

Why European alternative sectors provide a haven for investors in inflationary times

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Real estate investors today face the greatest economic uncertainty in over a decade. The ongoing economic crisis is anything but conventional, defined by supply chain turmoil, geopolitical upheaval, spiraling consumer prices, and the reversal of a 40-year decline in interest rates. This paper analyses the role that European alternative property can play in generating secure returns for investors at a time of high inflation and widespread volatility.

We begin with a quick recap of macroeconomic conditions. GDP growth expectations have been upended in the past six months. At the beginning of the year, the consensus forecast predicted moderate growth in Europe with a short-lived bout of modest inflation, averaging 2.5% this year. But the rosy outlook has been superseded; the base case now is that of falling output in the second half of 2022 and high inflation to persist through the next 12 to 18 months. Given the strength and persistence of inflationary forces (e.g. high commodity prices, low unemployment, etc.), and aggressive monetary tightening elsewhere, the European Central Bank has been forced to raise interest rates for the first time in 11 years. Financial markets expect the tightening bias to remain through 2024. Asset prices – primarily stocks and bonds – have corrected sharply as a result.

The last time European property markets faced a period of such economic stress was during the Global Financial Crisis, when commercial real estate lost about 20% of its value. Residential markets also suffered sharp losses, not only in the riskier “peripheral” countries but also in established markets such as the UK and the Netherlands. A like-for-like comparison with the GFC may not be appropriate; mortgage lending standards have improved, equity buffers are stronger, and debt

securitisation is much less widespread. Nonetheless, property prices are coming under some pressure. In the aftermath of the pandemic, a combination of factors (ultra-low mortgage rates, fiscal assistance, excess savings, need for extra space) led to rapid house price growth across developed markets. In the UK, prices rose by 20% after the pandemic; in Germany, the Netherlands, and Sweden, price growth ranged between 27% and 33%. Some correction to property prices in response to weaker macro conditions is now anticipated, although the consensus holds against a disorderly pullback.

We at Heitman believe that alternative property sectors in Europe will provide the best opportunities to take advantage of the coming market dislocation, offering more attractive risk-adjusted returns than the commercial sectors. We base this view on three main factors, all of which lean favourably for alternatives:

- resilience during downturns
- enhanced inflation protection
- value creation opportunities

The alternative sectors all have excellent fundamentals, but as yet they are relatively less understood and have fewer investors targeting them. They are also heavily fragmented. Ownership is largely non-institutional, lot sizes tend to be smaller, and operations are often suboptimal. Alternatives thus offer the broadest playing field for tactical opportunities for owner-managers who want to generate active returns.

Resilience

Institutional investors are becoming increasingly aware of the resilience of alternative sectors across the economic cycle; this in part accounts for the rapid growth in investment volumes in recent years. Alternative performance is driven by fundamentals that have proved to be largely independent of fluctuations in output. The most important of these drivers are needs-based demand, inelastic supply, and stabilising regulation.

Perhaps the most compelling example of needs-based demand

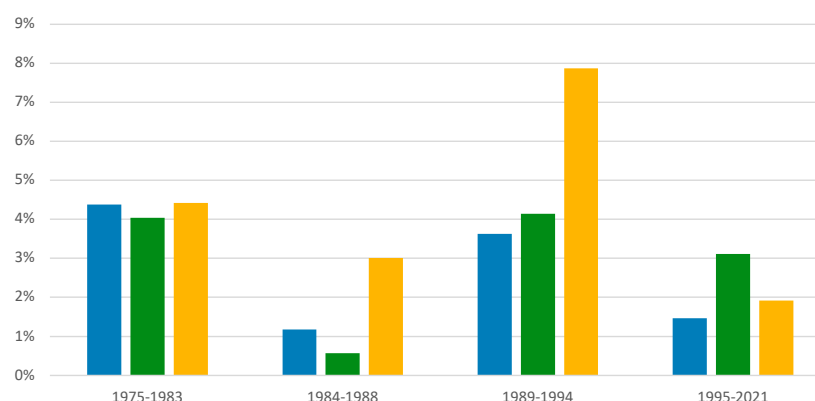
comes from senior housing in what is the world’s “greyest” continent. Senior housing demand in Europe is typically less discretionary than in the US. The independent-living model is less prevalent, and admission to an assisted-living facility often follows after a major event at home. Thus, resident needs tend to be more acute, and the average stay is 10 months shorter than in the US. Self-storage provides another data point; UK surveys show that two-thirds of demand follows from a life event, unrelated to economic conditions.

Meanwhile, the demand-supply gap continues to widen in alternatives. Substantial housing shortages exist in Western Europe, resulting in low vacancy rates, short void periods, and steady rent growth. In major markets like the UK and the Netherlands, the current housing deficit has been estimated at 1.2 million and 400,000 units respectively. In the context of stretched supply chains, rising cost of commodities, and persistent shortages of labour, we conclude that housing construction will fall further behind annual requirements. Returning to

pace with burgeoning demand. The investment opportunity in the top 10 markets has been calculated in excess of €10 billion.

Positive fundamentals generate rent growth even in tough times, but rent regulation also plays a key role. Unregulated residential markets like the UK and the Netherlands have seen rapid rent growth, and double-digit increases have become common in the largest metros like London, Manchester, and Amsterdam. In regulated markets, where current rents below market levels create upward reversionary potential, we expect steady catchup growth ahead. Notably in Germany, backward-looking market-indexing tools such as the Mietspiegel generate a ratcheting effect, delivering smooth and stable rent increases over time. Replacement costs above capital values also form an attractive barrier against supply. There is, of course, the risk of more intrusive regulation, as recently seen in Ireland and Spain. Agile investors will look to shift their focus towards more light-touch markets such as the UK and Scandinavia.

Chart 1: German residential prices and rents in inflationary periods



Source: Bulwiengesa; World Bank

the example of senior housing, the UK, Germany, and the Netherlands have all experienced significant declines in bed capacity in the past 20 years. On the other hand, Green Street estimates that in the largest markets, the senior housing sector will need to expand capacity by at least 70% by 2050 (more than 2 million beds, combined) to keep

Inflation hedge

As inflation is likely to remain at the forefront of investor concerns, it is useful to re-emphasise the traditional role of real estate as an inflation hedge. Sensitivity studies carried out by Heitman Research (on global asset classes between 2005 and 2021) show that total returns for real estate

are positively correlated to inflation, whereas returns are negatively correlated for bonds and equities. The inflation-fighting capability of real estate derives primarily from the structure and duration of leases. Although commercial leases are gradually becoming more flexible, the dominance of traditional lease models (e.g. 3-6-9 leases in Paris offices) still works against timely inflation pass-through.

The key to effective inflation pass-through lies in the frequency of adjustment, and it is here that the attraction of alternatives becomes evident. Unlike the multi-year leases that prevail in commercial property, leases in the alternative sector are typically short-term. They can last as little as 1-3 months in self-storage, or the duration of a semester or a school year in student housing. Survey data from the UK storage sector shows that 20% of all household tenants vacate their unit within 3 months, and 50% within 12 months. The operator is therefore at liberty to adjust rents for incoming tenants to reflect broader increases in the cost base. The introduction of “hotel-style” dynamic pricing helps to make the process of revenue maximisation even more precise and efficient. Our model shows that for every 1% change in inflation, storage generates significantly higher gross returns than what is generated by commercial property in a similar scenario. Evidence from the REIT sector also suggests that inflation protection is strong in European alternatives, with more than half of all income in inflation-linked categories.

The predominant risk is that of more stringent rent regulation. Unlike corporations, households have votes and the perception of “excessive” rents can become a political issue that directly impacts residential investors and landlords. This has been seen notably in the case of the 2020 Berlin rent freeze (eventually deemed unconstitutional), and more recently in the Irish residential sector. Regulators have capped annual rent growth at 2%, thus restricting the ability of Irish landlords to pass on inflation.

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Value creation opportunities
Needs-based demand, supply constraints, and regulatory regimes provide solid protection against downside risks. Yet the relative nascency and operational complexity of European alternatives also point to strong upside potential in driving higher returns, even in a difficult macro environment. Particularly in the value-add segment, alternatives offer the greatest scope for active asset management (alpha rather than beta) and for taking advantage of market dislocation. Traditional sectors typically rely on asset-level initiatives, but alternative investors can find opportunities for further value creation at the operator and portfolio level. These opportunities are appealing in a period of rising interest rates when achieving returns through continuous yield compression is no longer very likely.

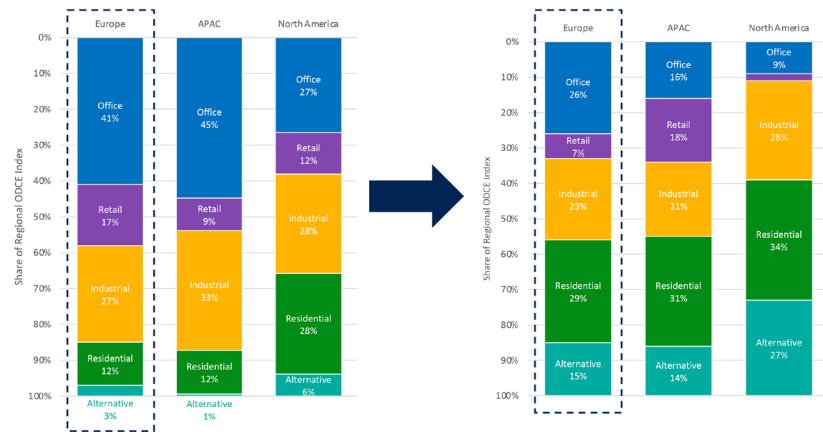
The potential for operator-level value creation is clear. A recent academic paper on the UK self-storage sector, produced by Heitman Research and published by Investment Property Forum, revealed that self-storage offers both downside protection and significant upside for value investors. For instance:

- a 10% decline in house prices brings about only a 3.2% reduction in storage rents
- but improvements in marketing operations can drive rent premiums of up to 25%
- large operators (10 stores or more) can command rents that are 36% higher than those achieved by smaller operators

These large premiums can be captured through fairly quick and inexpensive improvements in operations. Examples of such “low-hanging fruit” include faster responses to customer enquiries, posting rental prices on the website, deployment of dynamic pricing models, etc.

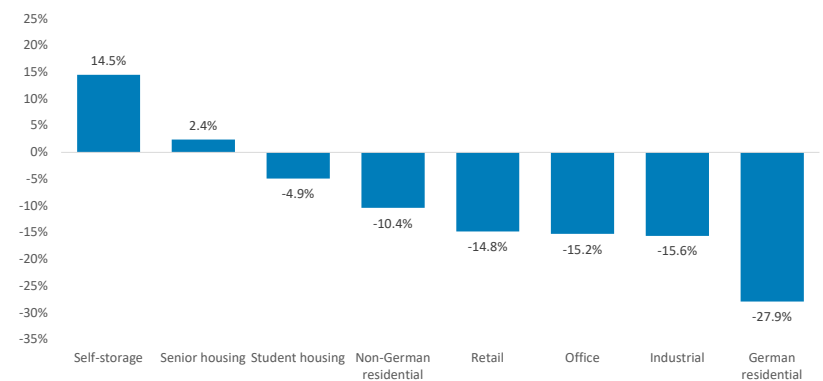
Operator markets are also heavily fragmented in European alternatives. Turning to senior housing, we find that the top five for-profit operators manage only 13% of beds in UK, 12% in Germany, and 5% in the Netherlands. There is huge potential for consolidation, which in turn could lead to economies of scale and better profitability. Indeed, the recent escalation in costs – in food, energy, and labour – is pushing weaker operators out (thus tightening supply) and forcing others to seek sale and leaseback agreements. The pandemic has also helped to expose the shortcomings of existing stock: a third of beds in the UK lack en-suite bathrooms, while a quarter of beds in Germany are in double occupancy. Investors thus have a clear opportunity to drive returns through renovation and development of the type of product that appeals to an increasingly wealthy and quality-conscious target population.

Chart 2: Ongoing capital rotation towards European alternatives



Source: NCREIF, INREV, and ANREV ODCE Fund Indices; Heitman Research
Source: INREV Investor Intentions Survey 2022; Heitman Research

Chart 3: Premium/discount to GAV by European REIT sector, 30 August 2022



Source: Green Street Advisors

For bearing operational risk, alternative investors are compensated with an attractive yield premium over mainstream sectors. Self-storage offers a 140 bps yield spread over logistics, senior housing a 150 bps spread over residential. This means that alternative returns have a solid income component and are less reliant on capital appreciation. Admittedly, the premium represents higher risk, but experienced investors with a hands-on approach are well-rewarded for their ability to navigate that risk.

Capital rotation out of commercial sectors and into European alternatives is ongoing. Annual investments in commercial property have remained broadly flat since 2015 (at around €150 billion per year), but they have tripled in European residential, now closing in on €100 billion annually. Public market investors have also thrown their weight behind alternatives, persuaded by the overall narrative of resilient demand, inelastic supply, and enhanced inflation protection. Self-storage, student housing, and senior housing REITs continue to trade at premiums to gross asset value in Europe, even as office, retail, and even industrial REITs trade at deep discounts. This suggests that investors do not expect imminent or material declines in alternative property values. The divergence between German and non-German residential REITs highlights the importance of perceptions around

inflation pass-through (which is affected by varying regulatory regimes) and development risk.

The next phase of the market is likely to be marked by ongoing macro volatility and a correction in real estate values. While acknowledging the probability of the latter, we note that higher borrowing costs and inflation will hit weaker alternative operators the hardest. This should create opportunities for investors to target groups with poor balance sheets but with capable management teams and attractive long-term occupational prospects. Even when the cyclical rebound arrives, commercial sectors are likely to remain challenged by deep structural changes, chiefly the ongoing shifts to remote working and e-commerce. By contrast, alternative sectors will continue to benefit from urbanisation trends, lifestyle and behavioural shifts, as well as growth in key demographic segments. Real estate investors must focus on the long term, beyond the immediate economic difficulties ahead. We argue that alternative assets provide the best route for European real estate investors to ride out the period of uncertainty, and to position themselves for the eventual recovery.