Contents

Preface 04
Executive summary 06
Economic environment 08
The four quadrants of pan-European residential investing 12
European housing markets 16
Inventing a European rental cycle 22
Market performance 24
Why this time will NOT be different! 30
Outlook 32
Dear readers,

The positive momentum on the real estate markets continues. Nobody knows when the current cycle will end, but we can say we might be closer to the end than to the beginning. Consequently, investors last year continued to search for secure, stable income to protect their portfolios. And there is one thing residential real estate has demonstrated since the last global financial crisis: it offers downside protection in comparison with commercial property investments. Residential investments deliver cash-flow stability as well as diversification benefits, offering a downside protection or income return floor within a multi-sector real estate portfolio. It is no wonder therefore that residential investments in Europe rose from less than €100m per week to almost €1bn per week during the past decade.

However, we need to be cautious when developing residential investment strategies on a pan-European scale and should keep history in mind. Although many cities are struggling with the challenges of urbanisation and the resulting boom in rental levels, we should not blindly follow historical patterns that have in the past led us to believe that conditions look sound. Indeed, history has taught us an important lesson:

While rent control offers tenants perhaps the greatest personal financial gains of any legislative initiative, this kind of measure only benefits current tenants, not tenants overall. It also harms tenants in surrounding communities. In addition, history has shown how damaging rent controls can be in the long run: take the former socialist GDR, for example. There such controls led to extreme decay in the country’s housing, which was readily evident to the whole world after the collapse of the inner-German border.

As “lower for much longer” is still the scenario institutional investors need to operate in when making investment decisions, a focus on business plan assumptions when underwriting an individual asset is crucial. Looking forward, overall returns might be a little lower compared to past years, but residential investments will continue to deliver cash-flow stability and diversification benefits if underwritten properly.

We hope you enjoy reading this year’s edition of our PATRIZIA INSIGHT European Residential Markets and we look forward to your feedback. Enjoy the issue!

Yours,

Wolfgang Egger
Executive summary

- **Outlook for European residential markets remains good:** Following years of healthy growth, the European economy is experiencing a slowdown that began in the second half of 2018. Despite markets adjusting to today’s more volatile geopolitical environment, high levels of liquidity remain as well as robust interest in income-producing investments, such as real assets, that supports the investment rationale for residential investments.

- **Only a quarter of Europe meets institutional investment criteria:** Modern demographic analytics use population density to distinguish between cities, towns and rural areas. Less than 9% of the entire geographical surface of Europe can be classified as cities, while an additional 17% can be classified as towns or suburbs. As institutional investors seek returns in areas of higher population density, only a quarter of Europe can be considered when seeking to identify investment opportunities. Furthermore, within this quarter, not all cities, towns or suburbs represent attractive investment targets for long-term investors as structural changes and aging leave their mark over time. For these reasons, excellent local knowledge and expertise is an essential ingredient in making successful investment decisions.

- **Rent control: Lessons from history:** Many cities are struggling to meet the challenges of urbanisation and the resulting boom in rent levels. Some governments are responding by setting limits on the rent property owners can charge. Most recently, London Mayor Sadiq Khan has called for controls to “fundamentally rebalance London’s private rented sector”, while Berlin is considering a five-year rent freeze to control a rapidly rising cost of living. For some policymakers, this seems like a sensible way to address the problem, but there will be long-term negative consequences. Rent control only benefits current tenants and incentivises the transfer of rental stock to the owner occupier market or leads to a decline in the levels of property maintenance. A historical example of the negative long-term effects of rent control was seen in East Germany at the time of reunification. Much of the housing stock was in a state of decay as a result of over 40 years of state-led rent control that resulted in little or no investment. If similar rent control policies were to be adopted again, then there is nothing to suggest that this time their impact would be different or less harmful.
Resilient rental cycle despite economic challenges: Despite efforts in data harmonisation across the real estate industry, there is still no unified, professional database to monitor rental movements across Europe, unlike in the owner occupier market. Extracting the rental component from the Consumer Price Index is a misleading approach. PATRIZIA addresses this by collecting rental data from online portals and other market sources to track rental performance at a city-level over time. PATRIZIA’s analysis of the European rental cycle has produced important insights. First, despite all the economic challenges Europe has faced since the millennium, rent levels have remained on a constant upward trajectory. Second the rental cycle has shown low volatility since the last global financial crisis. Both of these findings underpin the fact that multi-family offers downside protection for any investment portfolio.

Income protection is important: Compared to a year ago, the fundamentals for investing in European multi-family housing are still solid, despite a deteriorating economic environment and increasing geopolitical tensions. However, political involvement in the European residential market may limit rental growth prospects. Whilst the returns profile remains attractive, investors need to pay close attention to the income stream delivered by each asset as well as be sensitive to potential regulatory changes. With this in mind, investors can expect total returns for European buy-and-hold multi-family housing strategies of 5% to 6.5% p. a. over the next five years, of which 2.5% to 3.5% will be income return.

Going cross-border is predominantly an American and German behaviour: Cross-border capital targeting European residential mainly originates in the USA and Germany. While the former has a focus on Spain, attributable to higher return strategies targeting large-scale merger and acquisition activities, the latter has a European focus. German capital is seeking residential investment opportunities throughout Europe, particularly targeting cities in Austria, France, the Netherlands, the Nordics as well as Spain, and focused on core assets.
Economic environment

Following years of healthy growth, the European economy has been experiencing a slowdown that started in the second half of 2018. Although the markets are adjusting to a more volatile geopolitical environment, liquidity remains healthy and interest in income producing investments, like real assets, is robust.

The economic slowdown can primarily be attributed to the deterioration of the global growth environment driven by the escalation of the US-China conflict. Whilst last year most commentators were expecting a potential escalation to be followed by a deal, we have recently seen a paradigm shift. The new conventional wisdom seems to be that we are facing a geopolitical confrontation on a number of dimensions (trade, technology, currency), which is likely to endure and impact the rest of the global economy for some time. Although a truce is still possible, more geopolitical volatility is likely as the world is rearranging itself on multi-polar foundations.

Germany has unsurprisingly been hit harder due to its dependence on global trade and manufacturing exports. The troubles being experienced by the car industry remain a central factor. The key question is whether fiscal policy will finally turn more supportive to growth despite the country’s long-held commitment to fiscal prudence. Germany continues to run one of the largest budget surpluses in the world, which could be used to help the economy recover.

Real GDP and its components, Euro Zone

At constant prices

[Graph showing the components of Real GDP for the Euro Zone from 2010 to 2018]
from the recent slowdown and “manufacturing recession”. Political constraints to loosen fiscal policy remain, but recent official positions suggest that these are not insurmountable. Growth has been more resilient in France and Spain in contrast thanks to healthy domestic demand, positive business investment response to past structural reforms and a bit of fiscal stimulus. Economic data coming from Scandinavia, Benelux and Central Europe has also been more favourable over the last 3 – 4 quarters.

The UK economy has expanded at the same pace as the Euro Zone average over the past year despite politically challenging times. Consumer spending remains robust and public finance has improved considerably.
However, business CapEx has consistently underperformed compared to the other G7 economies post-2016 due to Brexit-related uncertainty. The medium-term outlook for the UK is benign given the economic fundamentals, yet at the time of writing a “no-deal Brexit” is increasingly becoming a key short-term risk.

A striking pattern we are seeing in the recent slowdown is the extent to which it has been led by manufacturing and external demand. Leading indicators show a sustained divergence between very poor showings for manufacturing (PMIs in contraction mode) and the relative resilience of the dominant services sector.

Whilst the exuberance of 2016 – 2017 has largely faded, a case can still be made for Europe. The cycle is less advanced than in the US, there is no excessive rise in debt and there is room for further CapEx recovery.

Fiscal policy is set to be more supportive to growth in the short-run and there is leeway in many countries for a fiscal response to a future slowdown. Therefore, the consensus forecast suggests that growth is set to be only slightly below trend across the Euro Zone and the UK, keeping in mind that estimates put potential growth at around 1.5% annually (at full employment).

Risks, however, are indeed skewed to the downside

The weaker economic outlook both in Europe and on a global scale will have an impact on demand for real estate investment. However, this situation needs to be considered in combination with one key structural economic trend – the considerable economic outperformance of cities. In an increasingly globalised and urbanised world, growth is increasingly being concentrated in major urban areas where the most competitive service industries tend to cluster.
Unsurprisingly, these are attracting an increasing share of real estate investment thanks to superior liquidity and capital growth potential, as cities offer strong outperformance in terms of growth. The outlook regarding monetary policy has seen a turnaround, with global central banks moving back to easing mode. The US FED recently cut rates for the first time since 2007 (by 25 bps) and another move is expected from most market participants this autumn. The ECB started a new programme of targeted long-term refinancing operations (TLTROs) in September 2019 and is set to announce a new stimulus programme. The package may include an interest rate cut, a tiered deposit rate and a re-start of quantitative easing, which was halted at the end of 2018, as the average inflation rate in the Euro Zone has yet to reach the 2% target. Details had yet to be announced at the time this report was written, but the direction is clear. This may feel like déjà vu, so expect interest rates to remain "lower for longer".

All of this will be reassuring for the markets, but interest rates are already in negative territory and the marginal benefits of more QE will be limited. Monetary policy alone will not be able to revive the European economy. This explains the reaction of the financial markets in the summer of 2019. Investors took a risk-off approach and piled back into fixed income, bringing bond yields to new record lows, often negative for European sovereigns.

All in all, the economic environment has changed and downside risks to the global economic cycle have increased. Still, the outlook for European residential investment remains healthy, given moderate economic growth, monetary easing, loose financial conditions and inexorable urban growth. With property yield premiums expected to remain high, investor interest for income-producing real estate should remain strong. The more defensive residential sector is well situated in the current risk-off environment.
The four quadrants of pan-European residential investing

During 2018, the maturing real estate cycle and fears of rising interest rates increased investor interest in new ways to package existing assets to protect their real estate exposure. The outlook regarding the traditional approach to accessing real estate via direct investing was heavily challenged and investors once again began the search for a more powerful, strategic approach to real estate investing.

The well-known four-quadrant model provides investors and fund managers with a structured platform for managing exposure and optimising performance across real estate, both public and private, as well as debt and equity markets. Given the huge opportunities available across the entire real estate universe, more and more investors are beginning to use this approach. A multi-sector model allows investors to seek alpha in several ways: market fundamentals, sector rotation and leverage. The four quadrants are bound together by analysis and hands-on experience in financing and management of the underlying real estate assets. Given the ongoing geopolitical and economic challenges, this trend can be expected to continue or even accelerate among larger institutional investors in an ongoing search for yield, combined with an increasing desire to protect portfolios during a cyclical downturn. In an ideal world, investors should be switching between the debt/equity and public/private quadrants to take advantage of their different behavioural patterns during the cycle. They should also look to take advantage of the resulting market segmentation and valuation differences between quadrants to optimise their risk return profile.

In this box we want to show if and how the four-quadrant approach can be used to invest in European residential markets. Private equity is the most common way to access exposure to European residential assets either via direct investing or via funds. Investor circumstances (e.g. size and in-house expertise) as well as their investment objectives will dictate the suitability of one access point over another. A Pre-qin survey in 2018 found that 73% of investors with > $1 billion invested in real estate choose direct investment versus only 40% for smaller investors with < $1 billion invested in real estate. When it comes to European residential investing, the private equity quadrant is generally a suitable and sensible way to gain exposure to residential real estate assets and the dynamics of different national residential markets.

### The four quadrants of real estate investing

<table>
<thead>
<tr>
<th>Private Equity</th>
<th>Public Equity</th>
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<tbody>
<tr>
<td>• Direct ownership of properties</td>
<td>• Real estate investment trusts (REITs)</td>
</tr>
<tr>
<td>• Funds/multi-managers</td>
<td>• Listed real estate companies</td>
</tr>
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<table>
<thead>
<tr>
<th>Private Debt</th>
<th>Public Debt</th>
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<tbody>
<tr>
<td>• Asset-level financing, direct lending to real estate companies</td>
<td>• Asset-backed securities</td>
</tr>
<tr>
<td>• Funds/multi-managers</td>
<td>• Corporate bonds issued by real estate companies</td>
</tr>
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<td></td>
<td>• Mortgage bonds</td>
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Public equity means investing in listed shares of residential real estate companies. Investing via listed real estate gives investors access to a broader range of properties due to unitisation than if they were to buy directly, hence enhancing property-level diversification. However, the range to be tapped depends on the universe of listed companies available for investing. Looking at European listed residential stocks, we see a strong bias towards Germany. Therefore, any investment strategy targeting European residential via public equity will have a bias towards Germany, which means missing out on opportunities in markets like Ireland, the UK and Spain. Due to product availability and the preference for liquidity that is embedded in public equity investing, any European residential portfolio will end up highly concentrated in a handful of stocks with a heavy geographical bias. As a result, public equity investing does not currently provide a sensible path for investors looking for pan-European residential exposure. But for investors with a single-country focus, e.g. Germany, taking such an approach could be feasible.

Private debt covers debt lending secured by real estate and/or unsecured debt to corporates engaged in real estate activities, again either direct or indirect via funds. Focusing on residential and taking the reasons behind residential exposure into account, only direct lending (generally via mortgages) would be an option for investors looking for residential exposure. Banks dominate this market in Europe, however, at country level and despite a generally low margin environment in private mortgage lending, some non-bank lenders, like insurance companies, are active as well. Taking the different regulatory regimes and their requirements across Europe into account, a pan-European residential strategy via private debt investing is not a suitable option. Costs related to compliance with the different regulations and high competition from banks do not justify a pan-European approach, as residential mortgage terms are to a high degree standardised, preventing investors from adjusting debt terms to suit their requirements. At country level, however, this approach can be an interesting addition to a residential portfolio, assuming national market size and the competitive situation permits an efficient internal or external setup.

Looking at public real estate debt investments with a focus on European residential, RMBS and mortgage bonds are possible ways to obtain exposure. Given the size of the different national mortgage markets combined with low acceptance for securitisation in Europe, especially since the GFC, an annual volume of around €100 bn to €120 bn, with a heavy bias towards the UK, only offers a limited option in terms of gaining exposure to the European residential market. In
In this regard mortgage bonds are a better way to gain exposure, but again geographic limitations hinder a truly European approach in mortgage bond investing and often the underlying mortgages are a mixture of commercial and residential, making mortgage bonds not a suitable product for pure residential exposure.

Keeping all of this in mind and looking at the four-quadrant model from a European residential sector perspective, we can see the current limitations of this model at sector level and it becomes clear why it is only partially suitable as an investment approach at sector level. But the approach does offer insight into how portfolios should be reviewed regularly from a tactical standpoint, as different quadrants outperform others at different points in the real estate cycle. Assuming product availability is given, a mixed portfolio can add additional value through tactical asset allocation based on a view of relative value and total return expectations throughout the cycle. This approach encourages investors to step away from the perspective of the conventional bond or equity investor, making it more likely that they will be able to identify market pricing opportunities or risks. In this way portfolio returns can be increased or risks decreased.

While all of this might seem straightforward in an ideal investment world, challenges in the real world remain. Most institutional investors operate from a traditional portfolio approach, distinguishing between stocks, bonds and alternatives. The comprehensive analytical approach of the four-quadrant model means that asset class borders have to be crossed and there needs to be collaboration between departments, often speaking different analytical languages. Even more importantly, portfolio quotas, which are influenced by regulatory restrictions, need to be combined and/or shared. While these are not insurmountable obstacles, the model will require time and further maturing of some quadrants for it to become a common investment approach, especially for investors focusing on a single sector like European residential.
European housing markets

Despite favourable economic conditions, European housing markets have never been more in the focus of politicians given current demand/supply imbalances and the resulting affordability issues. But urbanisation is here to stay and, as we will see later, housing construction is not large enough at the moment to mitigate this imbalance any time soon. Despite these challenges, European residential investment has matured and is no longer a niche market. As housing markets consist of two major segments, the owner-occupier market and the rental market, a sound understanding of market dynamics and the mutual dependencies involved is key to investment success.

European residential markets have benefited from the European economy over the past several years. The upturn in the housing market has been accompanied by an expansion in outstanding loans for housing purchases. At the same time, real disposable incomes have increased continuously, supporting the ability of households to service debt. The burden of paying interest has been particularly reduced due to the low interest rate environment, with interest rates for five-year fixed housing loans at a current 2 % p.a. on average, which corresponds to a decrease of roughly 300 bps compared to 2008. Stability in the debt position of households across Europe is crucial.

Aggregated yoy growth of loans for housing purchases and lending rates in the Euro Zone

Aggregated data from ECB

Loans for housing purchase yoy % (LHS)  ■ Housing lending rate 5Y % (RHS)
European real housing price cycle

House prices deflated by countries’ HICP. Value represents the mean, the 75% and 25% quantiles

European real house price growth at country level in Q2 2019 (yoy in %)

House prices deflated by countries’ HICP
when it comes to the stability of housing markets given that high indebtedness can be the source of booms and busts with severe and long-lasting consequences for economic and financial performance. However, an increase in outstanding loans does not suggest deterioration in household balance sheets, given the changed reserve requirements of banks.

The expansion of the European house price cycle continues into its sixth year. Adjusted for inflation, house prices rose almost 3% across Europe in Q2 2019, a slowdown of 100 bps compared to a year ago. From a longer-term perspective, the house price cycle of the past several years mirrors the development of the economy and market fundamentals. However, whilst the economic upturn and low inflation have been the main drivers of house prices during the past several years, the house price cycle is currently in an advanced phase with risks to the downside slowly increasing as a result of geo-political uncertainties and the resulting downside risks for growth. As the pace of expansion slows the divergence between countries increases: Germany and the Netherlands showed more than 2% growth whereas Sweden, Finland and the UK saw a decline in prices for differing reasons. In Sweden these reasons include stricter mortgage amortisation requirements and a strong increase in housing supply while Finland is still struggling to find new sources of growth following the decline of its key industries and the UK is feeling the uncertainty around Brexit.

When looking at supply dynamics at country level to better understand the housing cycle, it quickly becomes apparent that there is actually no such thing as what you could call a European construction cycle. The dynamics of supply are anything but uniform.

### European housing construction cycle

Construction activities clustered by countries with common patterns over time. Active (SE, DE, PL, AT), inactive (IE, IT, PT, ES), rising (FR, NO, UK, BE) and steady (CZ, HU, NL, DK, FI)

[Graph showing construction activities clustered by countries with common patterns over time.]
between countries, requiring clustering as a result by identifying groups of countries with common supply patterns. Not surprisingly, the PIIGS countries form a comparatively inactive cluster showing the lowest activity over the last 14 years despite an increase in construction since 2017. This development is still an aftereffect of the housing boom experienced in these countries in the run up to the Euro crisis. Given ongoing urbanisation, the lack of construction has caused housing shortages in many major cities as the situation in Madrid and Dublin shows. Sweden, Germany, Austria and Poland form a second group with a substantial increase in new supply over the past five years. Nevertheless some signs of a slowdown have been visible in these countries since 2018 with the result being increasing supply issues in major cities. The other two groups show a similar albeit different pattern. The third group of countries including France, the UK, Belgium and Norway saw a strong correction in construction between 2008 and 2010 followed by a more or less continuous increase in supply over the past decade. The last group consists of Finland, Denmark, the Netherlands, Hungary and the Czech Republic. In comparison with the rising cluster, the contraction after the financial crisis was much slower and longer, with the upswing starting later as a result. In addition, we have been seeing a sideways movement in construction activity over the past two years. Nevertheless some signs of a slowdown have been visible in these countries since 2018 with the result being increasing supply issues in major cities.

Demographics are the most important determinant of real estate investments, which is why detailed knowledge is essential when it comes to advice regarding strategy. While demographics in general are a slow-moving target, statistics about demographic developments are changing and improving continuously, specifically when looking at the spatial dimension. Modern demographic analytics distinguish between cities, towns and rural areas according to population density. Today Eurostat provides this differentiation not only at the traditional NUTS 3 level, but also on the basis of local administrative areas (LAU). These LAUs are the building blocks of NUTS analyses and comprise the municipalities and communes of the European Union, enabling much better regional differentiation of Europe for analytical assessment of demand trends. A city is defined as a highly densely populated cluster where more than 50% of the population live in grids with more than 1,500 inhabitants per sq km. Towns and suburbs are defined as intermediate urbanised areas where less than 50% of the population live in urban grids and less than 50% live in high-density clusters. Rural areas are areas per se thinly populated areas with less than 300 inhabitants per sq km. This approach is not fundamentally new, but the data gathered now reflects the whole of Europe, enabling detailed analysis.

The results show that less than 9% of European areas can be classified as cities. To put it simply, from a geographical point of view the universe of cities to consider for institutional residential investment is quite small, even if we consider the fact that towns and suburbs, the transitory areas between cities and rural areas, account for an additional 17% of European territory. The investment universe of institutional investors therefore comes down to only a quarter of European territory. And within this quarter not all cities, towns or suburbs constitute attractive investment targets for long-term investors, as structural changes and aging will leave their mark. The high competition for quality assets in attractive cities is therefore not a surprise. Given their low population density, most rural areas are not suitable targets for long-term investment strategies. However, they could be considered for development strategies targeting the owner-occupier market on a case-by-case basis if they are near cities and towns and well connected to the nearby cities and towns. This can be attributed to the fact that many young families looking to own a home are moving to these areas as housing affordability is an issue in most agglomerations around Europe. And these regions, if they are attractive for young families, will be future expansion areas of the continuously growing agglomerations, making them investment locations for classical residential investment in the medium to long term.
Degree of urbanisation with city, town and rural clusters

Density values obtained in a 1 sq km grid based on Eurostat as of 2018 at LAU level

- Cities
- Towns and suburbs
- Rural areas
Despite efforts in data harmonisation in Europe, we still do not have an effective European database on residential rents. This is not because there are no agents gathering rental data, but because the different European rental markets are not monitored in the same way as housing markets, despite their increasing political significance. That makes data collection challenging.

One way to obtain rental information is to extract the rental component of the harmonised consumer price index. However, this approach may be biased, as it does not reflect the whole rental sector but only a sample of households that are often not representative of tenants in the free rental market. Consequently, market movements and forecasts derived from this information may be misleading.

A better but more challenging option is to collect rental data from online portals and other market sources in order to construct a time series of rents at city level. Based on this second approach, PATRIZIA has been using and updating a unique European database covering 72 cities across 13 countries since 2000.

The number of observed markets in the PATRIZIA database varies from country to country, but this is an issue of market size rather than market coverage, e.g. 12 German vs. 3 Irish cities. In order to guarantee comparability of the collected raw data, observations are processed and cleaned to create a time series for the private rental market, thereby avoiding a mix of private and social rental data as well as student and subsidised rental data.

**Inventing a European rental cycle**

European rental cycle yoy-growth

Residential rents covering 72 cities across 13 countries from national private agents
Aggregating city-level rental growth data to a European average reveals a rental cycle that gives us important insights. One insight is that despite all economic challenges since the millennium, rental growth has remained in positive territory throughout, which underpins the stabilization aspect of residential investment. Another important feature of the rental cycle is the low volatility in rental growth apparent since the GFC. Since 2011, rental growth has been at around 2%, again confirming the high stability of residential investment. The latter development is to an extent a reflection of the rent regulation at city level. But the average level of rental growth of 2.3% over the past 10 years also shows that regulation should not put investors off as, taking detailed knowledge as a basis, they can tap inflation protection.

A look at the underlying city level data reveals even more interesting facets. If we look at the compound annual growth rate at city level over the past five years, it becomes apparent that 85% of cities in the database saw positive rental growth during this period. Only some Italian and French cities did not see any rental growth because of regulation (France) and poor economic development (Italy). More regional patterns can be seen as well. The highest growth rates are to be found in the PIIGS countries, as cities like Madrid, Barcelona, Dublin and Cork are showing catch-up effects and we are seeing the private rental sector mature in these countries. On the other end of the spectrum, French cities on average are seeing positive rental growth. However, with growth rates of less than 2% p.a. the effects of the regulatory environment can clearly be seen.

Compound average growth rates 2014 – 2018
Residential rents covering 72 cities across 13 countries from national private agents

Stay tuned for more analysis and stories in future, as the PATRIZIA database will continue to grow to accompany investment strategies, serving as a guide for rental growth forecasts and market correlations.
Market performance

The performance of European residential markets reflects the positive momentum of the economic cycle. The residential investment market has matured as the number of investors, origin of capital and variety of products have increased significantly over the past several years. That means not only mounting pressure on prices, but, most importantly, that accessing deals has more than ever become a game of local knowledge, as a lack of investable products is increasingly putting a constraint on investments.

Residential assets across Europe continue to deliver total returns close to 8% p.a. on average. Whilst the valuation component of total return has settled at 5% p.a., income return has been experiencing a small but significant negative trend over the past several years. More important, however, is the fact that the cash flow component of residential investments is displaying anything but variance over time, with a variation of less than 70 bps since 2000, regardless of the economic cycle or crisis.

Total return performance of European residential markets

Based on MSCI-like portfolios including AT, DK, FR, DE, NL, SE and UK

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events like the GFC or the Euro crisis. This fact has definitely contributed to the perception that residential assets are not only a trendy opportunity, but a long-term diversifier in institutional portfolios.

Looking at the post-GFC period and comparing residential income return with corresponding numbers for office and retail, the downside protection offered by residential investments can clearly be seen. Despite having started at a low level, the disadvantages involved in residential have continuously declined. Average income return for residential investment has been moving within a narrow range with a variation of less than 24 bps. In comparison, commercial real estate investments saw a strong decline in income return in the same period and varied by more than 50 bps annually. Residential investment therefore delivers
Cross-border and overseas investment in residential markets Q3 2018 – Q2 2019

Aggregated data from RCA including transactions >€10 m, overall volume €35.1 bn
Cash-flow stability as well as diversification benefits, offering a kind of downside protection or income return floor within a multi-sector real estate portfolio.

Given these positive portfolio effects, institutional capital targeting residential assets has been gathering momentum since 2009. The huge dynamic we are seeing in residential investment is reflected in constant growth of investment volumes from €5 bn in 2009 to €50.8 bn in 2018. In other words, residential investments rose from less than €100 m per week to almost €1 bn per week. This massive increase in liquidity not only corresponds to a compound annual growth of roughly 30% within nine years but also reflects the maturity of the asset class and the vast investment opportunities available in the sector. This trend can be attributed to urbanisation and the urgency of new investment markets in former owner-occupier dominated countries like Ireland, the UK and Spain.

Copenhagen, for example, experienced a transaction volume of more than €1.5 bn in 2018 partly due to expected population growth of more than 8% in the next decade. The same applies to the Randstad in the Netherlands where transaction volumes reached a high of more than €4 bn in 2018, the highest ever recorded. Although the beneficiaries of residential capital inflows have undoubtedly been Germany and the UK, the past three years have shown a surge of investment in the PIIGS countries and the BENELUX region. Until 2016 at least 70% of institutional capital targeted Germany and the UK; in 2019 this dropped to less than 50%. It is not that investment volumes in Germany and the UK have declined, but rather that both countries have seen less growth than the Netherlands, Spain and Ireland.

Non-European cross-border capital targeting European residential markets came predominantly from the US and Canada with interest primarily in Spain and

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**Cross-border and overseas investments Q3 2018 – Q2 2019 in %**

Aggregated data from RCA including transactions > €10 m

![Cross-border and overseas investments chart](chart.png)
the remaining PIIGS. As capital inflow into Spain is attributable to large-scale M&A activities (like Hispania for €2.8bn or Axiare for €1.7bn), the dominance of Spain as a recipient of cross-border capital will decline in future. On an annual basis German and Nordic investors invested €15.1bn in Europe outside their home country, making Germans the most active players on the European residential market. The most notable development over the last four quarters is the low participation of UK investors in cross-border investment activities. This drop in activity does not appear to be the result of deterioration in investment appetite but more a response to structural trends and, especially, uncertainties regarding Brexit.

Luxembourg, Belgium, Sweden and, to a large extent, Germany are dominated by investment activity from domestic investors, whereas a balance between domestic and foreign investors can be found in the Netherlands, France, Finland and the UK. On the other end of the spectrum, countries like Denmark, Spain and Austria tend to be dominated by activity from foreign investors.

Overall, liquidity on the European residential markets is and will remain plentiful, resulting in high pricing and a shortage of suitable assets, especially at the core end of the risk spectrum. Pricing of residential assets has gone up compared to last year, leading to a decline in gross initial yields of 25bps on average. The primary difference compared with 2018, however, is that the yield gap to government bond yields has widened substantially to 270bps on average, with Denmark and Ireland showing the highest premiums of more than 330bps and 390bps, respectively.
Many cities are struggling with the challenges of urbanisation and the resulting boom in rental prices. Governments are responding by setting limits on the rent landlords can charge. For many, this seems a sensible way to address the problem, but there will be long-term negative consequences.

Do we want to destroy our cities? Many booming cities are experiencing gentrification, a process typically caused by the influx of people with higher incomes, which pushes up rents. Over time, this changes the nature of neighbourhoods, as low and middle-income households are squeezed out by soaring costs. In response to public demands to address the problem, many governments are introducing or are considering rent control. Most recently, London Mayor Sadiq Khan called for controls to “fundamentally rebalance London’s private rented sector”, while Berlin is considering a five-year rent freeze to control the rapidly rising cost of living in the city.

Rent control takes various forms, including a cap on the rent that can be charged and stabilisation, which sets a limit on how much rent can be raised throughout the duration of the tenancy. Proponents argue that such controls make for a fairer housing market and will help ensure that low and middle-income households are not squeezed out of cities. However, while rent control can have short-term benefits for people in rent-controlled properties, it can also have long-term negative impacts on the quality of rented housing and can decrease affordability. Writing for The New York Times, Paul Krugman, 2008 winner of the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel, observed that rent control is “among the best-understood issues in all of economics, and – among economists, anyway – one of the least controversial”.

It is consensus amongst economists that a restrictive price ceiling ultimately reduces the supply of property on the rental market as it motivates landlords to sell properties to owner-occupants in order to earn market value on their real estate. A more limited supply would exacerbate the housing crisis, particularly as it can lead to a “mismatch” between tenants and rental properties. Once having secured a rent-controlled property, tenants can be reluctant to leave and give up the benefits of artificially lower rents. This can lead to a misallocation of rental stock in which empty-nest households have family-sized apartments and young families are crammed into small apartments.

Empirical evidence from New York also shows that tenants in rent-controlled flats tend to have higher median incomes than those who rent market-rate apartments. This may be because wealthier households are better able to track down and
secure rent-stabilised properties, but it could also stem from an informal tenant selection process that occurs when landlords decide to whom they will rent their apartment. In any case, the result defeats the original intention behind rent control policy. Finally, rent control can lead to decay in the quality of rental housing stock, as landlords may refrain from investing in maintenance because they will not be able to recoup their costs through higher rents.

The politics of rent control: Despite an overwhelming case for rent control being bad economics, it is still an attractive option for politicians, as the downside only becomes visible after 10 to 25 years – a point in time in which most politicians introducing rent regulation today will no longer be in office. In the short-term, the effect of imposing rent control on the current supply of rental units is quite small, so proponents can focus on this to argue that economic objections are unsubstantiated.

More importantly, in cities where rent control is imposed, current local renters, who are the beneficiaries, often form a political majority or are a vocal minority that can count on overall public support. So, rent regulation can be rationalised as the democratic will of the people by politicians seeking to be re-elected.

But while rent control offers current tenants perhaps the greatest economic returns of any policy measure, they can vote for, the “pro-renter” rhetoric behind rent control is also a powerful form of misrepresentation. Rent control only benefits current renters, not renters overall. People seeking to rent generally don’t get a vote in the communities in which they’d like to rent. Rent control also harms renters in surrounding communities, as the restricted supply of available units forces potential renters to spill over into these areas, which raises rents there. Swedish economist Assar Lindbeck once wrote: “In many cases rent control appears to be the most efficient technique presently known to destroy a city – except for bombing.”

However, even if – unlike bombing – we do not see the immediate impact of rent control, historical evidence provides ample examples of the consequences of rent control. One vivid example of the long-term effects of rent control is the appalling decayed state of the East German housing market at the time of reunification, the result of over 40 years of centralised rent control. So, will the rent control policies now being introduced function better? There are no historical examples that would lead one to conclude that “this time will be different!”

The investor challenge: Despite rent control being bad economics, investors in the residential market need to be aware of the political dimensions. Depending on the exact nature of any regulatory measures introduced, investors targeting high-return strategies by bringing under rented properties to market level or refurbishing units could end up struggling to meet their targets as regulated rents will definitely be lower as current expected market rents. Long-term investors also need to monitor political developments closely and consider the impact these may have on an individual asset in their underwriting. Overall returns might be a little lower compared to an environment without regulation, but residential investments will continue to deliver cash-flow stability and diversification benefits if underwritten properly, as history has shown in the strongly regulated Swedish residential market over the past 3 decades.
Outlook

Compared with a year ago, fundamentals for investing in European multi-family housing are still solid, despite a deteriorating economic environment and increasing geopolitical tensions. However, the ongoing low interest rate environment, which is likely here to stay for several more years, will continue to challenge the execution of investment strategies. Availability of assets, especially at the lower end of the risk spectrum, will decrease and pricing will become more aggressive. At the same time, as described in this paper, political involvement in the European residential markets is here to stay and will in many cases limit rental growth perspectives going forward. Investors need to pay close attention to the income stream delivered by each asset as well as any sensitivity to regulatory changes. Investors therefore also need to understand the special demand/supply situation that multi-family markets across Europe are currently experiencing and what this means in terms of political involvement and regulatory activities. This assessment and its impact should be viewed against the background of a medium to long-term holding period. Whatever an investor currently decides to do should be flexible enough to cope with at least a 10-year investment period. To do this, it is vital to be aware of the trends involved in population shifts, ageing and spatial distribution as well as movements of the supply side.

Given high demand and the fact that supply is still low despite the increase in construction over the past several years, housing developments remain an attractive sector across Europe, assuming investors choose suitable sites in major agglomerations. Ongoing urbanisation in combination with current

**Completions and current stock**

*as % of existing stock p. a.

- 1.6 %
- 1.4 %
- 1.2 %
- 1.0 %
- 0.8 %
- 0.6 %
- 0.4 %
- 0.2 %
- 0 %

building activity continue to foster supply-constrained residential markets in most urban areas. However, the ongoing increase in land prices is a trend to be monitored closely. Increasing land prices in connection with growing political intervention for more social rental housing are challenging the profitability of developments. A slowdown in development activity can already be seen in markets like Sweden, whilst development activity is stabilizing in the majority of the European countries. On the other end of the spectrum, construction activity continues to increase only in Denmark and Ireland, making site selection a critical factor for success as regional pockets of oversupply start to emerge, especially in Denmark where construction activity has been buoyant for years.

“Lower for much longer” is again the scenario institutional investors have to deal with when making decisions regarding allocation. In such an environment and with pension funds looking for long-term, stable, secure income, residential property continues to be an attractive investment option. But its performance compared to alternative investments is not the only factor that makes residential so attractive. The ongoing imbalance of supply and demand in most European urban areas supports rental values, with a positive outlook for income returns and capital growth of multi-family housing investment. At the same time, construction activity continues to fall short of what is needed to balance the market, additionally supporting a favourable outlook for rents and capital values in coming years.

Overall, this will result in total returns for European buy-and-hold multi-family housing strategies ranging between 5% to 6.5% p.a. in the next five years. Despite regulatory challenges, which influence rental values, rising rents and high demand for assets will result in capital growth of between 2.0% and 3.0% p.a. In addition, investors will receive an income return of between 2.5% and 3.5%, significantly lower than historical 10- or 15-years averages, a reflection of the ongoing low interest rate environment. The income component will remain the dominant source of return across Europe, but capital growth is starting to increase its share of total returns, approaching 50% in markets like France, Denmark and the Netherlands.
Country abbreviations: AT = Austria, BE = Belgium, CA = Canada, CH = Switzerland, CZ = Czech Republic, DE = Germany, DK = Denmark, ES = Spain, FI = Finland, FR = France, GR = Greece, HU = Hungary, IE = Ireland, IT = Italy, JP = Japan, LU = Luxembourg, NL = Netherlands, NO = Norway, PL = Poland, PT = Portugal, SE = Sweden, UK = Great Britain, US = United States

Abbreviations of German federal states: BB = Brandenburg, BE = Berlin, BW = Baden-Wurttemberg, BY = Bavaria, HB = Bremen, HE = Hesse, HH = Hamburg, MV = Mecklenburg-Western Pomerania, NL = Lower Saxony, NW = North Rhine Westphalia, RP = Rhineland-Palatinate, SH = Schleswig-Holstein, SL = Saarland, SN = Saxony, ST = Saxony-Anhalt, TH = Thuringia

In essence the following sources have been used for the report: AFME, ArcGIS, AWS, BBSR, BIS, CBS, CECODHAS, CIA, Commercial Mortgage Alert, EIU, empirica, Euroconstruct, European Mortgage Federation, Eurostat, ECB, GfK, Google, INREV, IPD, IMF, JLL, KTI, National statistical agencies, OECD, Open Street Map, Oxford Economics, RCA, Reuters, UN, various Real Estate Agents, vdp, Veneficus

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