

REGIONAL HOUSING MARKETS IN EUROPE

First Quarter 2022

IN A NUTSHELL

- _ The attractiveness of residential real estate continues to drive investor demand and is causing a stronger sector allocation to housing
- _ Regional markets often provide strong market fundamentals on par with major agglomerations, while offering the potential for higher returns
- _ Given this outlook, regional markets in the Nordics, Spain and UK seem well positioned to benefit from widening investor demand and a further push beyond established prime hubs

Why look at regional residential markets? Experience and capital

Residential assets are today some of the most sort after investments across the European real estate market. The resilience of the sector during the financial crisis, rising rents and long-term structural changes are driving investors to allocate an increasing share of their portfolio over to this sector.

In the years from 2010 to 2020, European residential transaction volumes increased from 14 billion to 59 billion euros, driving the share of residential investments from 10% to 23% overall investment volumes.¹ Investment activity has grown strongly across the region, with marked increases in less established residential markets such as Spain and the United Kingdom, institutionalising and professionalising the residential rental market across many parts of Europe.

Investor interest in residential has only intensified due to the pandemic.² Accelerating the trend that we've witnessed over the past decade. We see few reasons to suggest this trend will reverse, and indeed as the volume of capital targeting residential increases, and as investors gain more experience, we expect activity to grow across the sub-sectors and more broadly across geographies and into regional cities.

Moving into regional cities may feel like a jump up the risk curve to some investors, and indeed for an inexperienced investor without expert knowledge and a local presence a regional investment strategy may be difficult to successfully execute. However, we increasingly see economically sound and growing regional cities as an attractive alternative to the major gateways.

We should stress that these regional cities are not small, peripheral locations. These are cities like Leipzig and Bristol with metropolitan populations often in excess of a million people, cities with a large and diversified employment base, centres of regional government and learning – often hosting major universities.

¹ Source: Real Capital Analytics, October 2021.

² See also: DWS Research Report May 2021 "The Case For European Residential"

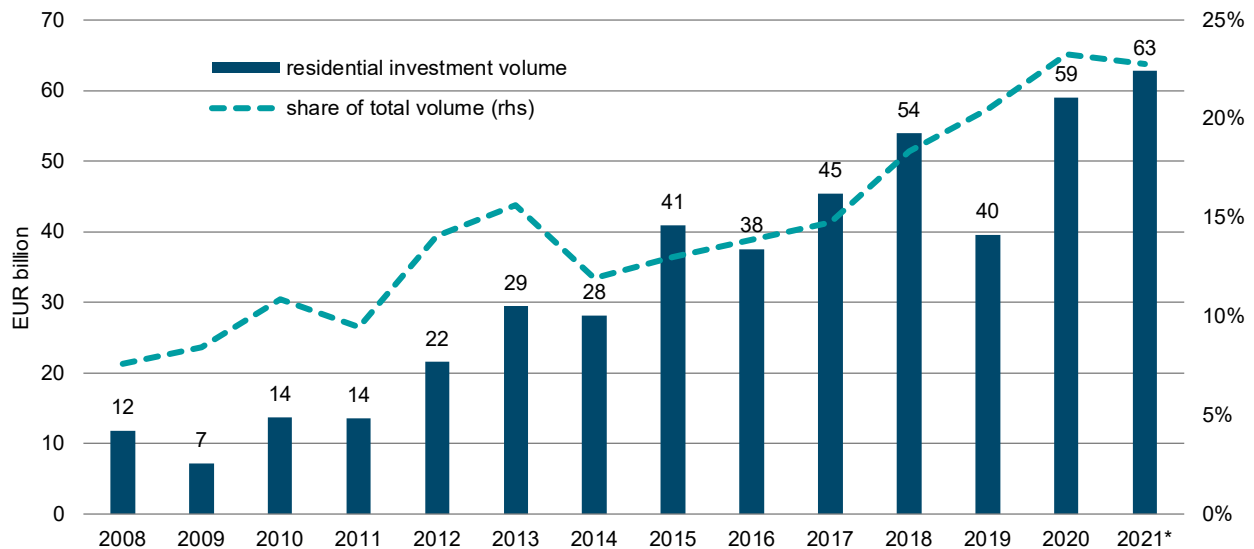
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While regional cities may offer a yield premium over the major markets, this is in no way sufficient to justify investment. The attraction of these regional cities must be one of strong market fundamentals. Indeed, over time we expect the current yield premium in regional markets will reduce, as high levels of capital help to deliver more institutional quality stock, lower operational costs and reduce today's illiquidity premium.

FIGURE 1: INVESTMENT VOLUME OF EUROPEAN RESIDENTIAL REAL ESTATE MARKET



Source: Real Capital Analytics, December 2021 *transaction volume displayed as 12-month total, as of September 30th

What we did: Measuring systematic risk and market conditions

In order to allow us to determine which regional cities could provide attractive residential opportunities, we undertook a comprehensive city scoring to provide information on the attractiveness and comparability of regional markets.

A total of 62 European housing markets were analysed and ranked based on a total of 15 socio-economic and residential indicators. This initial market selection was based on the size and attractiveness of the local housing market. Very small locations were not included in the analysis, only established regional cities with at least 200,000 inhabitants and an investable housing market.

Beyond this, we analysed indicators reflecting demographic, economic and housing market conditions. For the demographic assessment, the ten-year projections of household growth and young population growth (those aged 20-35) were used. With regards to economic factors, employment and disposable income growth were considered. Special attention was also given to the local housing market. Ownership structures, development activity, available housing supply and affordability were considered.

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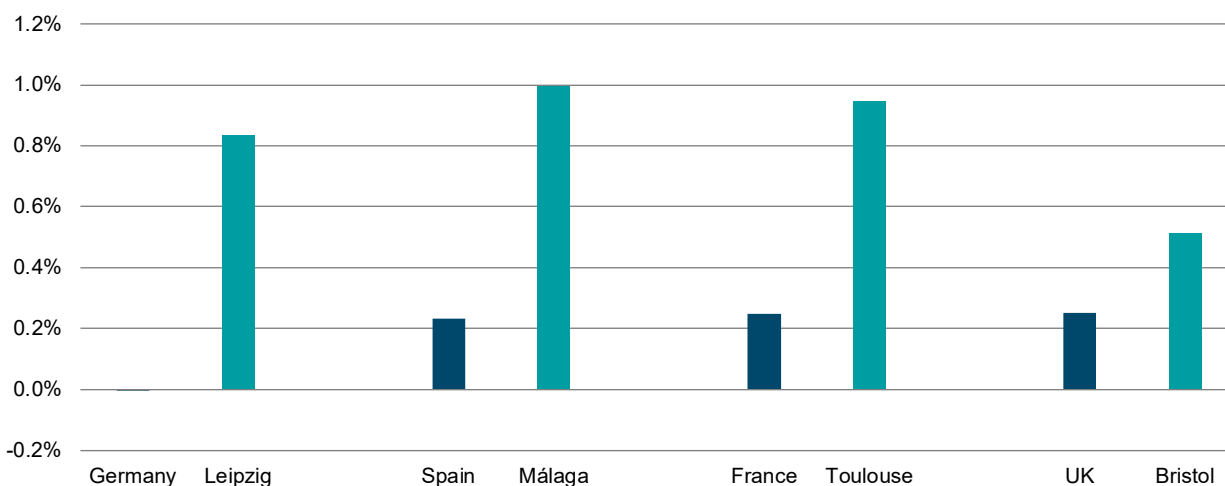
What we found: Regional gems are easily overlooked but offer potential for outperformance

Among the regional markets studied, the Compound Annual Growth Rate of residential transaction volume from 2019-2020 is nearly 30%. This suggests that regional markets are already moving further into the focus of institutional investors and a stronger allocation to these markets could happen over time.

A further examination of supply and demand data confirms the assumption that regional markets can keep up with the major prime markets in many respects:

The projected population growth (in %) is roughly the same on average for the regional and prime markets. However, there are some regional outperformers: Malaga (+1.0%) and Toulouse (+0.9%) are well above the European average of 0.3% annual projected increase by 2030.³ For young people, regional university cities such as Tampere, Porto or Leipzig are particularly appealing and show higher young population growth than the capitals in Finland, Portugal or Germany respectively.⁴

FIGURE 2: FORECAST OF TOTAL POPULATION GROWTH IN SELECTED MARKETS (2022-2032, % PER ANNUM)



Source: Oxford Economics, December 2021.

Sustained economic growth in some regional cities is expected to lead to above average rates of disposable income growth. For example, Bristol stands more than 60 percentage points (10-year average growth rate: +3.3% p.a.) above the UK capital. Aarhus, another regional outperformer, has a 10-year growth rate of 3.5% per annum. On average, regional markets surveyed are generally at about the same level as prime hubs, reflecting their robust economic footing.

Construction activity in the 62 regions studied is gradually increasing, but supply shortages often persist. In the past, the supply focus typically rested on prime markets, however development activity is now increasing in many regional markets. An example for this is Aarhus, where the number of completions in 2020 stood at a very low level of around 0.3% of stock, while the number of permits indicates an acceleration in the years ahead. In Copenhagen, on the other hand, building completions and permits issued in 2020 are at a similar level. This trend towards regional markets can be observed in many other cities.

³ Source: Eurostat, November 2021.

⁴ Source: Oxford Economics, October 2021.

The average 3-year rental growth rate (2018-2020) in regional markets also looks favourable at more than 4%, whereas the 15 prime markets studied average less than 1.5%, partly driven by rental decline in more volatile prime hubs. Particularly high rental growth can be observed in southern regional markets (e.g. Spain). In several cases, the comparatively low rents have risen sharply in recent years.

For example, the 3-year rental growth in Valencia is over 10% p.a., but other regions are showing strong results as well. In Freiburg im Breisgau rents increased by almost 6% p.a. over the three-year period.⁵ In terms of affordability, regional markets are mostly ahead of major cities surveyed and lead the table almost without exception. Here the favourable economic and income situation in combination with lower rents is playing out.

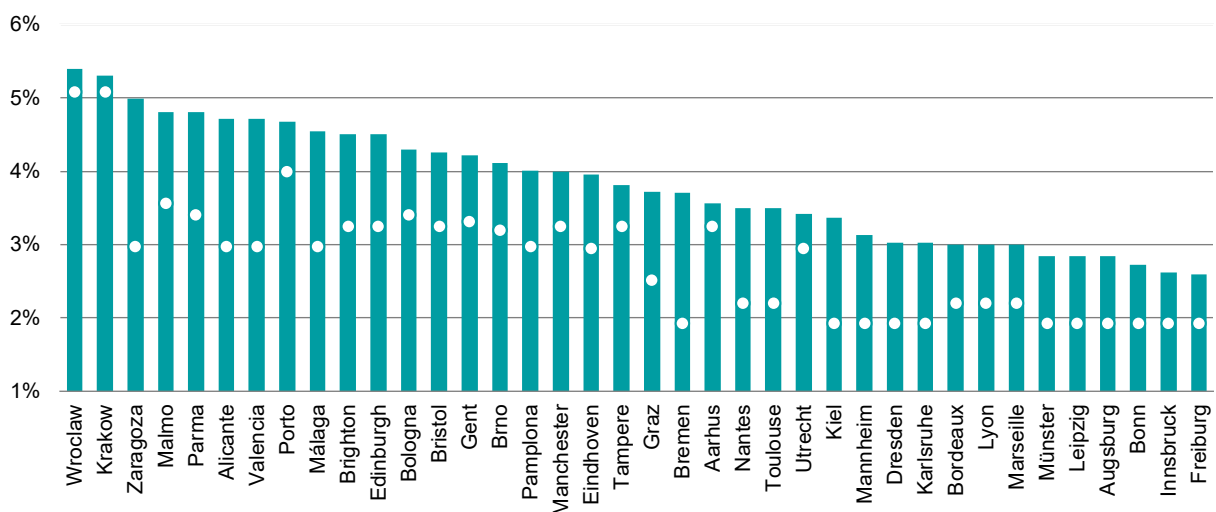
Admittedly, the liquidity of regional markets has so far been limited compared to the well-known prime locations, due to the smaller size of their housing market. The ten highest transaction volumes are consistently attributable to national prime markets. However, we assume that gradual changes will occur and that the increase in institutional capital in the less established markets will continue to be accompanied by a reduction in liquidity risk.

On average, regional markets have achieved similar overall results (total score) and share the top positions together with the “usual suspects” among major agglomerations. Nevertheless, there is still a trade-off between performance and stability in regional markets, which will be cushioned by stronger returns.

Winners combine strong fundamentals with sustainable returns

In general, regional markets have higher yield levels than the national champion, moreover, pricing varies greatly between countries. Higher yields typically imply a higher perceived risk of the respective market but could also mean an opportunity for outperformance. Based on strong market fundamentals, regional cities can be identified that have a similar risk profile to top markets at a higher premium and are therefore financially advantageous. These markets are not yet fully priced in due to a lack of transparency and investor appetite, hence we expect yields to fall over time. But again, the main reason for this analysis is not expected yield compression and increasing investor appetite, but rather the strong market fundamentals which will lead to an outperformance on the rental side. Both yield compression and above average rent growth will contribute to the return outperformance.

FIGURE 3: 2021 PRIME NET YIELDS OF SELECTED REGIONAL MARKETS



Source: DWS, Catella, CBRE, idealista, RIWIS et al, 2021. White points indicate the Prime Net Yield of the national Prime Market (Market with lowest Prime Yield).

⁵ Source: idealista & RIWIS, October 2021.

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Northern Europe in focus, but attractive regional markets in the rest of Europe

Top ranked regional markets are mainly cities with a positive demographic and economic outlook which already have a healthy and established housing market. Bristol, Brighton and Aarhus are three of these markets and it is the UK markets in particular that not only rank highly but also have some of the highest expected return levels.

Spanish cities also rank highly thanks to their below average level of supply, combined with a positive demand side. Malaga, in southern Spain, is an example of a region that has been severely affected economically by the COVID-pandemic but is expected to see a rebound in the coming years. Accordingly, the local housing market is subject to a high dislocation potential, hence investment opportunities could arise, as property pricing might not fully reflect the long-term cash-flow and value of an investment. In other words, investors could capitalise on softer pricing due to the heightened uncertainty during the current pandemic.

Among the German markets, Freiburg im Breisgau, Leipzig and Dresden stand out. The latter two show higher demographic growth compared to other German cities and therefore perform better. These so-called "swarm cities" are currently the focus of domestic migration by young people, as the cost of living is lower compared to major agglomerations.

In addition, Polish cities stand out for their high economic growth, but have more muted housing market fundamentals by comparison. Above average supply levels and a very high owner occupation rate indicate the early stage of the local PRS market. A focus on outperforming subsegments like small-scale, centrally located dwellings is a way to mitigate this, while already benefitting from comparatively high entry yields and a likely convergence to Western European peers. Going forward we expect the Polish PRS market to mature further.

Examples of attractive regional markets

Attractive, up-and-coming regional markets are spread across Europe. To provide insights into the top scoring regional markets, we highlight three cities that performed particularly well at regional level.

The city of Bristol in the United Kingdom is an example of a market with excess demand. Looking forward, we believe this demand will be difficult to satisfy in the short- to mid-term. Currently, the conversion of old office stock into residential space is helping to ease demand pressure. However, due to its status as a regional tech-hub and a generally good economic picture, going forward demand is expected to continuously outpace supply, thus driving up rents and prices.

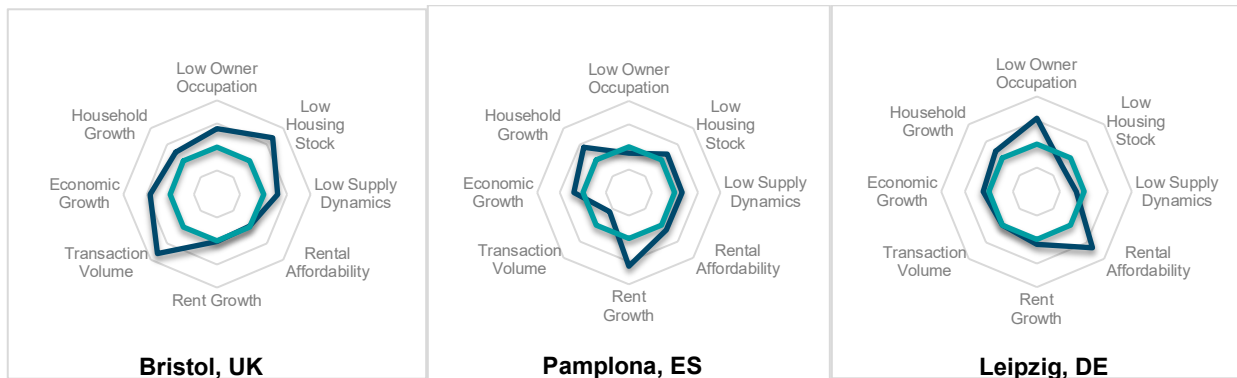
Pamplona, the capital of the Spanish autonomous region of Navarre, is an example of a regional city that, thanks to its affordability, attracts both new inhabitants and new businesses.⁶ This attractiveness has caused rents in the region to increase by over 10 %⁷ in the last three years and further growth is expected. In addition to three inner-city universities, Pamplona is already home to well-known companies such as VW and Siemens.

Leipzig, a university city in the east of Germany, offers not only (comparatively) affordable, family-friendly housing, but also an interesting investment market. As an important economic hub in the east of Germany, Leipzig has experienced high population growth in recent years, which is likely to continue in the coming years, further tightening the availability of housing.

⁶ The 10Y-Average-Forecast GDP Growth equals 1.7% with a strong 10-Y-Average-Forecast of Young Population Growth of 1.5% (Source: Oxford Economics, October 2021.)

⁷ Source: idealista.com, October 2021.

FIGURE 4: BRISTOL, PAMPLONA & LEIPZIG – SCORING OVERVIEW



Source: DWS, 2021.

So what? Regional markets expected to profit from persistent investor demand

As the allocation of capital to the residential sector continues to grow, alternatives to the major markets are gaining in popularity. Our analysis has shown that certain European regional markets have a sound socio-economic foundation. We expect these regional markets could offer higher returns with comparable systematic risk to the top cities and even outperform the prime markets in some areas.

FIGURE 5: TOP-15 EUROPEAN REGIONAL MARKETS MAP



Source: DWS, 2021.

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Across the regional cities, we see some of the most attractive opportunities in Northern Europe, in the United Kingdom and Spain. Here, the demographic and economic growth is among the highest compared to the 62 regions analysed. In addition to high growth rates, these regions already represent an attractive and secure housing market, while liquidity is expected to increase in the coming years. The top 3 regional markets (Bristol, Brighton and Aarhus) offer an average yield premium of 70 bps and are therefore particularly interesting investment locations. The average yield premium for all regional markets analysed in comparison to major agglomerations even goes above 80bps.

In conclusion, regional markets will play a key role in the growing allocation of capital to housing markets in the future. Diversification and good micro-locations in regional markets can help to further mitigate risks and thus maximise returns. Our analysis suggests that investors should already include regional markets as an addition to their portfolio and go beyond the established, hubs that most investors are currently targeting.

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