Marketing Material*

April 2020 / Research Report

COVID-19 SPECIAL EDIT: EUROPE REAL ESTATE STRATEGIC OUTLOOK

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1 / Executive Summary

It's been only four months since we released our previous Strategic Outlook. However, the message in this new report could not be more different. As we entered 2020, the outlook for European real estate was one of positivity, with another year of strong returns foreseen. We remained conscious that the cycle had run on long, and that pricing in some parts of the market had become aggressive; nevertheless, jobs were being created, vacancy was low and monetary policy was ever more supportive.

And here we are today. The Covid-19 crisis has the potential to be one of the most significant economic events in our lifetime. Looking back over history it is difficult to find examples where economic activity has fallen so far over such a short period of time. No matter which country we look at, we expect a sharp rise in unemployment.

We also expect significant rental decline across markets and sectors in 2020. However, the rate of decline is still forecast to be less severe than the financial crisis. The occupier market is in better shape going into this recession. On average we forecast prime office rents to fall by 6% in 2020, logistics by 5% and residential by 4%. The exception here is retail; already facing strong headwinds, we predict that prime European shopping centre rents will fall by around 12% this year.

Prime capital values are forecast to fall by around 10% to 20% this year. Logistics and residential sit at the bottom end of this range, with offices and shopping centres more exposed to a major price correction. However, these sector averages also mask huge differences across cities and assets.

Over the coming year, we expect defensive strategies to outperform the wider real estate market. Long incomes, strong tenants, core locations and low leverage should all help to support performance. During this crisis every effort should be made to sustain income and value, but for most investors it's now too late to substantially reposition portfolios until the crisis recedes. However, we should already be preparing for life after the crisis. Pricing adjustments may create cyclical opportunities, and the acceleration of long-term structural trends suggests a repositioning of core balanced funds.

Ahead of this crisis we were extremely negative on the outlook for the retail sector. This has not changed. Office may suffer from steep falls in value and reduced demand from businesses over the longer term, but should still offer attractive opportunities during the recovery phase. We expect logistics and residential to be the main winners from this crisis. Both look more resilient to the downturn and are well positioned to gain from accelerating structural drivers. We believe, therefore, that both are set to become an increasingly large part of the European investable universe.

EUROPE REAL ESTATE SUMMARY:

Occupier Market	**Income at risk**. Falling collection rates and rising voids. Rent decline in all sectors during 2020. Resi and logistics most resilient.
	Prime rent growth from 2021 onwards supported by resumption of economic activity and limited supply pipeline.
	Logistics benefitting from sustained increase in demand, with more ecommerce, larger inventories and reshoring of production.
Investment Market	**Investor demand to fall sharply.** Despite high dry power, buyers and sellers likely to adopt a wait and see approach in 2020.
	Prime yields rising. Low liquidity and increased income risk to push prime yields higher in 2020.
	Yield compression in 2021 as uncertainties subside and in anticipation of occupier recovery. Yields may be lower for longer.
Investment Strategy	**Core portfolios and those overweight in logistics and residential** expected to outperform the market during the crisis.
	Office and hotel to offer significant tactical opportunities to benefit from the cyclical recovery phase.
	Portfolio balance shifting away from retail, with logistics and residential becoming much larger parts of the investable universe.

Source: DWS, January 2020. No assurance can be given that any forecast will materialise.
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.

2 / Real Estate Performance

2.1 Occupier Fundamentals

The Covid-19 crisis has the potential to be one of the most significant economic events in our lifetime. Looking back over history it is difficult to find examples where economic activity has fallen so far over such a short period of time. The real estate industry is not immune, and is often on the front line. Shops are shut and offices are empty. The ongoing impact of this crisis will likely be felt well into the decade.

However, we shouldn't view all real estate through the same lens. To date, the impact of Covid-19 has been far from uniform across Europe. While it would be wrong to speculate on the final cost to human life, some economies do appear to be more vulnerable. We believe core markets such as Germany and the Nordics look better placed to weather the storm, as lower debt provides governments with the room to support businesses and sustain employment. This is far less the case for Italy.

No matter which country we look at, we expect a sharp rise in unemployment, something already witnessed in those countries with the fewest labour market restrictions. Many governments are implementing measures to furlough employees, helping to limit extreme swings in unemployment from the temporary closure of businesses. But it seems improbable that we will not see significant job losses in all countries.

Importantly for our consideration of real estate, job losses have so far been concentrated in the retail, travel and hospitality sectors. We have seen manufacturing halted and office-based businesses furloughing employees, but so far this has been relatively minor compared to the widespread closure of shops, restaurants, bars and hotels. However, we shouldn't be complacent about the other sectors. The longer this recession goes on, the greater the likelihood that second round effects will lead to a widening impact on the economy and jobs.

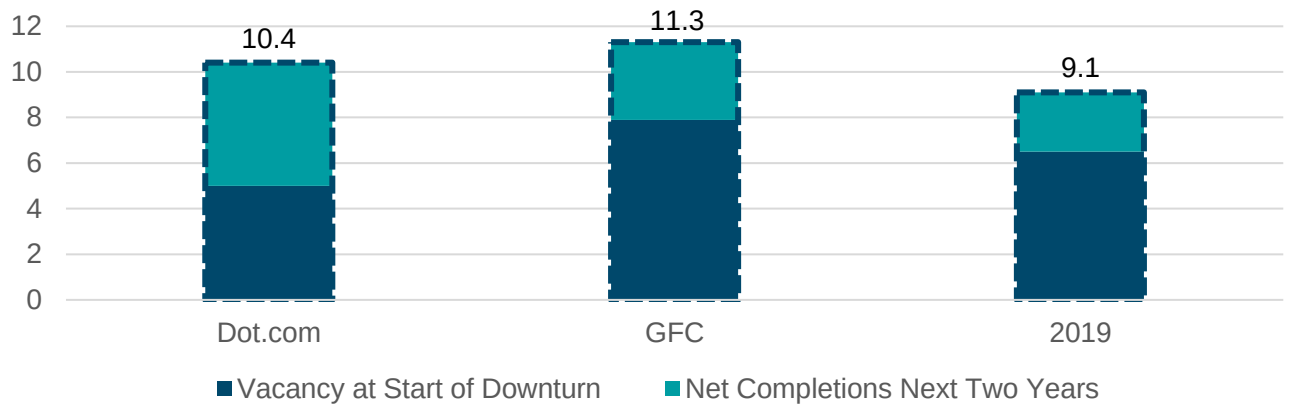
So far we have limited data to assess the impact of the crisis on real estate occupiers. The first quarter data released in April does not yet capture the full extent of the market adjustment. Vacancy rates have so far recorded little or no change.[1] We've seen relatively few business failures and it will take time for leases to become void.

Income has been at risk and rent collection rates are likely to have fallen across much of Europe. According to a survey by Remit Consulting, rent collection at the start of April was less than 60% in the United Kingdom, down from 90% in 2019. Office and industrial occupiers were the most likely to have paid, with retail and residential tenants paying less than half the amount owed.[2] We would expect this pattern to be repeated (to varying degrees) in other European countries – apart from residential, where we've been recording very high levels of rent collection.

We expect significant rental decline across markets and sectors in 2020. However, the total fall is forecast to be less severe than the financial crisis. The occupier market is in better shape going into this recession. Average office vacancy across Europe's major cities was just 6.5% at the start of this year, 150 basis points lower than in early 2008. Furthermore, the outlook for the development pipeline is more favourable – we expect net completions over the next two years to be 25% lower compared to the GFC.[3]

[1] JLL, April 2020
[2] Remit Consulting, April 2020
[3] DWS, PMA, April 2020
Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

EUROPEAN OFFICE VACANCY RATE (%)



Source: DWS, PMA, April 2020

The exception here is retail. Already facing strong headwinds, the closure of shops and the acceleration of online sales further weakens the outlook. We predict that prime European shopping centre rents will fall by around 12% this year.

We anticipate the other sectors to be more resilient but none will be immune. On average we expect prime office rents to fall by 6%, logistics by 5% and residential by 4% this year.

These averages mask significant differences across cities and assets though. Within the office sector we expect to see above-average rental declines in London and Dublin. Both cities have historically been more volatile, while we were already concerned about the supply pipeline and rental affordability in Dublin. In contrast, markets such as Berlin, Munich and the Paris CBD may be more insulated given exceptionally low levels of vacancy.

We see a more positive trend for the logistics sector, and early evidence of tenant demand has been encouraging. That said, with lower retail sales and major disruptions to trade and manufacturing, we are still forecasting a short-term dip in rents. The only exception to this is the urban logistics sector. With surging demand for home delivery, we expect urban stock in big cities such as London and Paris to continue to record positive growth this year.

Residential is forecast to see the smallest rent reduction, with the likes of Munich and Amsterdam looking most resilient. Going into this, many cities were suffering acute supply-demand imbalances, and our experience on the ground suggests that demand is being sustained. Lower disposable incomes and rising unemployment may create some stress, but on balance, reduced mortgage lending and low consumer confidence should help to sustain demand for rentals.

How long the recession will last is an important question. We shouldn't underestimate the length of any recession, and it is likely that the effect of Covid-19 will be felt for some time. However, it is encouraging to see the uptick in economic activity in China and the falling number of new Covid-19 cases across Europe and the United States. Indeed, when we look back through history, event-driven recessions like this tend to be shorter and have less of a lasting impact than financial crises.

Our forecasts are based on the view that economic activity picks up sharply in 2021. And while it may take longer to fully recover lost economic output, this suggests rents may stabilise next year. Indeed, with likely curbs to development, the period heading into the middle of the decade is forecast to see sustained annual rental growth at around 3%. Again the exception is shopping centres, where despite the economic recovery, we see no rental growth in the coming five years.

Important for the real estate market is the outlook for inflation. This year price growth is set to fall sharply in response to lower activity, wages and oil prices. However, over the medium term there is certainly a chance that inflation overshoots target, as a recovery in demand – aided by exceptional monetary and fiscal stimulus – meets continued economic supply-side restrictions. Typically this outcome is positive for real estate income growth, particularly for assets with indexed leases.

Finally, we should consider the long-term impacts on the occupier market. From home working to shop closures, surging online deliveries to standing in queues outside grocery stores, this crisis is already proving to be a huge experiment in the way we interact with real estate. It's highly likely that some of these new habits will stick, influencing occupier demand.

Across the sectors, we expect that on average, demand for office, retail and hotels will, to varying degrees, see a sustained negative impact from these changing trends, while logistics and residential should gain. Indeed, many of these trends were already underway, with recent disruption acting as a catalyst.

Nevertheless, it is important that we don't over simplify or exaggerate these impacts. It would be easy to conclude that an average increase of one to two days working from home could reduce office demand by 20% to 40%, but is that realistic? We have to question whether regulators and employees will tolerate reduced office space per worker. And furthermore, with the ongoing competition for talent, and innovative tech companies showing the value of collaborative and inspiring office space, we need to be careful about underestimating the importance of the office.

Another example would be the hotel sector. While it's easy to see why current disruption to travel and increased usage of video conferencing may reduce demand for travel, we think the negative impact will be focused on business hotels. Looking back over previous periods of disruptions, such as 9/11, the financial crisis and SARS, this has not had a permanent impact on tourist arrivals; indeed these events present as a small blip on a sustained upward trend.

2.2 Capital Markets

While the full effects of the Covid-19 outbreak could take a considerable time to become fully apparent in the real estate investment market, there is already some evidence of a significant slowdown in investment activity. Looking at provisional figures for the first quarter of 2020 shows a year-on-year fall of just 7% in all property volumes; however, given that the full extent of the outbreak and measures to contain it were not fully known until towards the end of the quarter, this doesn't tell the whole story.

Higher-frequency data is typically more volatile and should be interpreted with caution, but a glance at the most recent figures begins to suggest a weaker trend. Provisional volumes for the month of March were down by more than 10% year-on-year – still not a huge drop. But in the month from mid-March to mid-April, the number of confirmed deals (including portfolios) was down by around two thirds from the same period a year ago. The final data might reveal a smaller fall than this, but is nonetheless likely to show a precipitous drop in market activity.[4]

In the direct real estate market, there has so far been relatively little hard data to suggest the extent of any value adjustment that might result from the current market situation. Yet the listed market has already seen a significant correction. Between mid-February and mid-March, the FTSE EPRA/NAREIT developed Europe Index lost more than 40% of its value. And within this decline there were clear signs of which sectors the market expects to be hit hardest. Residential (-33%) and industrial (-36%) were the best performing sectors over this period, with offices (-46%) lagging behind and retail (-56%) bringing up the rear. Since then, all sectors have begun to recover some lost ground, but again there are large differences by sector, with residential and industrial down by a total of less than 20% since the peak, and retail still down by a total of more than 50%.[5]

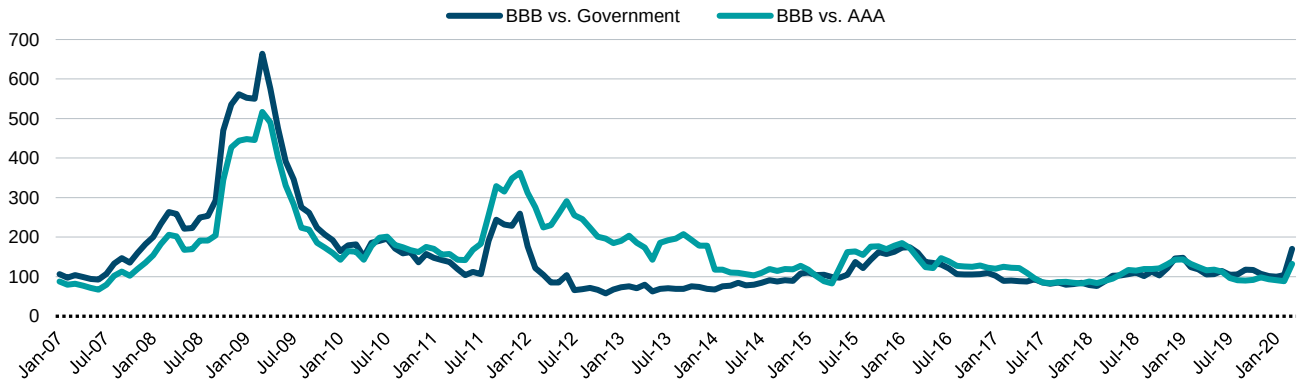
[4] RCA, April 2020
[5] Macrobond, April 2020
Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect. Past performance is not a reliable indicator of future returns.

In the retail sector, listed companies are expressing concerns that with a large proportion of centres remaining closed across the continent, a protracted decline in retail sales could mean that tenant solvency – and therefore the ability for landlords to collect rents – is compromised. A similar situation exists in the hotel sector, where operators have suffered a dramatic fall in revenues.[6]

Europe's governments and central banks have responded with a range of measures to help businesses and individuals through the current economic shock and ensure a functioning financial system. Responses have so far been varied and rather uncoordinated, with some countries adopting much more stringent measures than others. Taking a range of response factors into account – including fiscal, monetary, social and medical – countries such as Spain, Italy and France have adopted a more severe set of responses, while Germany and the United Kingdom have been less strict in their adopted measures.[7] Central banks have offered significant support through asset purchase programmes, with the Bank of England aiming to buy an extra £200 billion of government and corporate bonds and reducing the UK policy rate from 0.75% to an all-time low of 0.1% within the space of a week. The European Central Bank also aims to buy an additional €750 billion of bonds, although has so far left interest rates unchanged at 0%.

In line with a sharp drop in risk appetite among investors, equity and commodity prices have taken a sizeable hit since the beginning of the crisis in March. However, while markets have rapidly repriced, the peak-to-trough correction in Euro Area equities has been shallower compared to the GFC, and markets have already recovered around a third of their initial losses.[8] What's more, a look at spreads in the bond market would suggest that so far, a much lower level of risk is being priced into the corporate sector this time round.

EURO AREA 10-YEAR BOND YIELD SPREADS (BPS)



Source: Macrobond, April 2020. Past performance is not a reliable indicator of future returns.

And at the same time, government bond yields have, on average, remained exceptionally low, despite some volatility. Partly, this could be down to investors switching to more secure investments. But central banks have also been pumping money into the economy, supporting bond prices and supressing yields.

The near-term outlook for inflation is also very weak. Along with low oil prices, which will filter through into the economy in the coming months, weaker consumer demand is likely to pull prices down. Beyond the short term though, oil prices are likely to increase. And with governments spending huge amounts to keep unemployment down, in many cases people will have built up additional savings, meaning consumer spending is forecast to rise fairly rapidly once social restrictions are eased. Usually, this would mean that bond yields begin to come under upward pressure as CPI grows. However, with central banks beginning

[6] S&P, March 2020
[7] University of Oxford / Blavatnik School of Government, April 2020
[8] Macrobond, Stoxx 50 Index, April 2020
Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

to switch their focus from inflation targeting to yield curve control, this could mean that long-term government bond yields remain low for an extended period.

In the short term, there could be competing forces at play when it comes to real estate pricing. On one hand, there is an expectation that government bond yields may fall even further, making property look more attractive in relative terms. However, on the other hand there is also an expectation that rents will decline this year – in some cases sharply – and investment liquidity is also likely to be severely impaired. At the same time, there is likely to be a temporary reduction in the availability of new lending, with banks focusing on lending to longstanding clients and some alternative sources of debt reducing or pausing lending activity.

With this in mind, we have adjusted our outlook for property yields, both in the short term and the longer term. While we don't foresee anything like the same number of forced sales that we saw during the GFC, there is still likely to be a liquidity squeeze. So far, there has already been some gating among European open-ended funds, particularly in the UK. And if there is a further rapid decline in investor sentiment, we could see an increasing number of blocks on redemptions, which may go some way to preventing a mass fire sale of assets within this section of the market.

However, we would still expect a sharp drop in liquidity to push property yields out slightly this year. For logistics and residential assets, we expect relatively little outward movement. Some urban logistics properties may even see yields continue to tick downwards. Conversely, we expect to see more significant outward movement for offices, with yields increasing by 25-50 basis points on average. And for retail, where we were already seeing yields moving out before the Covid-19 pandemic, we would expect to see the largest impact, with yields on prime shopping centres increasing by close to 100 basis points this year, although the rise could be even greater for secondary assets.

The spread of lending terms between certain property types is also likely to grow. Compared to offices and logistics, where the cost of borrowing has been relatively stable recently, margins on senior loans for retail property were already beginning to rise before the current crisis, and we might expect to see a significant further widening of this gap now.

Nevertheless, when the economy begins to normalise and rents return to growth, we expect most sectors to look more attractive in relative terms. With this in mind, our longer-term forecasts for property yields have mostly been revised downwards to reflect our expectation of lower government bond yields over the next five years. This means that despite a short-term rise, we expect yields for offices, logistics and private rented residential to end up lower by 2024 compared to our previous forecast. Retail is once again the outlier here, and while we do expect some degree of normalisation over time, we do feel that retail yields are unlikely to compress to the same extent as the other sectors given the unfavourable occupier outlook.

2.3 Returns

At this early stage of proceedings, there is relatively little evidence of a value correction to date. With such a sharp drop in investment activity, valuers are unlikely to make any significant write-downs without at least some transactional evidence. Nevertheless, we do expect to see values decline across almost all parts of the market this year as the situation becomes clearer. During the GFC, prime capital values fell by around a quarter on average, with relatively little difference in scale between the sectors. This time, we expect the fall in values to be somewhat shallower overall. And we would also expect the nature of the current downturn to lead to some significant variation in performance by sector.

In our previous forecast, logistics was the top performer, and this hasn't changed. Online sales has been one of the few parts of the economy to fare relatively well during the lockdowns that have been implemented in many countries. And while not all parts of the logistics market are strongly linked to online retail, there are some in particular that we expect to do well this year and beyond. With a predicted prime total return of around 7% per annum over the next five years, the European big box logistics market is still one of the best performing segments, although it's the urban logistics market where we expect to see the best returns. Even this year, we are forecasting prime total returns for urban logistics properties to remain comfortably positive, and over a five year period we expect this type of asset to outperform the wider logistics market. Geographically, we expect Germany and the UK to do well, buoyed by a larger share of online sales.

At the other end of the scale, we have further reduced our outlook for European retail performance. On average, we now expect prime shopping centres returns of close to -20% this year and just +1% per annum over five years, a full percentage point lower than our previous forecast. Germany and France – where online sales rates are already quite advanced – are forecast to be among the worst performers. The United Kingdom, where online sales are already at approximately 20% of total retail sales, has already seen yields move out much further than any other market. And while we fully expect further pain in the short term, we also see potential for the U.K. market to find a floor sooner than elsewhere, particularly for the very best centres.

Our total return forecasts for the office and residential sectors are broadly unchanged on a five-year average basis. In the office sector, we still believe the U.K. market should be an outperformer, although this is predicated on achieving an orderly exit from the European Union – something that now looks increasingly likely to be delayed beyond the end of 2020 given the abrupt halt to discussions as the pandemic has taken hold. Spain and Italy are likely to take an outsized hit in the short term, although we feel the Spanish markets have greater potential for a swift recovery.

The German markets could also be among the main beneficiaries of the revised economic outlook; with the 10-year Bund yield predicted to remain negative for the next couple of years, the major German cities could look especially attractive on a relative basis, despite property yields already being at record lows.

However, while we were previously forecasting returns to be more front loaded, reflecting a continuation – but gradual fading – of recent momentum, we now expect a significantly negative return this year, followed by several years of stronger performance. In this light, current conditions represent a challenging environment in which to invest. From a practical point of view, ongoing deals are still getting pushed through but it is harder to initiate new deals in the current environment. And from a strategic perspective, investors are likely to weigh up the risk of significant near-term value decline. However, with the possibility of a strong recovery in performance from next year, investment timing will be crucial.

PRIME TOTAL RETURNS BY SECTOR (2020-24F, %)

Source: DWS, December 2019
Notes: f = forecast. Core Europe = Germany, France, Benelux, Nordics, Austria & Switzerland; Periphery = Iberia, Italy, Greece & Ireland; CE = Czech Republic, Hungary & Poland. There is no guarantee the forecast shown will materialise. As such, the performance and forecast shown represent hypothetical and simulated performance, which has many inherent limitations. One of the limitations of hypothetical performance results is that they are generally prepared with the benefit of hindsight. In addition, hypothetical trading does not involve financial risk, and no hypothetical trading record can completely account for the impact of financial risk in actual trading. No assurance is made that forecast returns will be achieved.

2.4 Strategic Implications

During this crisis every effort should be made to sustain income and value, but for most investors it's now too late to substantially reposition portfolios until the crisis recedes. However, we should already be preparing for life after the crisis. Pricing adjustments create cyclical opportunities, and the acceleration of long-term structural trends suggests a repositioning of core balanced funds.

Over the coming year, defensive strategies will likely outperform the wider real estate market. Long incomes, strong tenants, core locations and low leverage should all help to support performance. Indeed, at this juncture we expect that those core funds that went in search of yield, ignoring warnings of style drift, will be shown to be lacking.

For some, this year and next will provide an opening for opportunistic investment, although with relatively low leverage and support from the banking sector, we see limited distress. As the market resumes growth and with development activity likely to be curtailed for some time, this may also open up opportunities for value add; however, perhaps not for a few years.

Overall we expect logistics and residential will be the main winners from this crisis. Both look more resilient to the downturn and well positioned to gain from accelerating structural drivers. Both are therefore set to become an increasingly large part of the European investable universe.

For logistics, we believe not only is this sector set to be well positioned in the face Covid-19, we see the virus accelerating online sales growth, boosting inventories and encouraging the reshoring of manufacturing. Logistics looks well placed throughout the coming decade, with urban logistics best placed of all to gain from these trends.

We believe residential is still a relatively niche sector across much of Europe, but this recession may once again highlight the stabilising effect of increasing portfolio allocations to the sector. We continue to favour the more affordable, mass market part of the market, and believe this crisis could accelerate the push towards well connected, suburban schemes.

Office may suffer from steep falls in value this year and reduced demand from businesses over the longer-term, but could still offer attractive opportunities during the recovery phase. Re-pricing of prime stock in the likes of London and Paris may open up these markets to core investors, while we continue to be supportive of emerging locations within the major cities. However, with many peripheral locations never fully recovering from the financial crisis, we continue to question the merits of investing in out-of-town and business park locations, particularly if back office activities are increasingly completed remotely.

Ahead of this crisis we were extremely negative on the outlook for the retail sector. This has not changed and the sector is set to play a diminishing role within the investable universe. There is certainly a chance that retail will become oversold, opening up attractive opportunities, but as of today, we see a large underweight position being accretive to relative performance.

Finally we still see value in some of the more niche sectors. While hotels are suffering and could take more time than other sectors to recover from the crisis, we don't see a material reduction in the trend growth of tourist arrivals. We see a similar story for student accommodation, where although we've seen a major reduction in demand this year – with disruption to overseas demand continuing into 2021 – we see little evidence for a sustained reduction in demand for overseas study.

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Investments are subject to risk, including market fluctuations, regulatory change, possible delays in repayment and loss of income and principal invested. The value of investments can fall as well as rise and you might not get back the amount originally invested at any point in time.

Investment in real estate may be or become nonperforming after acquisition for a wide variety of reasons. Non-performing real estate investment may require substantial workout negotiations and/ or restructuring. Environmental liabilities may pose a risk such that the owner or operator of real property may become liable for the costs of removal or remediation of certain hazardous substances released on, about, under, or in its property. Additionally, to the extent real estate investments are made in foreign countries, such countries may prove to be politically or economically unstable. Finally, exposure to fluctuations in currency exchange rates may affect the value of a real estate investment.

Investments in Real Estate are subject to various risks, including but not limited to the following:

_ Adverse changes in economic conditions including changes in the financial conditions of tenants, buyer and sellers, changes in the availability of debt financing, changes in interest rates, real estate tax rates and other operating expenses;
_ Adverse changes in law and regulation including environmental laws and regulations, zoning laws and other governmental rules and fiscal policies;
_ Environmental claims arising in respect of real estate acquired with undisclosed or unknown environmental problems or as to which inadequate reserves have been established;
_ Changes in the relative popularity of property types and locations;
_ Risks and operating problems arising out of the presence of certain construction materials; and
_ Currency / exchange rate risks where the investments are denominated in a currency other than the investor's home currency.

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