

WHERE NEXT FOR RESIDENTIAL MARKETS?

This edition of Living Thoughts covers seven trends to watch in the European residential markets. They describe a new phase of investment where investors want resilient financial performance and enhanced social value, and where renters want more space and better value for money. The changing regulatory landscape means the residential market would always require strong local expertise. Overall, these trends combine to show that residential is a diverse sector with much to offer investors in the current market conditions and over the long term.



MORE RETAIL (PRIVATE) MONEY

Retail (private) investors are likely to be a growing source of capital alongside institutional investment. People are becoming more environmentally and socially aware and expect to see investment options that reflect their values. For example, in a survey¹ of over 2,000 people in the UK, over half of those under 45-years-old chose investments tackling social rather than environmental issues, and 18 to 24-year-olds focused on making a positive social impact, specifically health and wellbeing, more than any other age group. All residential investment has social value and can play a key role in delivering against these requirements.

In France, for example, social and affordable housing are key elements of solidarity-based investment – products that reconcile financial performance and social impact, and offer savers the opportunity to give their savings more meaning. Many products also seek independent certification, such as the Finansol label, to verify their social impact credentials.



RENTER INCOME DEFINES NEEDS

The rising cost of homeownership has led to an increase in high-income renters. Renter incomes now spread across an extremely wide range. Moreover, the vastly different economic circumstances of households that rent could have more influence over their housing needs than other factors such as age or demographic group (i.e. millennials).

Developers and operators of build-to-rent would need to consider carefully which segment of the renter market they want to cater for and what their tenants would need. For example, low-income renters – whether young or old – are more likely to focus on essential needs like security and reliability. Low-income renters have been hit hard by the sharp rise in the cost of living. Meanwhile, high-income renters, regardless of age, may want many amenities in their next rental property and a higher specification than the current market provides, but they would still have the desire and means to pay.

¹ Censuswide and Big Society Capital (January 2022), among 2000 UK adults (18+) who have at least one investment outside their pension





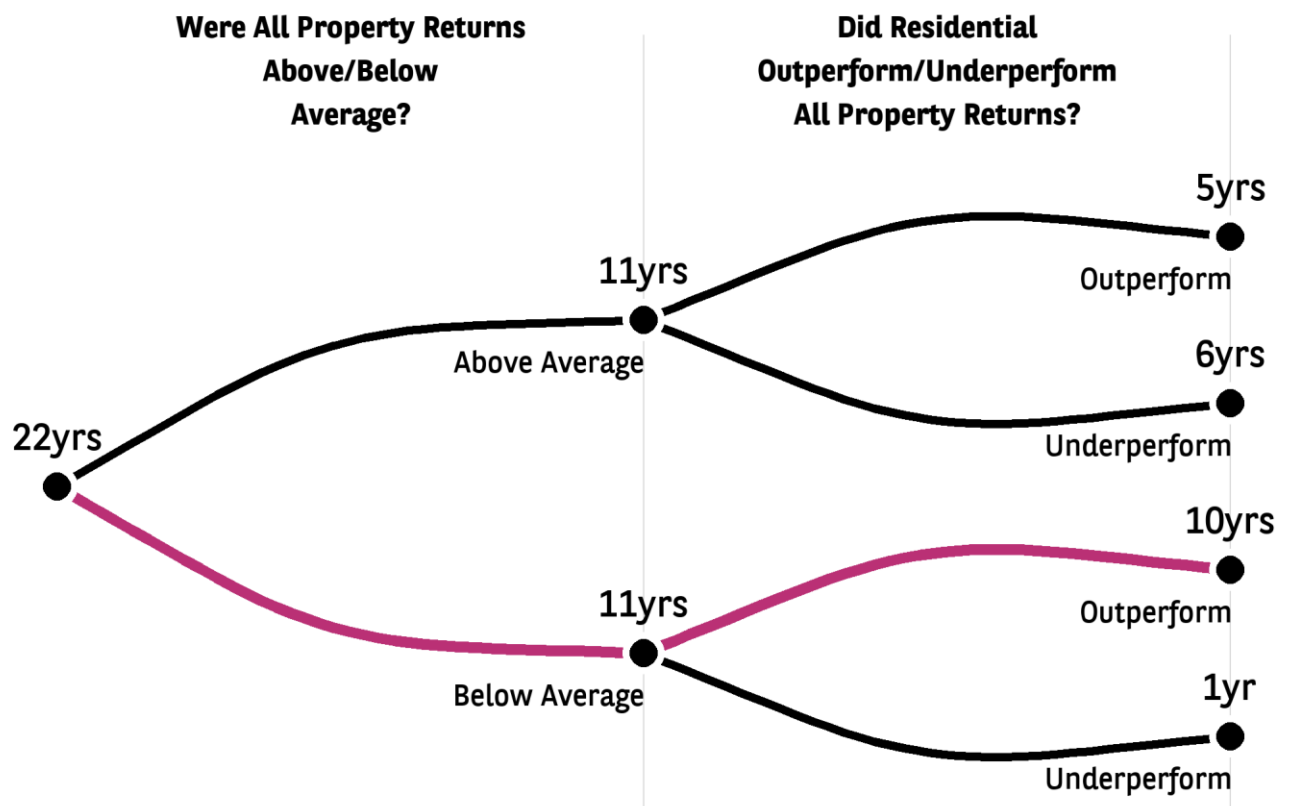
RESIDENTIAL AS A DEFENSIVE OPTION

Residential is likely to be a resilient part of a real estate portfolio, not necessarily the source of the strongest returns. Figure 1 shows that when European real estate returns (for all property types) were below average, residential outperformed the market in almost every instance over the last 22 years. Residential also outperformed around half the time when all property returns were above average.

Overall, residential returns have been less volatile than commercial real property returns. Furthermore, European residential returns have been positive for the last 22 years in a row, despite the recessions seen in that period. Ultimately, the sector has a good record of providing defensive returns when the market weakens, adding to its investment case in the current downturn and future cycles.

FIGURE 1: RESIDENTIAL OFTEN OUTPERFORMED WHEN ALL PROPERTY RETURNS WERE WEAK (2001-2022)

Count of years, European Residential versus European All Property total returns (% y/y) over the last 22 years



Source: BNP Paribas REIM calculations, MSCI European Annual Property Index (data as at May 2023)

INVESTMENT MANAGEMENT



MORE SUBSIDISED HOUSING

Current market conditions could be the catalyst for sustained institutional investment into affordable and social housing. Around 35% of households in the Eurozone's main cities have incomes under thirty-five thousand euros. Housing costs are often a burden for these low-income households, which the OECD defines as over 40% of disposable income. To demonstrate this, we looked at over 6,500 live listings of one- and two-bed apartments for rent in March 2023 in the 12 largest cities in the Eurozone. The most affordable city was Brussels. If you had an income of thirty-five thousand euros, 15% of apartments listed for rent would be affordable. Paris was the least affordable. If you had an income of thirty-five thousand euros, you would not be able to find any listing below 30% of your income. Even median earners would have to accept that they would need to pay more than 30% of their income on rent to secure housing.

There may be new schemes to encourage progressive ownership among younger people and decumulation for older homeowners. In response to the cost of living crisis, there are also likely to be more schemes that offer rental subsidies or other specialist tenures. However, government-backed housing providers may not have the funds to keep up with growing need for subsidised rents, especially in the least affordable cities. Private sector investment can fill the gap. Here, an investor is committing to a partnership with a housing provider for the long term. All parties need to be aligned and conscious of the reputational risk of delivering a poor service to renters. Overall, long-term investment in partnership with public bodies is attractive, especially if long leases secure the underlying income that is linked to inflation.



MIDMARKET VALUE AND SPACE

The increase in remote work has had three effects on renter demand. First, renters want more space to work from home in privacy and comfort. Second, some renters have moved out of city centres and into the suburbs or beyond, knowing they would commute less often. The third effect is perhaps not as intuitive: working from home more often has caused a surge in household formation. In their search for more space, groups of renters who share an apartment are more likely to separate and look for a new apartment on their own or in a smaller group, especially in the most dense and expensive areas. This has already been observed in the U.S. markets,² but similar drivers are at play in Europe. The growing number of households is a driver of strong rental growth in city centres despite outmigration.

The combination of these effects has created two demand trends. Some renters want to stay in city centres and get more space by renting alone or in smaller groups. The higher individual cost of doing so means they may need to lower the quality of their housing. This group creates more demand for city centre midmarket apartments that offer good value for the space provided. Here, the specification and amenities of the building matter less. Other renters are moving away from the city centre to cheaper areas while hoping to maintain the level of building quality and amenities with which they are familiar.

Despite these compromises to keep housing costs affordable, people who can work from home are still spending more on housing than those who cannot work remotely. There is a clear need for more midmarket apartments in city centres and good-quality suburban housing, as demand for better value and more space outstrips supply.

2 Ozimek and Carlson (2023), Remote Work and Household Formation





DYNAMIC, LOCAL REGULATION

Regulation is an important factor in residential investment. There is a wide range of relevant regulations: planning, construction, rent controls, tax treatment and more. Authorities can apply measures at city, regional or national level and change them often, sometimes at short notice. Berlin introduced a rent cap, the Mietendeckel, in January 2020, but the German Constitutional Court declared it unconstitutional in April 2021, effectively reversing the rent cap. In Scotland, for example, a temporary rent freeze was fast-tracked through Scottish Parliament in 2022, and today there remains a temporary 3% cap on rent increases during private tenancies that should stay in place until at least 30 September 2023.

The dynamic nature of regulation makes it hard for investors to implement a broad European or global strategy. Residential investment, therefore, needs local expertise to avoid the pitfalls of changing regulation and see the opportunities it may present.



ESG FOCUSES ON SOCIAL FACTORS

ESG frameworks could put as much focus on social factors in the coming years as they have done with environmental factors. Although it is intuitive to think residential has a strong link to its local community, we currently lack the standards to measure its social value, impact and responsibility.

However, there has been some recent progress. At a corporate level, GRI include additional disclosures for affordable and social housing, and SASB has some social topics that relate to residential construction. At the fund or portfolio level, INREV's new reporting standards include a wide range of social KPIs. EPRA and GRESB include community engagement and impact in their reporting frameworks. At the asset level, only FITWEL includes social responsibility in its certification framework that is applicable to multifamily, and WELL has an ongoing pilot for multifamily assets that includes social metrics.³

3 ULI, 2022, Mapping ESG: A landscape review of certifications, reporting frameworks and practices. Various organisations' documentation

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