On the rise

Growth of the global rental housing sector | White paper

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The steady growth of the global rental housing sector is offering appealing opportunities for real estate investors looking for a stable source of revenue. The resilience and inflation hedge attributes of residential income make it particularly attractive in the current macroeconomic environment.

Focus on robust rental income

All around the globe, investor demand for the rental residential asset class has been growing dramatically over the last decade. This elevated investor interest is fueled by a steady growth in occupier demand and the robust nature of residential rental income.

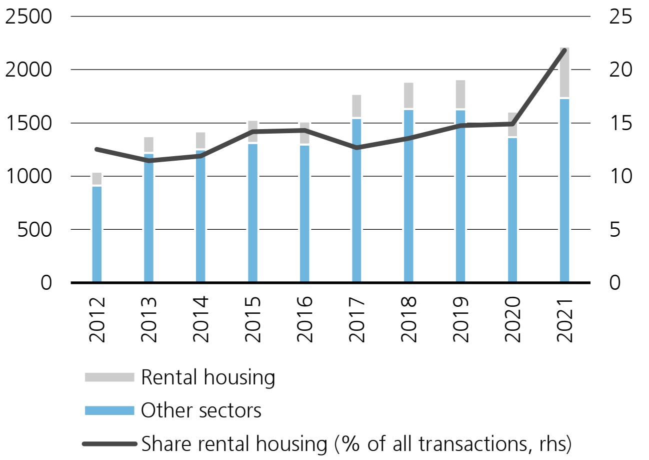
Global upswing in rental residential transaction volumes
For some parts of the global investor community, the COVID-19 outbreak revealed the resilience of the rental residential asset class. In fact, while many commercial sectors in occupier markets struggled during the pandemic, rental housing properties kept showing elevated levels of occupancy and rent collection. The resilience of residential income is not just a one-off effect due to the special nature of the pandemic. It is actually visible in historic property performance data. This is supported by long-term occupier market trends which are expected to persist over the next few years.

Although the pandemic gave an additional boost to the attractiveness of the sector, the transaction volume of rental residential assets was already evolving for several years with an upward trend (see Figure 1).

According to Real Capital Analytics (RCA), global rental housing transactions in the form of income-producing assets and development projects, posted a record volume of over USD 480 billion in 2021. In relative terms, one out of five global property transactions took place in the rental residential sector.

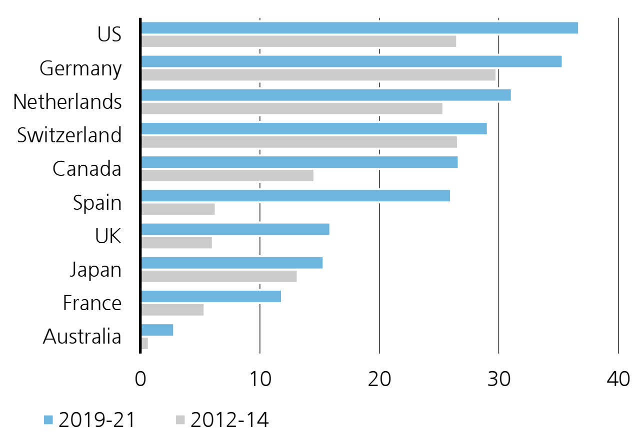
A growing sector in most local property markets
The global trend towards a growing rental housing asset class is also observed on a local level in the single property markets (see Figure 2). Markets with a nascent institutional residential sector – such as France, the UK or Canada – witnessed a major increase of the share of rental housing transactions over the last three years compared to the period 2012-2014 as a reference. Despite their increased level of institutionalization, established markets like the US, Germany, Switzerland and Japan also witnessed a growing predominance of rental residential transactions, albeit at a slower pace than in more emerging residential markets.

Figure 1: Yearly property transaction volume (USD billion)



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

Figure 2: Share of rental residential transactions
(% of total transaction volume, 3-year average)



Source: Real Capital Analytics ; UBS Asset Management, Real Estate & Private Markets (REPM), May 2022.

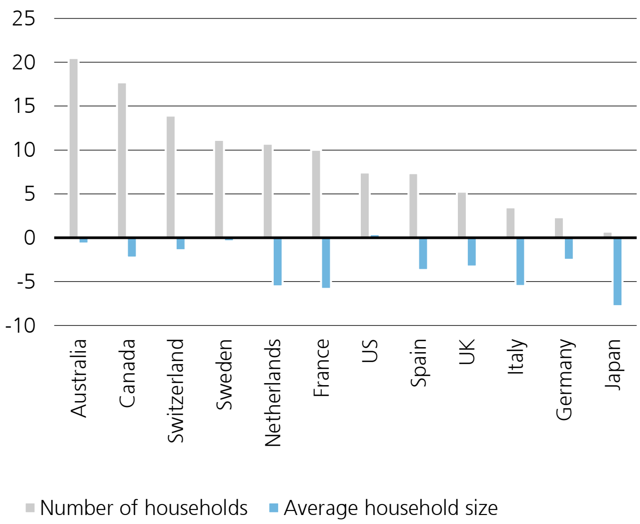
Socio-demographic trends lifting occupier demand
An important driver behind the rise of the global rental residential asset class, is the steady increase in occupier demand boosted by strong socio-demographic trends and evolving lifestyles of local populations.

Despite the trend towards aging societies observed in most developed economies, the majority of local residential markets around the globe are set to enjoy growth in demand over the coming decade according to current forecasts (see Figure 3). Naturally, popular immigration destinations such as Australia, Canada, Switzerland or the Nordics are expected to see the most dynamic absorption potential. By contrast, countries such as Italy, Germany or Japan which are very advanced in the aging trend, are expected to see a more muted growth in demand over the next few years. However, the steady decrease of the average household size will support more demand in these markets despite a stagnating (Germany) or gradually retreating total population (Italy, Japan).

Strong potential for geographically focused strategies
In addition to the steady decrease of the average household size, internal migration trends are also an important factor to account for when looking at residential markets facing top-down demographic headwinds. Taking Germany as an example (the largest and most liquid rental housing market in Europe), we see that several local regions of the country are expected to experience dynamic population growth over the coming decade (see Figure 4).

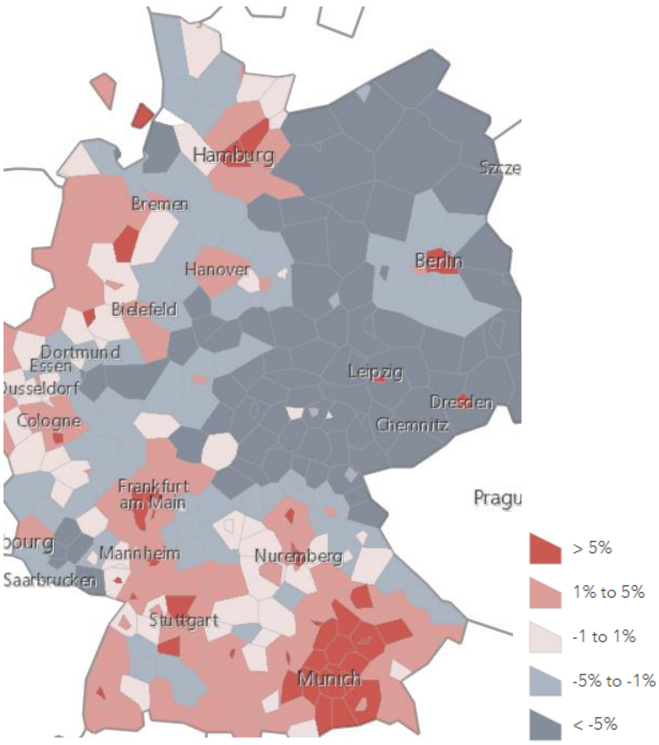
This is particularly the case for most agglomeration areas in the western and southern parts of the country, as well as selected cities in the eastern part of Germany such as Berlin, Leipzig, Dresden or Erfurt. A similar trend is observed in the Japanese residential market, where Savills[1] reports that the Tokyo area still benefits from sizeable inter-regional migration fluxes, while important secondary centers such as Osaka and Fukuoka are driving additional demand on an intra-regional scale. Such local demand trends offer interesting opportunities for geographically focused investment strategies in the local rental housing sector.

Figure 3: Demographic change 2020-2035 (%)



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

Figure 4: Expected regional population growth 2020-2030 in Germany



Source: Oxford Economics, 2020; ESRI; UBS Asset Management, Real Estate & Private Markets (REPM), May 2022

[1] Savills research, Japan Regional Residential Markets, March 2021

Lifestyle and affordability as additional boosters for rental demand

The increasing number of households, on both national and local levels, is a positive driver of overall residential demand. In addition, there are several other factors increasing the demand shift away from the owner-occupied housing market towards the rental sector.

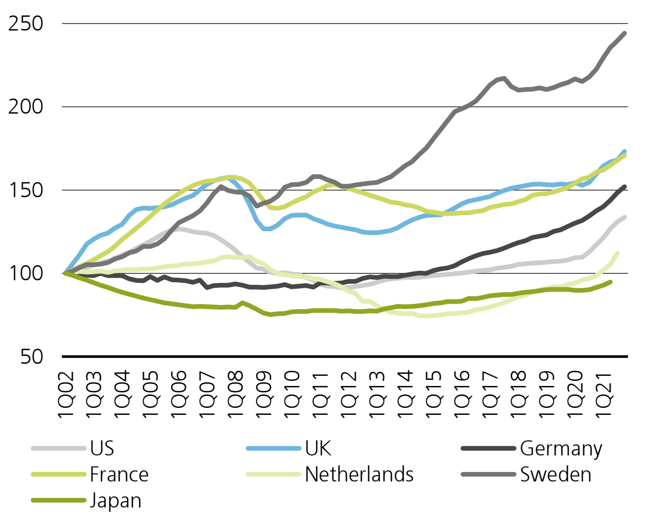
A major driver of this trend is the decreasing affordability of housing, in particular in growing urban areas with very limited land availability. During the recovery phase post Global Financial Crisis (GFC), most major residential markets in the world saw housing prices rise at a more dynamic pace than wages and residential rents. The historic evolution of local price-to-rent ratios, which compares the relative costs of buying versus renting an average residential property, underlines the trend towards the increasing financial attractiveness of the rental residential sector (see Figure 5). On a cyclical note, the recent rate increase observed in the financing markets is likely to deepen this disparity.

Limited supply risks in most local markets

So far, rental housing supply has not developed to the same extent as the absorption potential in most local markets around the globe. One of the consequences of the GFC is more restrictive third-party financing practices in residential projects, which is very likely to contribute towards this trend. Also, the availability of building plots in dense urban areas is becoming very scarce and costly, which is another factor weighing on supply growth in most agglomerations. As a result, most local residential markets around the world did not experience a significant acceleration in production of new residential units over the last few years (see Figure 6).

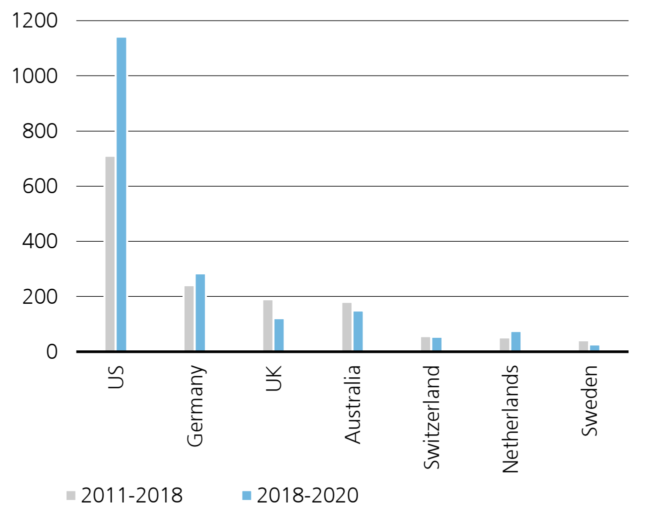
The US is an exception to this global trend, although recent data indicates a stabilization of construction activity, while demand growth has accelerated in this market (see our publication Real Estate Outlook – US, Edition 2 – 2022). In the short-term, elevated construction prices which have resulted from long-lasting supply chain disturbances, and the inflationary consequences due to the war in Ukraine, are likely to put an additional drag on the production of new residential units globally.

Figure 5: Residential price-to-rent ratio (100 = value 1Q02)



Source: Refinitiv 4Q21; UBS Asset Management, Real Estate & Private Markets (REPM), May 2022

Figure 6: Yearly addition of new dwellings (1,000 units)



Source: OECD; DESTATIS; Swiss Statistical Office; UBS Asset Management, Real Estate & Private Markets (REPM), May 2022

In addition to increasing housing prices, the growing importance of flexibility is another factor likely to drive more demand towards the rental residential sector. When compared with owner-occupied housing, rental residential property does not require sizeable third-party financing or commitment to a long-term stay in a specific location. This flexibility is gaining importance in an increasingly mobile and individualized society, particularly in the younger cohorts of residential users.

Strong inflation hedge through real rental growth

Steady occupier demand growth as well as moderate supply, support this compelling rental growth story in most global rental housing markets. Positive rental growth is particularly important in the current macroeconomic environment, where higher inflation and interest rates are materializing.

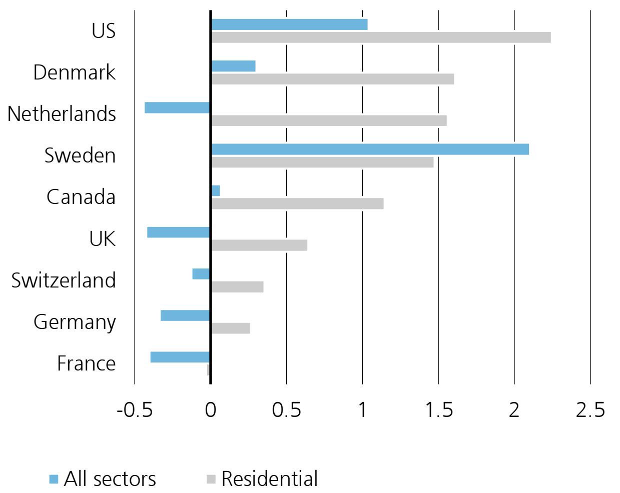
This is not the first time residential rental income has proven its strength. Positive demographic forces and the limited dependency of occupier demand drivers to the macroeconomic environment support the occupation rate and rent collection level of rental housing assets over the various business cycles. Also, according to historic property market data, residential income tends to offer a strong inflation hedge when compared with the commercial real estate market average (see Figure 7). According to data from MSCI and NCREIF from nine global property markets, residential assets managed to beat inflation and outperform the hedge provided by the average of the property sector in seven countries.

Focus on attractive risk-adjusted returns

Residential has the potential to deliver attractive risk-adjusted returns. Figure 8 presents the analysis of historic-adjusted total returns in several major rental housing markets across the globe.

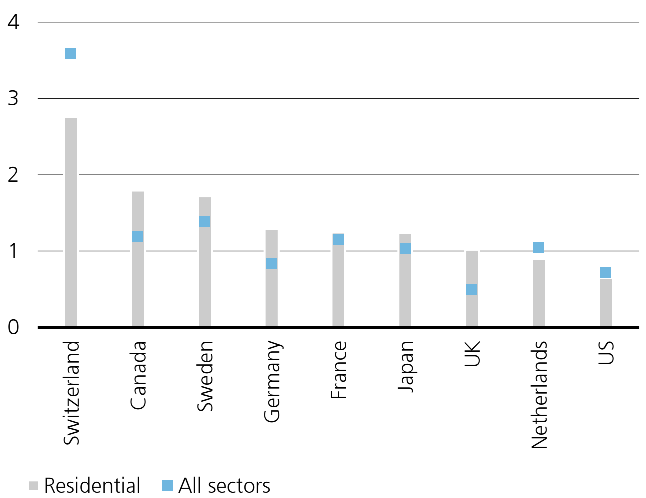
The results of the assessment shows that in seven out of nine markets analyzed during the 18-year period ranging from 2004 to 2021, residential assets posted higher (Canada, Sweden, Germany, Japan and the UK) or equal (France, US) risk-adjusted total returns compared to the overall local property sector. Only the Dutch and the Swiss residential markets showed a lower risk-adjusted performance than the local market average, although Switzerland returned the highest risk-adjusted performance indicator in the whole series with 2.8 points.

Figure 7: Real rental growth 2013-2021 (% p.a.)



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

Figure 8: Indicator of risk-adjusted excess total return 2004-2021*



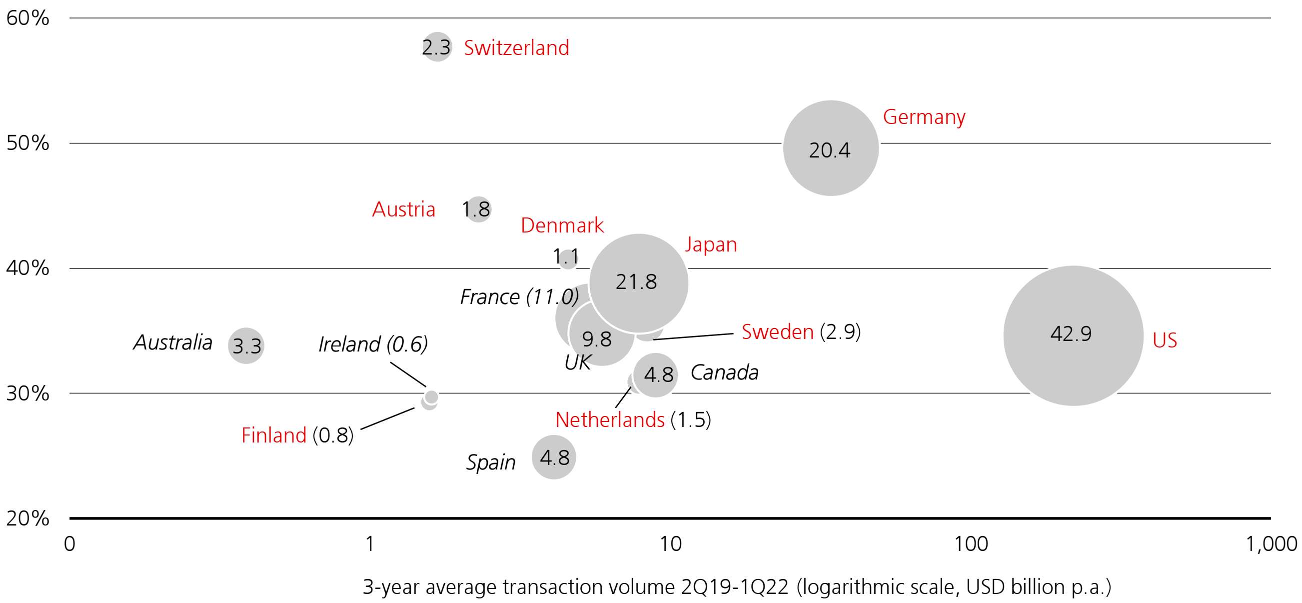
Source: MSCI; Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), May 2022. Note on indicator calculation: Historic average of the annual total property return minus the annual yield on the local 10-year government bond (excess return) divided by the historic standard deviation of these excess returns. Past performance is not a guarantee for future results.

> "Residential rental income has the potential to drive attractive risk-adjusted returns."

Global rental residential: large property universe offering diverse investment opportunities
The global rental housing sector offers a sizeable investment universe with numerous local markets showing different depth, liquidity and institutionalization grades (see Figure 9). With an estimated size of almost 43 million units in rental housing stock and an annual transaction volume of over USD 200 billion, the US is by far the largest and most liquid rental housing market in the world.

In Europe, Germany also offers a very liquid rental housing market, with over 20 million units of stock and almost USD 35 billion of annual transaction volume measured over the past three years. By contrast, the emerging rental residential sector of Australia recorded less than USD 400 million of transactions annually over this time period, but with an accelerating trend.

Figure 9: Major rental housing market worldwide (% tenant population)
Bubbles: estimated market size in 2021 in million units incl. subsidized segments
Red: institutionalized markets; Italics: frontier markets.



Source: Real Capital Analytics, 1Q22; Oxford Economics; Trading Economics; UBS Asset Management, Real Estate & Private Markets (REPM), May 2022
Note: All shares of tenant population as of 2020, with the exception of the US (2022) and the UK / Canada / Japan / Australia (2018). Swiss rental housing only accessible for local investors / residents due to Lex Koller constraints.

Differentiate between institutionalized and frontier markets
When classifying global rental housing markets as institutionalized (red markets in Figure 9) or frontier (italicized markets in Figure 9), market size and liquidity are not the only elements to account for in our view. Much more important is the level of sophistication of the local rental residential value chain (from property management to portfolio management activities), the ownership structure of the rental housing stock, and the types of players present in the transaction market. Typically, established markets are driven by large professional investors, who often have a strong local anchor.

Accordingly, property and investment management activities are typically consolidated in larger professional companies and platforms. By contrast, frontier markets tend to show a more fragmented ownership and market structure, where private individuals and smaller corporates tend to be the core players of the investment market and operational activities.

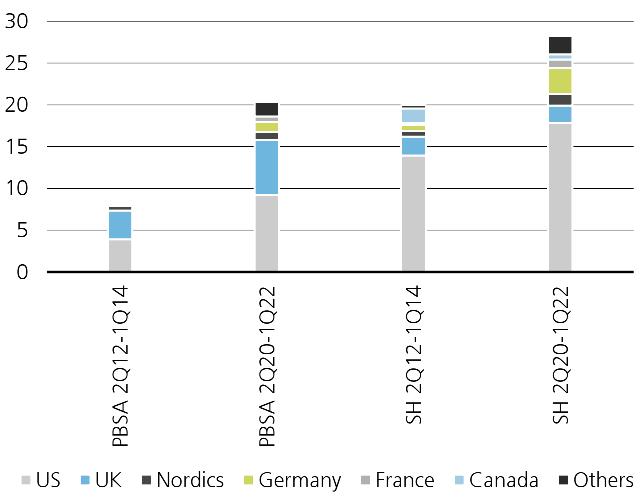
Investor willing to build exposure to global rental residential need to adapt their investment approach depending on the level of maturity of the targeted markets. In established rental housing markets, it is rather easy to deploy sizeable volumes of capital through portfolio deals of income-producing assets based in multiple locations.

By contrast, frontier markets tend be focused on a few gateway cities and often lack the supply of institutional-grade products. Adopting a more active investment management stance, such as partnering with local developers or upgrading existing stock, is key to unlocking investment opportunities in these less established, but growing rental residential markets.

Niche sectors also in upswing
In line with the development of the rental housing sector, rental residential niches with focus on particular tenant segments are gaining increasing traction, particularly in North America and Europe. Purpose-built student accommodation (PBSA) is an example of these niches (see Figure 10). Lifted by the increasing number of international students, which constitute the core demand for professionally managed student housing units, the sector is already well established in the US and the UK. Recently, continental Europe also witnessed the increasing emergence of this niche sector, as many European university locations are enjoying growing demand related to international student mobility.

Another residential niche supported by strong socio-demographic trends, is the growing senior housing sector (see Figure 10). The gradual aging of societies in developed economies leads to increasing demand for rental housing units adapted to the senior layers of local populations. This paves the way for the development of a diverse senior housing sector, with segments ranging from barrier-free housing units, dedicated to independent seniors, to proper care-housing structures with a deeper operative nature.

Figure 10: Average annual transaction volume in residential niches (USD billion p.a.)



Source: Real Capital Analytics, 1Q22; UBS Asset Management, Real Estate & Private Markets (REPM), May 2022. Notes: PBSA: purpose-built student accommodations; SH: senior housing (incl. age-restricted apartments and care houses).

Rental residential more and more client targeted
The trend towards a more tailor-made offering focused on precise tenant-segments is also observed in the plain-vanilla rental housing market. In large cities for instance, where smaller-sized households and younger generations of professionals are present in numbers, investment strategies with focus on smaller dwellings, micro-apartments and co-living schemes make sense.

By contrast, agglomeration areas and well-connected secondary cities tend to attract larger households, like at the time of family formation, for instance. In these markets, betting on an apartment mix tilted towards larger units with balconies and/or garden amenities is, in our view, a sensible approach to follow. In certain local markets such as in the suburbs of many American cities, single-family rental housing (SFR) is an offering that may meet growing rental demand needs from larger households. According to Arbor (4Q21), 2021 saw the acceleration of the institutionalization of the US SFR sector as an asset class, both from an investment as from an occupier market view.

Local expertise is key to succeed in very promising but granular global rental housing markets.

Granular market expertise as a must-have
As discussed in this paper, the global rental housing sector is set to grow further in the coming years lifted by strong socio-demographic trends and an evolution in lifestyle. This trend will offer sizeable investment opportunities for investors looking for a stable source of income in their diversified property portfolio.

However, investing in these sectors and niches is usually more asset management intensive – due to the more granular tenant base and shorter lease terms – and requires more local market expertise (in particular in terms of regulation) than other commercial real estate sectors. In our view, a professional investment management approach, as well as local market expertise, are key to succeed in the very promising, but also granular global rental housing market.

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