Real Estate Research

February 2023

Global Real Estate Strategic Outlook

First Quarter 2023

IN A NUTSHELL

— Global real estate has entered a period of correction. Valuations lag behind market pricing in most markets.
— European correction looks most advanced and is expected to support outperformance over the coming years.
— Divergence in regional and sector performance renewing the case for global portfolio diversification.

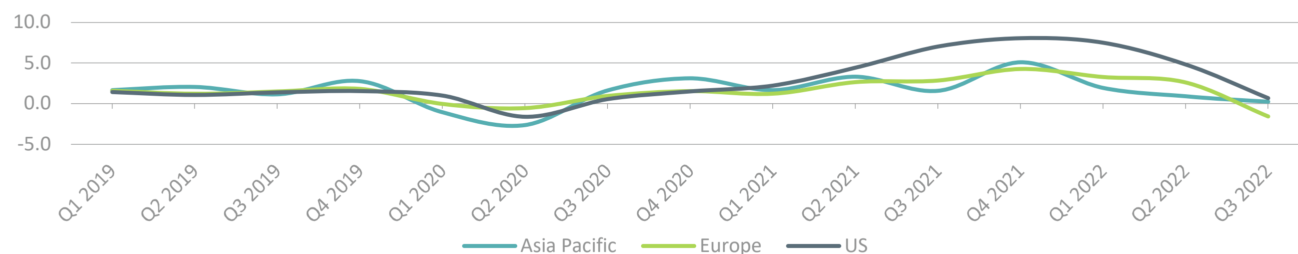
Ongoing market correction laying the foundations for higher returns

Valuation correction gained momentum throughout the final months of 2022

The global real estate market has entered a period of price correction. Having held up well during the first half of 2022, the sector has succumbed to the relentless rise of interest rates. Faced with negative financing yields and the drag of the denominator effect, investors paused, transaction volumes tumbled, and yields increased. Despite exceptionally strong rental growth, by the end of the year, most markets were recording sharply falling prices.

Europe's correction looks most progressed, with the US not far behind. Faced with an energy crisis and recession, sentiment in Europe has been particularly poor, pushing total returns in the third quarter of the year into negative territory[1]. Having held up better, the US also turned sharply negative in the final months of the year.[2] APAC has so far been the outlier, recording little in the way of value correction. In part, the result of robust rental growth in Korea, Australia and Singapore, Japan drove the difference, with stronger performance on the back of prolonged monetary support.

Quarterly Real Estate Total Returns by Region (%)



Source: GREFI, January 2023

[1] INREV, November 2022
[2] NCREIF, January 2023

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1 / Real Estate Outlook

Real estate prices fell sharply during the final part of 2022, and while valuations are continuing to move lower, strong occupier fundamentals and a potential peak in interest rates are laying the foundations for recovery and a period of strong returns.

1.1 Values moving lower but prices may already be nearing a low point in some locations

How far will valuations decline is not an easy question. Across the three regions, our latest forecasts are showing a decline of anywhere between 10-30%, but as ever this varies considerably by location, sector and quality. Given the expected frailty of the global economy, we see secondary assets as the most vulnerable. Not only this but following an almost decade-long period of unbroken price growth, there is a strong possibility that risks have not been fully priced.

Pricing running ahead of valuations

We expect that this period of correction has further to run, but with fewer transactions, appraisers are often struggling to accurately determine the true value. However, when assets do trade, sales prices are normally coming in below book value. As such, while data from valuation appraisals may track lower for some time, in some cases achieved sales prices may already be close to reaching a low point. This is an important distinction. This mismatch between pricing and valuations could weigh on liquidity, sustain the gap between buyer and seller expectations and reduce inflows into established open-ended vehicles, while also increasing demand for both re-priced assets and funds without significant legacy.

Office and the US expected to experience the most significant correction

At the sector level, office looks most vulnerable, with growing evidence from markets such as London and New York that assets are already trading at a considerable discount to six months ago. Retail is also exposed, particularly in Europe. Still high on many investor wishlists, residential and industrial have not been immune to this downturn, and in those places where capital had previously pushed yields to record lows, the price correction in these two sectors has often been brutally swift.

Having held up well, the US market is expected to see significant falls as the consequences of Fed tightening and an expected recession push vales into negative territory. The decline in the US is heavily influenced by a very weak outlook for the office sector.

Our outlook for Europe is less severe and in line with less aggressive monetary tightening and what now seems to be a more benign economic outlook. Our estimate of a peak-to-trough fall in values of around 15-20% is also in line with recent transaction evidence, with growing evidence of prime assets in the most liquid markets receiving bids at this level of pricing.

The outlook for APAC is relatively strong, with a peak-to-trough valuation decline in the region of 10%. This number flatters the region, however, as the strength of Japan masks corrections in Korea and Australia similar in magnitude to that of Europe. We should also not be complacent in the outlook for Japan. While our central scenario assumes the Bank of Japan continues to hold onto its ultra-loose monetary policy, there is a downside risk to this view.

When will valuations reach their low point?

In all three regions, we expect valuations to be at, or very close to, reaching a low point by the end of 2023. There are a few exceptions, most notably US office, where vacancy rates of over 20%[3] are projected to continue to weigh on rents and values into the middle of the decade. Again it is important to stress the lagging effect of valuations. The valuation and performance data reported across indices from

[3] CBRE, January 2023

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NCREIF to INREV, ANREV to MSCI, in the vast majority of cases will be a reflection of transactions started and completed months beforehand.

1.2 Recovery emerging in 2023

Signs of recovery are expected to emerge this year, before gaining momentum through to the middle of the decade. Annual returns during this recovery phase are forecast to rise well above their historical annual average in response to both rental growth and the return of yield compression.

Low vacancy and moderating development pipeline to support an acceleration of rental growth

Nothing lasts forever. Recessions end and prices eventually find their floor. This period will be no different as the combination of repricing, strengthening occupier fundamentals and improved investor confidence come together to support a period of above-average performance.

Globally the occupier market is forecast to be relatively weak throughout 2023 and 2024, recording only modestly positive rent growth in each of these years. However, this is notably more positive than in previous downturns. In all of the last major downturns from the early 90s through to the GFC, global real estate rents have fallen by somewhere between 5-10%, and often for as long as three years.[4]

Peak to Trough Rental Growth During Periods of Economic Stress (%)

Source: DWS, MSCI, NCREIF, PMA, Various Broker Sources, February 2023.

The difference today is both economics and real estate. Unlike the GFC, we do not expect to see a severe economic downturn, with relatively few jobs lost in the process. It's important not to be complacent about this, but on the whole, this outlook should have only a modest drag on demand. More important perhaps is the strength of the occupier market going into this downturn. Unlike Dot.com or the early 90s, the sector has been disciplined, sometimes to the point of restriction, in the development of new stock. Despite hangovers from the pandemic, exceptionally high office vacancy in the US, and ongoing structural challenges in European retail, average global vacancy rates are broadly in line with their historical average, pulled down by exceptionally low availability across the industrial and residential sectors.

The development pipeline has also been reduced. Rising construction costs and reduced development financing, coupled with an uncertain market climate, have forced many to rethink future projects. Add to these several years of pandemic-related disruption and the number of new projects expected to be delivered over the coming years is low.

Economic growth, modest vacancy and a diminished pipeline should support faster rental growth through the middle of the decade. Add to this an expectation that as inflation moderates, central banks loosen policy and investor confidence builds, real estate yields will see a

[4] PMA, NCREIF, JLL, Cushman & Wakefield, CBRE, DWS, January 2023

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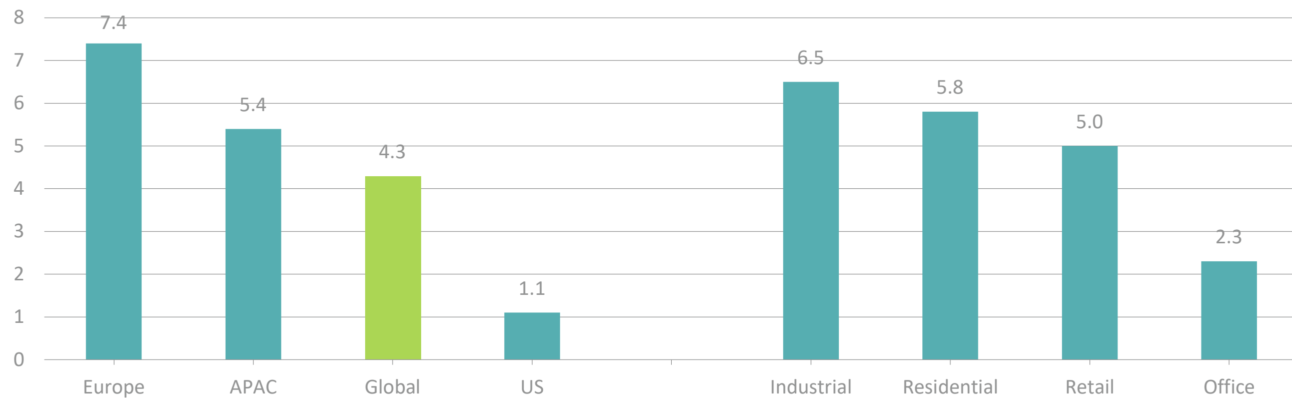
period of modest compression over the coming five years. This upturn in performance is set to occur first in Europe and APAC, with the US economic cycle dragging on rents throughout 2024.

Total return expectations

Annual total returns are forecast to be just 4.3% in the years 2023 to 2027, which would in effect make this one of the weakest five-year periods for global real estate in over twenty years. However, we must remember that this outlook is heavily frontloaded, and influenced by our expectations for US valuations during 2023. Indeed, our short-term outlook for the US pushes the region into third place over these five years, with APAC and in particular, Europe projected to record considerably higher returns. Yet after a period of re-pricing in 2023, US real estate is expected to rebound sharply over the ensuing years.

At the sector level, the outlook is not dissimilar from much of the past decade. Once again industrial and residential top our outlook, with both sectors continuing to benefit from low vacancy and outsized rental growth. However, unlike in previous years, office rather than retail takes last place. Again, this is the result of our outlook for US office, as the sector in Europe and APAC is expected to perform not dissimilar to the regional average.

Real Estate Total Return by Region (% per annum, 2023-27F)



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2 / Investment Strategy

Having been through a period of converging investment strategies, we look to be entering a period of divergence across the three regions. Our outlook on market timing, sector calls and investment strategies are once more showing the attraction of global diversification.

2.1 Global divergence

There is a sense of unease permeating throughout much of the investment community. Whether uncertainty over future valuations, concerns over access to finance or an ongoing lack of liquidity, investor caution is likely to remain for at least the first half of this year. But, as is often the case with these periods of price correction, those that are willing and able, could today gain access to some exceptional investment opportunities.

Region, city and sector returns

Looking at the five largest cities per region, we see European names tending to the top of our hierarchy. Despite ongoing concerns about the national economy, London tops our outlook across all sectors, reflecting in part the speed and depth of the UK real estate correction. Paris also looks well positioned with ongoing supply constraints, while the German cities, having seen a surge in yields during the final part of 2022, may have now seen the bulk of the price correction.

APAC cities are also expected to be some of the top-performing markets. Having been one of the better-performing markets during 2022, we're now relatively cautious about Tokyo. Yields in Japan have continued to fall, while Tokyo office is now set to see a sharp increase in new supply. We're more positive in our outlook for Seoul and the Australian cities, where price correction is already somewhat more advanced. The Korean capital continues to record strong rental growth, with the vacancy in the office sector falling to less than 3%, while in cities such as Melbourne and Sydney, rents look well positioned for a bounceback, following some of the largest falls in net effective rents during the pandemic period.

Almost without exception, US cities sit at the bottom of our hierarchy. However, it's important to remember that we expect much of this correction to have passed before the end of 2023. Indeed, in the four years from 2024, our outlook for the region is one of outperformance over the global average, with the residential and industrial sectors, short of quality stock, forecast to record double-digit returns over this period. This is not the case for office, where vacancy rates of between 15% in New York, and 24% in Dallas are expected to weigh on performance for several years to come.

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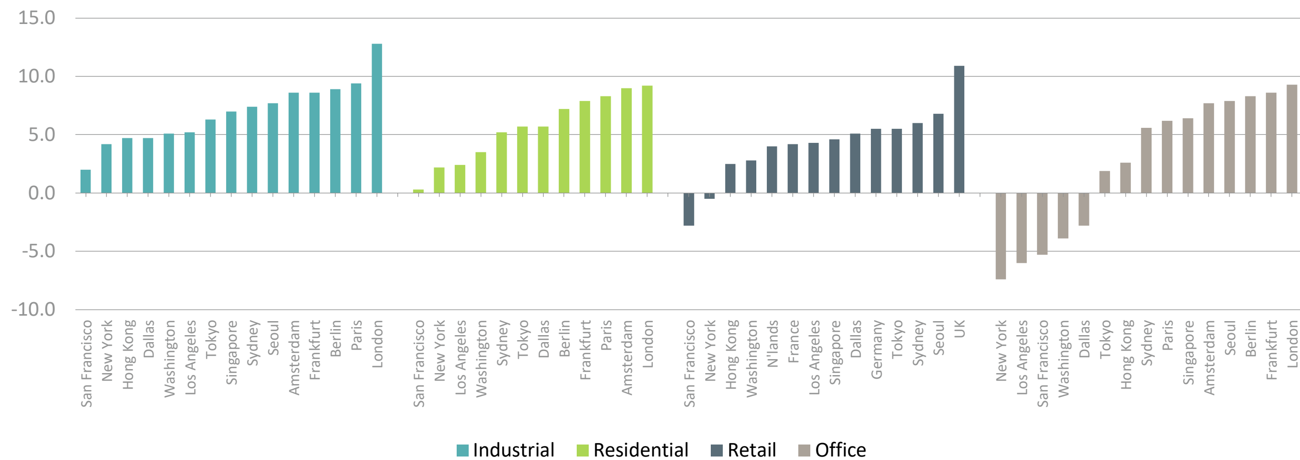
Real Estate Return by City and Sector (% per annum, 2023-27F)



Source: DWS, January 2023

2.2 Occupier fundamentals supporting higher risk strategies

Global real estate market fundamentals are generally in good shape. Vacancy is low and the development pipeline is under control. In previous years this may have tempted more capital to shift into active management and value add, but looking at recent investor intention surveys this is so far not the case. There remains a high degree of caution across the investment community, potentially creating a window of opportunity.

Supply shortages support living sector development

We see a strong case for the development of residential space. At around 4% vacancy in the US and 2% in Europe, there is a clear lack of good quality, affordable stock, with few signs of improvement. The situation may only get worse, as rising mortgage costs push more people into the rental sector. In both regions, we favour well-connected suburban locations for rental housing, with additional space available for periods of remote working. And while we are more cautious about urban locations, in Europe we increasingly favour urban co-living operations, providing young professionals with a ready-made community and additional services such as co-working space. We increasingly favour this sort of operational residential, including student and senior, particularly the development of quality assets in partnership with established operators, who at present may be seeking the support of institutional capital.

Office refurbishment in Europe, and emerging locations in APAC

We have a strong conviction about the need for better European office space. Constrained development, environmental regulations and a push from tenants to take high-quality, low-carbon space, are all expected to culminate in a continued shortage of next-generation office stock. Supported by a growing price differential between the best and the rest, we, therefore, see an opportunity to achieve attractive returns through the refurbishment of older stock – refurbishment rather than newbuild, saving carbon and supporting the growing number of occupiers looking for this type of space. Not appropriate for all locations, we favour this strategy in central locations, within high-productivity cities such as London and Paris, where occupiers are willing and able to pay higher rents, in line with the delivery of best-in-class, environmentally certified space.

We see fewer opportunities to target office in the US, but continue to favour emerging locations in fast-growing cities in the APAC region. Places such as Collingwood in Melbourne or Pangyo in Seoul may see a sustained convergence of rents towards the CBD, as occupiers increasingly favour central but mixed-use locations. Accessing these locations can be difficult, but where developers are looking to sell, we see opportunities to enter at price reflecting the recent market correction.

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Industrial returning as a global investment theme

Finally, the logistics sector is once more a global investment theme. Rarely questioning the drivers of rent growth, in Europe over recent years we had grown concerned over pricing, particularly in less constrained corridor markets. The aggressive repricing of recent months both provided validation to these concerns, but is also now supporting a return to the sector. As shown, the sector is expected to be one of the best performing in all three regions, while strong demand, low vacancy and in some places a lack of modern stock, support investors taking on an active management approach. Delivering new product in large population centres (London, Sydney, New York), rolling out logistics capacity in emerging regional hubs (Bushan, Korea, US Mountain West), and supporting the transformation of Europe's logistics supply chains in CEE markets such as Poland, we see room for outsized returns with relatively low void risk.

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