savills investment management

SAVILLS INVESTMENT MANAGEMENT

Why European Living now?

September 2023

Adam Alari
Head of European Living
Research & Strategy

In our report *'Why Living is an essential asset class'* (2022) we observed several factors that suggest the Living sector will attract higher allocation amongst investors. As the economic cycle has moved over the last year we revisit to assess if that logic holds and ask: Why Living now?

Investors should note that the Living sector has historically produced high risk-adjusted returns over the long term. This outperformance has been lowly correlated with commercial real estate, and therefore provides attractive diversification benefits.

Across the Living segments, performance has been driven by considerable and persistent demand-supply imbalances that have supported rental and capital value growth.

Furthermore, European housing stock is outdated, and does not meet modern energy regulations.

Shifting demographics is creating significant demand for smaller housing units. Housing remains an essential need; it is not as susceptible to disruption from technology and consumer trends as other investment sectors. Overall, in our view, the structural fundamentals for the Living sector remain intact.

> "Cyclically, there are economic impacts upon residents and consequently the Living sector, but these macro challenges can also be supportive for the rental market.

The Living sector has performed well in times of economic challenge, including the financial crisis when US Multifamily net operating income (NOI) barely declined. This was not the case for other sectors of commercial real estate.

Economic distress can be supportive of investment performance in residential real estate. Less accessible mortgage finance tends to increase renter demand and, importantly, the average duration of their stay. Supply will continue to fall short as the cost of finance and construction bites.

We recognize the risks of the cyclical challenges. However, we believe rental growth in the Living sectors will likely exceed that of other commercial real estate. Thus, relatively, it should continue to be appealing for investors.

Our survey evidence (February 2023) noted that institutional allocations to Living may double within a 3-to-5-year period – does this hold today? We believe yes, as pricing adjustment creates the entry point.

Current pricing creates an attractive entry point for a sector that is fundamentally well supported for the long term; that is why we believe investors should consider European Living now.

While we are very positive about the long-term prospects for the Living sector, we are mindful of the cyclical and structural challenges.

Cyclically, given the significant macroeconomic changes in recent months; do these dilute the prospects for the Living sector and do they impact Why European Living now?

1. RESILIENCE

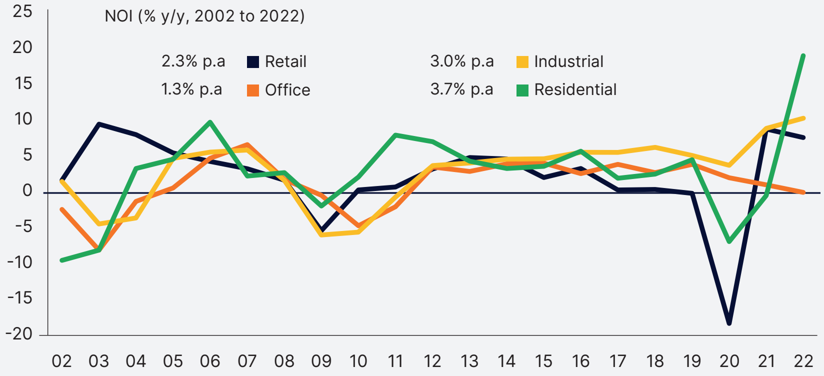
As mentioned above, the Living sector has performed well in times of economic challenge. As figure 1 shows, looking back to the global financial crisis, although total returns fell across the real estate spectrum, one prominent trend does standout: multifamily NOI growth was resilient. For long-term investors this is particularly important as income returns remained durable during a major financial and economic downturn.

US Multifamily NOI declined by 1.8% year-on-year (y-o-y) in 2009 with growth resuming in 2010. This compares with offices and industrials where NOI declined by 6.8% and 12% respectively between 2009 and 2011. In the five years from the start of 2008, the Multifamily sector witnessed nearly 5% per annum higher average NOI growth than other commercial sectors.

2. ECONOMIC WEAKNESS CAN SUPPORT RENTER DEMAND

Prospective buyers will be constrained by the cost and availability of mortgage finance. Additionally, some buyers may have sensitivity to the timing of

FIGURE 1:
US commercial & Multifamily real estate net operating income growth 2002-2022



Sources: MSCI US Annual Property Index, July 2023.

their purchases; and many have no choice other than to rent.

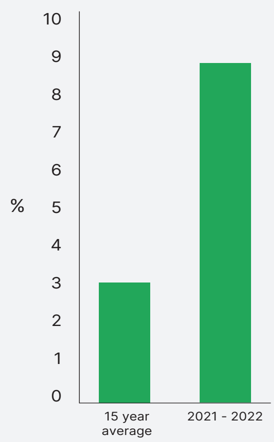
The average cost of mortgage finance for European households has risen from 1.4% in 2019 to 4.1% at the end of June 2023[1]. Demand for mortgages has plummeted and unless house prices correct dramatically, the overall cost of ownership is expected to remain out of reach for many. In our view, this supports the likelihood of increased rental demand over the short term.

3. FURTHERMORE, ALREADY UNDERSUPPLIED LIVING MARKETS WILL BE FURTHER EXACERBATED BY LIMITED NEW DEVELOPMENT

As Figure 2 highlights the significantly higher cost of construction has hindered activity and will impact future undersupply. Some current illustrations include:

- Sweden has recorded a dramatic slowdown in new dwellings, with 14,550 started in H1 2023. This represents a decline of 57% compared with the same period in 2022.
- In Germany, building permits for apartments declined by 27% to 135,200 apartments during the first half of 2023. That is c.50,000 fewer than the same period in 2022. Declines were even sharper for houses.

FIGURE 2:
Average annual growth rate of European residential construction costs



Sources: Savills IM, Eurostat, data as at July 2023.

1 ECB, August 2023, nb: references fixed rate housing loans for terms of between 1-5yrs
* European Living Investor Survey 2023 Savills/Savills IM, 20th March 2023

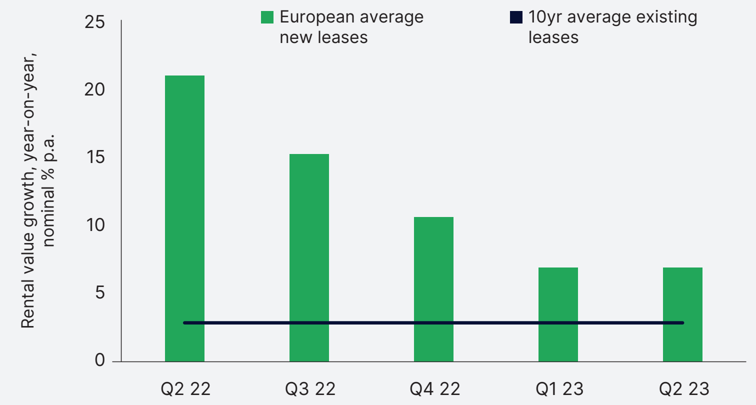
- In the UK during Q1 2023, construction worked started on 37,810 dwellings, 12% below the same period a year ago, pointing to annual completions coming in below the 232,820 achieved in 2022[2].

- The same applies with purpose-built student accommodation (PBSA), with too few new beds coming through the pipeline across Europe this year.

"

The shortages of suitable stock, and a growing demand from renters, implies that the demand-supply imbalances will produce high rental growth short-term.

FIGURE 3:
Average European one bedroom apartment rental value growth (new leases)



Sources: Savills IM, Housing Anywhere, data as at May 2023.

4. RENTAL GROWTH IS STRONG

The listed sector has recently recorded robust rental value growth. In the UK, Grainger Plc, a build-to-rent specialist, posted like-for-like rental growth of 6.8% in H1 2023, guiding to more than 7% for the full year. In Germany Vonovia reported 3.5% rent growth year-on-year in H1 2023, guiding towards 4% for the full year. Unite Plc a student housing specialist is guiding towards c.7% rental value growth for the academic year 2023/24 and at least 5% for the academic year 2024/25. As Figure 3 highlights, recent rent growth for new residential leases has exceeded historical growth.

Some analysts are pointing to stronger multifamily rental value growth still to come in Germany, with Citi suggesting 7% p.a[3]. could be realised by 2027 given the structural factors mentioned above.

Across Europe we expect average nominal in-tenancy multifamily rental value growth to settle into a range of between 2-3% p.a. over the medium term; effectively inflation plus given typical rent controls but there will be positive exceptions. CBRE has forecast western European multifamily rents will grow by 3% p.a. (nominal) on average[4] and Eurozone inflation forecasts[5] are for 2% p.a. on average over the next five years. Rent regulations and a moderation in wage growth should check rents over the medium term.

We recognize the risks of the cyclical challenges. Nevertheless, we believe rental growth will persist. It is important to note that, for long-term investors, rental growth that is too high is neither sustainable nor desirable. Consequently, affordability is increasingly important in the rental market and we will be publishing our thoughts on this topic soon.

2 DLUHC, SCB, ifo, data as at August 2023
3 Citi – Citi's Take Vonovia: Rental growth set to restore confidence, 2nd August 202
4 CBRE European Prime Forecasts Q2 2023
5 Oxford Economics, as at June 2023

5. CAPITAL VALUES HAVE DECLINED

Our analysis suggests prime European multifamily capital values per sqm have declined by 20% on average over the year to the end of Q2 2023. As Figure 4 highlights, in the past 18 months, multifamily yields have moved out on average by 75 basis points.

Listed real estate investment trusts (REIT) share prices are trading on average at 30% discount to estimated 2023 net asset values (NAV), with some German residential listed companies trading at c.50% of estimated net tangible asset values for 2023. Much of this is related to capital structure rather than poor underlying real estate fundamentals. The effects of elevated interest rates have been exacerbated given high loan-to-value ratios (40%+) that are making refinancing more expensive. This has driven asset disposals to reduce leverage, which in turn drives down estimated earnings per share.

Has the listed market overshot the correction or is the private market set to experience further declines? In our view, the public markets have overshot, because low or no leverage would not have caused such pronounced share price declines. However, we also maintain there are further declines to come in the private markets.

FIGURE 4:
Prime multifamily outward yield movement 2022-end August

Sources: Savills IM, CBRE, data as at Sept. 2023, nb: valuation yields.

We believe the markets where yields have moved out by more than the European average of 90 basis points merit closer inspection, as per Figure 4. This is particularly so if one believes interest rates might peak in early 2024 and the focus pivots to cajoling economic growth once again.

We recognise vendors not in distress are unlikely to agree to the steep discounts. Many will be motivated by a desire to re-position, diversify, and herald the next phase of growth. This suggests slower transactional activity in the short term, led by realistic negotiations.

FACTORING IN RENT REGULATIONS

Spain is arguably more attractive than Ireland given risk of rent controls in Spain has receded for the time being following its general election. In Ireland, where the rental cap is now 2% a year, yields have moved out by less than Spain (despite a similar decline in capital values per sqm) and no rental controls.

Dublin's five-year average rental value growth of 5.1% was boosted by a 4% p.a. rental growth cap being in place for much of the period. While in Spain's two major cities, growth was lower - constrained by strict rent controls in Barcelona. The rental growth outlook in Spain's two major cities is for 5% p.a. growth out to 2027[6], higher in Barcelona compared with 2.4% p.a. in Dublin.

6 Green Street, forecasts as at April 2023

INVESTOR SENTIMENT TOWARDS LIVING SECTORS SUGGESTS SUBSTANTIAL GROWTH

Our survey of institutional investors carried out in February 2023 suggested that allocations to Living may double within the next five years. More than half of the investors surveyed expect to have more than 25% of their real assets under management (AuM) allocated to the Living sectors by 2025. This compares with an allocation of 10% on average at the end of 2022.

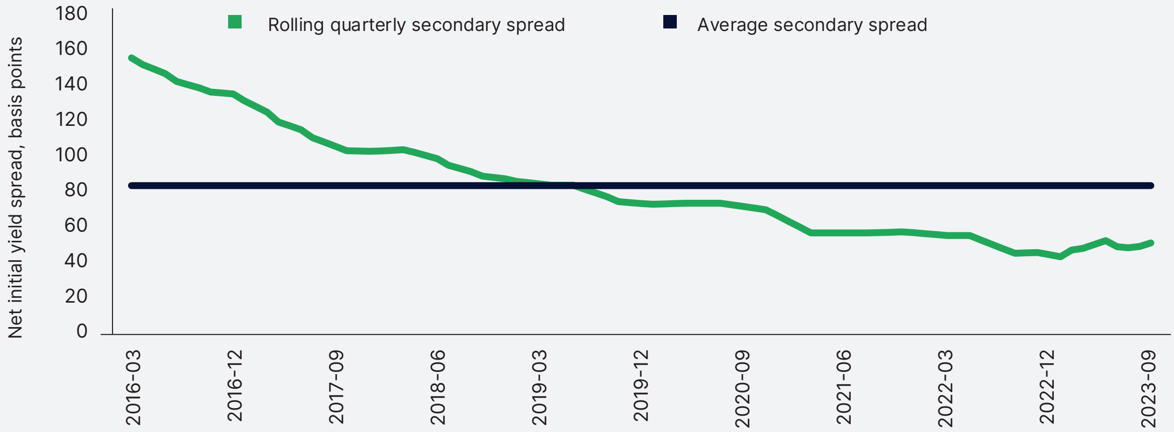
The long-term housing shortage and increasing renter demand will deliver consistent rental value growth. Even within the continuously changing regulatory frameworks, rental growth has helped offset some impact from rising yields which is compelling to investors seeking resilient income.

House price declines may exert some further pressure on pricing in 2024 but net operating income is expected to hold up given greater rental demand. As inflation eases, this will further support net income. This suggests relatively low yields in the multifamily sector will continue to be justified.

THE KEY RISKS

- Further rises in interest rates and rates remaining elevated for longer. In our view this would just mean less development and fewer house purchases suggesting further tension in the rental sector.
- Not every market and quality grade has fully adjusted yet in our view. As Figure 5 suggests, German secondary standing stock in the G7* historically traded at c.160 basis points above ‘prime’, but as of the end of August that spread was c.60 basis points (we recognize it is unlikely to revert to historical highs). Secondary stock is disproportionately impacted by capex requirements. Rent and capital growth is much harder to achieve suggesting a further adjustment in secondary pricing is required.
- An uptick in unemployment remains a risk and is greater in the case of single-person households. However, the granularity of units in proportion to a multifamily or student accommodation scheme are such that individual resident risk is well diversified.
- Further roll out of rental regulations in Europe’s cities could affect some multifamily markets. As we highlight in our recent paper on Rent Regulations (May 2022), provided any rent controls are not clumsily created and poorly implemented, such policies can be supportive of resilient long-term rental value growth.

FIGURE 5:
German Multifamily secondary standing stock spread versus 5yr average.



Sources: Savills IM, CBRE, data as at Sept. 2023, nb: valuation yields, *G7 represents Germany.

* G7 is Berlin, Cologne, Dusseldorf, Frankfurt, Hamburg, Munich and Stuttgart

Why Living now?

As we have noted in our earlier work, housing is ultimately an essential social infrastructure and demand often more robust than may be recognised. By example, there is a debate in Ireland around whether a roof over one's head is a constitutional right, such is the topicality and seriousness of the housing shortages.

The essentiality of housing, shifting household formation and barriers to ownership are further exacerbated by insufficient supply and, in particular, supply of appropriate units as well as rental price points.

These conditions continue to support resilient income returns for the investor.

Given the supportive structural fundamentals, which lie in contrast to those for offices and retail, it seems reasonable to suggest that Living will be Europe's largest real estate sector within five years and become that home for investors.

Low-risk investors will find appeal in the diversifying characteristics of the sector allocation, higher-risk investors may find appeal in creating the modern rental product that residents and investors want. Pricing creates the entry point for this sector that is fundamentally so well supported long term; that is why we strongly maintain that the time is right for investment in European Living.

CONTACT:

Adam Alari
Head of European Living
Research & Strategy
adam.alari@savillsim.com

RECENT PUBLICATIONS:

Savills Investment Management Research Reports are available at **savillsim.com/research**

FOLLOW US ON LINKEDIN:

www.linkedin.com/in/hamish smith
linkedin.com/company/savills-im

savills investment management

IMPORTANT NOTICE

This document has been prepared by Savills Investment Management LLP, a limited liability partnership authorised and regulated by the Financial Conduct Authority (FCA) of the United Kingdom under firm reference number 615368, registration number OC306423 (England), and having its registered office at 33 Margaret Street, London W1G 0JD. Property is not a financial Instrument as defined by the Market in Financial Instrument Directive under European regulation; consequently, the direct investment into and management of property is not regulated by the FCA.

This document may not be reproduced, in whole or in part and in any form, without the permission of Savills Investment Management LLP. To the extent that it is passed on, care must be taken to ensure that this is in a form that accurately reflects the information presented here.

Certain statements included in this document are forward looking and are therefore subject to risks, assumptions and uncertainties that could cause actual results to differ materially from those expressed or implied because they relate to future events. Consequently, the actual performance and results could differ materially from the plans, goals and expectations set out in our forward-looking statements. Accordingly, no assurance can be given that any particular expectation will be met, and readers are cautioned not to place undue reliance on forward- looking statements that speak only at their respective dates.

Past performance is not necessarily a guide to future performance. The information contained herein should not be taken as an indicator of investment returns that will be achieved, as this will depend on a variety of factors. Property can be difficult to sell, and it may be difficult to realise investments when desired. This is a marketing communication. It has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any promotion on dealing ahead of the dissemination of investment research.