Will "necessity" sectors drive outperformance for core European real estate?

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From the outset of the global pandemic, we have experienced a complete disruption to our everyday lives. Images of food shortages, empty playgrounds and quiet skies have made us take stock of what we see as essential.

We've learned to follow a new way of life, at home, work and within our communities. We've also been forming new habits. Like wearing a facemask, what may have felt strange six months ago, for many of us is now commonplace. While not all of these new habits will last forever, some are likely to stick.

The pandemic has also made many of us think about what is absolutely necessary in life. Certainly most of us have struggled, deprived of the things and often the people we love, but I'm sure we've also found there are plenty of things we can do without.

The way we live and work has a direct influence on real estate. The global pandemic has no doubt raised some fundamental questions about how we use real estate. But it has also made us think about the necessity of the sector.

If we define "Necessity" as something that everyone needs such as food, water, shelter and clothing, clearly the residential sector falls into this category. And certainly during this crisis, and indeed in previous downturns, we have seen sustained demand for residential space.

For core investors, the stability of residential throughout the cycle continues to be a highly attractive feature of the sector. Add to this a structural increase in occupier demand and constraints on new supply, and it's perhaps of little surprise that investor interest in residential is a growing story amongst global asset managers.

At DWS our European residential "story" began in 2011 within our home market of Germany. Attracted by the sector's defensive valuation qualities and strong income profile, and complementing our diversified core strategies, over the last decade we've built a large, multi-city portfolio, expanding into a further four European countries.

We've been particularly focusing our efforts on affordable "mass market" residential - apartments with rents affordable for the majority of the population.

By way of an example, in 2018 we purchased a portfolio of twelve affordable residential assets in the Netherlands - the first investment for our newly launched European core open ended institutional fund. The value of residential being the first investment of a diversified fund was to create a bedrock of income, allowing it to go on to pursue other key strategies such as logistics and emerging office locations.

The key investment rationale centres on the desire to secure exposure to the stability of the residential sector together with the structural shortfall of affordable housing in the Netherlands. The majority of the subject portfolio's income is generated in the Randstad area which has strong economic and demographic forecasts.

The strength and stability of income has been shown throughout the current crisis. Having consistently provided high occupancy of over 97% throughout its history, even during the second and third quarters of 2020, the occupancy of the portfolio has only marginally moved to 96.5%.

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Further evidence of this sector's resilience can be demonstrated across our large residential portfolio in Germany, where out of the 10,000 apartment portfolio, we have received a negligible number of requests for rent deferrals or rental holidays.

We've had a similar experience even in markets that are considered still in their maturity phase such as our residential assets in Dublin. Here occupancy remains high and stable and it has also been our experience that apartments have continued to lease throughout the crisis. We've completed 21 "remote move ins" over the Covid-19 period where virtual tours have proven an acceptable medium prior to signing a tenancy agreement.

Of course we remain 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 have looked to take an ethical and responsible approach including postponing scheduled rent reviews, freezing rents or creating new rent payment schedules, together with following any prevailing Government directives.

Looking beyond residential, we would also consider the logistics sector a necessity. Indeed for those forced to isolate over recent months, home delivery has been vital. But more than this, the sector is an essential part of any national economy – supporting both production and consumption.

With more and more consumption switching online, the necessity of logistics has only continued to grow. Again, this has seen the sector perform well throughout the recent crisis, further supporting the interest of global asset managers.

A good illustration of the necessity of logistics, is a portfolio of six French logistics assets acquired by DWS 18 months ago. The 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 portfolio compliments the other holdings of the European diversified open ended fund in which it's held. It offers rental growth supported by increasing demand from tenants who are looking for efficient cost-effective space and last hour transportation of perishable goods.

The assets themselves have been developed to suit a wide range of logistics operators and have the additional attraction of offering, in part, cold storage facilities.

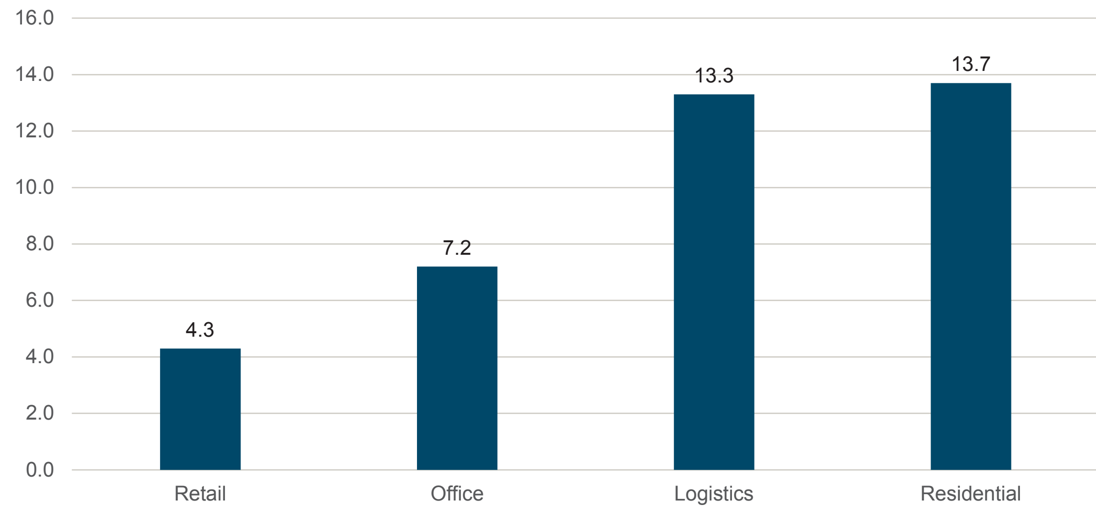
As a result of this flexible logistics format there is a diverse tenant mix with a number of the larger tenants in the "necessity industries" of food and pharmaceuticals. In today's Covid-19 cycle such industry exposures further strengthen a fund's credentials now that tenant credit is being particularly scrutinised. We have experienced stable occupancy during this year and similar to the residential assets there have only been a small number of tenant requests to change rent payment schedules or deferrals.

The attraction of logistics and residential has been clear to see over recent months. Whether from an income or a capital value perspective, these sectors have outperformed during the crisis. But what about in more normal times?

Over recent history the sectors have been some of Europe's top performers. Looking at the INREV fund level data for the five years to the end of 2019, European logistics and residential recorded annual average returns of more than 13%, 600 basis points above offices, and 900 basis points above retail[1].

EUROPEAN FUND LEVEL TOTAL RETURN, 2015 – 2019

% per annum



Source: INREV, August 2020

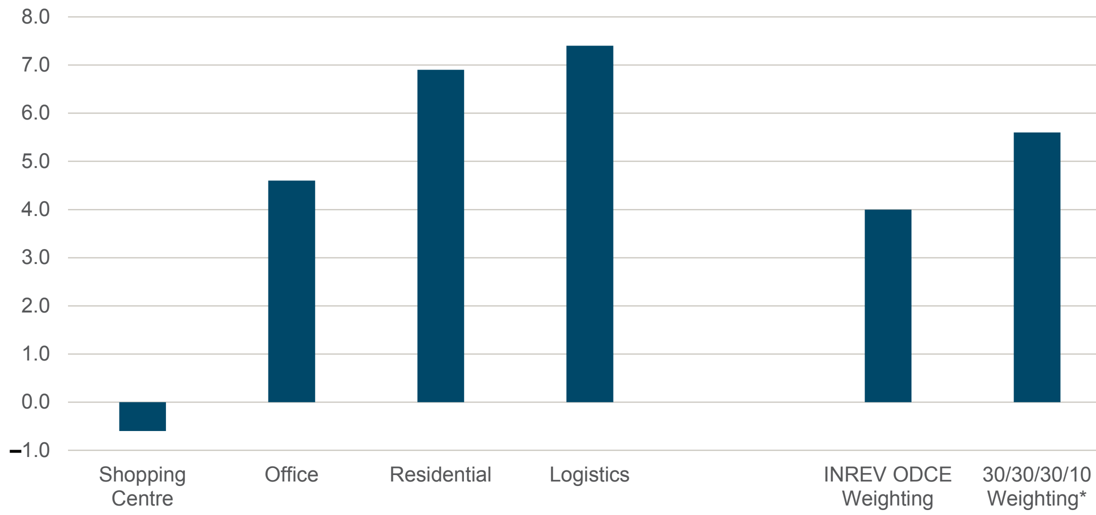
Past performance is not indicative of future results.

As every compliance officer will tell you, past performance is no guarantee of future results. However, looking forward, our latest house view forecasts are showing both of these sectors outperforming over the coming decade. With the support of major structural changes in ecommerce and home occupancy, as well as increasing volumes of investor capital, both sectors are well placed for rental growth and yield compression.

This is in sharp contrast to other sectors, particularly retail. According to our latest 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 to 300 basis points above office, and 700 to 800 basis points above that of shopping centres[2].

EUROPEAN PROPERTY LEVEL TOTAL RETURN PROJECTIONS, 2020 – 2024F

% per annum



Source: 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.

We expect both sectors will continue to become an increasingly important part of the European market, gaining prominence within the core real estate benchmarks. Indeed this has already started to happen, 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.

Today, Pan-European open-ended core funds within the INREV ODCE Index hold an average sector allocation of around 20% in industrial & logistics and just 5% to the residential sector – retail (21% and office (46%) making up the bulk of the remainder.

Applying our latest forecasts to this sector balance, suggests the market could record a property level return of 4% over this period[3]. However given our projections for potentially higher returns in logistics and residential, we believe taking an overweight position in these sectors is expected to be advantageous to performance.

If we were to shift the portfolio balance in favour of logistics and residential, raising the weighting of these two sectors to 30%, while reducing allocation to retail and office to 10% and 30% respectively, this now leads to a comparable annualised return of 5.6%.

A 30% allocation to residential is a big shift from the current balance of the ODCE universe, but at the portfolio level this would not be an unrealistic target. There is sufficient volume of investment activity in the residential sector, with markets such as the Netherlands, Spain and the Nordics all seeing residential investment accounting for around 30% of total transaction activity in 2019[4].

Take nothing else into consideration, this analysis suggests a portfolio with strong overweight positions in logistics and residential, could be expected to outperform the European average. However, portfolio balance is in no way sufficient to ensure performance. There is, and always will be, a huge range in performance.

Indeed it is this consideration that pushes us to focus on particular investment themes within logistics and residential. As already mentioned, within residential we see both income resilience and pricing advantage within the mass market segment. 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 consistently outperformed the market over the past five years, we forecast that these urban locations may record annual rental growth double the sector average[5].

Maintaining resilient income should be a key priority for any core fund during these turbulent economic times. Whilst recent events can test even "necessity" sectors, evidence suggests that funds with an existing overweight to residential and logistics are in a better position to weather this storm.

In the short term, for these more intense operational assets, managers will need to be equipped with local asset management capabilities and experience to steady core fund returns. Over the medium term, with these sectors' high occupancy and low supply investment drivers, core funds already overweight to residential and logistics should be able to fully dedicate their efforts to extracting further asset performance and capitalise swiftly on these future trends.

FOOTNOTE

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

2 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.

3 No assurance can be given that any forecast, target or opinion will materialise.

4 Real Capital Analytics, August 2020

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

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