For professional clients and/or qualified investors only

2024
Global Real Estate Outlook

COLUMBIA THREADNEEDLE™
ALTERNATIVES

Q6 Q7, 68161 Mannheim, Germany

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Key takeaways

1

A more stable macroeconomic environment should help provide additional clarity to investment decisions. Financial conditions are anticipated to remain tight heading into 2024 but should begin to loosen in the second half of the year.

2

Global megatrends – demographics, digitisation, deglobalisation and decarbonisation – will continue to influence return potential and sector allocation, affecting different regions in different ways. Assets must retain functional relevance to justify a place in investment portfolios – themes we will return to throughout this year.

3

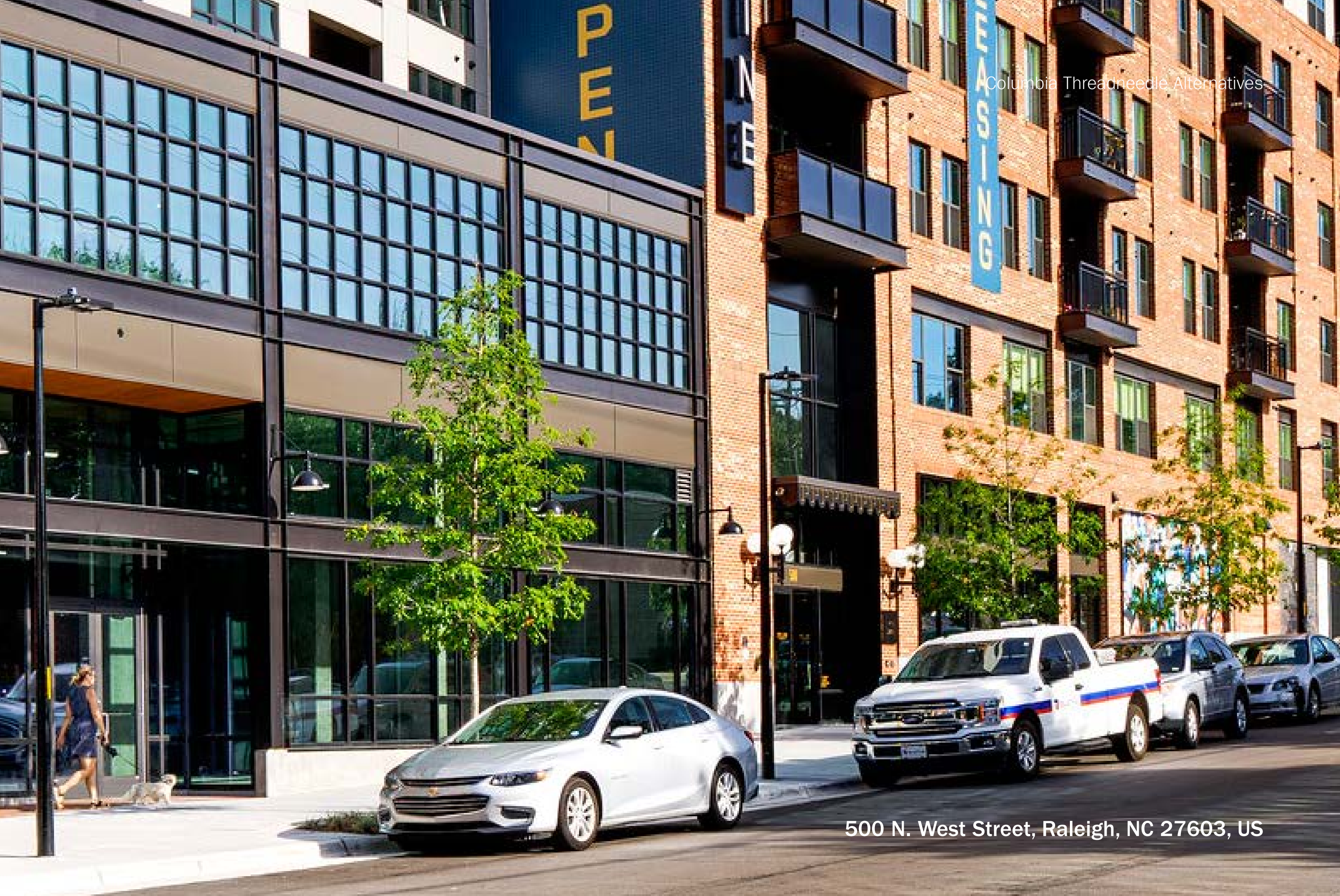
Demographic changes – an aging population, along with a younger population that will be more technologically enabled, more physically mobile and more sustainably motivated, will direct the future of the real estate across multiple sectors.

4

These structural tailwinds favour some sectors, and we favour allocations to logistics, select parts of the retail market and residential.

a. Logistics – demand driven by near shoring, on shoring and friend shoring as many corporates looked to future-proof their supply chains and against low vacancy rates paves the way for positive rental growth.

b. High street retail – markets are benefitting from the solid recovery of tourism, both international and domestic with luxury the most resilient area as they look beyond their



500 N. West Street, Raleigh, NC 27603, US

'traditional' products, enhancing and expanding their brands to include hotels and hospitality, offering a lifestyle choice to their customers.

c. Retail warehousing – the changing tenant mix on retail parks is improving consumer appeal and lengthening dwell time, transforming retail warehouse parks into a day-to-day spending destination, offering operational resilience and robust tenant demand in a low vacancy environment.

d. Residential – the housing sector is being transformed by the demographic changes, but supply is not matching demand in terms of number, size and location. The cost of buying has increased beyond wage growth and the unaffordability of homeownership continues to see more demand for the rented sector.

e. Purpose-built-student-accommodation (PBSA) – this residential subsector has rapidly evolved from an often-fragmented ownership structure, outdated stock, and smaller lot sizes to an established institutional asset class offering income and value-add potential.

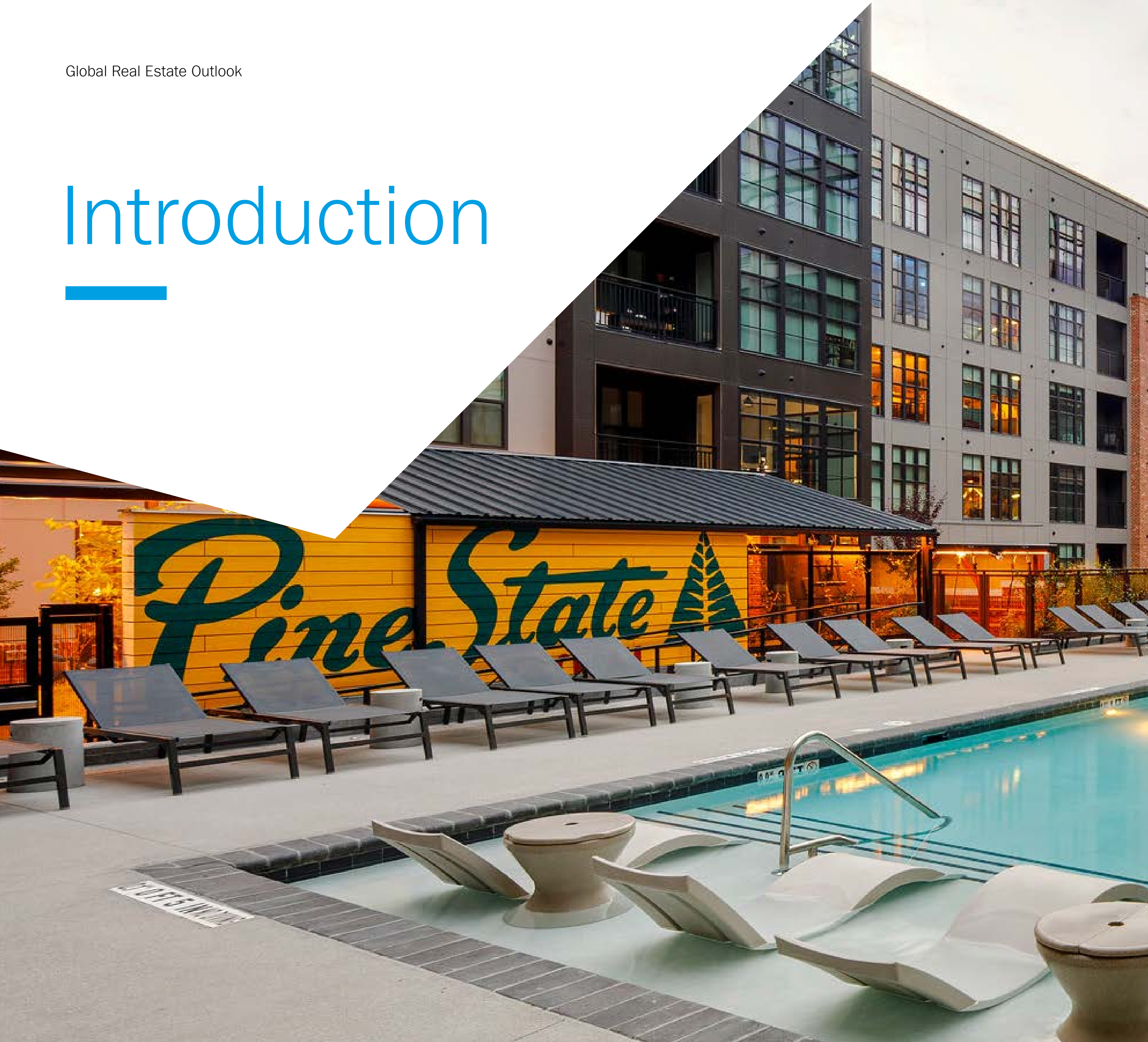
5

We anticipate further asset repricing in some regions and sectors will present an attractive buying opportunity for investors brave enough to transact in an environment which does not yet offer full transparency.

6

Targeted acquisitions are crucial, considering geography, quality and sector at both the macro and micro level to take advantage of the dislocation in the market. Decisions should be guided by long-term trends supporting overarching sector choices but paying attention to the differences and opportunities within, and between sectors, subsectors, cities and submarkets will be crucial too. Stock selection remains an important skill set to monetise structural trends.

Introduction



The era of financialisation of real estate is over and we are entering an era where real estate must be functionally relevant to derive value.

The real estate market took a long, deep breath in 2023 and held it for a while. Volatility in financial markets, uncertainty as to where and when sharp rises in interest rates would eventually taper and persistently high inflation across jurisdictions dampened investor appetite for real estate, delaying the much needed and long-anticipated recovery in the sector. Investment volumes were greatly reduced against long-term averages and pricing became difficult to gauge. Occupiers tightened their belts as corporate margins were squeezed and consumer spending was reined in as inflation dented real incomes and impacted household budgets.

As 2024 unfolds, while there are still several unanswered questions, there seems to be a more balanced investor sentiment emerging as some of the haze of the past twelve months begins to lift. The path ahead is not without its challenges, and it will change as the seasons do, but we do anticipate a more stable economic setting which will feed into a more manageable financial environment, helping to support investor decisions and spur transactional activity on. We have not seen the deluge of distress in real estate markets that many had anticipated, and while we do not expect massive valuation correction, we do expect there will be some repricing leading to a greater buying opportunity of good quality assets. We also expect the gap in expectations of buyers and sellers to narrow.

500 N. West Street, Raleigh, NC 27603, US

The key to success in 2024 will be access to dry powder allowing for nimble transacting, along with sector and asset selection. Investors need to understand the nuances within sectors and work to deliver property that is functionally relevant now and in the future. Investors will have to go well beyond the traditional bricks and mortar, job done approach. The ongoing dichotomy between the volatility we have seen in capital markets and largely supportive fundamentals in real estate is producing a compelling dynamic not seen in previous cycles.

"Global megatrends – demographics, digitisation, deglobalisation and decarbonisation – will continue to influence return potential and sector allocation, affecting different regions in different ways. Assets must retain functional relevance to justify a place in investment portfolios."

Joanna Tano, Head of Research, Real Estate (EMEA)

Demographics

Change is afoot and influencing decisions

There are numerous global trends that impact real estate today and how it will develop in the future.

One of the key trends we would like to focus on is the enduring trend of demographics. Why? Because it will have far reaching impacts on certain real estate sectors namely logistics, retail and residential where we think the impact will be the most significant.

The challenges and demands are multifaceted. As many western countries face an aging population, we anticipate that the younger population will be more technologically enabled, more physically mobile and more sustainably motivated, all of which will direct the future of the real estate sector. Environmental, social and governance (ESG) factors remain firmly on the agenda and related considerations are becoming more intertwined into occupier and investor decision making processes.

The global population is increasing, as are the urban populations in our focus regions of Western Europe and the United States, all the while embracing new ways of living and working. Migration trends, a shrinking workforce as the baby boom generation retire, an expanding older generation (+65 years) and the evolution of young and middle-aged cohorts, are making their impact felt too. So as the developed world ages, at the same time Generation Z – those born between 1997 and 2012 – is coming of age and they will place different demands on real estate.

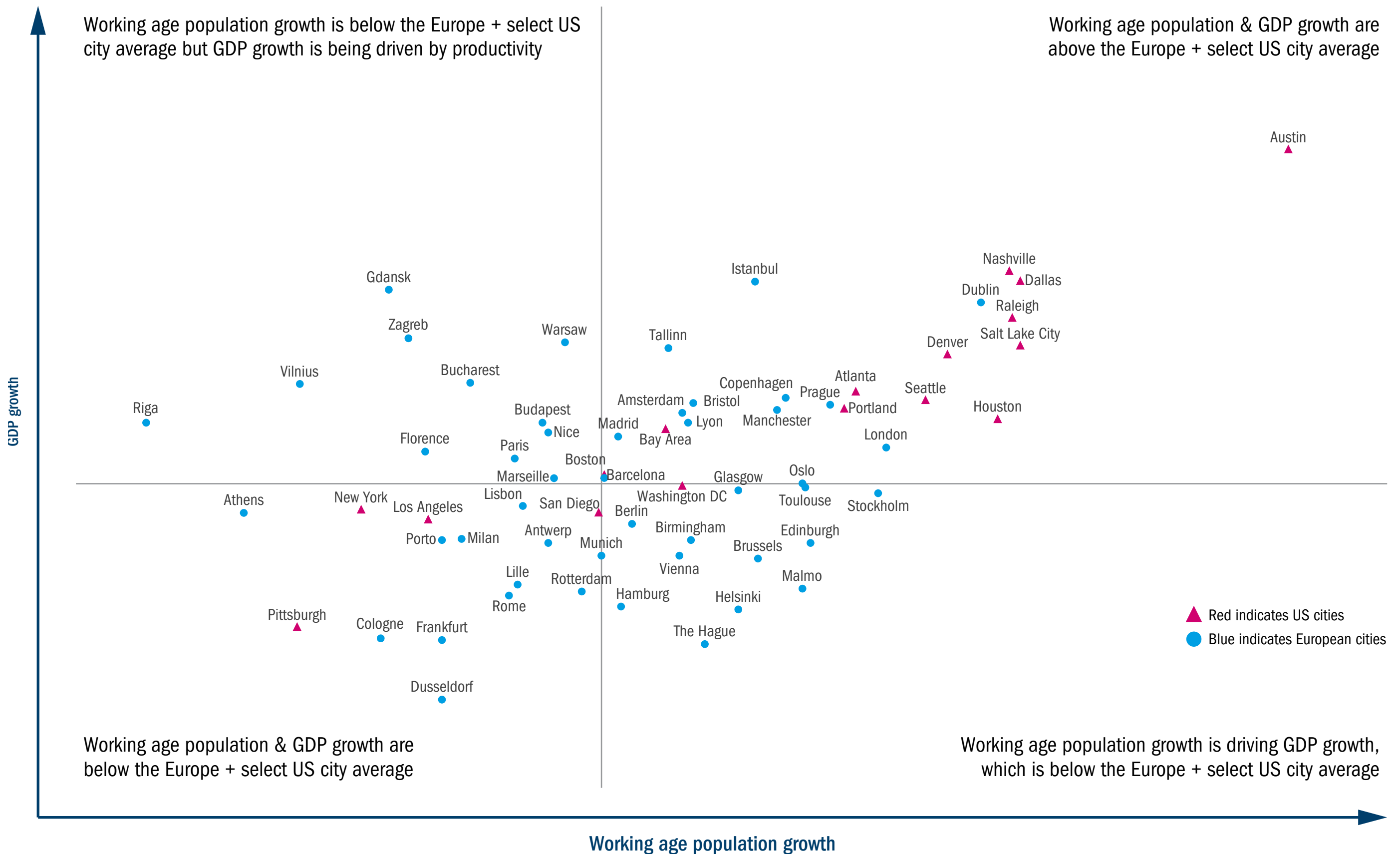
The European population is projected to reach 762 million by 2024, but there are notable differences across the continent. Stronger population rises are being seen in cities of strong economic and employment growth. The story is not dissimilar in the United States. The uneven distribution of population growth and economic success across these two continents will likely impact regional economies and total returns for real estate.

Key takeaway

Changing demographics will have far reaching impacts on certain real estate sectors namely logistics, retail and residential where we think the impact will be the most significant

Boulevard, Grünwälderstraße 9–13 (unger.), 79098 Freiburg, Germany

Chart 1: GDP growth versus working age population growth (10 year CAGR to 2030)



Source: Columbia Threadneedle Real Estate Partners Research, Lionstone Research, Oxford Economics (Sept 2023), Moody's. CAGR is compound annual growth rate.

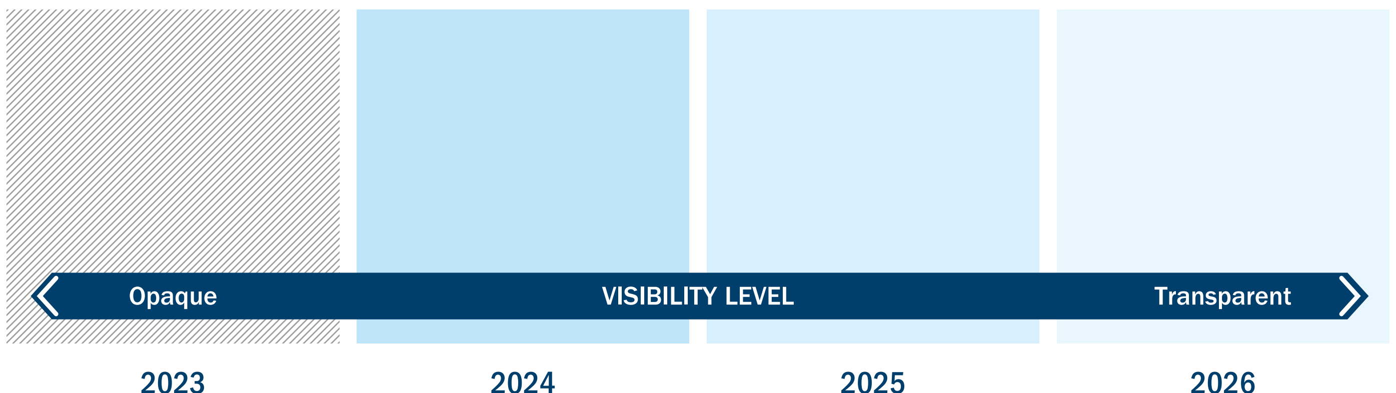
When is the buying opportunity?

Parkview, 3737 Cogdell Street, Houston, TX 77019, US

Real estate values have adjusted significantly in reaction to the new financial conditions and investors need to adjust to this new normal as well. There have been variations between sectors, but the general direction of travel in terms of pricing has been the same – downwards.

We expect 2024 to be less uncertain and less volatile than 2023. It may be too early to see a marked improvement, but the market dislocation will serve to unlock opportunities for those with experience and a level of conviction to see through the easing haze and move into a more active buying mode. Whilst we are not expecting a wall of distressed assets to come to the market, be that in the UK, Continental Europe or in the US, we do anticipate a rise in the volume of distressed sales as refinancing remains challenging with a wealth of buying opportunities in 2024 and 2025 in particular.

#Next buying opportunity



Source: Columbia Threadneedle Real Estate Partners Research.

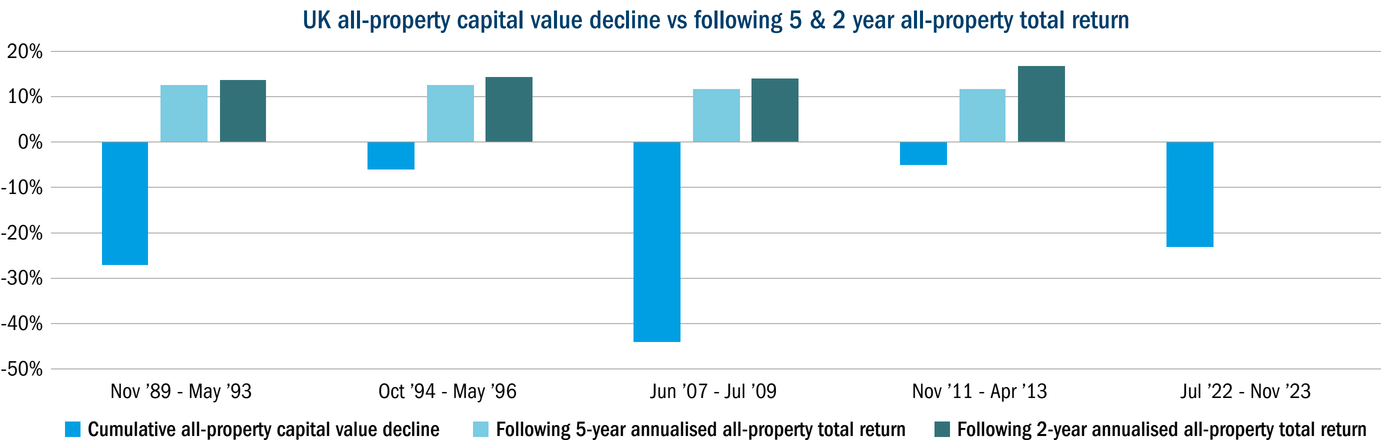
BOX STD, UK

Regional opportunities

UK and Continental Europe may see double digit returns

Historically, after recent economic downturns in the UK and the associated fall in commercial property capital values that followed, the following two and five years has seen double digit growth on an all-property total return basis. This is true of the last five downturns that we analysed – see chart 2 below.

Chart 2: UK – taking advantage of cyclicality of the real estate sector



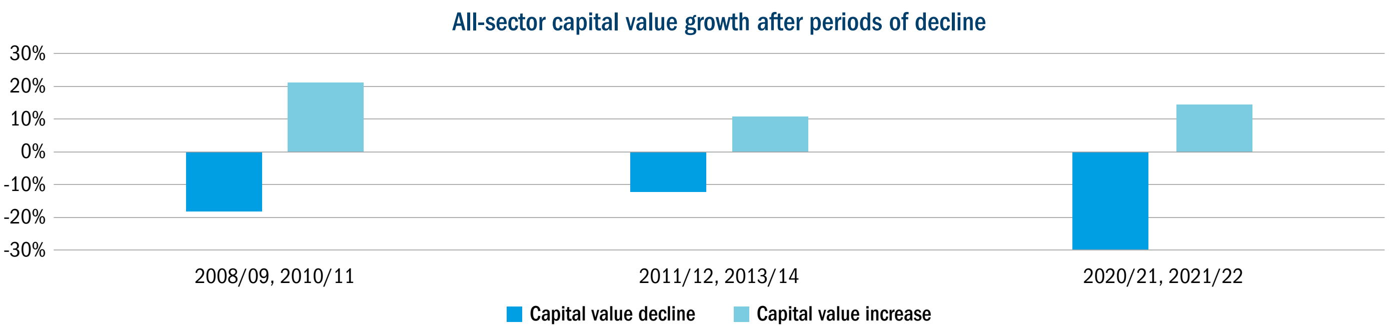
Source: Columbia Threadneedle Real Estate Partners Research, MSCI UK Monthly Digest (November 2023).

> "We are expecting 2024 to be an improvement on last year for real estate investment. With values expected to bottom out this year and new clarity on pricing, we are seeing opportunities emerge and a renewed appetite for real estate."

Hiti Singh, Head of EMEA
Alternatives Client Management
Columbia Threadneedle Investments

The story is similar across Europe whereby after recent periods of market disruption and where capital values registered, often significant, declines, the gains in the period following more than made up for the falls.

Chart 3: Europe – taking advantage of cyclicality of the real estate sector



Source: Columbia Threadneedle Real Estate Partners Research, Property Market Analysis (November 2023).

But as always this is not uniformly true across all sectors, geographies and quality of real estate. It varies at a country and city level, for example in Germany, across the same time periods the capital declines were not as dramatic as seen in some other European locations and so selection under each of the three categories requires careful and detailed due diligence. But what is clear is the message, taking advantage of the cyclicality of the real estate sector can make sense. While uncertainty remains, looking for targeted opportunities now and over the next 18-24 months could see investors rewarded by strong returns.

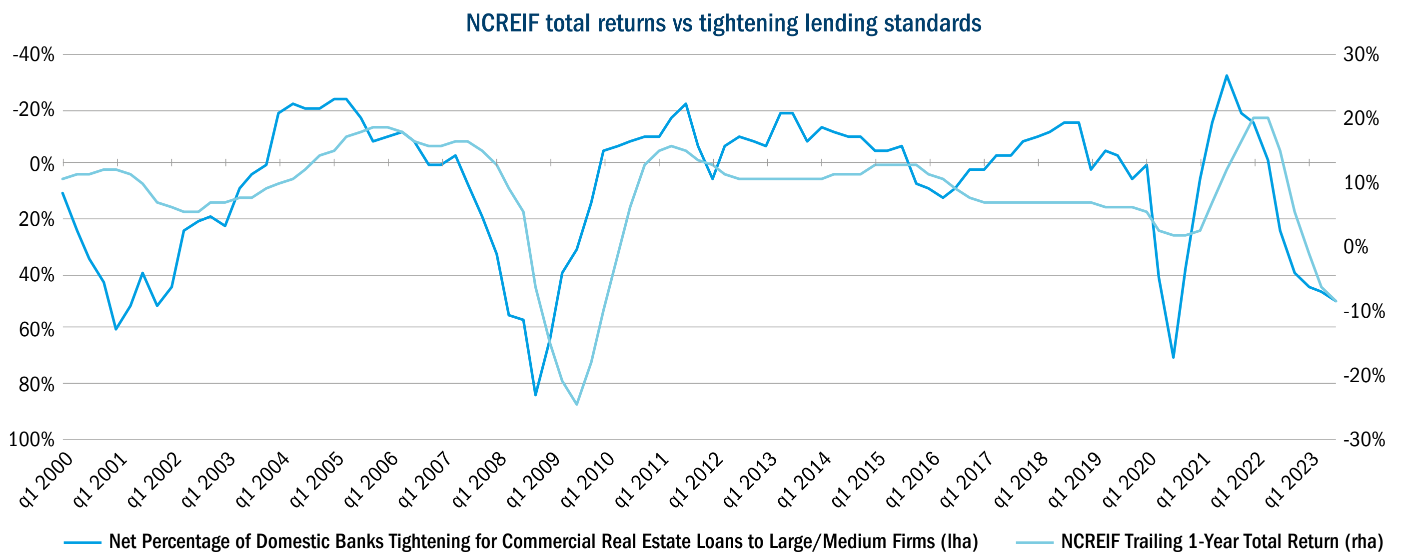
Key takeaway

While uncertainty remains, looking for targeted opportunities now and over the next 18-24 months could see investors rewarded by strong returns

US, with wide lender spreads, strong investment vintages expected to follow

US real estate investors are being hit by the double whammy of higher interest rates and tighter lending markets, resulting in rising borrowing costs and downward pressure on equity valuations. While that is not great news in the short run, NCREIF returns following previous challenging cycles have been strong.

Chart 4: 2024 – 2026 should be strong vintage years

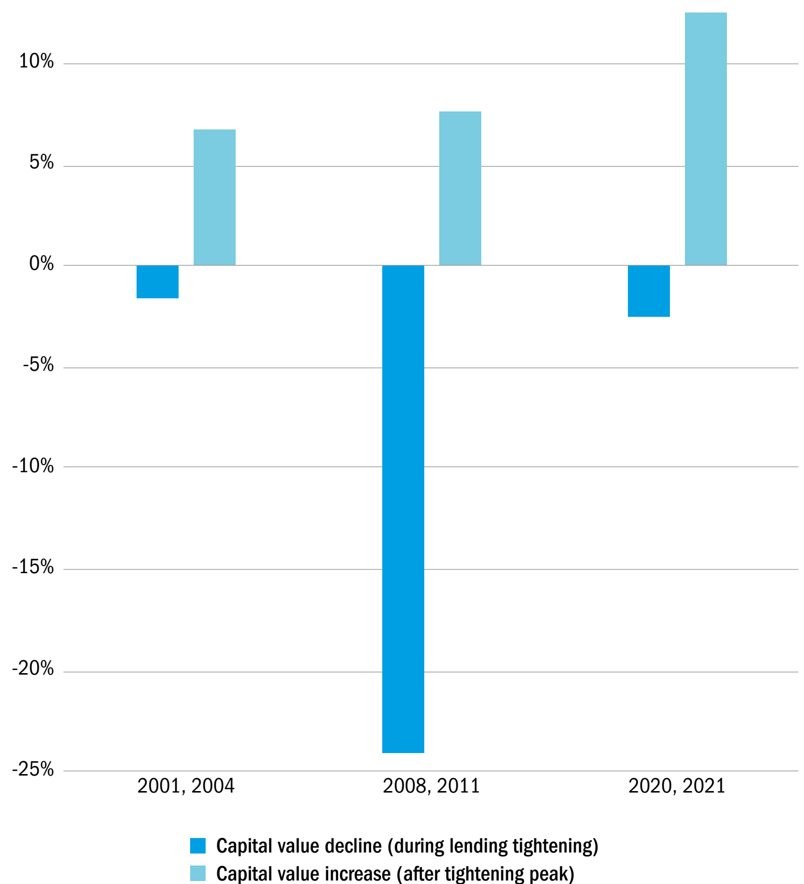


Source: Lionstone Research, Federal Reserve Bank of St. Louis (October 2023), National Council of Real Estate Investment Fiduciaries (NCREIF).

FedEx
ONE WAY
A. DuiePYLE

In 2001, 2008 and 2020 banks overwhelmingly tightened lending on commercial and multifamily real estate loans. Concurrently, equity valuations fell, with NCREIF reporting capital value losses of -1.6%, -24.1% and -2.5% in the year following each period of tightening. After lending spreads peaked, the NCREIF index reported above average capital value gains of 6.7%, 7.6% and 12.5% in 2004, 2011 and 2021, respectively. Our belief is the lending market normalisation in 2024 and 2025 could result in similarly above-average gains.

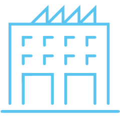
Chart 5: A peak in lending spreads may create opportunity (capital value decrease/increase, annual, %)



Source: National Council of Real Estate Investment Fiduciaries (NCREIF).

Real estate

Real estate has its role to play in providing income, diversification and is, to an extent, an inflation hedge. The sector has shown, some might say surprising resilience through the disruption of the last few years – performance that is largely thanks to buoyant occupier markets across the spectrum of property types. Solid fundamentals and structural tailwinds are bringing some sectors to the fore, namely logistics, select parts of the retail market and residential.



Logistics: still an investor pick

The logistics sector has been the record breaker of recent years, grabbing headlines for record high take-up levels, record low vacancy rates and previously unseen double digit rental growth.

Covid-19 boosted demand for space and geopolitical events highlighted the near shoring, on shoring and friend shoring as many corporates looked to shore up their supply chains and serve their burgeoning online order books. It is well documented how the sector benefited from growth in online retail and with very low penetration rates in many markets there is still opportunity.

The sector's share of the investment market in Europe has grown steadily from 10% in 2013 to 20% at the end of September 2023, a similar trend to what we have seen in the US. There is a window of opportunity for some buyers (often equity backed) to pick-up good quality assets via sale-leasebacks transactions given the disruption in the lending market. Companies in need of cash, and there are plenty as higher inflation pressurised margins, are using their own assets to raise capital. Timing is crucial as once the capital markets stabilise companies will be less motivated to rotate out of balance sheet assets to unlock liquidity.

Investment grade stock is outweighed by demand and so some investors, looking for higher returns, are tilting an allocation of their capital to the smaller, albeit growing areas of interest such as urban logistics. Areas such as manufacturing, open storage/ truck terminals, and cold/dark storage logistics facilities are all rising in popularity, backed by occupier demand.

There is an expanding depth of occupiers active in the sector able to insulate income streams to an extent and the real estate dynamics are currently tipped in favour of those that own logistics and industrial as there is limited new space coming to the market in Europe and the United States. This should go some way to driving on positive rental growth. Admittedly we are not expecting the strong annual upswing in rents seen since the height of the pandemic but still anticipate them being ahead of the historic traditional flatlining in rents that we had become accustomed to.

In both Europe and the US there appears to be a strong relationship between logistics property rent growth and household income growth. As shown in Chart 6, metropolitan areas such as Prague, Dublin, Seattle and Nashville posted strong growth both in rents and income gains. Higher incomes may be driving increased retail sales locally, supporting demand for warehouse space. Also, expanding local manufacturing or distribution hubs may support household income gains, which may in turn support logistics property rent growth. Conversely, geographies such as Houston and Rome, where household income growth lagged, also posted modest industrial rent growth.

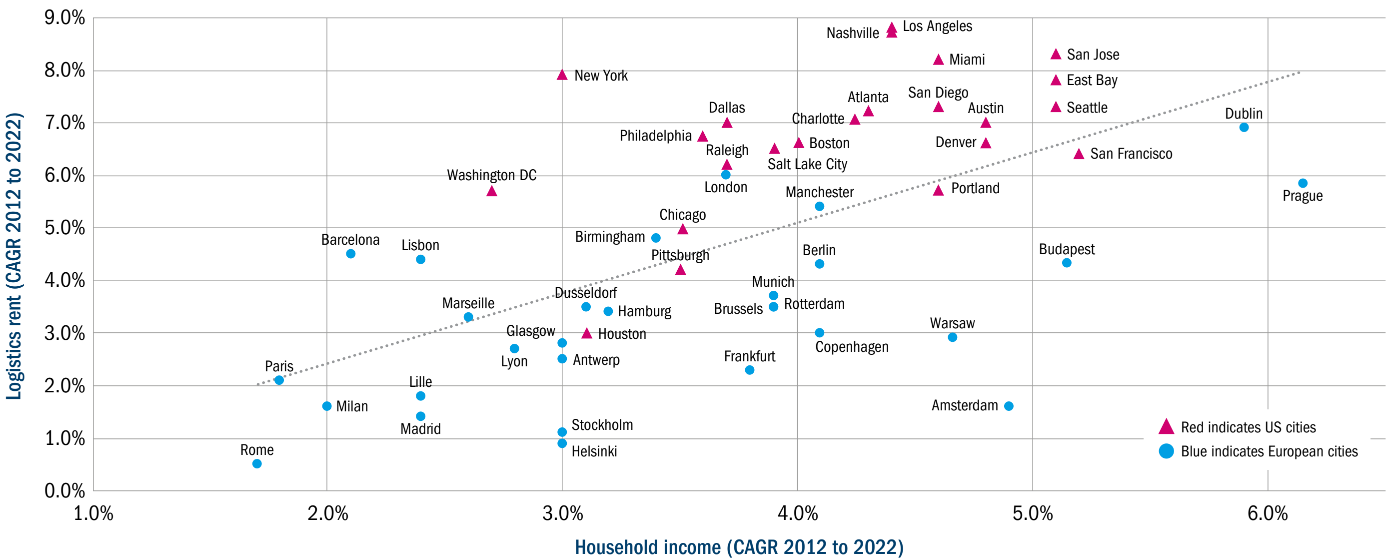
There are additional factors at play too, such as land constraints and high replacement costs which are limiting availability in key European logistics corridors. This is exacerbated by the slowdown in new development as debt becomes more difficult and expensive to obtain. Vacancy is therefore expected to stay low well into 2024 supporting positive rental growth. Cities such as Birmingham and Manchester in the UK, Paris, Barcelona and Berlin (leading the charge for the German cities) should outperform, but Prague for example should also benefit from the eastward movement of supply chains.

Logistics across Europe, like other sectors, must increasingly comply with stricter energy efficiency standards. With a large proportion of Europe's industrial stock old and not meeting the requirements of today's occupier this is focusing minds on the futureproofing of assets via automation and sustainability.
In addition, the new stock that is being developed is limited. Those that have the expertise and the ability to reposition older logistics assets will be able to create additional value by delivering energy-efficient warehouses enabling occupiers to enhance operational efficiencies and reduce running costs. For example, installing photovoltaic panels to roofs, feeding back energy to occupiers, and lessening the reliance on the grid while reducing energy costs.

Key takeaway

Land constraints and high replacement costs which are limiting availability in key European logistics corridors

Chart 6: Investment opportunities in logistics are closely aligned with growth in household income



Source: Columbia Threadneedle Real Estate Partners, Lionstone Research, Property Market Analysis, Oxford Economics, CoStar, Moody's (October 2023). Median household income for the US and disposable household income for Europe.

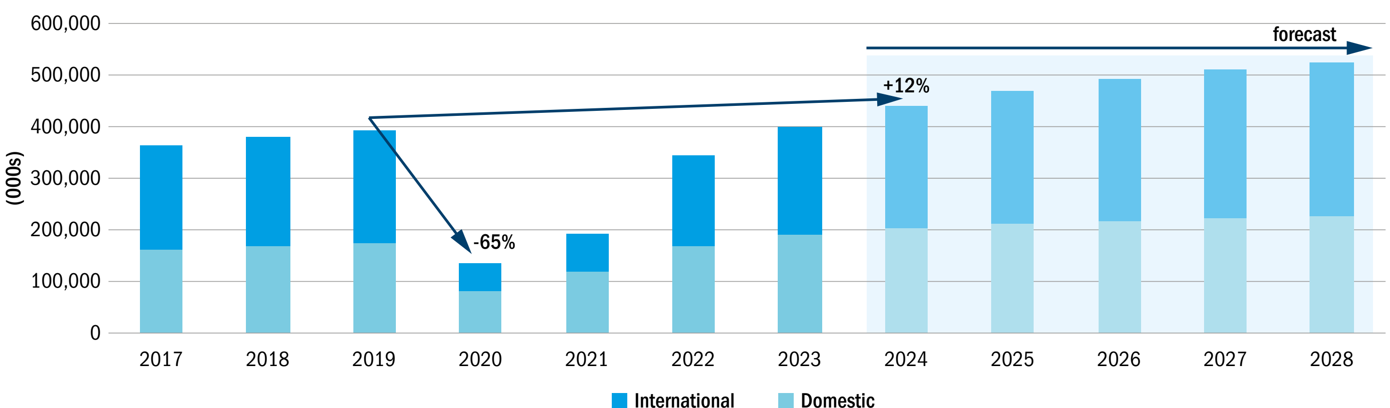
Retail

High street retail: Europe in focus

High street retail markets across Europe are benefitting from the solid recovery of tourism, both international and domestic. Retail was the second most traded sector in the year to September 2023 after offices with an investment volume of approximately €22.0 billion exchanging hands, equivalent to a 19% market share.

Travel, both domestic and international across Europe, had been steadily picking up since the dip experienced in 2009 following the Global Financial Crisis, although incomparable to the 65% fall seen in 2020 as governments around the world locked down their economies. This is good news for the retail sector as tourism is an important indicator of the health of our international high streets.

Chart 7 – Overnight visits in paid accommodation in Europe



Source: Oxford Economics (November 2023).

Consumers accelerated their online spend during the COVID-19 pandemic, as the opportunity to visit physical stores was withdrawn, but as economies reopened consumers voted with their feet, returning to physical stores, prompting a gradual but steady decline in online retail spending in most European countries.

Navigating the retail landscape is not without its challenges for occupiers. High street activity saw a revival as markets emerged from an almost standstill during the pandemic as consumers were allowed back onto high streets and into physical stores. But inflation has eroded households' purchasing power and squeezed retailer margins. Having said that, those retailers that are well capitalised have been able to look beyond the current market conditions and are best placed to execute on strategic plans, even if they have been scaled back. Although, with margins squeezed as rapid inflation rises took their toll, and despite recent falls, retailers are conscious of where and how to deploy capital. There will be increased focus on store performance with retailers trying to maximise the value of their real estate assets.

One area that has shown its resilience and strength is the luxury retail sector. Retail generally slowed down in 2020, an inevitable consequence of the COVID-19 pandemic. But the subsequent rebound has been nothing short of outstanding with the global personal luxury goods market growing by 32% in 2021 year-on-year (Bain & Company). And this is despite current headwinds such as inflationary pressures and the wider economic slowdown, reflected in a general squeeze on household incomes and subdued GDP growth. The resilience of the global retail sector is shown in the subsequent 19% year-on-year increase that followed in 2022 with global turnover in the luxury goods market reaching €345 billion.

There are a several key reasons behind this trend. One is that the impact of financial crises on consumers with a higher-than-average purchasing power tends to be more limited as they have a greater financial buffer. A second is the growing consumer base expected to expand from around 400 million people in 2022 to 500 million by 2030. Thirdly, companies which trade in luxury goods have spent time and money successfully developing their omni-channel platforms in recent years which has helped them to extend their distribution and reach higher numbers of consumers globally, boosting sales.

Luxury brands are also looking beyond their 'traditional' products and are enhancing and expanding their offering to include hotels and hospitality, providing a lifestyle choice to their customers. The 'traditional' product allows the brand to get closer to their target customers whilst the expansion into hospitality helps them to elevate their brand. For example, LVMH's Cheval Blanc Hotels or Bulgari Hotels, who have opened several hotels in global gateway cities and resort destinations, are offering a combination of hospitality and the luxury experience in one, extending their brand reputation.

For a more in-depth coverage of European high street retail you may enjoy our "European High Street" report published in December 2023 (**View the report**).

Key takeaway

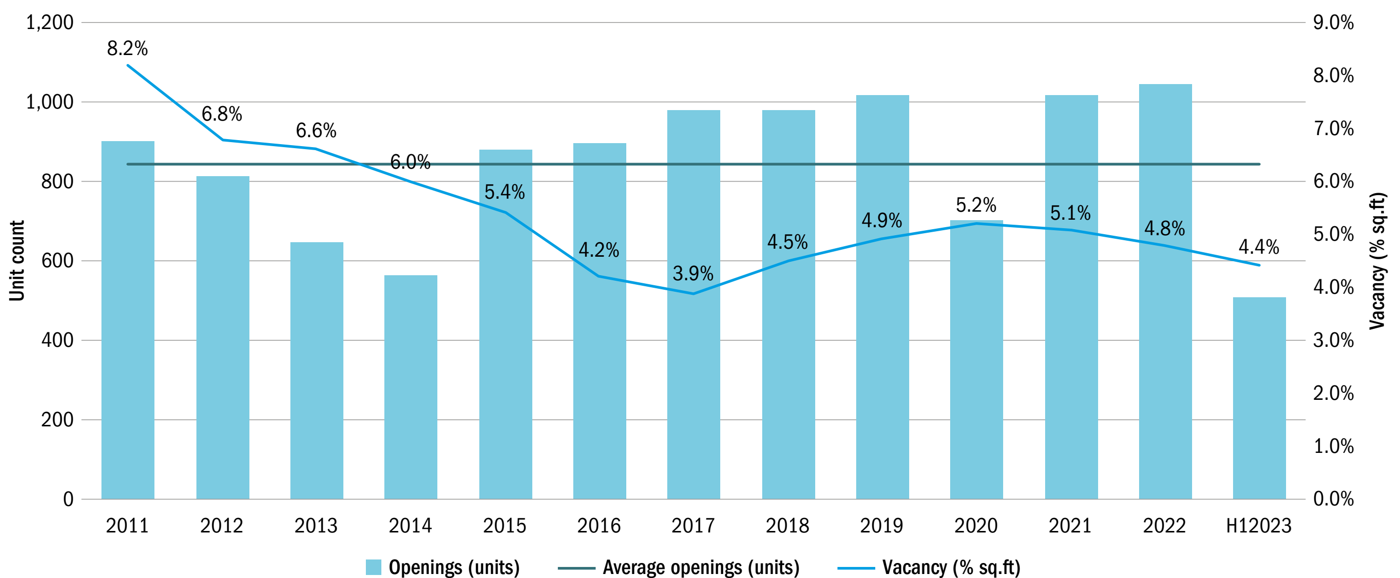
The resilience of the global retail sector is shown in the 19% year-on-year increase in 2022 with global turnover in the luxury goods market reaching €345 billion

Retail warehousing: UK in focus

Retail warehousing continues to demonstrate its resilience and has drawn considerable interest from institutional investors and a more diverse occupier base over the past few years. As the cost-of-living crisis squeezes household incomes, retailers in retail parks have by and large performed relatively well with footfall figures close to 2019 levels, outperforming other areas of the wider retail market. Historically retail warehousing was lumped together with high streets and shopping centres under the single banner of retail but is now showing its worth and its diversification benefits. Through UK national lockdowns retail warehousing was able to show off its resilience and its flexibility, despite the difficult and uncertain backdrop. As more spend moves online, physical units and schemes have had to work even harder to attract footfall, offering a level of convenience, accessibility and experience that cannot be replicated on the internet. Retail parks can use their large formats to showcase product and establish click-and-collect hubs.

The occupier market is strong. Vacancy rates are around 4.5%, low when compared to almost 14% for high streets and almost 18% for shopping centres (as at H1 2023). There has also been a notable evolution of occupiers looking to establish a presence on retail parks. Traditionally a sector that has focused on bulky goods retailers such as DIY, furniture, carpet, electronic and kitchen operators, discount/value-orientated retailers (with a focus on homeware and food) are increasing their presence, whilst some high streets brands such as Marks & Spencer and Next have been adjusting their networks, closing high street shops in favour of retail park locations. The number of F&B outlets in out-of-town locations is rising, including drive-thru restaurants and coffee chains, as they look to capitalise on the robust footfall levels to retail warehouse parks. In addition, services such as dentists and vets are increasingly recognising that retail warehousing can suit their business needs.

Chart 8 – Retail warehousing new openings (year-on-year)



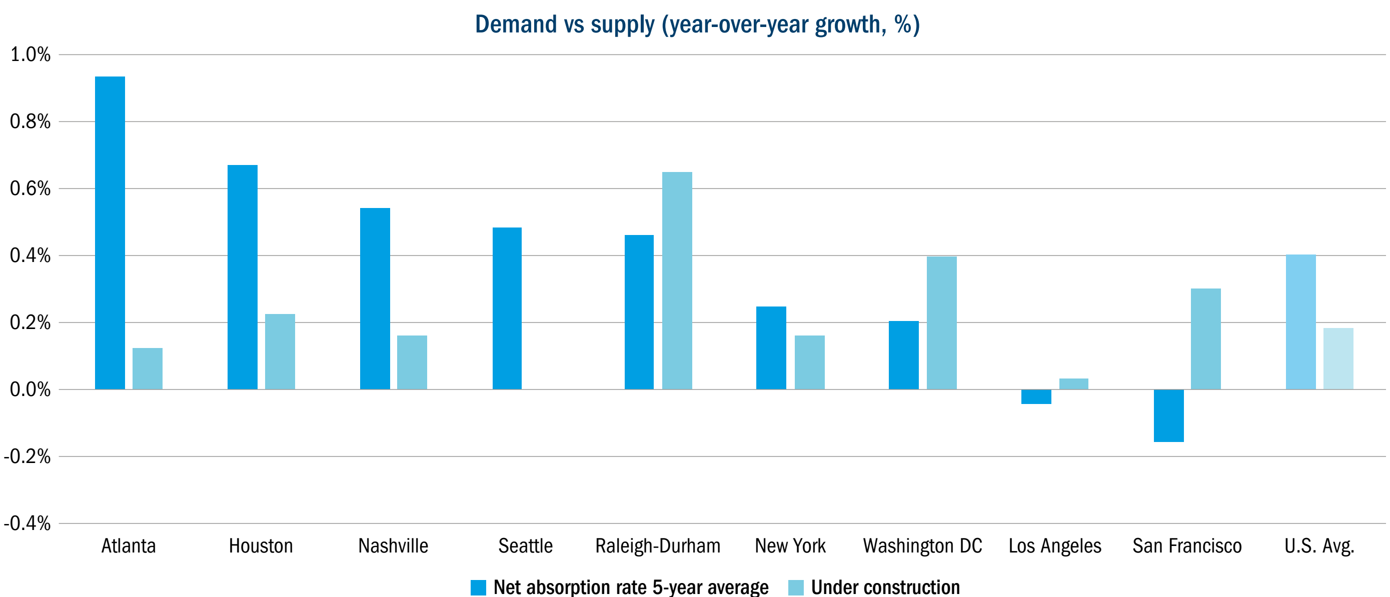
Source: Savills (August 2023).

The changing tenant mix on retail parks is improving consumer appeal and lengthening dwell time, transforming retail warehouse parks into a day-to-day spending destination, rather than one-off discretionary spending one. And so, from an investor perspective the sector offers operational resilience and robust tenant demand equating to strong annualised income returns and some capital value growth. Plus, with very limited development satisfying retailer demand will only get more difficult and continue to put upward pressure on rental values. The strong occupier fundamentals and what appears to be stabilisation in the interest rate higher investment activity should begin to follow over the next 12-18 months and we anticipate that institutional investors will focus on core plus assets whilst more opportunistic investors will look towards secondary assets, attracted by the softer pricing and opportunity to add/create value.

US focus

The retail sector in the US, particularly mixed-use and strip retail formats in cities with solid population and income growth, appears well positioned for success. Our focus for investment is in markets with an above-average in-migration and growth in the 35 to 54 year-old age cohort. Broadly defined as the metropolitan statistical areas extending from Seattle, down through the Rockies, into Texas and over to the Carolinas, Georgia, and Tennessee, these markets posted 0.7% average annual absorption in the strip retail space but have only 0.3% of strip retail under construction.

Chart 9: Strip retail: demand thrives in cities with favourable demographics

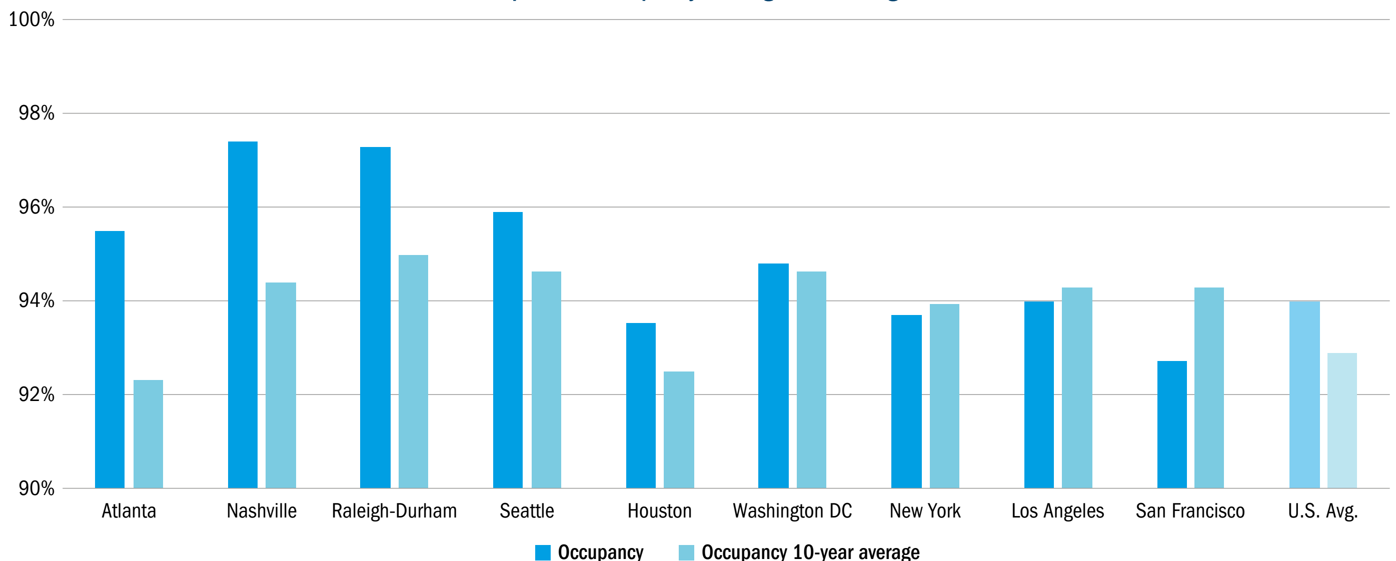


Source: CoStar (March 2023).

Autry Park, 811 Buffalo Park Drive, Houston, TX, US
(a rendering image)

In contrast, other markets that we cover posted demand growth of just 0.1% over the same period, less than the 0.2% of inventory now underway. Remarkably, Salt Lake City, Atlanta, Seattle, Houston, Phoenix, and Nashville have demand growth about three times current construction levels and enjoy occupancies above those of the last ten years. However, this makes sense. In addition to pandemic-driven migration, these cities offer more affordable housing and often better-rated public schools for the middle class than big coastal cities, valued qualities for the 35 to 54 year-old demographic. Conversely, the San Francisco Bay area, Los Angeles and New York are all suffering occupancies below their ten-year average as well as new construction in line with or even higher than recent absorption rates.

Strip retail: occupancy vs long-term average



Source: CoStar (March 2023).

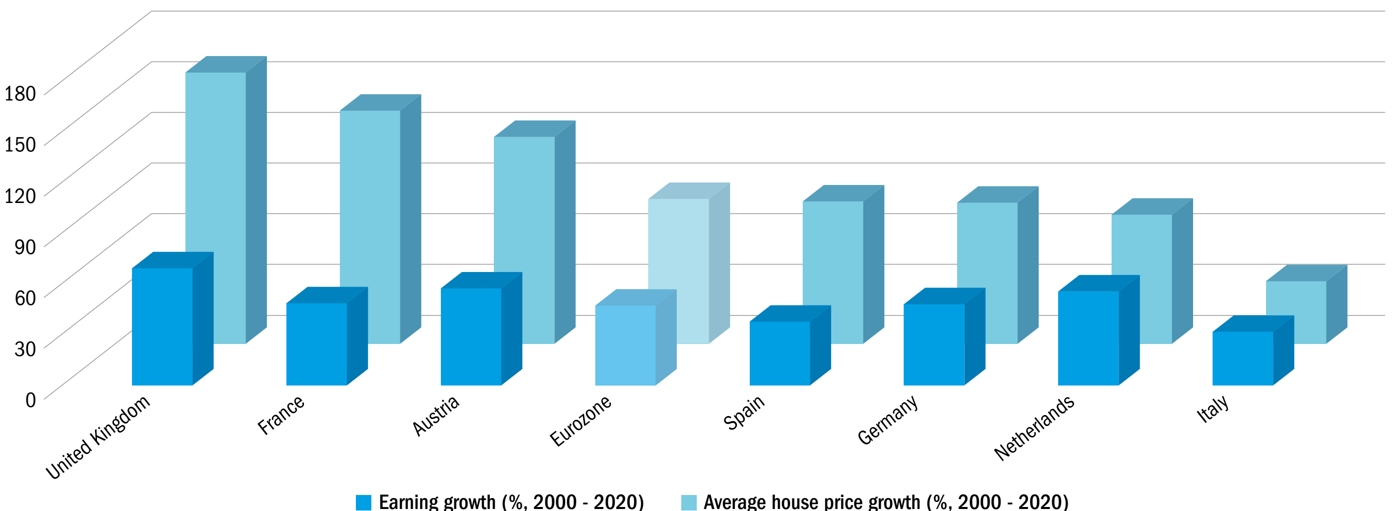
Residential

Europe in focus: build-to-rent

The housing sector across Europe is being transformed by the demographic changes. Since 2000 the continent's population has grown by 54 million people. At the same time, we are also seeing a lower birth rate and people starting families later in life. Both these trends drive the need for more housing and rising demand for single/two person households. Put simply, the supply is not matching the demand in terms of size, number, and location.

Despite record low unemployment rates and strong wage growth, the cost of buying a home in Europe has increased by 45% since 2013, far beyond any wage growth figures. The unaffordability of homeownership continues to see more demand for the rented sector. Plus rising urban populations across Europe are driving demand for housing in major cities – across the European Union urban populations are forecast to rise by a further 9% by 2050 and with this the number of households is expected to increase dramatically.

Chart 10: Earnings growth vs average house price growth (%, 2000 – 2020)



Source: Oxford Economics (December 2023).

Eurozone average house prices rose by 3.1% per annum between 2000 and 2020, while wages rose by 1.9% per annum. Earnings are 47% higher in 2020 than 2000, but house prices are 86% higher. House price growth and interest rates hikes over the past 18 months have pushed mortgage costs up making it increasingly cheaper to rent homes than it is to buy, and despite mortgage rates coming down they are still well above the levels seen over the last fifteen years.

At the same time, supply remains challenged given land constraints, planning regimes, regulation, rising costs, in terms of labour, construction and material. Together these factors continue to exacerbate the housing shortages in most major European cities, pushing more and more people to the rental market for their accommodation needs. And so, through an investor's lens there are clearly reasons to be positive on the outlook for residential real estate with the undersupply supporting a positive outlook for rental growth and the sector remains a top pick offering diversification, a largely untapped depth to a maturing sector and, in part, an inflation hedge. Europe's main cities are chronically undersupplied with quality residential stock and the trend is not showing any signs of easing. Plus, with less new supply and a squeeze on mortgage affordability, positive rental growth looks set to be sustained.

Prime yields on Build-to-Rent (BTR) stock have compressed as investors allocated more to the sector. Since interest rate rises over the last 12-18 months however, across Europe the sector has seen some repricing, albeit slowly. Residential has shown a high level of resilience and the pace and consistency of the repricing has been more stable than in other sectors. There is still a mismatch between buyer and seller expectations which is slowing activity. It is likely that yields will move out in certain markets because of the weaker macro-economic conditions and sellers accepting that pricing must soften to attract buyers back to the market could well stimulate more activity.

Stock is increasingly difficult to access with residential construction costs having risen upwards of 10% in some European markets over the past two years this has impacted the delivery of new supply, and the development market is increasingly challenging for the time being. Construction inflation has begun to come down, but underlying costs are still high, there is a shortage of skilled workers and development financing is much harder to come by while higher interest rates offset profit margins. This has seen some investors and developers rethink new developments as a combination of supply chain issues and rising costs push up overall delivery costs, squeezing profit margins. Some investors therefore have turned to either fully operational schemes or nearly completed stock which carry a lower level of risk and here we have seen early signs of yield stabilisation in standing stock. But this situation is only exacerbating future supply in an already undersupplied sector.

Markets like Dublin, Amsterdam and Lisbon are expected to be long-term outperformers, while other markets such as Stockholm, Vienna, Barcelona, Madrid and some Tier I German cities have seen significant price corrections which should set them up for a rebound in activity in 2024. Given the ongoing level of repricing due to much higher interest rates, more opportunities are expected to emerge.

With a residential sector characterised by acute supply issues and rising demand levels policy makers are facing more and more challenges to finding housing solutions. As a result, there is increasing pressure on local authorities and public bodies to provide efficient public services and infrastructure to support the growth. Some governments are adopting short-term fixes; in Germany the government is proposing a three-year national rent freeze whereby landlords would still be allowed to raise rents, but there would be stricter rules about how much more they could charge and where. France meanwhile put in place a "rent shield" to cap rent increases to a maximum of 3.5% initially in place for one year until 30 June 2023. This has been extended to cap on consumer price index (CPI)-uplifts from the second quarter of 2023 to the first quarter of 2024. In the UK private landlords are offloading stock due to Energy Performance Certificate (EPC) regulations that will come into effect by 2025 for new tenancies and 2028 for existing tenancies.

Such measures can ease pressure on tenants but may be counterproductive if they discourage development or triggering pre-emptive rent rises before they take effect. Ultimately, soaring rents everywhere have the same underlying cause: a failure by the housing sector to provide enough supply where demand is strong. This shortfall provides a great opportunity for institutional capital to step into the sector, reflected in the growing share of residential in terms of overall investment volumes. It has grown from 8% to 23% across Europe over the last 15 years.

Despite the strong appetite, residential remains a relatively small part of many investors' portfolios. Growth in investor appetite, despite the tough economic environment, is supported by structural tailwinds and we think that Europe's residential market continues to offer a compelling and wide range of products for investors seeking diversification together with stable income streams with some degree of inflation protection.

Key takeaway

Europe's main cities are chronically undersupplied with quality residential stock and the trend is not showing any signs of easing

Watling Grange, Skipton Road, Harrogate

UK in focus: affordable build-to-rent and single-family housing

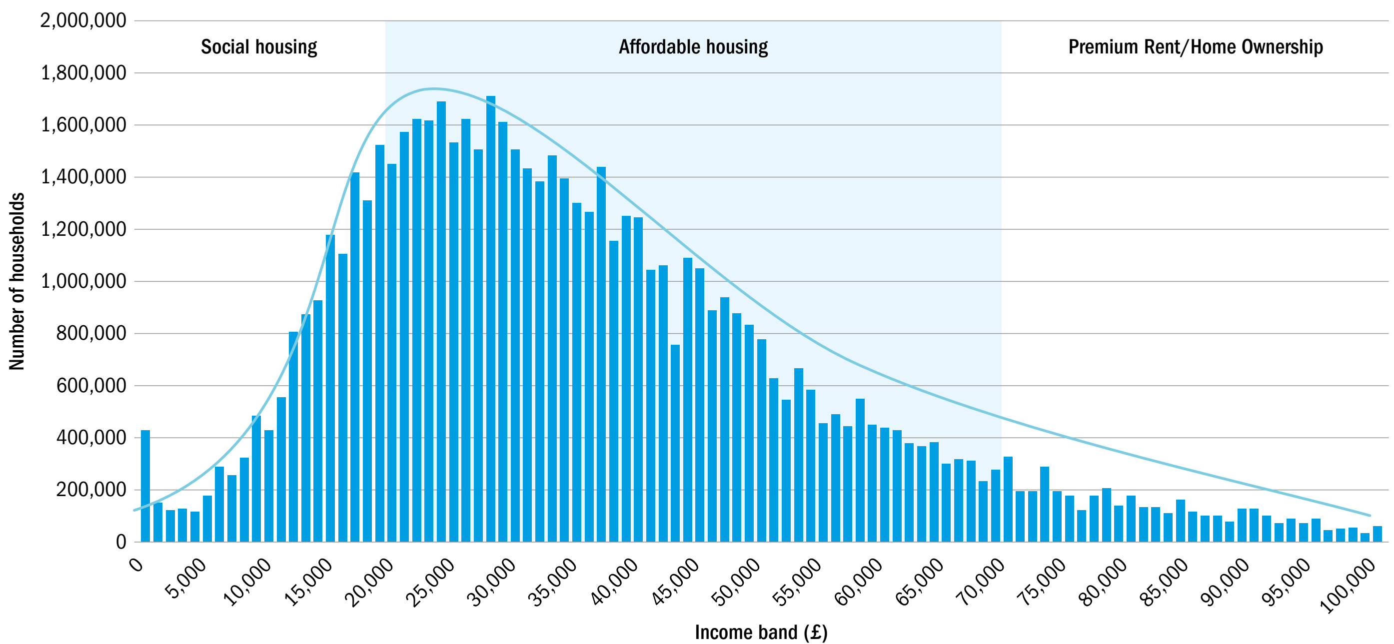
The UK rental market has experienced significant changes over the years. Rising house prices, stringent lending criteria, and changing demographics have led to a surge in demand for rental properties. However, renters are grappling with various challenges, including soaring rental costs, lack of long-term security, inadequate maintenance standards, and limited choice. These challenges have created an urgent need for innovative solutions that address the concerns of both tenants and investors.

The rented sector in the UK is expected to reach 50% of all households by 2039 and despite the progress made in build-to-rent provision, the UK still faces a severe shortage of affordable and high-quality homes for renters. Plus, the historic focus on premium BTR leaves a gap for affordable rental housing for median and lower-income households. Already low levels of supply are being compounded by smaller landlords offloading their properties partly due to the higher interest rate environment, but more due to (proposed) regulation changes to Energy Performance Certificates. For example, all rental homes must achieve an EPC C rating by 2028, the implementation of the Buildings Safety Act, the Renters (Reform) Bill of May 2023 and tax changes, all of which have made buy-to-let increasingly unviable. Many individuals and families struggle to find suitable accommodation that meets their needs and budget. This shortage not only impacts people's well-being but also has broader social and economic implications.

Amongst the undesirable consequences of this increased pressure on the rental market are the disproportionate constraints upon lower to middle income renters and key workers. The largest renting demographic in the UK is the 'low to middle income working households' – a group that is growing. However, with wages and pensions failing to keep up with housing prices, more families and older people are being priced out of the housing market and many households have limited options within the rental market and therefore compromise on quality or opt to spend over 30% of their income on rent, which is unaffordable for many. The situation is particularly acute for single earning households, lower quartile earners and those who require larger homes. This does however provide an opportunity to create good quality rental housing, with a focus on delivering local affordability, aimed at an underserved market through quality purpose-built and professionally managed rental homes.

Much like mass-market BTR the supply imbalance here is such that the flow of capital and its deployment and ongoing management can deliver core market investment returns, underpinned by defensive and sustainable income streams, and compelling growth drivers while creating positive impact by increasing housing supply and improving the quality and environmental credentials of available residents' homes.

Chart 11: Depth of the demand



Source: Columbia Threadneedle Real Estate Partners, UK Office for National Statistics, UK Household Finances Survey (August 2023).

More than 60% of existing UK renters live in houses rather than multi-family apartments. This equates to 3 million households but within this single-family housing (SFH) represents just 0.3% of existing available stock. Investors in the build-to-rent sector have traditionally focused on purpose-built multifamily flats in city centres, but some are now turning to suburban/edge of town locations, seeking to unlock a far larger sector, one that has thus far largely been untouched by institutional capital. This also supports the UK government's Levelling Up agenda which aims to address the need to tackle social and economic inequality across the country. The ambition is to raise the level of equality by empowering local governments to make decisions at a local level as they have a greater understanding of what their local areas and communities need and where the gaps might be. These are not uniform across the UK and the differences are stark.

With construction costs high and not expected to fall significantly, despite an easing in inflation, some house builders are struggling to fully develop out planned schemes and so have increased multi-unit sales to institutional investors to offset some of the risk, a risk that has been exacerbated by the end of the Help to Buy scheme and the soaring costs of mortgages. This has left some housebuilders with stock that they need to churn so that they can recycle the capital. It also provides investors with relatively quick access to built stock and the ability to scale portfolios at speed whilst delivering quality well-managed units to the undersupplied residential sector. Doing so can secure long-term income streams with the potential to capture positive rental at renewal and/or on new leases and grow capital value.

Key takeaway

Investors in the build-to-rent sector have traditionally focused on purpose-built multifamily flats in city centres, but some are now turning to suburban/edge of town locations, seeking to unlock a far larger sector

Europe in focus: purpose built student accommodation

The purpose-built student accommodation (PBSA) sector is one of the more dynamic across Europe's real estate landscape and has undergone remarkable change and growth over the past few years, boosted by its countercyclical benefits. The sector is evolving from an often fragmented ownership structure, outdated stock, and smaller lot sizes, suffering from lack of coordinated and professional management. With a large number of students relying on the often expensive private rented sector for their accommodation needs, it looks set to attract rising interest from institutional capital.

Growth in the sector is being driven by a strong student population growth, in particular a rise in international students. Activity is further supported by the changing student demographics and a heightened focus on a quality living experience. There is a strong case for both mid-range and high-end student housing. Mid-range aims to offer relatively affordable accommodation, primarily targeting domestically mobile students typically in regional cities with good universities and low vacancy levels in the private residential market. High-end accommodation offers additional amenities such as gyms, laundry rooms and communal areas for socialising and entertainment. One of the obvious attractions of the PBSA market is that it provides amenities and services all under one roof, and which are typically included in the rent paid.

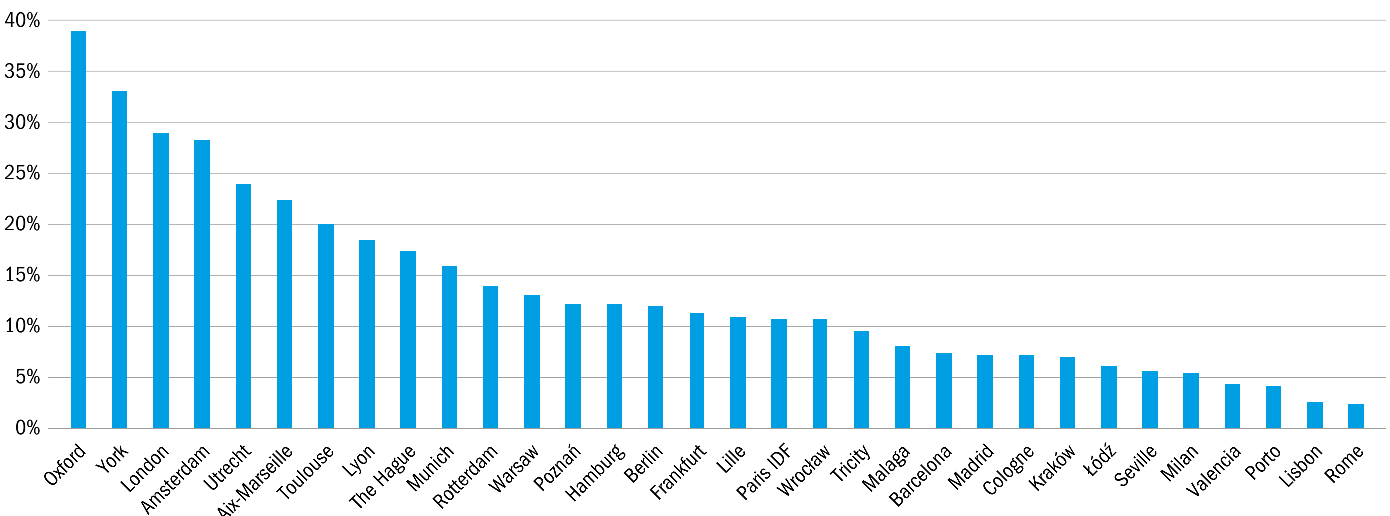
PBSA also goes some way to help alleviate the widespread pressure on the private rented sector (PRS) which can be overrented, and students having to navigate entry barriers such as unfamiliarity with the local housing market and contract law. As more households are forced to the rental market as affordability in buying a house continues to skyrocket, this implies that there is more competition in the PRS that is already facing supply shortages and so forcing students to pay high rents for accommodation in an already crowded private rented market.

This scarcity creates opportunity for joint ventures between developers, operators, and capital to create products that are fit for the future needs of changing student requirements. At the same time creating scale that can either be managed or parcelled up and sold on when the time is right. Platform deals are popular as investors can build scale quickly without having to invest time and resources to set up an operating platform in-house or be slowed down by build-up strategies. In addition, universities are looking to divest of stock with bigger roles for private sector partners that can deliver the right solutions in terms of accommodation portfolios.

The UK, France, Germany, Spain, and the Netherlands are key markets in Europe. Primary cities in each country are predominantly the focus but quality, purpose-built student accommodation close to universities and amenities is typically undersupplied in many European markets. Challenges around land acquisitions for development, the lack of standing investable assets and current pricing levels are issues that investors face. Some seasoned investors are therefore beginning to look at strong second Tier cities where there has been, or there is potential for some growth in higher education.

The European student housing market is severely undersupplied, both in terms of quantity and quality. Provision rates (*the proportion of beds per student) according to Savills, vary widely by country in Europe, ranging from 4% in Italy and Portugal to 32% in the UK.

Chart 12: Purpose Built Student Accommodation – select European city provision rates



Source: Savills (2022).

1211 E. 5th Street, Austin, TX 78702, US

“We believe many cities with excess apartment supply in 2024 provide investment opportunity as household income and population growth drive rent and demand gains over economic cycles.”

Hans Nordby, Head of Research & Analytics, Real Estate (US)

US in focus: rental growth and working age population growth go hand in hand

In both the decade preceding the pandemic and more recently, markets with strong working age population growth such as Raleigh, Atlanta, Dallas, and Austin posted above-average residential rent gains, despite these markets also being characterised as cities with low barriers to new construction. In contrast, markets with high perceived barriers to supply such as the Bay Area, Los Angeles and New York City either moved to a below-average level of rent growth or remain unchanged. We believe the most attractive markets for investment over economic cycles, such as 2010 – 2019 time period shown below, have both household earnings and working age population growth.

Chart 13 – Cities with higher income growth have seen higher rent growth
(10-year market asking rent CAGR, % vs median household income CAGR, %)

Source: Lionstone Investments, CoStar for the 10-years ending 12/31/19. Internationally competitive (IC) cities are those that score highly in a proprietary market ranking that evaluates economic growth, demographic trends, sustainability, and the business climate. The rankings are run on an annual basis. CAGR is compound annual growth rate.

We also believe that the current apartment market offers attractive opportunities for investors carefully seeking submarkets with attractive supply and demand fundamentals. Apartment submarkets nationwide are generally facing higher current levels of supply than historic demand growth. However, there are submarkets where near-term supply is less than historic demand growth including River Oaks in Houston, Orem and South Jordan in Salt Lake City and Forsyth County in Atlanta. All these submarkets are also located in metropolitan areas with above-average working age population growth.

Chart 14: Select US neighbourhoods stand out for apartment investment opportunities
(10-year average net absorption, % vs share of existing inventory underway, %)

Source: Lionstone Research, CoStar (December 2023). Net absorption is a measure of demand for real estate and reflects the total amount of space that has been rented minus the amount of space that has been vacated during a set time frame. A market with positive net absorption indicates a stronger demand trend.

> "Both the macro and the micro lenses are necessary to take advantage of the dislocation in the market, see through the lingering uncertainty and uncover those opportunities that could very well deliver strong returns."

Joanna Tano, Head of Research, Real Estate (EMEA)

North Hills Innovation District, Raleigh, NC, US
(a rendering image)

"Tight financial conditions in early 2024 should yield fertile ground for investment in select real assets with strong demand fundamentals, especially those in housing, logistics and retail."

Hans Nordby, Head of Research & Analytics, Real Estate (US)

Conclusion

We expect more opportunities to come to the market over the next twelve to twenty-four months. Financing conditions will remain tight although begin to loosen in the second half of the year but, acquisitions need to be targeted, not just geographically but in terms of quality and at a sector level too. The era of financialisation of real estate is over and we are entering an era where real estate must be functionally relevant to derive value. Decisions should be guided by long-term trends supporting overarching sector choices, but the differences and opportunities within, and between sectors, subsectors, cities and submarkets will be crucial too.

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