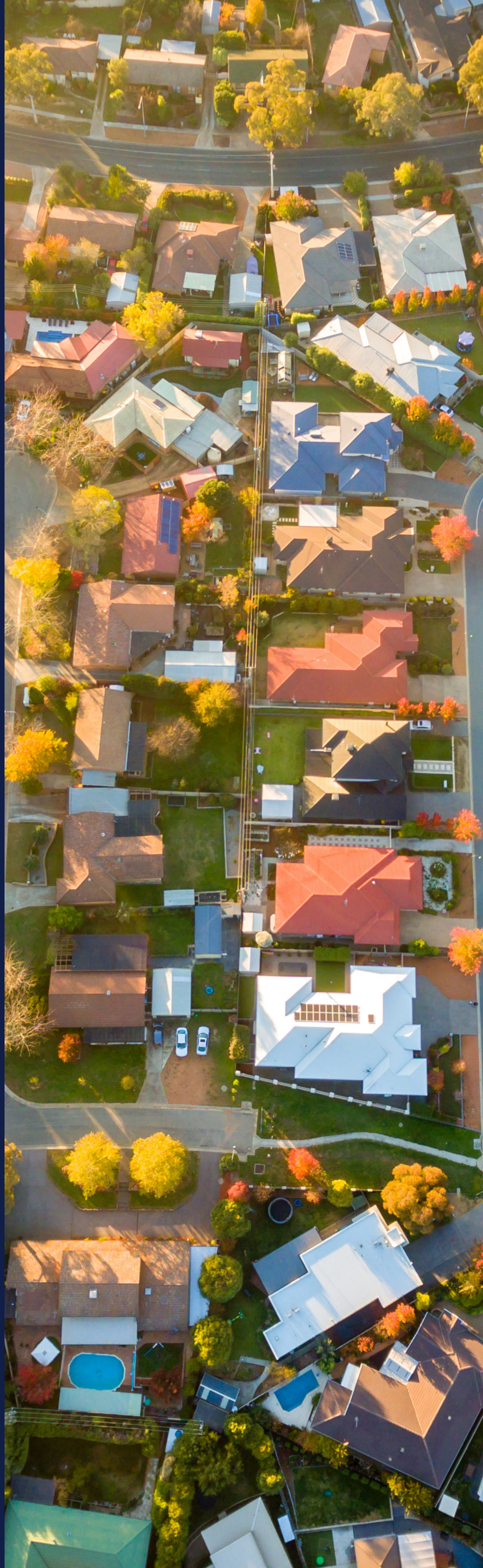
Why living is an *essential* asset class for institutional investors

THE CASE FOR PAN-EUROPEAN LIVING INVESTMENT

MAY 2022



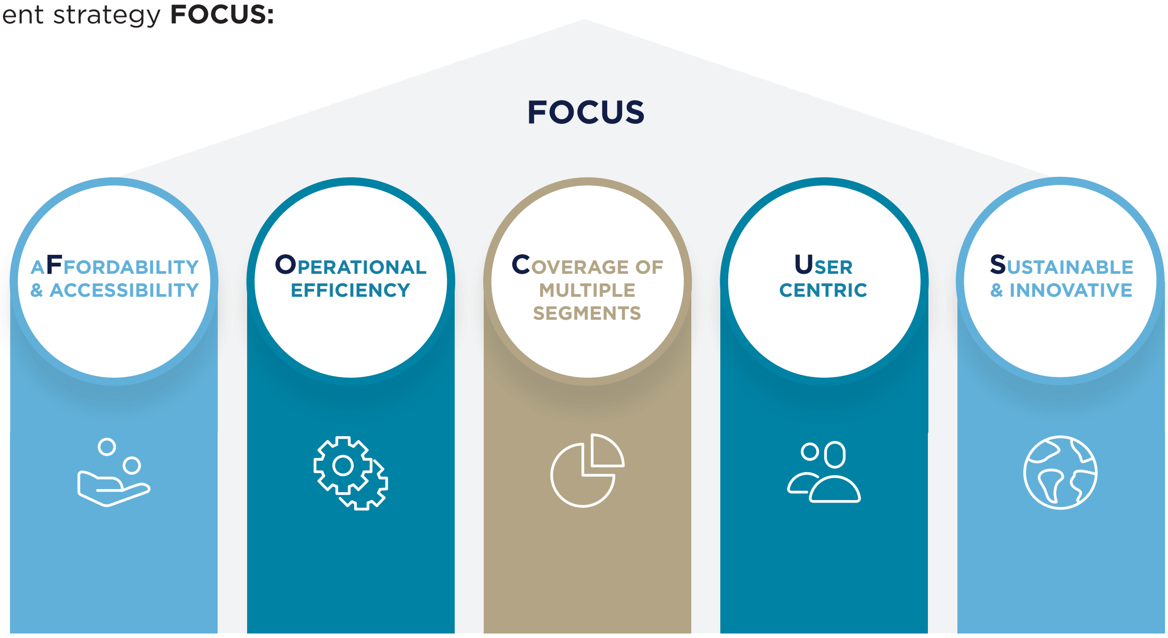
Executive Summary

Shelter or a "roof over one's head" is essential and certainly shouldn't cost the earth.

In today's turbulent markets, the stable income and attractive risk-adjusted returns institutional investors seek, can appear illusive. Rental housing provides a compelling opportunity for institutions to acquire, develop and manage high quality modern housing at affordable rents providing essential social infrastructure that generates potentially resilient long-term income returns.

Savills IM believe that a long-term investment horizon and cost management are fundamental to successful European multifamily investment.

There are five key pillars that give Savills IM's Living investment strategy **FOCUS:**



Savills IM consider **five** key factors that make residential an essential long-term holding for institutional investors:

1 A widening divergence between housing provision in and around Europe's metropolitan areas and today's household growth, driven by the maturation of recent generations who share similar preferences for more private space, higher educational attainment and career development.

2 The continued decline in homeownership, or at least the deferral of this stage in life in some countries, is extending the duration of those renting.

3 Urbanisation marches on and this requires the right size of units in urban areas with an emphasis on operational efficiency and resident satisfaction.

4 Development is integral to solving the imbalance, requiring renovation and a re-think in how we design new homes fit for residents.

5 A greater focus on the delivery of affordable housing is needed and will require investors to take a long-term view and arguably partner with the public sector to deliver affordability that works for more people.

At Savills Investment Management we like to connect the DOTS[1]; demographic shifts, originate impact, technological advancements as well as the social and political changes that have and will continue to shape real estate markets. During the past two decades, specifically the 2010's, advancement through everyday technological applications like android smart phones, 5G networks, virtual reality, Artificial Intelligence, electric cars and Instagram (we jest slightly with this last one!) have and are heralding change to the way we shop, what we drive and how we consume news and media.

Yet there are areas of the economy, although touched by advancements in technology, which are not experiencing disruption because of them; housing is one. Beyond the introduction of new raw materials and construction processes, house and apartment dimensions and floorplates persist. What has changed is the urban landscape and the cost of housing, both radically impacted by demographic, economic and political forces.

Housing is, as Primo Levi surmises, essential and it should be said, an essential social infrastructure. Like most key infrastructure such as hospitals, schools and fibre networks, it faces a huge overburden of demand relative to accessible and available supply in most cities around Europe.

Housing should be comfortable, support community and not cost the earth. Yet a lack of availability, low accessibility and stretched affordability mean there are more individuals and families unable to live in or close to cities and employment opportunities, with housing consuming a greater proportion of their income. Economists and housing advocates have long sought to lobby government for supply-side reform with limited success in many countries.

Governments' have intervened on the demand side, along with mortgage lending changes, that have penalised private individual investors in some markets and supported first-time buyers. Despite this house price escalation, fuelled by a low cost of borrowing and lack of supply, is the tipping point for tenure toward the rental model and renting for longer in many markets. So there is need for more modern, good quality, diverse housing types across the affordability spectrum.

Rental housing provides a compelling long-term investment opportunity for institutions. The essentiality of a roof over the head supports resilient income that is less correlated to business cycles and offers diversification. Rents must be affordable and homes fit-for purpose, making for happy residents and landlords. Stable, long-term income returns need not be mutually exclusive to the provision of an essential social infrastructure.

Today broadly there are five key factors that underpin the investment case for European multifamily; the rise of single-person households, declining ownership, continued urbanisation, supply-demand imbalances and a need for affordable rental stock.

> **“My house is characterized by a lack of character... It has no ambitions, it is a machine for living, it possesses almost everything that is essential for living and almost nothing of the superfluous.”**
>
> *My House* by Primo Levi, translated by Raymond Rosenthal, The New York Review, January 19, 1989 issue[2].

Household growth will support demand

Global demographic trends are well known; populations becoming older and fertility rates declining. In Europe, Germany saw its population of c.83.2 million broadly remain unchanged in 2021 compared with both 2020 and 2019, as deaths exceeded births, and net migration filled the gap[3]. Coronavirus-induced lockdowns have interrupted migration, particularly immigration flows experienced by many countries, but these are expected to recovery gradually as employment opportunities, especially in tight labour markets, attract young and experienced professionals from overseas aided by global travel returning to levels at or close to pre-pandemic.

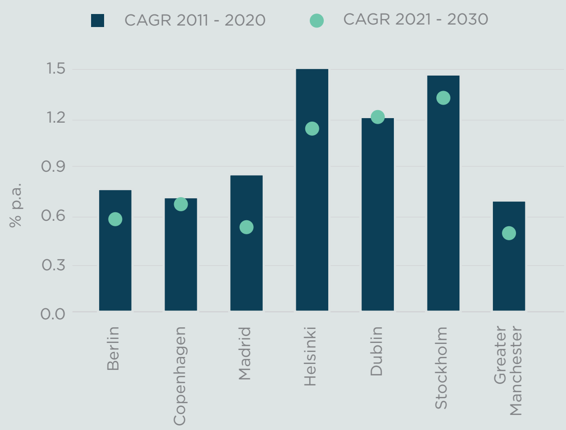
Around 49% of households without children consisted of a single adult in 2020, with growth in all households averaging 7.2% between 2010 and 2020 while single adult households rose far faster by 19.5% over the same period[4]. However, the rise of the single-person household should not be read as a license to build smaller, one bedroom apartments (size matters) as no one wants to live in too-small housing.

[1] Savills Investment Management, February 2022
[2] https://www.nybooks.com/articles/1989/01/19/my-house/

[3] Destatis.de/EN/Press/2022/01/2022
[4] Eurostat, Household composition statistics, 1 June 2021

Like Generation Y, some of Generation Z have had their plans disrupted by a major event, on this occasion epidemiological. Nevertheless both generations share some of the same characteristics including preferences for more private space, high educational attainment and career development (the latter is possibly not a desire but an anxiety concerning economic means) over relationships contributing to delayed co-habitation and family formation. At the other end of the age spectrum, better health and medical advances have seen older cohorts live for longer, and often alone. Consequently household formation growth is forecast to persist and support demand for housing, as shown in Figure 1.

FIGURE 1:
Household Formation Growth Outlook



Source: Savills IM, Oxford Economics, data and forecasts as at 21 February 2022

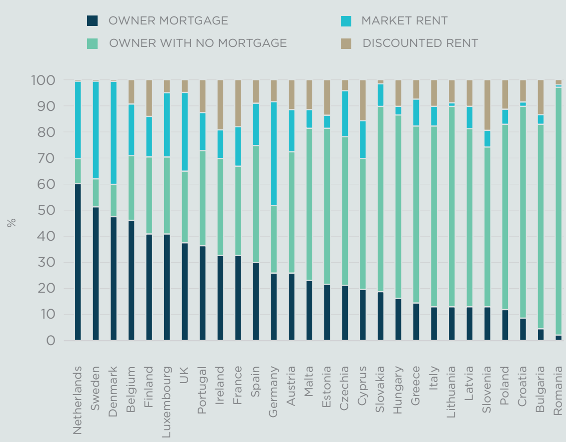
Further decline in ownership expected

Running in parallel to the rise of the single-person household has been the decline in home ownership in many countries. For those with no assets and too small a deposit ownership is a stretch. At the same time government intervention in the buy-to-let market, as seen in the Netherlands and UK, is putting pressure on private landlords, further exacerbating supply and affordability.

A fallout from the global financial crisis that affected Generation Y, has been tighter bank lending criteria in some countries, with more restrictive loan-to-income and loan-to-value ratios, as is the case in Ireland and the Netherlands. At the same time, government schemes aimed at supporting first-time-buyers and purchaser tax breaks, while boosting developer volumes and profits, have perversely inflated prices.

As Figure 2 highlights, the highest distribution of renters is in Germany at c.50%, Austria at c.45% followed by Denmark and Sweden where rental tenure houses more than 35% of the respective populations. The UK which has traditionally favoured owner occupation has seen a gradual decline in this tenure as price rises have made deposits difficult to save for. As a result rental housing accounts for over a third of the tenure, and is growing. Southern Europe, the Netherlands and Ireland are expected to follow a similar trend of declining ownership unless bank lending criteria eases and house prices significantly fall. This highlights the need for better designed rental units with more flexibility to cater to single persons and young couples.

FIGURE 2:
European Population by Housing Tenure



Source: Savills IM, Eurostat, data as at January 2022

Urbanisation to gradually march on

This is not to say ownership is dead. First time purchases are occurring later and in some cases there is evidence of the traditional first stage entry level apartment being skipped in favour of small houses further afield. This is not possible for everyone given stretched affordability or lack of labour mobility meaning those renting are likely to rent for longer which in principle will lead to lower churn. For those seeking second moves the price gap between apartments and houses has in many cases widened, delaying this move. Housing ladder issues may be a contributing factor to delayed family formation, although the reasons behind Europe's declining birth rate are undoubtedly more complex and nuanced.

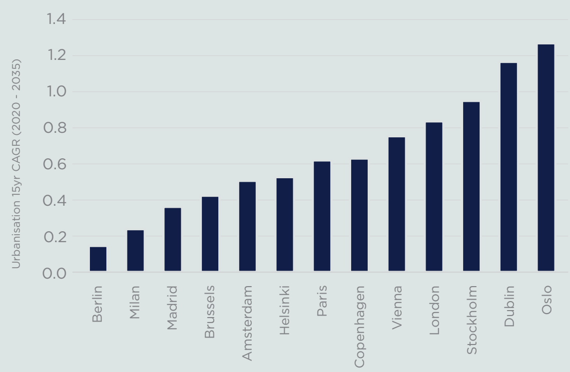
> **Hybrid working is changing how we live, it is not happening at the expense of urbanisation.**

For young professionals the need for hands-on, in-person learning and management remains critical to career development. Moreover, many want to be in or close to the centre of cultural, leisure and networking opportunities, making some suburban settings undesirable at an early life stage. The same is true for many retirees who wish to remain close to cities. So while hybrid working is changing how we live, it is not happening at the expense of urbanisation which is expected to persist as Figure 3 illustrates. This will require more suitably proportioned one and two bedroom apartments. Furthermore landlords will have to ensure residents are happy with their accommodation as the focus shifts to optimising operational impacts on income.

It's the supply...

Of course developers have ultimately built to the highest underwritten return in the face of planning uncertainty. Planning constraints remain a major obstacle afflicting housing supply in many European cities. Moreover, traditional house builders as well as public providers are inadequately equipped on their own to meet the supply targets that governments have set out. This is creating an opportunity for institutional capital with a long-term investment horizon to step in and bolster supply as well as renovating older purpose-built stock.

FIGURE 3:
Pre-pandemic Urbanisation Projections



Source: Savills IM, UN World Urbanisation Prospects 2018 revisions, data as at January 2022

High levels of old stock mean more energy efficient dwellings will take time to reach residents. Cladding in the UK is an example of one issue relating to the safety and efficiency of apartments that is taking time and significant capital to remedy. The European Commission intends that all residential dwellings will need to be at least energy-efficiency standard F by January 1st 2030 and E by January 1st 2033 (standard runs A-G best-to-worst).

Energy performance certificates will be valid for five years for buildings certified D or below and 10 years for housing rated A, B or C[5]. So it will pay for institutional investors to exceed current standards so as to reduce costs, resident churn and bolster net income returns.

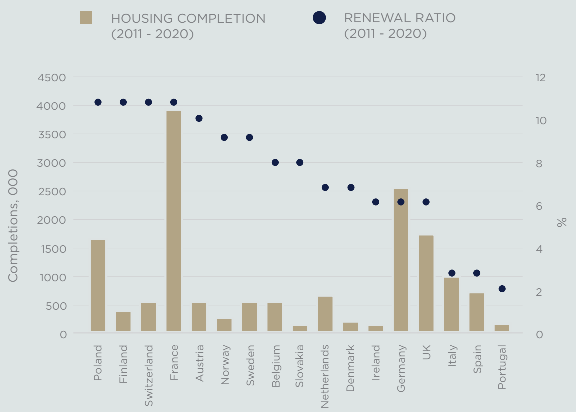
European urban residential vacancy rates are low, with Germany at c.3.5%, Ireland 7% and the UK around 2%[6]. Drilling into cities, and these vacancy rates drop further, for example Munich's residential vacancy rate is estimated to be close to zero[7]. However, it is important to not overstate supply as an issue in every market. Overall for most countries the level of housing completions and the ratio of stock renewals over the past decade (not accounting for refurbishments) has been insufficient. As Figure 4 highlights, many of the largest countries have not delivered enough new supply in the past decade, France being one of the exceptions.

[5] Proposal for a Directive of the European Parliament and of the Council on the energy performance of buildings, 15 December 2021
[6] OECD, Housing stock and construction pdf, Affordable Housing Database, 18th January 2022
[7] Deutsche Bank, Research, Outlook for the German residential property market 2021 and beyond, 24th March 2021

Europe's housing stock has aged disproportionately in the major economies post 2000, given the average proportion of newly built is c.9.8%[8] of total stock, resulting in a cumulative undersupply given expansion in household numbers.

For urban areas this suggests small and flexible units that are built to a higher standard fit for smaller households. Retrofitting old stock will become less expensive and more desirable from an embedded carbon perspective relative to the very high but necessary focus today on forward funding of new developments.

FIGURE 4:
European Housing Renewal



Source: Savills IM, Buildecon blog, data as at 20th April 2021

Affordability requires a long-term view

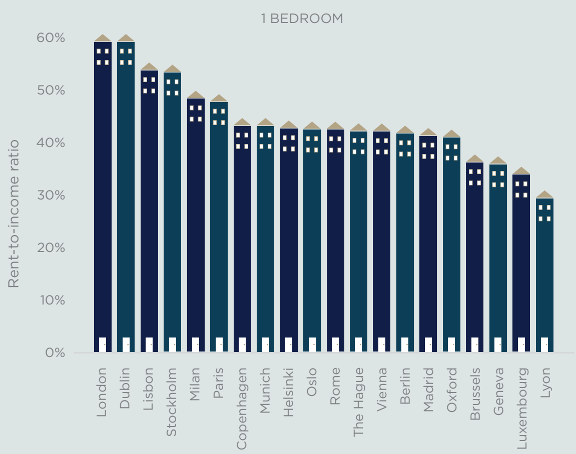
In tandem with institutional growth in the multifamily sector is greater regulatory scrutiny, to ensure residents are treated fairly. However, poorly conceived regulation such as that witnessed recently in Berlin, has acted as a partial brake on development as well as causing underinvestment. Contrary to received wisdom however, rent regulation is not a reason to not invest in multifamily (a subject we will touch on soon). It does mean that multifamily investment requires a more sophisticated and ethical approach in terms of pricing and delivery, than the highly fragmented private landlord model can deliver.

> **Contrary to received wisdom however, rent regulation is not a reason to not invest in multifamily.**

Rent affordability is a major political topic and poses serious risk to the sector. Although there is no internationally established measure of affordability, housing costs greater than 30% of gross income are deemed as a burden or stress[9]. In the Netherlands affordable liberalised rental homes are sometimes considered to price between a monthly rent of €763 - €1,000 but there is not a hard test like there is for social rental homes where rents are sub-€763 per month. On a very crude measure rent-to-income ratios in most major cities today are in excess of 30% of median incomes, as Figure 5 illustrates.

A greater focus on delivery of affordable housing is needed. This requires that investors are prepared to take a long-term view on housing in order to help deliver affordability that works for more people.

FIGURE 5:
Average Rental Apartment Affordability



Source: Savills IM, Eurostat, Numbeo, data as at January 2021, nb net monthly incomes as at mid-2020 rents as at end 2019

Rental growth is real in the long-run

On the continent, a large proportion of markets use indexation to help determine rental increases and pro-resident tenancy frameworks underpin lease stability. The lack of supply has in many markets driven rental value growth in excess of inflation. This together with low vacancy rates support multifamily cap rates that are lower relative to other commercial property sectors.

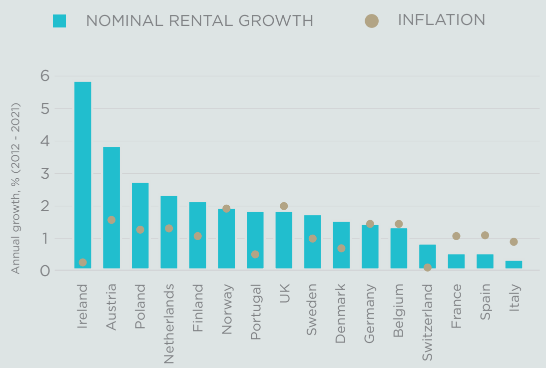
[8] BRE Trust, Briefing Paper, The cost of poor housing in the European Union, Nicol. S, Roys. M, Ormandy. D and Ezratty. V, 19th September 2016

[9] OECD, Affordable Housing Database, Overview of Affordable Housing Indicators, 27th May 2021

Despite higher management costs, the essentiality of housing drives high occupancy and rent collection rates. Income returns are typically very stable and in addition diversified by a granular number of leases. This has supported real rental value growth over the long-term of c.0.7%[10] per annum on average across the major European Union countries, see Figure 6.

Savills IM believe cost control rather than excessive rent escalation is the key to supporting residents and improving net operating income through a given cycle. Astute management will attract a valuation premia for intrinsic value creation. Owners and property managers have more data today than ever before and this should also drive accelerated improvements in this area.

FIGURE 6:
Median 10 year rental value growth v inflation



Source: Savills IM, Eurostat, ONS, data as at 21 February 2022

So what is the size of the institutional multifamily opportunity in Europe?

Today in Germany, home to the largest institutional stock of multifamily in Europe, private housing companies own less than one-quarter of rental dwellings[11]. In Spain the institutional residential rental market is estimated to be less than c.5% of the total rental stock, highlighting the huge scope for the professionalisation of this sector. Even the UK, a highly institutionalised market for commercial real estate, is as an illustration of an emerging multifamily market. The UK multifamily sector delivered just 11,428[12] units in 2020 or approximately c.6.5% of new completions. So conservatively over the next decade institutions could potentially contribute between 5-7%[13] of total annual housing completions.

Savills IM see residential as a core part of its long-term growth strategy. Opportunities of varying proportions exist across Europe, with sufficient scope for further institutional growth even in established markets like Germany, the Nordics and the Netherlands.

What of pricing?

Interest rates will certainly enter the conversation over the coming months and years with regards to residential pricing. Rising interest rates will affect all yielding assets, the more pertinent and difficult question to tackle is where key interest rates end up and what this means for the multifamily bid/ask. In the near term interest rates appear likely to remain low in relative terms in Europe.

> **What managers like Savills IM can do today is select the best assets as well as seek to improve the operational set-up.**

Some institutional investment managers are likely to view rising interest rates as an tactical opportunity to seek out bid/ask dislocations or mispricing on an absolute and relative basis. For most long-term asset allocators, multifamily opportunities will be viewed in a broader portfolio context, including diversification, certainty of income and social impact. What managers like Savills IM can do today is select the best assets as well as seek to improve the operational set-up to manage costs and by doing so maximise the net operating income over the long-term.

[10] Eurostat, Agents Survey, as at March 2021
[11] Brookings, Case Study: Germany, 20th April 2021
[12] BPF, Built to Rent Q4 2021
[13] Savills Investment Management, ONS, BPF, February 2022

In summary

Housing is set to remain in high demand, as shifting household formation continues to place a burden on today's housing stock. While ownership is not dead, cost pressures suggest a further rise in the rental tenure and a greater need for appropriately sized and proportioned modern urban stock.

Urbanisation will persist and with it the need for apartments that meet the demand being driven by single-person household formation, but with more focus on layout and build to accommodate young professionals and couples who are likely to rent for longer.

With political risks high and house builders and public providers ill-equipped to meet the need, institutional capital will play a bigger role. Delivery of affordable housing that works for more people is required and this will mean greater public and private partnerships with a long-term investment horizon.

The European multifamily sector is set to go through another phase of transformational growth, having experienced the first wave of significant capital inflows. This next leg of investment and development will calibrate pricing as emerging social needs demand best-in-class environmental design. Bifurcation in pricing will take into account more than just location.

For residential the pricing premia will not just reflect whether an asset is 'prime' but how well managed the income is and whether it makes a positive social impact for its community. Multifamily assets which are best placed to meets the demands of tomorrow's society will make for happy residents and happy landlords.

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