



European Residential: The essential core of your portfolio

In this paper, Bouwfonds IM – the real asset investment unit of Rabobank – will explain the key attractions of residential real estate as an investment class on a Pan-European level.

European residential real estate is an increasingly popular segment of the real estate market. After a decline in total inflows during the most acute years of the financial crisis (2007-2009), total investment in European residential real estate rose from under 10 billion euros in 2009 to nearly 40 billion euros in 2015, with American and European institutional investors the most active players in 2015. The sector owes its popularity to a superior risk return profile. The fundamental outlook for European residential real estate is strong as well, especially in the larger urban areas.

European real estate is an attractive investment class

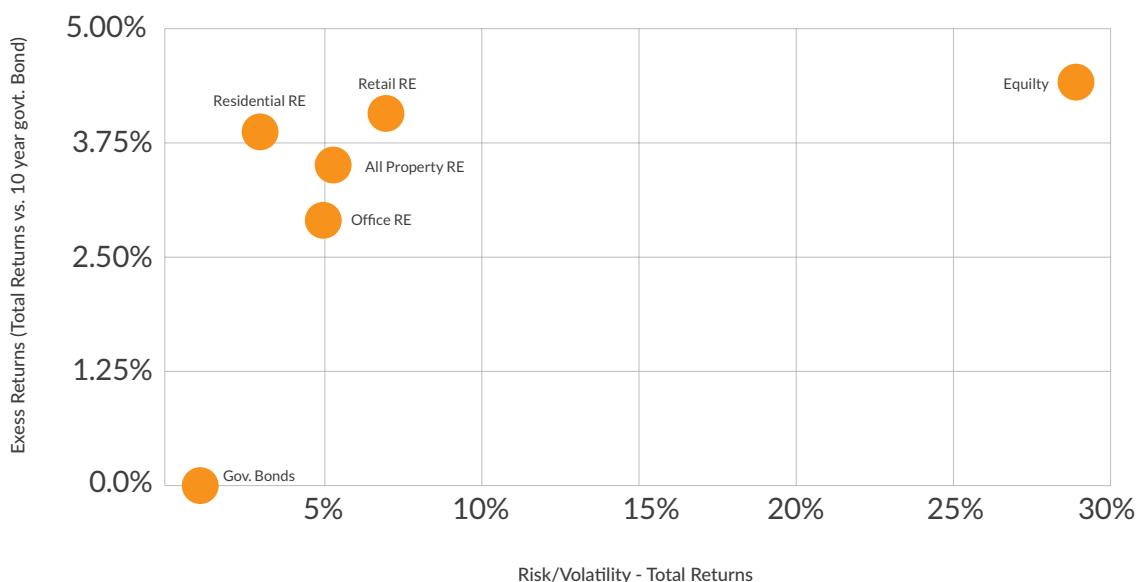
There are four principal arguments why European residential property should form the core of investors' real estate allocation:

1. *Superior risk returns*
2. *Stable income returns*
3. *A Pan-European investment strategy provides scope for further risk reduction*
4. *Inflation hedging or inflation outperformance*

1. Superior risk returns

European residential real estate has proven itself to be an attractive asset class between 2004-2015.

On a risk return profile it outperformed within real estate and also versus equities and bonds.



Risk return of various European asset classes (2004-2015) - Source: IPD, Bloomberg, Montesquieu

The historical yield premium of European residential real estate over bonds, meanwhile, has widened significantly over the past decade: the national average return on investment in European residential real estate rose from less than one percentage point over the benchmark 10-year German 'Bunds' (state bonds) in 2007 to nearly six percentage points in 2015.

2. Stable income returns

Strong capital inflow into European residential real estate has begun to put gross initial yields under pressure. In the Netherlands, for example, gross initial yields fell by 35 basis points in 2015, and observers of the Dutch market expect these to ease further in 2016 to around 4.0% in Amsterdam

and 4.5-5.0% in the other major cities of the country. But the stable long-term rental income provided by this class of real estate, is underpinned by the strong demand and limited new supply.



Pan-European Residential Performance - Source: IPD, Bloomberg, Montesquieu

3. A Pan-European investment strategy provides scope for further risk reduction

Analyses show that the total returns on investment in residential real estate are only weakly correlated across Europe's markets. For example, Germany has a low or even negative correlation with most other European countries. Consequently, diversifying investment across Europe can provide a hedge for investors, for example against political and tax risks such as a cap on rent increases or changes in attractive tax regimes.



Residential risk return for selected countries (2004-2015) - Source: IPD, Bloomberg, Montesquieu

It should be noted in this context that the risk return profile of such a Pan-European approach improves if expanded beyond the Eurozone. It increases diversification and includes countries with high Sharpe ratios (i.e. high return in excess of the return on 10-year government bonds, relative to the risk associated with them), such as Sweden and the UK.

4. Inflation hedging or inflation outperformance

The value of the capital invested in residential real estate is buffered against erosion as most rent control systems in many European countries allow owners to increase their rents in line with inflation. Consequently, historical analyses of the development of rents compared with inflation show a strongly correlated development over the longer term. For example, the correlation of average rent increases and inflation measured over some three decades ranged from 55% in Germany to 65% in the Netherlands and 69% in France.

Given strong urbanisation trends and insufficient apartment buildings in many European cities, the likelihood of above-inflation income growth for investors is high.

The fundamental outlook for European residential real estate is strong, especially in urban centres

European residential real estate has offered strong capital growth in the past, and much of the perceived risk stems from capital growth volatility. Indeed, the strong capital inflow into residential real estate of recent years has begun to put gross initial yields under pressure.

However, the outlook for residential real estate in Europe is underpinned by strong fundamentals over the long term, especially in economically resilient urban centres which will therefore be the focus of any investment strategy targeted at this particular investment class. The following key drivers support the outlook for investing in European residential real estate:

- Household numbers continue to grow
- The urbanisation trend continues
- More Europeans prefer or need the flexibility of renting
- As a result, the existing housing shortage (qualitative and quantitative) will increase further in European cities

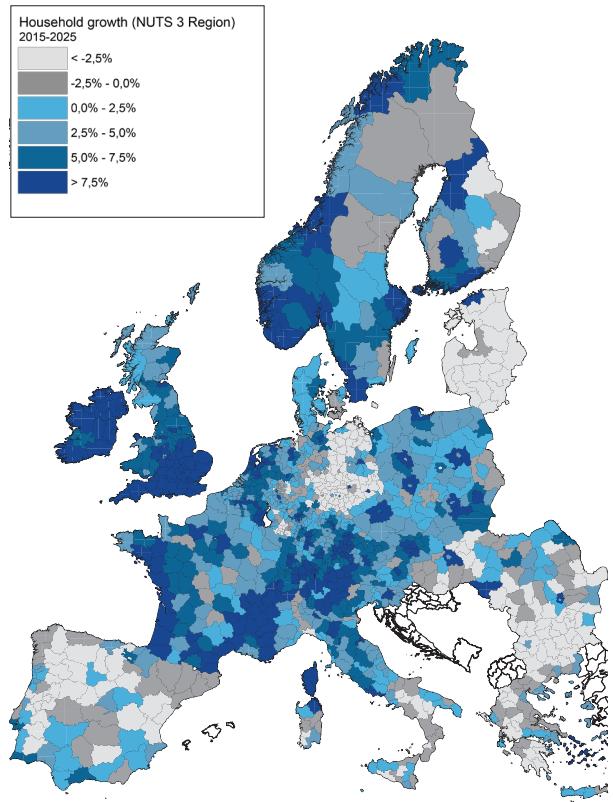
Household numbers continue to grow

The number of households is expected to show continued growth over the long term. Over the next decade, the total number of households in the EU (28 member states) is forecast to grow by 9.4 million, or 4%. Like immigration, this growth in the number of households directly contributes to demand for housing – in particular due to the increasing number of single-person households.

The net effect on the housing market will be growing demand, for example from young professionals for smaller accommodation in big cities, located close to daily facilities. But also increasing demand from elderly with special needs such as lifts, and within easy reach of the healthcare facilities.

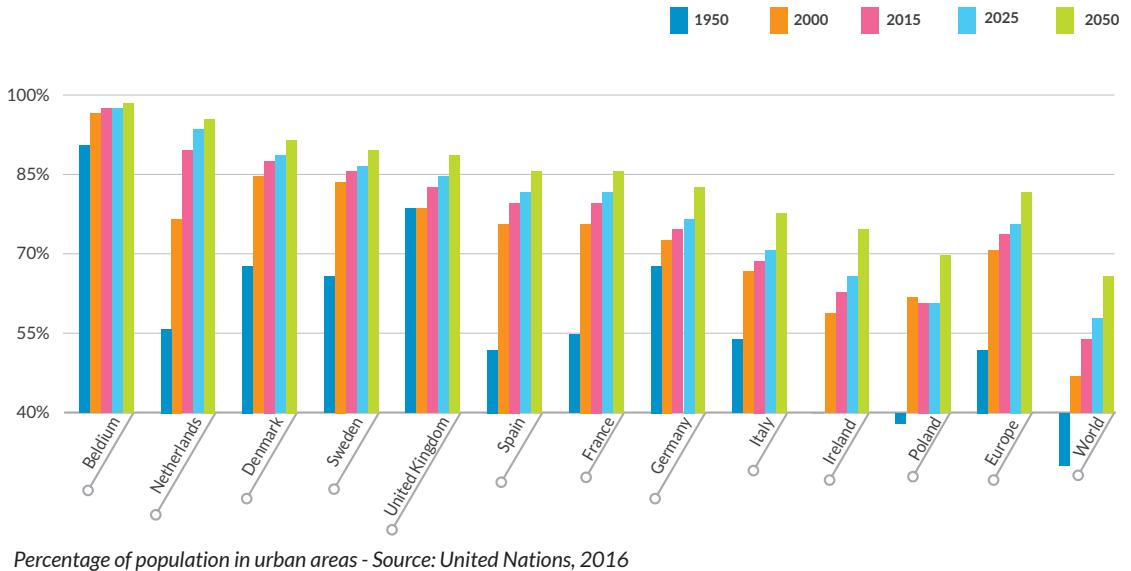
The urbanisation trend continues

The long-term trend of urbanisation – people moving from the countryside to the city – which has been gathering strength since the mid-20th century, looks set to continue. Estimates suggest that by 2050, about 80% of Europe's population will live in urban areas – up from 70% around the turn of the century. Drivers of urbanisation are the cities' superior employment opportunities, schools and universities, healthcare facilities, infrastructure and the concentration of information, knowledge, innovation and entrepreneurship, as well as sports and cultural facilities.



Source: Oxford Economics, 2016

The number of persons moving into urban areas increased by immigration, which has become a major contributor to European population growth. More than one million migrants and refugees entered Europe in 2015, with Germany receiving the highest number of new asylum applications. Net migrations is already the main driver for population growth in Germany, the UK, the Netherlands, Belgium and Denmark. In France, the natural increase – i.e. surplus of births over deaths, excluding immigration – contributes more strongly to population growth. Like young people, immigrants tend to move into the larger urban centres, as these typically offer more employment opportunities, compared with smaller towns and villages. In addition, major urban centres are attractive to immigrants because of their multi-cultural character, while some may already have relatives there. Like young people, immigrants increase the demand for affordable rental homes.



Percentage of population in urban areas - Source: United Nations, 2016

European cities becoming more attractive to live in.

Across Europe, major urban centres today offer a noticeably better quality of life than several decades ago, owing to improvements in planning over the years (for example to reduce traffic congestion), ongoing efforts to reduce pollution (for example, bans on coal-fired heating of homes, the introduction first of catalytic converters for cars and more recently of electric cars), expanding infrastructure (e.g. metro systems), and expanding cultural offerings. More single-person households and families with fewer children than their parents and grandparents – and with greater purchasing power – prefer to live in cities for this better quality of life. Similarly, a wealthier population is increasingly looking for a higher quality of urban life.

More Europeans prefer or need the flexibility of renting

Across the EU a growing preference for renting over buying can be witnessed, for a variety of reasons. For one, tenant protection provides security in many jurisdictions across Europe. And while owning one's own home has long been the ambition of many people, the fluctuations in house prices in recent



years, coupled with changes in government policy in a number of areas, are making many people cautious about 'getting onto the property ladder' even if they can afford to make that first step.

Demand for rental accommodation remains strong when consumer confidence is not very strong. Also governments in many European countries are attempting to make labour markets more flexible in order to boost employment. Faced with decreasing job security and the prospect of perhaps having to move more often to where the jobs are, young people in particular are now less inclined to buy than before the crisis.

Also, fewer co-habiting couples are pooling their resources to buy a flat or a house amid the high separation and divorce rates witnessed in many countries. They fear grave financial consequences if their relationship does not hold, which also reduces the willingness of many people to buy a home.



The existing housing shortage (qualitative and quantitative) will increase further in European cities

While house building has picked up in general since the crisis, new construction is still below pre-crisis levels in many countries, for example Denmark, Ireland, Italy and Spain. Also, many cities have been facing a housing shortage for years and with the growing need for housing (due to the various long-term social trends cited earlier) demand is expected to continue to outpace supply for the foreseeable future. This will be the case particularly in Europe's economically strong and therefore most sought-after centres such as the major capitals, but also cities with solid demographics and low levels of housebuilding (e.g. due to high land prices). Not all European cities will grow uniformly though and local expertise is needed to both determine the future winning macro and micro locations, as well as to manage the granular nature of residential property investment.



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