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Logistics and residential forecast to drive outperformance of core European real estate

It's easy to convince ourselves that everything changed in March 2020. The onset of the global pandemic turned the world upside down, raising fundamental questions about how and even why we use our real estate.

There have been clear winners and losers across the industry. Whether it be occupier fundamentals or the capital markets, residential and logistics have prospered, while retail and, to a lesser extent, offices have suffered.

However, this is in no way a new story. Looking at the INREV data for the five years to the end of 2019, European logistics and residential funds recorded annual average returns of more than 13 percent in this period, 500 basis points above offices, and 900 basis points above retail.[1]

Not only have we seen this dramatic difference in performance, we're also seeing a shift in the structure of the market — with more and more capital targeting these outperforming sectors.

We see this in the investment figures. According to Real Capital Analytics (RCA), the logistics and residential sectors respectively accounted for 11 percent and 20 percent of all European transactions over the past 12 months, compared with less than 10 percent a decade ago.[2]

We've seen similar trends reflected across various benchmarks and indices. However, changes to the composition of these do tend to be slow, with portfolio rebalancing occurring over multiple years for those funds with legacy assets.

Pan-European open-ended core funds within the INREV ODCE Index currently hold an average sector allocation of 19 percent to industrial & logistics, and just 5 percent to the residential sector. Over the coming decade we foresee an increase in the size of both sectors, particularly residential, as higher occupier demand supports the virtuous circle of NOI growth, new stock, inflows of institutional capital and lower yields.

This backdrop suggests both sectors should continue to outperform the wider market over the coming years, even as current market conditions start to normalise.

This is evident in the latest DWS house view forecasts. In the five years to the end of 2024 — which includes the current market downturn — we anticipate prime property-level total returns for logistics and residential may be some 200 basis points to 300 basis points above office, and 700 basis points to 800 basis points above that of shopping centres.[3]

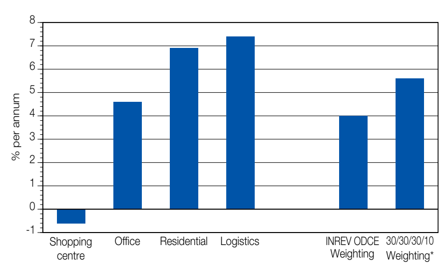
Assuming a portfolio balance in line with the current INREV ODCE Index, our current house view forecasts suggest the market could record a property level return of 4 percent over this period[4].

Given our projections for potentially higher returns in logistics and residential, we believe that taking an overweight position in these sectors is expected to be advantageous to performance.

For example, if we shift the previous ODCE balance in favour of logistics and residential, raising the weighting of these two sectors to 30 percent, alongside a reduced 30 percent allocation to office and 10 percent allocation to retail, this now leads to a comparable annualised return of 5.6 percent for the index.

While a 30 percent allocation to residential may seem a dramatic shift from the current balance of the ODCE universe, at the portfolio level this would not be an unrealistic target. As shown by the RCA data, there is clearly a sufficient volume of investment activity in the residential sector, while a 30 percent allocation to the sector is not dissimilar from what we see at the national level in places like Germany and the United States.

European property-level total return projections, 2020–2024f



Sources: DWS, INREV, August 2020
*Note: *30% Office, 30% Logistics, 30% Residential, 10% Shopping Centres*
No assurance can be given that any forecast, target or opinion will materialise.

Importantly, a portfolio with this sort of balance would still provide diversification — particularly if assets were geographically spread across Europe. Indeed, by increasing the allocation to the residential sector, the tenant base would broaden considerably.

This analysis suggests that if we were to take nothing else into consideration, a portfolio with strong overweight positions in logistics and residential can be expected to outperform the European average. However, this is too simplistic. Within all sectors there will be huge differences in performance across geographies and individual assets. It is imperative that we understand this.

This understanding is fundamental to our house view. Forecasting city- and sector-level returns is only the first step. Using the combined weight of experience within our research, transaction, asset management and portfolio teams, we have formulated key strategic investment themes across all parts of the market.

For logistics, our key focus is Urban and what we've coined Last Hour logistics facilities — specifically, those locations with natural constraints on supply, as well as access to high volumes of both traditional and online spend.

Having already consistently outperformed the market over the past five years, we forecast that these urban locations may record annual rental growth in excess of 4 percent over the coming five years — more than double the sector average.[5]

Importantly for all of these investment themes, they need to be executable.

One such example is a portfolio of French logistics assets acquired by DWS 18 months ago. The portfolio of six logistics properties are situated along the main logistics backbone of France, with four of the assets situated within an hour of Greater Paris — notably, one of our top-performing logistics regions in our latest forecasts.

The assets themselves have been developed to suit a wide range of logistics operators and have the additional

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attraction of offering, in part, controlled temperate facilities.

This portfolio complements the other holdings in this Pan-European diversified open-ended institutional fund, by offering rental growth supported by increasing demand from tenants who are looking for efficient cost-effective space and a resilient need for transportation of perishable goods.

There is a diverse tenant mix, with a number of the larger tenants in the "necessity industries" of food and pharmaceuticals, which now in the COVID-19 cycle strengthen this portfolio even further, from a tenant-credit perspective.

Occupancy has remained consistent, but a small number of changes to rent payment schedules (quarterly to monthly) and rent deferrals have been granted to those tenants who have been more impacted by recent events.

Turning to the residential sector, our key focus here has been on accessible, mass-market stock in those major European cities with clear supply-demand imbalance. By mass market we are not referring to social housing, but rather apartments with rents that are affordable for the majority of the population.

Again, it's important that this strategy is executable. For many institutional investors, the residential sector has historically been difficult to access — reflected in the small 5 percent allocation within the INREV ODCE Index.

Over the last decade, DWS has been a growing investor in European residential. DWS commenced with the residential strategy in its home market Germany from 2011 and has subsequently extended its residential footprint to a further four European residential markets.

By way of example, in 2019 DWS purchased a 281-unit residential scheme in a residential suburb in the South of Dublin, Ireland, on behalf of its Pan-European core open-ended institutional fund.

Following the DWS residential house view, the investment thesis focused on obtaining a significant fund exposure to the stability of the residential sector together with the structural shortfall of housing in Dublin.

Evidence from similar nearby residential schemes demonstrated solid local demand and, together with the strength of pre-letting levels for the first two phases of this four-phase scheme, indicated the ability to achieve high occupancy levels within short marketing periods. In fact, the end result was that the scheme reached 75 percent occupancy at the point of completion of the development and, rolling forward several months, now sits at 99 percent.

Even through the current COVID-19 situation, the scheme has continued to operate a successful marketing campaign, signing 21 "remote move ins". This demonstrates yet another resilient side to the residential sector — that customers have accepted virtual tours as a sufficient medium before signing their tenancy agreements.

Of course we now need to be watchful and considerate that some of our customers may be exposed to financial difficulties in the coming months, with the potential for rising unemployment across Europe.

DWS has looked to take a fair and responsible approach, including postponing scheduled rent reviews, freezing rents or creating new rent payment schedules, together with following local-government directives.

The overall merits of holding a strong tilt to residential in a diversified fund is to create a bedrock of income for the fund, to allow it to go on to pursue other key strategies such as logistics and emerging office location strategies.

Without a doubt, in the short term we will continue to operate in a turbulent economic environment, and such times can test even the most resilient sectors of residential and logistics. With logistics and residential being intense operational asset classes, those investment managers with access to well-developed asset-management capabilities and experience will prove valuable in steadying the proverbial total-performance ship. However, with maintaining resilient income being a high priority for any core fund, those funds that are already strongly allocated to residential and logistics, and so benefiting from the high occupancy and low supply metrics, are likely to fair better with defensive and stable income return driving relative outperformance.

The Fairways — 281-unit residential scheme

Notes:

[1] INREV, August 2020. Past performance is not indicative of future results.

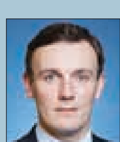
[2] Real Capital Analytics, August 2020

[3] DWS, July 2020. Forecasts are not a reliable indicator of future performance. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

[4] No assurance can be given that any forecast, target or opinion will materialise.

[5] PMA, MSCI, August 2020. No assurance can be given that any forecast, target or opinion will materialise.

CONTRIBUTORS



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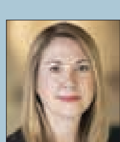

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CORPORATE OVERVIEW

DWS – Real Estate. DWS's real estate investment business has been investing in real estate assets for 50 years. It has more than 450 employees around the world and €64 billion in assets under management (as of 31 March 2020). We offer a diverse range of strategies and solutions across the risk/return and geographic spectrums, including core and value-added real estate, real estate debt, real estate securities, and opportunistic real estate.

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