

A structural global shift to the living sector

Institutional investors have increased their holdings in the living sector in the past few years. They are attracted by the steady income stream from this kind of investment. The pressure in the worldwide housing market strongly suggests it will remain an attractive asset class for the foreseeable future.

By Joost van Mierlo

These are some of the thoughts of Andy Allen, Global Chief Investment Officer, Equity Investment, and Shaowei Toh, Head of Research and Strategy in Asia Pacific, both from Savills Investment Management. They are delighted about the renewed interest in what they call the institutional living sector.

Allen: ‘There are good reasons why the traditional focus of real estate investments in commercial retail and offices is changing. The living sector offers a very compelling alternative.’

Toh: ‘Investments in the living sector are very significant in the United States. It’s a very mature market and of great interest to investors. But there are also rewarding opportunities in Asia. That is especially true for Japan, by far the largest market in Asia. Down under, there are interesting prospects in Australia too, where demand supply imbalances also prevail.’

Investors have been reluctant to invest in what you call the living sector. The returns were considered dismal. Are they right?
Toh: ‘Some investors might balk at the relatively low absolute returns on these

forms of investment. But we will always tell them they have to look at the complete picture. On a risk-adjusted basis, this asset class is really attractive, especially for institutional investors. It creates a stable and durable income stream with very little fluctuation.’

Allen: ‘It is not completely true that institutional investors shied away from this asset class. In our estimates, American pension funds invest about 25% of their real estate investments in the living sector. For some Dutch pension funds that number will be even higher. They are far ahead of their equivalents in, for example, the United Kingdom, Spain, and Italy, where allocations have been low but growing.’

The stability of the returns makes investments in the living sector attractive. What causes this stability?

Toh: ‘One of the obvious reasons is that accommodation is non-discretionary. This is always true, but it became even more clear during the covid pandemic. It’s possible to cut down on shopping and on a beer after a day in the office, but you still need a roof over your head. That is why this sector has proven to be more resilient than others, and counter-cyclical.’

Allen: ‘It’s not only non-discretionary. As owners and renters become wealthier, their demands for housing tend to rise, they desire more and better space, whether that be additional bedrooms or indeed space to work or study from home.’

Principally though, the considerable imbalance between the volume and the quality of existing housing stock against the current and prospective demand means that housing is occupied to very high levels, and tenants, if treated suitably, will stay for longer, meaning income is long and relatively secure for the investor.”

When it comes to housing, especially housing for lower incomes, regulation in the form of rent controls might be a concern for investors. How do you look at it?

Allen: ‘Regulation in the form of rent control is a very sensitive subject for investors. From a tenant’s perspective, one could be delighted when a government or a local council issues rent controls, as affordability for the resident improves. However, there can be a disincentive for

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the landlord to maintain or invest further if the investment cannot be recaptured over time through rental or value uplift. This is an ultimately untenable situation which can worsen the prospect for renters: as property quality will reduce over time, supply will not be added as needed.

What we have seen in recent years is that countries have been reluctant to issue strict national rent controls, with Germany, Spain and the UK as examples. But there has been some city or regional control elsewhere, like in Berlin, Catalonia (Barcelona) and Scotland. The most obvious result of hard cap rent controls is that they reduce investment and investor confidence, leading to an unsatisfactory situation.'

How to deal with it?

Allen: 'In recent years, countries and regions have chosen less rigid forms of rent control. There might be a contract that has a limited index-linked increase in rent during the term of the contract, perhaps to local CPI. When the contract ends or when the tenant leaves, it would be possible for the landlord to offer the apartment to a new tenant at the current market rent.

It is a situation where everyone can be happy. I call it a win-win-win situation. It's attractive for residents, policymakers, and for investors too. Investors recognise that a happy long-term resident will have lower operational costs to manage.

Above all else, we notice that the way to fix rental affordability is through greater supply of affordable homes, and that requires investment at scale from the private sector. We observe that policy makers increasingly recognise this. We see that the US and UK governments put the delivery of affordable housing central to public policy.'

Toh: 'The situation in Japan is different. Since the post-war period there has been a long time when rent control was standard. That has since been abolished. The situation in Japan is unique though. The whole system and society is designed around harmony.

In the living sector one not only has legal contracts, which are very similar to the contracts one would see in the US or Europe, but there's also a social contract which deals with protecting both tenants and landlords. It is true that traditional



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Andy Allen

Andrew Allen is Global Chief Investment Officer, Equity Investment at Savills Investment Management. In this role he is responsible for the creation and implementation of the firm's investment and risk strategies. With nearly 30 years' experience, he is a member of the Global Executive Committee and chairs the New Business Committee. From 2004 to 2010 Allen was Head of Research & Strategy for Cordea Savills, now Savills Investment Management.

lease terms tend to favour the tenant, but they don't preclude landlords from negotiating new rates. The outcome is that rent increases are reasonably managed across the life cycle of the lease.'

You mentioned earlier that US pension funds deploy around 25% of their real estate assets towards the living sector. Are other countries following?

Allen: 'There are huge variations in allocations to living across the world. Whilst the US, the Netherlands, Sweden, Switzerland and Germany have mature institutional markets and high allocations, this is not mirrored across investment markets. Many countries, while having a large rental market, are disaggregated, owned by private investors. Examples are the UK, Spain, France, Australia, and Japan. Surveys from INREV, PMA and our own client capital survey all point towards material shifts in allocations to the sector by institutions, even from countries where the living sector is nascent, like Australia and South Korea.

It is our view that as investors allocate more to the sector, this will raise liquidity, improve operational skills and the transfer of knowledge across countries and living segments, and this will further raise confidence in the sector, attracting more capital.'

What makes the Asian market so attractive?

Toh: 'It's not so much that the Asian market is especially attractive, but that it broadens the range of possibilities. When we talk about the living sector in Asia, we are basically talking about Japan and, increasingly, Australia. There are some pockets of investments in South Korea and Hong Kong, but they are not really relevant from the viewpoint of an institutional investor.'

Japan is by far the biggest market in Asia. It is still small compared to the US, but it's an established market with strong risk-adjusted returns due to the reasons I indicated earlier. It's also a specialized market where one needs to gain the experience over time to make the right kind of investment decisions, which is something we think we can offer.

The other interesting market in Asia is Australia. It is much smaller than Japan or European living markets, but developing fast. There's an enormous political focus on bridging the housing gap in the country. It means ramping up supply, and creating a conducive environment for private capital to participate. Naturally, this creates opportunities for investors.'

You have explained the social contracts that are common in Japan and you indicated a desire to bridge the housing gap in Australia. Would some kind of regulation in the form of rent controls not be a danger for investors?

Toh: 'Although there is no indication of any measures at the moment, no one should be surprised if the government at one point comes up with something which gives them more control over their desired housing goals. But everyone is aware of the experiences in other countries. There's a clear need for investments into the sector. It is thus unlikely that lawmakers would willingly create an ambiguous environment that puts off potential investors.'

Dutch investors are very much concerned about ESG criteria. You have already spoken a lot about social standards, which these kinds of assets definitely address. What about environmental standards?

Allen: 'We are talking about buildings with high sustainability credentials, affordable



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Shaowei Toh

Shaowei Toh is Head of Research & Strategy for Asia Pacific at Savills Investment Management. He is a member of the regional investment committee, leads the development of market and investment theses, and provides an Asia Pacific perspective into the firm's global investment and growth strategies. Toh is based in Singapore.

for middle-income tenants where the need of quality housing is greatest.'

Toh: 'Environmental standards are not just a regulatory requirement. To us, maintaining high standards in areas such as energy efficiency benefit both residents and investors. Clearly there is that restorative and environmental angle from ESG which we strive for. But we believe quality matters. Renters will prefer energy efficient buildings for better comfort and lower utility bills. And in the long run, that translates into longer lease durations which soothe the operational costs of maintaining higher energy efficiency levels.' ■

Savills IM uses the term 'Living' sector to cover a wide array of homes intended for rental, spanning student accommodation, multi and single family housing through to affordable housing and senior and care related facilities.

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