Heads, Beds and Sheds: Targets for Growth in European Property


BRIAN KLINKSIEK
Director of European Investment Research

ZUBAER MAHBOOB
Vice President

Despite recent evidence of moderating growth, the European economy is remarkably strong. Property markets are tight, with solid demand and limited levels of new supply. Real estate investment activity remains robust and interest rates are still low, especially relative to property yields. Central banks are tightening, but in Europe this is expected to happen only gradually. What could go wrong? Our view is that risks are mounting, including Brexit, trade tensions, and populism. And yet, no factor has yet to materially diminish the European property markets' strength. At best, investors must accept that high absolute pricing metrics point to less potential for capital appreciation. At worst, a correction may be in the offing.

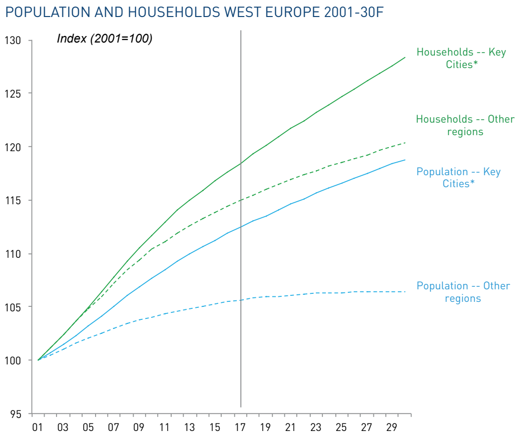
How should investors position their European property portfolios and direct new investment activity in such an environment? We recommend focusing on three long-term themes – heads, beds, and sheds – that provide a mixture of non-cyclical growth and defensiveness. Heads refers to the demographic and structural changes driving the growth of key cities and dynamic submarkets. Beds refers to the emergence of the defensive Living Sectors, which include rented apartments as well as student and senior housing. Sheds encompasses the logistics sector, which is a favourite globally, but has especially attractive growth potential in Europe.

HEADS

High-level European demographics don't look exciting. The aggregate working-age population is falling and birth rates are low, constraining potential macroeconomic growth. But this broad picture obscures considerable strength evident at regional, city, and submarket levels. The European population is more mobile than before and immigration both within and from outside Europe has increased. The movement of people from rural areas and smaller metro areas to its most dynamic regions means that key cities are growing at remarkably strong rates. Investing successfully in Europe today requires asking – where are the heads going? Due to structural changes, selected property markets are growing far more strongly than Europe as a whole.

Figure 1 compares projected population and household numbers in Europe for 41 key cities and compares those to figures for other areas. As the chart shows, the population in regions outside the key cities is set to level out, while key cities are expected to see further growth – the big cities are getting bigger. On top of this, household growth, even in weaker areas, is set to run at a faster rate than population growth, because household sizes are shrinking as young people marry and have families later, and as older people live longer. As each additional household corresponds to an additional unit of housing required, strong household growth bodes well for residential demand.

FIGURE 1
DEMAND: STRONG DEMOGRAPHICS IN KEY CITIES



Key cities refers to 41 significant metro areas across Western Europe. Selection methodology: capital cities, large cities, business hubs. Source: Oxford Economics; Heitman Research

These demographic changes support investment opportunities in several property sectors, including functional, well-located, and affordable rental housing for young professionals on one end of the spectrum, and residential units designed for older people, including care homes, at the other.

The opportunity created by these and other structural changes is not restricted to the Living Sectors. The dynamism of Europe's growing cities is beneficial across their property types, including office, logistics, self-storage, and even retail. For example, Berlin is experiencing sustained and rapid growth as functions it had lost to other parts of Germany during its more than forty years of division come back to the city. The federal government returned to Berlin shortly after reunification, and it continues to gradually regain its status as the country's principal city in business services, adding to its existing strength in technology and creative sectors. This has contributed to pushing office vacancy rates down into the low single digits and a significant increase in rents.

At a more granular geographic scale, infrastructure improvements and regeneration of urban districts are also creating opportunities. For example, the number of relevant London office submarkets has proliferated as new transport improvements and demand from tech occupiers have come together to boost places like King's Cross, Southbank, and the City Fringe. In Paris, the Grand Paris project to build new rail lines is opening up locations for offices and other uses. Examples of other major projects that are reshaping property markets and driving demand include Crossrail and High Speed 2 in the UK, HafenCity and the new concert hall in Hamburg, and new metro lines in Amsterdam and Warsaw, among others. At the same time, a combination of organic revitalisation of neighbourhoods and a penchant among high-tech office workers for more authentic, mixed-use urban environments is driving activity in places like London's Shoreditch and Berlin's Kreuzberg.

We recommend paying close attention to urban change and investing where these structural and demographic trends drive long-term opportunity. This includes high-level targeting of dynamic cities, such as Berlin and Amsterdam. It also involves identifying more specific opportunities in emerging submarkets with improving amenities or infrastructure, and making bets on these markets calibrated to the current scale of the opportunity and risk that a downturn might cause current structural changes to stall.

BEDS

In Europe, we see a broad opportunity to invest in what we call the Living Sectors. Simply put, this is the property where people make their homes at the various stages of life – places with beds. Living encompasses the rented residential, student accommodation, and senior housing property types. It also includes micro-flats and co-living. Although student and senior housing have sometimes been included in an "alternatives" or "specialty" bucket, we view them as having the same underlying drivers as traditional residential – they are supported by an undersupply of accommodation relative to demographic demand and a functional mismatch between the stock that exists and what is required today. This is due to the demographic trends noted above, as well as severe constraints on the supply of new stock in the markets where it is needed.

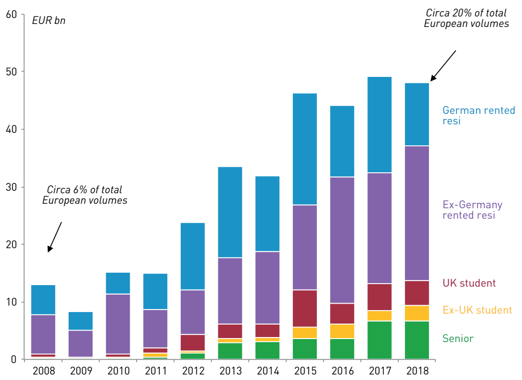
The Living Sectors add an attractive combination of stable income and growth to a European or global portfolio. They offer an attractive defensive quality underpinned by their intrinsic secular and structural characteristics. As the provider of housing – a basic need – the Living Sectors have a foundation of partly non-cyclical demand drivers, providing insulation from volatility. At the same time, growth potential is clearly evident. This is due to a shortage of suitable supply compared to demand, the opportunity to invest capital to modernise units at an accretive return, a relative lack of professional management, and movement toward greater institutional ownership and more sophisticated business models. The Living Sectors have been embraced in the largest and deepest European markets – such as the UK and Germany – but investment liquidity and professional management have also begun to spread geographically as the Living Sectors take root across much of Europe.

The Living Sectors account for a significant and growing share of investment activity in Europe. We estimate that over the four quarters ending Q2 2018, the Living Sectors made up nearly 20% of all investment activity in Europe. This is consistent with our estimate that the Living Sectors make up at least 20% of the European institutional real estate investable universe, or around $600 billion of market value, having risen from only $380 billion in 2015. However, most European property investors are grossly underweight to Living, with allocations mostly in the single digits.

FIGURE 2

INCREASING LIVING SECTORS LIQUIDITY & INVESTMENT MARKET DEPTH

EUROPEAN LIVING SECTORS TRANSACTION VOLUMES 2007-2018 (YE Q2)



Source: Real Capital Analytics; Heitman Research

We recommend a pan-European Living Sectors strategy that seeks to achieve diversified exposure across geographies, the Living Sectors' constituent property types, and both regulated and non-regulated environments. Defensive core and core-plus strategies should offer an attractive source of low-correlation, low-volatility cash flow, combined with long-term growth. A further allocation to higher-risk strategies that focus on the creation of stock where it does not exist is also attractive. In our view, Living Sectors exposure is appropriate both for investors looking to add diversification and defensive characteristics to existing European portfolios, as well as for investors who are relatively new to European strategies and are looking for a cycle-appropriate entry point into the market.

SHEDS

Logistics property – or sheds in the British lexicon – is perhaps the most consensual investment strategy across global property markets. Logistics assets are benefitting from the ongoing shift of retail activity from physical stores to online channels, and capital has flowed accordingly. According to Real Capital Analytics, global investment volumes in industrial were up 45% in the year ending Q2 2018 compared to the prior four quarters, while retail investment volumes were down 8%. In Europe, the corresponding figures were a gain of 41% for industrial and a decline of 14% for retail.

Some investors have asked whether logistics assets have become too expensive. If the preference for logistics is so widespread, why is it still one of our top picks? In short, the growth case for logistics assets remains intact. Recently, logistics returns have been dominated by capital appreciation, due especially to the relative compression of logistics yields versus other sectors. Although there may be some additional scope for relative yield compression, going forward the story will be more about growth.

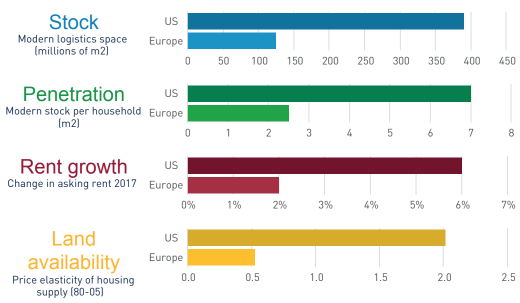
Growth includes both the potential for expanded market size, depth, and liquidity, as well as the prospects for increasing rents. The case for both is especially compelling in Europe, which lags the US in terms of the modernisation of the logistics sector and the path of rental growth.

Figure 3 compares the US and European logistics markets, and the contrasts are striking. The stock of modern logistics space in the US is more than three times larger than in Europe, despite Europe's slightly larger economy. As such, the penetration of modern logistics stock on a per household basis is also substantially higher in the US than in Europe.

FIGURE 3

EUROPEAN LOGISTICS MARKET STILL YOUNG; TO FOLLOW IN FOOTSTEPS OF THE US?

COMPARISON OF LOGISTICS MARKETS US VS. EUROPE



Source: CBRE; Oxford Economics; OECD; Heitman Research

These differences remind us that the emergence of a modern, investor- and developer-led logistics property market was much more recent in Europe than the US. Until the 2000s, logistics space in Europe was largely owner-occupied and built for a specific user's needs, rather than designed for a wide range of possible occupants. The existence of border checks across Western Europe until the mid-1990s prevented pan-European distribution models. Logisticians and the property markets that served them remained largely in national silos until the 2000s, with buildings mostly sub-scale and characterised by non-standardised designs. The growth of pan-European supply chains in the 2000s coincided with the emergence of pan-European logistics developers and investors, leading to a gradual shift by occupiers from specialised assets to the customisable but flexible "box" that is now the global standard; this transition remains incomplete and continues to this day.

Another way in which European logistics has lagged the US is in terms of real NOI growth. After years of struggling to generate rental increases that exceeded inflation other than for brief periods, the US logistics market is now seeing rental growth running at over 6% per year at the national level. This formidable level of growth has been sustained since mid-2015, and it has exceeded inflation since 2012. (In the prior cycle, rental growth exceeded inflation for only four quarters in 2006-07). Led by close-in submarkets that are attracting "last mile" distribution uses, it is likely that fundamentals have made a step change. It appears that industrial developers lack the ability to create sufficient space in the right locations to meet demand. Rents must rise in order to stimulate sufficient levels of supply, especially in infill locations where logistics was previously not viable.

Meanwhile, rental growth in European logistics markets is only now accelerating, reaching an annual rate of roughly 2% in mid-2018, or roughly in-line with inflation. Will European logistics follow the US's lead? In our estimation, this is likely. Indeed, if anything, the case is stronger for long-run real rental growth in Europe than in the US.

Our view is down primarily to differences in land availability. Europe faces more acute constraints on land supply than in the US, in the form of greenbelt restrictions, environmental regulations, and greater population densities. One key difference is the attitude of municipalities and urban planners. Many US suburbs, particularly those on the outskirts of metro areas, have long sought to attract industrial development – through tax incentives, favourable zoning, and infrastructure – as a part of their economic development strategies. But European planners are less favourable to logistics as a land use, as they worry about its impact on traffic and aesthetics.

At the same time, Europe has catch-up growth potential. As already discussed, there is much less modern logistics stock per household in Europe than the US, so continued growth is likely as occupiers modernise their supply chains and real estate footprints. At the same time, European e-commerce penetration, with the exception of the UK, is lower than in the US but is growing strongly. As such, more of online retailing's beneficial impact on logistics demand and rents has yet to be captured compared to the US. Logistics therefore remains an attractive investment even if yield compression is likely to slow or stop, as growth should be driven through NOI and rents.

STRUCTURAL OVER CYCLICAL

Signs remain positive about the continuation of growth in the European economy and property market cycle. But all things must come to an end. Long-term investors in direct property should consider increasing allocations to structural and demographic change (heads), the increasingly institutional but already defensive Living Sectors (beds), and the growing logistics market (sheds). Such positioning maximises exposure to long-term themes and demand drivers that are expected to persist throughout the market cycle.

HEITMAN
A REAL ESTATE INVESTMENT MANAGEMENT FIRM