THE EUROPEAN RESIDENTIAL OPPORTUNITY

Why It Is Now The Right Time To Execute A European Residential Strategy

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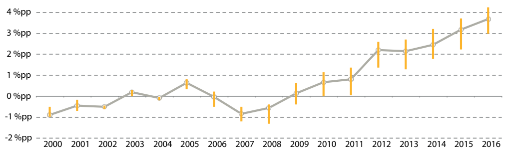
Since World War II up until the financial crisis ownership rates in most European countries were continuously increasing. In many countries owner occupancy rates more than doubled during this period, making owning the dominant tenure across Europe. In the wake of this development, institutional investment in the private rented sector (PRS) nearly disappeared in most countries. The progressive dilution of private rental markets in the EU was driven by the alignment of market and policy incentives favouring ownership as the best option to meet accommodation needs. Only a few countries were able to escape this development, of which the most prominent example was Germany. Since the financial crisis in 2007 the attitude towards home owning in parts of the population and in the political environment has changed, e.g. in Ireland, Spain, the Netherlands and the UK. Especially from the political side owning is not seen as the favourite tenure any more, as the financial crisis brought the economic consequences of high home ownership in combination with high mortgage debt to the surface: giving rise to macro-financial risks and vulnerabilities in the banking sector, as well as leading to an inefficient resource allocation to housing production, potentially crowding out tradable sectors and generating or aggravating external imbalances, as the examples of Spain and Ireland have shown in the last decade. Overall, this leads to a situation where renting is much more of an accepted tenure for a certain period of life in high ownership countries than it has been in the past and to a trend reversal, with ownership rates slowly declining in many countries.

Parallel to these developments institutional investors increasingly realise the attractiveness of investments in the PRS: firstly strong urbanisation across Europe in combination with insufficient construction activity leads to continuously increasing rents, with average rental growth above inflation for the last 15 years, despite all the different national regulatory frameworks. And rental growth of European multi-family housing investments has proven to be crisis-resistant, especially after the global financial crisis, with rental growth accelerating between 2007 and 2009. Secondly, although PRS investments have historically relatively low income returns between 3.5 and 4.5%, a structural break in the relative attractiveness of multi-family investments in comparison with fixed-income investments, such as 10-year government bonds, can be seen in 2008. Prior to 2008 the income-return-yield gap was close to zero, indicating similar performance of residential assets relative to fixed income. In contrast, in the aftermath of the global financial crisis, the expansionary monetary policy of global central banks led to an enormous compression of risk-free rates, pushing the gap to historical highs. The income-return-yield gap has continued to rise since 2009, resulting in an income-return premium above national (risk-free) 10-year government bonds of about 3 percentage points on average, with a nearly non-existing default risk. Overall this leads to a very attractive compensation of the liquidity risk associated with PRS investments, especially if investors like pension funds hold the assets long term to benefit from low volatility and high predictability of multi-family investments to fulfil their pay-out requirements.

Parallel to this development the cross border transaction activity in the PRS has increased considerably, with Germany, the UK and the Netherlands being the most sought after markets in the last 18 months. But investors have to keep in mind, that understanding regulation is crucial for the investment success, as a very diverse regulatory landscape can be seen in Europe. Regulatory activities of governments have and will be carried out for two reasons: on the one hand to ensure social stability / fairness through sufficient supply of affordable priced accommodation, urban integration and stable living conditions for all households, and on the other hand to avoid market segmentation and ensure effective contract enforcement. Due to these reasons rental market regulation developed mainly at times of overcrowding and social unrest intensified by housing shortages. As the significance of these reasons grow, as do the discussions in Germany, Spain, Sweden and the UK show- understanding rental market regulation remains a crucial aspect in the development of any Pan-European PRS strategy. In general, the regulations targeting the private rental sector can be divided into two main groups: regulations covering rents / rent controls and regulations targeting the tenant-landlord relationship. Based on an index between 0 (no regulation) and 5 (very highly regulated), a very diverse regulatory picture can be seen in Europe.

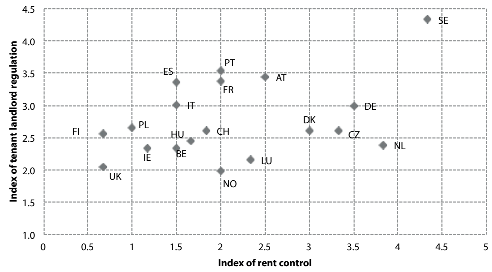
But it is about understanding the regulation and not about regulation per se, which makes a national PRS attractive for institutional investors as the investment volumes in Sweden, Germany and the Netherlands show. Nevertheless the national regulatory framework demands a constant monitoring for ongoing changes, as the historical example of the UK in the 1950s and 1960s is a good example of how (very) strong and constantly changing regulation can thwart a successful market development of the PRS. In addition, due to the ongoing urbanisation across Europe, institutional investors need to understand the demographics of the different countries on a regional, or better, city level, to invest in the demographically winning cities. If taken into account, all this leads to a situation that for the first time in more than 50 years a Pan-European multi-family investment strategy with a clear city focus can be implemented successfully.

Figure 1 Income return spreads on 10Y government bond yields in Europe



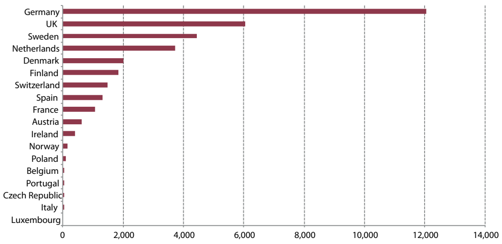
Source: MSCI/IPD, KTI.

Figure 2 Dimensions of rent regulation



Source: OECD.

Figure 3 Residential transactions in 2016 (€m)



Source: RCA.

PATRIZIA