Residential investment: cash cows or question marks?

Residential property is a unique real estate investment, as it represents the largest asset class in most European countries fluctuating between the 3 and 8 per cent of the gross domestic product (GDP). Many research papers have shown that residential investment is a leading indicator of GDP, while the non-residential investment is not. Housing investment, despite being a small share of total output, plays a huge role in the business cycle, as housing (and its prices) is an indicator of recessions and booms in the market.

Houses are the most important assets in households’ portfolio: more than half European population lives in owner-occupied houses or apartments, with a peak of ownership recorded in Romania (around 96 per cent of the population) and the lower percentage in Germany (around 52 per cent). Only in Switzerland, the share of tenants is higher (56 per cent) than the share of people who lives in owner-occupied dwellings. Residential property is intrinsically linked with wealth.

Although residential rented sector has significant numbers, as shown before, and huge potential, ownership still dominates the market, and rents are generally not sufficiently attractive for large investors, who are looking for a constant income flow rather than a return in capital growth. Therefore, the lack of well-structured investment vehicles in the housing sector is a structural weakness of the European market. Market analysis regarding institutional and large investors shows that the residential plays a marginal role in their portfolios, and the option to invest in mainstream residential remains narrow. In some countries, special residential investment vehicles have been introduced, but only small-scale players prevail in the market, and the number of assets managed by institutional investors is still low.

Low-income flow and high operating costs are a barrier for the market. The housing market shows much higher tenant turnover and more intensive property management both in term of efforts and costs. In fact, the management of a fractional real estate asset like the residential, with its particularities, characteristics, and complexities, requires a constant and continuous technical approach that not all companies are willing to face. Tax issues are, in some countries, another barrier, which are difficult to overcome.

What are the benefits of investing in the residential sector?

Given the issues above, should we leave this market segment behind and forget about it? The residential sector still represents a significant investment opportunity in emerging countries or cities with leading and robust economies, because of demographic growth and the increase of middleclass wealth. The residential investment has favourable income matching and guarantees higher stability in comparison to other forms of investment. Residential property provides a good return, privileging long-term holding rather than a trading option. In the long market cycle, rents tend to oscillate less than house prices, showing that rental income yields generally have low volatility and potential growth of expected future rent streams. The residential investments are inflation hedging properties for institutional investors.

Furthermore, residential properties are sometimes easier to refurbish or to readapt to new uses. Residential buildings do not become obsolete as quickly as commercial buildings, in which technologies play an essential role and might change entirely over time, and they can be expensive to replace. Even if the housing sector has a higher customer service
element, higher management and operating costs, these could be priced into the rent, or minimised through economies of scales, with large-scale professional property managers.

In a world of both where we have an aging population and a need for greater affordability of housing, social housing is becoming, for a discrete number of investment funds and vehicles, the new “cash cow” as indicated in the BGC growth-share matrix.

The cash cow is a mature and well-established investment which generates more cash than it consumes, with high market share but low growth perspective. In comparison to the proper “cash cow” product in the market, the affordable housing sector is a safe (and ethical) investment, even if it is not a high return vehicle and it is usually considered more for its longevity of income.

It has been a decade since social housing has been included in REITs or other institutional investors’ portfolios as a source of diversification first, and as an only investment for some (few) specialised property funds. Affordable housing has long-term and authority backed rents, with a very low-risk profile. Moreover, as they aim at providing a roof over the more vulnerable heads, this sector ticks the box of the ethical investment, which tries to balance the needs of the market and the return of the investors.

On the opposite square of the BGC matrix, the question marks are investments with the potential to gain market shares and becoming a leader in the market. Nevertheless, those products must be analysed and considered very carefully as they require substantial investments at the beginning of their life cycle. The question mark products are collocated in an expanding market, with massive investments and low market shares at the beginning.

**Which products are the question marks in the residential market in the future?**

According to the analysis of the demand and the reports of the gurus of the market, the success of the residential sector lies in different typologies, which may well expand in the future, with the rises of incomes and wealth.

The residential sector is continuously adapting to the temporary nature of our life: the new way of living and working has changes the demand for houses and apartments. The demand of the future will be extremely segmented. On one side, an increasingly flexible and global economy push the workforce of young professionals, temporary job workers, and people who work and live in different cities to look for small and smart spaces, with flexible and short-term rents.

On the other side, families will again experience after the economic recovery and the upturn of their earnings rising living standards, the demands for larger houses or first-class real estate. This demand is considerably more significant than the one coming from the growth of population, which affect only specific areas (principally the main cities), while the impact of rising living standards will be a more widespread trend.

Higher demand for independent senior living properties and retirement communities, due to the constant aging of the population, will be expected in the forthcoming, and will attract some players active in this specialist area. These models, which are quite used in North America, are not conventional in many European countries, where the demand is not even tracked in the radar of the market analysts.

Housing specialised real estate investment vehicles are well established where the homeownership rate is low (e.g. in the USA, or, in Europe, as Germany and Switzerland).

The housing sector of the future will increase the global investors’ interest in all those sub-segments characterised by high services components, such as home and spaces for elderly and students, for professionals and workers. As well as for that part of the population that clashes with difficulties in becoming homeowners due to salary, house prices or borrowing constraints, they will increase the demand for good quality private-rented properties.

The customer will increasingly demand a place where to live which takes on the connotation of “consumer product” and status symbol and no longer of a pure asset class.
The living space of the future will be designed as “big hub,” large-scale residential investment in the form of new “villages” constructed on the different characteristics/needs of the consumers, as, e.g., multi-families, seniors, students, young workers. All of them have different needs, and they require different spaces, innovative and smart, managed in full by specialised operators.

Professional players in the new market will create, moreover, economies of scale on marketing investment, in-depth knowledge of the local market, efficient management of agency resources, the maximisation of the relationship between the various local stakeholders and the public administration.

Product differentiation is a key factor to achieve successful investments and achieve effective pricing of the good. A strategic approach to the management of the assets for the future is required even in the real estate market. Unfortunately, the shortage of land in already highly urbanised territory with no space left for new buildings, or planning constraints could be an issue for large-scale residential investment. However, it also could be a significant sphere of a challenge.

Also, the challenge of the future will also focus on the increase of the attractiveness of the residential product, it is necessary to improve the quality of the urban spaces around the buildings, and so increase the value of the buildings.

Not forgetting the existing buildings, which represent the majority of the assets around us. The existing housing stock is inadequate to meet the needs of (some part of) the demand. On the re-use side, the investor should concentrate on product innovation, improve the standards, the energy efficiency, the flexibility of spaces, and the housing service and adapt the building to seismic standards. There is much work to be done.

So what is next for the residential investment? Question mark, indeed.

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