Looking to the city

Mahdi Mokrane and Marcelo Cajias explain why a city-focused approach is vital for investing in the European residential sector

At PATRIZIA, we are strong believers in the potential of residential real estate in Europe to deliver outstanding returns for investors. However, in order for those returns to be maximised, capital needs to be deployed in a strategic manner, based on sound market research. As a result, we have developed what we believe to be a market-leading approach.

Firstly, our focus on European residential is tightly urban – and with good reason. After all, Europe has been on the path towards ever greater urbanisation since the 1960s. Of course, that manifests itself in different ways in different countries. At one end of the scale, around 35 per cent of people in Poland lived in cities in 1960, a figure that is expected to reach just shy of 80 per cent by 2050. At the other, Belgium started from a position of more than 90 per cent urbanisation in 1960 and is likely to be nearing 100 per cent by 2050. However, the line on the graph is only going in one direction no matter which European state is considered.

It also has to be said that cities routinely outperform their national economies, sometimes by a quite staggering extent. Between 2005 and 2019, for instance, Oslo saw more than twice the GDP growth than Norway as a whole. Amsterdam performed similarly compared to the Netherlands. Brussels and Lisbon saw significantly lower growth than Belgium and Portugal, but they are the exceptions. Quite simply, cities are increasingly the engine rooms of European economies.

What's more, even Covid-19 does not appear to have had a material impact on Europeans' desire to live in cities. During the pandemic – and especially when people were largely confined to their homes – it was common to read newspaper headlines predicting the death of the city as many people realised that they could do their jobs perfectly well remotely.

However, according to the latest Google workplace mobility data, it appears that Europeans are slowly but surely returning to the office. Again, there are differences between countries – the UK lags significantly behind Germany, for instance – but overall, the trend is clear. It should also be noted that real estate fund performance has already recovered well from the pandemic: there is simply no comparison with the impact of the global financial crisis (GFC).

The centrality of cities to European economies is reflected in the real estate data. In France, for instance, around 77 per cent of real estate transactions take place in either Paris or Lyon. In Spain, the equivalent figure for Madrid and Barcelona is 72 per cent. In short, liquidity is generally far higher in Europe's biggest cities when compared to their home nations. In addition, it appears that the bigger the city, the higher the liquidity: the likes of Berlin, Paris and London dominate the upper echelons of Real Capital Analytics' European cities liquidity ranking.

It is also clear that residential is now the most popular real estate sector among investors, a situation that has developed remarkably quickly over the past decade *[see figure 1]*. In 2011, a time when the market was still recovering from the GFC, the overwhelming majority of investment was directed towards the office and retail sectors. So far in 2021 – and we see no reason why this would change as we approach the end of the year – those sectors represent significantly less than 50 per cent of investments, with both residential and industrial emerging as the clear winners. Currently, around a third of European real estate capital is invested in living sectors, although transaction activity is currently dragged down by a fall in investment in hotels.

Gross initial yields for multi-family housing in particular are also highly attractive, especially so when compared to the returns available on government bonds. At the lower end of the spectrum,

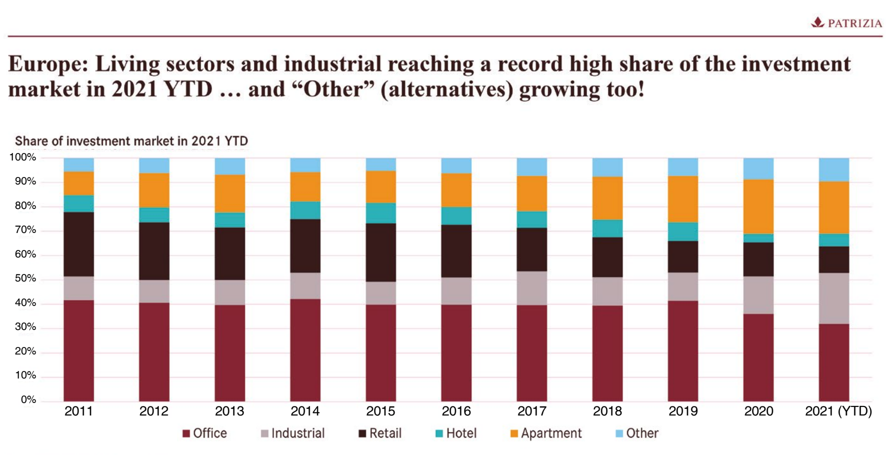

figure 1

yields in Sweden range from 2-4 per cent. At the opposite end, yields in Poland come in at between 4 per cent and 6 per cent. A similarly positive story can be told when it comes to capital values in the European living sectors, with most countries recording a strong growth trajectory since the nadir of 2008.

Of course, it has to be acknowledged that regulations on rental properties are reasonably common in Europe. Broadly speaking countries can be grouped into three categories: free markets such as the UK and Italy; countries that regulate both initial rents and rent increases, such as France and the Netherlands; and those that just regulate rent increases, like Germany and Spain. It is also likely that governments will increasingly bow to public pressure in cities where a lack of affordability is seen is a major issue. However, provided that such regulations are transparent and not forced through overly quickly, they do not need to be a major issue for investors. It should also be remembered that European rents have consistently outperformed inflation since the GFC.

However, it is still important that investors fully understand city dynamics in order to match locations to investment strategies. To that end, PATRIZIA has developed its Living Cities Index, in order to understand emerging issues and challenges *[see figure 2]*. The index, which is regularly updated, takes in a wide range of demographic and economic factors, as well as the innovative capacity and connectivity of each city, in order to build a rich picture of individual places and how they sit relative to other cities.

All of these factors are used to rate a city's attractiveness, which the index plots on a horizontal axis. However, this is only part of the picture. The index also provides intelligence on the vertical axis on how liquid the residential market is in any of the 119 cities examined. This is critical as liquidity dictates how quickly capital can be deployed and how active portfolio management activities can enhance property value while the fund matures.

The index then allows us to place cities into one of four quadrants: powerful, affordable, liquid and innovative. All four sections are seen as investable as they provide different opportunities depending on fund strategy and, crucially, desired levels of risk and return. Inevitably, some are categorised as neither attractive nor liquid and are therefore placed in a fifth section, which we view as un-investable. However, it should be said that cities to move between segments with each iteration of the index. For instance, in the latest iteration Luxembourg moved from innovative to powerful owing to an increase in liquidity.

By building a powerful picture of individual city dynamics and how they compare to other locations we are also able to target investments towards residential sub-sectors as appropriate. When it comes to multi-family housing, for instance, we have identified Dublin and Paris as leading locations for investment.

The former is currently benefiting from the fallout from Brexit, with both the financial and technology sectors continuing to attract well paid, relatively young people, thereby creating a growing demand for high quality rental accommodation. In Paris, meanwhile, new opportunities are opening up as a result of the transport improvements delivered by the Grand Paris infrastructure project.

Similarly, a robust analysis of the data reveals those cities that are currently underserved by purpose-built student accommodation. In the UK, for instance, the market is reasonably mature, both in the capital and regional cities. The same is true in Poland. Elsewhere, however, the PBSA market is characterised by under supply or outdated stock. A thorough understanding of a city's demographics also allows for investment into later living developments to be targeted intelligently.

So, our view is that opportunities abound across all living sectors in Europe. However, investors need to be armed with the best market intelligence in order to deploy capital as profitably as possible. PATRIZIA's in depth research – as well as our team's on the ground insight – allows them to do just that.

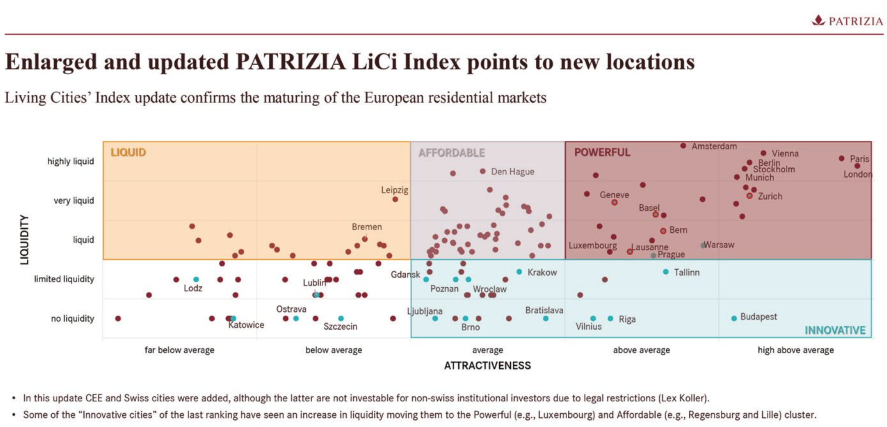

figure 2

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