REAL ESTATE

European Real Estate: The Build-to-Rent Opportunity

INSIGHTS

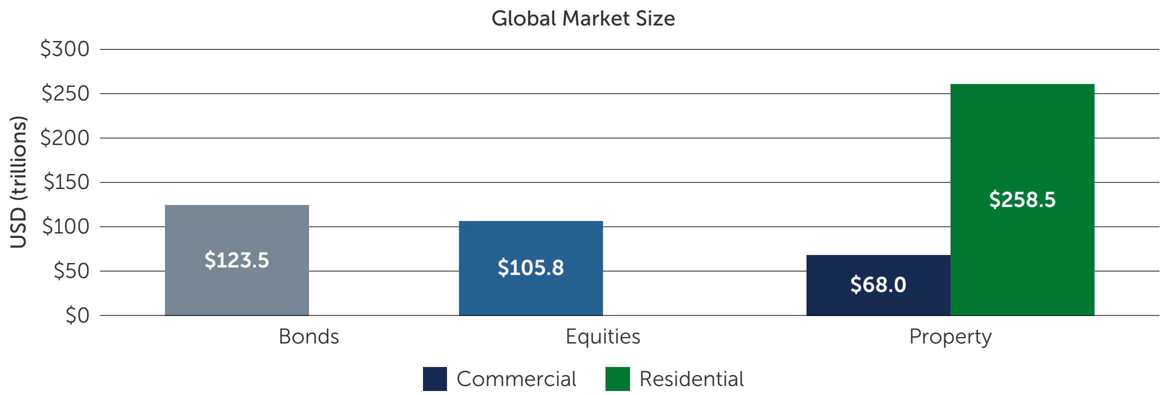
Paul Stewart
Head of Europe & Asia Pacific
Real Estate Research & Strategy

Given the sizeable opportunity set, potential for superior long-term risk-adjusted returns, strong diversification benefits and inflation protection, there is a compelling opportunity in European residential real estate.

A Large and Diverse Opportunity Set

The residential property market offers enormous scope for both property investors and multi-asset allocators to widen their investment universe. The global residential property market has a total estimated value of $258.5 trillion, which dwarfs its' commercial sibling ($68 trillion) and more than doubles the potential investment capacity of the global equity ($105.8 trillion) and global bond ($123.5 trillion) markets.[1] With a global glut of savings outpacing the supply of institutional grade investments, residential property is an opportunity set that is simply too big for institutions to ignore.

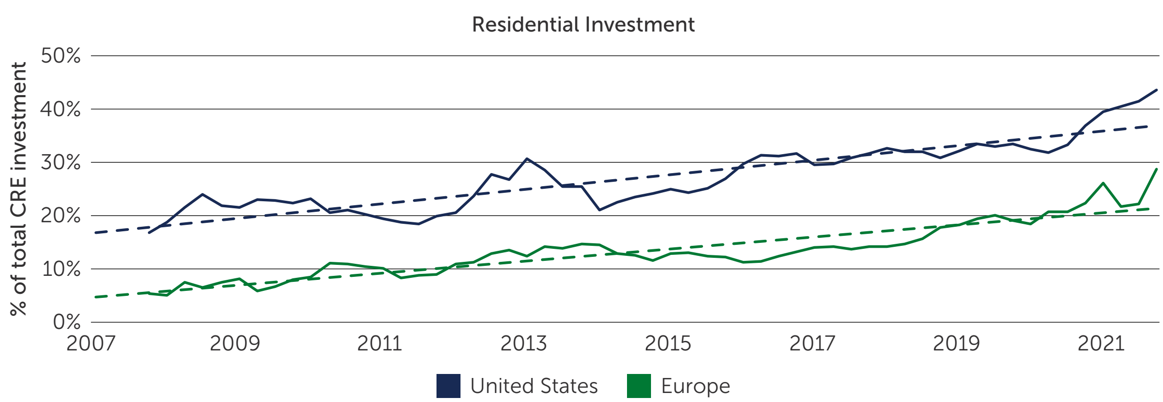
Figure 1: Residential Property Market Dwarfs the Global Equity and Bond Markets



Sources: SIFMA. As of July 2021. Savills. As of December 2021.

Investment interest in European residential property, in particular, has surged of late, with transaction volumes trebling to nearly 30% of total deal flow over the past decade.[2] This rise has been driven not only by a desire to plug the gap left by retail property's e-commerce-driven demise, but also by the compelling investment rationale. Given the residential sector accounted for over 40% of transactions in 2021 in the U.S., we anticipate that this sector will become the dominant form of property investment in Europe within the next five years—or perhaps even sooner.

Figure 2: An Existing Need to Plug the Retail Investment Gap



Source: RCA. As of February 2022.

1. Sources: Savills; SIFMA. Data for equities and bonds as of July 2021, and data for real estate as of December 2021.
2. Source: RCA. As of February 2022.

The sheer variation within the residential opportunity set is an added attraction, and includes offerings such as:

- Holding existing private rented sector (PRS) stock
- Creating new stock via build-to-rent (BTR) or build-to-sell (BTS) in multifamily apartments/or single family dwellings
- Land banking
- Access to niche sectors (e.g. co-living and micro-apartments)
- Targeting specific demographics via senior living and purpose built student accommodation (PBSA)

The rise of impact investing and a greater focus on ESG have also boosted the emphasis on "social" factors, which has increased the volume of capital targeting social rented and affordable housing markets. Indeed, the sector's diversity raises the possibility that an investor could build a highly diversified investment portfolio that solely comprises residential assets.

A Strong Investment Track Record

When comparing European property to the U.S. equity and bond markets over the past 20 years, commercial property has generated an average return of 6.7% pa, and residential property a return of 7.4% pa—similar to U.S. equities, but significantly higher than U.S. Treasury bonds (4.9% pa).[3] U.S. corporate bonds had the second-highest return overall at 7.8% pa, only bettered by industrial property at 8.9% pa.[4] On the understanding that return volatility only reflects one aspect of investment risk, a typical multi-property sector portfolio (All-Property) would have achieved these returns with significantly less 'risk' than the leading global investment markets. Through the period, for every 1% of total return, a property investor would have experienced roughly a quarter of the volatility experienced by a U.S. stock market investor and about half that experienced by U.S. government and corporate bondholders.[5] Residential volatility is even lower than the All-Property average. This indicates that on a risk-adjusted basis, both commercial and residential European property look highly compelling historically. Modern portfolio theory (MPT) is based on the assumption that diversification reduces total portfolio risk,

Figure 3: Risk-Adjusted Returns

20-year (2000–2020)	European All-Property	European Residential	European Retail	European Offices	European Industrials	U.S. Equities (S&P 500)	U.S. T. Bond (10-year)	U.S. BAA Corporate Bonds	Cash (3-month T. bill)
Total Return (% pa)	6.7%	7.4%	6.2%	6.2%	8.9%	7.4%	4.9%	7.8%	1.3%
Volatility (SD)	4.1%	2.4%	6.4%	3.9%	6.8%	17.6%	7.8%	6.7%	1.5%
Risk Adjusted Return	1.61	3.05	0.95	1.56	1.30	0.42	0.64	1.15	0.87

Source: RCA. As of February 2022.

3, 4, and 5. Sources: Bloomberg; MSCI. As of March 2022.

with an optimal portfolio comprising assets that are not subject to simultaneous price swings. Correlation is a decent indicator of potential investment diversity, with the least correlated assets expected to provide the greatest risk reduction benefits.

Over the past 20 years, the U.S. stock market and U.S. Treasury bond market show a negative correlation of -0.6, which reflects that bonds typically outperform in downswings and periods of uncertainty, while equities rise to the fore when the economy gains momentum and investor confidence rises. The correlation between U.S. equities and European property is low, at 0.33, highlighting the significant diversification benefits of a multi-asset portfolio. The slightly negative correlation to U.S. bonds (-0.24) highlights that the relationship between interest rates and property pricing and returns is not as direct as most assume. This is because property is a hybrid investment type—part bond, but with a more generous income return, and part equity with a rental growth component.

While some benefits will accrue for commercial property investors diversifying into residential, a strong correlation (+0.84) suggests these benefits will be lower than for a multi-asset investor. This suggests that residential property returns are still very much "real estate" in nature. Instead, the primary attraction of residential investment, in our view, has to be the opportunity to expand into the world's largest, but not yet fully realized, asset base on a superior long-term risk-adjusted basis.

Figure 4: Correlation Matrix

Correlations (20-year)	European All-Property	European Residential	European Retail	European Offices	European Industrials	U.S. Equities (S&P 500)	U.S. T. Bond (10-year)	U.S. BAA Corp Bonds	Cash (3-month T. bill)
European All-Property	1.00	0.84	0.85	0.94	0.91	0.33	-0.24	0.06	0.32
European Residential	0.84	1.00	0.53	0.89	0.75	0.13	-0.02	-0.16	0.58
European Retail	0.85	0.53	1.00	0.63	0.67	0.19	-0.26	0.15	0.24
European Offices	0.94	0.89	0.63	1.00	0.86	0.35	-0.18	-0.02	0.36
European Industrials	0.91	0.75	0.67	0.86	1.00	0.34	-0.23	0.03	0.17
U.S. Equities (S&P 500)	0.33	0.13	0.19	0.35	0.34	1.00	-0.60	0.48	-0.26
U.S. T. Bond (10-year)	-0.24	-0.02	-0.26	-0.18	-0.23	-0.60	1.00	-0.13	0.10
U.S. BAA Corp Bonds	0.06	-0.16	0.15	-0.02	0.03	0.48	-0.13	1.00	-0.23
Cash (3-month T. bill)	0.32	0.58	0.24	0.36	0.17	-0.26	0.10	-0.23	1.00
CPI Inflation (E.U.)	-0.14	0.04	0.09	-0.24	-0.30	-0.49	0.42	-0.28	0.46

Sources: Bloomberg; MSCI. As of March 2022.

A Still Highly Compelling Proposition

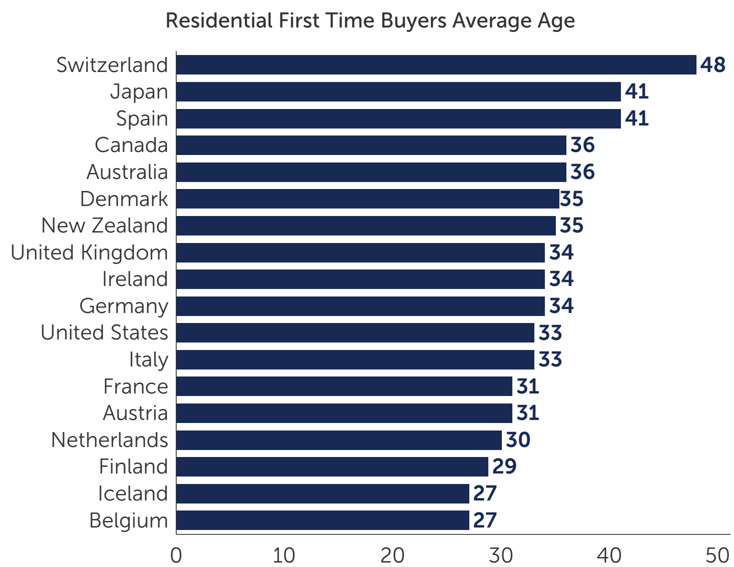
While history is always instructive, the economic environment going forward will inevitably be different than that which generated the investment returns of the past 20 years. For example, part of the positive story around residential property over the past two decades is, undoubtedly, connected to the relentless march downward of inflation and thus interest rates. As a result, yields have been driven down and returns pushed up across all asset classes (not just commercial and residential property).

Even ignoring current inflationary challenges, such interest rate gains are now likely in the past. However, other favorable secular tailwinds that are supportive of residential investment remain very much at play. First, poor buyer affordability will likely persist. With the 'institutional memory' of the GFC potentially remaining a factor for the next decade, the current circumspect post-GFC residential mortgage-lending environment should persist. This implies that large deposits will continue to frustrate buyers, as is evident in the rising average age of first-time home buyers (FTBs), which is boosting and sustaining future rental demand.

Underpinning high house prices and the resultant lack of buyer affordability, new development (supply) has consistently lagged the household formation rate (i.e. housing market balance).

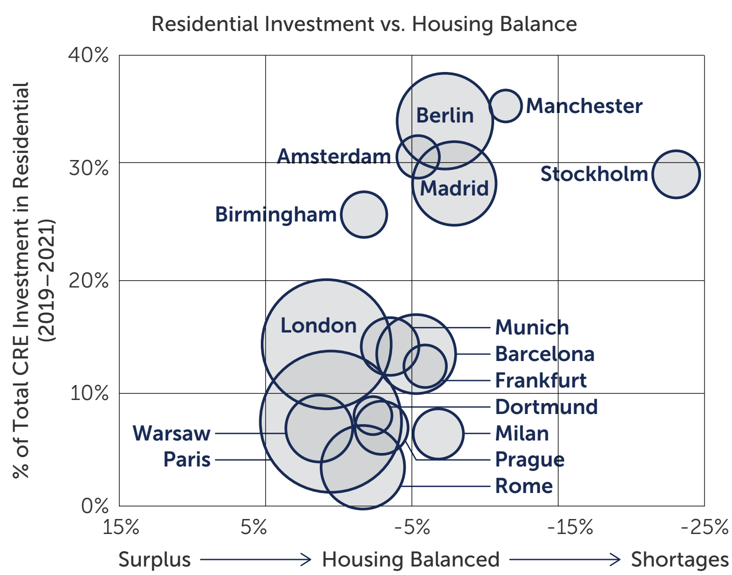
As **Figure 6** highlights, the recent rise in residential investment activity has broadly tended to skew toward locations where housing shortages are more pronounced. Albeit, this measure of the housing market balance does not account for stock obsolescence, which would right-shift and improve the values on the x-axis, indicating more pronounced shortages than the chart suggests. While still meaningful on a relative basis, a better absolute measure would be net additions to stock instead of gross development levels, but a consistent and timely European dataset does not yet exist.

Figure 5: Poor Affordability is Pushing up the Age of the Average First-Time Home Buyer



Source: OECD. As of 2020.

Figure 6: Recent Investment Tends to Focus on Locations With Lower Long-Term Housing Supply



Source: ECB; Oxford Economics. As of February 2022.
Note: Size of bubble denotes market size; Housing balance = Household formation less new completions/stock.

"The primary attraction of residential investment, in our view, has to be the opportunity to expand into the world's largest, but not yet fully realized, asset base on a superior long-term risk-adjusted basis."

Inflation Protection, But Not a Hedge

Inflation anxiety is currently rife in capital markets, and investors are on the hunt for assets offering protection. Property is not a 'hedge' in the truest sense of the word, like a financial instrument such as a TIP or Index Linked Gilt. This is evident in a nil and negative correlation between property returns and inflation. The same is true of other non-index linked asset types. For instance, U.S. equity returns are negatively correlated to inflation (-0.49), but fixed income U.S. government bonds show a surprising positive correlation (+0.42). At least corporate bond returns show the expected sign (-0.28).

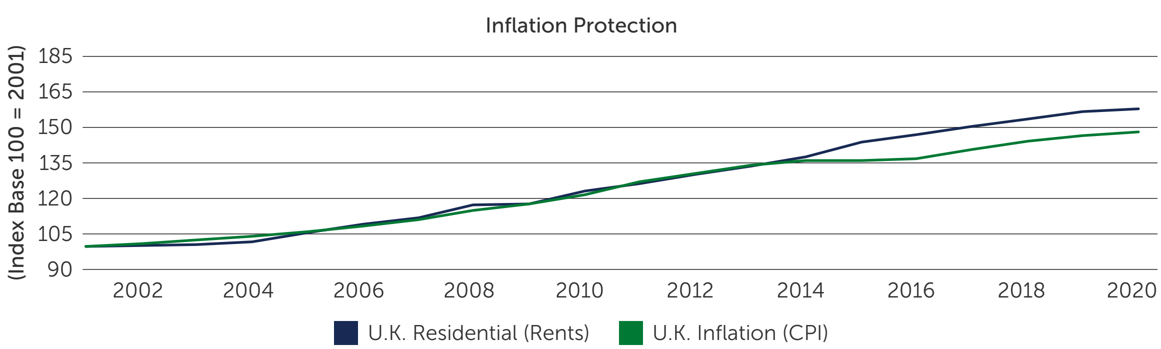
Figure 7: Inflation Correlation

20-year (2000–2020)	CPI Inflation (EU)
European All-Property	-0.14
European Residential	0.04
European Retail	0.09
European Offices	-0.24
European Industrials	-0.30
U.S. Equities (S&P 500)	-0.49
U.S. T. Bond (10-year)	0.42
Corporate Bonds	-0.28
Cash (3-month T. bill)	0.46

Source: Bloomberg; MSCI. As of March 2022.

Yet, in theory, property rental income—and thus prices—tend to rise with economic activity and therefore general prices over the longer term. This means real estate rental cashflows have the potential to offer a good degree of insulation against rising prices over the long-term. Looking briefly at U.K. data, few assets are likely to provide cashflows that are as good a long-term match for inflation as residential rents.

Figure 8: U.K. Residential Rents are More Than a Match for Inflation Over the Longer Term



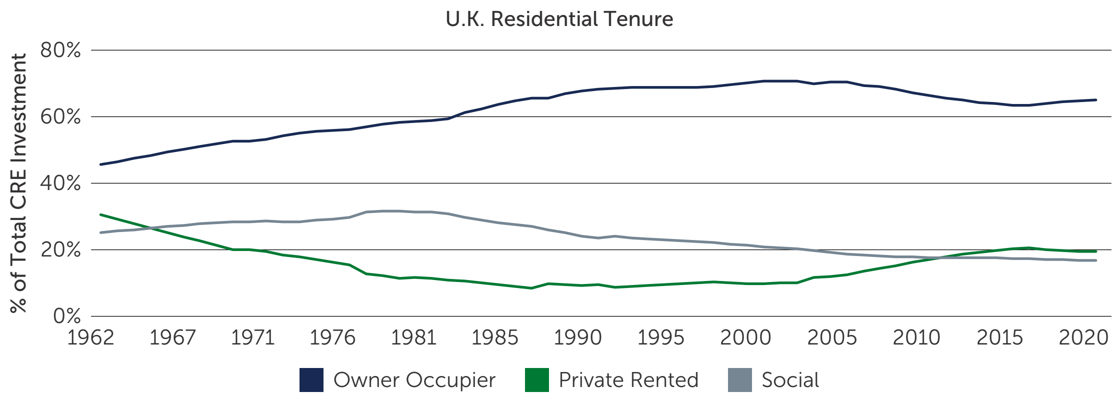
Source: MSCI Annual Index. As of February 2022.

To Hold or to Build?

While home ownership is still the aspiration for most, numerous surveys[6] suggest that poor buyer affordability has meant the millennial and now Gen-Z generations are increasingly agnostic. Instead, the surveys suggest that these generations prefer the flexibility to delay financial obligations and retain higher disposable income levels to enjoy a better standard of living, in more attractive locations than ownership might otherwise allow.

This trend is readily apparent in the U.K. housing market, where the housing tenure has been steadily moving away from ownership, with the proportion of PRS doubling to around 20% in the first 15 years of this century.[7]

Figure 9: Preferences in Housing Tenure Continue to Evolve



Source: www.gov.uk. As of February 2022.

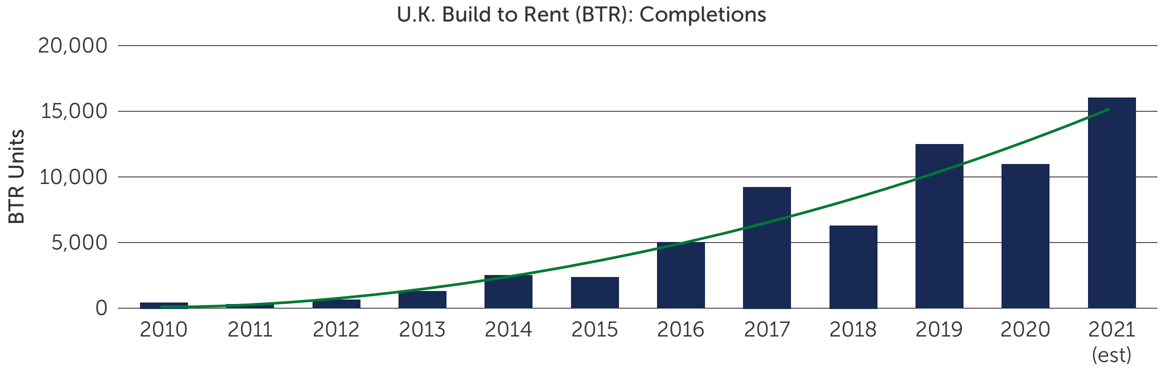
However, in the past five years, the rise of PRS has slowed and the decline in ownership appears to have stabilized. This might be partly a result of the pandemic, with a reduced need for labor market mobility that renting affords. However, given the strong house price growth, buyer affordability actually deteriorated during the pandemic. Instead, the likely reason resides elsewhere and relates to changes in previously favorable U.K. income and transfer tax treatment for smaller, private buy-to-let (BTL) landlords—which resulted in a demand reduction from this investor group.

With the number of households in England alone forecast to grow by nearly 1.6 million by the end of the decade,[8] the challenge to provide affordable high-quality residential accommodation is now acute. The sharp rise in institutional capital targeting this sector is evident in new build-to-rent (BTR) completions, which have grown at a near exponential pace. However, with BTR completions for 2021 and 2022 likely to total less than 20,000 units each year, this is a small change against the U.K. government's stated election manifesto, which is to seek to rebalance the housing market with a targeted 300,000 new homes pa. Clearly, there is a huge opportunity to provide new, high-quality yet affordable rental accommodation.

6. Source: CBRE Research. As of December 2017.
7. Source: www.gov.uk. As of February 2022.
8. Source: Office for National Statistics. As of June 2020.

"Going forward, the ongoing localized housing shortages and poor buyer affordability underpin a positive investment performance outlook for the rental sector."

Figure 10: BTR has Huge Scope for Growth in the Context of Stated Government Housing Targets



Source: British Property Federation. As of Q3 2021.

Institutional funding methods for BTR schemes generally involve partnerships with specialist developers via forward funding or forward purchase arrangements. Today, BTR projects are increasingly assessed on a cash flow basis over a longer investment horizon—just like mainstream commercial assets. The days of assuming a higher vacant possession value and having to break-up ownership and sell off individual units, are going. Alpha generating asset management initiatives are possible in these purpose-built residential schemes, where the focus is on customer-centric service, high specification, high amenities, and the use of the latest technological and sustainability innovations to minimize running costs. Where a better living experience presents, evidence suggests that fewer tenant moves will occur, which implies increased security of tenure for the customer, and longer lease lengths and lower voids for the investor.

Key Takeaway

The residential property market offers investors a number of benefits, from the enormous scope—for both property investors and multi-asset allocators—to widen their potential investment universe, to the potential for superior long-term risk-adjusted returns and particularly strong diversification benefits for multi-asset investors. Moreover, in the U.K., residential rents are more than a match for inflation over the longer term.

Going forward, the ongoing localized housing shortages and poor buyer affordability underpin a positive investment performance outlook for the rental sector. More specifically, within the U.K., institutional interest in BTR development is growing rapidly, but output falls well short of the government's housing target. In our view, this is creating a considerable investment opportunity.

Barings is a $391+ billion global investment manager sourcing differentiated opportunities and building long-term portfolios across public and private fixed income, real estate and specialist equity markets. With investment professionals based in North America, Europe and Asia Pacific, the firm, a subsidiary of MassMutual, aims to serve its clients, communities and employees, and is committed to sustainable practices and responsible investment.*

IMPORTANT INFORMATION

Any forecasts in this document are based upon Barings opinion of the market at the date of preparation and are subject to change without notice, dependent upon many factors. Any prediction, projection or forecast is not necessarily indicative of the future or likely performance. Investment involves risk. The value of any investments and any income generated may go down as well as up and is not guaranteed by Barings or any other person. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. Any investment results, portfolio compositions and or examples set forth in this document are provided for illustrative purposes only and are not indicative of any future investment results, future portfolio composition or investments. The composition, size of, and risks associated with an investment may differ substantially from any examples set forth in this document. No representation is made that an investment will be profitable or will not incur losses. Where appropriate, changes in the currency exchange rates may affect the value of investments. Prospective investors should read the offering documents, if applicable, for the details and specific risk factors of any Fund/Strategy discussed in this document.

Barings is the brand name for the worldwide asset management and associated businesses of Barings LLC and its global affiliates. Barings Securities LLC, Barings (U.K.) Limited, Barings Global Advisers Limited, Barings Australia Pty Ltd, Barings Japan Limited, Baring Asset Management Limited, Baring International Investment Limited, Baring Fund Managers Limited, Baring International Fund Managers (Ireland) Limited, Baring Asset Management (Asia) Limited, Baring SICE (Taiwan) Limited, Baring Asset Management Switzerland Sarl, Baring Asset Management Korea Limited, and Barings Singapore Pte. Ltd. each are affiliated financial service companies owned by Barings LLC (each, individually, an "Affiliate"). Some Affiliates may act as an introducer or distributor of the products and services of some others and may be paid a fee for doing so.

NO OFFER: The document is for informational purposes only and is not an offer or solicitation for the purchase or sale of any financial instrument or service in any jurisdiction. The material herein was prepared without any consideration of the investment objectives, financial situation or particular needs of anyone who may receive it. This document is not, and must not be treated as, investment advice, an investment recommendation, investment research, or a recommendation about the suitability or appropriateness of any security, commodity, investment, or particular investment strategy, and must not be construed as a projection or prediction.

Unless otherwise mentioned, the views contained in this document are those of Barings. These views are made in good faith in relation to the facts known at the time of preparation and are subject to change without notice. Individual portfolio management teams may hold different views than the views expressed herein and may make different investment decisions for different clients. Parts of this document may be based on information received from sources we believe to be reliable. Although every effort is taken to ensure that the information contained in this document is accurate, Barings makes no representation or warranty, express or implied, regarding the accuracy, completeness or adequacy of the information.

Any service, security, investment or product outlined in this document may not be suitable for a prospective investor or available in their jurisdiction.

LEARN MORE AT BARINGS.COM

**As of December 31, 2021*

22-2071964