2022/23

Knight Frank

European Living Sectors Investor Survey

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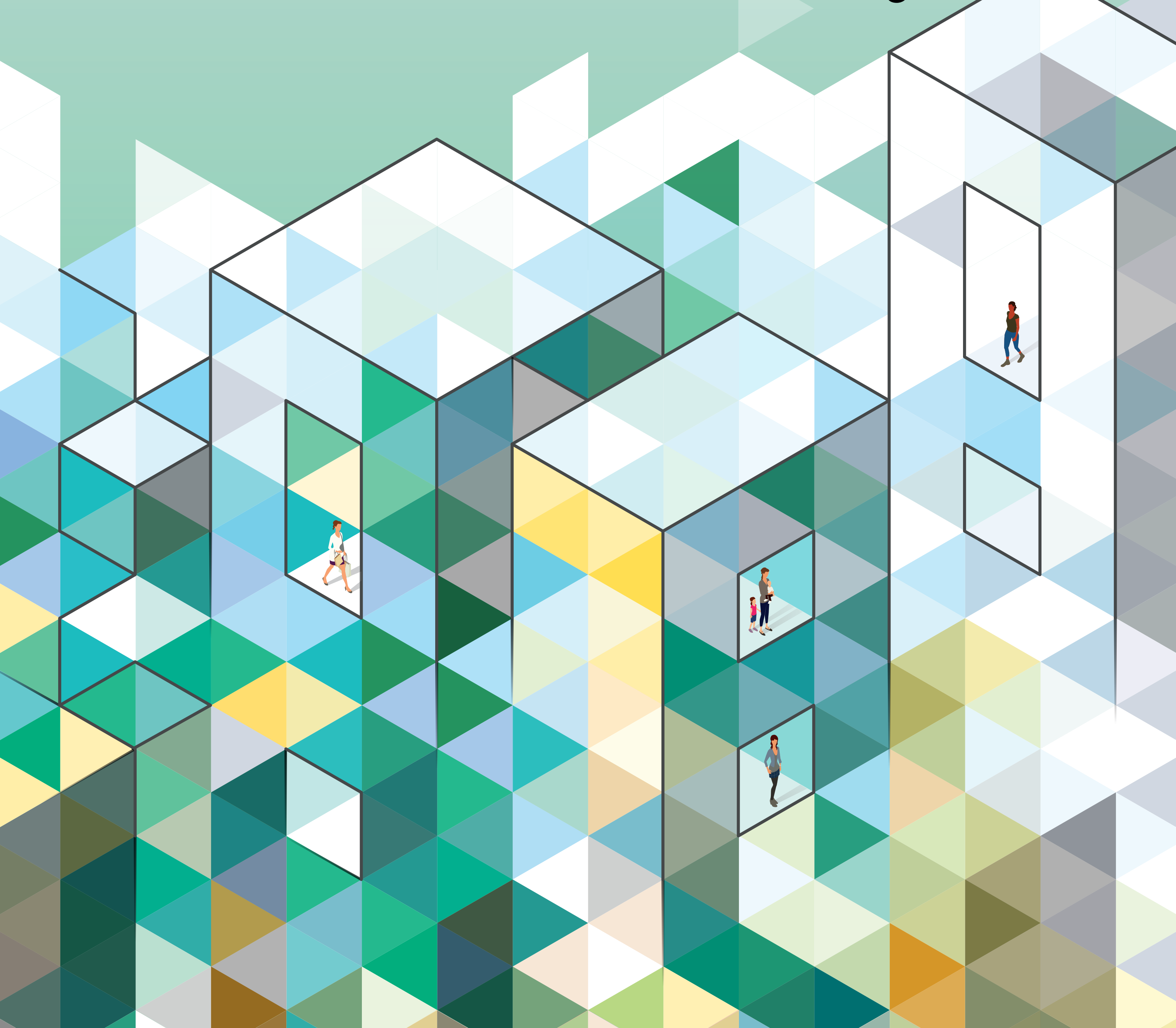


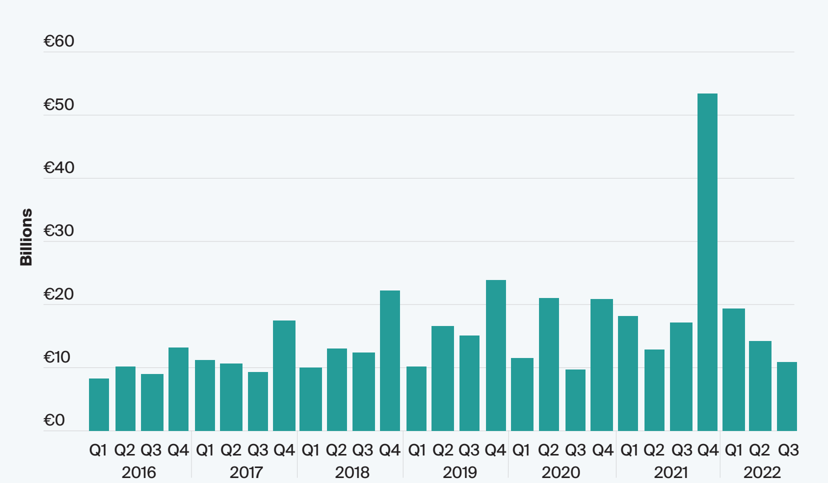
SHORT-TERM CHALLENGES, LONG-TERM PERFORMANCE

With investors still digesting the changing macroeconomic backdrop, the current approach to European Living markets are mixed, but underlying fundamentals remain strong.

Institutional investment into European Living sectors totalled an estimated €44.5 billion over the first three quarters of 2022. An expected slowing of investment in Q3 relative to last year meant that overall, volumes in 2022 are 8% lower than the same period last year.

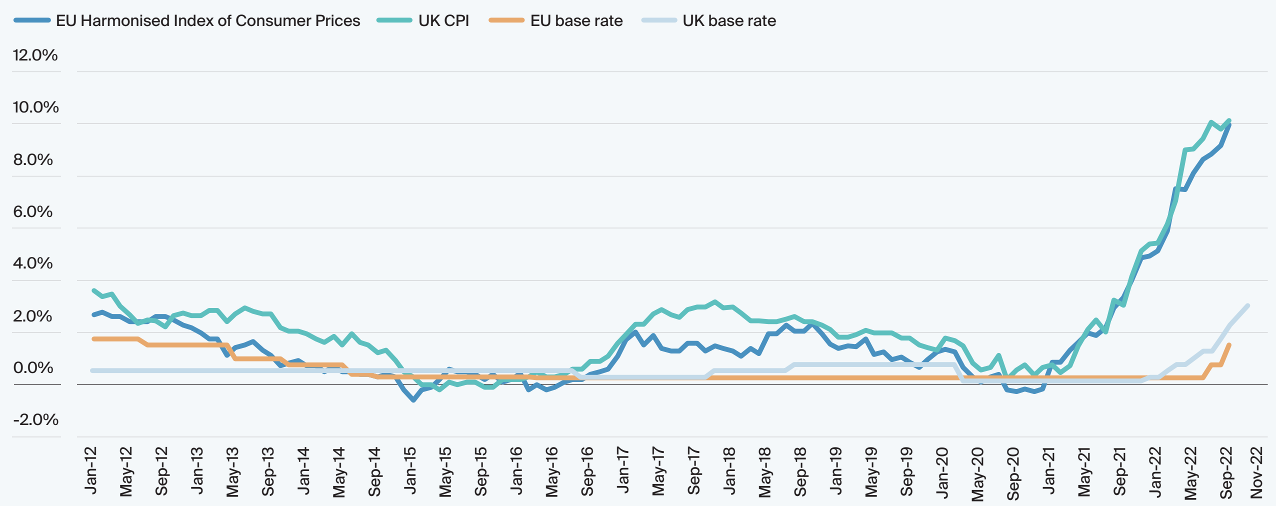
Some €10.8 billion was invested in the third quarter, provisional data shows, down 37% on the same period of 2021. The slowing in investment volumes in the most recent quarter is reflective of the challenging macro-economic and geopolitical backdrop across Europe, and indeed the world. Lower investment volumes ultimately demonstrate the sharp impact that soaring inflation, higher commodity prices and supply side constraints have had on real estate.

European Living sector investment cools after strong start to the year
Quarterly volumes



Source: Knight Frank Research / RCA *provisional

Inflation and interest rates on the rise



Source: Knight Frank Research / ECB / BoE

To combat this, central banks globally have started tightening monetary policy. The European Central Bank (ECB) raised rates for the first time in 11 years in July and again by a record 75bps in September and October. In the UK, the Bank of England has raised rates higher at each of its last eight meetings.

Euro area swap rates have risen as a result, leading to a rapid repricing of debt markets – a move which has increased costs for some investors and has given those seeking higher returns something to consider, with returns being affected across the capital spectrum.

The impact of this is borne out in the results of our survey of more than 40 investors active in the Living sectors across Europe. Just 15% said that the current geopolitical and macro-economic environment was having “no impact” on their investment strategy.

In practice this has meant some investors, particularly those that require debt funding, putting investment plans on hold. Others, keen to remain active, have looked to reduce or renegotiate offers. Marketing processes for assets being launched or in the market have generally been extended, while transactions have taken longer to close, with investors considering the impact of changing swap rates on their hold periods, or in some cases re-basing pricing.

Investors keen to deploy capital

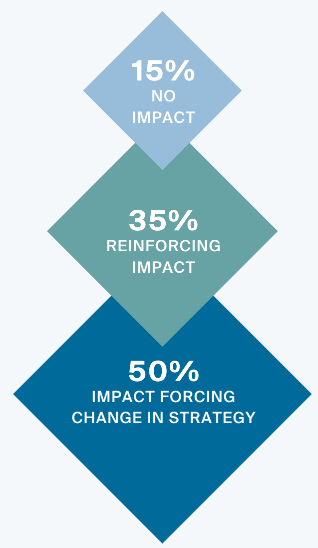
Despite these challenges, investors remain committed to the Living sectors. Underlying supply and demand imbalances remain severe in many markets. Student numbers are rising and, in areas with an ageing population, demand for seniors housing continues to grow.

We may see an uptick in activity in the final months of the year, as investors get more comfort in where values sit longer term. At the time of writing, pricing looks to be stabilising , though discounts vary across markets as far out as 50 to 75 basis points.

Residential rental markets are also seen as offering some hedge against spiralling inflation thanks to the presence of shorter leases and a frequent turnover of tenants. Indeed, more than a third (35%) of the investors we spoke with said that the current backdrop is having a “positive reinforcing impact” on their investment strategy.

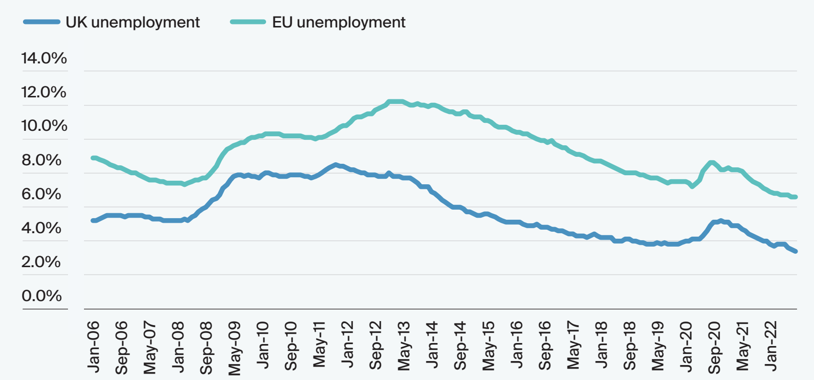
There are other reasons to be optimistic. Labour markets across Europe remain tight. The unemployment rate in the Eurozone fell to a low of 6.6% in August, while in the UK it dropped to 3.5%, the lowest rate since 1974, in part thanks to a rising number of people opting to move into education. Wages are also rising, supporting rental growth.

What impact is the current geopolitical and macroeconomic uncertainty having on your investment strategy?
% of respondents



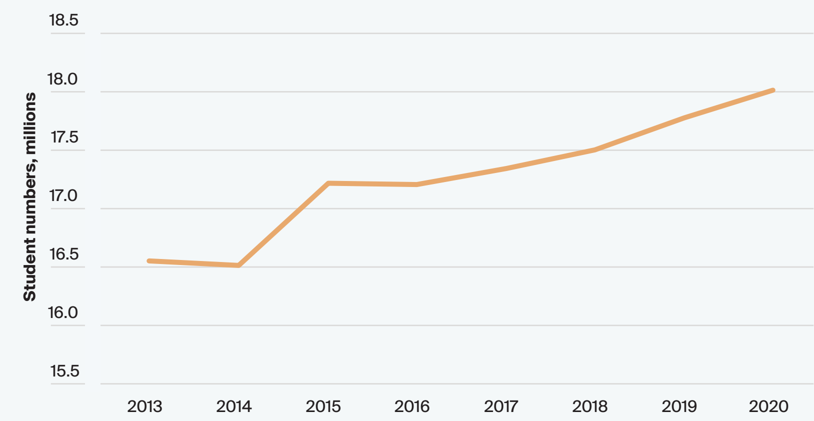
Source: Knight Frank Research

Strong labour markets



Source: Knight Frank Research / ONS / Eurostat

Rising student numbers
EU Higher Education enrollments



Source: Eurostat

Increasing interest rates will have a greater impact on the affordability of mortgages, with more aspiring homeowners looking to rent as a result. This will be particularly relevant in markets where there are already stringent rules around borrowing ratios.

Finally, while inflation is currently high, long term inflation expectations are more modest. The ECB forecasts inflation of 6.8% in 2022 and 3.5% in 2023 before returning closer to the 2% target in 2024. A similar pattern is forecast in the UK.

Fundamentals remain supportive

Long-term shifts in demography, such as shrinking household sizes and people living longer, as well as deteriorating affordability in sales markets, and rising student numbers will support activity across the Living sectors.

The defensive nature of these sectors in times of economic uncertainty is cause for optimism too – particularly with student housing having proven highly defensive for investors during previous crises thanks to its counter-cyclical demand profiles as more people head to university to re-skill. Rented accommodation generally gives residents flexibility in times of uncertainty, along with relative affordability and the chance to live in areas they wouldn't necessarily afford if buying.

Living sectors captured the second largest share of total European investment volumes during the first nine months of the year, only behind offices.

This is reflected in the results of our survey, with 75% of respondents saying they plan to "significantly increase" their total investment into European Living markets over the coming five years. Significantly, a quarter (25%) said that this would represent a doubling of current investment.

Living taking an increased share

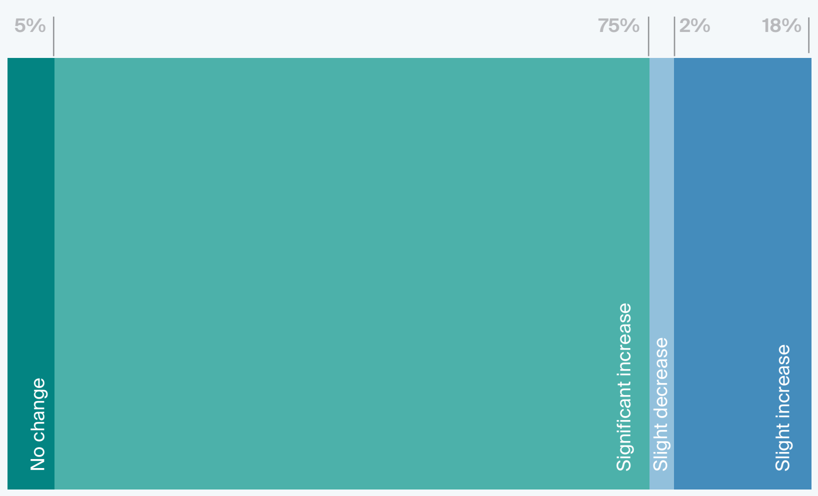
Living sectors captured the second largest share of total European investment volumes during the first nine months of the year, only behind offices. In total, provisional data suggests that Living accounted for 22% of total European CRE investment between January and September. The Living sectors have increased their share of total investment for seven consecutive years. Cross-border investment accounted for 53% of the total so far in 2022.

As investors and developers strive to create solutions to construction cost inflation, open book construction contracts, hedging costs and increasing swap rates, the student, BTR and seniors housing sectors will remain attractive to global investors, especially as we see the curve flatten and fixed price contracts return. In particular, the strength of the US dollar could lead to an uptick in US capital looking at European markets in 2023.

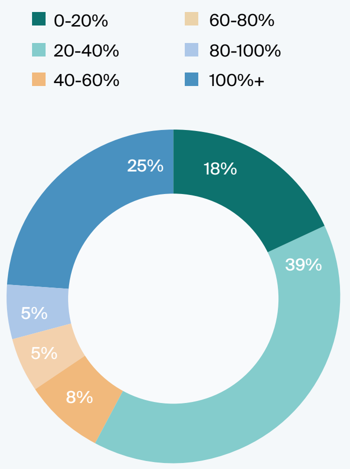
A recent survey of more than 600 global investors as part of Knight Frank's Active Capital research, found that 46% plan to target the Living sectors over the next 18 months.

According to our survey results, the top three markets offering the best opportunity for investment are the UK, Spain and Germany with a focus on liquidity and safe havens with some opportunistic investment.

Taking a five year view, how do you expect your total investment into Living sectors to change by 2027?
% of respondents

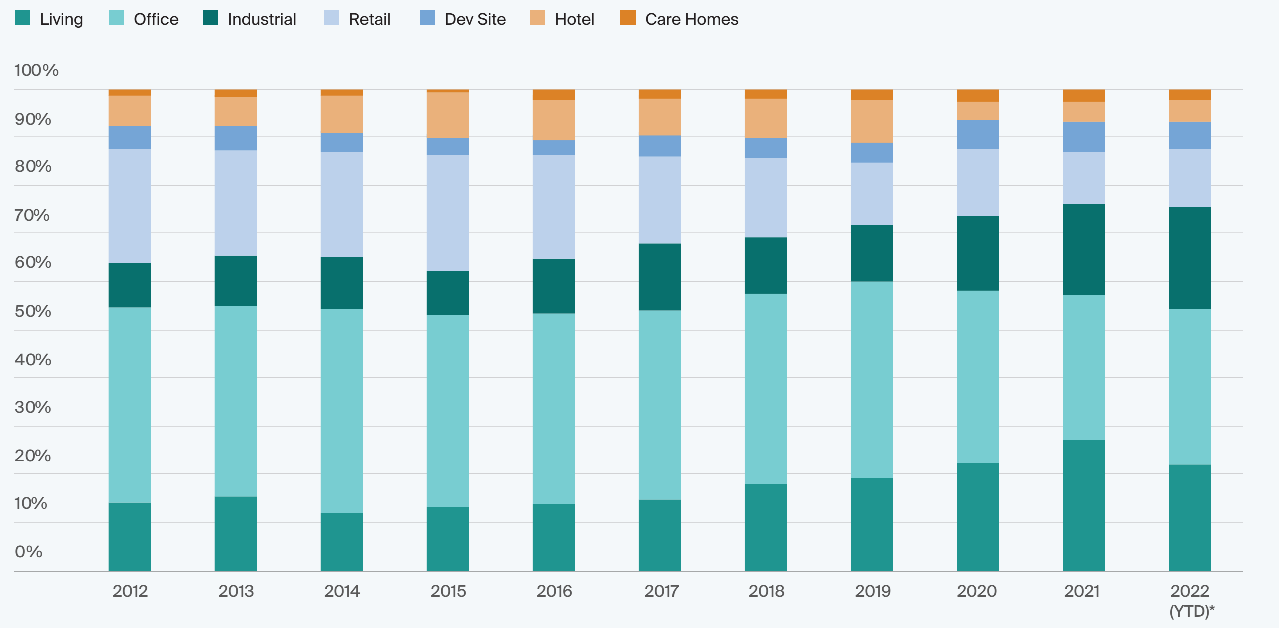


How much do you plan to invest in Living sectors over the next five years, as a % of total current investment?
% of respondents



Source: Knight Frank Research

Living sectors capture a greater share of European CRE investment
Investment as a proportion of total



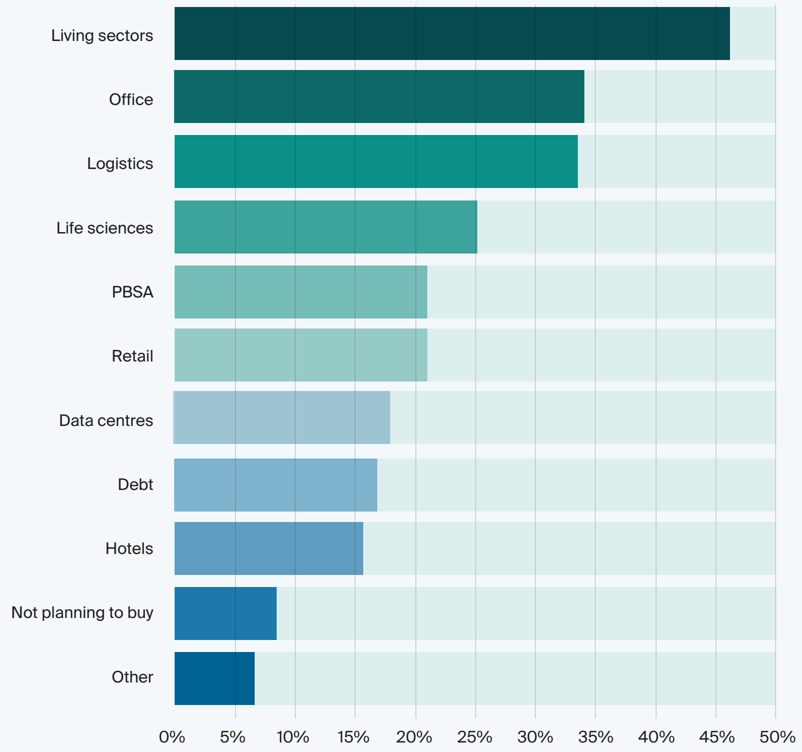
Source: Knight Frank Research / RCA *provisional

Where are the top locations for investment?
% of survey respondents (top five locations)

1	UK
2	Spain
3	Germany
4	Ireland
5	Italy

Source: Knight Frank Research

Which sectors are you targeting over the next 18 months?
Active Capital webinar 2022/23 live poll results



Source: Knight Frank Research

LIVING MARKET SPOTLIGHTS

AVERAGE LIVING INVESTMENT VOLS (LAST THREE YEARS) | FULL-TIME STUDENT NUMBERS | % OF HOUSEHOLDS RENTING PRIVATELY | % OF POPULATION AGED 65+

IRELAND

JOAN HENRY, CHIEF ECONOMIST AND HEAD OF RESEARCH, IRELAND

€2.1BN | 0.2M | 14% | 15%

Investment into the Living sectors accounted for 37% of the overall investment spend in the Irish market, the strongest sector in the quarter. Multifamily continues to be the most dominant sub sector.

Investors have recently shown significant interest in the Purpose Built Student Accommodation (PBSA) sector, which is considerably undersupplied. The countercyclical nature of this sector also makes it attractive. In Dublin there are five PBSA developments on site and due for completion between Q4 2022 and Q3 2024, which will add 2,800 bed spaces. The majority are investor or developer-led schemes with only one being university owned.

Given current global economic and geopolitical conditions which are impacting investor sentiment and pricing, we expect the remainder of 2022 to be subdued by comparison to investment activity year to date. These challenging global conditions come at a time when demand continues to significantly outstrip supply across all categories of housing and when employment is set to remain underpinned by growth sectors.

SPAIN

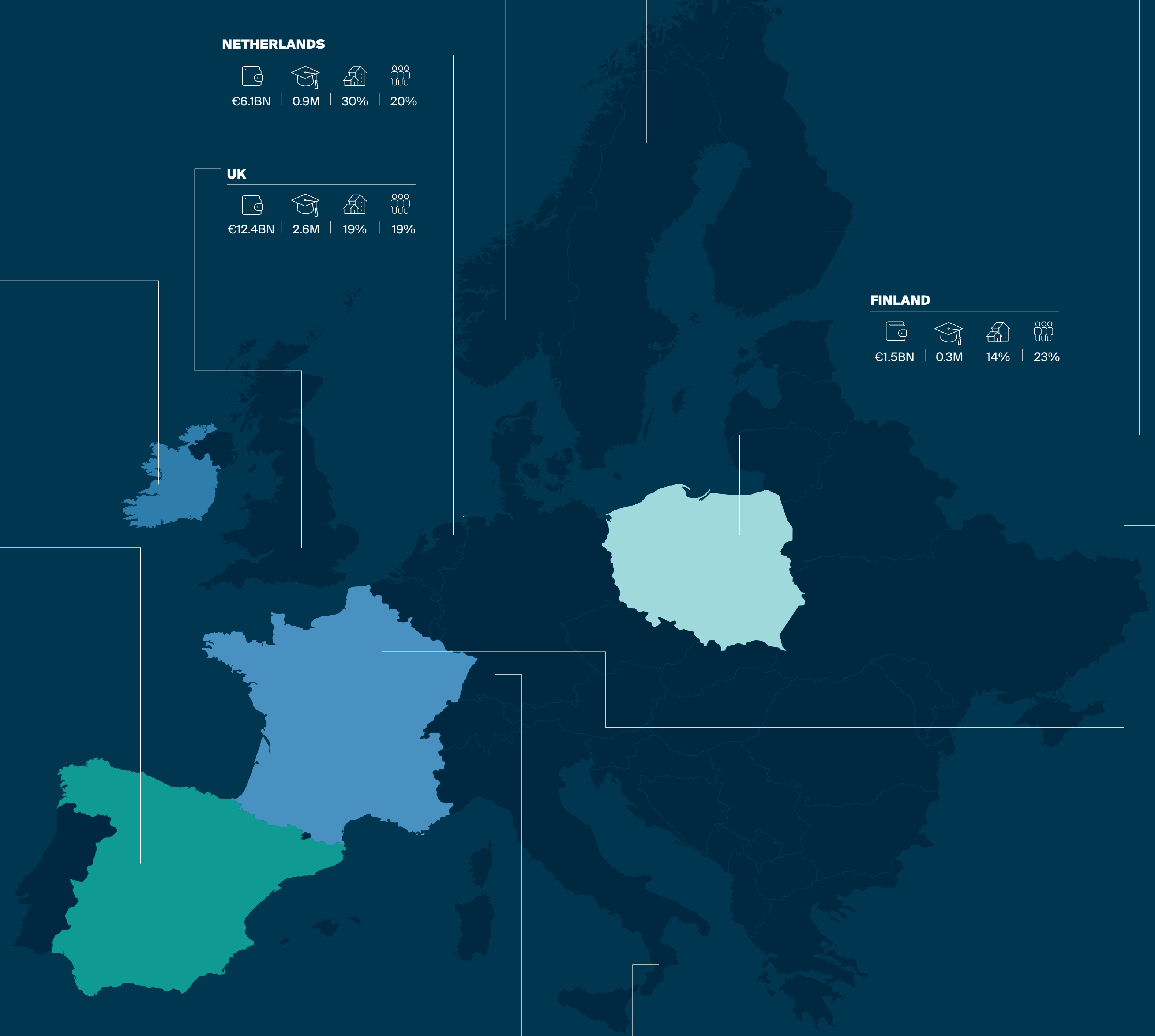
ROSA URIOL, DEPUTY HEAD OF VALUATIONS AND HEAD OF RESEARCH, SPAIN

€2.3BN | 2.1M | 15% | 20%

Investor appetite for rental product remains strong, underpinned by supply and demand imbalances across the country. Accordingly, investment volumes during the first nine months of the year have been robust and currently sit 60% higher than the total recorded in 2021.

Among the main investors are investment funds, institutions, and developers, who have accounted for 40%, 23% and 20% of total investment so far this year respectively. Against this backdrop, specialist built to rent supply is increasing (albeit from a low base), and we are also seeing developers and banks reposition build to sell assets for the rental market.

Like other markets across Europe, higher inflation is a cause for concern as interest rates rise, though a lack of supply of new homes may mean that the development sector is more insulated from rates hikes, and banks continue to provide finance. We expect investors will be more selective as a result but yields in the Living sectors are still above those of other assets classes, such as government bonds or fixed income.



NORWAY

€0.5BN | 0.3M | 17% | 18%

SWEDEN

€7.6BN | 0.4M | 35% | 20%

NETHERLANDS

€6.1BN | 0.9M | 30% | 20%

UK

€12.4BN | 2.6M | 19% | 19%

FINLAND

€1.5BN | 0.3M | 14% | 23%

GERMANY

€29.8BN | 3.3M | 43% | 22%

ITALY

€0.4BN | 2.0M | 17% | 24%

POLAND

ELŻBIETA CZERPAK, HEAD OF RESEARCH, POLAND

€0.5BN | 1.4M | 3% | 19%

The Living sectors remain at a nascent stage of development, but activity and interest in acquiring or developing assets is rising. Interest is coming from both new entrants to the market in Poland, as well as domestic investors, some of whom are pivoting from other real estate sectors to diversify their portfolio of assets.

Additionally, we are seeing an increasing amount of M&A activity among residential developers. By the end of this year, we expect a handful of single-asset transactions will complete as more investors look for opportunities in the Living sectors due to its good performance in Poland.

Rental demand is strengthening, while student numbers are robust. Interest rates have risen from 1.75% in December 2021 to 6.75% in October this year, pushing affordability in the sales market, while a surge in the number of residents in Poland will create additional demand for housing, especially on the rental market.

FRANCE

DAVID BOURLA, CHIEF ECONOMIST AND HEAD OF RESEARCH, FRANCE

€5.4BN | 2.7M | 15% | 21%

While the size of the French Living markets remains relatively modest compared to the UK and Germany, its importance is growing. A record €7.1 billion was invested in 2021, accounting for 21% of total French real estate investment. In the first half of 2022, just under €4 billion has been spent, 20% lower than in the first half of 2021.

French-based investors remain dominant, accounting for between 80% and 90% of total investment over the last 3 years, but cross-border capital is rising. Last year, PGIM and Hines made their first residential acquisitions in France. Several are also active in the serviced residential market with the acquisition of senior and student residences by Lasalle IM, M&G and ABRDN in 2022.

While the pandemic has accelerated diversification strategies, domestic and cross-border appetite for student and senior housing should not wane despite the economic slowdown and the changing financial environment. A scarcity of existing supply, growing student and senior populations and the search for secure investments will continue make serviced residential properties a sought-after asset.

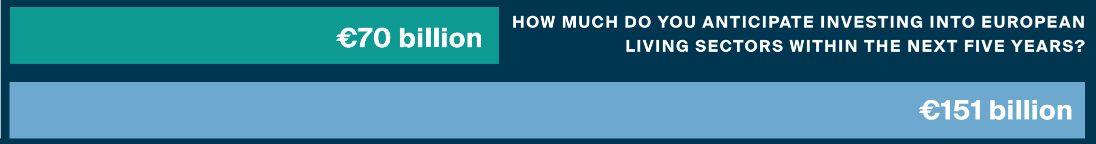
Source: Knight Frank Research / RCA / Eurostat / World Bank
NB. latest available data

EUROPEAN LIVING INVESTOR SURVEY

The Knight Frank European Living Investor Survey represents the views of 44 institutional investors currently active in the sector who currently account for €70 billion in Living assets under management across Europe

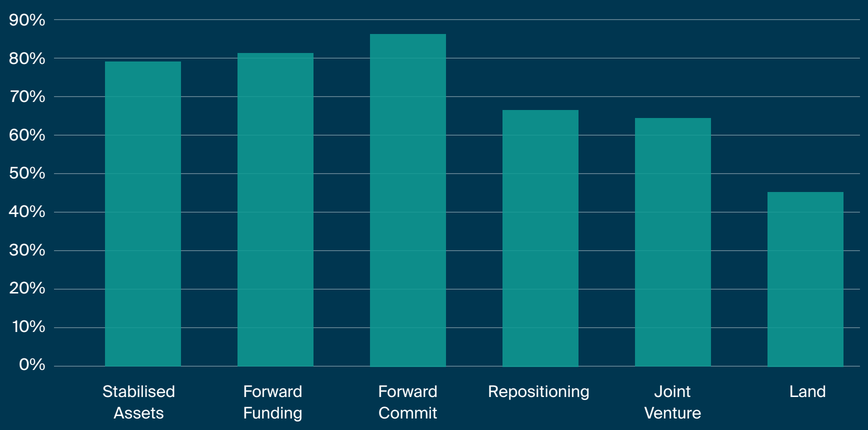
WHAT IS YOUR TOTAL CURRENT AND COMMITTED INVESTMENT ACROSS EUROPEAN LIVING ASSETS?

HOW MUCH DO YOU ANTICIPATE INVESTING INTO EUROPEAN LIVING SECTORS WITHIN THE NEXT FIVE YEARS?

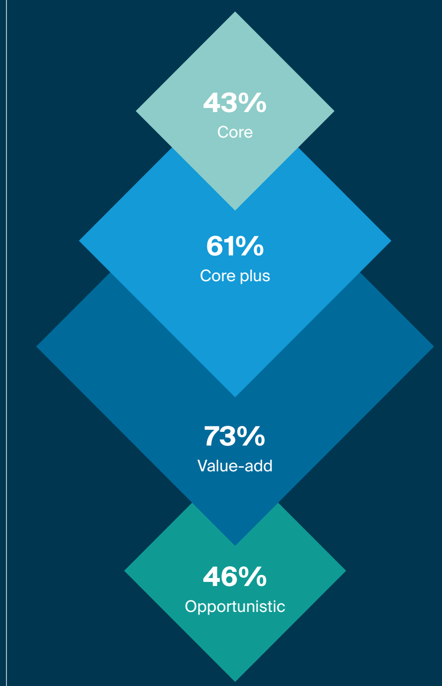


115%
PROJECTED INCREASE IN INVESTMENT BY SURVEY RESPONDENTS

WHICH OF THE FOLLOWING INVESTMENT PROPOSITIONS ARE YOU CURRENTLY TARGETING? Respondents can choose multiple answers



WHICH OF THE FOLLOWING INVESTMENT PROFILES ARE YOU CURRENTLY TARGETING?
Respondents can choose multiple answers

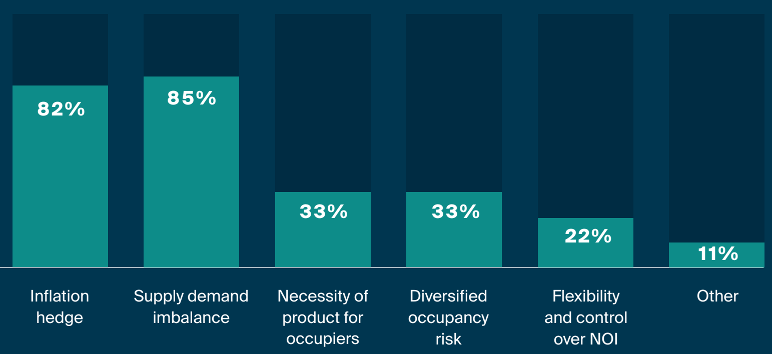


32%
OF RESPONDENTS ACTIVE ACROSS ALL EUROPEAN LIVING SECTORS CURRENTLY

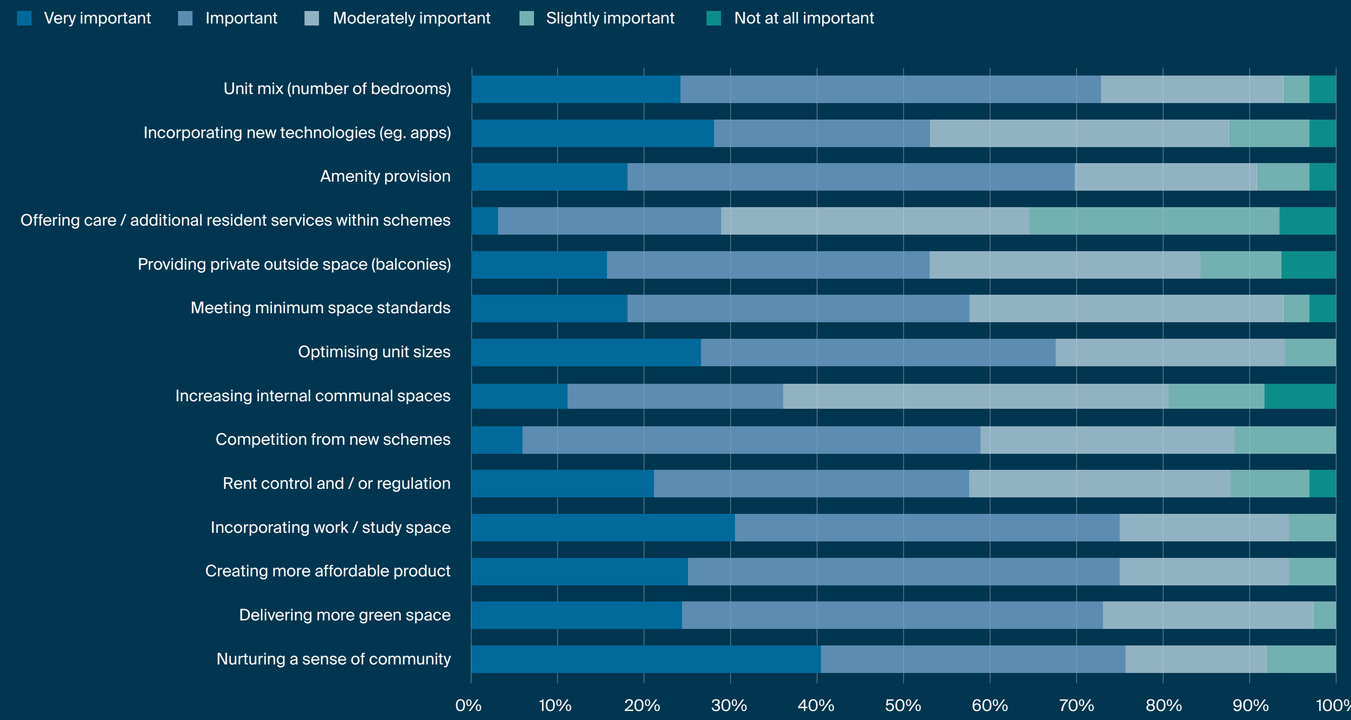
52%
OF RESPONDENTS EXPECT TO BE ACTIVE ACROSS ALL EUROPEAN LIVING SECTORS WITHIN FIVE YEARS

DO YOU THINK LIVING SECTORS WILL OUTPERFORM OTHER REAL ESTATE SECTORS IN 2023?

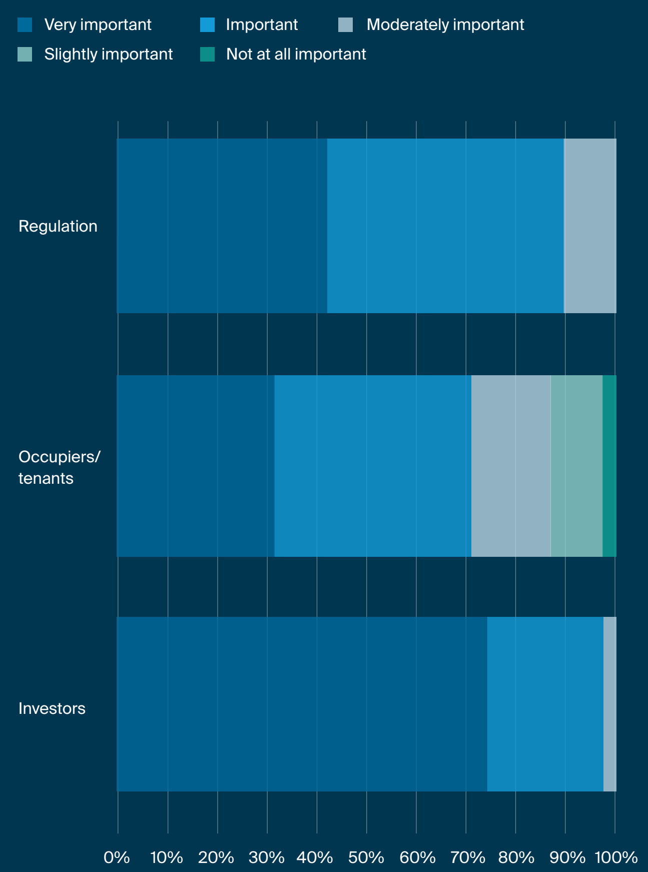
WHY DO YOU THINK LIVING SECTORS WILL OUTPERFORM IN 2023?



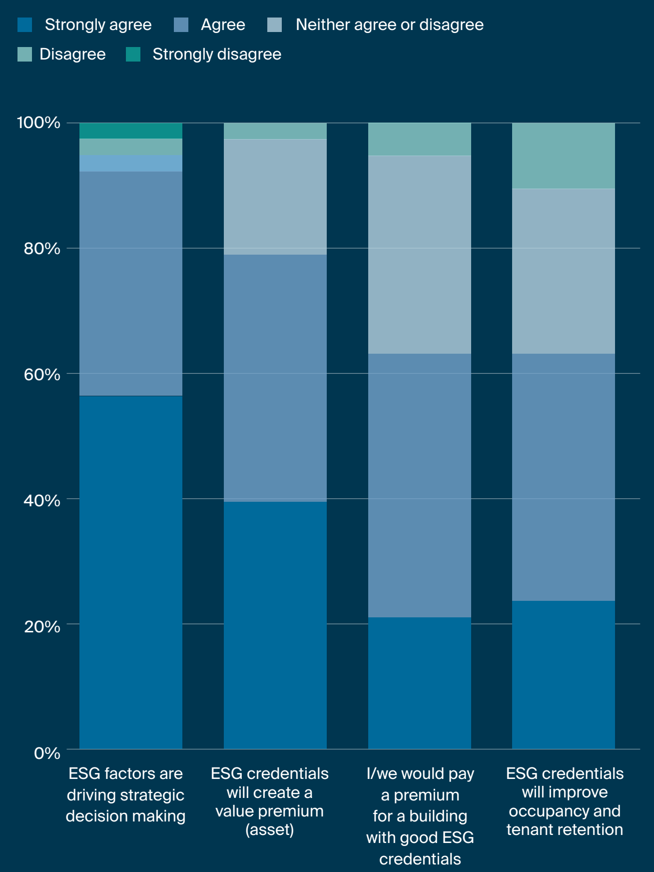
HOW IMPORTANT ARE THE FOLLOWING FACTORS IN INFLUENCING SCHEME DESIGN AND BUSINESS STRATEGY?



HOW IMPORTANT ARE THE FOLLOWING IN DRIVING HOW YOU APPROACH ESG?



TO WHAT EXTEND DO YOU AGREE WITH THE FOLLOWING STATEMENTS?



Q&A: Making sense of debt markets

Lisa Attenborough, Head of Debt Advisory at Knight Frank, reveals how the real estate debt market has reacted to recent events and discusses where residential sits in the new landscape.

What impact are volatile swap rates and the changing economic landscape having on lending to residential real estate across Europe and how will this change over the coming year?

Over the past six months, driven by economic uncertainty following the war in Ukraine and near record high levels of inflation, the lending market has experienced seismic change. The most notable impact of this uncertainty has been the sharp increase in interest rates and corresponding volatility in the swap markets.

After benefitting from over a decade of historically low interest rates, borrowers are now faced with increased debt servicing costs. Any loans which were secured against assets acquired in 2018 and beyond must be reviewed in the context of their maturity dates and the new all-in cost of debt that will need to be serviced from existing income. Interest cover ratios and leveraged returns will need to be adjusted to reflect this higher all-in cost.

> “We expect lender appetite to remain resilient in the coming year, albeit on a more selective basis.”

How do you envisage lender appetite evolving over the coming year and which types of lenders will be most active?

We expect lender appetite to remain resilient in the coming year, albeit on a more selective basis. It's important to note that unlike in previous economic downturns, banks remain incredibly well capitalised and willing to make funds available for the right opportunities.

With regard to the alternative lending market, the top 30 debt funds in Europe have raised over $80bn in the preceding five-year period, an increase of 12% on the previous year. This weight of capital will need to be deployed and due to reduced transaction volumes in Q4 of 2022, we expect debt funds to actively seek out high quality lending opportunities.

> “For new or existing operational assets, occupancy and room rates must be underwritten at levels supported by the appropriate demand characteristics.”

At the same time, due to wider macro-economic volatility, all lender types will be increasingly discerning and forensic in their assessment of risk. This may lead to deals taking longer than the norm to complete.

Which specific property types will lenders be more willing to lend against over the coming 18 months?

Debt providers will look for several key features when assessing lending opportunities in the coming 18 months:

- Firstly, there will be a flight to quality. Lenders will look to back well-capitalised and experienced sponsors, who are seeking sensible leverage which is supported by a thorough business plan.
- The business plan itself must demonstrate sustainability of income. For new or existing operational assets, occupancy and room rates must be underwritten at levels supported by the appropriate demand characteristics and located in those jurisdictions which demonstrate pronounced undersupply.
- For development facilities, the appraisals must contain a sufficient level of contingency and cost overrun guarantees will come back into focus.

How is lender appetite varying across regions?

Certain European jurisdictions benefit from a broader range of lenders than others. For example, Germany, Ireland and the Netherlands attract interest from banks and alternative lenders alike. Within those markets, build to rent and residential opportunities located in major cities can attract the keenest debt terms.

In Spain the domestic banks continue to service their client base well, albeit providing finance at the senior end of the capital stack. For higher leverage or more core-plus deals, the debt funds are becoming increasingly active as they see the underlying demand for purpose built residential units.

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