HEITMAN

Perspective

Creating Value in Europe

Opportunities in Resilient, Nascent, and Dislocated Markets

October 2020

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Executive Summary

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of light, it was the season of darkness, it was the spring of hope, it was the winter of despair."

— Charles Dickens, A Tale of Two Cities

The longest economic expansion in modern history came to an abrupt end due to the COVID-19 pandemic. Movement restrictions and other virus containment measures pushed the globe into recession. This unprecedented shock to economic activity is likely to be outlived by some lasting changes in the areas of living, working and leisure. Remote working is leading some office occupiers to reconsider their occupational strategy. E-commerce uptake has accelerated as safety concerns shift consumption away from physical stores. These increasing risks to traditional sectors are not yet reflected in valuations because sellers are not forced to accept risk or buyers overlook it. By contrast, Europe's specialty sectors[1] are poised for outperformance, benefiting from non-cyclical, needs-based demand, more-constrained supply, and higher yield premia than in traditional sectors. While both traditional and specialty sectors have attractive prospects for value-add opportunities, specialty has the advantage of greater predictability on several dimensions, examined in the following pages.

The occupier outlook is brighter in specialty than in the traditional sectors, which face familiar challenges such as an uncertain economic outlook and slowly growing or shrinking working-age populations, combined with new challenges such as remote working. An exception is logistics, where the shift to online shopping creates structural support. By contrast, specialty sector demand is driven more by demography than the economy. It has secular tailwinds causing demand to accelerate, such as ageing populations generating senior housing admissions. The supply outlook is also more favourable in specialty, with capacity even falling in some sectors.

From a capital market perspective, accommodative monetary policy and "lower for longer" interest rates should continue to support property pricing in aggregate, but is unlikely to offset a structural increase in office, retail and hotel yields. We expect further tightening of specialty property yields – already experienced in some markets since COVID-19 appeared – a reflection of its resilient occupier fundamentals and increased demand from investor capital seeking to increase their portfolio weighting to these defensive sectors. Investment volumes in these latter sectors have been close to or above levels reached in previous years, while specialty also offers an average 60 basis point yield premium over the traditional sectors.

European specialty enjoys many attractive characteristics that have helped specialty sectors gain a role in US institutional investor portfolios. (The rented-residential sector, for example, represents more than 20% of US institutional portfolios). But European specialty has some advantages that position it for strong performance. First, strict planning regimes are among the factors that have helped limit development of specialty property in Europe, creating favourable supply/demand relationships. Second, European specialty is earlier in its institutionalisation than it is in the US. As a result, yield spreads relative to traditional sectors are much wider in Europe today than they are in the US, reminding us of what we observed (and capitalised on) 20 years or more ago in the US. Europe's nascent market therefore offers attractive risk-return and growth fundamentals.

Specialty sectors also provide portfolio enhancement as their performance is less correlated with the drivers of performance of traditional real estate. Specialty has demonstrated its de-linked nature and overall resilience during the pandemic due to needs-based demand dynamics. The specialty sectors are also complex, operational, and fragmented in Europe, allowing skilled managers to create value, with one example being assemblage strategies where scale leads to lower operating costs.

In the pages that follow, we provide more detail on value-added investment opportunities in Europe in the current complex environment.

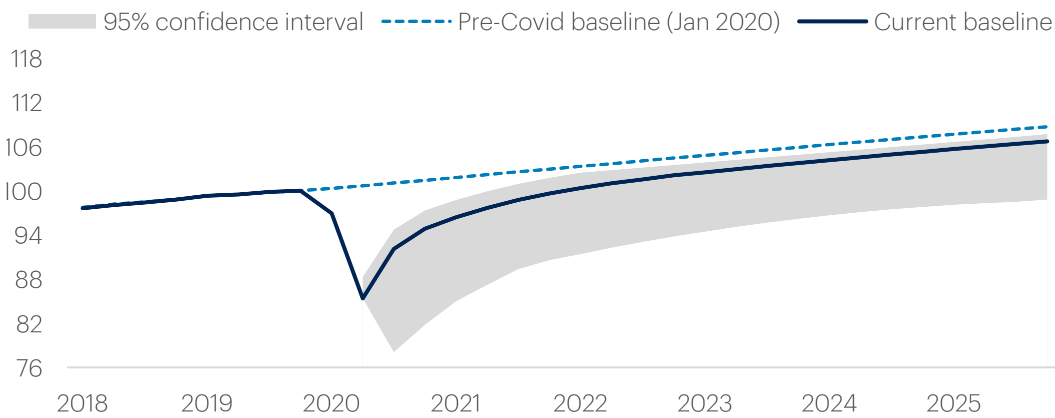
[1] In this paper the European specialty sectors are defined as self-storage, rented-residential (or 'multifamily'), senior living, and student accommodation

European Macroeconomic Context

An uncertain economic growth outlook. The shape of the economic recovery in Europe remains uncertain, with the outcomes heavily dependent on the future course of the pandemic. Assuming no significant reintroduction of lockdown measures, the consensus view is that EU-28 output will return to pre-COVID levels in early 2022. GDP is expected to fall by -8% in 2020 followed by a +6% rebound in 2021. It is likely that there will be variation in national performance, according to economic structure, breadth and severity of lockdown measures, and the degree of government fiscal support. For example, industry-orientation and generous state support in Germany are likely to enable economic outperformance. By contrast, Spain is reliant on tourism and financial support from other EU countries. Brexit also creates uncertainty in the outlook, especially for the UK and Irish economies given the increasing likelihood of a disruptive outcome for trade. The sensitivity of pricing to this uncertainty is evident in the spread of 130 basis points between London City and Berlin CBD prime office yields created since the referendum. It is likely the pandemic will cause 'scarring' effects that permanently lower economic output, as shown in the below chart.

The consensus view is that Europe output will return to pre-COVID levels in early 2022, assuming no future national lockdowns

EU-28 REAL GDP, INDEXED, Q4 2019 = 100



Source: Oxford Economics Forecast produced June 2020

Economic, epidemiological, and geopolitical factors improve the case for investment in Europe. Europe compares favourably against other major regions since the start of the pandemic. EU leaders agreed in July on a €1.8 trillion financial package, including €750 billion in loans and grants for worse-affected countries. The increased coordination reduces downside risk in the near term, while the economic reform requirements of the package improve prospects for long-term growth. Government furlough schemes have also shielded households from the crisis, with unemployment increasing only marginally (+2%) in the Eurozone and UK. Unemployment has meanwhile doubled in the US, where a lack of political consensus has left tens of millions of Americans without direct state financial support or protection from eviction. After a slow start in countries such as Italy and Spain, European countries have also demonstrated a more coordinated public health response to the pandemic. During August, COVID-19 fatalities averaged 8 per one million people in the EU-28, compared to over 90 in the US and 14 in APAC[2]. Geopolitical trends are also likely to create opportunities. While some studies suggest Europe stands to gain economically from the US-China trade war – which is likely to resume to some degree after the US election – European universities have already experienced higher demand from Chinese students averse to study in the US. All these factors create diversification benefits for allocations to European property sectors, particularly those that are de-linked from the economic cycle. The nascency of these latter sectors

[2] Figure excludes China, Russia, and (due to a lack of available data) Myanmar. Included countries make up 95% of APAC's remaining population, and are namely: India, Indonesia, Pakistan, Bangladesh, Japan, Philippines, Vietnam, Thailand, and South Korea.

means they enjoy wider yield premia than in the more-mature US market. They are yet still developed enough to create credible investment opportunities in multiple geographies and sectors. This is unlike the APAC region, where Japan is the only country with an institutional-grade rented-residential market, for example. Europe therefore offers an early mover advantage with scale.

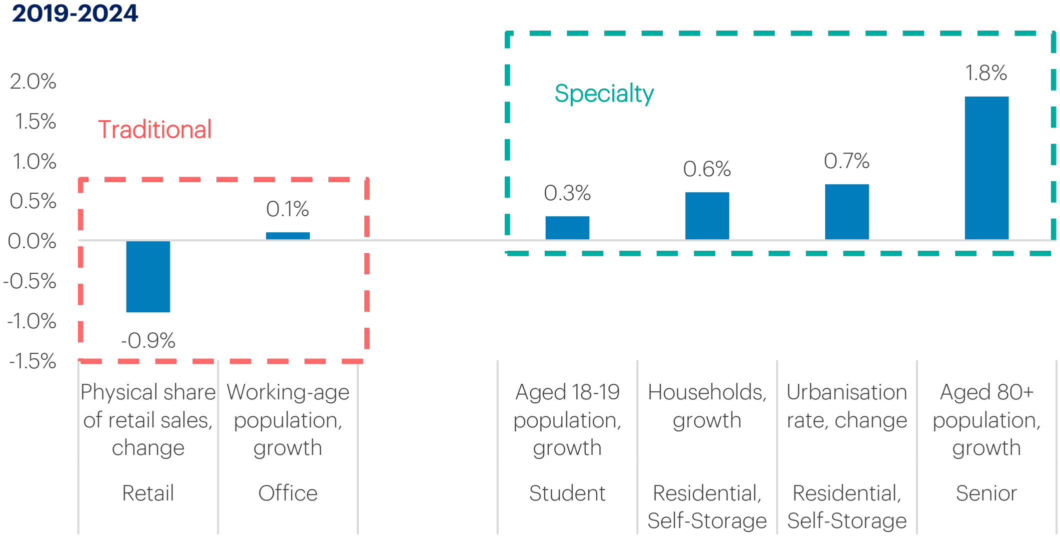
Interest rate environment improves the return profile of property relative to fixed income assets, particularly for de-linked property sectors. Forward guidance from the ECB indicates a lower-for-longer interest rate policy, while a trillion euros in asset purchases have been used to counter the pandemic. Sovereign bond yields are negative in several European countries – a key reason for the global value of negative-yielding debt ballooning from $2trn to $16trn during 2014-19. The positive income profile of real estate – and specialty in particular – has obvious attractions for investors in such a climate. Sovereign yield spreads are generally at or below 2019 levels across European economies, reflecting some confidence in the policy response of central banks such as the ECB and Bank of England.

Fiscal stimulus has supported occupier demand, and reinforced resilience in specialty. European governments have taken unprecedented steps to prop up households, most notably through generous income subsidisation that ranges from 60% of salary in Germany to 90% in the Netherlands. As a result, most European households have kept up with mortgage and rent payments, even as commercial tenants report difficulties in paying rents. Income support is being extended in some European countries – notably by two years in Germany and France. Risks associated with the eventual withdrawal of this support are likely to differ by country, which has prompted richer European countries to provide grants and loans to poorer EU member states.

Property Market Outlook: European Specialty and Traditional

Demand and supply

STRUCTURAL TRENDS MORE SUPPORTIVE OF SPECIALTY, 2019-2024

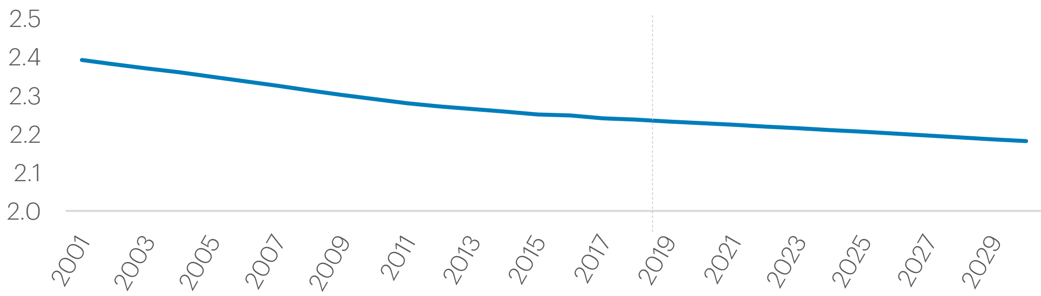


Sources: CBRE; Oxford Economics; Eurostat
Includes Germany, UK, France, Spain, Netherlands, Sweden, Ireland Data is for countries (share of retail sales, aged 18-19 population, aged 80+ population, urbanisation rate) and cities (working-age population, households)

Demographic and structural changes favour specialty and logistics demand, while posing challenges in office and retail. As shown in the above chart, specialty sectors stand to gain from broad, significant growth in key demographic metrics, including households, the population aged 80+, and the population aged 18-19. Other trends, such as shrinking household sizes (shown in the below chart), and increasing student mobility as students move farther from home, provide additional tailwinds. This contrasts sharply with the office sector, which faces near stagnation in the working-age population, and increased adoption of remote working. These demographics are particularly weak in Germany, which is Europe's largest market in investment volume, although the country's polycentricity may temper the expected rise in remote working. Challenges are especially acute in retail, where e-commerce is continuing to erode footfall and occupancy. This trend has underpinned demand growth in logistics, as has a broader reconfiguration of supply chains. Longer-term decline in industries such as automobile production does however create localised risks in industrial occupier demand.

Specialty sectors stand to gain from broad, significant growth in key demographic metrics

AVERAGE HOUSEHOLD SIZE, EUROPE*



Source: Oxford Economics *Germany, UK, France, Spain, Netherlands,

Lower supply risk in specialty, while elevated in traditional sectors. The specialty sectors are all experiencing undersupply relative to demand growth, with the exception of some student housing markets. This has typically been the case throughout the past cycle, and throughout several cycles in some markets. Traditional sectors, whilst seeing less aggressive construction than in 2007/8, face risk from new supply in the office and logistics sectors, as well as an increasing threat of shadow vacancy in the office sector. The elevated supply in traditional sectors follows increased development in 2017-19, driven by the cyclicality of rents and occupancy. This was notable across seven of Europe's ten largest logistics markets in 2019, where vacancy rates increased following a sustained rise in new supply. Only a few traditional markets have highly durable supply constraints, such as small-box logistics in densely populated, land-constrained urban centers (e.g. London, Munich).

Self-storage demand has been characteristically resilient during pandemic. Life events independent of the economic cycle, such as death, divorce, and downsizing, help keep occupier demand for self-storage stable during economic contractions. Demand has been recession-proof thus far during the pandemic, with 97-99% rent collection and minimal occupancy change reported by UK REITs in the first half of 2020. Self-storage is a concept well-suited to the European landscape, given its high population density, high rates of urbanisation, small homes, and rising rents and house prices. With penetration rates substantially lower than in the US, a key to unlocking this European growth potential is increasing awareness of the concept. In the UK, for example, 64% of the UK population cannot recall an operator brand from memory. This means that platforms can capture market share through effective advertising – particularly via investments in search engine optimisation, which have become even more important in light of the pandemic.

Self-storage has exhibited 97-99% rent collection with minimal occupancy change during the pandemic

Ageing society underpins senior housing demand. Half of European senior housing markets recorded marked occupancy declines during the height of the pandemic in spring 2020. This included Italy, Spain, Belgium, and the UK – the latter of which experienced a -7% fall in occupancy.

Fatalities among residents have since been limited and concentrated, with around half of UK care homes not reporting a single case of COVID-19. Given this disparity, we anticipate that well-run care homes will be able to return to pre-COVID occupancy within the next 12-24 months, in light of rapidly ageing demographics and needs-based demand. Indeed, larger operators have reported a 2% increase in occupancy during the summer period alone, with admissions back at pre-COVID levels. Fee-paying capacity will remain high due to lifetime wealth accumulation by the elderly, home equity, and state support. Any adverse shift in public perception of care homes is likely to be temporary, and countered by the dominance of critical life events (e.g. a fall, or death of a care-giver) in driving admissions, as shown in the below table. Homes with resilience during the pandemic may even experience a net increase in demand, as customers become more selective and weaker homes are forced to shut down. This reinforces the investment case for partnering with best-in-class operators, who can attain high care-quality ratings and market such credentials effectively. In Spain and Italy, more established use of home care and a lack of longer duration experience in senior housing operations create more uncertainty in the short-term outlook. These untapped markets nonetheless have two of the most aged populations globally.

Well-run care homes will likely return to pre-COVID occupancy within 12-24 months

REASON FOR ADMISSION TO UK CARE HOMES

Type of admission	Share of total admissions, %
Critical life event	78
Sudden illness, no hospital admission	3
Admitted for respite and did not want to go home	6
Fall but no hospital admission	14
Fall resulting in hospital admission	17
Hospital admission for another reason	19
Care-giver fallen ill or died	19
Non-critical life events	22

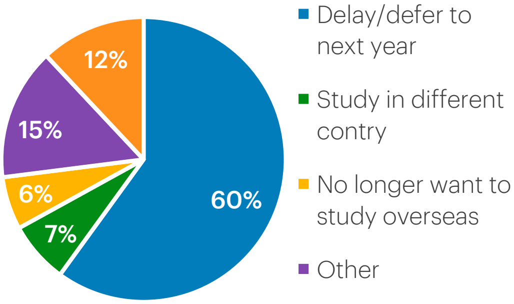
Source: Institute of Public Health

Shortage of modern, purpose-built senior housing exactly as ageing populations accelerate. The number of senior care beds per capita declined across Europe in the past decade. In the UK, nationwide capacity fell by 14 units for every 1,000 increase in the population aged 75+ during 2015-18. Undersupply is likely to intensify further, as the pandemic accelerates obsolescence of Europe's outdated senior housing stock. For example, 30% of UK units are not en-suite (i.e. do not have private bathrooms) and 27% of German privately-owned units are in double rooms, yet these room types are ill-suited to social distancing. Particularly in the UK, distress among smaller, inefficient operators is likely to cause some to exit the market, thereby creating attractive entry conditions for new investment.

Student demand driven by demographics, global mobility and a decline in the jobs market for young people. Student demand will be driven up by growth in the 18-19 year-old population, increasing student mobility, and counter-cyclical effects. Low rates of bed provision mean that occupancy is resilient in continental Europe, while foreign student exposure is limited. In the Netherlands, university registrations are up 6.5% on 2019. In the UK, PBSA (purpose-built student accommodation) penetration and the foreign student share are higher, but offset by demographics and a mobile domestic student population (only 20% of which stays home for university). Changes in school grading systems and immigration policy in the UK have in fact enabled a sharp increase in domestic and non-EU university acceptances for 2020-21. Given a decline in EU acceptances and barriers to study abroad more broadly (such as that created by more limited access to student visas during the pandemic), there may be a temporary shift in occupancy toward domestic UK students. While vacancy risk is therefore low, the reduction in foreign students (who are typically associated with a propensity to pay higher rents) may require a downward adjustment in rent levels. Any impact from COVID-19 is likely to be temporary, with only 6% of prospective students globally intending to forgo study abroad entirely, and the vast majority intending to enroll by 2021-22, as shown in the below pie charts. The value proposition of in-person education has for many been boosted by the negative experience of online learning (45% of UK students say they like it 'a lot less' than in-person teaching, vs. only 14% saying they prefer it). The vast majority of students also expect a substantial fee discount for online, which is unsustainable for universities given high costs in providing online education.

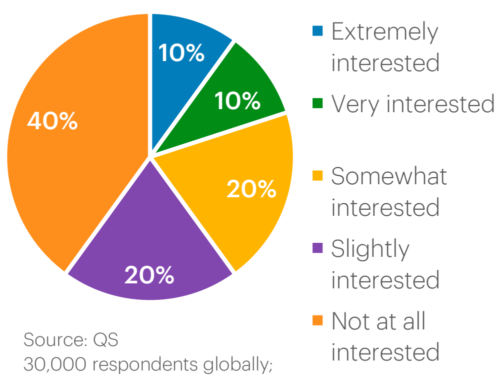
QS GLOBAL STUDENT SURVEY RESULTS

Q. Which of these best describes how the coronavirus has changed your plans to study abroad?



Source: QS
30,000 respondents globally; survey conducted May 2020

Q. How interested would you be in studying your degree online because of coronavirus?



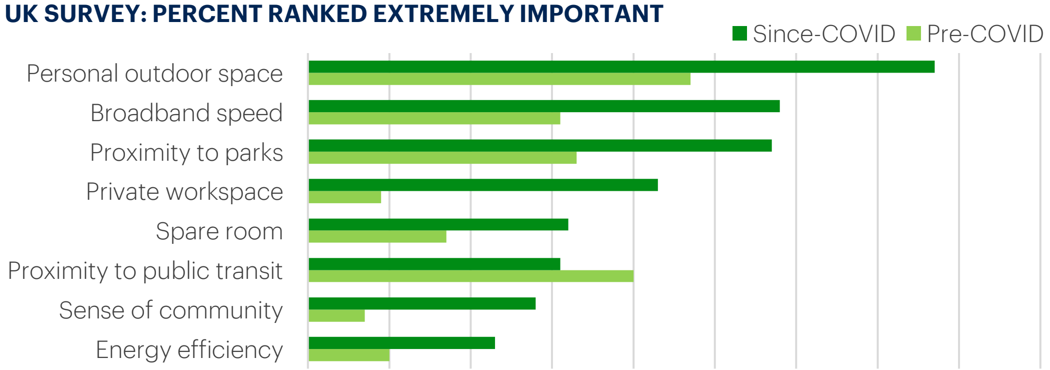
Source: QS
30,000 respondents globally; survey conducted May 2020

Student-to-PBSA bed ratios range from 7 to 33 across most of Europe, with stock typically outdated. Competition with alternative land uses (e.g. for-sale residential) has restricted development of new PBSA supply in most locations across Europe. An exception is the UK, which has experienced robust supply levels in some markets. Sweden, the other exception, has a ratio of four students for every bed, but the lack of alternative housing in the standard rental market due to rental regulations means that this still represents a significant deficit. Excess demand and obsolescence of supply have translated into occupancy that is relatively insensitive to changes in enrolment across markets, providing protection from vacancy risk in the event of slowing or even contracting local university enrolment.

Occupancy likely to remain resilient in rental-residential. We expect rental occupancy to remain high, given the needs-based nature of demand, long leases, and critical undersupply across Europe. This is expected to provide resilience to rent levels, with rent-paying capacity reinforced by fiscal support to households. The eventual withdrawal of this support and increasing unemployment may nonetheless bring affordability more into focus. Rental markets could gain in such an environment, given that most European countries have below-market in-place rents due to rent regulation. Low confidence and tighter lending in the for-sale market may also drive the marginal household towards renting. A possible exception is higher-end accommodation in the UK, where the market is unregulated. A shift to remote working may be a net positive for rental demand, given evidence that renters want to stay in cities but also have more space. A survey of UK renters shows only 13% desire to 'live in a rural area', highlighting the value of proximity to social and cultural epicenters, and not just the office. Demand for private workspace and a spare room have meanwhile increased sharply, as shown in the below chart, which may translate into more residential spatial demand by households.

Rental occupancy likely to remain high due to needs-based demand, long leases, and regional undersupply

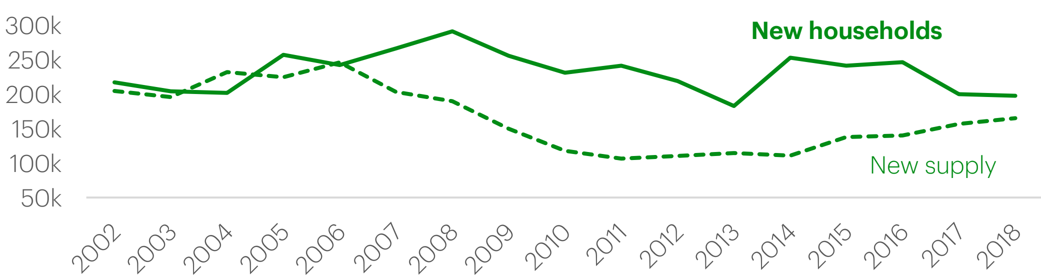
UK SURVEY: PERCENT RANKED EXTREMELY IMPORTANT



Source: JLL
Sample of 200 JLL UK staff members, conducted June 2020

Rented-residential supply critically constrained. Shortages of land, driven by European planning constraints, and inadequate construction capacity have inhibited development of rental housing. This is evident in the vacancy rates of major cities in Germany, the UK and Sweden, which are sub-1%. In those few cities where supply has been more elastic (e.g. Gothenburg and Dublin), new units have been built almost entirely for the owner-occupied market. This is due in part to rent regulation and rising construction costs. Planning systems also constrain supply; London's green belt is largely responsible for only one dwelling being constructed per five new inhabitants during 1990-2018. Across major cities, household formation has significantly outstripped supply in every year since 2006 (as shown in the below chart), household sizes have increased[3], and new supply has been rapidly absorbed. During 2009-13 – at the height of the global economic and Eurozone downturns – vacancy rates in major cities in Germany, UK, and Sweden actually fell.

DEMOGRAPHIC GROWTH IN CITIES* HAS OUTPACED HOUSING SUPPLY IN EVERY YEAR SINCE 2006



Sources: GOV.UK; Bulwiengesa; INSEE; INE; Statistics Netherlands; Statistics Denmark; Statistics Sweden
*Berlin, Hamburg, Munich, Cologne, London, Manchester, Birmingham, Paris, Madrid, Barcelona, Amsterdam, Rotterdam, The Hague, Utrecht, Stockholm, Gothenburg, Copenhagen

Intensified downside risks to office demand. In office markets such as Dublin, Frankfurt, London and Paris, sublet availability has risen sharply.[i] Occupier demand for office space typically contracts during recessions. Remote working appears to be exacerbating this trend. More sublease space combined with delivery of additional space in office development initiated before the pandemic raise prospects for higher vacancy rates. Vacancy rates are expected to be 150-300 basis points higher by 2022[ii], with opinion divided on when they will begin to retighten. With

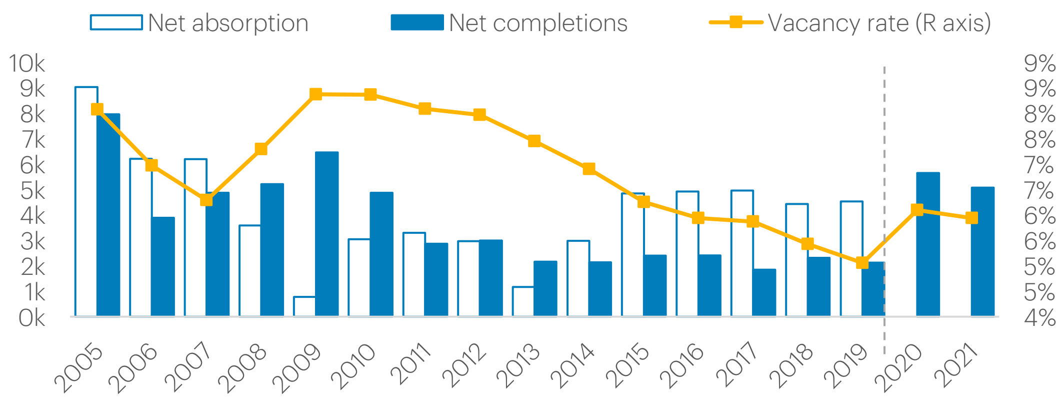
[3] National average household size has fallen in recent decades in most European countries, due in part to cultural factors such as people getting married at older ages. This has put upward pressure on housing demand. In major cities, an accompanying shortage of housing means it has become harder to move out of the family home, and house-sharing has increased. The result in cities has been higher average household sizes, minimal vacancy, and strong price and rent growth.

European space utilisation being lower, but company utilisation targets higher than anywhere else in the world, occupancy is vulnerable to downsizing in light of increased remote working. 57% of European firms have reported no or minimal reduction in productivity, versus only 15% reporting a material decline. While the office is still cited as important for collaboration, creativity, and mentorship – the loss of which may still be unrecognised by businesses – 93% of office occupiers expecting to adopt greater remote working after the pandemic, owing to cost savings, employee preferences, and greater potential access to talent. The applicability of these factors across cities and industries means demand risks in the office sector are highly diffused. This limits predictability and the opportunity set in the office sector for value strategies. That said, the significant demand shock opens up potential for mispricing, particularly in exposed markets such as London and Paris. Potential mispricing due to Brexit is also relevant to these two cities. Occupier surveys indicate a more mixed outlook for co-working demand, which suggests dislocation – and hence investment potential – given severe short-term stress in this segment of the market.

Significant demand shock opens up potential for mispricing, especially in the traditional sectors

Supply risk is elevated in the office sector, given limited prospects for net absorption. Across European office markets, net completions in the two-year period 2020-21 are expected to exceed those for the four-year period 2016-19. Vacancy rates are therefore highly sensitive to the expected sharp decline in net absorption. Forecasts of peak-to-trough vacancy increases range from 150bps to 300bps across major markets. Sub-letting means vacancy risk remains elevated even in markets where supply pipeline is mostly pre-let (e.g. Dublin). The below chart shows the CBRE outlook in Q2 2020, and the supply pick up.

EUROPEAN OFFICE* SECTOR NOW FACES SUPPLY RISK



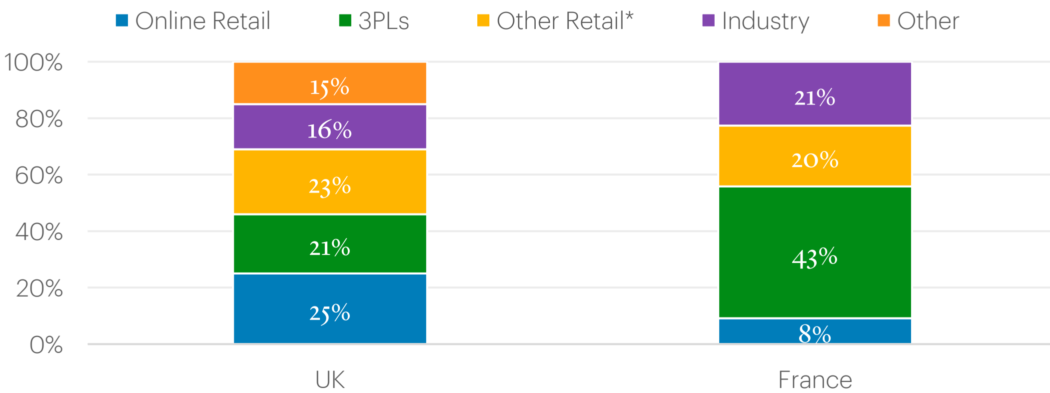
Source: CBRE *Amsterdam, Barcelona, Berlin, Bratislava, Brussels, Bucharest, Budapest, Central Paris, Cologne, Copenhagen, Dublin, Dusseldorf, Frankfurt, Hamburg, Helsinki, Lille, Lisbon, London – City, London – West End, Lyon, Madrid, Marseille, Milan, Moscow, Munich, Oslo, Outer Paris, Paris, Prague, Rotterdam, The Hague, Utrecht, Vienna, Warsaw, Zurich Forecast: Q2 2020

Weakness in tourism and hospitality to suppress retail demand further. Subdued consumer confidence and incomes mean discretionary retail spending is likely to be weak at least through 2021. Social distancing requirements and aversion to dense public spaces particularly constrain activity for hospitality and leisure businesses like restaurants, hence threatening their solvency and the footfall of nearby retailers. Prime high streets will be exposed to a likely slow recovery in tourism, with global inbound arrivals not expected to recover to 2019 levels until 2023. Of spending that does occur, a lower share is likely to be in-store, especially with lockdowns and aversion to public places among households having increased familiarity with internet shopping. 59% of UK shoppers aged 26-35 expect to buy more online post-pandemic, as do 21% of over-65s.

Logistics demand has structural tailwinds from the growth of e-commerce and optimisation of supply chains

Pandemic provides a boost to e-commerce demand. Logistics demand has structural tailwinds from the growth of e-commerce and optimisation of supply chains. In major markets, up to 40% of take-up in the past three years has nonetheless come from now-exposed industrial firms and physical retailers (see below chart). It is uncertain if the impact in these sectors will be offset by increased take-up from supermarkets and online retail, at least in the short-term. In the longer-term, occupier demand is expected to grow mostly rapidly in the Southern European countries, where e-commerce penetration is rising from a lower starting point. The broad shift toward faster delivery times should also support occupancy among 'last-mile' industrial facilities close to urban centers. Logistics could gain from a shift toward reshoring after the pandemic, though this shift may be limited to strategically important sectors (e.g. pharma, telecoms). The adoption of near-shoring, i.e. facilities just outside the EU, is more commonly cited by industrial firms, due in part to wage costs.

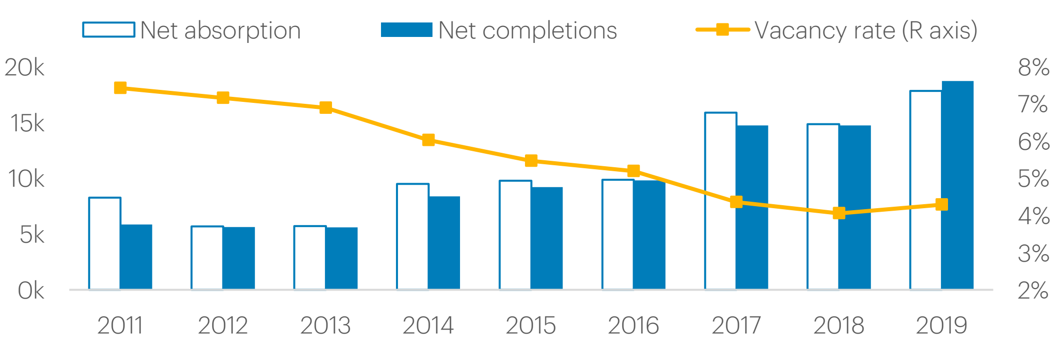
LOGISTICS TAKE-UP, 2017-2019



Source: CBRE *For France, includes specialized retail

Supply risk exists also in logistics, due to robust development pipeline. Logistics supply was already getting ahead of absorption in 2019, with seven of the ten largest markets reporting higher vacancy rates. There is a material risk that absorption from online retail and supermarkets will not offset reduced absorption from physical retailers, industrial firms, and some 3PLs. Across Europe's five largest economies, vacancy rates are expected to increase by 0.4-1.3% by 2023, with increased e-commerce expected to gradually reduce slack in the market. The main impact on medium-term supply is likely to be the delay of construction, not outright curtailment. Indeed, the relatively short construction times of even big-box logistics units create a lack of visibility and constraint in the supply pipeline. This improves the relative case for urban logistics, the scarcity of which has increased sharply in recent decades as inner-city industrial space has been lost to competing, alternative uses.

EXCESS LOGISTICS* SUPPLY HAS PUSHED UP VACANCY

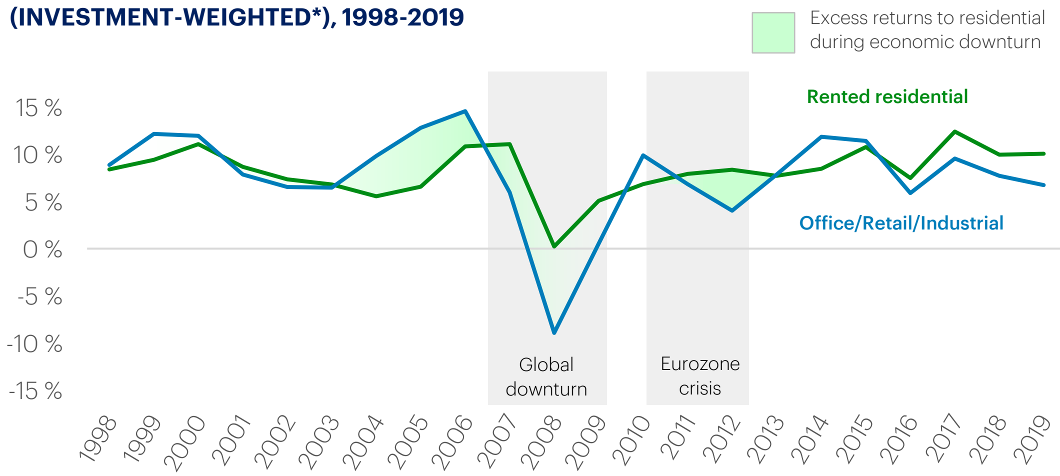


Source: CBRE *Germany, UK, France, Italy, Spain, Netherlands, Poland, Belgium, Czech Republic, Hungary

Investment markets

Inherent resilience in specialty performance. Unlike the traditional sectors, specialty has low reliance on cyclical demand drivers, enabling it to outperform during downturns and offer more stable returns across cycles. Demand for commercial space tends to be correlated to the economic cycle. Commercial returns and pricing are therefore likely to be more volatile going forward. By contrast, specialty is driven by long-term demographics and structural undersupply, while it's fundamentally needs-driven nature makes demand relatively inelastic to income. Transaction volumes in the year to August reflect this resilience, with capital continuing to invest into rented-residential and senior housing even in a time of widespread uncertainty.

TOTAL RETURNS IN GERMANY, UK, FRANCE, AND THE NETHERLANDS (INVESTMENT-WEIGHTED*), 1998-2019

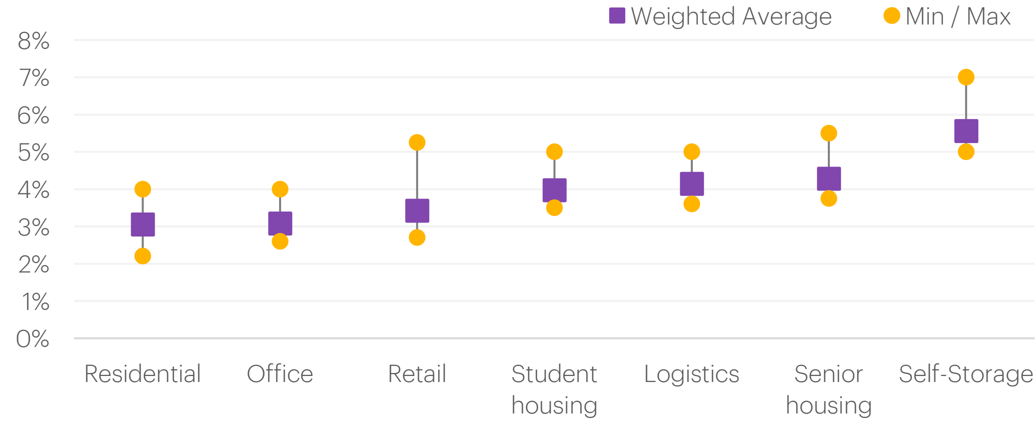


Source: MSCI; RCA *Weighted using total investment volumes for the period 2007-2019

Higher, more diversified yield profile in specialty. Reflecting its nascency, specialty sector yields are typically higher than traditional sector yields. This is despite specialty yields typically being better 'quality', representing true net cash flows rather than headline yields, excluding leasing incentives, downtime and so on. The exception is the rented-residential market, where large quantities of tradable stock and active domestic investors have led to well-established institutional markets in countries such as Germany and Netherlands, resulting in tighter yields. Capital rotation away from office and retail is likely to accelerate, and the proven performance and growing liquidity of specialty is attracting investors seeking less cyclical alternatives. Europe is in the early stages of rotation; ODCE fund allocations to non-traditional sectors, for example, are only 10% in Europe, compared to 13% in APAC and 28% in the mature US market. Spreads are wider than in the US market, suggesting that as capital market rotation continues, yield compression potential exists across the equivalent, newer sectors in Europe. Early-stage investors will be rewarded through more attractive yield premia. The pronounced outward shift in European shopping centre and secondary retail yields since 2018 is also notable. While retail occupier fundamentals warrant caution, the pandemic has made market dislocation more likely, and increased the viability of change-of-use strategies. The typically large catchment areas of these former retail assets supports long-term value potential, particularly where tenant mix can be shifted toward the high-growth sectors of residential, logistics, healthcare, and self-storage.

Specialty sector yields are typically higher than traditional sector yields

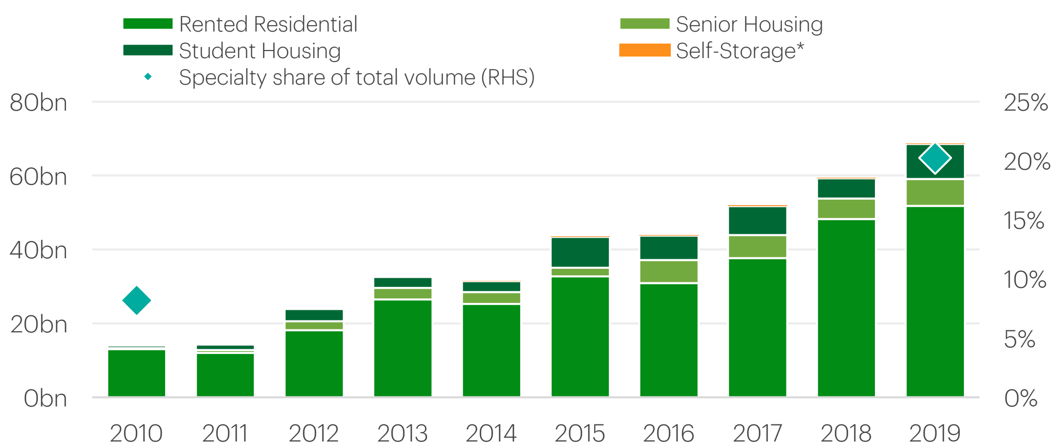
GDP-WEIGHTED PRIME YIELDS, BY SECTOR, Q4 2019



Source: CBRE; Catella; Cushman & Wakefield *Germany, UK, France, Spain, Netherlands, Sweden, Ireland

Growing liquidity, larger investable universe. Specialty's share of European transaction volume has increased from 8% in 2010 to 22% in 2019, with absolute volume increasing fivefold during the same period. Growth has been fastest in the non-residential sectors, but rental housing still dominates the investable universe. Heitman Research estimates that the investable universe for European specialty increased by 60%, from $380 billion to $600 billion, between 2015 and 2018. Savills estimate that the UK PRS (private rental sector or rented-residential) market alone could increase from £10 billion in 2019 to £550 billion in the next few decades, should PRS come to account for a third of all privately-rented homes, compared to just 1-2% currently.

EUROPEAN INVESTMENT VOLUME BY SPECIALTY SECTOR, €BN



Source: RCA *UK only

Pandemic will widen the investable universe in the specialty sectors, and improve pricing. Specialty sectors are highly fragmented, with numerous smaller, under-capitalised operators. Pandemic dislocation is likely to increase distressed opportunities among these players, as well as sale-and-leaseback activity. Indebted governments may also resort to asset sales in future. Specialty REITs are meanwhile entering new markets to take advantage of mispricing and yield spreads, while themselves enjoying significant premiums to underlying asset value (as shown in the below table). Examples include German housing group Vonovia and Belgian healthcare REIT Aedifica. This trend is creating greater competition for institutional-grade real estate and higher demand for joint-venture partners. Potential for yield compression and value creation through operating entity investments is therefore increasing.

Specialty sectors reward economies of scale and aggregation. Whilst the specialty sectors are fragmented, the demand from institutional investors to allocate into these sectors means that portfolios typically trade at a premium to individual asset values. This rewards investors who build up portfolio positions and gain scale in the specialty sectors. This dynamic contrasts with the traditional sectors, which can suffer a discount. Operator quality varies widely, with value implications. Portfolios operated by the high-quality operators (either on a third-party basis or due to common ownership with the portfolio) trade at a premium. Participating in the latent growth in these sectors requires building specialist operations and exporting best practices from different sectors, geographies and experiences. This allows experienced investment managers to create additional value in a way that is unique to the specialty sectors.

PREMIUM/DISCOUNT TO GROSS ASSET VALUE BY REIT SECTOR

	Retail	Office	Residential	Industrial	Senior housing	Self-storage
Premium / discount to gross asset value	-15%	-13%	3%	7%	22%	34%

Source: Green Street Advisors; Heitman Research Data as of 03 September 2020

Property Market Outlook: European Comparison to US Specialty

A comparison of the European and US specialty sectors now follows. While these sectors are relatively nascent in Europe, they are highly-evolved in the US. The comparison underlines not only the significant growth potential of European specialty, but also its strong value fundamentals.

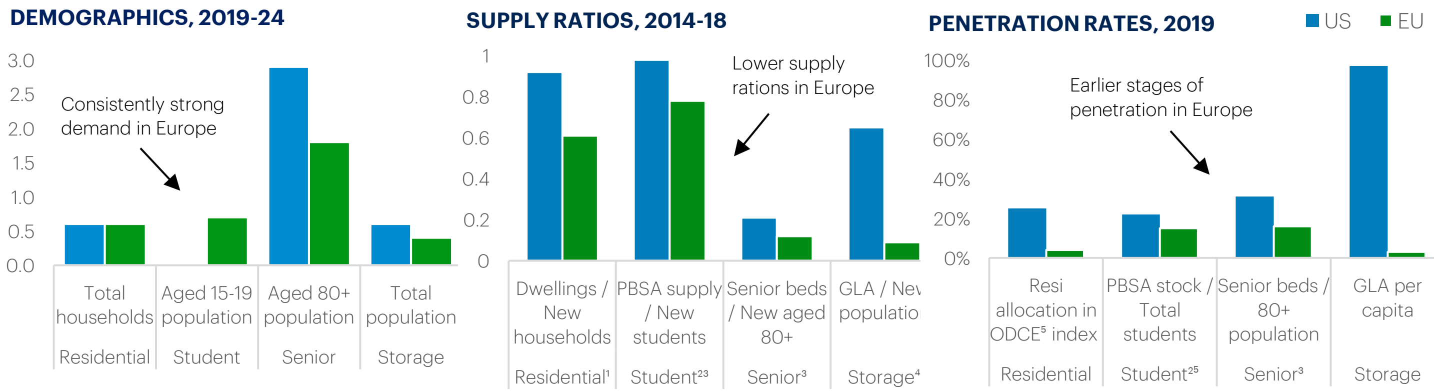
European specialty exhibits many of the favourable characteristics that underpinned the institutionalisation of the US market

European specialty enjoys many of the same favourable characteristics that have underpinned the institutionalisation of the US market. A rotation in capital toward specialty has also been underway in Europe, as has occurred in the US during recent decades. The US market therefore serves as a leading indicator for Europe, in terms of penetration rates, operational sophistication, market liquidity, and yield premia. Global platforms can use knowledge transfer to capitalise on Europe's convergence, such as through the creation of institutional-grade assets and operational entities with yield-compression potential. The comparison also underlines the attractive risk profile of European specialty, given low supply rates and market regulation. Such factors create barriers to entry, which can be navigated using local market expertise.

Demand and supply

Market dynamics in European specialty indicate broad catch-up potential to the US. Comparison of supply and demand metrics with the mature US market highlights significant undersupply in European specialty, and the protection to occupier fundamentals afforded by factors such as regulation, planning regimes, and Europe's nascency. In the rented-residential market, for example, household formation is strong in both regions, yet longer leases in Europe provide added resilience to demand, and supply is more constrained. Partly reflecting less maturation and institutional capital in European specialty, penetration and supply rates are indeed several years, and in some instances even decades, behind the US market. The shared nature of needs-based, demography-driven demand underpins catch-up potential in Europe, while supply constraints and regulation limit downside risks. The favourable demographic and supply fundamentals of European specialty are highlighted below.

DEMOGRAPHICS, SUPPLY RATES, AND PENETRATION RATES TO DRIVE CATCH UP IN EUROPE

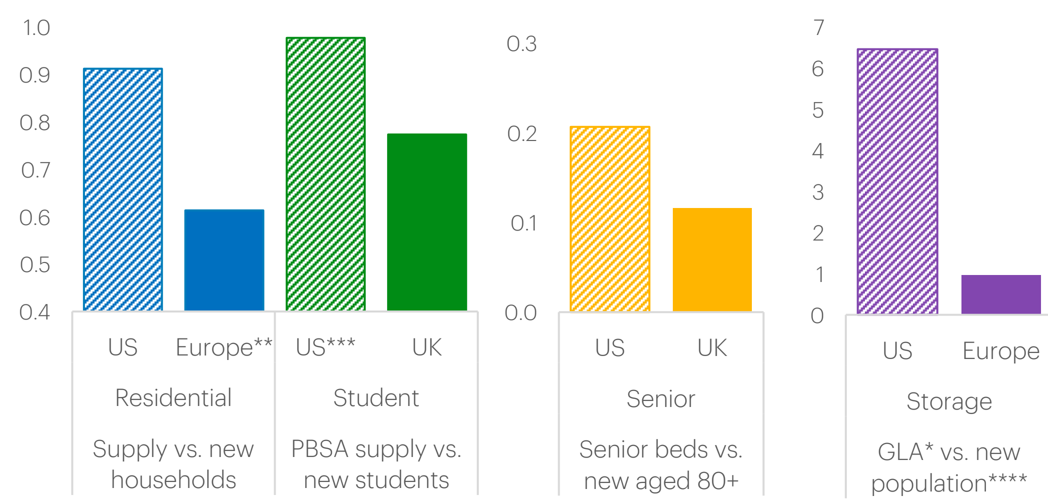


Source: GOV.UK; INSEE; Destatis; INE; Statistics Netherlands; Statistics Sweden; Statistics Denmark; Bulwiengesa; NIC; Laing Buisson; Axiometrics; FEDESSA; JLL; NCREIF; INREV; Oxford Economics
EU = Germany, UK, France, Spain, Netherlands, Sweden, Ireland Note: demographics data is for cities (households and population) and countries (aged 15-19 population and aged 80+ population)
[1]Includes cities BER, HAM, MUN, COL, LON, MAN, PAR, MAD, BAR, AMS (Europe); NYC, LAX, CHG, HOU, PHO, PHI, SAT, SDG, DAL, SJS (US) [2]Top 175 markets covered by Axiometrics (for US) [3]UK (for EU) [4]Gross leasable area; values divided by 10 [5]Open End Diversified Core Equity

Market value of European self-storage converging with US market, from a low starting point. 30x lower self-storage space per capita in Europe than in the US, alongside demand dynamics being similarly positive or better on some measures (e.g. population density), underlines strong growth potential in Europe. This can be realised through increased awareness of the concept and operator brands. In London, for example, where adoption is further along in the 'catch-up' process, 59% of survey respondents say they know a reasonable amount about self-storage, versus 25%-44% in the rest of the UK.

Significantly lower supply and penetration in European self-storage. While 6.5sqm of gross leasble area has been constructed per one-person increase in the US over the past four years, only 1sqm has been delivered in Europe. Furthermore, whereas total gross leasable area is 0.87sqm per capita in the US, the comparative figure in Europe is only 0.03sqm. As in other European specialty sectors, land scarcity and a lack of institutional capital are major supply constraints, providing protection to self-storage investors.

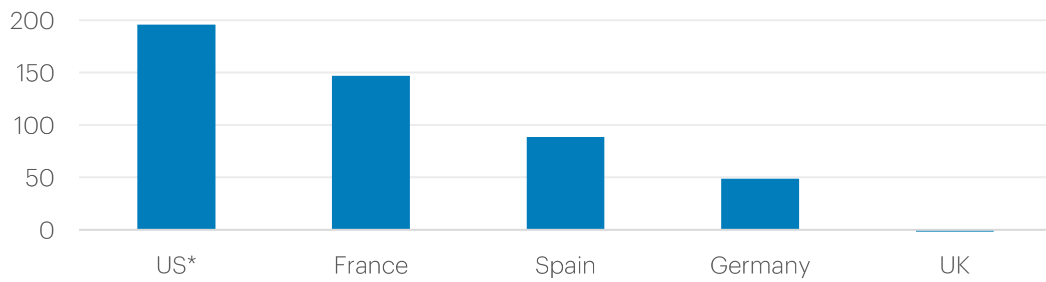
LOWER SUPPLY RATES IN EUROPE COMPARED TO US



*Gross leasable area (sqm) **10 major markets. Europe: BER, HAM, MUN, COL, LON, MAN, PAR, MAD, BAR, AMS. US: NYC, LAX, CHG, HOU, PHO, PHI, SAT, SDG, DAL, SJS ***Top 175 markets ****4-year changes used. GLA = gross leasable area
NOTE: period covered is 2014-2018

Steep barriers to senior housing development in Europe. The below chart shows that around 200 beds were delivered per 1,000 increase in the population aged 75+ in the US in recent years, compared to 150 in France, and less than 100 in Spain and Germany. In the UK, supply actually declined, primarily due to the withdrawal of smaller, non-purpose-built facilities by inefficient operators owning less than three homes. In Europe, the capital and skills required to build and run high-quality facilities still lag behind the demand created by a rapidly-ageing population. Strong competition for land from alternative uses is among the factors constraining provision of senior housing. A shortage of operational expertise and the capital means only some operators are able to commission the development of high-quality facilities – the requirements upon which have increased due to regulation and shifting consumer needs. This is at its most extreme in the UK, where the number of senior housing beds per person aged 80+ is only 40% of that in the US. As a result, entry into UK facilities is more needs-based, as indicated by the median stay in the UK being only 16 months, compared to 26 months in the US.

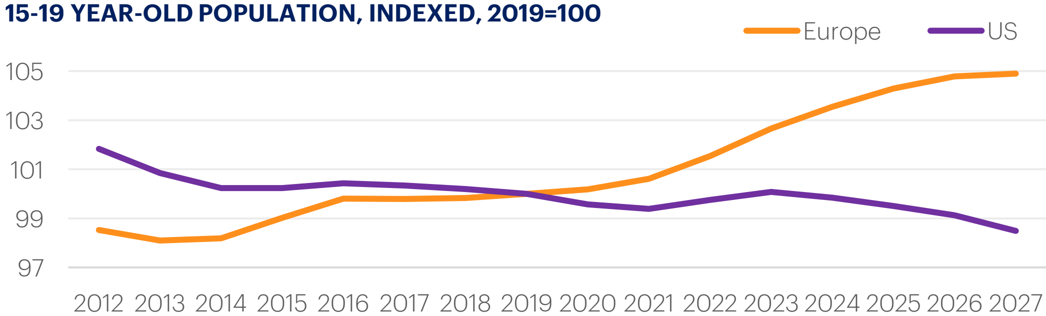
RATIO OF NET NEW SUPPLY OVER 1,000 CHANGE IN 75+ POPULATION (2009-17, 8 YEARS)



Sources: NIC; INSEE; CSIC; Destatis; Laing Buisson; Oxford Economics
*Period covered is 2015-2019

Strong tailwinds from demographics and foreign enrolment in European student housing. US university enrolment has fallen in every year for the past decade, equating to a -5% decline since 2010. In the same period, enrolment in Europe has increased by 11%, due in part to the domestic university-going population increasing (as shown in the below chart), lower tuition fees and student debt. European universities have been rapidly expanding their offer of English-taught degree courses, enabling them to attract more international students. By contrast, foreign student enrolment in US colleges has fallen four years in a row due to several factors, including shifts in US immigration policy. European foreign student inflows are also proving more resilient (meaning more similar to previous years) in the pandemic, due to them being more diversified by country source and primarily intra-European, with EU-origin students not needing visas or long-haul flights to reach their campus of choice.

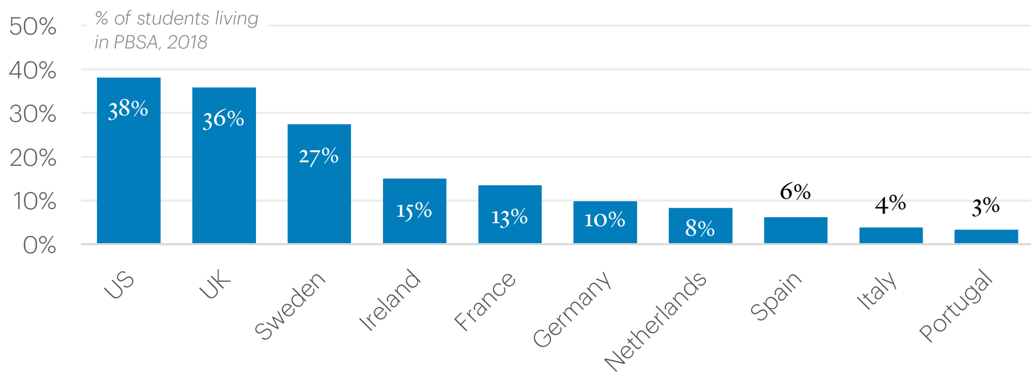
15-19 YEAR-OLD POPULATION, INDEXED, 2019=100



Source: Oxford Economics
Europe includes France, Germany, Ireland, Netherlands, Spain, Sweden, UK

Low penetration of student beds in Europe. While the student-per-bed ratio is more than six across most of Europe, including large student markets such as Germany (10) and Spain (17), the ratio is less than 3 in the US. The ratio is also 3 in the more-mature UK market, which, like the US, faces localised supply risks. That said, this is less pronounced in the UK, as its PBSA market – and those across Europe – are supported by severe imbalances in the competing standard rented-residential sector. In the US, PBSA is modern and amenity-rich, yet much of the continental European stock is outdated and unfit for modern tastes. New-build units in Europe thus have even less direct competition, especially when attracting affluent foreign students.

LOWER PBSA SUPPLY IN CONTINENTAL EUROPE



Source: AXIOMetrics; Cushman & Wakefield

Regulation provides resilience to European rented-residential demand. While demographic trends are supportive of rented-residential in the US and Europe, demand has overall proven more resilient in Europe due to longer leases (typically 3-10 years), rent regulation (which improves affordability), and greater state support to households (as seen during the pandemic). This is likely to remain the case in highly regulated markets with strong government finances, such as Germany and Sweden. Performance may prove more similar to the US in some better-supplied parts of the unregulated UK market once government fiscal support starts to be gradually withdrawn.

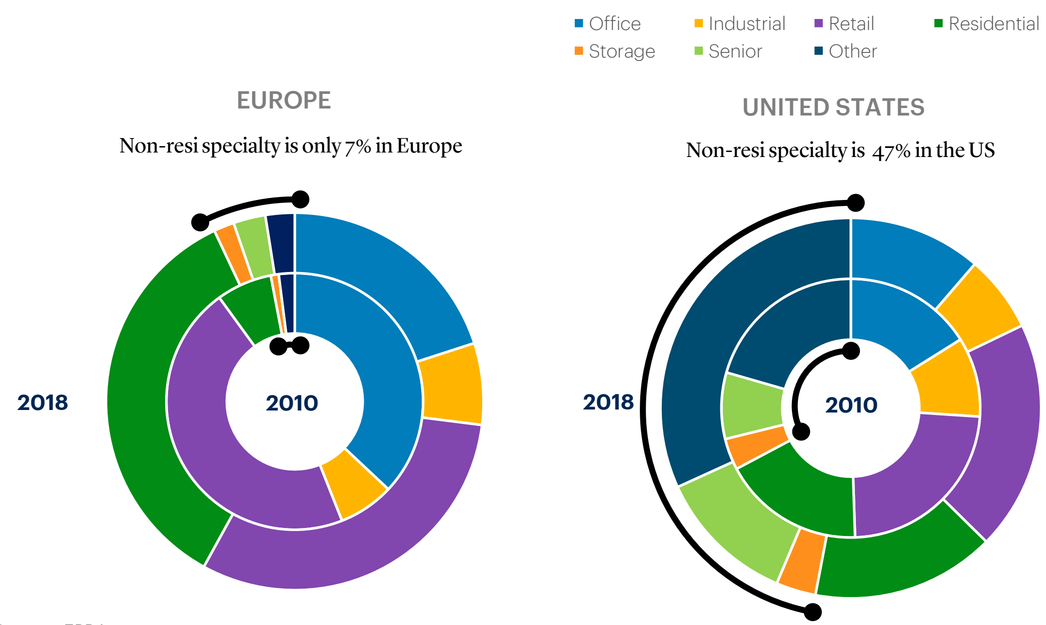
Less elastic supply in European rented-residential. The multitude of supply constraints in European cities meant that housing starts and permits were already falling in 2019, before COVID-19. In the US, starts and permits reached a cyclical high in 2019. Supply has been lower in Europe over the longer term, due to greater scarcity of land, more restrictive planning regimes and market regulation. During 2014-18, only six dwellings were built per 10 new households in major European cities, compared to nine in the US. Combined with significant shortages that accumulated in the post-GFC period, supply risk in Europe is limited.

Investment markets

Rapid growth in European housing REIT allocations indicates ongoing convergence with the US. Meanwhile, allocations to other specialty sectors are currently only 7% in Europe, compared to 47% in the US (see below chart). This points to strong potential for investment growth in European student housing, senior housing and self-storage. Institutional capital is likely to drive yield compression through market consolidation, asset modernisation, and more professional management. This rotation process has a tailwind from the specialty sectors having proven resilient during the pandemic, but also having been relatively underallocated to previously. As shown in the right-hand chart, percentage allocations to the currently most-exposed sectors were significantly larger in Europe than in the US prior to the pandemic. With public market pricing having eased, there is also the implication that price discounts may become more widespread in the private market.

> Allocation to European specialty remains only a fraction of what it is in the US

EUROPEAN REIT ALLOCATIONS SHOW SHIFT IN CAPITAL TO SPECIALTY ALREADY UNDERWAY (2010 VS. 2018)

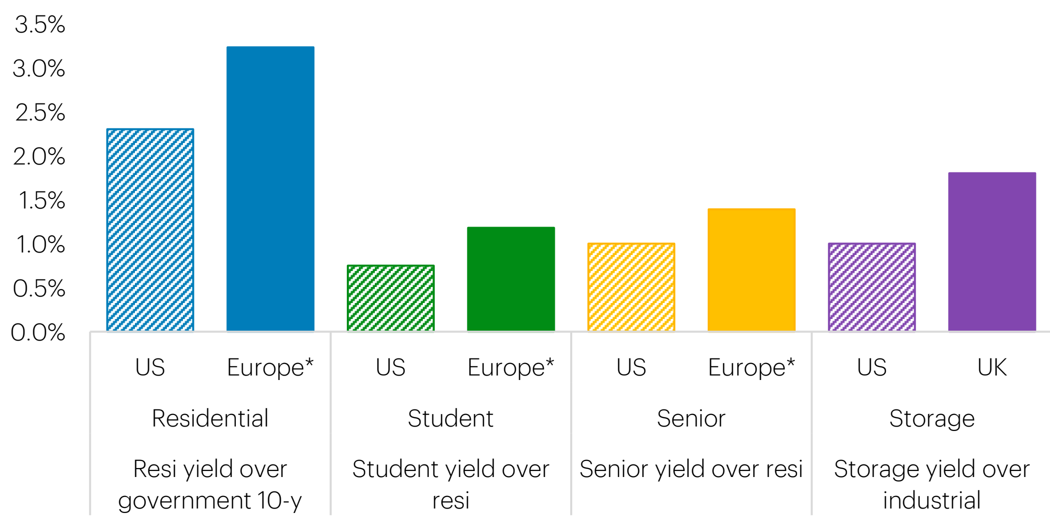


Source: EPRA

Source: NAREIT

Higher yield premia and earlier stages of capital rotation in Europe. Specialty constituted 40% of US annual investment volume in 2019, yet only 22% in Europe. Core fund allocations to US residential are meanwhile 25%, compared to just 4% in Europe. While parts of European specialty are relatively mature (e.g. UK student housing), the pandemic is likely to accelerate investment into other sectors and geographies. As the below chart shows, spreads of European property yields over related benchmarks are wider than in the US. This suggests early-stage investors in European specialty could be rewarded through more attractive yield premia.

GREATER YIELD PREMIA IN EUROPE COMAPRED TO US, Q4 2019



*Europe defined as UK, Germany, France, Spain, Netherlands, weighted by GDP
Source: Bloomberg, Savills, CBRE NOTE: bond yields as of property yield date

Risk Profile of European Specialty

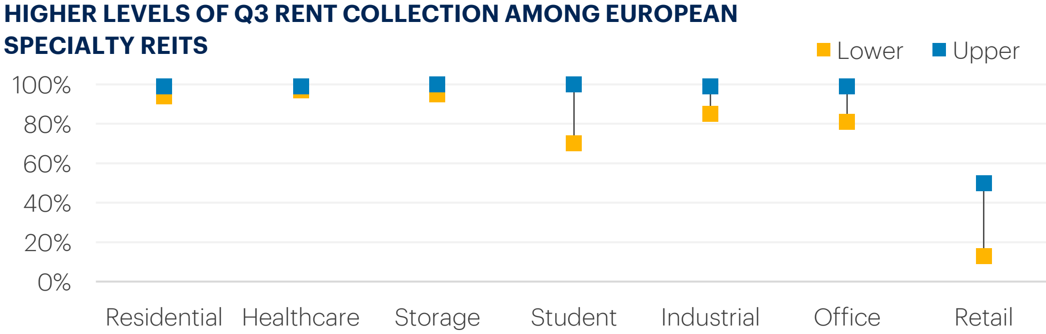
The addition of specialty decreases risk within real estate portfolios. Specialty returns are largely delinked, providing an attractive stabiliser and diversifier to existing real estate portfolios. Being needs-based, specialty demand is delinked from other specialty sectors, from the traditional sectors and from the broader economic cycle. Structural demand drivers are growing stronger and sensitivity to income fluctuations is low. The below table demonstrates this and shows returns correlations among the main property sectors in the US. European correlations are likely to be even lower, owing to more inelastic supply and regulation. Experience during the pandemic corroborates this view, with incomes streams having been more reliable. The below chart highlights the greater resilience of rent collection in European specialty, compared to traditional sectors, in recent months.

US REAL ESTATE DATA SUGGESTS THAT SPECIALTY HAS A LOW CORRELATION TO TRADITIONAL REAL ESTATE

CORRELATIONS OF NCREIF TOTAL RETURNS BY PROPERTY TYPE (1Q11-4Q18)	Multifamily	Hotel	Industrial	Office	Retail	Self Storage	Student Housing	Senior Housing	Medical Office
Multifamily	1.00								
Hotel	0.75	1.00							
Industrial	0.20	0.59	1.00						
Office	0.89	0.92	0.41	1.00					
Retail	0.77	0.71	0.04	0.86	1.00				
Self Storage	0.24	0.23	-0.22	0.38	0.63	1.00			
Student Housing	0.90	0.59	-0.03	0.79	0.78	0.36	1.00		
Senior Housing	-0.13	0.21	0.17	0.19	0.30	0.25	-0.18	1.00	
Medical Office	0.23	0.41	0.33	0.36	0.21	-0.18	0.11	0.40	1.00

Source: NAREIT; Heitman Research

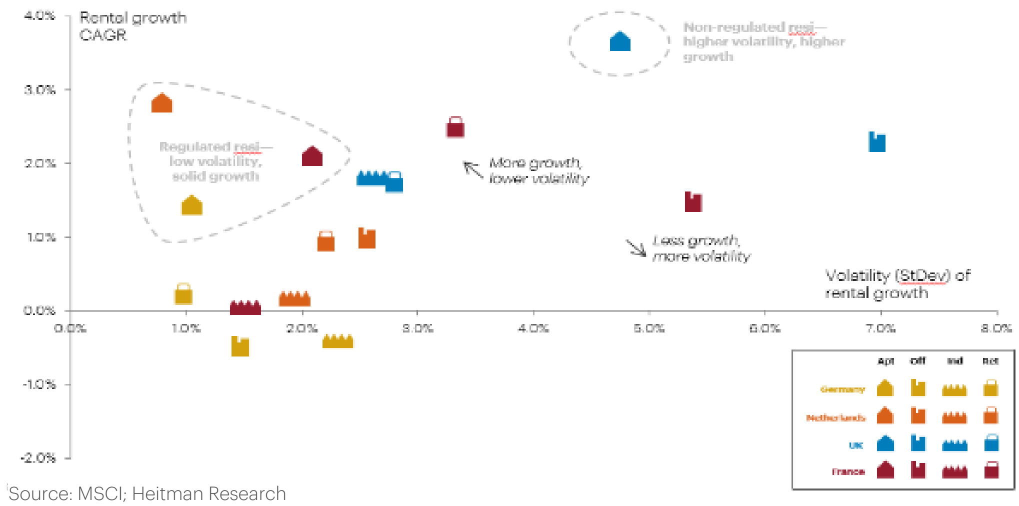
HIGHER LEVELS OF Q3 RENT COLLECTION AMONG EUROPEAN SPECIALTY REITS



Source: Company filings; Heitman Research
Note: markers represent upper and lower bounds

European regulatory framework acts to reduce risk. Europe's regulatory environment increases resilience and lowers volatility, especially in rented-residential. The UK market is largely unregulated, but countries like Germany and Sweden have nationwide rent regulation and strong security of tenure. Regulation makes rents and occupancy less sensitive to economic downturns, and can serve to stabilise long-term returns in a portfolio. This translates to higher rent growth with higher volatility in an unregulated market like the UK, and only modestly lower rent growth but far lower volatility in a regulated market like Germany, as shown in the below chart. Other markets offer a middle ground of varying risk-return profiles.

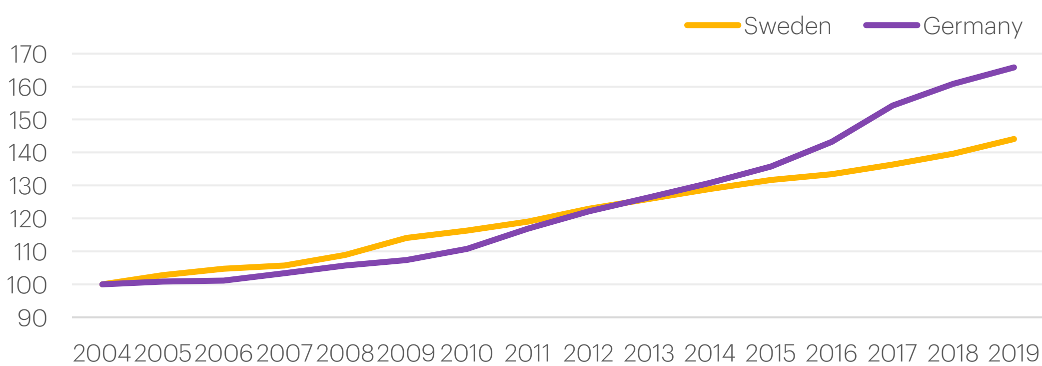
SAME-STORE RENTAL GROWTH VS. RENT VOLATILITY 1998-2018



Source: MSCI; Heitman Research

Rent regulation creates secure income streams. Rent regulation reduces the sensitivity of rents to economic conditions. These measures 'smooth out' and stabilise rental growth, for example, by being tied to a backward-looking index such as the Mietspiegel in Germany. This can ensure upward rent movement even in a downturn. In the past 15 years, rents for existing dwellings in both Germany and Sweden have increased continuously, with much stronger growth in big cities like Berlin and Stockholm. This demonstrates that regulation can create highly secure income streams without sacrificing potential for long-term rent growth.

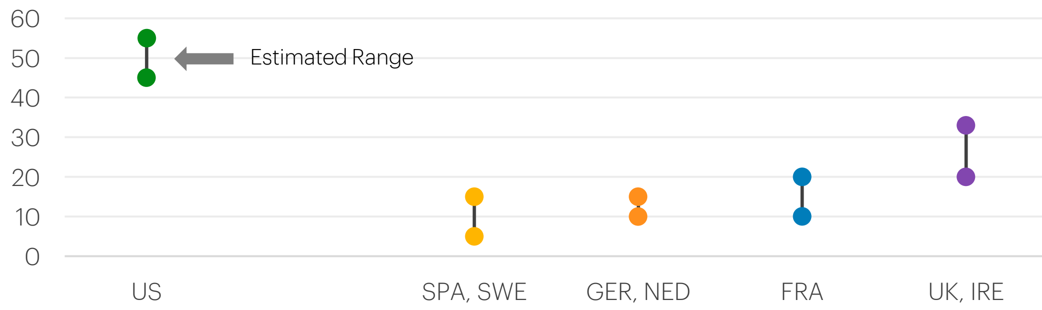
RENTS PER SQM FOR EXISTING APARTMENTS, INDEXED, 2004=100*



Sources: Statistics Sweden; Bulwiengesa
Rents for existing apartments

Security of tenure creates tenant stickiness, hence reducing vacancy risk. Regulation often includes minimum tenancy length requirements and strict rules governing eviction. Together, these serve to reduce churn in rented-residential. The combination of below-market in-place rents and low churn leads to more resilient cash flows and predictable rental growth, and lower volatility. Longer average stays (e.g. 8 years in Germany, 10 in Sweden) also allow tenants to build affinity with their homes, and prompt them to independently invest in home improvements.

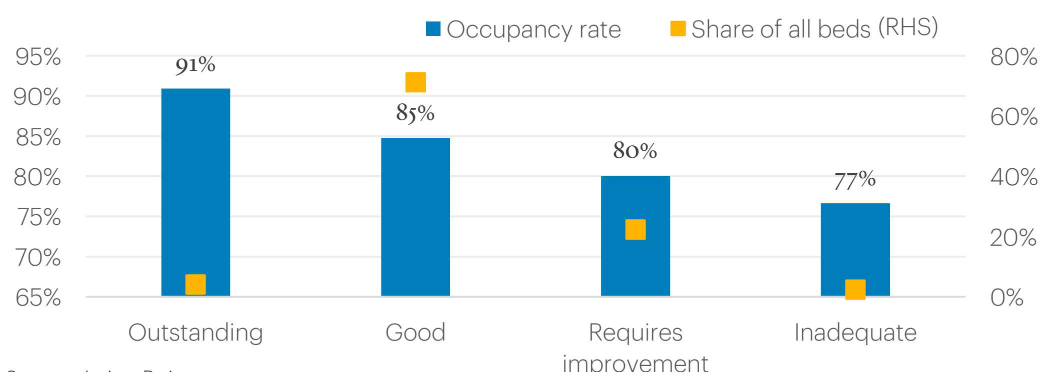
TYPICAL RESIDENTIAL TENANT CHURN/TURNOVER EACH YEAR, %



Source: Heitman Research

Fragmented nature of specialty increases risks associated with operational intensity, requiring greater scrutiny of operators and assets. The added focus on end user services and experiences in specialty sectors means performance is highly contingent on the operator as well as the property. This creates operational risk for the investor, while the partnership itself can create reputational risk. Such risks are mitigated by leveraging in-house expertise to select best-in-class operators and acquire assets with long-term functionality. For example, care quality ratings issued by the regulator are the best predictor of occupancy in UK care homes. The correlation is shown in the below chart. Such ratings are a function of the quality of the operator and the property, not supply and demand. There is greater emphasis on the investor needing to be able to evaluate operators, understand success factors, and manage risks due to the fragmentation and nascency of Europe's specialty sectors. Lower levels of sophistication among assets and operators can create a lack of clear market standards and transparency. This requires experience on the part of the investor in assessing factors such as creditworthiness. Both the operator and the investor also need to be able to adapt to risks such as regulation risk. This is particularly important in the rented-residential sector, where stricter rent control legislation has been tabled by politicians in some parts of Europe.

UK CARE HOME OCCUPANCY RATE BY CARE HOME REGULATOR RATING*, 2019



Source: Laing Buisson
*Issued by the Care Quality Commission (the official UK regulator of care homes)

Complexity and Barriers to Entry

Europe offers a rich, varied investment environment. European specialty is marked by geographical and sectoral complexity. A diverse range of countries creates variation in market dynamics, regulation, planning regimes, operational practices, and languages. Understanding these differences is critical for success in specialty sectors; they are also a major barrier to entry for newcomers without the requisite knowledge or expertise. A key source of variation is rental regulation, summarised in the below table.

SIGNIFICANT VARIATION IN RENTAL REGULATIONS

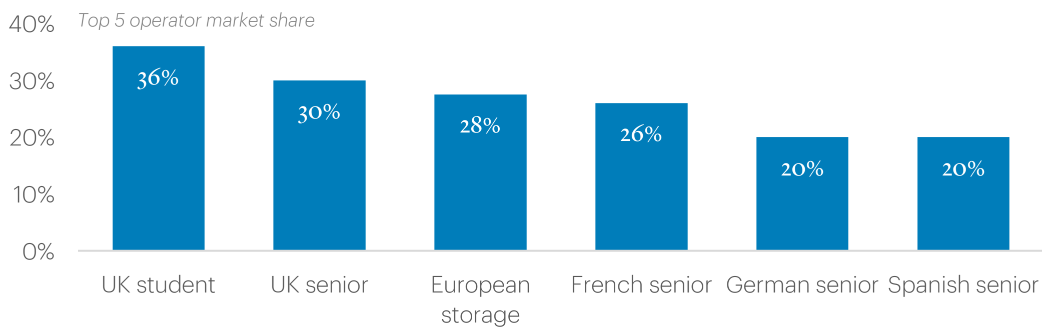
Residential Market	Rent regulation	Security of tenure	Change in regulation*
Germany	High	High	Higher
Netherlands	Low	High	Stable
UK	Low	Low	Stable
France	High	Medium	Stable
Spain	High	Medium	Higher
Sweden	High	High	Stable
Denmark	High	Medium	Higher
Belgium	Low	Low	Lower
Ireland	Medium	Medium	Higher

Source: Heitman Research *In last 10 years

Fragmentation underlines consolidation potential. Due to high levels of fragmentation, the majority of current opportunities are to be found in small- to mid-sized and off-market transactions. This rewards experienced investors with a track record of success in sourcing assets and selecting partners. With more capital entering European specialty, the future is likely to be defined by greater consolidation – a process accelerated by the pandemic, which is weeding out weaker, under-capitalised operators.

The majority of opportunities are likely to be found in small- to mid-sized and off-market transactions

FRAGMENTED MARKETS MEAN PRESENCE, RELATIONSHIP AND EXPERTISE MATTER



Source: Cushman & Wakefield; Knight Frank; Laing Buisson; FEDESSA/JLL

Experts can navigate complexity to drive returns. For instance, Heitman has successfully leveraged regulatory change in the Netherlands to 'liberalise' (i.e. privatise) social housing and achieve robust returns through rental uplift. Operational intensity is a key barrier to entry, and it allows specialty investors to enhance the value proposition by working together with a best-in-class operator. Identifying and collaborating with operating partners requires market knowledge and experience. Experts can also achieve outperformance by importing best practices from mature markets like the US, which lends an advantage to truly global platforms. Such knowledge transfer is expected to drive future market consolidation, property modernisation, and professionalisation of operations in European specialty.

[i] Society of Industrial and Office Realtors
[ii] Green Street Advisors