Real Estate Research

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DWS

Netherlands Real Estate Strategic Outlook

Third Quarter 2022

IN A NUTSHELL

– A slowing economy and rising interest rates are expected to lead to a period of price correction for real estate. Capital values are forecast to fall over the next 18 months as yields expand, although this should be partly offset by robust rental growth.
– Higher financing costs are weighing on the appeal of real estate investment in the absence of price reductions. However, in time, opportunities, including value-add strategies, are set to emerge.
– Senior living and student housing offer attractive yield premiums over multi-family residential, and are expected to be resilient to economic disruption given sustained tenant demand and undersupply of good-quality stock.

The Russia-Ukraine conflict has changed the European economic landscape, leading to significantly higher inflation, and weakening output growth. The Dutch economy is expected to slow in 2023 due to E.U. gas rationing, renewed supply chain disruption and tighter monetary policy from the European Central Bank (ECB), and therefore the risk of an inflation-induced recession is elevated.

Real estate market entering period of price correction

An effect of higher inflation has been a swift rise in longer-term interest rates. The ECB has already begun to act against inflation by raising policy rates, although the market is pricing in further tightening in the short-to-medium term. As a result, the Dutch ten-year government bond yield, having been close to zero at the start of the year, climbed rapidly to reach more than 2.0% by mid-June, although has since fallen back slightly to around 1.8% by the end of August.[1] With swap rates seeing a similar trend, substantially higher borrowing costs have lowered levered return expectations for real estate, and a growing number of investors are now requiring a price discount. At present, evidence of a correction is largely anecdotal, although yields for some sectors are now starting to increase according the latest monthly data.[2] We anticipate that yields will increase across almost all sectors, leading values to fall by 5-15%. With a price correction underway, and the risk of recession, investment strategies should focus on resilient assets with strong long-term rental growth prospects, as well as value-add opportunities in markets or sectors with potential price dislocation.

[1] Macrobond, August 2022
[2] CBRE, August 2022

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Residential sector the most resilient, but difficult to meet return targets

Residential could be considered the most defensive property sector, with relatively inelastic demand, low vacancy and stable income returns. The sector has also generally proven to offer reasonable protection against inflation over time, thanks to persistent undersupply, favourable demographic trends, and typically shorter leases – providing opportunities for regular rental uplifts. Additionally, house prices and mortgage requirements have risen significantly in recent years, making homeownership unattainable for many younger people. On the demand side, higher inflation, alongside low unemployment, is expected to push up wages in the short term; however, surging energy prices and an elevated cost of living will impact total occupancy costs and overall affordability, which may trigger a regulatory response.

Over the longer term, ongoing urbanisation and a solid outlook for household income growth mean we expect rental growth of around 3.5% per annum over the next ten years in Amsterdam. However, stricter rental regulation and higher transfer taxes could make residential less appealing for institutional investors. Increased borrowing costs will also put downward pressure on levered cash-on-cash returns and are likely to trigger some level of repricing in the short term. Therefore, we currently see limited opportunities in core residential investments, despite a large number of portfolios on the market, although value-add opportunities may still be viable.

Senior living: An attractive alternative to private residential

Operational residential assets such as senior living typically offer a yield premium over multi-family residential, while having many of the same safe-haven characteristics, including low vacancy, stable income returns and a supply-demand imbalance. Demographic trends are likely to be a significant demand driver for the Dutch senior living market, with the number of people aged over 75 expected to grow by around 40% over the next ten years, compared to a modest 5% growth in the overall population[3]. In addition, the baby boomer generation – those currently at or approaching retirement age – have often benefitted from defined benefit pension schemes and strong historical house price appreciation, meaning that the Netherlands has among the highest average disposable incomes and average net wealth at retirement in Europe[4]. As such, senior living looks highly likely to see rising demand looking ahead.

Furthermore, the Dutch penetration rate – the percentage of the population above 75 years old as a proportion of the number of assisted living units – remains well below more mature markets. Rates in the United States and Australia, for example, are as high as 6-7%, with France and Germany in the 3-4% range[5]. However, the sector remains nascent in most of the rest of Europe, with an estimated penetration rate of less than 1% in the Netherlands, suggesting significant room for growth.

Student housing: A sector with countercyclical characteristics

In addition to senior living, student housing sits high on our list of key investment themes, especially during a potential economic downturn, as enrolment numbers are typically inversely related to the economic cycle: The tougher the job market, the more likely the decision to study. Student housing is an attractive sector, with demand coming from both domestic and international students. Enrolment among Dutch students continues to grow but increasing international student mobility is likely to be the more significant driver of growth, with the Netherlands offering a number of high-quality universities, a large number of English-language-based courses, a relatively low cost of study and possible rent subsidies.

However, there is still a shortage of good-quality purpose-built student accommodation (PBSA), despite the recent development of several large complexes. The current number of PBSA beds relative to the full-time student population – also known as the provision rate – is estimated to be around 15-20% in the Netherlands, well below the U.K. (circa 35%), which is the most

[3] Eurostat, August 2022
[4] DWS, Eurostat and Credit Suisse, February 2022
[5] Bonard, NIC and JLL, 2021

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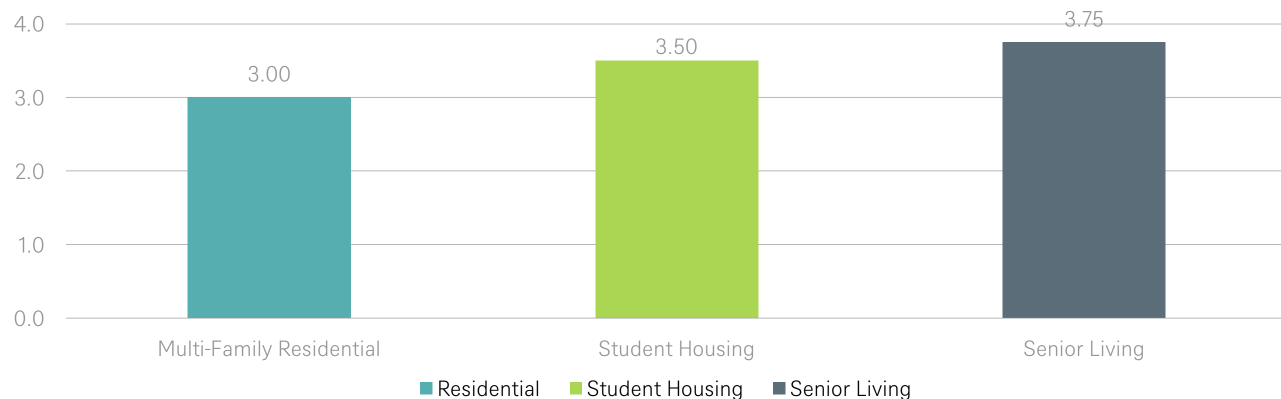
mature market in Europe[6]. As such, entering the PBSA market would most likely require a development strategy given the size of the sector and limited high-quality standing stock.

A case can be made for both a mid-range and high-end student housing investment strategy. The mid-range segment offers relatively affordable accommodation with standard amenities, aimed at domestically mobile students in regional cities with good universities and low vacancy in the private residential market. High-end accommodation offers additional amenities, such as a cinema, gym, or bar, with the target tenants being predominately international students looking to study at the top universities in large cities.

Prime Net Initial Yield (%)



Source: DWS, CBRE, July 2022.

Both senior living and student housing assets are typically valued at a 50-100 basis point yield premium over multi-family residential,[7] depending on micro-location and market maturity. While in part this reflects additional operational and alternative use risk, the combination of a higher income return and strong rental growth could result in attractive total returns for institutional investors.

Potential price reductions provide opportunities for core and value-add strategies

We believe that logistics will continue to perform well due to strong demand and low levels of vacancy, with limited availability of zoned land restricting speculative supply. A lack of good-quality logistics space is expected to push up rents in the near term; however, lower consumer spending due to the increased cost of living and slowing economic growth may impact demand. Our focus remains on urban logistics, given that core logistics looks keenly priced, although potential price reductions may present new investment opportunities in the future.

Urban locations in Amsterdam remain attractive based on the continued rise of e-commerce, low vacancy, and limited land availability. Here, we believe that modern stock in supply-constrained submarkets is most likely to achieve sufficient rental growth. We also see an opportunity to redevelop and reposition old light industrial assets into last-hour logistics near Amsterdam and Rotterdam given the tight pricing in the logistics sector. Such a value-add strategy is supported by strong demand from third-party logistics tenants and healthy development margins, despite an increase in construction costs.

[6] Bonard, Savills and Xior, 2021

[7] CBRE, July 2022

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Recent take-up in the Dutch office sector has been well below the ten-year average due to increased work-from-home adoption rates, although outside Amsterdam, office markets have typically seen vacancy rates drop as old office space is withdrawn from the market, mostly for conversion to other uses[8]. Conversely, Amsterdam has seen rising vacancy for the last two years as significant new supply has coincided with weaker demand, a trend we expect to continue into the medium term. However, as stock is removed from the market on the back of the government's energy efficiency regulations, this is preventing a drastic rise in availability, and looking ahead we expect to see a further increase in the number of refurbishments, demolitions, and conversions of old office buildings.

In order to achieve additional return while also reducing carbon impact, we have a strong preference for the refurbishment of old, but centrally located office stock over new build assets. Our 'Next Generation' office refurbishment strategy is aimed at high-productivity markets where good-quality space with strong ESG credentials is still in short supply, although finding suitable and attractive opportunities could represent a challenge here.
The retail sector remains difficult and the post-Covid recovery will likely be hindered by lower consumer confidence and discretionary spending due to the rising cost of living. We expect further market rental value declines in the short term as spending rotates from goods to services, economic growth slows, and consumer confidence remains low.

Prime Rent Growth Forecast (2022-2031f, % p.a.)

Source: DWS, July 2022. Note: F= forecast. Forecasts are not a reliable indicator of future returns. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

[8] PMA, June 2022

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