The Changing World of Real Estate

October 2024

IN A NUTSHELL

- The European real estate market is diversifying in response to global mega-trends, including advancements in data and energy, a focus on health and well-being and the increasing demand for flexible lifestyles.
- Niche sectors, including co-living and senior housing, data centres, self-storage and healthcare, are expected to become a larger part of the investable universe and increasingly integrate into core real estate portfolios.
- Investing in niche real estate sectors at this nascent stage offers the potential for higher returns. As liquidity improves, we anticipate value growth, which could result in outperformance compared to traditional sectors.

The Evolution of Real Estate Portfolios

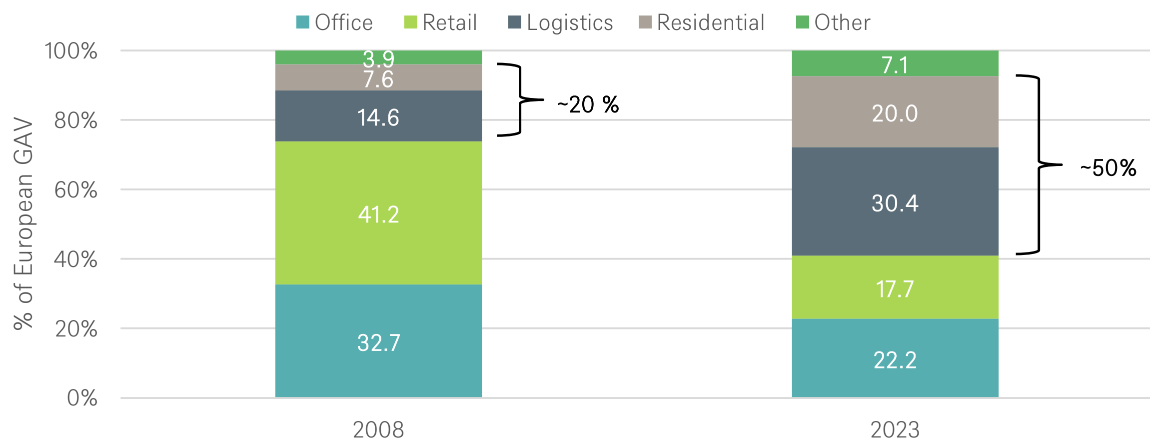
The real estate universe is ever adapting, with the composition of core portfolios constantly changing to reflect wider structural occupier and investor trends. Over the past two decades, a substantial shift in European real estate portfolios and investment activity has been evident. In 2007, for example, the office and retail sectors combined accounted for close to 70% of the annual all-property investment volume, a proportion which has consistently fallen to stand at 43% at end-2023.[1] Similarly, having accounted for over 70% of the MSCI European Property Index in 2008, the office and retail sectors make up just 40% of the index value today (Chart 1).[2] We expect office and retail allocations to continue to decline.

The logistics and residential sectors, by comparison, have recorded significant growth over the same period. Once arguably considered non-core, particularly the residential sector given the lack of institutional product, both are now key components of core real estate portfolios. Indeed, these sectors have grown from 22% of the value of the MSCI European Property Index in 2008, to over 50% today.[2] Furthermore, having accounted for just 15% of annual European real estate investment volumes in 2007, the logistics and residential sectors combined made up 40% of investment volumes in 2023, having peaked at 47% in 2021.[1]

With residential and logistics now an established part of European core real estate portfolios, some investors are looking elsewhere for diversification and higher return potential. With that, we expect niche and alternative sectors, such as data centres, senior housing and life sciences, to likely make up a larger proportion of the private real estate market going forward.

[1] RCA, September 2024
[2] MSCI, September 2024

Chart 1: MSCI European Property Index Capital Value Weight



Source: MSCI, September 2024

Emergence of Niche Real Estate Sectors

In recent years, niche real estate sectors have gained significant traction among institutional investors in Europe. A recent report by PwC and the Urban Land Institute, which aimed to identify emerging trends in European real estate, ranked twenty-six real estate sectors based on their investment and development prospects. Notably, niche and alternative sectors dominated the top ranked, with logistics being the only traditional sector to make the top ten. Leading the rankings were new energy infrastructure, data centres and healthcare, followed closely by operational residential, such as student and senior living, alongside self-storage and life sciences.[3]

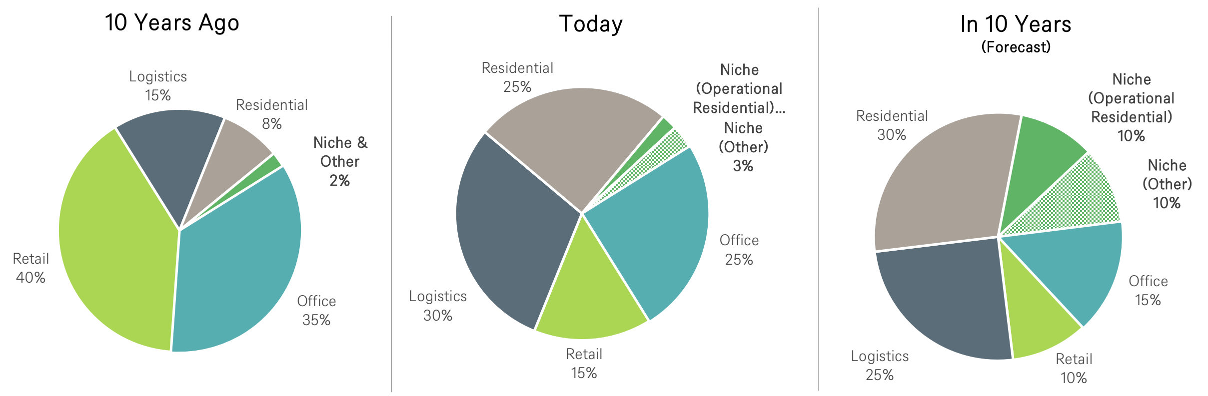
At present, niche real estate sectors remain in the nascent stages in Europe, with investment volumes a fraction of traditional core real estate and mostly falling below €10 billion per annum, compared to €110 billion for offices and over €50 billion for each residential, logistics and retail.[4] That said, growth prospects are strong. For example, we believe the Purpose-Build Student Accommodation (PBSA) sector in the UK is on the verge of transitioning from a niche category. Over the last decade, investment into this sector has increased significantly, with annual investment volumes growing from a yearly average of around £4.1 billion in the five years before the pandemic (2015-2019) to peak at £8.6 billion in 2022.[4]

Another forward-looking indicator is the public market. Analysing the FTSE NAREIT U.S. Real Estate Index, niche sectors like data centres, cell towers and self-storage accounted for less than 15% of the total market capitalisation ten years ago – today these sectors represent nearly 30% of the index (Chart 2).[5] In Europe, whilst not as diversified as in the US, the niche sectors have also seen considerable gains and currently makeup 11% of the European Listed Real Estate market, representing a total market capitalisation value of €27 billion, up from €7 billion 10 years ago.[6] Looking forward, EPRA is forecasting the niche and alternative sectors are expected grow by a CAGR of 16% over the next ten years, to reach 26% of the EPRA Index by 2034.

[3] Emerging Trends in Real Estate®: Europe 2024, PWC and Urban Land Institute, November 2023
[4] RCA, September 2024
[5] NAREIT, July 2024
[6] EPRA, July 2024

The public market would likely continue to have a higher share of alternative and niche sectors compared to the private market, but we still believe these sectors could become part of core private real estate portfolios in five-to-ten years' time given the compelling structural drivers. Ultimately, we expect niche sectors could make up around 20% of the European Private Real Estate universe by 2034, up from around 5% today. (Chart 2).[7]

Chart 2: Size of the Alternative Sector in Europe (% of total)



Source: DWS, NAREIT, NCREIF, EPRA, September 2024

Megatrend Investing

As real estate investors, it is important to adapt to structural and cyclical changes. Trend-focused investment strategies should ensure real estate investments are sustainable and future-proofed. We believe there are currently three key megatrends that are driving, and are expected to continue to support, the growth of niche real estate sectors. They are:

Data & Energy

Technological advancement and energy transition

Health and Well-Being

Demographic changes and post-pandemic priorities

Flexible Lifestyles

Next-gen living and experience economy

Data & Energy

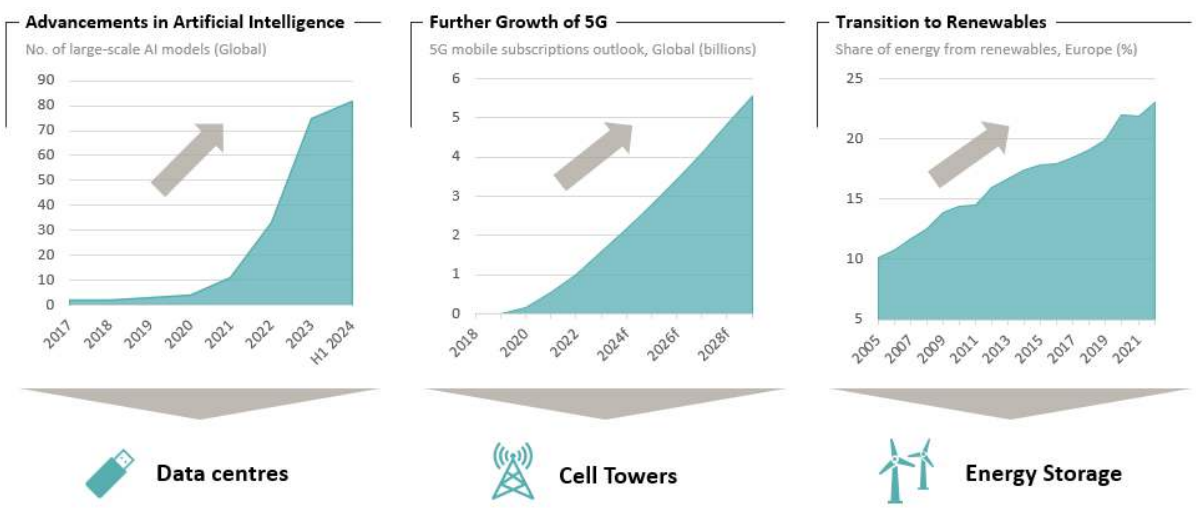
Advancements in artificial intelligence (AI) are rapidly emerging as a recurring theme within real estate discussions. In particular, the strong growth trajectory of AI has refocused occupier and investor interest in the data centre market. As the sector gains traction among traditional real estate investors, we anticipate the European data centre market to grow at a compound annual growth rate (CAGR) exceeding 10% over the next five years.[8] Given exceptionally strong demand and notable supply constraints, particularly with regards to energy and water, the data centre sector is in a strong position. However, it is still in its infancy and with obsolescence and liquidity presenting clear risks, developing a deep operational understanding is critical.

[7] NCREIF, DWS, September 2024
[8] DWS, Green Street, August 2024

Also, within the realm of technological advancements, since its rollout in 2019, 5G subscriptions have experienced remarkable growth, a trend expected to continue over the next decade. Ericsson forecasts 5.6 billion 5G subscriptions globally by 2029, representing a CAGR of 23%.[9] In order to service this demand, substantial investment in 5G infrastructure and real estate is crucial. With that in mind, we see strong structural demand drivers behind cell towers. European cell tower supply is currently well below demand, which should support robust rental growth. However, the sector presents several complexities. Traditionally viewed as an infrastructure asset, or at the very least associated with the listed real estate market, private real estate investment in this sector remains in its early stages. While there have been a handful of large portfolio sales, the sector is still highly fragmented and predominantly controlled by owner-occupier mobile network operators.

Energy transition and decarbonisation are prominent themes on the radar of today's real estate investors, whether through asset management of existing stock or future strategic investments. While renewable energy installations, like solar farms and wind turbines, are typically categorised under infrastructure, the storage of renewable energy is an important consideration from a real estate perspective. Industrial outdoor storage (IOS) solutions are also crucial for accommodating the large-scale equipment needed for renewable energy storage. Consequently, we anticipate significant growth in battery energy storage systems (BESS) and IOS within the real estate investment universe in the coming years. At present, the European BESS market is small and fragmented, albeit future scalability looks strong, and barriers to entry are arguably high, reducing the likelihood of oversupply.

Data & Energy Real Estate: Structural Drivers



Source: Epoch, Ericsson, Eurostat, September 2024

Health & Well-Being

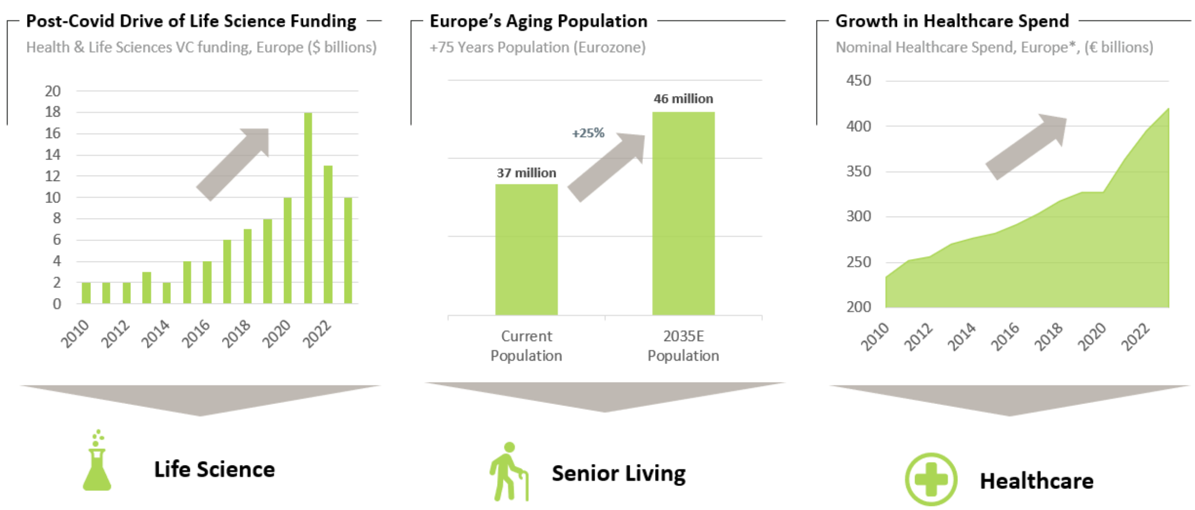
An upward trend in venture capital funding for the biotech, pharmaceutical and healthcare sectors has been evident for the last decade. However, investment surged as a result of the COVID-19 pandemic, leading to significant growth in life science real estate demand. Investors have been drawn to the sector by supportive fundamentals, attractive entry pricing and a desire to diversify away from the challenged office sector. More recently, venture capital funding has slowed, hindered by broader macro-economic weakness and an over-development and double-digit vacancy rates are adversely affecting some markets in the United States, particularly Boston.[10] Currently, however, despite a notable increase in development, supply in Europe's main life science clusters - such as Oxford and Cambridge in the United Kingdom or Leiden in the Netherlands - remains constrained.

[9] Ericsson, June 2024
[10] Green Street, August 2024

Europe's population is ageing. By 2035, the population of over 75-year-olds is expected to grow by 25%, to reach 46 million.[11] This has clear implications for Europe's housing and underscores the strong structural drivers behind senior living assets. Currently, the sector is dominated by care and nursing homes, but the senior living market – including independent and assisted living – is expected to grow strongly over the next decade, supported by a wealthier elderly generation. In addition, the stock of assisted living units relative to the elderly population – also known as the penetration rate – currently remains well below more mature markets such as the United States and Australia. We believe the assisted living sector could be a natural expansion for institutional investors with existing residential exposure.

Europe's ageing population not only requires more suitable living arrangements, but also has increased healthcare needs that must be addressed. The current state of public healthcare in Europe is inadequate to meet these demands, with waiting times at or near record highs and healthcare real estate often outdated. This presents clear opportunities for investment in healthcare facilities, including medical offices, primary care facilities, outpatient centres and specialist clinics. In addition, the COVID-19 pandemic re-enforced the prioritisation of physical and mental well-being, leading to a more health-conscious population that is dedicating more time and resources to their health. Consequently, both public and private healthcare spending has been on the rise.[12] Although rent growth potential may not match that of other niche real estate sectors, healthcare real estate offers stable and resilient income, typically resilient to economic fluctuations.

Health & Well-Being Real Estate: Structural Drivers



*France, Germany, UK, Spain, Italy Netherlands, Poland
Source: DealRoom, Oxford Economics, July 2024

Flexible Lifestyles

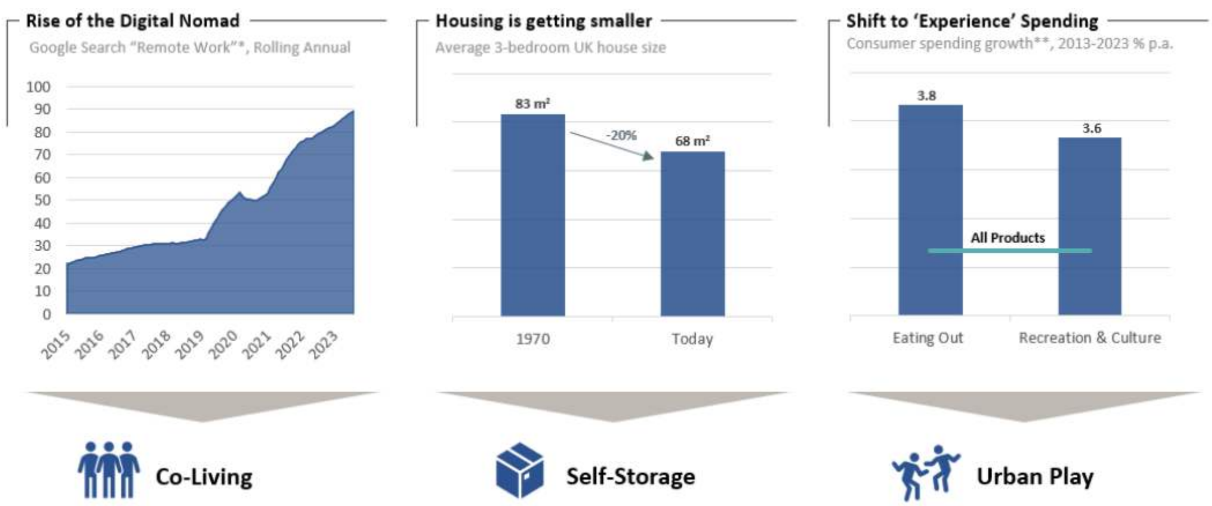
The Covid-19 pandemic significantly transformed work patterns and remote and hybrid working is now commonplace across Europe. Building on this trend, an increasing number of professionals, particularly within the ever-growing tech sector, are adopting a 'Digital Nomad' lifestyle. This shift has driven increased demand for flexible living arrangements, particularly co-living residential schemes with shorter, more adaptable leases. With housing shortages in many European cities, we believe there is substantial rent growth potential, especially in dynamic and vibrant cities popular with students and young professionals, such as London, Berlin and Copenhagen. However, it is crucial to thoroughly understand and account for regulatory complexities.

[11] Oxford Economics, August 2024
[12] Eurostat, September 2024

As younger populations seek more flexible lifestyles, opting for professionally managed build-to-rent schemes, household unit sizes are shrinking. This trend is one of the driving factors behind a rise in self-storage use across Europe. That said, Europe remains well behind the United States with regards to utilisation rates and we believe European markets should benefit from significant growth potential. Institutional real estate investors are becoming increasingly aware of self-storage, however, the sector remains in its infancy and institutional product is limited, fragmented and typically comprised of small a lot sizes. In addition, self-storage is arguably more exposed to economic volatility and carries a higher risk.

Younger generations' preference for flexible lifestyles is driving a shift towards micro-living solutions, resulting in more leisure time spent outside the home. Europe's experience economy is on the rise, with consumers increasingly spending on services like dining out, sports, music events and entertainment, rather than tangible goods. We term this trend 'Urban Play'. Encompassing urban entertainment facilities such as stadiums, arenas, food halls, cinemas, and social games venues. We see significant investment opportunities in developing a portfolio of 'Urban Play' assets in key European city centres. However, challenges include the varying quality of existing stock and the difficulty of undertaking a piecemeal approach due to smaller lot sizes.

Flexible Lifestyles Real Estate: Structural Drivers



*Numbers represent search interest relative to the highest point globally. A value of 100 is the peak popularity for the term..
**Germany, France, Netherlands Spain, Italy
Source: Google, Rightmove, Zoopla, Oxford Economics, September 2024

Niche Real Estate Strategy

As indicated, we anticipate that niche sectors would constitute an increasingly significant proportion of the institutional real estate universe in the coming years, potentially comprising up to 20% of core portfolios over the next decade. Consequently, we believe it will be beneficial for existing diversified funds to integrate niche and emerging sectors into portfolios. Alongside diversification benefits, given the nascent stage of these sectors in Europe, early market entry is anticipated to yield higher returns. Improving liquidity should drive value growth, potentially leading to outperformance relative to traditional real estate sectors.

To identify the optimal investment strategy, we have conducted a comprehensive analysis of each of the nine niche real estate sectors identified within this report. Our evaluation encompassed the market opportunity, such as market size, scalability potential and prevailing market fundamentals. Additionally, in order to assess the investment opportunity, we considered the accessibility of products, potential risks and anticipated returns.

Based on our analysis, we support targeting the operational residential sectors, specifically senior and co-living, which we believe are poised to benefit from demographic and societal trends. The scalability of these sectors is robust, supported by favourable market fundamentals that indicate strong rent growth potential. Additionally, the expertise and knowledge acquired through traditional multi-family investments can be effectively leveraged. For optimal market entry into both senior and co-living sectors, we advise partnering with reputable operators and forward funding new developments.

We also support investing in the data centre sector, which is underpinned by strong fundamentals and significant growth potential. Despite the anticipated high level of competition, in our view the sector offers promising return expectations, well above traditional core real estate. Our strategy would likely target powered shells, which involve securing long leases with single tenants, with market entry facilitated through build-to-suit developments or sale and leaseback agreements.

Finally, European healthcare, in our view, presents a compelling investment opportunity. Favourable demographic trends and a shortage of modern, purpose-built medical facilities underpin the sector's potential. Moreover, healthcare real estate often features long-term leases with reliable tenants, frequently backed by government entities, ensuring stable income streams. Investors can gain exposure to healthcare through the acquisition of existing portfolios, which may require capex, or through development.

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