UBS Asset Management

Set to grow.

The rise of the European multifamily sector | White paper

By: **Brice Hoffer,** Head of Real Estate Research & Strategy – DACH

Real estate investor interest for European multifamily assets has been growing continuously in the last decade. In our view, resilient income-driven performance, supported by strong occupier market fundamentals and long-term socio-demographic trends, will continue to fuel the rise of this asset class in the coming years.

Strong forces lifting the European multifamily market

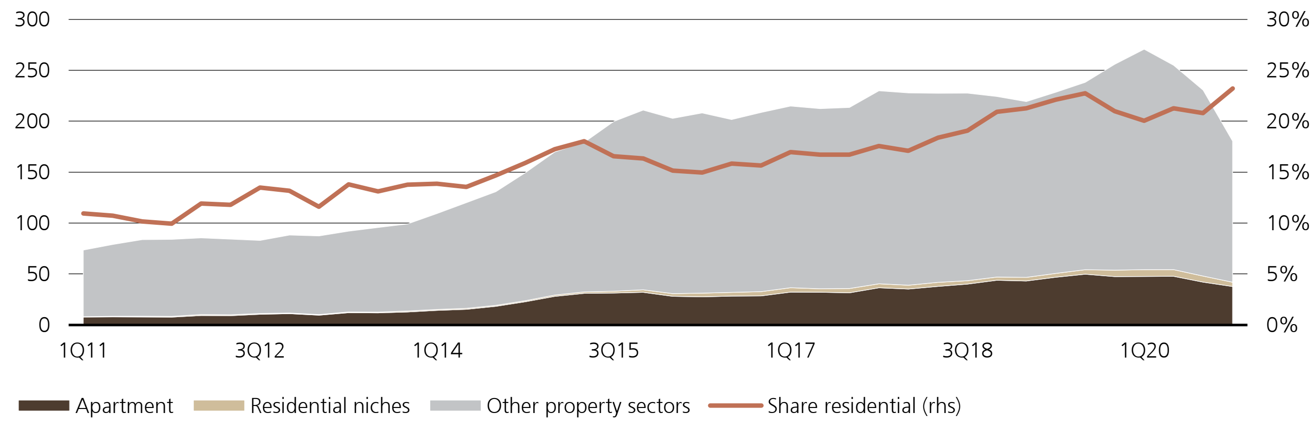
European multifamily assets are showing their resilient nature by continuing to ride out the COVID-19 storm. We identify numerous cyclical factors and long-term trends advocating for the further growth of the multifamily sector as an established real estate asset class in Europe going forward. Furthermore, we propose concrete approaches for building direct exposure to this sector depending on the maturity of the local multifamily market.

Home sweet home…

Compared to most other commercial real estate sectors, residential properties probably enjoyed a higher usage rate than ever in 2020 in most countries of the world. As a consequence of the lockdown measures introduced to fight the global pandemic outbreak, apartments became the shelter of most daily activities, particularly in Europe as the region had to cope with several infection waves and lockdown cycles. Despite this extraordinary situation, residential rent collection activities remained widely undisrupted in Europe, while the occupier market for multifamily properties kept showing signs of robustness.

This defensive nature fueled the investor interest for multifamily assets in 2020. Despite the elevated level of insecurity and mobility constraints, the transaction volume for European residential assets (incl. niches) remained rather resilient in 2020 compared to the average in the three previous years (-11%). In comparison, the rest of the commercial real estate (CRE) market posted a 24% retreat. The rising investor interest for multifamily assets is actually a trend which started years before the COVID-19 outbreak (see Figure 1). Looking back at 1Q11, residential investments contributed to less than 11% of the yearly CRE transaction volume in Europe. Since then, this share steadily increased to reach over 23% in 4Q20. This evolution underlines the increasing establishment of the European multifamily sector as an institutional asset class and there are numerous cyclical factors and long-term trends, which speak for the continuation of this development going forward.

Figure 1: Yearly transaction volume by sector in Europe (EUR billion)

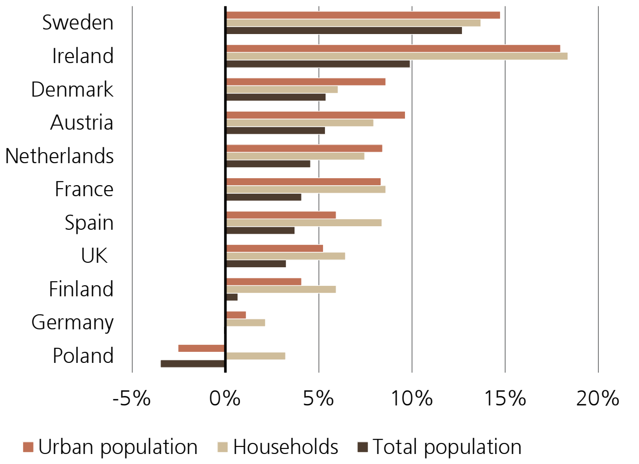


Source: Real Capital Analytics 4Q20; UBS Asset Management, Real Estate & Private Markets (REPM), January 2021
Notes: 4Q20 transaction data is preliminary.

Shrinking household sizes and urbanization trend driving additional demand

From an occupier market perspective, demographics probably constitutes the most important demand factor when assessing residential property investments. As in most regions of the world, population growth prospects are expected to be impacted by an increasingly aging society and a chronically subdued level of birth rate in the coming decades in Europe. However, a closer look is required in order to estimate the real future demand potential for residential real estate in European markets. First, despite a muted top down picture, some European countries are likely to experience a dynamic population development between 2020 and 2035 (see Figure 2). This is evident in countries such as Sweden (ca. 13%) and Ireland (ca. 10%).

Figure 2: Expected demographic growth 2020-2035



Source: Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), January 2021

Secondly, housing demand fundamentals are actually driven by the growth in the number of households, which of course partly relies on the total population increase, but also on household size. As a consequence of the growing individualization of European society, average household size has been on a downward trend for decades. A country like Poland, whose total population is expected to shrink by 3.5% over 2020-2035, should still benefit from a positive demand growth in terms of household number (+3.2%), which matters when looking at net additional demand in the residential market.

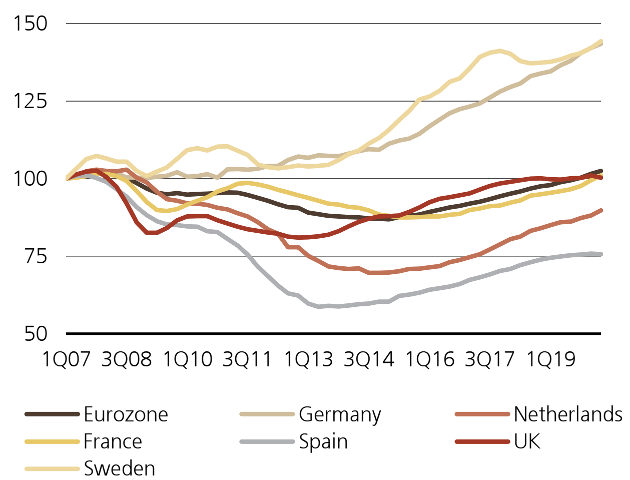
Furthermore, demographic changes are set to vary widely on a country-level. The ongoing urbanization trend, which is expected to persist in Europe in the coming decades, is driving more and more inhabitants towards the largest metropolitan areas of the continent. Despite the increasing digitalization of the job market, which enjoyed an additional boost from the COVID-19 pandemic, we believe that large urban centers will remain the hotspots for the service sector, which makes up the largest stake of the job market. In addition, these locations are likely to remain highly attractive due to their cultural and entertainment offering.

However, as home- and near-office activities are expected to gain traction even in the aftermath of the pandemic, suburban municipalities and well-connected secondary cities – particularly locations with strong public transportation links – will likely become more attractive going forward. This could also influence the geography of the European multifamily market on a micro-level.

Rising property prices and flexibility needs shifting users towards renting

Focusing on the rental market only, there is an additional factor to mention that will likely drive further demand growth in this sector in the coming years. House and apartment prices rose faster than wages and residential rents for several years in most European countries due to the persisting ultra-low interest and mortgage rates (see Figure 3). This steady inflation of housing prices contributes towards an upward movement of the local price-to-rent ratios, which means that renting a dwelling becomes more attractive when compared to acquiring a property.

Figure 3: Housing price-to-rent ratios in Europe



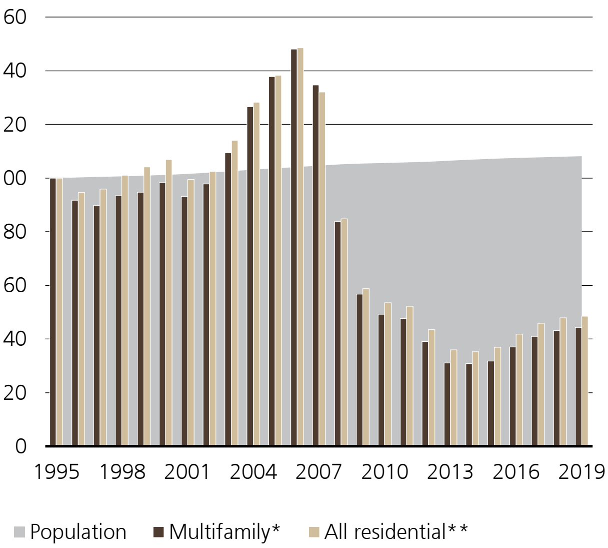
Source: Refinitiv; UBS Asset Management, Real Estate & Private Markets (REPM), January 2021

This trend is supportive of a demand shift from the owner-occupied residential sector towards rental apartments. This is particularly true in dense urban regions, where dynamic demographic growth and increasing building plot scarcity are making housing acquisition unaffordable for a growing share of the local population. Furthermore, renting rather than buying housing might not be forced by financial constraints, but rather the result of a conscious choice. As European society becomes increasingly individualized, flexibility – in particular in terms of housing conditions – is gaining more and more popularity. This evolution is expected to give an additional boost to rental demand.

Chronic construction gap to support market fundamentals

Supply prospects are expected to contribute to a robust state of the occupier market in the European multifamily sector going forward. The project pipeline for new residential dwellings overshot the demographic dynamics in the few years preceding the Global Financial Crisis (GFC). The consequences of this large-scale economic disruption in the eurozone constrained residential construction activity at long-lasting subdued levels (see Figure 4).

Figure 4: Volume of dwellings with building permits and demographics in the Eurozone (Index, 1995 = 100)



Source: Eurostat, Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), January 2021
Notes: * 2 or more dwellings; ** excluding residence for communities

This construction gap still prevails today as accessibility of third-party funding remains low in the European financial market for such building projects compared to pre-GFC. And despite a slight rebound in the planning activity of new housing units in recent years, the chronic lack of residential supply experienced in most urban regions in Europe is likely to remain acute in the near future.

Both demand and supply prospects are supportive of firm market fundamentals and further rental growth in the European multifamily market.

Agglomeration areas and attractive secondary cities with firmest rental growth prospects

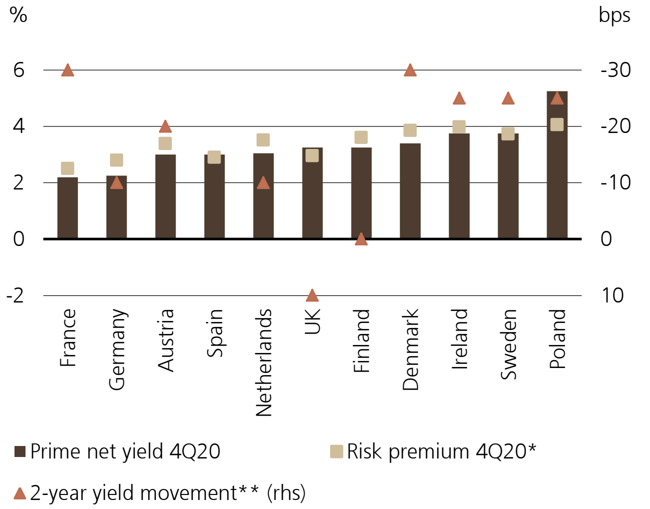
Growing demand potential together with the persisting muted level of supply underpin robust rental growth prospects in the European multifamily market going forward. However, the dynamic is likely to be somewhat tempered by growing housing affordability concerns. On the one hand, this directly influences the level of rent that can be tolerated and, on the other hand, might contribute to a higher level of regulation and tenant protection in regions with very tight market conditions. Furthermore, job market and household income disruptions triggered by the COVID-19 pandemic are likely to give an additional boost to this risk factor in the short to mid-term outlook.

In contrast to the recent past, we expect municipalities in the agglomeration areas and attractive secondary cities to outperform large gateway cities and their immediate surroundings in terms of rental growth in the future. Indeed, these locations typically benefit from more affordable market rents and lower regulatory risks than, for instance, the prime markets of the largest European cities. The expected additional demand boost for these secondary markets, as a consequence of more frequent home- and near-office activities (see p. 3), further supports this thesis.

Investor interest pressuring initial yield levels

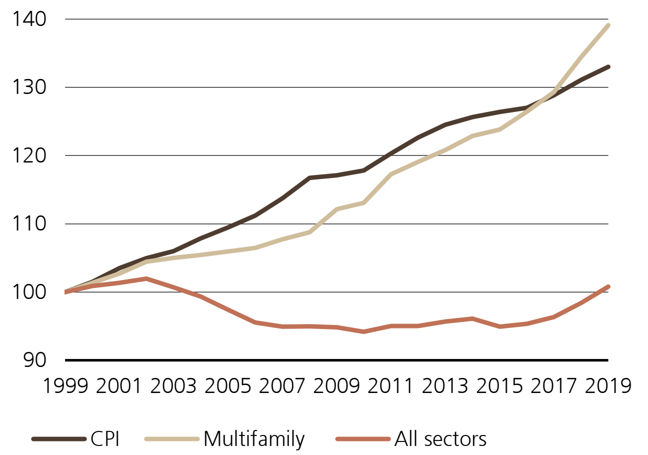
As shown in the transaction data in Figure 1 (see p.2), the European multifamily market experienced growing investor interest in the last few years due to the elevated demand for real asset investment opportunities amidst a persisting low interest rate environment. Consequently, acquisition prices moved upwards and initial yield levels compressed across the continent, particularly in prime markets (see Figure 5). The UK is an exception to this trend, as Brexit-related risks triggered a slight outward yield shift (+10bps) over the last two years.

Figure 5: Multifamily yields and risk premiums



Source: CBRE 4Q20, Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), January 2021
Notes:* Net initial yield versus local 10-year government bond yield.
** No data for Spain (time series going till 4Q19 only)

Figure 6: Above-inflation rental growth in the German multifamily market



Source: MSCI, Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), January 2021

Despite increasing entry prices, risk premiums on the local 10-year government bond yields remain elevated in European countries, ranging from 2.5% for prime French residential assets to 4% in core Polish markets. Taking into account the stable income-driven nature of the sector (see next section), such levels of risk premium make exposure to European multifamily investments particularly attractive in terms of risk-adjusted returns and performance stability. This holds particularly true in the current stage of the real estate cycle, where the robustness of income-return is set to gain in importance as a total performance driver compared to capital value growth. The latter has been strongly supported by the steady compression of the discount rate in the recent past.

Robust income-driven performance in focus

The resilience of multifamily as an asset class arises primarily because of the stable nature of its occupier market drivers. Socio-demographic trends defining both owner-occupied and rental housing demand are mostly long-term, and not as prone to economic shocks like the fundamentals of most other commercial real estate sectors.

In addition, rents in the residential sector tend to offer a better inflation hedge than their commercial peers. This is attributed to more frequent adjustments to market rent levels due to dynamic tenant fluctuation or, in certain cases, by contractual in-place rent increases following the development of the consumer price index (CPI). As an example, MSCI reports that rents of German residential assets have been able to deliver above-inflation growth between 1999 and 2019, while the average rental price increase in all commercial property sectors posted a stagnation in the country (see Figure 6). Given the sound conditions of most local occupier markets in Europe (see p. 3 and 4), it is reasonable to think that this trend will persist in the coming years, further supporting rental income robustness in the European multifamily sector going forward.

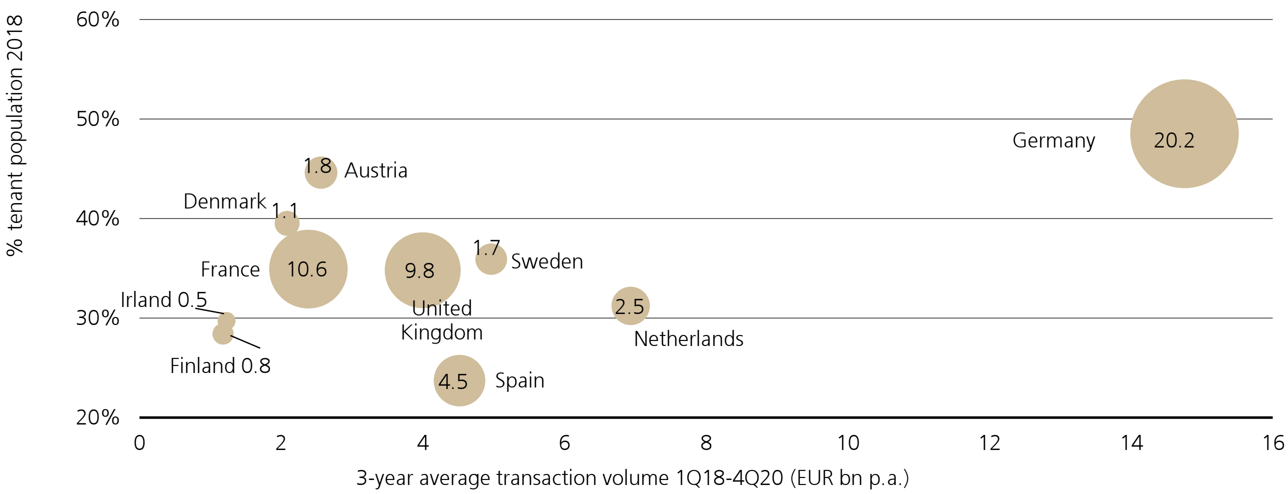
Diverse investment universe across Europe

European countries are very diverse in terms of market size, liquidity and level of institutionalization in the multifamily sector. Standing out from the crowd, Germany appears to be by far the most established multifamily market in the continent, with a stock of around 20 million rental dwellings and an average transaction volume of almost EUR 15 billion a year (see Figure 7). Furthermore, professionalization of the German multifamily sector is very advanced when compared to other European countries. As an example, Real Capital Analytics reports that between 2016 and 2020, almost 85% of the yearly transaction volume was concluded by either institutional, cross-border or local professional buyers (i.e. listed real estate companies).

In addition to Germany, numerous other European markets are compelling, in terms of investment universe, for building direct multifamily exposure to this region. Nordic countries as well as the Netherlands are also very advanced in terms of institutionalization of their multifamily sector and, despite a rather modest market size, have been able to attract important investment volumes in the recent years from both local and international players.

Furthermore, large European countries such as France or the UK offer sizeable rental dwelling stocks. However, the professionalization of their multifamily sectors is lagging behind when compared to the markets previously discussed. Despite a lower level of market maturity and a more fragmented owner base, such frontier markets should also be considered when building diversified exposure to the European multifamily market. However, this type of market typically requires a more focused and active investment approach when compared to other European countries, where rental housing has already been established as a common investable asset class (see next section).

Figure 7: Most liquid and investable multifamily markets in Europe
Bubbles: Estimated market size 2020 in million units incl. subsidized segments



Source: Real Capital Analytics 4Q20, Eurostat 2018, Oxford Economics 2020; UBS Asset Management, Real Estate & Private Markets (REPM), January 2021
Notes: Switzerland is not considered in this analysis since foreign investments in the Swiss multifamily market are constrained by law (Lex Koller); 4Q20 transaction data is preliminary.

Investment strategies based on market maturity
In this section, we propose concrete investment strategies for building direct exposure to the European multifamily sector based on the maturity level of specific markets (see Figure 8). Markets are considered established once their property management industry has been largely institutionalized and when professional players, both local and from abroad, are driving most of the transaction activity with sizeable investment volumes. By contrast, frontier markets tend to show a more infant institutionalization of their multifamily sector. Furthermore, private individuals and small local investment companies are likely to play a significant role in frontier markets in terms of ownership and management of the existing rental dwelling stock, as well as in the transaction market. Finally, some of these markets might show a rather limited liquidity level due to their emerging nature.

However, it must be noted that the proposed classification of established and frontier markets in Figure 8 is not meant to be a strict separation, i.e. some countries may show characteristics of both groups depending on the single factors analyzed. The grouping does not entirely rely on market statistics but more so on a certain level of qualitative judgment. Finally, Figure 8 displays a snapshot which is susceptible to change over time depending on the dynamics of the respective local market.

Thanks to their depth, established European multifamily markets typically offer a wide investment spectrum in terms of investable macro-locations. Amidst the ongoing urbanization forces mentioned previously on page 3, a focus on main conurbations of the selected countries is set to be at the core of investment strategies in this type of market.

However, given the actual investment pressure in prime locations and the potential effects of increasing home and near-office activities, attractive micro-locations in the agglomeration areas and well-connected secondary cities are likely to be preferred over large city locations, both in terms of initial yield level and rental growth prospects. Given the high level of institutionalization of these markets, sizeable direct exposure can be efficiently achieved through the acquisition of an existing professionally managed portfolio. Single assets should also be considered as these are likely to offer some extra-yield compared to portfolio deals, which tend to attract larger and more ambitious buyers in terms of pricing. Once the initial exposure has been achieved, active asset management strategies can be applied in order to create value within the existing stock in the long run.

The investment approach in frontier markets is set to be somewhat different given that institutional-grade products are likely to be either not available or so scarce that pricing and availability of quality multifamily assets will probably be inadequate in the existing stock. Also, the geographical scope of frontier multifamily markets tends to be focused on a few gateway cities and locations in close proximity. Therefore, partnering with local residential developers who have access to building plots in these targeted areas and can deliver the expected building quality, is an interesting strategy for core residential investors seeking multifamily exposure in frontier markets. For investors willing to ride a bit up the risk curve, acquiring existing residential stock from non-professional owners and repositioning the acquired stock via a manage-to-core approach might be a good approach to accessing attractive multifamily investments in the European frontier market universe.

Figure 8: Level of market maturity and proposed strategic approach

	Countries	Strategic focus
Established markets	Austria Denmark Finland Germany Sweden The Netherlands	– Target robust micro-locations in metropolitan areas (outside of core urban centers) and attractive secondary cities – Build up exposure by acquiring portfolio of established properties and consider selected single asset deals offering an extra yield – Apply active asset management strategies to unlock untapped potential of existing properties in the portfolio
Frontier markets	Belgium France Ireland Italy Luxembourg Norway Poland Spain United Kingdom	– Use a geographically focused strategy on a limited number of gateway cities and surrounding municipalities – Partner with established local players to access desired product quality through forward-purchased deals – Selectively reposition existing properties lacking professional management using a manage-to-core approach

Source: UBS Asset Management, Real Estate & Private Markets (REPM), January 2021
Notes: Switzerland is not considered in this analysis due to legal constraints (Lex Koller) on foreign investments in the Swiss multifamily market.

For more information, please contact:

UBS Asset Management
Real Estate & Private Markets (REPM)
Research & Strategy – DACH

Brice Hoffer
+41-44-234 91 56
brice.hoffer@ubs.com

Follow us on LinkedIn

To visit our research platform, scan me!

www.ubs.com/repm-research