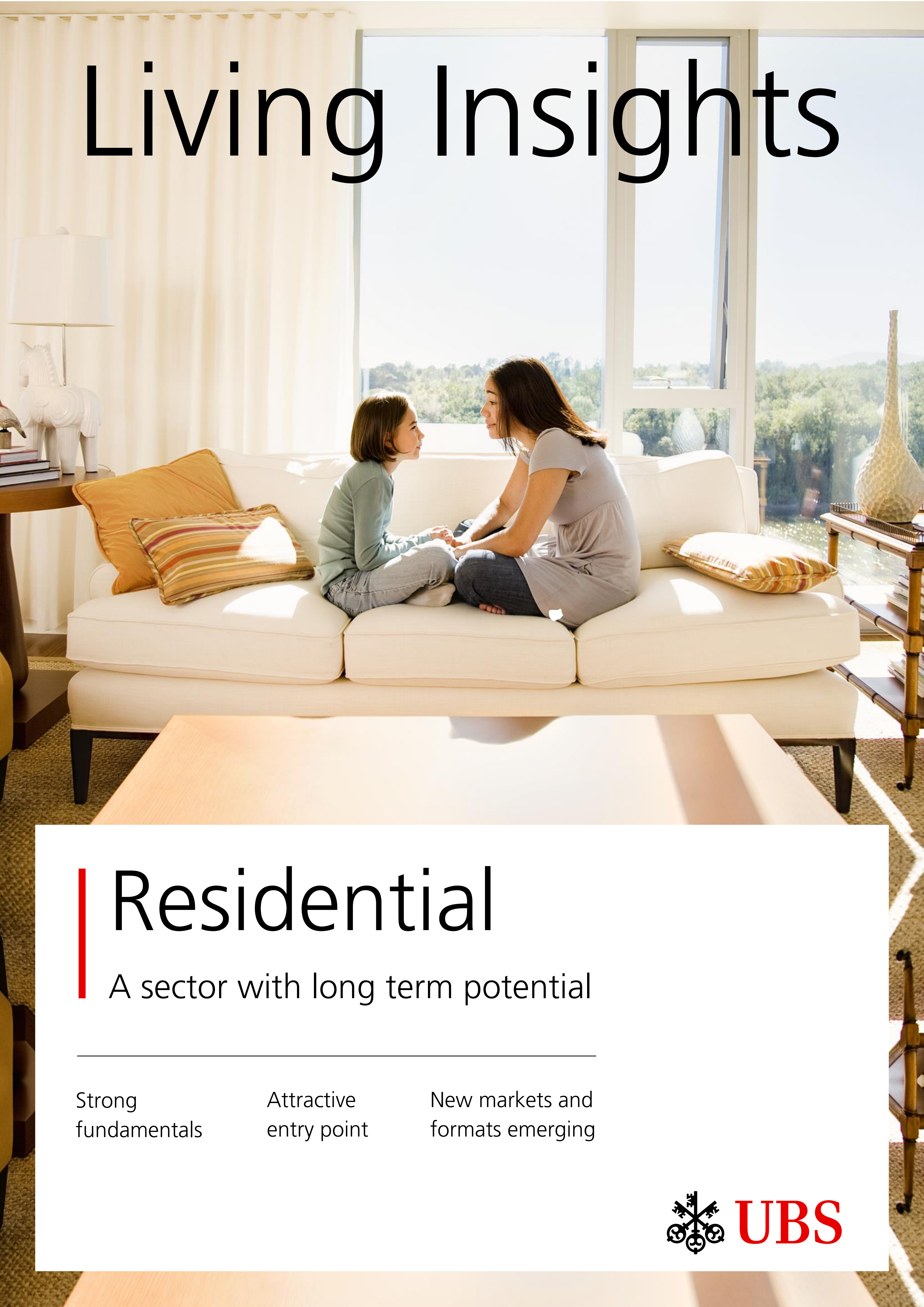
Living Insights



Residential

A sector with long term potential

Strong fundamentals

Attractive entry point

New markets and formats emerging

UBS

Attractive entry point to a growth sector

Residential real estate markets have been tight for some time in terms of their demand-supply balance and are expected to remain so. A price correction due to sharp interest rate rises in the wake of the pandemic makes for an attractive entry point for investment.

We think the long-term fundamentals of the sector are good and should drive rental growth. The sector is also developing in more countries, with new formats emerging.

Strong long-term fundamentals

Quality housing is essential for human wellbeing
The provision of high-quality living accommodation is essential for human welfare across the population. Furthermore, it supports the smooth functioning of the economy and labor market by facilitating the movement of people between regions experiencing growth and those in decline. Ultimately, the amount of housing provided is determined by the interaction of demand and supply, along with government policies, which play a key role. Demand reflects household numbers and other socio-economic and demographic factors. Supply is driven by the availability of land, construction costs and government planning policies.

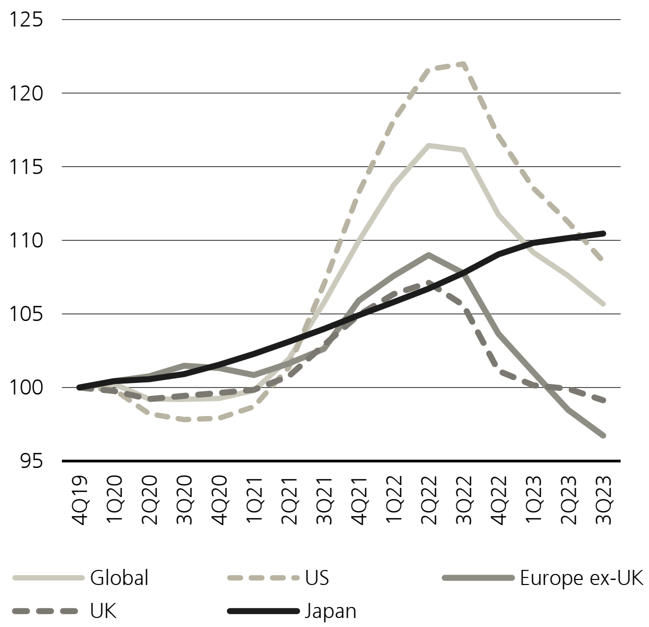
Housing markets globally have been tight for some time and there is a general shortage of living accommodation. This manifests itself in high sales prices, high rental values and younger generations that cannot afford to leave their family homes. Against this backdrop living accommodation can present attractive opportunities for investors and allow them to have a positive social impact. Moreover, the sector is evolving, with new formats emerging to meet the changing and growing accommodation needs of society at large.

Attractive entry point following price correction
Along with the wider property investment market, residential property prices showed a significant correction from mid-2022 as they digested sharp rises in interest rates from central banks as they battled inflation at multi-decade highs. By 3Q23, in local currency terms global residential capital values had fallen 9% from their peak in 2Q22. Capital values have fallen across the US, UK and other European markets (see Chart 1).

By contrast residential capital values in Japan continued to rise, up 2.5% YoY in 3Q23. Interest rates on hold in Japan have not created the same downward pressure on residential capital values as in other markets. Moreover, Japan has also been an attractive market for foreign investors due to significant hedging gains on JPY denominated investments.

Overall, we expect global residential capital values to bottom out in 2024 and think that this will create an attractive entry point to the market for investors. Moreover, we think there will be good opportunities to purchase assets and portfolios at discounted and distressed prices, as sellers seek either to sell quickly for liquidity reasons, or as they struggle to refinance debt. Banks tightened lending standards in 2023, making it more difficult to refinance existing debt and to secure debt for new investments.

Chart 1: Residential capital value indices
(4Q19 = 100, local currency)



Source: MSCI; NCREIF; UBS Asset Management, Real Estate & Private Markets (REPM), January 2024. **Past performance is not a guarantee for future results.**

The sector has strong fundamentals

For some time, housing markets have been squeezed. On the demand side, growing populations have combined with shrinking household sizes to fuel growth in household numbers and demand for dwellings, be they rented or owner-occupied. In the owner-occupied market, the combination of higher debt burdens on younger generations and higher mortgage interest rates in the wake of the pandemic have put home ownership out of the reach of many, forcing them to turn to the rental sector. Moreover, for other reasons, such as more transient populations, renting can be preferable to owning.

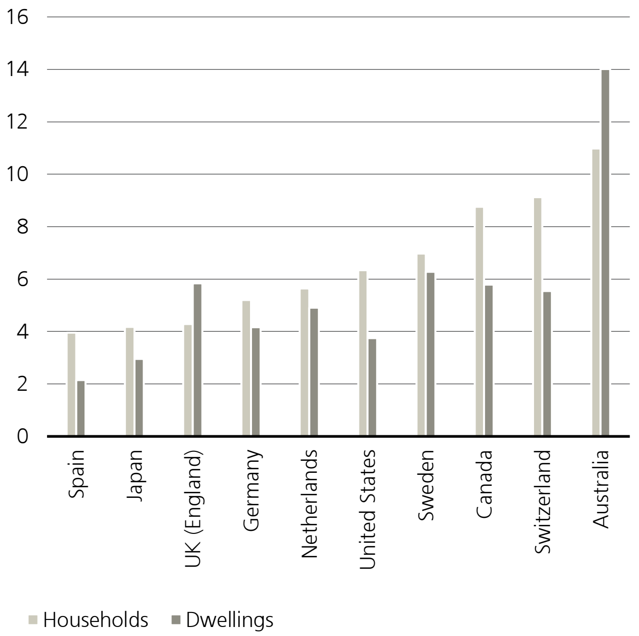
Growth in households has tended to outstrip supply of dwellings, generating pressures on housing markets and resulting in rises in both prices and rents (see Chart 2). For example, in the US household numbers rose 6.3% between 2011 and 2018, while the number of dwellings increased by only 3.8%. This represented a new shortfall of 2.5 million homes, putting pressure on the existing housing stock. On the supply-side of the market, many countries lack available land, particularly in metropolitan areas, and tight planning policies also curb supply.

Moreover, underlying desired household growth is likely higher than that which actually occurs, held back by housing availability and affordability. For example, the younger generations unable to afford to leave their family homes.

Going forward, pressures in housing markets are expected to remain, with further growth in household numbers forecast, even for countries whose overall populations are projected to decline. This is due to falls in average household sizes more than offsetting declines in population. For example, in Japan the population is forecast to drop 2.3% between 2023 and 2028, though household numbers are projected to rise 0.5% as the average household size falls from 2.2 to 2.1 (see Chart 3).

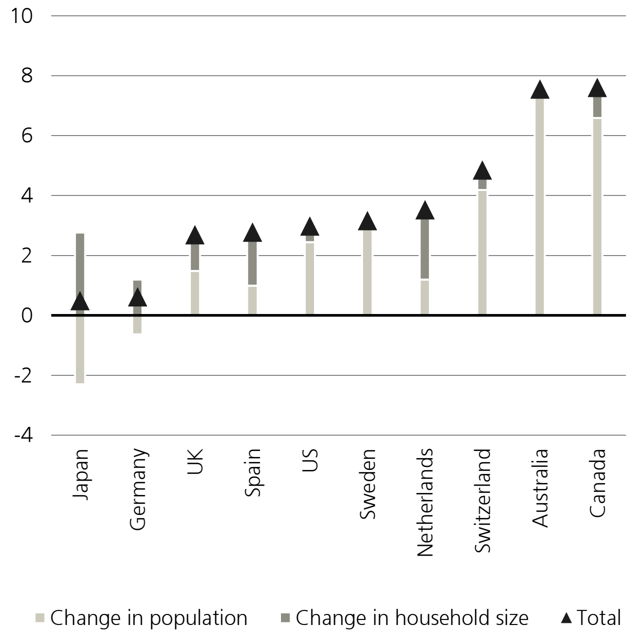
Across most major markets, over the next five years household numbers are expected to continue to rise, although the pace of growth is expected to ease slightly on an annualized basis compared to the 2011 to 2018 period. Ever falling household sizes also imply that demand will be focused on smaller unit sizes as household sizes shrink further. And there also tends to be population shift away from rural areas and towards metropolitan areas.

Chart 2: Growth in households and dwellings (2011 to 2018, % total change)



Source: OECD; ONS; Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), January 2024

Chart 3: Forecast growth in household numbers by contribution (2023 to 2028, % total change)

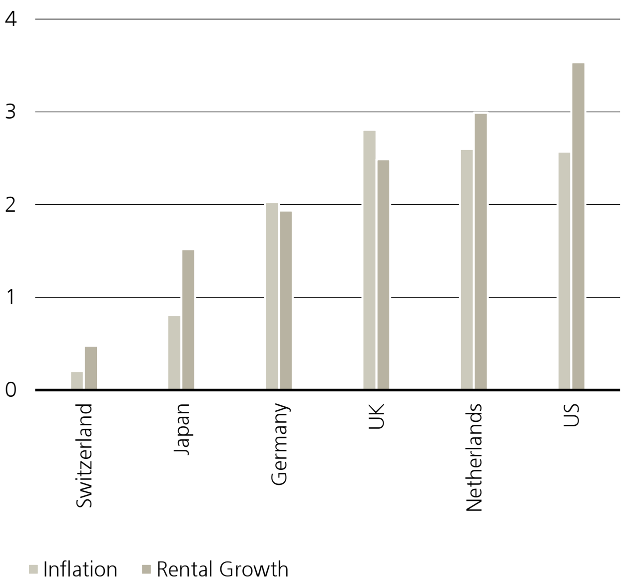


Source: OECD; Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), January 2024

Favorable lease terms and inflation protection

The residential sector benefits from favorable lease terms for landlords, with leases often being just twelve months long. There are exceptions in some parts of Europe and other markets where leases can be longer. Short leases allow for rental increases to capture inflation and in the wake of the pandemic-induced inflation residential rents rose significantly in many markets. Moreover, real rents have tended to increase over time as rental growth has outpaced inflation (see Chart 4). Hence living sector real estate provides investors both with good inflation protection and the potential for real rental growth due to fundamental demand-supply imbalances and lease structures.

Chart 4: Residential rental growth and inflation
(2011 to 2022 inclusive, % p.a.)



Source: AtHome; CBRE; MSCI; UBS Asset Management, Real Estate & Private Markets (REPM), January 2024

Expanding to new countries and formats

Historically, institutional investment into residential property was focused on the US, with its large so-called multi-family market. Indeed, according to MSCI data, as of end-2022 the US accounted for the bulk (62%) of the USD 2.5 trillion institutional residential investment market. Japan was the second largest market, at 8% of the total, followed Switzerland at 7% and the Netherlands at 5%.

However, institutional residential property is expanding to other markets too. These include the UK, Ireland, Spain, and Australia, amongst others. Institutional investment in the residential sector has spurred innovation and seen new specialist types of residential property emerge which meet the evolving needs of the population at large. These include student accommodation, single family rental homes (SFR), focused on the US, co-living concepts, affordable housing, retirement communities and other types of property aimed at ageing populations.

Another way for investors to access residential property is to lend against it, via development loans, bridging loans and other types of lending. Much higher interest rates in the wake of the pandemic have made debt strategies more attractive for investors, particularly as banks have tightened lending standards and retrenched.

Knowledge of regulations is important

Essentially, all forms of residential property are providing housing services to people and hence inextricably linked to their welfare. As such, governments normally take a keen interest in the sector and closely monitor it. In many cases this results in regulation, whether limits on planning approvals or restrictions and caps on rental growth.

Regulations can be detrimental or supportive to investors and it is important to understand their impact. The key factor determining this is whether the regulatory and policy environment is stable or erratic. A stable and known regulatory environment means that investors can price in the impact of any regulations at purchase. For example, a 2% p.a. cap on rental growth can create more certainty over future rental income for investors and may also lead to excess demand and lower vacancy. More certainty can be beneficial to investors and priced into the purchase price. By contrast, unexpected changes in regulations which are not underwritten at the time of purchase can significantly impact achieved returns and be detrimental to investors, such as the introduction of new rental caps.

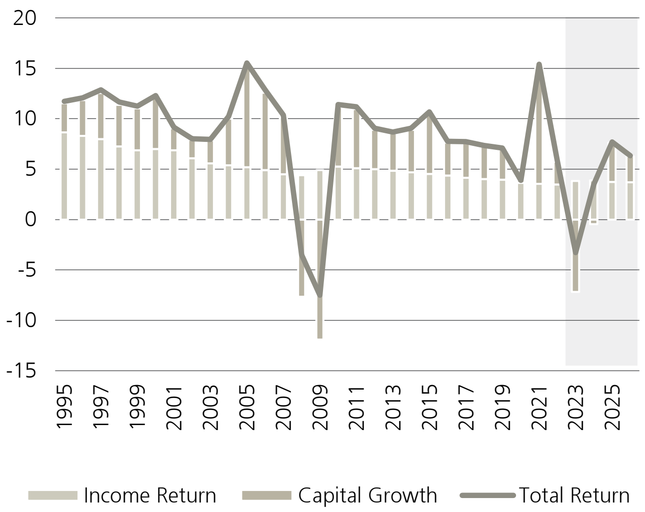
Return expectations

Historically, global residential property has delivered returns slightly above the wider property market, with slightly lower volatility. Going forward, we expect unlevered residential total returns in local currency terms to be around 6% p.a. for the three years 2024-26, accelerating in 2025 as capital growth picks up (see Chart 5).

Historically, rental income has accounted for about 60% of total returns, with the remainder coming from capital value appreciation.

Currency is an important consideration for investors and whether to hedge or take on the full currency exposure. Many investors choose the greater certainty that hedging provides, with the impact of hedging on returns determined by interest rate differentials. Over the next three years, based on latest forward rates and versus local currency returns, we expect hedging to reduce returns in JPY by around 300bps as Japanese interest rates remain around zero. We expect a drag of 55bps for EUR returns and of 190bps for CHF returns. By contrast, we expect a hedging gain of 100bps for US investors and 90bps for CAD investors.

Chart 5: Global residential returns
(% YoY, local currency)



Source: MSCI; NCREIF; Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), January 2024. **Past performance is not a guarantee for future results.**

Benefits of going global

As for all property types, investors in the residential sector can benefit from a global allocation over purely investing in their domestic market. Investing in residential property globally brings diversification benefits which can reduce risk and enhance returns. Moreover, institutional residential property investment is not available in some countries at any significant scale. For example, Italy. Hence these investors must go abroad to access the sector. Going global opens up a much larger investment universe and allows for investment in specialist types of residential property. In addition, going global allows for tactical investment to benefit from markets which are at different stages in their cycles.

Although private investors might consider buying residential property directly themselves, apart from those with the deepest pockets, rather than diversification benefits, they will suffer from concentration risk. Moreover, they may not have the specialist knowledge, contacts and time required to enter foreign markets. They must also consider how to manage their properties.

Sustainability factors

The real estate sector overall is responsible for almost 40% of global carbon emissions, with 70% of these emissions caused by building operations and the remaining 30% by construction[1]. As such, the sector has a key role to play in the transition to net zero. The International Energy Agency (IEA) estimates that direct and indirect building carbon emissions will need to drop by 50% and 60% by 2030, respectively, in order to reach net zero by 2050[2].

This presents significant challenges, coupled with unique opportunities for the real estate sector. The residential sector has an important role to play in maximizing efficiency, minimizing energy use and switching homes to renewable energy sources (both on and off-site) and ensuring that new living accommodation minimizes energy demand and procures green energy for any excess.

Decarbonization in the residential real estate sector can be implemented during both construction and operation phases, and may encompass various tools and initiatives, including energy reduction through smart building systems (sensor-driven lighting and cooling/heating), building retrofits, installation of on-site renewable energy, and the use of high-quality carbon offsets for embodied carbon management after all other carbon minimization options have been pursued. These environmental-driven solutions can also be coupled with social initiatives such as affordable housing and tenant engagement to maximize sustainability impacts.

Source: **1** United Nations Environment Programme – Finance Initiative, April 2022. **2** International Energy Agency, July 2023.

Conclusion

Long term appeal
Overall, we think that residential and living property presents compelling opportunities for investors. Pricing is attractive following drawdowns after the sharp interest rate rises in the wake of the pandemic. In addition, we expect discounted and distressed deals to present an appealing entry point for investors.

Moreover, in the long term we think the underlying demand and supply fundamentals of the sector are positive and should drive real rental growth and returns for investors. The institutional residential and living sector is growing in markets it was not present in before and new niche property types and formats are emerging.

In addition, the residential sector has an important role to play in reducing energy use and carbon emissions and offers the opportunity to have positive social impact.

Overall, we believe that these factors bode well for the sector and make it appealing to investors.

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