AXA IM – Real Assets

European PRS: Resilient income underpinned by socio-demographics and a lack of stock

Major cities are amongst the most prohibitively expensive places to live in the world, and yet continued urbanization is a trend that is expected to persist for the foreseeable future. A confluence of demographic factors including migration, population growth, delayed marriage and shrinking household size is driving rental demand. In the United States, some of this demand is being met through institutions developing, owning and operating private for-rent housing (multifamily), which over the last 25 years has seen its market share rise from 10 percent to more than 25 percent.[1] Similar strong demand for housing in many European countries is also evident, but beyond Germany and the Netherlands, both of which have established apartment rental markets, the private rented sector (PRS) has remained fragmented in the rest of Europe. This has resulted in under-invested social and private stock, with the latter often owned and operated by small private individuals and landlords.

The persistent growth in housing demand across much of Europe is being met with limited new supply, leading to a supply-demand imbalance. While the resultant housing shortage varies market by market, most major cities across the globe are suffering from a degree of a housing provision gap that is supporting strong rental value growth prospects for rented accommodation. Indeed, for-sale dwelling completions have declined markedly since the peak in 2006 in many European countries, with the cost of land, high building standards and prohibitive planning regulations impeding the volume of completions. Furthermore, there is a capacity constraint in some markets from both rising cost inputs and limited bank finance, which is impacting the profitability of new development. Until consistent levels of supply can be sustained, demand will continue to place an overwhelming burden on stock, specifically at the affordable end of these markets.

It is the supply-demand fundamentals that, in our view, are underpinning a favorable backdrop for the institutional private rented sector in Europe, driven by the overarching trend of urbanisation, with a varying set of demographic trends evident between the national and city levels. While ownership remains attractive, the affordability issue, coupled with the preference to live in and around city centers, is boosting rental demand. Together with capacity constraints, changing requirements and the need for large-scale investment, a focus on locations and sites that offer scalable opportunities to maximize investment efficiency is, in our view, one of the most desirable approaches.

The low-interest-rate environment over the past decade has also helped fuel a rise in home values, and with house prices more than five times average salaries in many countries, affordability is a major issue. In conjunction with strong price appreciation, stricter lending regulations in many European countries have created barriers to ownership, especially for the young. Subsequently, home ownership is in decline across many European countries, as Figure 1 shows. However, we acknowledge the desirability to own is unlikely to diminish, especially in those markets where it has been the traditional preference, but affordability is also unlikely to be remedied in the short run. With ownership rates stagnating in many markets, we believe that the conditions support the case for developing institutional PRS, as households are increasingly forced to consider rental options and, in many cases, are renting for longer.

Figure 1: Homeownership rates

	2009	2017	2018
Norway	85.4	81.5	
Spain	79.6	77.1	76.3
Belgium	72.7	72.7	72.7
Italy	72.8	72.4	
Finland	74.1	71.4	71.6
Ireland	73.7	69.5	
Netherlands	68.4	69.4	69.0
Sweden	66.9	65.2	64.1
United Kingdom	69.9	65.0	
France	63.0	64.4	
United States	67.4	63.9	64.4
Denmark	66.3	62.2	60.5
Austria	57.6	55.0	55.4
Germany	53.3	51.4	
Switzerland	44.4	41.3	
Euro area	71.9	66.1	

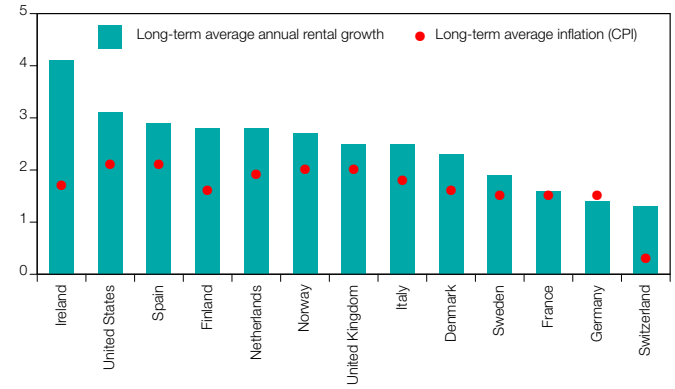
Sources: Eurostat, FRED, AXA IM – Real Assets, data as of Aug. 27. Note: Germany and Switzerland data for 2009 interpolated; trend lines 2009–2017; Euro area = BE, DE, EE, IE, EL, ES, FR, IT, CY, LV, LT, LU, MT, NL, AT, PT, SI, SK, FI

From an investment perspective, we believe that the PRS offers property investors long-term and stable income streams with inflation linkages (Figure 2) that are relatively swift to mark to market and are underpinned by a granular tenant base. Moreover, despite residential yields being low compared to other traditional commercial real estate sectors such as offices, residential yields have been more stable, arguably making residential an attractive relative value opportunity. Operational efficiency and scale are, of course, in our view, key to enhancing net income, managing costs and producing sustainable long-term cash flows, justifying these expensive entry yields.

In terms of selecting markets in which to make residential investments, we have traditionally demonstrated a preference for gateway and regionally dominant cities, given the proclivity for these cities to demonstrate the strongest fundamentals as well as higher liquidity, both of which provide greater reassurance when underwriting investments. However, with multi-locational portfolio opportunities expected to increase, a rigid one-size-fits-all approach is clearly going to result in missed opportunities. As a result, there are preferred market characteristics that are important in filtering prospective locations, which include but are not limited to: above-trend historic and expected GDP growth, growth across population groups, a higher ownership cost versus renting, a market-friendly regulatory environment, diverse demand, low forecast construction levels and a liquid investment market.

A key threat to rented residential investment is that of regulation and its potential impact on the income stream. However, while some regulations are a headwind to returns, not all intervention is negative for residential investment. Identifying and understanding the regulations and potential scope for government interventions is critical to underwriting, establishing asset management strategies and inform-

Figure 2: Long-term residential rental value growth



Sources: AXA IM – Real Assets, Eurostat, FRED, data as of May 2019

ing asset allocation through the cycle. As Berlin has recently reminded us, regulation is a key risk to PRS investment, as political cycles can change the regulatory impact of rented accommodation overnight. We are confident that regulation should not be a reason to avoid a market; indeed, a scalable operating model, strong partnerships and a focus on place making can aim to generate sustainable long-term income even in a highly regulated market.

As highlighted at the outset, Europe is lagging someway behind the United States in terms of its institutions adopting private rented into their investment portfolios. Recently there have been some encouraging signs, as European investor appetite has started to generate momentum in residential volumes. The transaction of several large portfolios, including most recently the German listed-property company Vonovia acquiring a 61.2 percent stake in the Swedish property firm Hembla AB in third quarter 2019, from Vega Holdco SARL (owned by Blackstone) for SEK 12.2 billion — coming on the back of their purchase of Austrian residential specialist Buwog earlier in first quarter 2018 — is evidence of markets maturing. The lack of large, purpose-built assets has been a stumbling block in terms of European institutions entering the space, but 2018 appeared to mark a year when M&A and portfolio deals, as a share of the total transactional volume, increased to 52.9 percent from 34.9 percent a year earlier.[2] Furthermore, in maturing markets such as the United Kingdom, Spain and Ireland, many institutions, recognizing the lack of scalable stock, are pushing ahead with the forward-funding of developments and, in doing so, are creating de-risked and stabilized assets, which should spur further investment activity.

In summary, resilient and stable income returns are the defining characteristics of the residential sector. Factors such as the necessity of housing and the granular leases providing diversification, the ability for rents to keep pace with inflation and the lower volatility of returns benefit the residential investment asset class. We believe that this combination of factors makes residential attractive on a risk-adjusted basis compared with other commercial real estate sectors.

Notes:

[1] NCREIF Property Index, Q2 2019

[2] JLL, *Multifamily Investment Market Update,* Q1 2019

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CORPORATE PROFILE

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[1] IPE Real Estate Top 100 Investment Management Survey, Nov./Dec. 2018.

[2] INREV Fund Manager Survey, May 2019. Rankings based on non-listed direct real estate assets under management.

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