Is it prime for picking?

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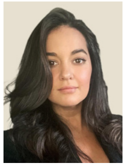

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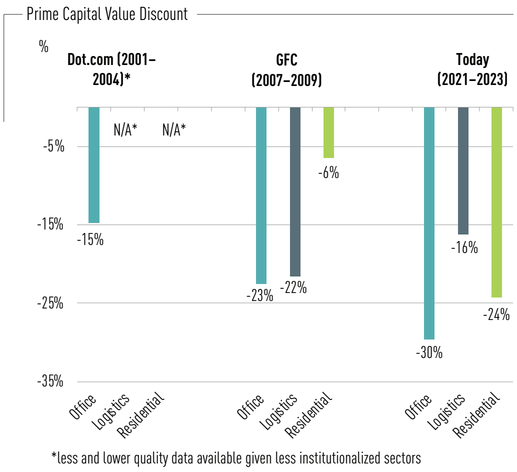
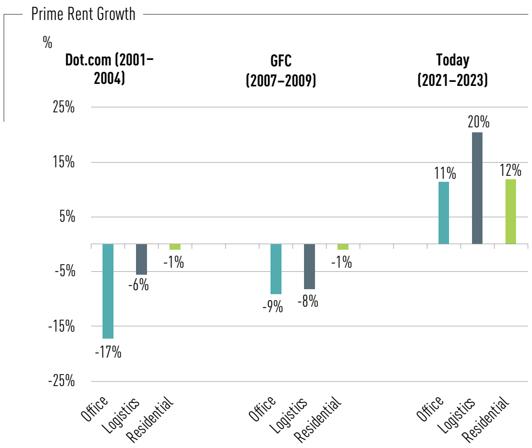




Source: PMA, Greenstreet, DWS, June 2024

If you were to write down the combination of factors to create the ideal scenario for value-add investing, it would look remarkably similar to what we see in today's markets. The alignment of deep repricing, intense liquidity pressures, the need to bridge the debt financing gap, a progressive regulatory environment, a reduced supply pipeline, evolving structural mega-trends and the loosening of interest rates have created a distinct opportunity for investors ready and able to deploy capital into real estate. This window provides access to opportunities often unavailable or prohibitively priced during other phases of the cycle.

However, like all good things, these optimal conditions will end reasonably rapidly. Investors must be swift and decisive to capture what we see as a highly attractive buying opportunity in a new cycle. In our most recent DWS Strategic Outlook, we showed yields compressing quickly once market liquidity improves, potentially falling even faster than models predict. Although opportunities will always remain, those that drive the highest returns will be more difficult to uncover.

Don't play checkers when the game is chess.

The board might be the same, but the game has changed. In the aftermath of the Global Financial Crisis (GFC), a "simplistic" value-add strategy was to let the markets do most of the work as opposed to actively enhancing the value of the asset. Investors could acquire an asset below fundamental values, typically from distressed owners looking for liquidity, take advantage of the more relaxed monetary conditions created by the European central banks, wait for values to rise in the recovery market and sell to cash-rich core investors.

One of the most significant risks for investors is assuming that strong performance in this vintage can be achieved solely by buying "cheap" and waiting for values to rise. From experience, we know that market downturns expose underlying weaknesses in assets previously supported by a strong market. Combining this with the growing polarisation in demand between sustainable and unsustainable assets goes some way to explaining why some of these stranded assets are priced as low as they are and will remain so.

Charts 1 and 2 demonstrate that it might come as a surprise that European real estate markets have been as severely disrupted as we saw in the GFC because this real estate cycle is characterised by occupier market resilience, with vacancies hardly moving from record lows and rents growing throughout the entire market reset.

To generate value-added returns in today's market, investors must consider market timing and use a far greater number of tools in their toolkit. Simply put, those with the know-how and a willingness to roll up their sleeves to actively improve assets will have an edge.

Finger on the pulse: Structural shifts have led to unprecedented dispersion and polarisation between and within sectors. And with this, we see enormous implications for the real estate investment environment. Understanding those trends takes work to be on the right side of the shifting tectonics. Europe has a potent combination of a strained geopolitical environment, evolving demographic trends, fast-paced technological advances, and a changing regulatory environment. It is critical to assimilate this information and extrapolate key data to develop effective investment strategies.

When seeking to uncover diamonds, you need to dig deep: Although there is distress in the markets, the most attractive opportunities will neither be openly marketed nor declared. This is not to say that there are no good deals to be had via a broker; however, if an investor seeks to acquire stock at 30-40% below peak values, these will likely originate through a combination of a deep network of industry relationships and creative solutions. It will require the know-how to understand whether the value decline can be reversed or is a manifestation of overly buoyant historical values or assets that are no longer fit for use. The opportunity may also come not only from the repositioning opportunity of an asset but also from the capital structure or special liquidity position of the owner of the asset (e.g., exposure to more demanding public markets or where investors' equity has reached a maturity).

For example, by taking advantage of the current "equity gap," where developers and investors cannot obtain refinancing at similar LTV or require higher ICR levels, or the financing costs have become too prohibitive to be sustainable. Ultimately, it would provide access to redevelopment projects or existing stock that wouldn't necessarily be available.

Curating assets: Unlike the last two cycles, today's environment requires a more acute focus on stock selection. We expect the best rewards will be reaped by those with the capability and the vision to target the right sustainability measures (both from an environmental and social perspective) at the right time in the right sector. The right asset will have the best chance of delivering outperformance through this cycle.

As most long-term real estate investors know, selecting assets for a portfolio is rarely straightforward. This is primarily when significant elements of asset management must be undertaken, specifically relating to sustainability. Effectively analysing whether a deal is suitable for repurposing or repositioning means having a deep understanding and expertise in executing these projects to ensure the creation of the optimum product at the optimum price.

Complex asset management: This time, investors won't benefit from a low-cost debt environment and can't rely just on cap rate compression to drive returns. Decarbonisation regulations are increasing demand for low-carbon properties. These energy-efficient buildings mean that we expect those with sector specialism and local market knowledge combined with utilising new AI technologies to deliver value-enhancing initiatives through developments, refurbishments, and repurposing of buildings. Sector, regulatory, financing and on-the-ground expertise will be required to deliver complex projects and the ability to manage CapEx budgets in an effort to maximise returns.

Real Estate x Private Equity: Once the preserve of niche property sectors, Operational Real Estate

(OPRE), where income and capital value are linked to the performance of the underlying operator, is now, to some extent, being integrated across most major real estate sectors. Creating an operating company or restructuring an existing operating company to consolidate operations, as well as aggregate assets, may make the ability to enhance returns further.

Finding the floor

The age-old question of when the best time to invest during a market reset remains challenging, as timing the bottom is nearly impossible. However, there are a number of leading indicators we use to identify windows of opportunity.

With inflation starting to moderate across Europe (possibly even faster than expected), with the ECB and other Central Banks loosening policy, yield spreads are returning to long-term averages, and public markets are rising, indicating a new recovery cycle. At the beginning of the year, we saw that real estate values were starting to bottom out; it is clear that over six months through the year, the data shows a stabilisation in pricing. That is also the feedback from the market itself. 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 reached the trough.

In the current climate, we are seeing access to very attractive entry prices for well-located stock with value-add potential and enough distressed situations to exploit. As the bid-offer spread has narrowed, sellers have become more realistic in their willingness to accept prices. We believe deploying capital from H2 2024 will help to mitigate the risk of catching the tail-end of the market correction.

New Era of Transformation

One of Europe's strongest structural megatrends is the demand for well-performing, sustainable stock. A critical juncture was the introduction of the Sustainable Finance Disclosure Regulation (SFDR) in 2021, which imposed much-needed transparency of investment funds and their assets. Since then, a raft of new and imminent regulations has been rolled out, such as the Corporate Sustainability Reporting Directive (CSRD) and local minimum energy performance standards such as Minimum Energy Efficiency Standards (MEES) in the UK, and the Decret Tertiare in France, as well as the Energy Performance Buildings Directive.

With ~85% of existing building stock built before 2001[1], the current regulatory requirements will drive further polarisation in asset performance across all sectors in the coming years. Obsolescence is a critical risk but also one of the best opportunities at the start of this new cycle. This is supported by better financing terms, the ability to implement higher rent increases in regulated markets and subsidies.

There is not just a strong investment case for transforming assets into future-fit stock through refurbishment or repurposing; it is imperative to preserve long-term value. Future-fit assets can often carry lower operating costs, qualify for better finance terms, and boost occupancy rates due to increasing demands from occupiers in all asset classes.

Despite Europe being considered the leader in investor and occupier demand for future-fit assets, it is estimated that only ~11% of European buildings are refurbished to some extent annually. This leads to a 1% annual energy refurbishment rate, and only 20% of refurbishments improve energy efficiency significantly. Deep refurbishments—where energy consumption is reduced by at least 60%—represent only 0.2% of building stock renovation per year[2].

The reason for low rates of refurbishments and repurposing can be attributed to several factors, such as:

High Initial Costs: Refurbishing and Repurposing buildings to meet these new standards requires significant CapEx. This includes costs for energy-efficient materials, renewable energy systems, and advanced technologies and paying for external advisors. While there are long-term savings in energy costs, the initial financial outlay and detailed expertise can deter many low-cost capital investors.

Regulatory Complexity: Navigating the various regulations and standards for sustainable buildings can be complex and time-consuming for those without deep internal capabilities. Compliance with the EU's stringent energy performance and sustainability criteria can be a barrier for those who own stranding assets.[3]

Technical Challenges: Upgrading older buildings to meet modern sustainability standards can be technically challenging. Therefore, delivering a project on time and budget requires experience. As the real push for sustainable buildings has only been at the forefront for a few years, the level of expertise among investors and developers in sustainable development, refurbishment, and repositioning varies significantly.

Therefore, despite the regulatory push, more capital and expertise are needed to drive most of this transformation at the required pace. The depth of value-add capabilities and capital will play a pivotal role in the transformation of European real estate in the coming years.

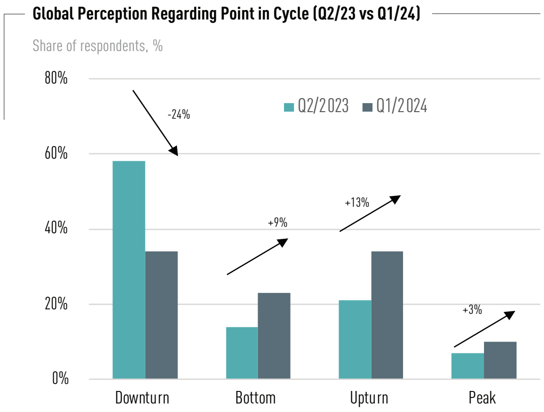
Our top pick for value-add?

Although there are opportunities across all sectors, we believe investors should be able to achieve both financial and sustainable investment targets in the Living sector, focusing on identifying under-managed, under-invested, not-fit-for-purpose assets that have the potential for significant value-enhancing initiatives in locations whether this is an existing Living asset to be repositioned or upgraded or taking, for example, an Office building which is not fit for use and converting to Student Housing.

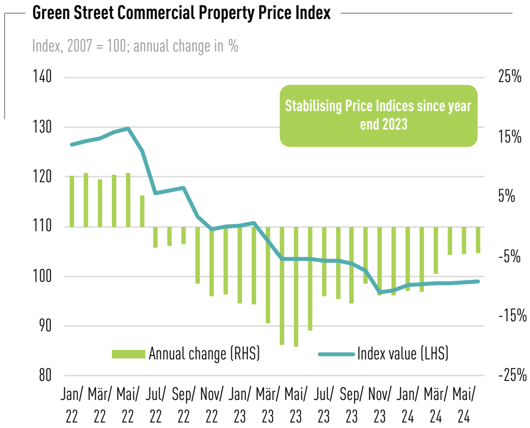
Over the past decade, we have seen the redefinition of housing into the broad spectrum of the Living sector—which includes private residential (single or multi-family), student housing, co-living, and senior Living. This demonstrates the significant evolution in the way society and tenants view housing. Understanding shifting demographic and population structure trends is imperative as there is undersupply in every sub-sector of Living. This is the result of a combination of the lack of construction activity over recent years and the growing demand for accommodation that meets higher sustainability and well-being standards.

Although there is significant interest in the Living sector, investors seem reluctant to focus purely on the private residential sector in value-added strategies due to changing residential rental regulations, which creates uncertainty in many European countries. Increasing examples of tenant-friendly regulation and stricter rent controls have become more visible in Europe in recent years. We believe investors should focus on the broader spectrum of Living across countries to create a diversified Living portfolio and seek to mitigate regulatory uncertainty.

Global Perception Regarding Point in Cycle (Q2/23 vs Q1/24)



Green Street Commercial Property Price Index



Source: RCA, RICS, May 2024. CBRE, Green Street, DWS, June 2024.

[1]European Commission, Questions and Answers on the Renovation Wave, 2020.
[2]Rooijers; Quentin Jossen; and Hugues de Meulemeest (2020), "Zero carbon buildings 2050: Background report",
[3]EU Commission, Energy climate change environment – Standards tools and labels, 2023