Resilience and opportunity in European specialty

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The longest economic expansion in modern history came to an abrupt end due to the COVID-19 pandemic, causing severe disruption to real estate markets. In commercial property, the pandemic has accelerated structural changes that were already underway, especially in retail and industrial. Perhaps the most unexpected consequence has been the re-thinking of long-term requirements for office space, an area that was considered relatively predictable and secure, as recently as the beginning of this year.

While the pandemic has affected occupier dynamics in all property types, those in specialty sectors have proved the most resilient. The most prominent European specialty sectors are rented-residential, student housing, senior housing, and self-storage. As the pandemic continues to cause unprecedented volatility in output and employment, we expect that investors will increasingly target these sectors, attracted by their acyclical, needs-based fundamentals. Indeed, European specialty presents a strong investment opportunity in today's environment, given capital underallocation, market fragmentation, and favorable risk-adjusted return profiles. In 2019, specialty accounted for only 22% of European investment volumes, compared to 40% in the US market.

Among the most compelling indicators of the resilience of the specialty sectors in the current context is rent collection. With the exception of the student accommodation sector, rent collections have been the highest in specialty, and lowest in office and retail (see chart below). While collection patterns may change in coming months, a wide divergence is likely to remain. The experience of past recessions teaches us that specialty rents (and returns) typically outperform those in commercial property during downturns. They also have low correlations with each other, and with the property cycle more broadly.

A key reason for this divergence is the non-cyclical nature of specialty demand. Demographic drivers are long-term in nature and less sensitive to annual GDP fluctuations; the same applies for trends like student mobility and migration. Indeed, repeated downturns have demonstrated the counter-cyclical nature of demand for higher education. The most inexorable trend of all is the ageing of the population, which continues to intensify in most developed nations. Together, these trends are expected to generate strong demand for specialty through the next decade. This contrasts with adverse secular trends affecting commercial sectors, notably the rising popularity of e-commerce and m-commerce, as well as the emergence of remote working technology that has proved much more reliable than what was available even a few years ago.

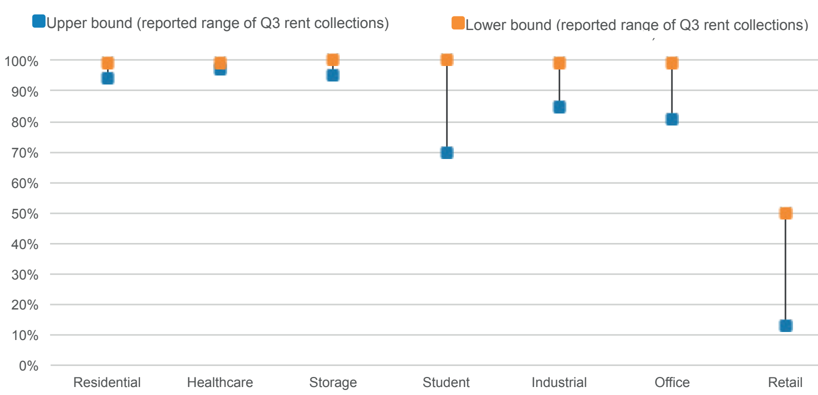
The above secular trends are reinforced by sector-specific factors. An important feature of European residential markets is regulation governing rent and tenure. In Germany, for example, in-place tenants typically pay below-market rents (that lag a market-wide index), making income streams less sensitive to cyclical conditions. Strong security of tenure encourages "stickiness" in occupancy and lowers turnover costs. As a result, rents for existing apartments in Germany have not fallen since records began in 2004. In senior housing, demand is needs-based (i.e., non-discretionary); critical life events such as a fall or the death of a caregiver account for the majority of new admissions (80% according to a study of the UK market). In self-storage, occupancy is again driven by life events like death or divorce, while a significant element of demand diversification is provided by small- and medium-sized businesses.

Government policy to counter the pandemic has also directly supported specialty demand. The most important measure has been the widespread use of wage subsidies for temporarily laid-off workers that pay between 60% to 90% of pre-COVID wages. A third of the European workforce has benefitted from some kind of subsidy scheme, directly improving rent-paying capacity among households. Key countries such as Germany and France have extended their schemes through 2021, while the UK government has reiterated its commitment against imposing austerity on the household sector. These are likely to be important defences against the growing threat of layoffs and business failures. State support has also extended to the senior housing sector, with governments covering some operating costs during the pandemic in the UK and Germany.

Specialty is also marked by a relative lack of volatility, tied to its favourable supply conditions. Thanks to needs-based demand and persistently low supply, occupancy and rents tend to have greater stability. Future risks are mostly short-term in duration and localised in reach. Of course, the unwinding of state support is a key source of uncertainty, which could potentially affect rented-residential. Short-term travel restrictions will weigh on international student demand. However, longer-term supply constraints will remain supportive in these sectors, allowing them to rebound quickly. Indeed, occupancy in UK senior housing is forecast to recover to pre-COVID levels within 12-24 months. This reflects not just the rapid growth of the 80+ age group, but also the declining stock of care beds.

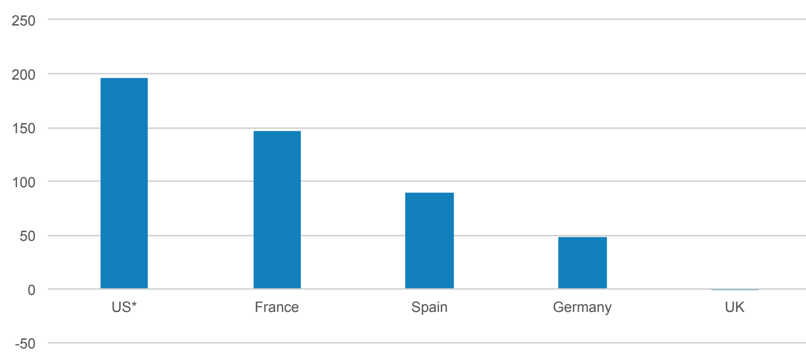
Compare this against the outlook for commercial. Delivery of new supply in Europe's office sector is expected to be twice as high in 2020-2021 as in 2016-

RENT COLLECTION AMONG MAJOR EUROPEAN REITS



Source: Heitman Research; company filings

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



*The period covered in 2015-2019
Sources: NIC, Laing Buisson, Destatis, INSEE, CSIC, Oxford Economics

2019, even as occupiers look to downsize. In logistics, increasing supply was pushing up vacancy rates prior to the pandemic, and many operators must now deal with the damage to their businesses' client base (i.e., struggling retailers, manufacturers, and exporters).

SECTOR SUMMARIES:

The largest European specialty sector is rented-residential, accounting for 80% of specialty investment in 2019. The key threat here is that of economic dislocation followed by mass unemployment; however, there are mitigants, not just limited to the ongoing governmental support for workers mentioned above. Over the past decade, a critical shortage of rental housing has emerged in many European cities, especially in the affordable/mid-market segments. This shortage is worsening during the pandemic thanks to uncertainties and restrictions in the broader housing market (e.g. development schemes on hold and tighter mortgage lending). Indeed, residential rents in the UK (ex-London) have grown in the middle of the pandemic, at a 2% year-over-year pace in June. Despite the popularity of remote working, surveys find a significant majority of UK renters still want to live in cities, not only to stay within commuting distance of the office, but also because of the value they place on social, cultural, and leisure amenities.

We view the growth outlook for rental housing as positive, although affordability is likely to become a more important consideration, especially in those cities where rents have outpaced incomes in recent years. Another risk is the spate of Airbnb units coming back to the long-term rental market; however, this risk is concentrated in a few city centres with heavy tourist traffic prior to the pandemic.

The specialty sector that is perhaps subject to the greatest uncertainty is student housing. The pandemic has forced universities to go online, and many long-haul airline routes and visa offices remain closed. This has significantly impaired international student demand (a key target for student housing operators) and cast doubt on overall enrolment levels. However, in several countries, key metrics for 2020/21 (e.g., acceptances and room reservations) are similar to last year. In the Netherlands, for example, university registrations are up 6.5% on 2019.

A few key factors will determine student housing performance going forward, and will help investors to differentiate among student markets. The first is the share of foreign students; the UK with an 18% share appears more exposed than Germany (10%) or France (12%). Continental European markets are also at an advantage from the perspective of flights and visas, as the majority of their foreign students come from within Europe and do not need visas. Finally, from a supply perspective, the UK also appears to have a relative abundance of beds; 36% of students occupy a purpose-built student accommodation (PBSA) bed, compared to only 10% in Germany and 13% in France.

Nonetheless, most of the risks facing student housing in general (and the UK in particular) are short-term in nature and are unlikely to last beyond the pandemic. Demand for quality higher education continues to grow in a globalizing economy. The competition for the lucrative foreign student market is prompting governments to relax visa rules, and universities to expand their English-taught course offerings. Even the domestic adoption of higher education is rising. This is occurring in the UK despite increased fees. In short, university education will remain a highly desired commodity among young people, with recent surveys showing that students regard online classes to be a poor substitute for the in-person experience. As before the pandemic, investors should target upper-tier universities, which stand to gain most from increased selectivity among prospective students.

The senior housing sector was at the centre of the coronavirus crisis in the spring. Approximately half of European fatalities have been among care home residents, though the impact was mostly concentrated in a handful of countries (UK, Italy, Spain, and Belgium). Since then, operators have been better able to protect residents through deployment of testing and PPE. The impact has also been localised; almost half of UK care homes are yet to report a single case of COVID-19. Public perception of care homes is unlikely to suffer long-term damage, although prospective residents are likely to become more selective in choosing a home. Care home operators that are best able to retrofit their facilities and adapt operations stand to gain most in this environment. Indeed, competition could even decrease as poor-quality stock (e.g. rooms without an ensuite, or rooms for double occupancy) is pushed out of the market more quickly.

The pace of ageing in Europe means that long-term demand for care is likely to intensify in coming years. The share of the 65+ age cohort rises by around 3% every decade, and one in four Europeans will be of retirement age by 2030. Combined with absolute undersupply of beds, and mismatch of current stock with customer needs, the outlook is one of robust occupancy in both the short and the long run. Indeed, the needs-based nature of demand means that admissions have already started to normalize. Customer surveys show that the willingness and ability to pay for care home fees is high in Western Europe. We expect this to persist as generational wealth is most concentrated among older age cohorts.

The last major specialty sector, self-storage, is likely to prove the least affected in the pandemic. Household demand for storage is driven by the four "D's" (death, divorce, downsizing, and dislocation), and is additionally supported in Europe by demand from small and medium-sized businesses. Stock saturation per capita remains exceptionally low by global standards (30x lower than in the US), even though storage is especially well-suited to a continent marked by high urbanisation, dense populations, small homes and high rents. Indeed, demand has proven to be resilient to the pandemic, best evidenced by stable occupancy and very high rent collection rates (96-98%) reported by leading UK REITs throughout the pandemic. The high growth potential inherent in the sector can be unlocked by targeted operator spending on marketing campaigns and search engine optimization.

RESILIENT FUNDAMENTALS, ENHANCED RETURNS:

Historically, specialty demand has been needs-driven and income-inelastic. Accordingly, returns have been resilient during downturns, typically outperforming commercial returns. Investors are catching on; while total European real estate transactions shrank by 10% YOY in H1 2020, rented-residential investment increased by 13%. Those investors seeking value returns may be rewarded with higher yields than in traditional sectors, with specialty investment supported by superior risk profiles, a rapidly expanding investable universe, and increasing institutionalisation.

GDP-WEIGHTED PRIME YIELDS, BY SECTOR, Q4 2019

Source: CBRE, Catella, Cushman & Wakefield

Capital allocation away from office and retail is likely to accelerate, as investors looking for alternatives are drawn to the proven performance and growing liquidity of specialty. Europe is in the early stages of this capital rotation; ODCE fund allocation to specialty is only 10% in Europe, compared to 28% in the US. Yield spreads are also wider than in the US market, implying long-term yield compression potential. Listed names in European specialty have been investor favourites in the pandemic, enjoying significant premiums to underlying asset value and actively expanding into newer markets.

Due to the high degree of fragmentation, most current opportunities in specialty are in small- to mid-sized transactions and in off-market transactions. This rewards experienced investors with a proven track record of sourcing assets and selecting partners. The ability to navigate market regulation and to select operators is critical, as these factors create steep barriers to entry in European specialty. Similar to regulation, we consider operational intensity to be a feature, not a bug, which can significantly enhance the value proposition for an investor. With more capital entering European specialty, a period of consolidation lies ahead as the pandemic speeds up the rationalisation of weaker operators.

In spite of the challenges presented by the pandemic, the long-term trajectory of European specialty remains fundamentally unaltered and continues to track in a positive direction. Demand benefits from inherent resilience, strong demographic tailwinds, and additional support from recent policy decisions. Needs-based demand and low supply allow for a high degree of predictability and low volatility in occupancy and rents. These elements are of even greater value to investors in the current environment; rising transaction volumes in the midst of the pandemic attest to the accelerated capital rotation away from commercial toward specialty. In more fragmented areas of the market, this process should create opportunities for yield compression and enhanced returns. Early-stage investors are rewarded with wider yield premia, income streams protected by secure risk profiles, and future exits supported by the structural trend of increasing institutionalisation.

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