DIVERSIFICATION POTENTIALS IN EUROPEAN HOUSING MARKETS

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The different economic, financial and, most importantly, institutional and structural factors on the European housing markets currently make it challenging to develop a pan-European residential investment strategy. The structural differences constitute one of the reasons why the performance of residential assets varies strongly. While factors such as interest rates, government bond yields and demographic demand play an important role in the common understanding of housing markets, other factors such as rent regulation, building quality and tenure security are obstacles that fundamentally affect the performance of residential assets as well as the inflow of national and foreign capital into residential investments.

Because the degree of regulation in housing markets is difficult to measure, one can only qualitatively determine whether the degree of governmental intervention in the private-rented sector has narrowed or widened over time. Based on a qualitative assessment of factors such as initial rent determination and increases, lease length, selling opportunities, getting property back during the lease (tenant eviction) as well as legal enforcements, regulation in European housing markets has changed structurally during the past three decades.

Looking at the last three decades, there has been a significant relaxation of regulation in Finland, UK and Norway. The level of regulation in Finland, for example, fell significantly through the abolition of rent control and the relaxation of tenure security in 1995 in order to spur (foreign) investment in the residential market and expand the residential stock. A similar development can be seen in Norway, where rent control for new and existing dwellings was abolished in 1999. In contrast, the regulations on rent increases introduced in Germany in 2014 suggest a stricter regulatory regime than in the late 1980s.

The "point system" in the Netherlands is an example of a system that controls the rent level of dwellings leasing for less than €700/month, and which affects almost 88% of all existing dwellings. While the system is based on hedonic characteristics like number of rooms, heating, thermal insulation, inclusion of a kitchen, age, etc., the regulation changes under way also cover rent increases, which are restricted to a percentage based on inflation plus a premium, liberalising the sector somewhat.

The Dutch regulation is an example of how the attractiveness of the PRS for national and international investors can be enhanced in the medium-term since it will increase the share of dwellings in the deregulated market. These differences constitute a key factor that investors should consider when developing an investment strategy for residential assets and especially when assessing future performance.

Figure 1 Residential total returns and components since 2000

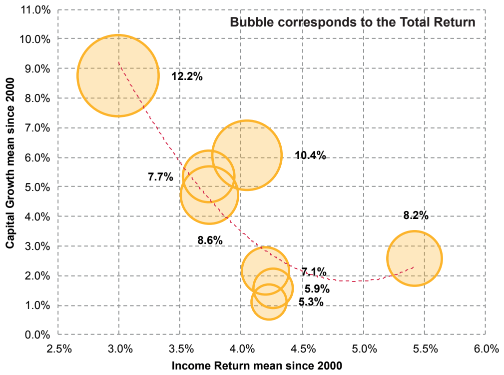


Figure 2 Total return distribution since 2000

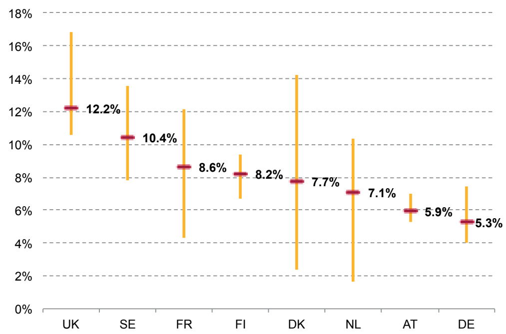
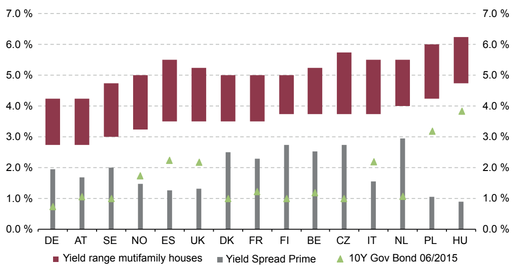


Figure 3 Gross initial yields for multi-family housing vs. government bond yields in Europe



While regulation in the private-rented sector can only be measured qualitatively, performance of the different European residential markets varies strongly and can be measured by total return figures for many European markets. Looking at the components of the total return over the last 14 years, institutional housing markets in the UK and Sweden show a very strong focus on capital growth rather than income return. Both markets display very robust total returns primarily driven by strong capital growth of ca. 9% and 6% p.a., respectively.

In contrast, Germany, Austria and the Netherlands constitute a group of markets in which total returns are mainly affected by variations in income return rather than capital growth. While the income return in Germany, Austria and the Netherlands has been constant at about 4% p.a. since 2000, Finland posted the highest income return from a European perspective of around 5.5% p.a.

Looking at the volatility of the different markets, the data again indicate strong variation across European residential markets. Because the UK, Denmark, Sweden and France have a strong focus on the capital growth, they represent the markets with the highest total return volatility since 2000. In contrast, average residential total returns in Finland, Austria and Germany have been moving within a tight range of ±3 percentage points since 2000, a comparatively low volatility due to the high significance of the income return for the total return performance. Overall, this differing risk and return characteristics of the national residential markets offer institutional investors a great diversification potential not only within European residential investments, but also in comparison to other sectors.

Another reason why multi-family housing investments are so popular with institutional investors is that they are comparatively attractive, especially given the low income return volatility. Multi-family investments have a bond-like quality in the case of a buy-and-hold strategy, resulting from the high granularity of the tenant base and, because having a place to live is a basic need, from the fact that tenant fluctuations are less dependent on economic activity compared to commercial property investments.

In the current interest rate environment, the traditionally low achievable yields are therefore relatively attractive, as multi-family housing in Europe still offers a decent spread above national 10-year government bond yields, between 100 and 250 basis points, especially when looking at France, Belgium and the Netherlands, but also at Finland, Denmark, as well as Germany and Sweden. Furthermore, the strong recovery of the Spanish economy during the last three years can make selective investments in multi-family housing attractive, especially when targeting the main urban centres and secondary cities with a modest increase in demographically induced demand.

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