STRONG FOUNDATIONS:

THE OUTLOOK FOR EUROPE'S POST-PANDEMIC RESIDENTIAL HOTSPOTS REMAINS COMPELLING

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From Amsterdam to Zurich, many cities across Europe have been dynamos of economic and population growth over the past decade, leading to soaring residential property prices, rising rents and increasing interest from investors, particularly for build-to-rent assets.

This burgeoning subsector of the private rented sector (PRS) has been supported by three factors: The strong economic performance of individual cities (which is often well above national levels to attract both internal and external migration); demographic trends such as rising levels of single occupancy; and low interest rates to fuel demand from investors.

However, after years of supply being unable to keep up with demand, due to the limited availability of land and development finance constraints, the COVID-19 pandemic risks changing the fundamental nature and draw of Europe's cities. The acceleration of working from home, the decline of physical retail and the yet unknown impact of a year of restrictions on our behaviour when it comes to socialising have led some to question the future of our urban centres. Will Europe's cities still be compelling places to live, or is the supply-and-demand imbalance likely to tip away from the favour of investors?

Reports of the death of the city due to the rise in remote working and a new-found fear of crowded places may have made for clickable headlines in publications from Forbes to Politico, but they have been somewhat exaggerated.

THE RESILIENCE OF CITIES

For a start, an important indicator of the future of city living comes from the findings of a survey by JLL of more than 2,000 workers: three-quarters of them wanted to return to the office, with many missing the social interaction and the opportunities for networking. Lockdown has created a craving for the cultural, sporting and leisure amenities offered by cities. Combined with their economic opportunities, this is likely to lead to a strong bounce back in demand as the pandemic begins to recede over the year through the rollout of COVID-19 vaccines across Europe.

That being said, we are likely to see increased levels of hybrid working that sees workers spend a portion of the working week at home, reducing the impact of commuting and potentially generating greater demand for residential property in the suburbs and satellite towns of major cities.

Next, it is important to understand that the supply-and-demand imbalance for homes is not a characteristic that can be changed overnight. Demand far outstrips supply by a multiple of 3.1 in Dublin, 2.2 in Rotterdam, 2.0 in Berlin, 1.9 in The Hague and 1.7 in Madrid. While rates of population growth slowed compared with previous years, and Berlin posted a very small reduction, this was due to reduced migration, something that is expected to return to normal levels after the pandemic. In fact, most cities, including Stockholm and the Netherlands' four major population centres of The Hague, Amsterdam, Utrecht and Rotterdam, still expanded their population during 2020. Furthermore, although many households have decreased in size, this has served to increase demand for the number of homes.

In addition, due to unprecedented government and institutional intervention through monetary and fiscal policy to combat the negative economic effects of the pandemic, investment in real estate assets will remain attractive over the next decade. Bond yields are at an all-time low and interest rates are likely to remain low in the short-to-medium-term.

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Within this environment, residential real estate is expected to outperform other real estate sectors. Over the past decade, investment in cities has pushed up capital values and compressed yields, but residential property has remained attractive to investors due to returns remaining above bond rates and risk being perceived as low.

In fact, the PRS sector is increasingly being viewed as a proxy–fixed income asset class by investors, with rates of return maintaining a significant basis point difference above fixed-asset income in major European countries. Combined with declining bricks-and-mortar retail, investment in the residential sector outstripped retail in 2018 and already has a greater than 20 percent share of EMEA real estate investment. It is predicted to be the dominant real estate asset class in 2030.

This is demonstrated by last year's investment volumes in the residential subsector, which reached €64 billion compared to €52 billion in 2019. According to CBRE Global Investors' own research, capital values for residential real estate in major cities in both Europe and the UK are expected to increase by 5.3 percent per annum from 2020 to 2025, compared to 5 percent for the property sector overall. Rents are expected to increase by 1.6 percent per annum compared with 1.1 percent for the sector overall.

We see this demand focusing on the institutionally managed, private rented sector, supported by high house price growth and rising household formation across Europe. During 2020 and the pandemic-induced downturn, average residential property prices continued to rise across the euro zone by 6 percent, according to Oxford Economics. Even in the UK, where there has been the added uncertainty of Brexit and the stamp-duty holiday, average residential prices have risen. This means that markets such as Ireland are predicted to be star performers — despite a small private residential market, it is expected that there will be a 60 percent growth in house prices alongside a 13 percent growth in households. Even in Germany, Europe's largest market, property prices are expected to increase by 40 percent, while households will increase by 2 percent.

To understand which markets will be attractive for different investment strategies, CBRE Global Investors uses a city-scoring model that takes into account market dominance through factors such as liquidity and the number of PRS homes, alongside market potential through affordability, economic outlook and household growth, while also evaluating supply and regulatory risks at a city level. Using this approach, we can understand how well-established markets such as Berlin, Vienna and Hamburg compare to markets with significant growth potential, such as Dublin, Oslo and Copenhagen.

AFFORDABILITY

An increasingly important factor to consider is affordability. In fact, the proportion of households spending more than 40 percent of their disposable income on rent is almost universal across the 27 EU member countries and the UK.

This trend is leading to a growing market for the supply of PRS homes that offer both affordable rents and economies of scale through large, well designed, low-maintenance, purpose-built accommodation projects. Key to the delivery of this type of asset will be increased cooperation between interested parties such as national, regional and local governments, developers and investors. In terms of location, well-connected city transport hubs will be particularly popular. However, with the growth of a hybrid mode of working, it can be expected that commuter locations in surrounding suburbs and satellite towns will also become PRS hotspots, particularly for cities with a large catchment such as London and Paris.

Despite the dramatic uncertainty caused by the pandemic, the fundamentals that have evolved over the past decade and driven the residential real estate market in Europe's major cities, remain intact. In some respects, massive state and EU intervention has extended the low interest-rate environment further into the coming decade, which will encourage more funds to pour into residential real estate.

However, there will be a change in the flow of this demand, as the impact of the pandemic makes the more affordable end of the market and new hotspots around well-connected suburbs and satellite locations of major cities particularly compelling.

Although the overall picture for major European cities is positive, a successful residential investment strategy will require more drilling down to the local level than ever before.