Seeking to unlock an edge in a new core landscape

The recovery is now

The European real estate market experienced one of the sharpest corrections in history, second only to the global financial crisis (GFC)1. After what has seemed like a never-ending period of declining values – seven consecutive quarters, to be exact – we are finally seeing the first green shoots of positive performance in some sectors and markets in Europe.

With inflation starting to moderate across Europe (possibly even faster than expected), the ECB and other central banks are loosening policy; yield spreads are returning to long-term averages; and public markets are rising, indicating a new recovery cycle. As mentioned in our *DWS Strategic Outlook,* following the aftermath of the GFC, transactional activity took nearly two years to bottom out. According to the data, if history repeats itself, we have now entered recovery.

For core real estate investors, there is much to process. The pandemic accentuated structural trends, which this current market reset has further exacerbated.

Times are changing

Historically, the rationale for investing in core real estate was simple: reliable income streams offering a higher relative yield spread to government bonds than REITs or equities and a partial hedge to inflation. The most significant component of core returns is income, typically delivered by investing in stabilised assets let to "high-grade credit" tenants and the ability to pass on the impact of inflation through rental uplifts – however, core real estate is now at an impasse.

Investors must reconcile the impact of higher-for-longer interest rates, a strained geopolitical environment, evolving demographic trends, fast-paced technological advances and a changing regulatory environment on their real estate portfolios. This bifurcation and polarisation between and within sectors have created a multitude of operational challenges and strained cashflows to the point where these assets are no longer considered core. In the short term, we expect to see a shortage in supply and higher competition for high-quality core assets across multiple sectors.

In this more challenging market environment, we are seeing an evolution of long-held assumptions about what constitutes and belongs in a core portfolio.

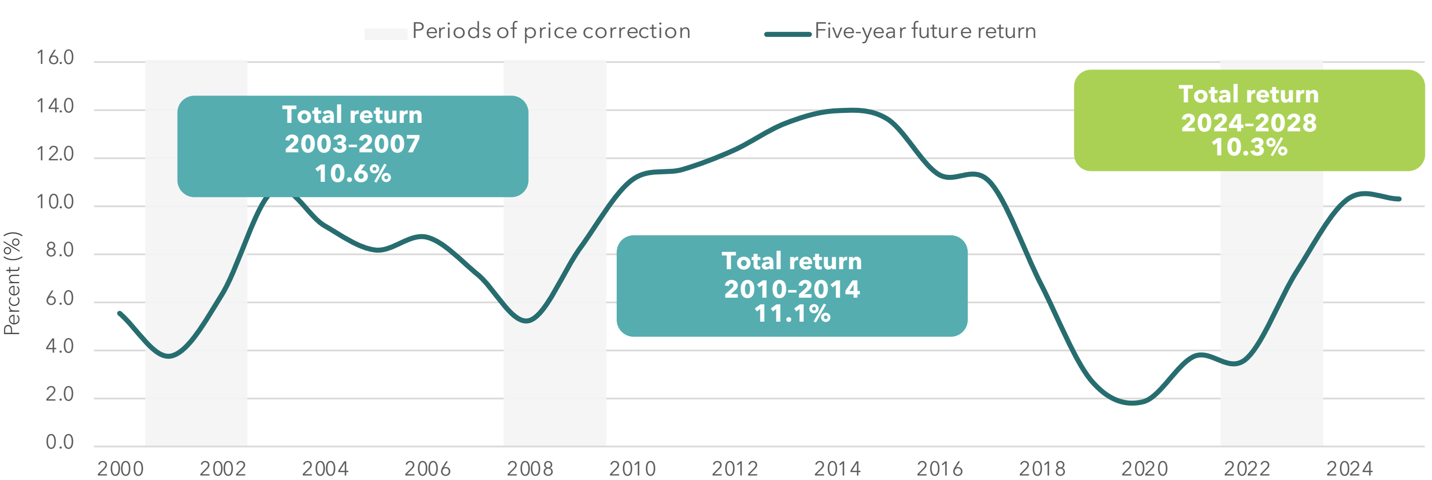
We believe a more proactive strategy will be paramount to achieve attractive returns over the longer term. The performance will be driven by growing income through operational efficiency rather than relying on yield compression and accretive leverage. Continuing to pursue a relatively passive strategy of simply investing in good assets in traditional sectors across the largest European markets is no longer sufficient.

There will be a bifurcation in the construction of core funds' portfolios during the next five to 10 years and, therefore, ultimately, performance, going forward. In our *DWS European Outlook,* we stated we believe there will be a greater allocation to growing subsectors, such as cold storage and data centres, healthcare and wellbeing, student housing and single-family residential as a diversified part of a living component could potentially gain favour in the medium-to-longer term.

Hunting for income-growth opportunities

The operational real estate (OpRE) landscape has evolved considerably in the past 10 years but is still a nascent investment approach. We believe that for those with the right expertise,

Forward-looking five-year core European property-level total return



Note: Based on an unweighted average of office, logistics, residential and shopping centre forecasts. Pre-2010 reflects only the office sector. Forecasts are based on assumptions, estimates, views, and hypothetical models or analyses, which might prove inaccurate or incorrect. Forecasts are not a reliable indicator of future performance. Past performance is not a reliable indicator of future returns.

Source: DWS, June 2024

however, the increasing operational intensity of real estate represents a potential opportunity to deliver an edge for core real estate investors.

Defining OpRE has become more complex than simply describing a physical sector or asset class. A common misconception is that OpRE relates only to the alternative sectors; we are seeing increasing operational exposure across all real estate sectors, including the expansion of the living sector, the "hotelisation" of offices and the growth of retail turnover rents.

We see this as a complementary strategy to the traditional bricks-and-mortar approach, as it can potentially provide enhanced performance from greater income returns driven by a risk premium associated with operational risks.

As OpRE involves more exposure to an asset's underlying business, it requires a greater depth of understanding of the key drivers of NOI. For instance, a new sustainable office building involves understanding and responding to tenants' demands to create a positive occupier experience. Factors such as air quality, temperature control, accessibility, green spaces and efficient meeting room management necessitate a higher degree of landlord involvement directly tied to the use of the space.

While, traditionally, OpRE has been associated with noncore players, such as private equity and value-added real estate investors, there is growing room for core real estate funds to expand into this domain. There has been a recognition that sectors and assets with shorter leases and a far more granulated set of tenants, combined with operational expertise, could provide a much-needed lever to drive inflation-beating rental growth over the long term.

In this new age of core, there will inevitably be a period of adjustment. Open-end core funds have been, albeit slowly, adjusting their portfolios in reaction to the contemporary market trends that are reshaping the industry.

Tooling up

Although it represents a relatively lighter-touch approach, investors should not expect that simply taking on additional operational-risk exposure will result in positive performance. Core investors will need a solid set of tools suitable for this new landscape:

Finger on the pulse: Structural shifts have led to unprecedented dispersion across sectors and geographies. Understanding those trends takes work to be on the right side of the shifting tectonics. It is critical to assimilate this information and extrapolate key data to develop effective investment strategies.

In seeking to uncover diamonds, you need to dig deep: As the quality of core assets further bifurcates in the short term, competition for the best assets will be high. Core strategies cannot necessarily wait until value-added investors create new core stock. Opportunities will need to be sorted through a combination of a deep network of industry relations, especially with operators and creative solutions.

Enhanced underwriting: When investing in OpRE assets, investors will require new methodologies and governance processes to conduct diligence on operators alongside the physical asset. Investment teams will need to be skilled in analysing EBITDA and challenging NOI projections. Those who have operational expertise already complementing traditional underwriting will have a potential advantage.

Curating assets: Today's environment requires a more acute focus on stock selection, especially when selecting and working with an operator, which is more complex. We expect the best rewards will be reaped by those with the capability and vision to target the right asset and the right operator at the right time in the right sector.

An active approach to asset management: Although OpRE transects all real estate, it is still nascent in most traditional sectors. In the short term, at least, higher returns will be sought in the sectors with a higher degree of tenant turnover, which is typically contrary to the stability of core strategies. Operational assets, correctly positioned in terms of service offering and pricing, can ensure increased tenant demand and lower void rates, while, at the same time, providing a potentially effective inflation hedge with the ability to grow rents.

Once the slow and sedate end of the real estate market, the core landscape is actively evolving. We believe the broadening of opportunities that come with operational real estate will play a much more prominent role in how investors think about core portfolio construction. We believe that long-term performance potential can be improved by those prepared to make the shift in their core investment approach combined with the requisite skills.

Notes:
[1] INREV Quarterly Fund Index, Q2 2024
[2] INREV European ODCE Quarterly Index, Q2 2024

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COMPANY PROFILE

DWS Real Estate has been investing in real estate assets for more than 50 years. The business has nearly 350 employees in more than 20 cities around the world and almost €73 billion in real estate assets under management (as of 30 June 2024). We offer a diverse range of strategies and solutions across the risk/return and geographic spectrums, including core, value-added and opportunistic real estate, real estate debt, real estate securities and opportunistic real estate.