

Europe Real Estate Strategic Outlook

Mid-Year 2024

IN A NUTSHELL

- We remain firm in our conviction that 2024 will be an exceptional vintage. Higher entry yields, falling interest rates, strong fundamentals and a diminished supply pipeline all point towards a period of recovery and elevated returns.
 - Occupier fundamentals look strong, especially given the collapse in development activity over the past two years which suggests supply shortages will only continue to mount over the coming two to three years.
 - We continue to favour residential and logistics, with both already showing the first signs of recovery. However, we also expect rapid growth in interest towards emerging niche sectors, in particular data centres.
 - Current market conditions offer an attractive proposition for value-add strategies: significant valuation declines for non-prime properties; a lack of capital to inject the equity necessary to de-lever and refinance loans; regulatory requirements accelerating obsolescence; and an increasing undersupply as new construction is falling.
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1 / Market Outlook

Looking back on the first six months of this year, it would be easy to conclude that 2024 has so far been something of a disappointment. But is this really the case?

Having gone into the year with the promise of rate cuts and recovery, it's true to say that so far there have been few signs of a material improvement in capital market conditions. Despite the denominator effect no longer presenting a major drag on allocations, fundraising for Europe-focused funds has remained muted for both open and closed-ended vehicles. Given this backdrop, perhaps it's no surprise that overall transaction activity remained muted, with MSCI announcing quarterly sales volumes down for the seventh consecutive quarter at the end of March, reaching their lowest level since 2011.¹

It's easy to understand this apparent ongoing lethargy. Since the start of the year, the news around inflation and interest rate cuts has disappointed. More so in the United States, where far fewer rate cuts are now priced in, but also in Europe where swap rates have gradually trended higher during the first five months of 2024. Although nowhere near as dramatic as previous years, the rise in swap rates does seem to have taken some of the momentum out of the market.

It's certainly true that the first quarter was slow, but that should have come as no surprise. We were never expecting the market to burst back into life – why would it? Previous recoveries have taught us that it will take time for investment activity to gain momentum. There will be lags between improved sentiment and rising activity, as sales processes can take many

¹ MSCI, April 2024

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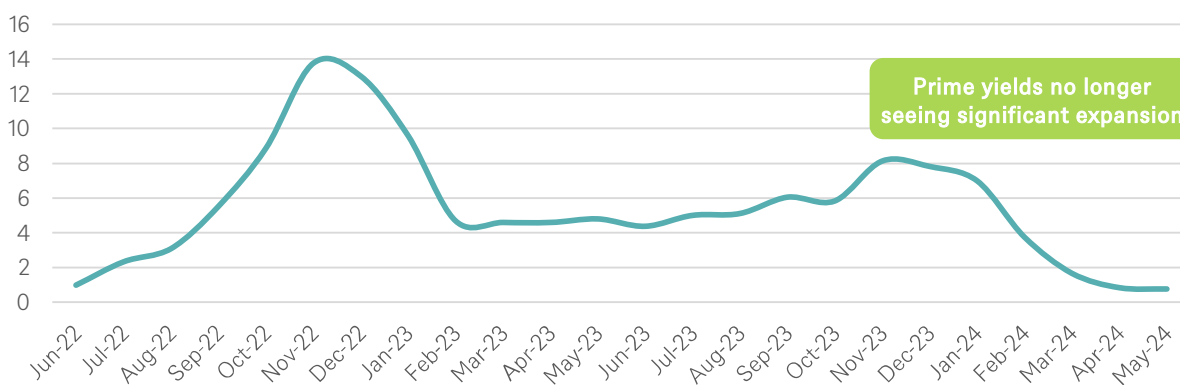
months, with an improving backdrop even resulting in some assets being withdrawn from the market in anticipation of rising prices – partly explaining a jump in terminated deals recorded during the first three months of this year.²

However, for those investors ready and able to deploy capital, today offers a unique opportunity to gain access to stock that is often either unavailable or prohibitively priced during other phases of the cycle. Where we have seen prime assets brought to market, particularly in residential and logistics, evidence is already suggesting a growing number of bidders.³ And although it's too soon to accurately predict second quarter investment volumes, preliminary data suggests the market could now be seeing an acceleration in deal activity. While nowhere near the volumes we were seeing two years ago, by early June, completed and pending deals recorded by MSCI were at €38 billion, already above the level seen in the first quarter.⁴

The return of competitive bidding at the prime end of the market and rising investment activity, have already helped to stabilise yields for better quality assets in the most liquid markets. Having seen prime yields expand at a rate of 25 basis points every quarter during 2023, over recent months this has fallen to almost zero.⁵ Importantly, occupier fundamentals also remain robust. Having gone into this year stalked by recession, both the Eurozone and the UK have seen the return of economic growth. And with vacancy rates in most sectors at or below historical average levels, rents have generally continued to increase, most evidently across the prime end of the market.

Overall, returns have seen a considerable improvement. The INREV ODCE index recorded a total return of -0.6% during the first quarter of the year, well above the -4.3% in the final three months of 2023⁶. And given the latest yield data available, we would expect this figure to improve further in the second quarter. This trend is certainly evident in the UK, where the more timely MSCI UK Monthly Index is already showing the return of positive capital value growth.⁷

Prime European Major Market Monthly Net Initial Yield Movement (Basis points, 3-month rolling average)



Note: Unweighted average of London, Paris, Berlin, Frankfurt, Munich, Milan, Madrid, Office, High Street Retail, Logistics and Residential
Source: DWS, CBRE, April 2024

Exceptional vintage

Reduced transaction activity not expected to hold back prime recovery

We remain firm in our conviction that 2024 will be an exceptional vintage. Higher entry yields, falling interest rates, strong fundamentals and a diminished supply pipeline all point towards a period of recovery and elevated returns.

² MSCI, April 2024

³ JLL, Bid Intensity Index, May 2024

⁴ MSCI, 4 June 2024

⁵ CBRE ERIX, June 2024

⁶ INREV ODCE Index, Q1 2024

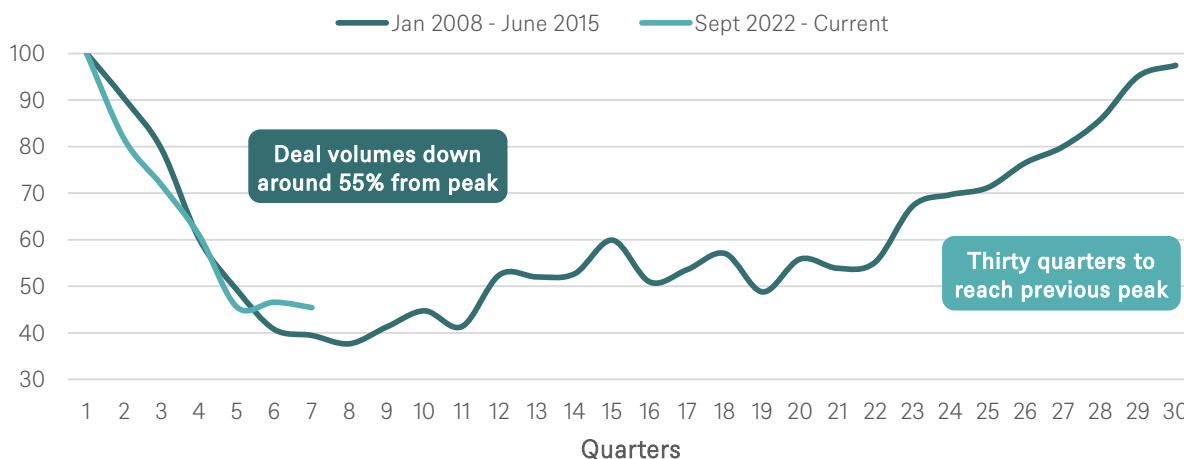
⁷ MSCI, May 2024

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The fight against inflation may have proven more protracted than expected, but with the ECB announcing its first interest rate cut last week, and two further cuts expected by the end of the year⁸, this sets the scene for improving capital market conditions. An upturn in liquidity is likely to be led by cash-rich investors looking to take advantage of market timing and access to stock, targeting elevated risk-adjusted IRRs rather than the cash return. Core and institutional capital may be slower to return, but as the threat of further repricing lessens, we would expect demand from these investors to increase as well.

Looking back to the global financial crisis, it took around two years for European transaction volumes to reach a trough – broadly in line with where we are today – after which, it took another five years to return to previous highs.⁹ We need to be cautious about drawing comparisons, but this reinforces the point that we shouldn't necessarily expect a rapid return to 2021 investment volumes. With this in mind, we don't foresee a widespread reduction in prime real estate yields until at least next year, apart from in a select number of the most liquid parts of the market, such as logistics and residential in the major gateway cities. But as the market gains momentum, supported by further interest rate cuts, our forecasts do show positive yield impact sustaining value growth well into the second half of the decade.

Number of European Commercial Real Estate Transactions (12-month rolling total, Market peak = 100)



Source: DWS, MSCI, May 2024

Perhaps more importantly, occupier fundamentals remain positive and are forecast to be a driving force behind the recovery. Not only is vacancy relatively low and the economy returning to growth, the collapse in development activity over the past two years suggests supply shortages will only continue to mount over the coming two to three years. With occupier requirements evolving, steered by technology, culture and regulation changes, this dearth of new stock is expected to be most acutely felt at the prime end of the market. And while it's true that the recent jump in prime rents may push some occupiers to consider more affordable buildings or locations, in general we believe the top end of the market will outperform.

Being an excellent vintage does not mean a market without risks. Again, we should stress that the coming few years will not be easy. It will take time for liquidity to return to the market, and financing is also expected to remain challenging well into the second half of the decade.¹⁰ History suggests that this is unlikely to be enough to prevent recovery, particularly for prime assets, but it may be one of the factors holding back transaction activity over the coming years.

Does this mean we have the luxury of time? We don't believe so, certainly not at the prime end of the market. Despite potentially lower levels of liquidity, we expect that when yields start to compress, they will do so quickly, perhaps even more

⁸ DWS, CIO View, May 2024

⁹ MSCI, May 2024

¹⁰ CBRE, December 2023

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quickly than our models would suggest. This is certainly something we've seen in the past, and during recovery phases it has not been uncommon to see years of double-digit capital value growth for prime assets. For secondary assets the window may be greater, but we believe it would be wise to be cautious towards this part of the market, particularly for assets and locations that may fail to meet future tenant requirements. These assets may have already underperformed, and could already be looking relatively cheap, but unless there is a viable refurbishment case or alternative use, the value decline may have some way to run.

Sector performance

Residential and logistics remain top picks, with a growing number of niche sectors rising up investor target lists

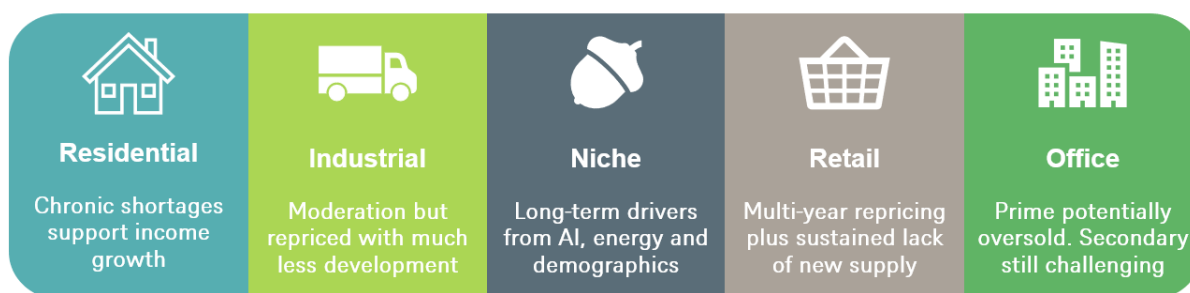
At the sector level our outlook remains broadly unchanged from the start of the year. We favour residential and logistics, with both already showing the first signs of recovery. Neither sector is without challenges though: logistics vacancy has been edging higher over recent quarters, while residential regulatory concerns remain prevalent. Nonetheless, given extensive repricing across both sectors, alongside well understood occupier fundamentals, both look well placed to outperform over the coming five years on both an absolute and a risk-adjusted basis.

Our negative outlook on retail continues to moderate. The worst of the cost-of-living crisis now seems to have passed, real wage growth is positive, and despite previous concerns about economic growth, the labour market has remained in good shape. Having gone through a prolonged period of correction, the market may now be finding a point of equilibrium. And while this doesn't mean all schemes will perform, we see those with a heavy focus on necessity, experience, or leisure in markets such as the UK and Spain doing relatively well.

Much of the office market remains out of favour, but again we see opportunities emerging, with prime stock in places such as Berlin, London and Paris CBD looking increasingly oversold. As we've stressed before, there are big differences between and within office markets. There are markets with too much average-quality stock but not enough prime stock, for example, lacking new centrally located supply but with plenty that could be removed from out-of-town locations, and with pricing levels that look increasingly attractive for best-in-class assets but are in danger of further correction for secondary assets. The sector is unlikely to bounce back quickly, with many investors still overallocated, but in select locations we're already starting to see the emergence of capital looking to take advantage of last year's aggressive repricing.

One notable change since our latest outlook has been the rapid growth in interest towards emerging niche sectors, in particular data centres. While hardly a new sector, the growth of AI over the past few years has refocused occupier and investor interest. Given exceptionally strong demand and notable supply constraints, particularly with regards to energy and water, the sector is certainly in a strong position. However, it is still in its infancy, with technology and liquidity presenting clear risks, and therefore developing a deep operational understanding will be important for investment into this part of the market.

The niche sectors do not start and end with data centres though, far from it. Indeed, the real estate market only looks set to become more diverse over the coming years, as the likes of student and senior housing, self-storage and cold storage, life science and medical office, and even battery storage forming a progressively large part of the investable universe. And as more investors target these sectors, higher liquidity, alongside structural demand drivers such as demographics and technology, suggest potential outperformance.



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Country performance

Most attractive risk-adjusted returns expected across Germany, the UK, Amsterdam, and Paris

We do not expect the recovery to be uniform. Both cities and sectors will be heavily influenced by occupier fundamentals, as well as the return of liquidity. Today we favour prime assets in large and fundamentally strong gateway markets, which we believe could be the first to see the material uptick in capital.

Germany is still our top pick. For some this will be controversial. Much has been written about Germany, the “sick man of Europe”, while the property market faces questions over debt and domestic capital. However, digging into the details, we see a real estate market that is both attractively priced and fundamentally strong – particularly for prime residential and logistics. And while it may take some time for domestic capital to gain momentum, broadening the rebound, the country looks well set for above average returns over the medium term given exceptionally low vacancy rates and a collapse in new supply.

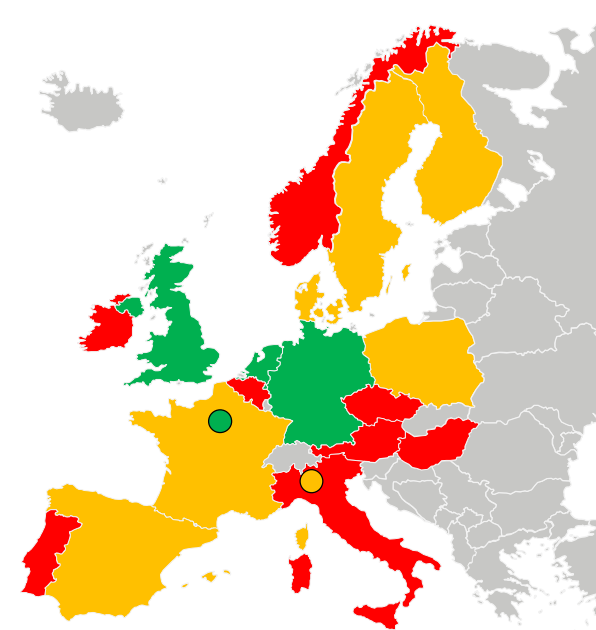
The UK sits closely behind Germany in our outlook. Prime London already looks to be returning to growth, but it’s not just the capital. Logistics looks well priced for the medium term – despite the recent pick-up in vacancy – while residential is in short supply and still emerging as an institutional sector. Prime retail is also increasingly in favour, attracting capital with higher yields and improved occupancy.

We also remain in favour of Paris. The French capital, in line for a possible Olympics boost this summer, looks increasingly attractively priced, having recorded a marked rebasing during the second half of last year. We particularly like logistics in and around the city, with low vacancy, competition for space and strong trend demand growth driving on rents. Dutch logistics is forecast to be one of our top performing markets, with virtually no vacancy for modern units and supply barriers for new developments.

Outside of Core Europe, we see good opportunities in parts of Spain and the Nordics. Spanish shopping centres are some of the most robust in Europe, while residential fundamentals across Madrid and most of the major regional cities look exceptionally strong. Capturing rental growth may prove difficult though, given regulatory constraints, and this may push some to consider alternative subsectors of the residential market. In the Nordics, residential in fast-growing Copenhagen is forecast to be among the best performing markets in Europe – a notable reversal compared to the past two years – with Helsinki logistics also doing well.

Elsewhere, we hold underweight calls on Italy, Ireland, Portugal, and the CEE region. While none of these markets are forecast to be major underperformers, for various reasons including lagging revaluation (Italy), oversupply (Dublin offices), or higher hurdle rates (Hungary) we see less compelling risk-adjusted returns. Finally, we have an improving but still neutral call on Poland. Again, reflecting risk-adjusted rather than absolute returns, our outlook continues to show strong expected long-term growth. With liquidity in the Polish market set to remain muted, particularly with current constraints on German capital, this suggests the market could stay subdued for longer, extending the window of opportunity.

Market Calls



Source: DWS, June 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

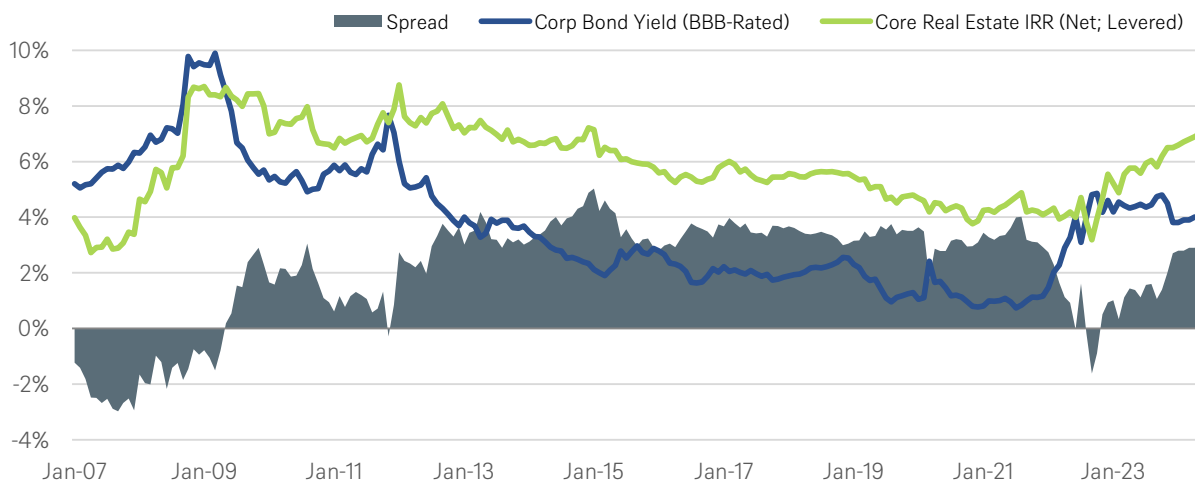
2 / Investment Strategies

The relative attractiveness of European real estate continued to improve over the past six months. Not only have real estate values moderated further – reaching what we expect to be their low point – when compared to rallying equity markets and broadly unchanged corporate bond yields, the pricing and the outlook for European real estate looks compelling.

We 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. We estimate investors may on average achieve a core levered IRRs of around 8% over a five-year holding period – with the top performing cities and sectors considerably higher – emphasising the expected yield compression and supply-constrained rental growth over the next five years.

Levered cash returns may appear less attractive compared to fixed income alternatives, with all-in borrowing costs often still higher than real estate yields – although it's important to remember that this not unusual for real estate. For cash-focused investors, private real estate debt may prove to be an attractive alternative.

Historical Expected Returns by Asset Class



Source: Macrobond, DWS, May 2024

Our return estimates include a view on declining interest rates, and thus we believe that property yields will be lower in five years compared to today. However, predicting future interest rates, and ultimately property yields is difficult, especially given the wide range of factors influencing interest rates. Conversely, rent growth is an easier component to forecast by assessing occupier demand, vacancy rates and expected new supply, as well as other structural and economic factors. Therefore, sector and market allocation, and ultimately asset selection will be key to maximising returns.

We expect logistics and residential to outperform over the next five years versus office and retail. Within residential we prefer new-build multi-family residential, student housing, co-living, and senior living, while for logistics we prefer last-hour locations. Overall, we prefer an overweight to these sectors for core portfolios. Looking ahead, we expect an increasing allocation to niche and alternative sectors, such as data centres and life sciences.

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Logistics

European logistics remains our top pick, 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. Logistics occupiers are increasingly seeking best-in-class product with the highest specifications, and aspects such as dock-to-door ratios, floor loading capacity and clear internal height are often imperative. With that in mind, we would typically target modern assets in last-hour locations, especially in supply-constrained areas. Micro location is also key and good existing infrastructure, access to power and a large labour pool are important.

New-build 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. However, affordability ratios may become more stretched, potentially leading to an increasing risk of regulatory interventions, negatively impacting business plans. We prefer new-build residential in commuter locations within major cities, given the better affordability ratios. Typically, new-builds provide the ability to increase rents in line with the market and meet ESG-related goals including energy efficiency ratings, air quality and carbon emissions.

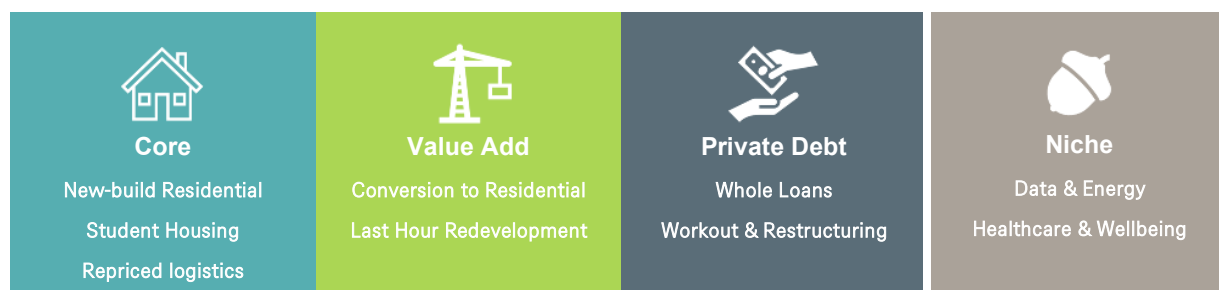
Affordable housing in partnership with local authorities remains a key long-term strategy. Such partnerships can support the provision of affordable and good-quality housing, while also helping meet risk-adjusted return requirements.

Student housing

The European student housing market rebounded strongly from the pandemic, highlighting ongoing shortfalls in supply in many key gateway cities, as well as regional markets with strong university offerings. Demand for student housing continues to grow due to a combination of demographics and increasing educational attainment rates.

Germany stands out in having excellent educational offerings, while suffering from low quality and quantity of purpose-built student accommodation. Southern Europe has the largest shortfall in student accommodation but key university cities in the UK, France, and the Netherlands also require investment to meet demand. In deploying capital in these markets, it will be important not to compromise on micro location and operator selection as these two elements can help define the operational performance of the asset on a long-term basis.

Investment Strategies



Source: DWS, June 2024

Value-add strategies

We also see attractive opportunities to pursue higher returns through refurbishment, redevelopment, and repositioning of ageing properties. Such value-add strategies could deliver double-digit returns in the mid-to-high teens. We believe the current market conditions offer an attractive proposition for value-add strategies: significant valuation declines for non-prime properties, a lack of capital to inject the equity necessary to de-lever and refinance loans, regulatory requirements accelerating obsolescence, and an increasing undersupply as new construction is falling.

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Current market uncertainty, elevated borrowing rates, and much higher construction costs have meant that developers have taken a step back. With a constrained pipeline of new supply, which may well shrink further, this should open future opportunities for those investors willing and able to purchase lower-quality assets at a reduced price, with a view to refurbishment, redevelopment, or repositioning. As a result, we expect increased allocation to value add, in line with the most recent INREV investor intentions survey.

Value-add in residential – including student housing, co-living and senior living – looks most appealing given the undersupply, strong demand fundamentals and pricing dynamics. Refurbishment involves updating existing properties to meet modern standards, including alignment with Minimum Energy Performance Standards (MEPS). Another option is the configuration of obsolete buildings to best and highest use via redevelopment and repositioning, thereby providing new housing.

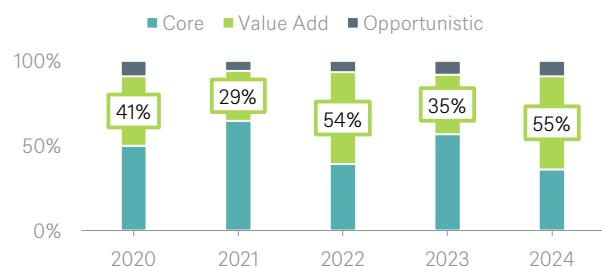
Niche & alternative strategies

The composition of core portfolios has changed substantially over the last 15-20 years. Ten years ago, office and retail accounted for around 80% of all core real estate portfolios, while residential was almost non-existent. However, office and retail now account for less than 50% together,¹¹ while the share of residential, which was long considered non-core and niche given the lack of institutional product, has reached 17% and continues to grow.¹² Many residential markets, including Spain, Italy, and Poland, are still in the early stages of institutionalisation, while student housing is also expected to become an established core sector over the next few years.

What are the next sectors that will become part of core portfolios in 5-10 years? We believe megatrends such as data and energy, and health and wellbeing, will translate into growing real estate (sub)sectors. A forward-looking indicator could be the public market, such as the FTSE NAREIT U.S. Real Estate Index. Niche sectors like data centres, cell towers and self-storage accounted for less than 15% of total REIT market capitalisations ten years ago – today these sectors represent nearly 30% of the index.¹³ Of course, the public market will have a higher share of alternative and niche sectors compared to the private market, but we still believe these sectors could become part of core portfolios in five-to-ten years’ time given the compelling structural drivers.

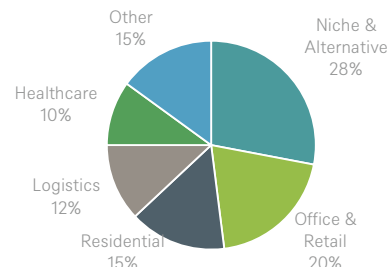
Capital Allocations

European Real Estate: Investment Style Preference



Source: INREV Investment Intentions Survey 2024, DWS, June 2024

US Nareit Index: Sector Breakdown



Source: FTSE Nareit All REITs Index, DWS, April 2024

¹¹ MSCI and INREV ODCE Index

¹² INREV ODCE Index, 2024 Q1

¹³ FTSE Nareit All REITs Index

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3 / Country Summaries

Germany	<ul style="list-style-type: none"> – Business indicators point to a gradual recovery in the short term. Rising real wages should support consumption. – Liquidity is still muted but yields have stabilised and price correction makes investments more attractive across sectors. Supply shortages most pronounced in residential. 	<ul style="list-style-type: none"> – Residential and logistics offer the strongest rent growth and return prospects, benefitting from low vacancy. Operational residential and urban logistics also a key focus. – Retail underperforming but gradually improving after a long spell of weakness. Polarisation in the office market driving prime rents, while price correction supports refurbishments.
France	<ul style="list-style-type: none"> – Outlook for GDP growth clouded by cuts to public sector spending and interest rates. – Logistics south of Paris offers strong rental growth potential, while vacancy is low and the supply pipeline is limited. Regional economic growth, particularly around Lyon, likely to boost demand in this region. 	<ul style="list-style-type: none"> – Office repositioning remains attractive in Paris given ongoing shortage of high-quality office space and concentration of occupier demand in central locations. – Hotel sector set for a boost with Summer Olympics in Paris but long-term fundamentals also promising given limited supply growth relative to expected demand.
UK & Ireland	<ul style="list-style-type: none"> – As the UK economy gains momentum, there is cautious optimism that the tide is now turning. Rate cuts expected in the second half, paving the way for a consumer-led recovery. – Yield compression is expected from 2025, with some logistics markets expected to move before. Over a five-year period, prime rent growth should further support robust returns. 	<ul style="list-style-type: none"> – The build-to-rent sector is supported by healthy fundamentals and we maintain a positive view on the major cities. Operational resi. offers stronger risk-adjusted return potential. – In the City of London, prime office yields are now at a level last seen in the aftermath of the Global Financial Crisis. We see opportunities to buy trophy assets at attractive prices.
Southern Europe	<ul style="list-style-type: none"> – GDP growth likely to exceed European average in the short term given ongoing strength of tourist industry. – Madrid a regional outperformer for most sectors, especially residential, due to high levels of population growth and low municipal tax regime attracting investment. 	<ul style="list-style-type: none"> – Logistics opportunities still available in Italy with development of regional markets in Bologna and Rome offering wider scope for investment. – Residential sector an ongoing focus in Spain. Opportunities in Barcelona now restricted by rent controls but fundamentals are attractive in Madrid, Valencia, and Seville.
Benelux	<ul style="list-style-type: none"> – New Dutch right-wing coalition aspires to strict immigration policies, in part to solve undersupply in the residential sector, but greater rent regulation also expected. – Dutch logistics is forecast to be a top-performing markets, with virtually no vacancy for modern units and a limited supply of zoned land constraining speculative development. 	<ul style="list-style-type: none"> – Pronounced scarcity of student accommodation, particularly in Amsterdam, coupled with the increasing presence of international students, creates an appealing opportunity. – A swiftly ageing population and a deficiency of suitable, high-quality senior living options create an opportunity for investment in this sector.
Nordics	<ul style="list-style-type: none"> – Growth over 2024 will likely remain subdued. Thereafter, the Nordic cities will drive growth in their respective markets. Copenhagen and Stockholm are expected to outperform. – A stabilisation in real estate pricing should pave the way for an improvement in liquidity. Prime real estate yields should then move in from 2025, compressing over a five-year period. 	<ul style="list-style-type: none"> – Copenhagen remains a target for build-to-rent and operational residential, supported by strong population growth, a persistent demand-supply imbalance and robust rent growth. – Following a price correction of around 20% for prime logistics stock, the sector looks poised for recovery. Last hour locations around Stockholm expected to outperform.
Central Europe	<ul style="list-style-type: none"> – Strong rebound of the Polish economy in 2024 with consumer spending remaining the key driver. Huge growth of 9% in real incomes. – Optimisation and flight to quality remain key trends for Polish offices, while construction activity is subdued. Retail set to benefit from falling inflation and rising purchasing power. 	<ul style="list-style-type: none"> – While fundamentals remain solid, logistics is expected to benefit from long-term trends. Vacancy is seen to stabilise as demand picks up, driving rent growth in the medium term. – Lack of housing supply increasing pricing, which could trigger further government support for private buyers. Normalisation of the rental market, but operational residential still in focus.

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