetheless, the results emphasise that alternative assets have a key role to play in portfolio allocation, particularly at intermediate risk budget levels (see also Figure 7).

The attractive risk-return balance of alternatives compared to fixed income and equities is underpinned by the fact that they combine some of the most interesting features of both worlds: high income and lower mark-to-market volatility on the one hand, inflation protection and a degree of growth exposure on the other hand. This is reflected in DWS's Long-Term Capital Market Assumptions (LTCMA) framework which forms the basis of the DWS Long View[24] – in a nutshell, our approach to estimating the 10-year return expectations treats real estate as a bond proxy with inbuilt inflation protection, while we regard infrastructure as two asset classes combined into one: regulated infrastructure businesses (with high dividend distributions but lower growth exposure – an example of this is a power grid operator) are treated analogously to real estate, whereas unregulated infrastructure businesses (with lower dividends but higher growth exposure – such as airport operators) are akin to broader equities.[25]

[22] INREV and EPRA 2022
[23] DWS Research Institute (April 2024) Energy efficiency policies and investments
[24] DWS Research Institute (March 2024) DWS Long View 2024 and DWS Research Institute (August 2024): DWS Long View Q2: Equity concentration risk & long-term estimates for Value, Growth and Small Cap
[25] See section 4 "Private infrastructure equity" of DWS Research Institute (November 2023) DWS Long View Q3: Japanese reflation for more details on the methodology and asset class characteristics

Figure 3: Historical risk-return relationship; CAGR and ann. quarterly volatility in EUR, 31/12/2002-30/06/2024



Source: DWS, Bloomberg Finance LP, EDHEC, ODCE, INREV, as of 13/11/2024

Figures 4 and 5 illustrate this in the context of our wider approach which decomposes long-term returns of asset classes into contributions from income, growth and valuations. Additional risk premia, such as a liquidity premium, are only explicitly included in cases where the illiquid asset class is modelled via a corresponding liquid proxy, such as in the case of private infrastructure debt.

Figure 4: LTCMA methodology for alternative asset classes: decomposing long-term returns into key pillar contributions

Asset Class	Income	Growth		Valuation			Premium
Real estate equity (listed / private)	Dividend yield	Inflation		Valuation adjustment			
Infrastructure equity (listed / private)	Dividend yield (and interest income)	Inflation	Earnings growth	Valuation adjustment			
Listed infra-structure debt	Yield	Roll Return		Valuation change	Credit migration	Credit default	
Private infra-structure debt	Yield	Roll Return		Valuation change	Credit migration	Credit default	Liquidity premium

Source: DWS, November 2024

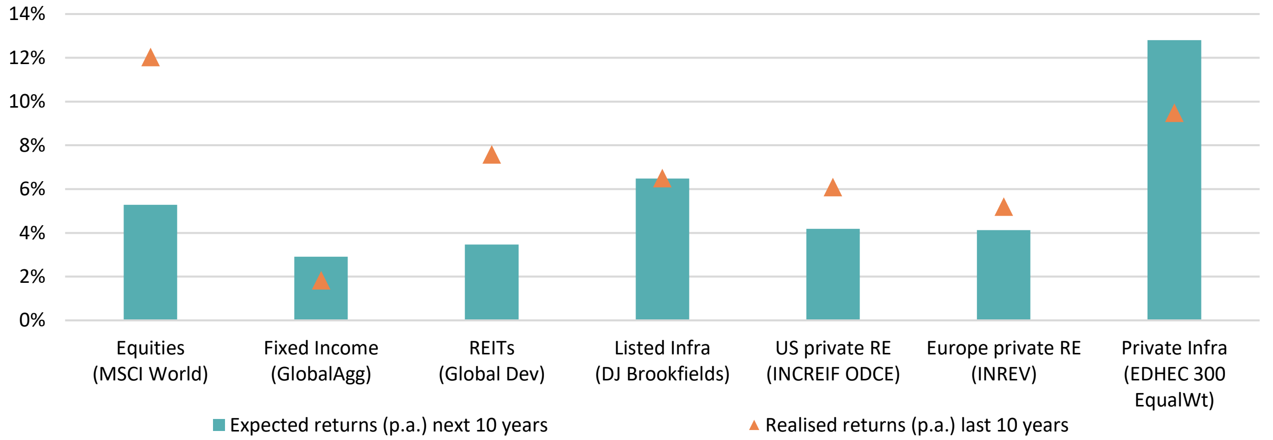
Figure 5: Detailed DWS LTCMA methodology for estimating long-term returns of real estate and infrastructure equity

Asset Class	Income	Growth		Valuation
	Dividend yield (and interest income)	Inflation	Earnings growth	Valuation adjustment
Listed real estate equity (REITs)	Trailing dividend yield	Combination of: 1) Proprietary model for 10Y inflation in each country, starting from near-term forecasts and mean-reverting towards central bank target 2) Market expectations (implied by inflation swap market)	Zero* (long-term rental growth in line with inflation; moreover, earnings primarily distributed as dividends) * currently under review for changes in dividend distribution policies and cyclical components	- Valuation based on spread between income return and real yield on TIPS (inflation-linked government bonds) - Assumption of valuations partially mean-reverting for each index to its own historical levels
Private real estate equity	Trailing income return (usually reported with one quarter lag)			
Listed infrastructure equity	Trailing dividend yield		Index split into: - regulated businesses (assumed zero real growth) and - unregulated businesses (for which the same growth proxy as for equities is applied): 1) Proxied by macro-economic growth 2) Proprietary model for long-term trend growth in each country 3) Lower transmission rate of GDP growth into earnings growth in select EMs	- For regulated businesses, apply RE valuation methodology - For unregulated businesses, apply equities valuation methodology: 1) Long term, cyclically and inflation adjusted valuation ratio 2) Assumption of valuations partially mean-reverting for each index to its own historical levels
Private infrastructure equity	Trailing income return (dividends & interest income), averaged over past 2Y due to dividend volatility			

Source: DWS, November 2024

Overall, our Long View methodology suggests that investors should brace themselves for lower returns in many financial markets over the next decade than the last decade – particularly at the risky end of the spectrum, where equities have significantly outperformed their long-term trend, largely driven by declining equity risk premia and fuelled by the long years of quantitative easing and zero interest rates, but also by the hunt for revenue growth and the belief in technological paradigm change. We estimate that equity returns in the next 10 years are likely to be less than half what they were in the past 10 years with the primary headwind coming from historically high starting valuations. While slightly higher fixed income returns, thanks to the normalization of rates in the current cycle are going to compensate partially for this, all but the most risk-averse investors would benefit from including alternatives in their asset allocation, as Figures 6 and 7 illustrate.

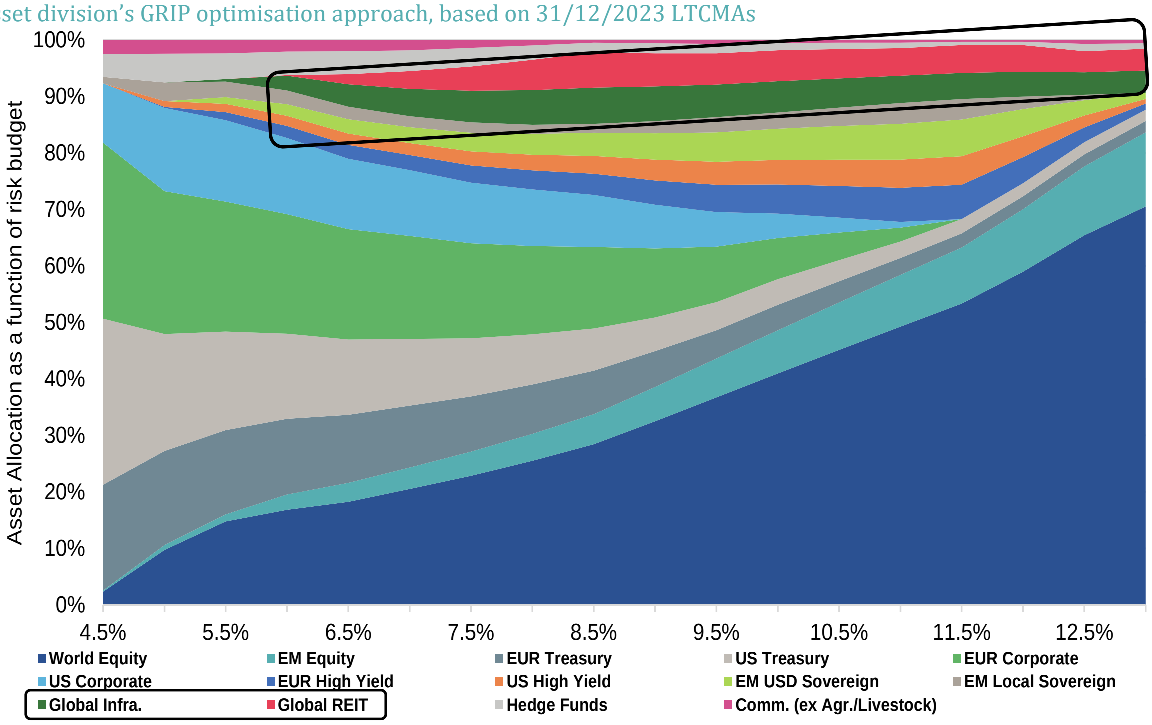
Figure 6: Last 10Y realised annualised returns vs. forecast returns for next 10Y, based on 30/09/2024 DWS LTCMAs (in EUR)



Source: DWS LTCMA, as of 30/09/2024

Readers may feel sceptical of the high returns in private infrastructure, and indeed some of this is a function of the index representing the asset class (which is an equal-weighted index of individual infrastructure projects, so in particular is an asset-level estimate, whereas the private real estate numbers are fund-level estimates), but in part this is due to structural features of private infrastructure (inbuilt leverage, and the hybrid nature of the asset class which typically combines equity stakes in the underlying assets with credit exposure via shareholder loans – and therefore benefits from both dividend and interest income).

Figure 7: Illustrative portfolio allocations as a function of risk budget (liquid asset class segments only), using DWS Multi-Asset division's GRIP optimisation approach, based on 31/12/2023 LTCMAs



Source: DWS Long View 2024 (Feb 2024), based on long-term capital market assumptions as of 31/12/2023

The benefits of including illiquid Alternatives in multi-asset portfolios are not just limited to their risk-adjusted returns, they provide important diversification benefits too, as Figure 8 shows: not only do private real estate and private infrastructure offer lower correlations with traditional asset classes, but they are also not especially correlated with each other.

Figure 8: Correlations of quarterly returns (in EUR), 31/12/2002-30/06/2024

	Equities (MSCI World)	Fixed Income (GlobalAgg)	REITs (Global Dev)	Listed Infra (DJ Brookfields)	US private RE (INCREIF ODCE)	Europe private RE (INREV)	Private Infra (EDHEC 300 EqualWt)
Equities	1.00	0.04	0.78	0.77	0.06	0.30	0.17
Fixed Income		1.00	0.26	0.25	-0.09	-0.13	0.36
REITs			1.00	0.81	0.18	0.38	0.44
Listed Infra				1.00	0.19	0.36	0.36
US private Real Estate					1.00	0.76	0.23
Europe private Real Estate						1.00	0.11
Private Infra							1.00

Source: DWS, Bloomberg Finance LP, EDHEC, ODCE, INREV, as of 13/11/2024

Finally, it is worth emphasising that in scenarios of higher inflation (a real risk, given the potential for increased tariffs and deglobalization in future years), return expectations of both private real estate and infrastructure would increase in nominal terms (see Figure 5 showing the direct feedthrough of inflation into the growth pillar), offering more protection of real returns than in fixed income.

2.3 The properties of infrastructure

When considering the investment needs and goals of Europe, many of the key competitiveness and energy targets will need to be addressed through investment into infrastructure. The infrastructure asset class has grown significantly over the last decade and now forms around 20% of AuM in European alternatives.[26]. The convergence of Europe's infrastructure market maturity, the region's investment needs, and the desire from investors to play a role in energy and digital transformation, further increases the asset classes' attractiveness.

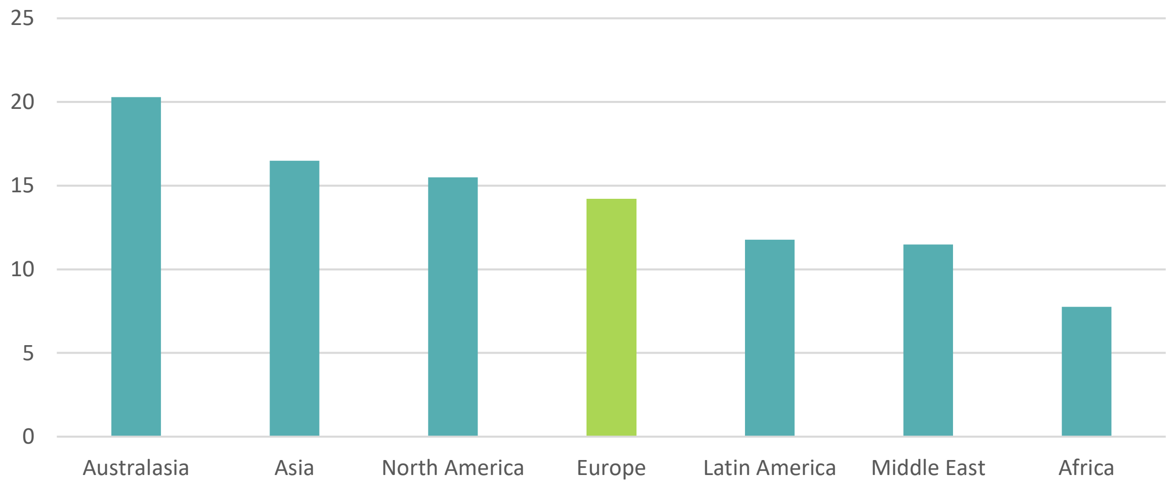
[26] Preqin (2024)

The European infrastructure has three crucial benefits relative to other regions: policy, diversity and value. As discussed above, Europe now has strategic challenges which it needs to address, which has been a powerful driver of policy formation in recent years. These drivers – for economic security, competitiveness, and sustainability – are long-term in nature, which match the investment horizon for infrastructure well.

Globally, infrastructure policy is often developed with the goal of stoking economic growth and creating employment, and as such is more vulnerable to political cycles. In comparison, consensus in European politics is to address the region's long-term challenges and this provides investors with greater policy stability. We also find that European infrastructure policy is often well-rounded, in that it looks to support marlets with both supply and demand initiatives; for example, in the energy sector, REPowerEU was introduced to stimulate alternative energy production to Russian gas imports, while at the same time the European Emissions Trading System (ETS) and Renewable Energy Directives (RED) push consumers towards lower-carbon fuels.

Europe also allows for greater geographical diversification, with each market able to pursue its own fiscal expenditure and reforms to attract private capital, while also implementing centrally agreed EU directives. Thus, assets in the same sector can still perform differently depending on the specific national regime under which they operate. In addition to geographic diversification, Europe also offers a greater breadth of infrastructure sectors open to private involvement. While the US is a market heavily dominated by the energy sector – which the IRA will likely exacerbate further – Europe has significantly more assets in the transportation, social infrastructure, telecommunications, and water infrastructure sectors. Europe also has a higher number of opportunities in the renewables and power sectors, meaning investors are also able to tap into the energy sectors.

Figure 7: Average closed infrastructure transaction EV/EBITDA multiple, by region



Source: DWS Infrastructure Research, Infralogic, October 2024. Note: aggregated EV/EBITDA averages are derived from 1000+ transactions with data available, of which Europe represents 60%, North America 31%, Rest of World 9%.

This in turn creates attractive European investment opportunities from a value perspective, with average European deal values consistently below those seen in North America and benefitting from lower EV/EBITDA multiple entry points. This is partly driven by the diversity offered in the region in terms of geographies and languages, which makes it more challenging to find opportunities and increases the likelihood of finding smaller, localised, family-owned business which need capital to scale. With smaller, localised businesses able to grow their offering to become pan-European, European assets are more able to benefit from the EV/EBITDA multiple scale that exists between mid-cap and large-cap businesses, with large cap infrastructure businesses on average transacting at higher multiples.

2.4 The properties of real estate

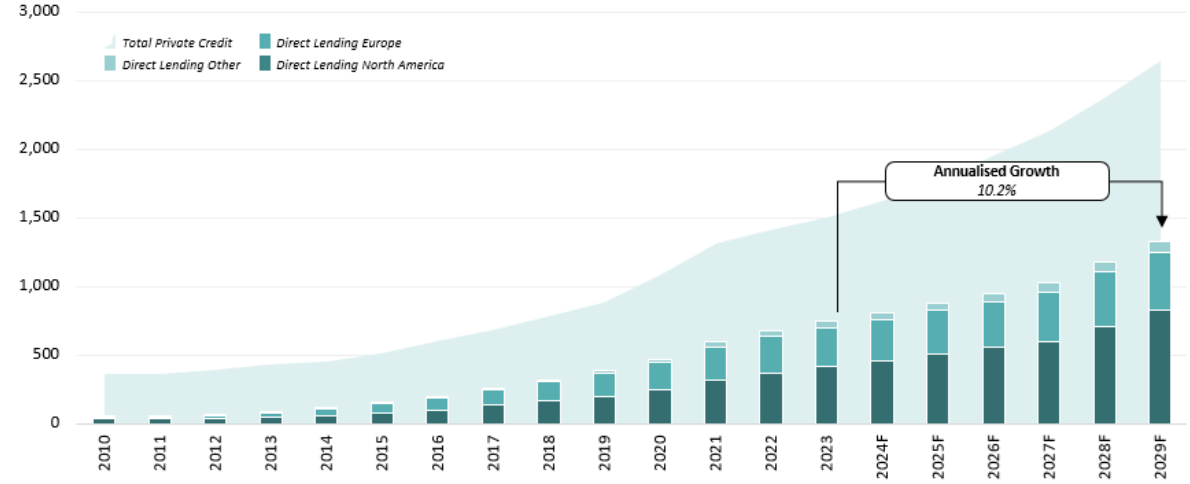
Real estate investment is pivotal in supporting Europe's transformation and can play a significant role in achieving economic and environmental goals, contributing to Europe's resilience and overall performance. Global megatrends, such as data and energy, health and wellbeing, and urbanisation, are driving, and will continue to support, the growth of niche real estate sectors. As Europe faces demographic shifts, notably its aging population, real estate can provide suitable housing and healthcare to meet these changing needs. Moreover, the rise of technological advancements necessitates increased data storage, which real estate can support through the development of data centres. Changes to our built environment are nothing new and real estate universe is ever adapting, with the composition of core portfolios constantly changing to reflect wider structural occupier and investor trends. In the United States, we've seen the emergence of niche and alternative real estate sectors over the last 10 years. Niche and alternative sector allocation grew from 3% in 2014 to 10% in 2024.[27] In addition, Green Street total returns data indicates that in the US, niche real estate sectors have outperformed traditional core sectors by 2.6% p.a. over the last decade.[28]

Many of the emerging niche and alternative real estate sectors in Europe are already well-established in the U.S., providing a strong indicator of growth potential. Given the nascent stage of these sectors in Europe, early market entry is anticipated to yield higher returns. Increasing liquidity should drive value growth, potentially leading to outperformance relative to traditional real estate sectors – similar to what we are witnessing in the United States.

2.5 The properties of direct lending

Private investments via direct lending as an alternative addition to bank loans can provide small and medium-sized enterprises (SMEs) with the capital needed for their transformation. SMEs are the backbone of Europe's economy and have a key role to play in the European transformation. They account for more than half of Europe's GDP and employ around 100 million people. Most SMEs have no direct access to capital markets or other sources beyond bank loans. Their growth is expected to be significantly accelerated by key technological, societal, and geopolitical mega-trends, with SMEs providing products and services.[29]

Figure 8: Private credit market size by region (EUR billion, cumulative)



Source: Preqin, Future of Alternatives 2029 report; Direct Lending Other includes APAC, diversified multi-regional and rest of the world | Past performance is not a reliable indicator of future returns | Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

The European mid-market is at the forefront of transforming the European economy with decarbonization and broader sustainability goals at its core as well as ensuring that Europe is not falling further behind in innovation and competitiveness. Therefore, direct lending offers investors a unique chance to finance transition within the European economy. The biggest segment is the lower mid-market, which offers plenty of sector investment opportunities. One facet that coincides with the ongoing transition is the slow exit of the 'boomer' generation and with that many founders that are looking to secure their legacy. This presents an opportunity to invest in profitable and well-established SMEs. As a result, many Private Equity funds are targeting these enterprises with direct lending as a partner to complete deals and inject capital into the economy to finance change. With investors already heavily allocated towards the U.S., Europe is offering them an opportunity to diversify on the one hand and reap the rewards of participating in a growing market on the other. Furthermore, the recent easing in European monetary policy and the floating nature of direct lending loans make them even more appealing as investors have a clearly outlined illiquidity premium. Indeed a recent DWS's report examined the similarities and differences between the European and U.S. direct lending market.[30]

[27] Bloomberg Finance LP (November 2024). US NECREIF Index
[28] Core Sectors: residential (25%), industrial (25%), office (25%), and retail (25%). Niche Sectors: medical office (25%), senior housing (25%), life science (25%), and self-storage (25%). January 2014 – September 2024. Green Street (October 2024)
[29] DWS Research Institute (April 2023) Direct lending and the European transformation
[30] DWS Research Institute (October 2024) Direct lending markets in Europe and the US

3 / Identifying investment opportunities

In this section, we explore some of the trends and specific investment opportunities across the infrastructure, real estate and direct lending asset classes.

3.1 Infrastructure

Addressing Europe's myriad investment needs lends itself to the diversity of the infrastructure asset class, with opportunities across major segments in energy, transport, digital and social infrastructure. We see perhaps the greatest opportunity in midmarket European infrastructure, given its ability to scale assets into pan-European service providers, and as larger, de-risked entities, potentially command a higher multiple on exit[31]. From a sector perspective, there are tailwinds present across all infrastructure sectors given the energy transition, the decarbonisation of industry and transport, the digitalisation of businesses, supply chain resilience improvements and demographic megatrends in the region.

In the energy space, we continue to like alternative fuels[32]. The challenge for infrastructure investors going forwards is to select sectors which will track a similar growth trajectory as solar and wind markets i.e., attractive risk-adjusted returns as a business is grown, de-risked and transitioned into a Core-profile asset. This is particularly difficult given the nature of the energy transition; as with any transition, there are likely to be winners and losers.

For investors looking to deploy capital now while at the same time navigate the risks of the transition within energy over the coming decades, identifying assets which form part of an existing, robust, and long-term value chain is crucial. In this instance, many biofuels are considered 'drop in' options that can be used to displace existing fossil-based fuels – particularly useful in hard to abate sectors. Bioethanol and biogas have long been targeted by investors, but with an increasing focus on the sustainability of feedstock, biomethane and sustainable aviation fuel (SAF) also offer attractive options.

There are several key trends contributing to the attractiveness of the European transportation market, such as shifting transport demand towards public transport and rail, as well as decarbonisation and the growth of the EV market. With demand recovery now underway across many sectors following the Covid-19 pandemic, we expect that transport assets may return to market at attractive valuations, given the long-term demand across the sector remains robust in our view.

There is also an opportunity to reposition many of the larger, more traditional infrastructure assets – such as airports – and align their business plans with net zero emissions targets. Infrastructure investors have played a significant role in enabling the low carbon energy transition across economies thus far and, with the return of larger transport assets to the market, they can continue to play a significant role in decarbonising this vital economic sector. Airports exemplify both the return of transport assets to market and the investment opportunity for infrastructure investors, supporting the decarbonisation process and creating additional value.[33]

As the global infrastructure megatrend of digitalisation gathers pace, investors continue to seek exposure to one of the strongest growth stories in the market – data centres. A fundamental part of digital networks, the demand for storing and processing data seems to offer the robust infrastructure characteristics that make data centres an attractive part of infrastructure portfolios. With the advent of commercially available artificial intelligence (AI), interest in the sector has grown further. However, many existing data centre markets in Europe are now reaching current capacity in terms of power, water, and land availability. Italy as a large-but-underserved market, and Spain given its large solar and wind markets, are emerging as key targets for investors, along with the Nordic markets with their high availability of hydroelectricity, and the North of the UK, home to Europe's largest offshore wind market.

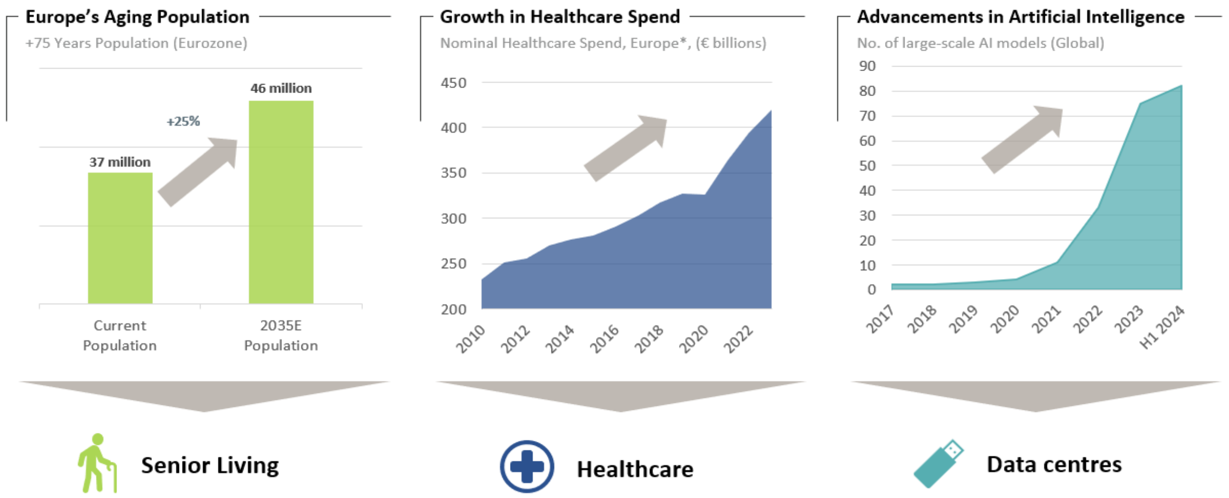
This broadening of the geographic focus of investment outside core markets could be further supported by growing data sovereignty desires in many European markets. While General Data Protection Regulation (GDPR) in Europe only requires data to be stored to the standards of the EU, not necessarily within an EU market, there are additional national level laws which are increasingly being applied and which require some data – such as in the health, financial services and telecommunications sectors – to be stored and processed domestically.

[31] DWS Infrastructure Research (2024) Infrastructure Strategic Outlook
[32] DWS Infrastructure Research (October 2023) Transforming European energy: alternative fuels
[33] DWS Infrastructure Research (June 2024) Transforming Infrastructure: The Opportunity of Transitioning Airports

3.2 Real Estate

As real estate investors, it is important to adapt to structural and cyclical changes. We believe that trend-focused investment strategies should ensure real estate investments are sustainable and future-proofed. Demographic shifts, decarbonisation and technological advancements serve as structural demand drivers for niche sectors, such as operational residential and healthcare, data centres and energy storage. Ultimately, we believe niche sectors are likely to form a progressively large part of the investible real estate universe over the coming years, potentially making up 10-20% of the European private real estate market in 5-10 years' time, a substantial increase on the <5% today.[34]

Figure 9: European megatrends and niche sector structural drivers



Source: Oxford Economics, Epoch

We believe the **senior living** sector is poised to benefit from demographic and societal trends. The scalability is robust, supported by favourable market fundamentals that indicate robust return potential. Additionally, the expertise and knowledge acquired through traditional multi-family investments can be effectively leveraged. For optimal market entry into senior living, we advise partnering with reputable operators and forward funding new developments.

In addition, Europe's **healthcare** sector presents a compelling investment opportunity. Favourable demographic trends and a shortage of modern, purpose-built medical facilities underpin the sector's potential. Moreover, healthcare real estate often features long-term leases with reliable tenants, frequently backed by government entities, ensuring stable income streams. Investors can gain exposure to healthcare through the acquisition of existing portfolios, which may require capex, or through development.

Like infrastructure, we also support investing in the **data centre** sector, which is underpinned by strong fundamentals and significant growth potential. Despite the anticipated high level of competition, in our view the sector offers promising return expectations, well above traditional core real estate. Unlike the infrastructure of investing as an owner operator, real estate investors can also access the data centre market through the investment of powered shells, which involve securing long leases with single tenants, with market entry facilitated through build-to-suit developments or sale and leaseback agreements.

3.3 Direct Lending

The SME mid-market represents the vast majority of the European economy, and these actors will be key to transforming the continent and making it competitive for the future. We still prefer non-cyclical sectors due to the uncertainty on a global scale and the threats we see to supply chains in an environment of heightened geopolitical risk.

However, with the prospect of more interest rate cuts into next year, we expect the European direct lending market will enjoy a pick-up in activity and consequently increased options for borrowers. Although we expect investors to stay cautious, this more benign interest rate environment will allow strong business models in cyclical sectors to become more attractive. One of the interesting features of the direct lending market has been its all-weather quality to date, thriving equally in both low and high

[34] NCREIF, DWS Real Estate Research (October 2024) The changing world of real estate

interest rate environments. In addition, we see improving growth prospects for the European economy and believe that many European businesses that do not have stretched supply chains can defend their market-leading positions in niche markets.

With regards to the overall efforts to drive European Transformation we believe that future orientated sectors should be the goal for investors such as increasing the European semi-conductor capabilities as well as investing into services and innovation to cater to Europe's aging population. Hence, healthcare should be a focus as well as driving innovation in leading sectors of the European economy that are experiencing fundamental change such as electric vehicles and pharmaceuticals. The latter is a positive example of a sector, in which Europe is among the leaders with the mRNA vaccinations during Covid and recently Novo Nordik's relatively recent creation of the drug Ozempic ostensibly used for weight loss, it may have the potential address multiple conditions.[35]

4 / Conclusion

To address the structural forces holding back European growth and investment returns requires a significant transformation of the European economy. This will include transforming not just the continent's transportation, building and energy sectors, but also how companies are accessing finance.

Investments in the European transformation can deliver significant benefits not just in terms of advancing the continent's ambitious environmental and climate goals, but also in terms of providing investors with attractive opportunities for their portfolios. In our view, the long-term nature of transformative investments makes Alternatives the most appropriate investment vehicle. Infrastructure, real estate and direct lending are particularly well-suited to support these challenging, but ultimately these beneficial transformational efforts.

[35] The Economist (October 2024). It's not just obesity. Drugs like Ozempic will change the world

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