HOME FOR GOOD

OCTOBER 2022

INVESTMENT OPPORTUNITIES IN EUROPEAN RESIDENTIAL REAL ESTATE

KGAL

WELCOME

The world has acquired a habit of uncertainty.

Just when the global economy and financial markets were beginning to recover from the Covid 19 pandemic, a tragic war in Europe has hit the world hard.

In particular, higher energy and commodity prices are pushing up inflation to levels last encountered during the oil crisis in the 1970s.

> **Investing in residential real estate can defend against unknowns**

With national banks seeking compromises that could achieve a soft landing, the reality is that European countries, corporates, and households face higher interest rates and cost pressures.

For investors, this means mainly a correction of asset values and investment returns sitting below inflation.

The search for investments that offer some kind of inflation protection, plus low downside risk on value deterioration, has now become more focused.

One such asset class is housing.

The European residential market offers a broad range of return profiles to built-up a well-diversified portfolio. In combination with an investment strategy that puts the focus on environmental, social and governance goals it can help investors to stand against the current market forces.

In this short paper we explain how investing in residential real estate across western Europe can defend against unknowns.

We also try to show that it can benefit from the things we know about – from rising inflation to clear demographic trends, such as higher divorce rates.

Finally, we seek to demonstrate why the current market environment could offer opportunities for long-term investors with a counter-cyclical approach.

We hope you find it useful.

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A GROWING MARKET WITH POSITIVE FUNDAMENTALS

Residential real estate market fundamentals remain broadly positive – despite economic turmoil.

In Europe, the numbers of inhabitants, city dwellers and households are all expected to rise.

With an expected population growth of 0.8% projected over the next 20 years, the continent will attain a net additional 3.9 million inhabitants. Models suggest the highest growth will be in Spain, the Netherlands and France.

The continent is very much an urban civilisation and will increasingly be so, as citizens continue to seek economic and social opportunities in denser environments.

For example, the largest European infrastructure project is an initiative to connect two huge urban centres more effectively. The Fehmarn Belt Fixed Link is a huge new tunnel that brings the populations of the Metropol regions of Hamburg (ca. 5.3 Mil. inhabitants) and Copenhagen (Öresundregion with 3.9 Mil. inhabitants)[1] much closer together.

URBANISATION

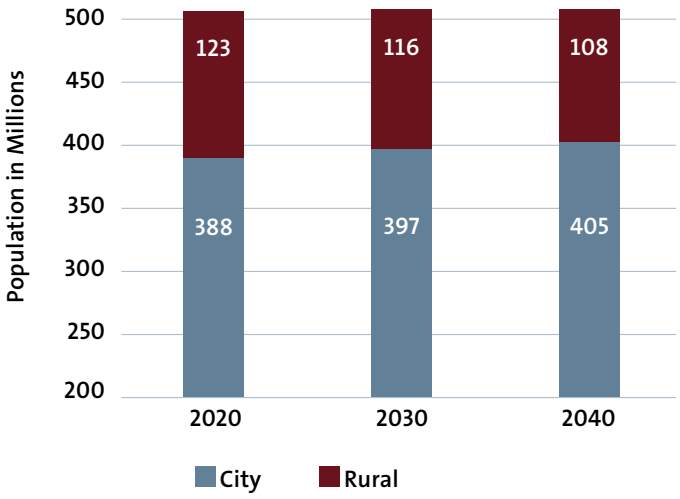

Figure 1 - Urbanisation [2]

A rising and urbanising population is also a fracturing one, with fewer and smaller families. For every sixteen people who married in 1964 it is now just over six. For every couple who divorced back then, it is now two couples[3].

Unsurprisingly, the composition of homes has changed. In 2012, the average EU household had close to 2.3 inhabitants. By 2021 it had fallen to 2.2[4]. Over the same period, the number of single households rose from 59.6 million to 70.6 million – an increase of nearly 20%.[5]

Arithmetically, a rising population plus falling household size can only equal demand for more housing units. In fact, some 11.5 million households are expected to be created between now and 2040[6].

PROJECTED HOUSEHOLD GROWTH EU 27

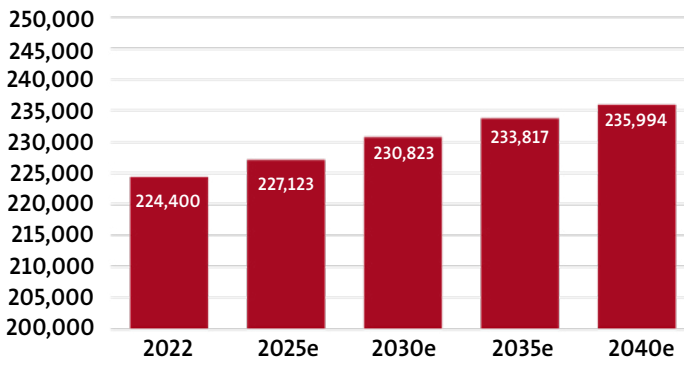

Figure 2 - Household Growth[7]

But Europeans need more. Governments are simply not building enough homes to meet this radically different demand pattern. In most of the European major cities, the rising need for rental homes cannot be met by the current rate of supply. For example, Germany just created 256,000 new flats in 2021. This is far below the 400,000 "new flat" objective of the German government and below the estimated annual demand of 310,000 new flats.[8]

Moreover, economic problems – which we examine later in this paper – may alter these projections negatively, as residential developments are put on ice or scrapped altogether.

And there's yet another issue. Even when people find somewhere to live, they may not be able to afford to live there.

Since 2005, earnings increased by 52%[9], while house prices in Germany are for example 94%[10] higher. This affordability gap is a key issue especially for young professionals. On average, annual household incomes in Europe will buy someone approximately 23 sqm of living space. In Paris, it is just 11 sqm – which means just over 9 sqm of living space after the occupier puts their bed in.

Again, affordability factors may worsen as rising interest rates pull people into letting.

This is a market desperate for supply of the right type of units.

AFFORDABILITY IN SQM

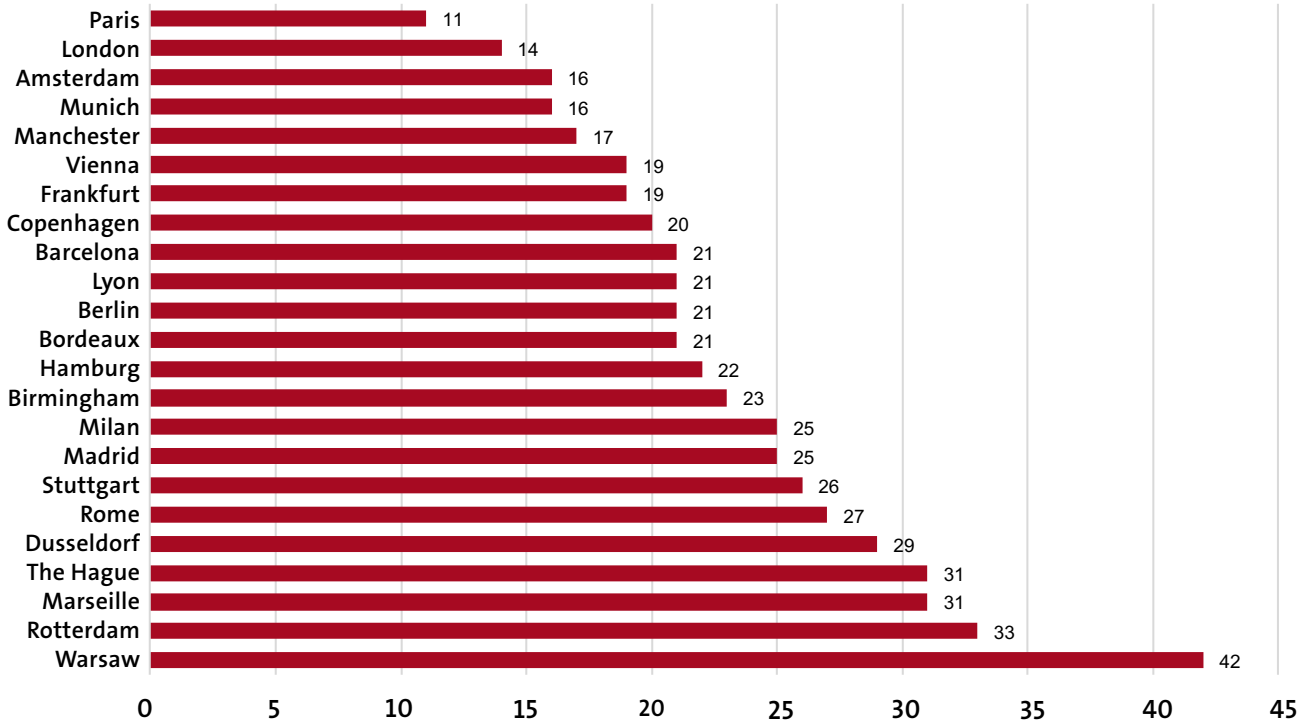

Figure 3 - Affordability [11]

A ROBUST INVESTMENT MARKET

Looking at the residential real estate market in isolation, positive fundamentals make it an attractive proposition for pension schemes and other institutional investors. And 2021 was a case in point.

Amidst the pandemic – and the economic woe it begot – European housing acquired a safe haven status in the eyes of many.

As investors sought secure income streams, the sector attracted record investment volumes (see Figure 4).

At the same time, the market saw further yield compression, of 25 basis points, which reached a record low of in average 3.05% for prime European multifamily assets[13].

With compressing yields, many asset owners and other investors are looking up the value chain towards residential development opportunities. Forward funded projects typically have a yield spread of 25-50 bps against stabilised, income producing assets of similar quality.

EUROPEAN INVESTMENT VOLUME (2021)

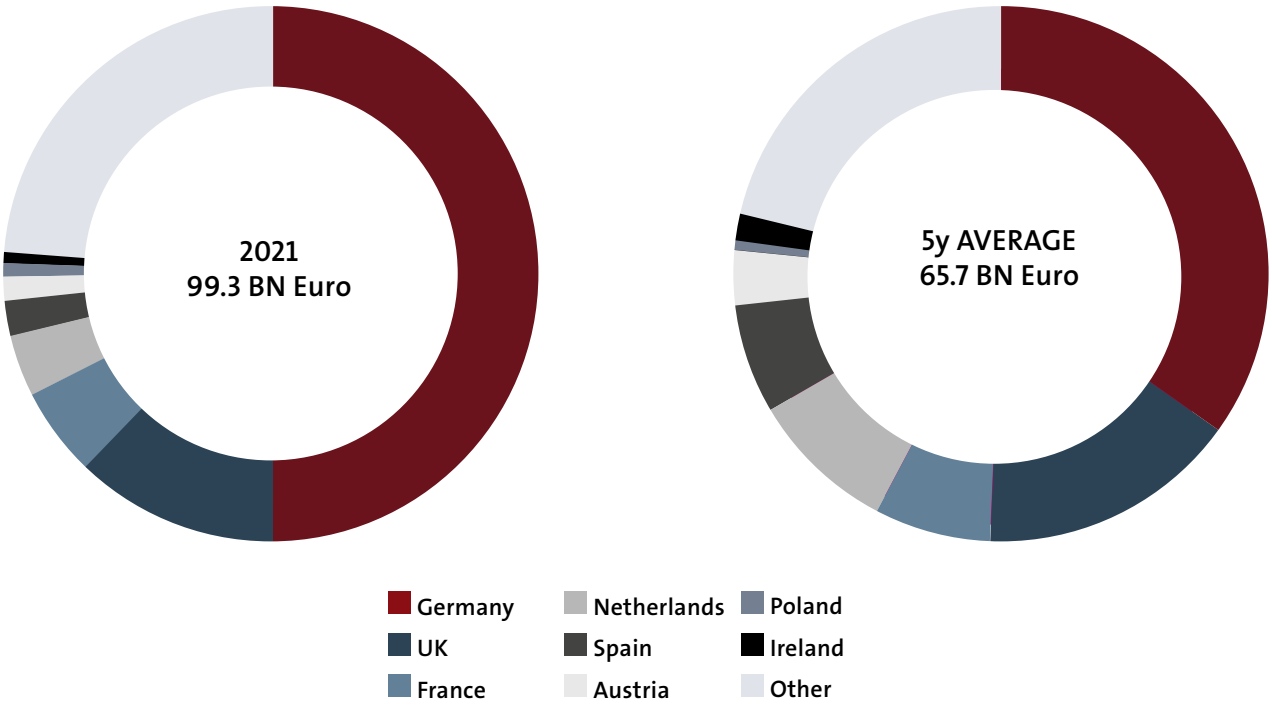

Figure 4 - Total Investment Volume 2021 [12]

Moreover, the market share for forward deals is now at 34%, significantly higher than the 10% seen as recently as 2015.

The lower end of the return profile in the mature markets and especially in Germany, is compelling investors to look over borders. Europe has a profoundly diverse housing market with, say, Spain, Ireland and Belgium lower down the maturity curve and offering comparatively more attractive returns. These big differences in national market maturity are reflected in factors such as rental share, investment volume and the quality of professional service providers. Added together, they help explain why 32% of equity invested in the EU multifamily sector during 2021 came from cross-border investors[14].

The market is evolving, professionalising, and internationalising – at pace – giving investors multiple entry points.

PRIME YIELDS - RESIDENTIAL (END OF 2021)

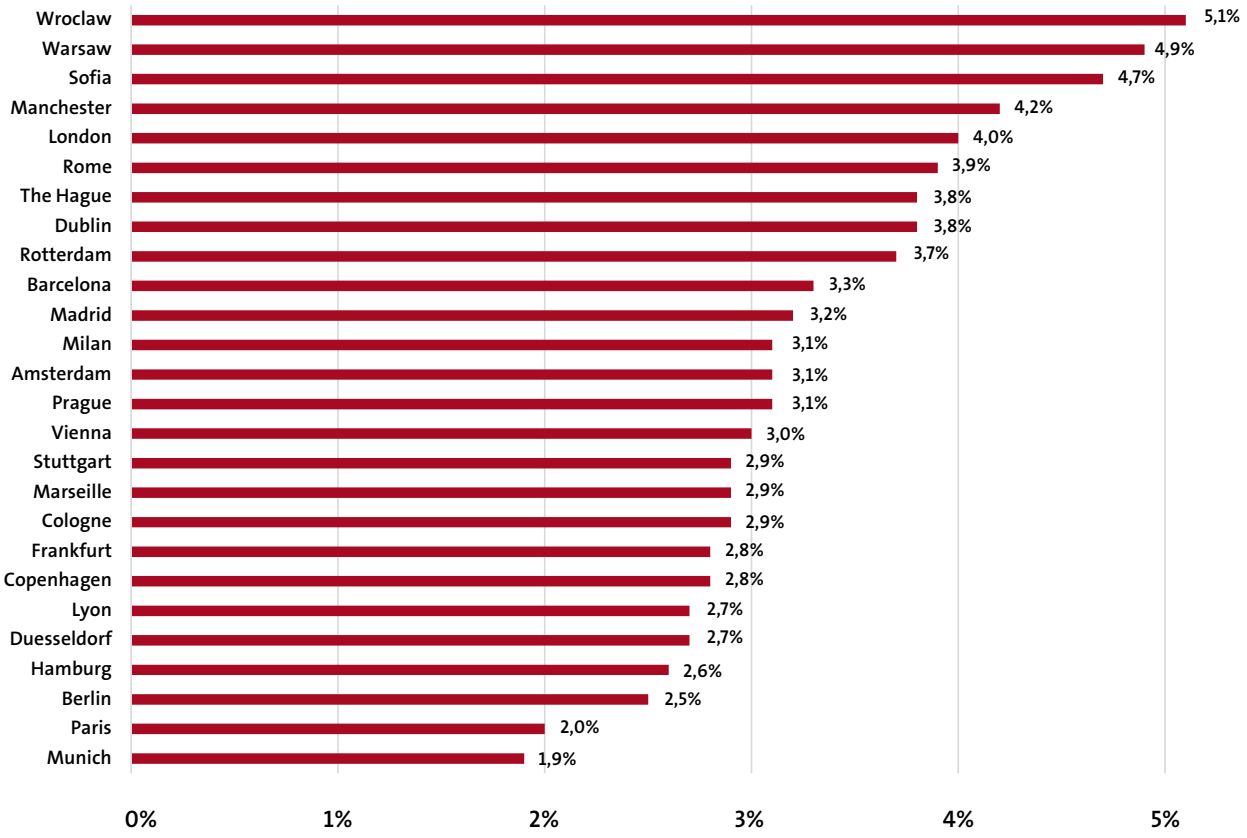

Figure 5 - Prime Yields Q4 2021 (Colliers)

AN UNPLEASANT ECONOMIC ENVIRONMENT

Moreover, the war in Ukraine and the zero-Covid policy in China have led to additional upward pressures on prices and reinforced global supply chain problems.

In August 2022, inflation was 8.3% in the United States, 9.1% in the euro area, and 8.6% in the United Kingdom[15].

Forecasts (see Figure 6) look slightly less pessimistic. However, the unsolved Ukraine war leaves us with the question of just how transitory the inflation will be. And if Russia, unpredictable as ever, completely cuts of gas supplies to Europe, then more inflation shocks could follow.

Central banks have responded, as many predicted, with higher rates. The Federal Reserve has nudged rates upwards through 2022 – back to levels last seen in 2018. The ECB has increased interest rates by 125 basis points to 1.25% - the first increase in 11 years.

Financing costs are up. For example, three months Euribor Rates rose within a year from -0.6% to 0.7% [17].

Who would be a central banker in 2022? They are in a difficult position because governments need low real interest rates to keep the public debt burden bearable. Yet they must also react to price stability considerations and protect against the risk of recession.

CPI FORECAST

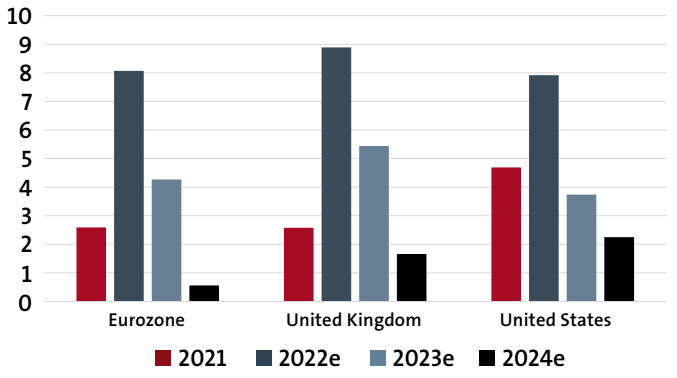

Figure 6 - CPI-Forecast[16]

EURIBOR IN %

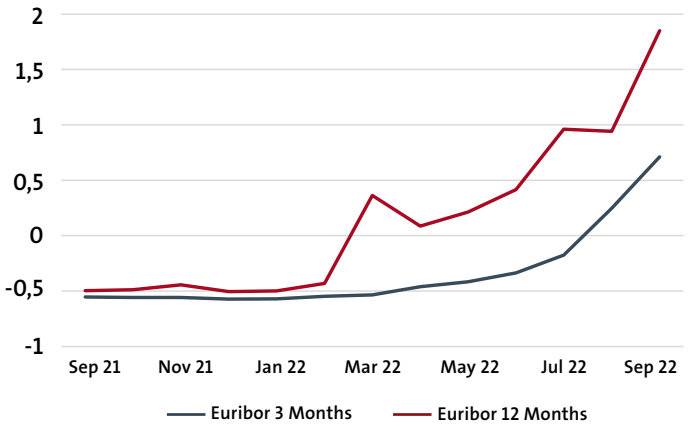

Figure 7 - Euribor Rates[18]

IMPLICATIONS FOR HOUSING INVESTORS

One of the real attractions of residential real estate is its ability to offer some kind of inflation protection.

Since the 1980s, market office rents proved broadly inflationary in New York, London, Paris and Frankfurt. Our own analysis shows that since 2008 the average total performance of European residential funds based in Germany has beaten inflation most of the time.

This helpful correlation is based on the fact that in the majority of the European countries residential tenants usually sign a contractual agreement that the landlord can raise rental payments in line with inflation. From the investor's perspective this means income growth should adjust to higher capital values.

Of course, when inflation is underpinned by economic growth ('demand-pull inflation') it should support real estate demand, rent increases and higher capital values. So far so good.

But not all inflation affects real estate investments positively. Owners are more exposed to the risks of cost-push inflation, which can lead to slower economic growth, and therefore reduced occupier demand.

In such an environment, investors need to be mindful of over-renting, if they pass inflation to tenants while occupier demand is weakening.

This is a scenario more common to the commercial real estate sector than the residential – because the latter benefits from full index-linked lease agreements as well as from positive market fundamentals, which we discussed earlier in this paper.

Overall, the magnitude and unpredictability of the current challenges has resulted in a riskier investment market and higher interest rates. This should lead to higher risk adjusted returns for all real estate segments.

Moreover, in an uncertain world, two things tend to hold true: people will always need somewhere to live – and someone will always need to build new homes.

TOTAL RETURN EUROPEAN RESIDENTIAL FUNDS VS. INFLATION

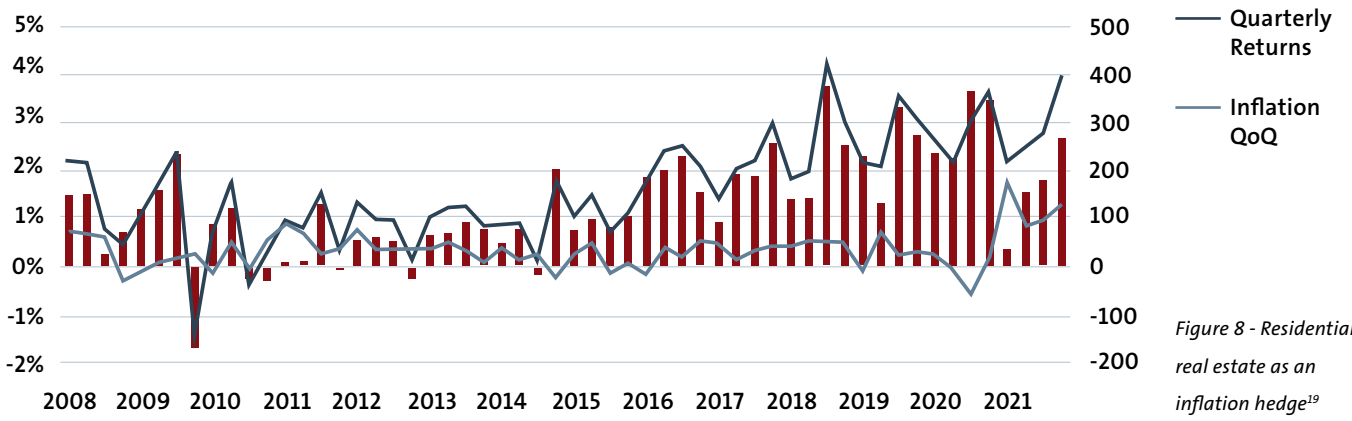

Figure 8 - Residential real estate as an inflation hedge[19]

RESIDENTIAL REAL ESTATE IN PERIOD OF ADJUSTMENTS

We have seen, above, that housing held up well in 2021.

This strong performance continued into 2022. In fact, European real estate transaction volumes had their the strongest ever first half of a year, with €157 bn in H1 2022[20].

But if we dig down a little further, transaction volumes considerably slowed in the second quarter. And now market participants are in a period of price adjustment: buyers are looking for higher yields and sellers are (as yet) unwilling to adapt to reduced asking prices. Sales negotiations are dragging on.

Such price adjustments are being driven by the higher cost of capital and the riskier business environment. They are not being motored by residential real estate fundamentals. In fact, higher construction costs are making it harder for forward deals to meet buyer price expectations.

First indications suggest that capitalisation rates moved up by 15-30 basis points but the volatile financing market (e.g. steep increase of approx. 80 bps from mid-August to mid-September for 3-month EURIBOR swaps with a 10 year maturity) makes it difficult for buyers and sellers to adapt to a new normal. But once volatility has settled down and investors are accustomed to the new reality, liquidity and transaction volumes will return. And with it also the competition for good assets.

Longer-term investors be comforted by market fundamentals. Today's market conditions with increased capitalisation rates, a lack of investible product and less investment competition will offer patient investors with longer term horizons opportunities.

For example, the multifamily subsector of residential real estate is still one of the most desired property types – thanks to its resilient cashflows, relative ability to match inflation and the sector's sustained strong fundamentals.

Moreover, capital values are expected to remain stable in the mid-term due to rising rents which are likely to soften the impact of the current environment.

TOTAL INVESTMENT VOLUME Q2 2022 IN BN €

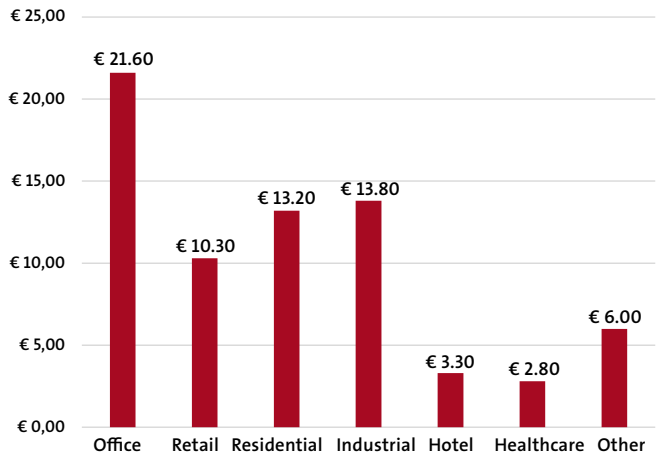

Figure 9 - Residential holds its own

INVESTMENT VOLUME Q2 VS. Q1 2022 IN %

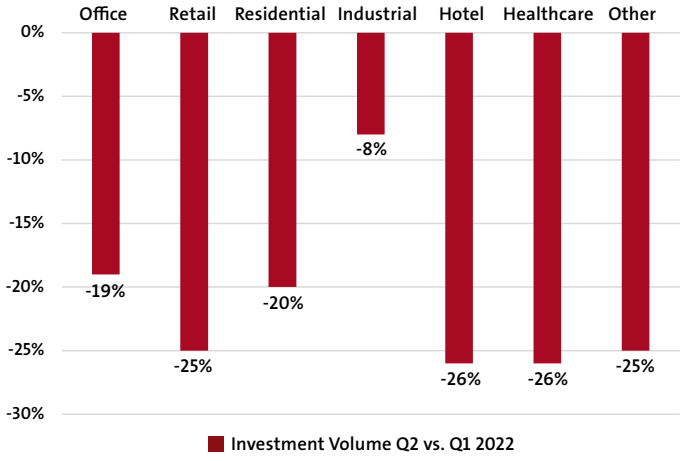

Figure 10 - Investment volumes in Q2 2022 were weaker than those in Q1


ESG

ESG: PRESERVING OR INCREASING ASSET VALUES

It's common knowledge that buildings tend to be a large part of the CO2 problem. Global Real estate contributes to 36% of the annual greenhouse gas (GHG) emissions and consumes around 38% of the world's energy[21]. According to the International Energy Agency, "[the] progress is far too slow. Accelerated efforts on all fronts will be needed to get [the real estate] industry on track with the Net Zero Emissions by 2050 Scenario."[22]

Thanks to new Europe-wide and national regulations, this is starting to change. The EU's Sustainable Finance Disclosure Regulation, requiring fund managers to disclose how sustainability risks are reflected in their investment process, is a strong start.

Add to this the proposed Corporate Sustainability Reporting Directive (CSRD), from January 2023, and Europe appears to be setting the global pace on sustainability.

Keeping abreast of such rapid developments – and profound changes – requires hard work. And, as many have pointed out, getting enough of the right (and reliable) data is perhaps the biggest challenge of all.

At the risk of stating the obvious, good data, such as that from smart meters, enables better analysis of risks and a deeper understanding of future asset performance. It can also help with tenant engagement, given they are residential real estate's prime users of energy and creators of waste.

THE ROLE OF ESG POLICIES

Managed well, a strong ESG policy can help investors to preserve or increase the value of their residential real estate investment. For example, ESG-compliant buildings are likely to achieve higher rents and higher capital values. This is because occupiers will see lower operating costs – and investors will experience better risk mitigation, fewer non-recoverable costs, and less future capital expenditure.

Conversely, homes with subpar ESG performance are likely to suffer a brown discount in the future, because as upgrading such properties to the required levels is either prohibitively expensive or a lost cause, because they are stranded assets.

A good example is a building's ability to withstand severe weather. Over the last 40 years, just 3% of weather events accounted for 60% of economic losses[23]. This comes at a time when weather-related disasters have increased by a factor of five over the last half century[24].

But an ESG-compliant building is more likely to withstand much of what a changing climate can throw at it.

Moreover, they can also offer affordable rents, better energy efficiency, lower GHG emissions, better awareness and transparency of consumption and costs, and better building quality. They also feature good quality amenities within the building or the broader community, such as medical and educational services.

ESG SCORING

This level of complexity is best viewed through a scoring system.

Such a method has plenty of uses. It can offer transparency to investors and lenders on climate targets, ESG goals, and performance against both the required taxonomy criteria of the EU's Action Plan on Sustainable Finance and the Paris Climate Agreement. It also helps investors track optimisation potential and create a roadmap to improve ESG performance.

A good scoring model should be based on the following principles

- The main goals and its performance indicators should represent real impacts
- Data accessibility, reliability and maintenance are paramount
- EU-Taxonomy-related performance indicators

Key scoring indicators include:

E

ENVIRONMENT

- Greenhouse gas intensity (kgCO2/(m2a))
- Energy intensity (kWh/(m2a))
- Resource efficiency (use of smart meters, waste management, use of LED-lights and recycling of building material etc.)
- Renewable energy use (such as PV)

S

SOCIAL

- Affordable housing (according to building-permit or Ø local disposable HH-Income)
- Social infrastructure (medical services, green areas, public transport, leisure etc.)
- User comfort, well-being and security (electric charging stations, barrier-free units and common areas, common green outdoor areas, burglar-resistant doors)

G

GOVERNANCE

- PRI signatory
- Aiming for UN SDGs
- Building certification (supports data availability for the scoring, reputational bonus)
- Sustainability strategies within service provider agreements (operating and maintenance costs, waste management,)
- Green leases (transparency on consumption, awareness of the tenants on sustainability, waste management etc.)
- Tenant communication platform (issue identification and resolution)

MATERIAL MEASURES AND REQUIREMENTS FOR RESIDENTIAL BUILDINGS

The world can seem bleak sometimes. The cost of living in Europe has increased dramatically, the consumption of resources is skyrocketing, and human loneliness is on the rise.

But properties that have a focus on ESG play a part in addressing such challenges. They can offer solutions that offer users a better environmental impact, improved quality of life and a community – while delivering a return to investors.

Ultimately, it is the fund manager who decides which ESG impact objectives to pursue, how a building should be designed and in which way management contracts should be structured.

They will start off by considering the house as a whole organism, with a direct effect on the community and the ecological environment, including the tenants. And they will move to design, usability, and resource management – over the very long term.

It's a bit like a constriction kit with numerous different customisation options. The parts available to create the optimal asset will include – but not be limited to – the following options:

ENVIRONMENTAL

PHOTOVOLTAIC SYSTEM

Basic demand for heat and/or electricity can be generated by the sun. Benefits include lower GHG emissions, more independence from external energy, reduced operating costs.

WATER SAVING EQUIPMENT AND TOOLS

Fixtures like low-flow toilets, water taps and showerheads reduce water consumption and utility costs.
Smart meters can help identify leaks, prevent waste, save water and reduce maintenance and operating costs.

FACADE AND ROOF GREENING

Green façades or roof greening promote cleaner air, absorb noise pollution, and improve heat insulation and cooling. They support biodiversity.

THERMAL INSULATION

A main construction element for creating a comfortable environment inside the building by protecting it from heat and cold, while also saving energy and ensure fire safety protection.

LED LIGHTS & MOTION SENSORS

Upgrading facilities to modern LED lighting and motions sensors is one of the fastest and easiest ways to cut energy consumption.

WASTE MANAGEMENT

At least 33% of waste is not managed in an environmentally friendly manner. The benefits of proper waste segregation includes lower waste costs, increased recycling rates and reduced landfill impacts.

Further options include:

- Wood-concrete hybrid construction
- Heat recovery
- Rainwater utilization and grey water utilization
- District heating (industrial waste heat recovery)
- Recycling of building materials

SOCIAL

AFFORDABLE HOUSING

Access to affordable housing provides residents with safe housing and improved living conditions. It is essential for building healthy and strong communities.
A space-efficient floor is key to keep the overall rental height as low as possible for occupants.

ELECTRIC MOBILITY AND CAR SHARING

Providing electric charging station with renewable energy helps to create cleaner, more accessible, affordable, and flexible urban transportation options. It provides significant benefits to cities and their inhabitants through reduced private car ownership, lower air pollution and positive climate impact.

SUSTAINABLE BUILDING MATERIALS

Healthy building materials with a long lifecycle, that are non-toxic, improve indoor air quality and occupant wellbeing. They also help to reduce maintenance costs.

COMMON AREAS AND CO-WORKING SPACES

Co-working spaces in a multifamily building helps tenants save time and money, and reduces both pollution and carbon footprints. Flexibly usable common areas expand one's own four walls with meeting and communication areas – reducing loneliness.

BARRIER-FREE ACCESSIBILITY

Accessible and barrier-free housing will play an increasing role, especially given human longevity and growing number of senior citizens.
Buildings must provide easy access to wide barrier-free passages, proper lighting and signs.

SUFFICIENT INFRASTRUCTURE

Properties with easy access to amenities, such as supermarkets, health services or education, will help to create sustainable, lively and inclusive communities.
They also reduce carbon emissions.

Further options include:

- Avoiding climate risks
- Guest apartments save space in the apartment and costs
- Different unit sizes providing residential space for singles as well as families.
- Tenant safety
- Children's playground, stroller storage
- Sharing concepts (e-cars, cargo bikes, TV, Internet, telephone, washing centre)
- Green outside area (communication, shading, no earth sealing)

GOVERNANCE

BUILDING CERTIFICATION

Building certification delivers valuable information on the three central sustainability issues: ecology, economy and sociocultural.

SUSTAINABILITY STRATEGY

Obtaining green service provider agreements for new agreements, prolongations or amendments helps to align service providers with investors' ESG goals.

GREEN LEASES

Cost savings can be achieved for tenants and owners through appropriate contractual regulations, data transparency and consumption awareness.

SUSTAINABILITY COMMUNICATION

Effective tenant communication platforms can increase community-building, identification with the building, consumption awareness on sustainability – as well as improve tenant-management dialogue.

OPPORTUNITIES IN A CHANGING ENVIRONMENT

Housing has long been an investable asset class.

The modern market can offer plenty of highly attractive opportunities – for returns, inflation protection and achieving sustainability goals.

But, at the time of writing, the asset class is buffeted by a complex confluence of factors: imbalanced supply and demand, macro shocks, and misaligned levels of maturity across different European markets.

Finding and exploiting these opportunities takes hard work.

Yet, with the sustained financing costs in 2022 it is reasonable to expect a price correction. Such a scenario will likely provide the potential for the best resourced and motivated investors, able to analyse the markets, to be very selective and react quickly when the right opportunity presents itself, to secure attractive assets.

For pension schemes and other institutional investors with a long-term horizon, this could be a useful addition to a portfolio.

It is perhaps overstating things if we say Europe has a housing crisis. In an age of true crises, such statements can lose their force. But it is true that western European nations are not building enough homes for people to have decent lives – at a time of social, demographic, and climatic change.

There is a pressing need for more homes – and for these homes to be sustainable.

Someone must roll up their sleeves and make an impact: by funding the construction of new homes and receiving the inflation-linked rental income.

The best candidates for this “someone” are Europe’s asset owners.

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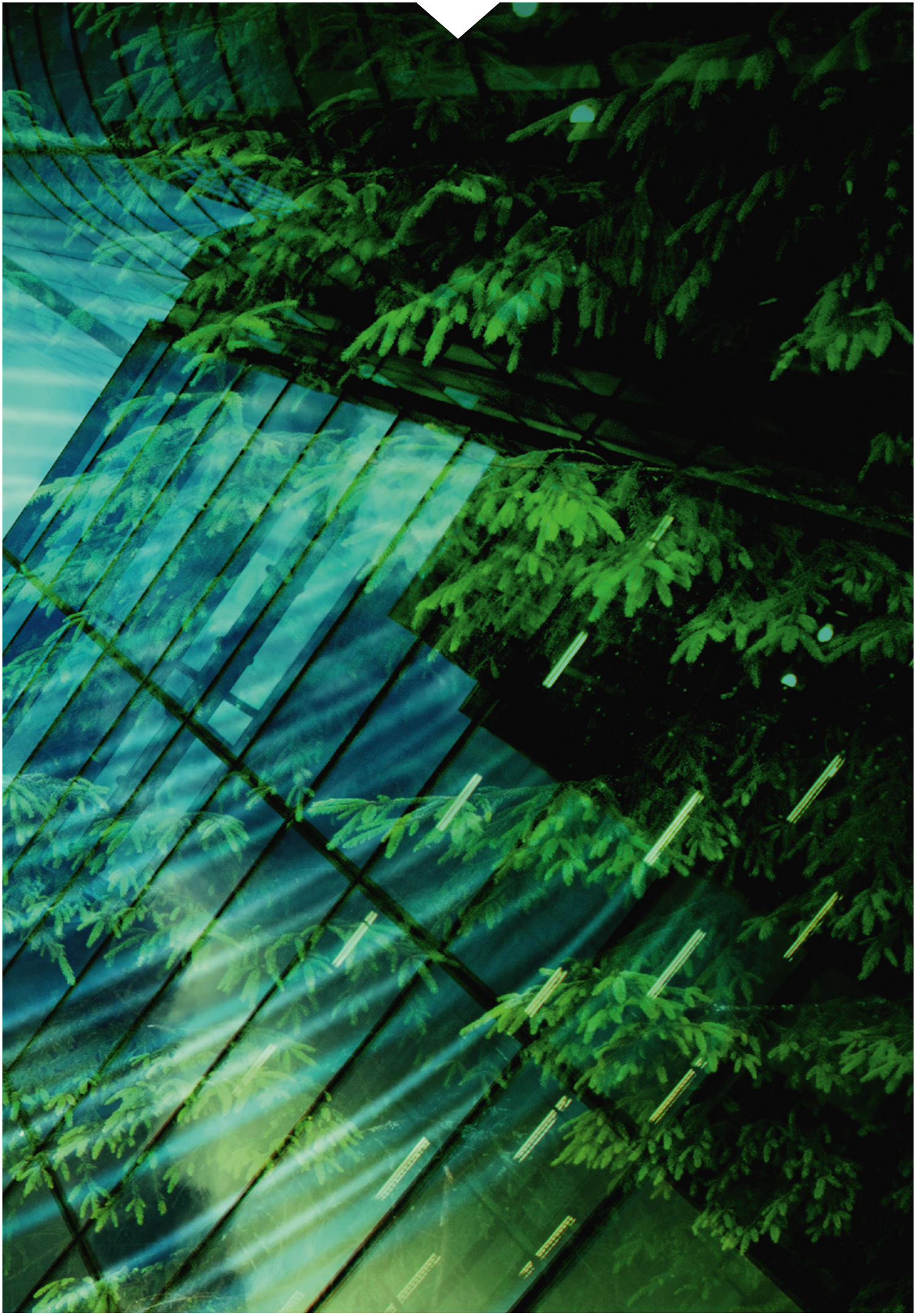

ABOUT KGAL'S REAL ESTATE EXPERTISE

KGAL Investment Management GmbH & Co. KG is a leading European real estate asset manager. It has a comparatively large team, a long heritage and a focus on solving the problems faced by modern asset owners.

KGAL has been active in the real estate market since the company was founded in 1968. To date, it has acquired real estate in individual or portfolio transactions for more than €21.5 billion.

The group is focused on three sectors – offices, retail, and mixed use and residential – and prides itself on its innovative approach. For example, it offers clients a location rating that evaluates locations on their proximity to public transport (40%), retail and service businesses (25%); places to eat and drink (25%); and public institutions (10%). These differently weighted criteria generate a 0-100 index rating which reflects the prevalence of these amenities across four zones within a radius of 150 metres, 300 metres, 500 metres and 800 metres from a property's location.

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IMPORTANT INFORMATION

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