LIVING SECTOR SERIES | PART 1

Growth and diversity in the living sector: Significant opportunities for real estate investors

INDRANEEL KARLEKAR, PH.D.
Senior Managing Director, Global Head of Research & Portfolio Strategies

DANIEL TOMASELLI
Manager,
Global Research

ARTHUR JONES
Senior Director,
Global Research

JD STEHWIEN
Senior Analyst,
Global Research

Introduction

Over the course of the past two decades, the institutionally owned residential sector in the U.S. and Europe has evolved from a focus on traditional apartments, to an increasingly diverse group of sub-sectors catering to growing and shifting demographic and economic needs. Broadly encompassing all forms of residential accommodation, the "living sector" covers a wide range of real estate investments, including apartments, student housing, single-family and built-to-rent homes.

This dynamism is gathering pace and the depth and variance of the living sectors are now widely recognized within the U.S. and Europe institutional universe. NCREIF and INREV, the preeminent associations providing performance benchmarks for institutional investors, have started to redefine and broaden the overall residential property sector to establish a more comprehensive view of the "living sector."

We believe there are pervasive and structural changes affecting the way people live and the type of residential accommodations they demand which include:

- Increasing urbanization
- Shifting demographic growth and income patterns
- Sustainability and affordability
- Changing lifestyles

The essential nature of shelter is that irrespective of economic conditions, people will always require a place to live. This inherent demand provides stability to the sector, even during times of economic uncertainty. To address these structural and complex shifts, more nuanced housing options are emerging, and traditional apartments or single-family-owned homes are no longer the only forms of residential accommodation. The way in which individuals want to live is rapidly evolving and makes the residential sector one of our highest-conviction investment strategies. Layer on an undersupply of moderately priced housing, and the opportunity set becomes even more compelling.

Patterns of living reflect shifting demographics and economics

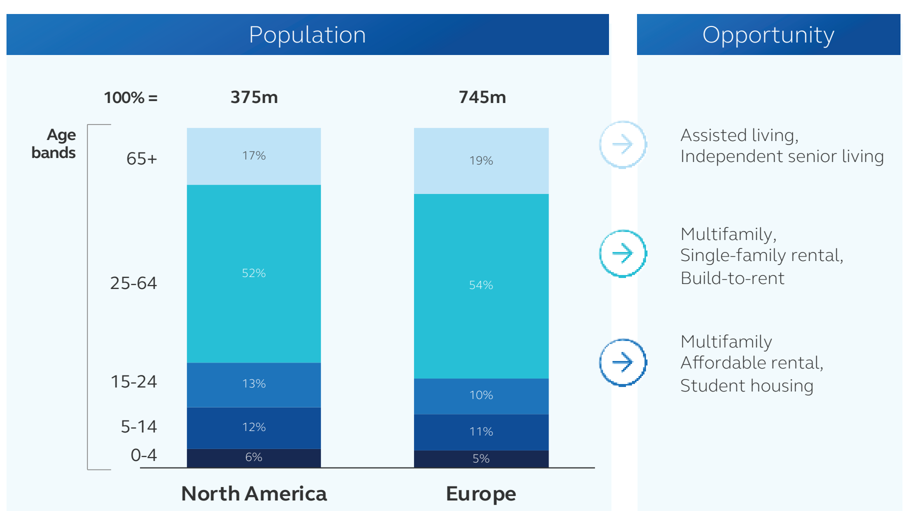
Demographic and economic changes are altering the way people live and in turn, the demand landscape for housing. For example, Millennials (those aged 27 to 42) are now the dominant population group in both the U.S. and Europe, accounting for roughly 20% of the population in each region. Including Generation Z, the prime-age renter cohort accounts for roughly 40% of the total population. This segment of the population has a different approach to living with a focus on affordability and changing lifestyle preferences, giving rise to alternative living arrangements and the demand for sustainable and eco-friendly housing, presenting avenues for innovation and investment. From an economic perspective, it has been difficult for many Millennials to save enough for first-time home purchases. Wage growth has failed to keep up with home price appreciation, particularly over the past two years when home price growth has averaged nearly 20% on an annual basis. Still, the demand for space has not been curbed by this wealth and income imbalance. As Millennials have aged, they continue to seek more space for their expanding families while balancing increased challenges to personal balance sheets.

At the same time, the U.S. and Europe are getting older—a trend that is destined to continue. In the U.S., the median age of the population is nearly 39 years old, while in Europe, it is 44. As a result of these aging and distinct populations, the structural demand for housing remains healthy but requires an increasingly diverse array of housing solutions.

Housing stock also varies greatly by region based on demographic and economic necessity. While homeownership rates in the U.S. and Europe are similar—roughly two-thirds in both regions—there are several differences in housing size, format, and location. In the U.S., for example, over 70% of households in large metropolitan areas describe their neighborhoods as suburban or rural. The share of traditional apartment stock located in suburban submarkets represents 73% of the rental market. Living arrangements are significantly denser in Europe, where cities have on average 4,000 inhabitants per square kilometer, compared to only 1,700 in North America.[1]

Demographic diversity has a profound impact on the living market. Varying age groups and household compositions and increasing urbanization have led to evolving housing needs and preferences. Different demographic groups have unique requirements and cultural considerations when it comes to housing choices, which require increasingly different living solutions. For instance, the housing preferences of Millennials and Generation Z cohorts, including their desire for urban living, access to amenities, and sustainability features are increasingly impacting the type of living solutions required. Understanding and addressing the diverse needs of different demographic groups opens the doors to a successful investment strategy that can marry affordability, inclusivity, and accessibility in an increasingly diverse society with investment opportunities that span the gamut of risk and return. We highlight some of these opportunities being driven by the diverse demands across demographic cohorts in Exhibit 1.

EXHIBIT 1: Different age groups require different housing solutions



Source: United Nations, Principal Real Estate, June 2023

[1] OECD (2020), "The changing shape of cities: Density and suburbanisation", in *OECD Regions and Cities at a Glance 2020*, OECD Publishing, Paris.

Homeownership is unattainable for many households

The case for institutional ownership in the living sector has been significantly buttressed by the lack of affordability in the residential for purchase market. For several decades, home ownership has been an aspirational goal and a key strategic investment for many households. The strategy has paid off, with home price appreciation adding substantial wealth to millions of households in the U.S. and Europe. However, an increasingly tight housing market combined with substantial home price appreciation and higher interest rates have effectively locked millions out of the single-family ownership market. Simply put, for a large swath of middle-class households, home ownership has become extremely challenging due to a combination of high price appreciation and income stratification which have significantly worsened housing affordability. In England for example, the ratio of house price to annual disposable household income increased by almost twofold, from 4.4 to 8.4 between 1999 and 2022. In other words, while for some households renting remains a choice, for a growing share of them, particularly those living in primary cities and tourism hot spots, it is increasingly turning into a necessity.

EXHIBIT 2: House prices have become less affordable

U.S. median home price to household income ratio

UK first time buyer house price to earnings ratio

Source: Census Bureau, National Association of Realtors, Nationwide, Principal Real Estate, November 2022

A key trend favoring the residential for-rent market is the skewed nature of economic and wealth distribution. Slower and below trend wage growth since the end of the Global Financial Crisis (GFC), particularly in the U.S., has tilted the metrics of home ownership to favor those in the upper end of the income distribution. Cyclically, however, the situation has been exacerbated, with rising interest rates pushing the conforming 30-year fixed-rate mortgage to roughly 7.1% as of this writing.[2]

In the UK, the average two-year fixed mortgage rate, a key indicator of housing borrowing costs, has recently climbed to 6.2-6.5%[3], a level not seen since 2008, further squeezing the finances of more than two million homeowners due to renew their fixed term mortgages by 2024, and lowering affordability of prospective first time buyers. In the Eurozone, banks and lenders are imposing tighter income tests and lower limits to the overall amounts prospective buyers can borrow. Many households want to own their homes but are unable to do so creating a growing pool of renters. The latest bank lending survey carried out by the European Central Bank also points in this direction. Demand for housing loans in the single currency area decreased substantially for the fourth consecutive quarter, as higher interest rates, negative consumer confidence, and uncertainty surrounding the housing outlook have negatively impacted mortgage applications.

[2] Source: Freddie Mac: Primary Mortgage Market Survey
[3] Source: Bank of England

Conclusion

The living sector is experiencing profound shifts that are reshaping the future of housing. Urbanization, technological advancements, sustainability, shifting demographics, and incomes are creating new opportunities and altering the traditional investment set in residential. As people will always require housing, the living sector can provide investors with a resilient investment strategy within commercial real estate. The ability to diversify portfolios and capitalize on social and demographic trends adds further value to investing in the living sector.

We strongly believe that the structural themes around the shifting patterns in demographics and cycles of economic growth create sustainable demand for investment products across the spectrum of living solutions.

We kick off an analysis of the different opportunities within this expanding space with a series of short papers starting with an analysis of traditional apartment housing and how it is adapting to a shifting demographic and economic landscape.

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