

Revisiting the Living Sectors: Evidence of Strong Growth and the Potential for More

Our article, “Introducing the Living Sectors: New Investment Targets for Stability and Growth in Europe”, published in the September/October 2015 issue of this publication, outlined the investment case for what we labelled the “Living Sectors” – to our knowledge a new coinage at the time. The Living Sectors are comprised of income-generating properties that are places people call home: rented residential, student housing, and senior housing. Two years ago, we pointed to data showing that these sectors offer a strong risk-adjusted growth profile, and we identified numerous opportunities to add value at the asset level. We highlighted the various non-cyclical themes supporting demand; these structural and secular drivers are becoming even more attractive as we enter what feels like the later stages of the global economic and property markets cycle.

Since the article was published, investors have continued to be drawn to the Living Sectors as strategic investment targets and have increasingly embraced them as long-term components of their portfolios’ construction. Our predictions of increasing institutionalisation and investor demand have turned out to be accurate. We expect these trends to continue, resulting in further convergence with mainstream property types and their counterparts in other world regions.

Now A Nearly \$520 Billion Sector

In 2015, we estimated that the Living Sectors across Europe, including the UK, had an investable capitalisation of \$380 billion. We recently updated this estimate for mid-2017 and conclude that the universe of European Living Sectors real estate now amounts to \$518 billion, up more than 36% compared to two years ago.

Drilling into our estimate, we see a trend toward increasing sector diversification of the Living universe. We estimate that today around 77% of Living stock by value consists of rented residential, with student and senior housing each accounting for about 11%. For comparison, two years ago we estimated that 87% of the investable universe consisted of traditional

rented residential. The reduced share of traditional residential underscores the increasing maturity of the student and senior sectors.

However, much of the recent growth in student and senior stock has been concentrated in a handful of key countries. This, along with a surge in UK PRS (private rented sector) stock, has – perhaps counterintuitively – contributed to an increasing geographic concentration of the Living investable universe. We estimate that 61% of Living assets by value are now located in Germany, the UK, and the Netherlands, up from 56% two years ago. We expect an eventual reversal of this trend as student and senior housing gain ground in France, as well as in smaller countries throughout Europe. For the time being, however, this concentration in Germany, the UK, and the Netherlands leads us to focus our own investment efforts primarily on those markets, because they are the largest and deepest ones for Living investment.

Strong Investment Activity

Investment volume in the Living Sectors has remained extremely strong. As Exhibit A shows, in the 12 months ending with the second quarter of 2017, more than €43.8 billion of Living assets were transacted, consisting of around 20% of overall property investment volumes across Europe. This was up from around 15% two years ago and brings it in line with the Living Sectors’ share of the investable universe of around 21%.

One important trend evident in the investment volume figures is increasing activity in the student and senior housing sectors. As Exhibit A shows, student and senior investment volume was close to nil in 2009, but has since grown to nearly €12 billion annually. Senior housing has seen especially strong growth in investment volume; activity in that sector increased by almost 75% compared to the prior year.

It should be noted that recent declines in German rented residential and UK student housing investment volumes primarily reflect the lumpiness of corporate M&A transactions and portfolio deals, rather than reduced interest in these sectors. In fact, one of the



BRIAN KLINSIEK
Director of European
Investment Research



ZUBAER MAHBOOB
Assistant Vice President

key factors holding back even stronger capital flows across the Living Sectors is a lack of stock available for sale to investors. This has driven investors into more transactions involving forward funding and forward commitment structures, and has led to compression of the pricing discounts available to those willing to commit their capital to assets prior to completion. Given the shortage of Living stock relative to both investor and – more importantly – occupier demand, we support undertaking selective development strategies, especially on a “build-to-core” basis.

Institutionalisation: Growth in Listed Market Cap

A key characteristic of the Living Sectors in Europe is that they are emerging sectors with less mature market dynamics as compared with the mainstream commercial real estate sectors and the equivalent sectors in North America. Until recently, Living Sectors assets in Europe had been largely owned by local and private entities, which have different motivations and strategies in the management of their assets than professional investors and institutions. This creates opportunity as the market moves toward greater maturity and professionalism.

For example, increasing maturity should lead to the growth of listed real estate companies in the residential, student, and senior spaces. The Living Sectors’ operational traits and pre-

dictable earnings mean that they are well suited to public company ownership. On the face of it, this is one area in which Europe has already made substantial progress. As shown in Exhibit B, residential and student housing companies already account for around 19% of the total capitalisation of the European (developed markets) EPRA index, surpassing the US level, which has been stable at around 16-17%.

A closer look reveals that this trend rests almost exclusively on the growth of the large, listed German residential companies. There is also a meaningful market cap in the UK student accommodation space, but this is dwarfed by the German residential asset base. There is virtually zero market capitalisation of Living Sectors companies in other countries, and there are no pan-European listed housing companies. Even in Germany, the listed residential firms are still not allowed to be organised as REITs for tax purposes.

We expect the growth and emergence of more listed Living Sectors companies, especially multi-national ones, as the sectors mature. This would be a positive development for liquidity and is consistent with how other property sectors have matured in Europe and elsewhere. Indeed, bringing a pan-European residential initial public offering (IPO) to market likely already represents a potential exit strategy option for investors amassing a multi-country Living portfolio.

Institutionalisation: Private Market Portfolios & Funds

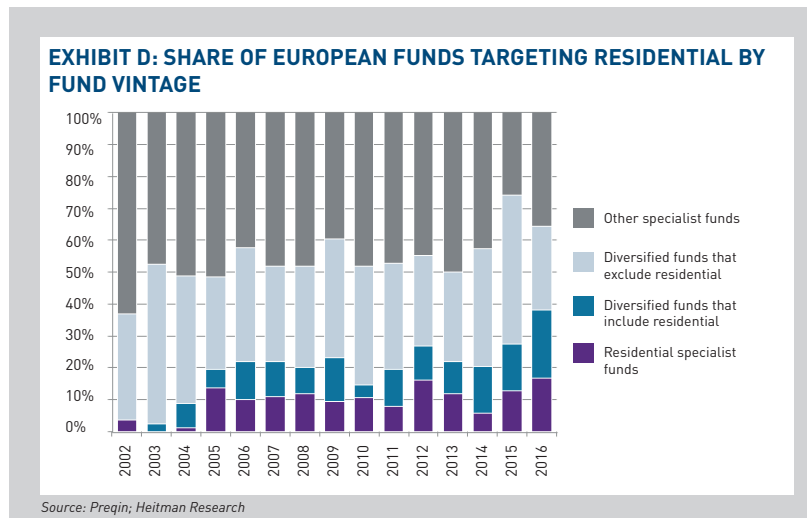
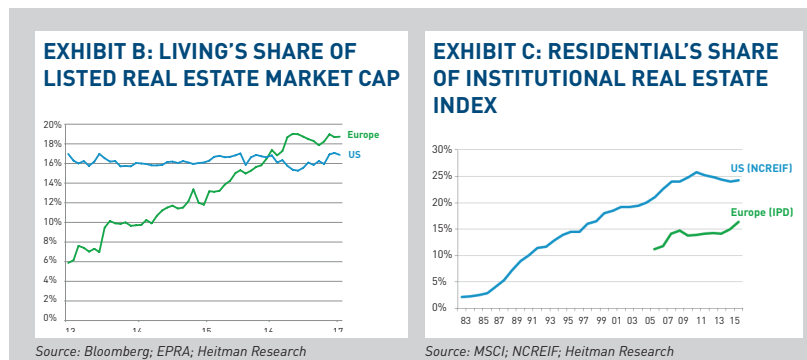
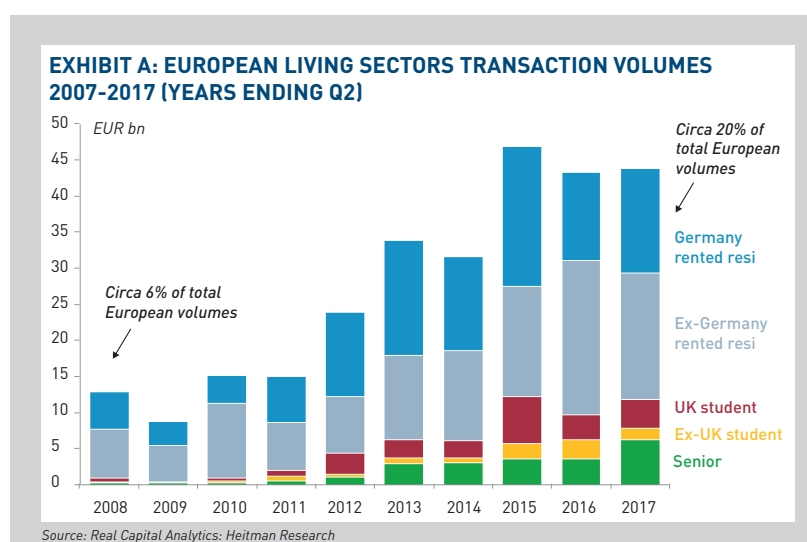
In addition to growth in the listed sector market cap, we also expect that the Living Sectors will continue to gain in their share of institutional portfolios. While it is not possible to directly observe the allocations of all individual pension funds to the various property types, sector breakdowns of institutional real estate indices provide a useful estimate in the aggregate.

As Exhibit C shows, the residential¹ share of the MSCI Pan-European real estate index (formerly IPD) is now around 16%, up from roughly 12% in 2006. The residential share of the US NCREIF Property Index, by contrast, is around 25%, having experienced a steady secular increase from below 3% in the mid-1980s. We expect continued gradual convergence in Europe toward US levels of institutional investor penetration in the residential sectors.

While residential is included in the portfolio construction of multi-sector US funds and there is a broad offering of residential in commingled funds broadly, Europe has a much narrower but quickly expanding offer. According to Prequin data, of the European funds launched in 2016, around 17% were residential specialists and 21% were generalist funds that included a residential allocation (see Exhibit D). This means that, in total, around 40% of European funds had some exposure to residential. This represents substantial growth from the 2002 vintage, when only one fund out of 27 new funds was a residential specialist and no diversified generalists included residential amongst their targets. The share of multi-sector European funds that included an allocation to residential has increased from zero in 2002 to 45% today.

For comparison, the share of funds in the US that included some element of residential has been stable in the 40-50% range for over a decade. Since the 2002 vintage, 58% of diversified multi-sector US funds launched have included residential in their portfolios.

We expect that the number of residential funds will continue to grow in Europe, driven especially by the number of pan-European or multi-country funds. We also expect that generalist allocator funds will increasingly include residential and the other Living Sectors alongside the commercial property types. In the meantime, investors seeking exposure to the Living Sectors must mainly do so through specialist funds, separate accounts, and listed securities.



Entry of US Players

One harbinger of increasing maturity has been the entry of North American players into the European Living Sectors. In particular, since the publication of our article two years ago, we have seen the entry of US-based multifamily developers, operators, and property managers into the UK PRS and student housing markets, as well as investment by US-based healthcare REITs into UK senior housing assets. Seeing the same relative underdevelopment of the Living Sectors in Europe that we have pointed out, these players hope to apply their US expertise to the European market and benefit from its growth.

Indeed, the US represents a possible benchmark with respect to the potential scale that the Living Sectors could

achieve, as well as inspiration for possible operating models. Our only caution is to avoid blindly expecting sector models that work in the US to be profitable in every market. For example, residential value-add strategies driven by product differentiation and amenity provision that apply in non-regulated markets such as the US are not likely to achieve the same investment result in regulated settings such as Germany and the Netherlands. Moreover, due to various cultural and structural barriers, US levels of penetration are not always achievable. Our experience in the European self-storage market, for instance, has convinced us that while low penetration can imply the possibility of growth and convergence toward a higher saturation level, the potential

level of penetration may vary by country and can remain permanently and significantly lower than what is observed in the US. Investors that possess a combination of the global perspective and on-the-ground teams with individual market knowledge will be best positioned to identify the most promising target sectors amid differing legal, cultural, and institutional realities.

Conclusions

The Living Sectors in Europe should be considered a key strategic element of any property portfolio. As we argued in these pages two years ago, Living offers an attractive combination of stability and growth. The stability theme derives in some cases from regulated cash flows that are inherently sticky on the downside. And, in all cases, it is rooted in favourable long-term structural and secular demographic themes that are largely de-linked from the economic cycle. The potential for growth is built on an increasing structural shortage of space relative to demand, and multiple opportunities to add value at the property level. Finally, the sectors continue to mature as institutional targets. Recent evidence, presented above, that shows growing transaction volumes and increased estimates of the investable universe confirms that this transformation is underway.

And yet, living real estate remains significantly underrepresented in existing European portfolios of institutional real estate, both relative to market size-based weights and to typical allocations in North America. Given this convergence potential, as well as the Living Sectors' particularly attractive portfolio role against the backdrop of an uncertain environment and the late cyclical stage observed in many sectors, we recommend that investors create and accumulate strategic positions in these sectors to benefit from the themes we have identified. Given the Living Sectors' favourable portfolio characteristics, we expect further growth in their asset stock, transaction volumes, and institutional portfolio penetration. Stay tuned.

FOOTNOTES

¹ A small element of student housing is included within residential for this analysis. It is currently not straightforward to accurately break out student housing and, especially, senior housing allocations in this analysis, as they are mostly lumped into an "other" category.