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Residential

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KEYNOTE INTERVIEW

The houses always win



*The pandemic has accelerated demand growth for rental residential, notes **Brice Hoffer**, with mature and frontier markets each offering compelling opportunities*

The rented residential sector has been a magnet for global institutional capital for years, first as a sound diversification play for commercial real estate investors but increasingly as a source of stable income that can ride out the ups and downs of the economic cycle. If anything, the pandemic has reinforced the long-term trend of investors looking for resilient income from residential – in all its forms – that is seen to benefit from strong demographic drivers.

With real estate investment now being played out against a backdrop of geopolitical uncertainty and above-average inflation, the residential sector is still proving its worth, according to Brice Hoffer, head of real estate research and strategy for the DACH region at UBS Asset Management. But as Hoffer mentions, residential is usually

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more asset management intensive than commercial property, regulatory aspects have to be accounted for and investors must adapt their strategies between mature and “frontier” markets.

Q There has been a long-term shift of capital into private rented residential - an accelerating trend during the pandemic. What is driving this increasing investor interest in the sector?

More institutional capital started flowing into this asset class way before the pandemic. If you look at global property transaction volumes by sector, 10

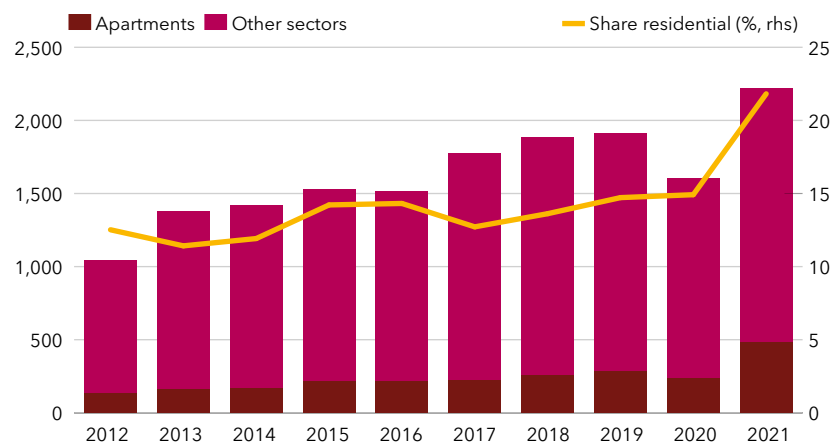
years back rental residential accounted for about 12 percent of total volume and now it is at least one out of five transactions. This growth is mostly supported by very long-term structural and demographic trends.

Despite discussions about an aging society, most developed economies continue to grow resulting in more inhabitants. Another important factor in demand – both for rental and owner-occupied-housing – is that the average size of households is decreasing.

Even if the population is stagnating or not growing as much as it used to do – in Germany, for instance – the overall trend of decreasing household sizes is creating more demand for residential.

It is true, however, that institutional investment in residential, as well as industrial, has really increased as a result

Yearly property transaction volume (\$bn)



Data includes development projects
 Source: Real Capital Analytics ; UBS Asset Management, Real Estate & Private Markets (REPM), May 2022

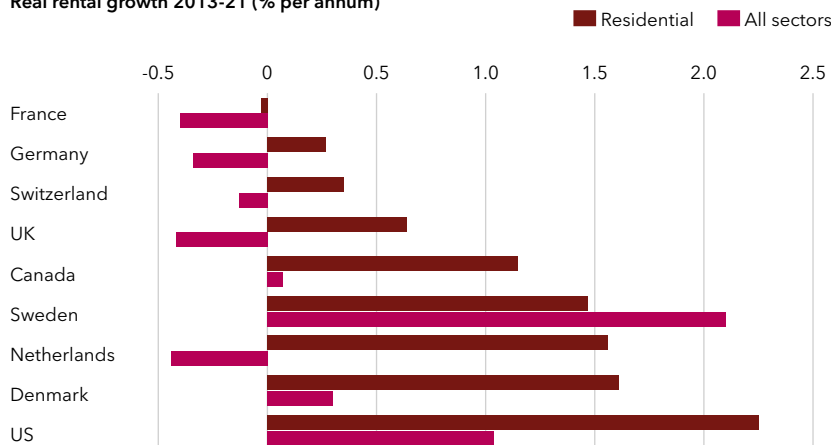
of the uncertainty created by the pandemic. During the pandemic, it was not such a concern to collect your rent from the residential and industrial sectors. Also, if you would acquire an industrial property, especially logistics – or in the case of residential, multifamily assets – there was no question about convincing investors that it would perform even in this troubled time. This pandemic boost has been a bit of a reactive play, but it is ongoing now because there is still uncertainty in the market.

Equally important, however, is the fact that the private rented sector is

growing at a faster pace than housing overall and for good reasons. Younger generations are not attracted to big mortgages anymore. Flexibility and mobility are more important for this generation. They see real estate as a product, rather than a long-term commitment. Lifestyle is an important aspect for the continuous growth of the sector.

Q In this year's economic environment of above-average inflation and rising interest rates, will the residential growth trend continue?

Real rental growth 2013-21 (% per annum)



Source: MSCI, NCREIF, Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), May 2022

We will still have growth in most developed economies, albeit lower than forecast before the outbreak of the war in Ukraine. Inflation is skyrocketing, and we think this will continue at least for a few months before it reaches a peak because we have additional pressure on prices of fuel and basic goods coming from the war.

There is clearly more downside risk for real estate values than before, although we don't foresee a major correction as of today. The other central element driving real estate performance is income return, which is very stable in residential and not highly correlated with the economic cycle. In this respect, it remains a good diversification away from commercial property.

As for inflation, the best way of mitigating risk is through rental growth. Residential demand is very strong in most markets, while supply isn't because it has been relatively difficult to secure third-party financing for development since the global financial crisis. In addition, building land availability is becoming scarce in growing urban regions. If we compare the track record of all property rents in the long run, the residential rental sector has usually been the best inflation hedge in most markets.

Q One consequence of covid has been greater scrutiny of lifestyles and the enduring appeal of big cities. How will residential investment influence this debate?

The US has been an interesting case to observe during the pandemic, as we saw people moving towards the suburbs and secondary cities (particularly in the Sunbelt states), with housing affordability and quality of life among the drivers. But large cities will still be sought-after living destinations, as they will remain at the center of the job market as well as the education and entertainment sectors. That will not change post-covid, in our view.

For young people in the early steps

of their career, New York, London, Paris or other big cities around the world will always be attractive. And we think the demand for residential units in the rental sector will still be important coming from this client segment.

The question is whether the digitalization of the work environment will allow a long-term dilution of this demand toward more secondary cities and agglomeration areas. But we think that we will still have many people commuting to and from city centers to work onsite.

I don't think that we will be working fully remotely. Even twice or three times a week in the office might be enough of a reason for some people to be willing to move outside central areas.

We believe the concentration of industries and activities will increase in selected secondary cities where, in the US for example, some large corporates are expanding and therefore fueling housing demand. The structure of residential demand is also changing. By the time people are at the household formation stage they may be looking for larger-sized housing outside city centers but still in commuting distance to the office location.

This means there are two main client segments for rental property, requiring different products, and investors can be successful in both. If you are going to the suburbs, you can target larger multifamily units. Also, single-family housing rentals are increasing in popularity, particularly in the US. However, for the younger client segment, micro-apartments, co-living or smaller-sized units in multifamily schemes in the big cities will be in demand now that we are coming out of covid.

Q What are the key opportunities, challenges and barriers to entry?

It depends on the markets you are targeting. In areas with established, institutionalized markets, capital can be deployed very quickly – for instance,

“Large cities will still be sought-after living destinations, as they will remain at the center of the job market”

the US, Germany, the Netherlands and the Nordics. In Asia Pacific, we see this trend only in Japan at the moment.

Many other markets are just in the process of becoming institutionalized – Canada, the UK, France and southern Europe as well as Australia – which makes them more complicated to access. Capital can't be deployed at scale in these frontier markets and there is often the need of a local partner. The high turnover of tenants, requiring more local market expertise than commercial real estate, makes residential more intense and granular to manage.

There is also regulation, which is seen as a big issue for residential investment. In our view, regulation is not problematic when clear rules about rental growth and tenants' rights are set and these are stable over time; regulation becomes more of a problem when you have regulatory volatility – when some rules of the game become unpredictable and could change over time.

Overall, we spend a lot of time looking at the agglomeration areas and attractive secondary cities, where you tend to face less political pressure and uncertainty. But, nowadays, I would say that regulatory risk applies across Europe. You really need to monitor it closely and work with thorough local expertise.

In my view, the growth of residential investment has really been lifted by structural trends and we believe this will continue to be the case. But there remains the question of how we will tackle all the social and affordability issues around housing.

It will be interesting to see how government and private institutions will manage to work together in the coming years to solve those challenges in a constructive way. If we have too much regulation and not enough cooperation between private and public sectors, the risk is that supply will continue to undershoot demand in many local markets. And that is not helpful for anybody.

Q How should investors adapt their investment strategies between mature and frontier markets?

In many mature markets, capital can be deployed rather quickly and in a number of locations across the country. In Germany for instance, this is particularly true in the agglomeration areas. This doesn't mean city centers won't be in demand anymore; but their current high price is tied to a higher regulatory risk and lower affordability for most tenant segments.

That is why we think in terms of entry price and rental growth prospects. For some investors, certain secondary cities and commuting locations in the agglomerations are more interesting now than the really prime big city markets.

With frontier markets that are not so institutionalized, such as the UK or Australia, you have the opportunity to be a front runner and capture a niche yield that does not exist anymore in established markets. However, you will need to take on more market risk and may need to find a local developer, which can result in a higher yield. But that is not for everyone; it is really for investors with more appetite for risk and a very active approach in terms of asset management. ■