

For professional and institutional clients only

Pursuing opportunity in an uncertain market

Utilising the Geographical Evaluation Model (GEM), DWS' proprietary research approach to examine historically high growth markets



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Covid-related supply chain bottlenecks remain and Europe confronts its biggest conflict since WW2, exacerbating existing supply-demand imbalances in energy markets and pushing inflation to the highest level in 10 years.

In this article we will discuss the DWS response to a selection of the most pressing investment strategy questions.

What is DWS's current overall approach to pursuing outperformance in European real estate?

The real estate market has enjoyed strong performance over the last decade.¹ However, asset owners can no longer rely on the direction of the market. Careful selection of opportunities is essential.

Comprehensive analysis at DWS centres on key investment pillars – 1. Strategy tools such as our Geographic Evaluation Model ("GEM"), DWS's proprietary research approach used for around 3 years for the residential sector, to examine historically high growth markets; 2. Acquiring and managing operational assets to maintain strong occupancy and stringent gross to net cost monitoring to maximise net income; 3. Identifying investment opportunities

where we can deploy our active refurbishment approach to potentially boost portfolio returns; and 4. In-depth ESG "profile" review of each asset - this process examines carbon and cost management of the assets and pursues portfolio liquidity and value.

What are the key sectors and locations that DWS are currently advocating?

Affordable residential in commuter locations and regional hubs: Residential remains our number one sector pick we believe offering an attractive return outlook. However, our approach is evolving. We remain committed to a focus on affordable accommodation, particularly assets located in commuter areas surrounding the major cities, but we're also now increasingly interested in

increasing demand and a growing pool of institutional capital.

Europe's population is ageing, and senior housing is still at an early stage of development in many countries. Investors are taking note. Investment volumes in the sector in Europe have increased over tenfold from 2011-2020, but the sector is still undersupplied. In Europe, the supply of senior housing relative to the potential demand pool ranges from 1%-3%, compared to 7% in the U.S. As operational risk is typically shifted to the operator via a long-term lease in this sector, tenant credit underwriting is a key consideration when evaluating individual transactional opportunities.

Growing demand is also a feature of the student housing market. Educational attainment levels continue to increase, and with the exception of the pandemic years, European universities

investment sub-sectors could benefit from outsized performance over the coming decade.

The expertise of operating partners are critical in driving value beyond broader market trends. Actionable local insights, based on real life consumer journeys, often prove to be the difference when looking to maximise net income and grow presence in markets and sectors attracting institutional attention. Equipped with significant data points from our existing large living sector portfolio supports a true "bottom up" underwriting approach. In our experience more accurate underwriting assumptions could deliver substantially higher total returns compared to applying just the "industry norms".⁴ To manage this premium, and manage potential risks, requires a robust framework of performance indicators that encourages and rewards initiatives consumers appreciate and are willing to pay for, while equally discourages and penalises operational inefficiencies.

How does the office sector embrace the ESG agenda and provide returns when construction costs are on the rise?

ESG obligations are having a major impact on corporate occupier decisions and meeting these needs will require active management. The industry will almost certainly fail to meet its carbon reduction commitments without a major push to transform the current stock. As such, for the office sector, we prefer refurbishment over new construction, providing high quality, operationally efficient space, while retaining much of the embodied carbon.

Currently, we believe this is best executed in high productivity cities and growing technology hubs such as London, Paris, Berlin, and Stockholm. These locations attract strong corporate tenants, and fast-growing, high-margin businesses, which provide a demand base for office space renovated to the highest occupier standards. This means prioritising employee wellbeing, environmental certification, flexibility in space use, and quality over quantity of space. Most major European markets lack office space that meets these standards. While we're starting to see developers respond, we believe this shortfall will persist for some time,⁵ supporting higher rents in renovated space. This won't be a viable option for all offices, however. Where a

The GEM (Geographical Evaluation Model) Approach

In applying DWS' proprietary research method, we undertake comprehensive market scoring to provide information on the attractiveness and comparability to determine markets we believe could provide attractive investment opportunities.

In applying this approach to the residential sector, we analysed and ranked a total of 62 European housing markets based on a total of 15 socio-economic and residential indicators. This initial market selection was based on the size and attractiveness of the local housing market. We did not include very small locations in the analysis, only established regional cities with at least 200,000 inhabitants and an investable housing market.

Beyond this, we analysed indicators reflecting demographic, economic and housing market conditions. For the demographic assessment, the analysis used the ten-year projections of household growth and young population growth (those aged 20-35). Macro-economic factors included employment and disposable income growth as well as local market dynamics such as ownership structures, development activity, available housing supply, and affordability.

key regional cities.

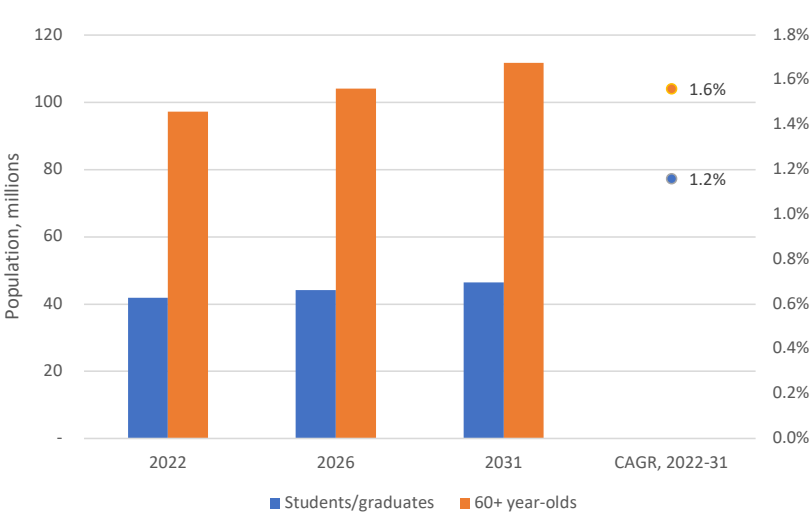
At first glance this may look like a search for yield, and indeed residential yields in these key regional cities do tend to be higher than major markets. However, this is a secondary consideration. The attraction of cities like Bristol, Malaga, Malmo, and Leipzig is based on solid fundamentals, including strong population and disposable income growth, access to renters, and a history of rental outperformance.²

Life-long living: We're also attracted to the more operationally intensive parts of the residential sector. This includes senior housing, student accommodation, and co-living. We currently believe that these sectors are likely to benefit from both

are attracting a growing number of international students. At present, much of the stock of purpose-built student accommodation is either ageing or insufficient relative to the demand pool. Similar to senior housing, a specialised operator is needed in this sector to successfully attract students during what is often a short leasing window.

Operational living assets typically record a yield premium compared to traditional residential, reflecting operational and alternative use risk.³ This premium is gradually narrowing as the sector matures, the operator market consolidates, and investment volumes increase as friction in accessing stock lessens. As such, we believe with yields compressing, early movers into these

European population, students and 60+ year-olds, 2022-31



Source: Oxford Economics, DWS, March 2022; UNESCO; September 2021

portfolio contains a high proportion of obsolete offices where the investment case for a refurbishment fails, we would strongly support considering sale, as the risk of obsolescence is only likely to grow.

In the short term, growing construction costs may narrow the pool of markets where a renovation strategy can be successfully executed to only those where it is possible to realise sufficient rental uplift to offset the expected renovation costs. However, in the medium to long term, rising construction costs could also have a dampening effect on future development,⁵ leading to less choice for occupiers and pushing rents higher, strengthening the case for renovation of existing buildings.

Currently, is there the potential for strong returns in European logistics?

We're more cautious about the logistics sector in Europe. There remains plenty of momentum which should sustain outperformance over the coming few years, but for long-term holders we do not believe current pricing reflects the risks for ageing stock and in those locations where supply is less constrained.

Investors looking to increase exposure to this sector should take an increasingly selective approach.⁷ We continue to see value in urban logistics locations. Despite a lower-than-average yield, which may deter cash focused investors. Gaining access is difficult, although the conversion of redundant retail space is becoming more common, but in general a lack of access may prevent many investors from a strategic push.

Similarly, we favour more niche logistics opportunities such as cold storage. Fewer in number and technically more challenging than dry storage, supply constraints and growing demand from sectors such as pharmaceuticals and food offer the potential for rental outperformance of the wider logistics sector. And while the yield premium over

dry storage has lessened in recent years, we think yield convergence will continue as institutional capital recognises the long-term potential of this part of the market.

Should investors be allocating according to SFDR articles?

Regulatory guidance from February of 2022 has been clear that Sustainable Finance Disclosures Regulation (SFDR) articles – a European regulation introduced to improve transparency, should not be construed as product labels, as these are intended as reporting requirements. However during this early phase of adoption many investors have looked to use the articles as an easy guide to assess the level of sustainability a strategy is targeting. We advocate that looking at the underlying ESG or Impact strategy is key. Funds based on transparency pursuant to article 8 of the Regulation (EU) 2019/2088 requirements offer the ability for investors to support strategies such as investing in “brown to green” asset transition and article 9 can benefit investors looking to invest in green buildings from day 1. Both of these investment styles have merits in the quest for decarbonisation and social impact.

Outlined in this article are some of the methods DWS utilises when pursuing real estate strategies aimed at capturing additional investment returns from highly demanded sectors and locations and incorporating a sustainability solution for both investor and consumer.

FOOTNOTE

1 Source: MSCI, DWS, March 2022

2 Source: DWS, Oxford Economics, Broker Sources, February 2022

3 Source: Savills, March 2022

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

5 DWS: April 2022



Case Study: Office Central London

The property is a 6-storey 1950's B-grade office building in London, last refurbished in 2003. Being in a central location close to excellent infrastructure and transport links, as well as local amenities, the asset is well-placed to attract occupiers from the media, telecommunications, technology, and professional services sectors.

The refurbishment aims to reposition the asset to meet the needs of the office occupier in a post-Covid world. The project includes remodelling of the main entrance, including disabled access, creation of roof terrace and various wellness features such as cycling facilities and feature staircase. Further, building HVAC, sanitary and lighting systems will be replaced and upgraded throughout, while retaining existing structures wherever possible.



Key ESG features of renovation project

Certification	Current	Planned
EPC	D	B
BREEAM	None	Outstanding
WELL	None	Gold
WIRED	None	Platinum
CREAM	Stranded	>2031

This case study is for illustrative purposes only and are provided to demonstrate the types of transactions entered into by the team previously. Source: DWS, BREEAM, WELL, WIRED, CRREM, April 2022

Case Study: Cold Storage Logistics Italy

This project comprises two Grade A cold storage logistics assets in Verona, Italy. The assets are strategically located at the intersection between two key highways and within a regionally dominant industrial area near affluent regional cities and towns.

In terms of ESG, the buildings have photovoltaic panels LED lighting, and there's potential for further renewable energy. In addition, the lease agreement includes green clauses.

Cold storage logistics is a sub-sector showing strong growth, driven by the increasing deep frozen food internal consumption rate, the export volumes growth, and the consolidation of the main logistic operators. Assets in this sector are built-to-suit leading to high barriers to entry and have higher development costs than dry storage meaning speculative development is less common. This, in addition to increased complexity of operating them, translates into higher rents and a yield premium over the dry storage warehouses.



This case study is for illustrative purposes only and are provided to demonstrate the types of transactions entered into by the team previously. The approach to incorporating ESG is tailored specifically to different strategies in accordance with client investment objectives and may require different tools to be utilized in consideration of ESG in the investment process.

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