AQUILA CAPITAL

SPAIN'S RESIDENTIAL MARKET IS DIFFERENT – A EUROPEAN OPPORTUNITY

Abstract

The Spanish residential market is undergoing a comprehensive structural change and, compared to other European markets, has special characteristics that open up attractive investment opportunities. Contrary to the majority of European markets, which showed price increases far exceeding rental growth due to asset price inflation, Spain shows an opposite trend. The reasons for this development lie in the enormous demand for rental housing, which differs substantially from the market supply.

The Spanish housing market is characterised by a historical ownership rate of around 80 %, but increased prices, reforms in equity requirements as well as a change in mentality have led to the unaffordability of home ownership or personal preferences driving the demand for rental apartments. However, this is countered by low levels of new construction and a highly fragmented, as privately owned, rental market that barely exists.

To meet the pent-up as well as future demand for rental apartments, institutionalisation of the segment is imperative. Companies that have a strong local network and the corresponding know-how are thus offered attractive opportunities. Investments meet a massive surplus demand, which is also characterised by potential catch-up potential in terms of value development compared to the Western European markets.

Authors:

Peter Schnellhammer
Investment Research Analyst
peter.schnellhammer@aquila-capital.com

Peter Schnellhammer is Investment Research Analyst at Aquila Capital. He has more than 6 years experience in Strategic Research and Alternative Investments. Prior to joining Aquila Capital in 2019, he focused on macroeconomic research of Real Estate markets. Peter holds a master's degree in Economics from University Rostock.

Till Schulz-Eickhorst
Managing Director Aquila Capital Investmentgesellschaft mbH
till.schulz-eickhorst@aquila-capital.com

Till Schulz-Eickhorst joint the Board of Directors of Aquila Capital Investmentgesellschaft mbH in March 2022. Mr. Schulz-Eickhorst oversees the portfolio and asset management of Aquila Capital Investmentgesellschaft as Chief Portfolio Manager.

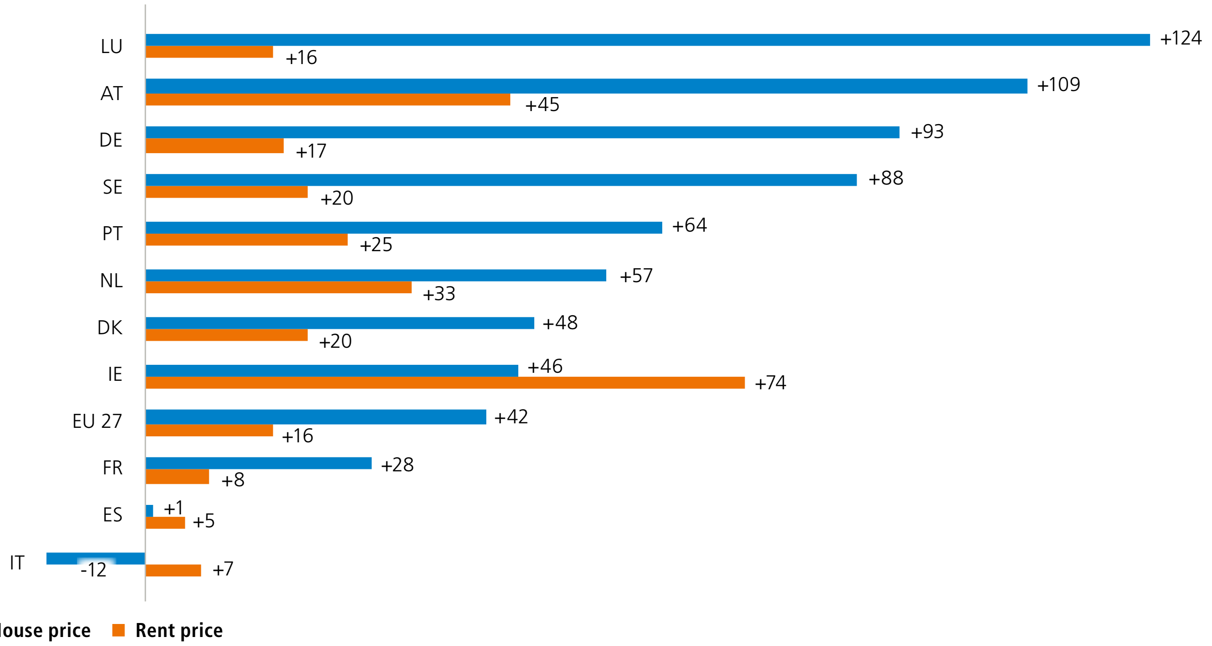
He has more than 17 years of experience in investment management and the real estate sector, where he was responsible for carrying out real estate transactions worth more than EUR 6 billion. Prior to joining Aquila Capital in 2019, he was Head of Fund Management at Deka-Immobilien Global, where he was responsible for the overall performance and strategy of the company's global real estate fund. Previously, he was Head Investment Manager, UK & Ireland, responsible for all acquisition and sales activities, including deal sourcing, negotiating purchase and sale agreements and due diligence. Till holds a degree in business administration with a focus on real estate as well as banking and finance from the European Business School in Oestrich-Winkel.

CONTENT

1. Low interest rate policy leads to asset price inflation

More than a decade of low interest rate policies in response to the economic dislocations following the global financial crisis posed significant challenges for investors. As bond markets generally did not show positive real interest rates or even negative nominal interest rates, demand for alternative asset classes increased. Especially real assets, including the important real estate segment, benefited from this development. Instead of moderate economic inflation, which is the declared goal and original task of the ECB, asset price inflation took place.

Chart 1: House price and rental price development in European comparison 2010–2021 (in %)[1]



The developments particularly affected the market for residential real estate, which on the one hand has a high crisis resilience due to its essential importance and on the other hand is characterised by scarce supply in most European markets.

The influx of capital as a result of investors' portfolio reallocation led to significant increases in house prices. Despite rising rental prices, which are characterised by persistent excess demand, house prices increased more than twice as fast as rental prices in the last decade.

[1] *Eurostat (2022)*

Nevertheless, the associated yield compression did not result in declining market activity. Marked by the euro crisis, a resurgence of protectionist trade practices, the Corona crisis and most recently the Russian invasion attempt of Ukraine, risk aversion increased. In particular, European residential real estate markets in the metropolises and conurbations were thus in the focus of international investors as safe havens.

Spain, however, shows a picture opposite to the European trend. Compared to the development of house prices, rents increased many times faster over time. Apart from the drastic correction of house prices after the bursting of the real estate bubble in 2008, this development is largely due to a housing market in Spain that is undergoing structural change.

2. Economic Framework – 15 years of ups and downs

Especially in Spain and the southern European countries in general, the global financial crisis that began in 2008 led to the uncovering and reinforcement of historically grown structural deficits. The growth models in Southern Europe focused on the expansion of domestic demand, which led to an expansion of industries producing non-tradable goods – mainly real estate. The construction sector in particular turned into a growth driver, supported by both public and private investments, which went hand in hand with expansive lending and the associated increase in debt. This was accompanied by a wage development decoupled from productivity, as a result of which price competitiveness and thus the export economy deteriorated significantly.

The external shock caused by the financial crisis and the global recession led to the collapse of the system and was amplified all the more by a high degree of rigidity in labour markets. In order to limit the damage to the national economy, there was almost no alternative to an expansion of government spending, financed by corresponding new debt. However, this development, combined with structural deficits, especially in Southern Europe, and a global loss of confidence, created doubts about the sustainability of this new debt. The subsequent assessment on the capital market led to diverging interest rates, which created considerable pressure on the states, resulting in the currency crisis of the euro. Only the intervention of the European Central Bank and Mario Draghi's historic speech, in which he made clear that the ECB would do "Whatever it takes" to save the euro, calmed the extremely tense situation.

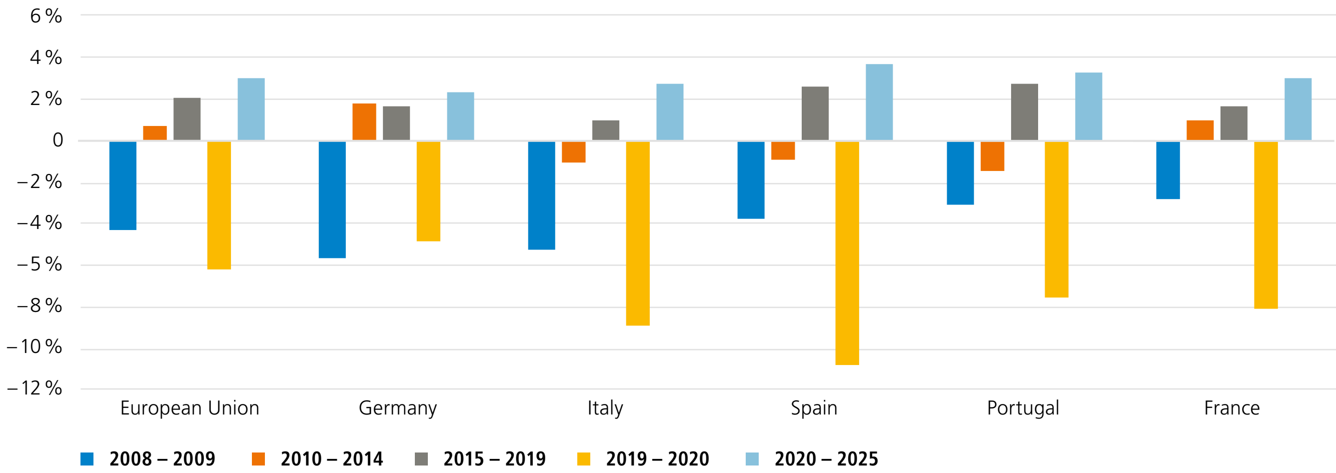
While the core Western European countries (including Germany, France, Great Britain) returned to growth relatively quickly, the recession in Southern Europe continued. In the course of this, however, extensive structural reforms were initiated in the crisis countries to correct the lack of responsiveness of wages and prices as well as the misallocation of resources in the non-tradable goods sector. These structural reforms, implemented on a considerable scale, had the corresponding effect and sustainably strengthened the competitive

situation of the Southern European states. In the period from 2015 onwards, Portugal and Spain recorded significantly above-average growth rates, while Germany and the UK, for example, lost momentum.

The result shows that the market correction and, in certain areas, the market adjustment painfully but effectively eliminated structural misdevelopments. Structural reforms based on this showed the desired effects by improving the competitive situation through increased flexibility of wages and prices, reducing heterogeneities within the monetary union and thus showing significantly improved growth and employment prospects. The economic recovery, which was delayed compared to the core countries of Western Europe, led to a decoupling of the economic cycles within the currency area, which resulted in diversification and growth potential.

With the onset of the pandemic in 2020, however, the positive economic development came to an abrupt end. Once again, Southern Europe, and Spain in particular, were the countries hardest hit by the pandemic and its severe economic consequences.

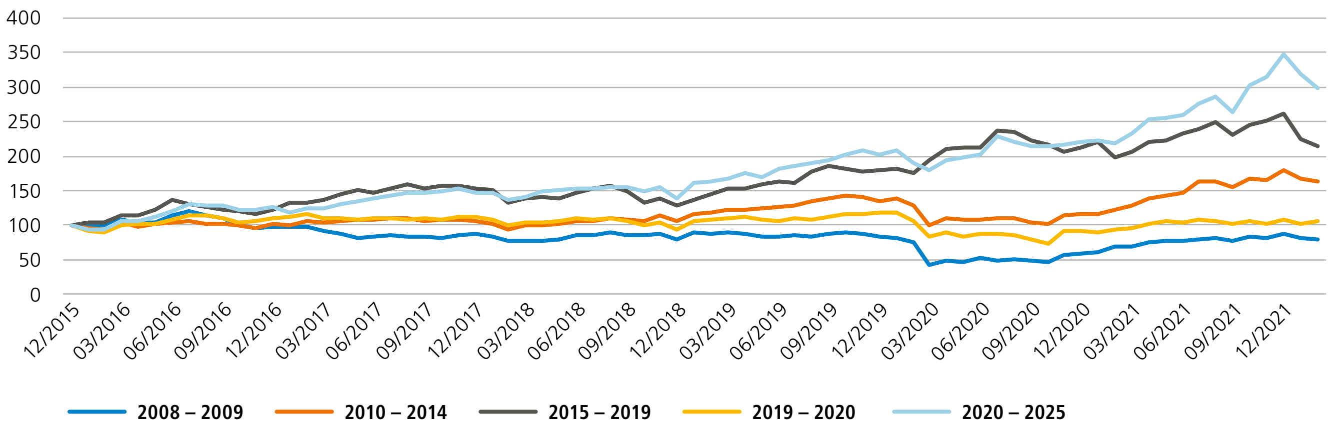
Chart 2: Phases of economic development (each in % p.a.)[2]



Nevertheless, the structural reforms are paying off and are having a positive effect in the context of economic recovery. As shown in chart 2, Spain in particular stands out in terms of its economic outlook, with growth rates well above the EU average.

In addition, the effects of the pandemic allow general conclusions to be drawn regarding the crisis resilience of different real estate segments.

Chart 3: Index REIT subsectors (2015=100)[3]



Logistics properties and data centres turned out to be clear winners of the crisis, as they benefited from mobility restrictions and digital working models. But also the housing market, driven by the fundamental importance of housing, continued its positive development almost steadily. While share price losses were also recorded with the onset of the pandemic, these were triggered by lower activity due to legal restrictions and were clearly overcompensated with the onset of recovery.

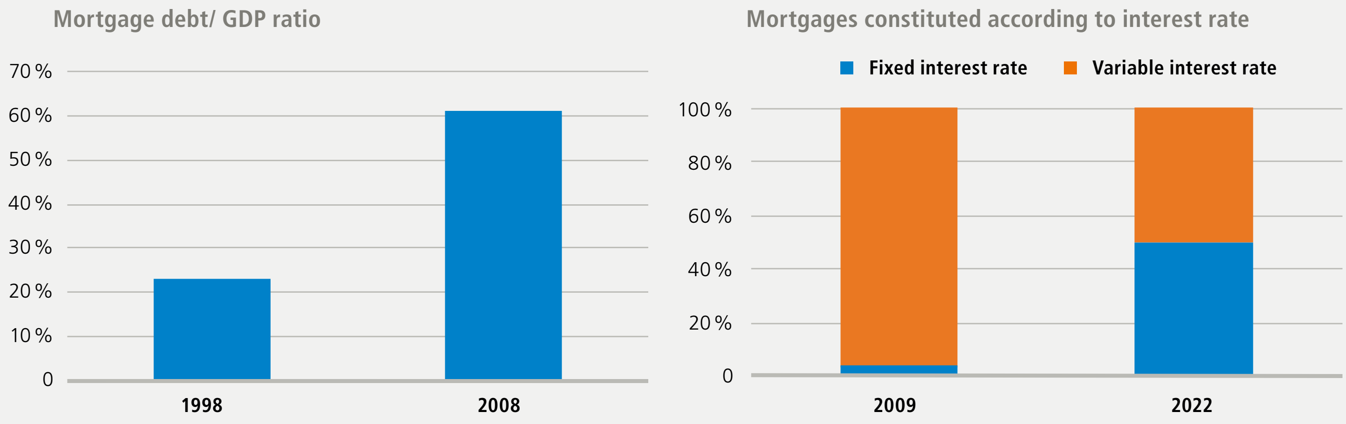
[2] *IMF (2022)*
[3] *Bloomberg (2022)*

3. Housing market Spain

3.1 Lessons learnt from GFC (Global Financial Crisis)

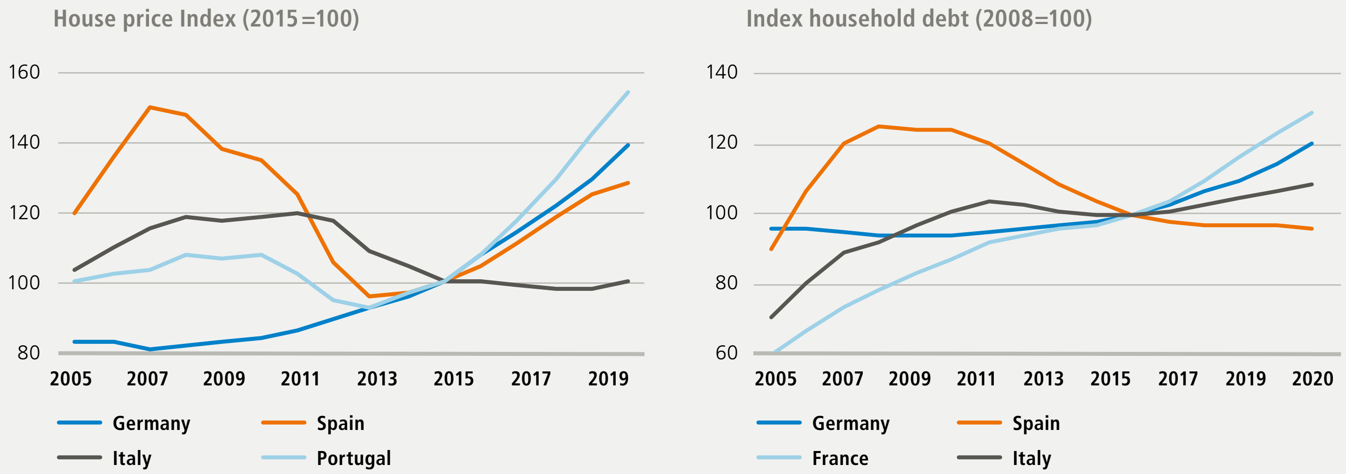
The Spanish housing market is undergoing a structural change. Over a long period from 1960 to 2007, renting was often considered a suboptimal investment. Rising house prices, government subsidies and easy access to mortgages led to an increase in home ownership to more than 80 %. This development was largely financed by private debt. Between 1998 and 2008, for example, mortgage burdens tripled, totalling more than 60 % of Spain's GDP. To make matters worse, more than 90 % of mortgages had variable interest rates, which dramatically increased the burden of household debt with the onset of the crisis.

Chart 4: Structure of financing[4]



The global financial crisis and the resulting recession exposed the implicit risks and led to far-reaching changes. On the one hand, there was a huge drop in prices, and on the other hand, access to credit was significantly reformed.

Chart 5: Development of house prices and household debt[5]



[4] INE (2022)
[5] Eurostat (2022)

The corresponding effects are shown in the charts above. After the significant correction of house prices, which lost more than a third of their value after the peak in 2007, healthy growth set in from 2013 onwards, which nevertheless lagged behind the dynamics in other EU countries. In addition, private debt declined steadily due to continued restrictive lending. Compared to other member states, where debt is rising, as can be seen above, largely driven by low interest rates, Spain continues to show a downward trend.

3.2 What a required equity share of 30 % means

With the reform of lending, equity requirements in particular were increased. While the possibility of 100 % financing allowed the ownership rate to rise to 80 % in the past, today at least 20 % of the purchase price and additionally around 10 % for ancillary acquisition costs are required in equity capital in order to gain access to a mortgage.

As a result, large parts of the population who do not have corresponding savings do not have the opportunity to acquire residential property. Young population groups in particular lack the necessary equity capital. As a result, the ownership rate in the 18–29 age group fell from over 50 % to less than 30 %. The average age of buyers rose to 41 years, which is also a peak value in European comparison. Accordingly, the demand for rental properties is increasing rapidly.

Chart 6: Development of tenure by age group (% of households renting) [6]

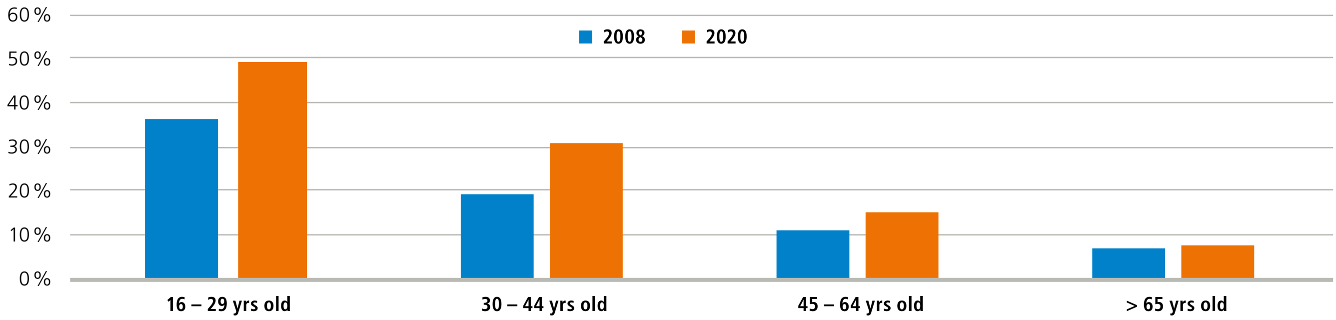


Chart 6 illustrates that the trend is not limited to the younger generation. Apart from the age group over 65, where the increase is only marginal but still positive, all age groups show significant increases in housing for rent. But is a market that has been characterised by rising ownership rates for decades prepared for this structural change?

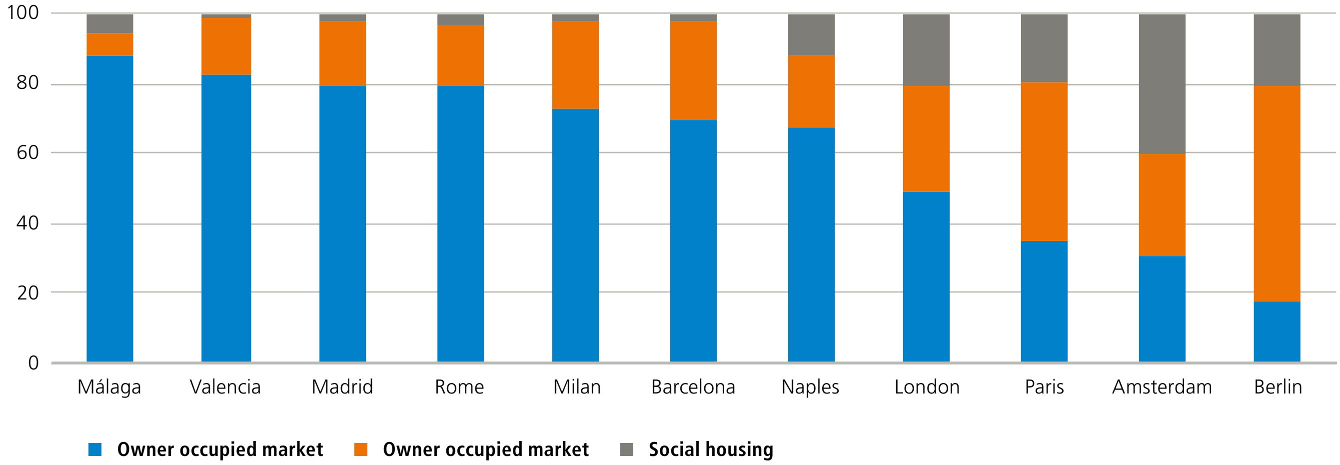
Not at all!

3.3 Rental market Spain

The focus on home ownership is reflected in the conditions of the Spanish housing markets. Especially in the economic centres of Spain, which offer career prospects, the rental markets are from severely underdeveloped to barely existent.

[6] *INE (2022)*

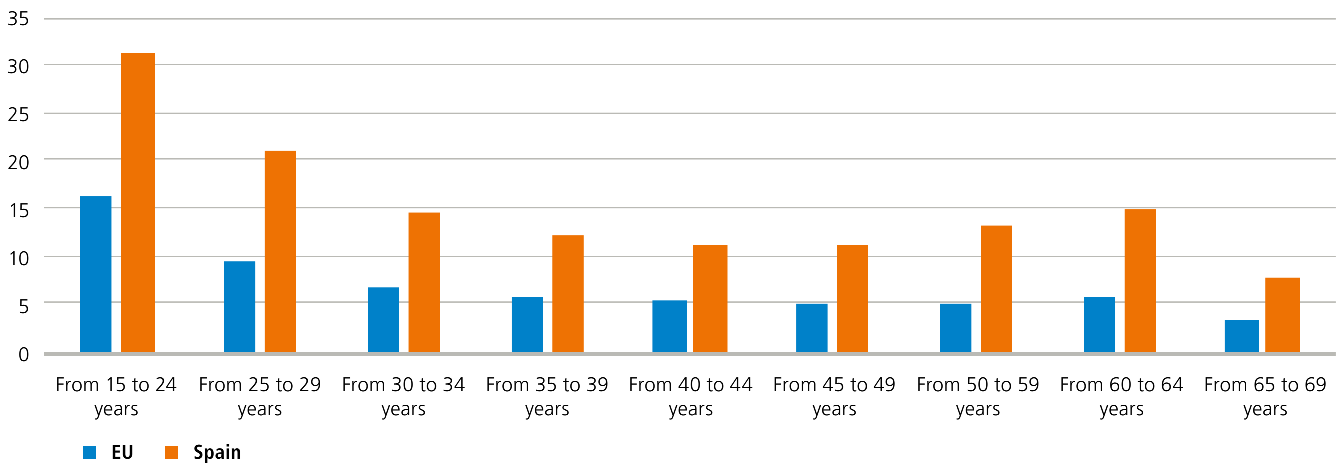
Chart 7: Market structure of European metropolises in comparison (in %)[7]



In line with historical demand, the residential markets in Spain are dominated by owner-occupied housing. While in Madrid, Valencia and Malaga only 10 % – 20 % of the stock is available for the rental market, Barcelona, with around 30 %, is also clearly underdeveloped in a European comparison. In addition, 90 % of the rental market is owned by private individuals. The consequences can be seen in the strong fragmentation of the market segment, which lacks professionalism.

In particular, the social rental market, i.e. flats with limited rents for lower-income households, hardly exists. As a result, young adults in particular, for whom the economic centres in the metropolitan areas could open up development prospects, lack access to affordable housing.This aspect is of fundamental importance in Spain, as youth unemployment has one of the highest rates in Europe.

Chart 8: Unemployment rate by age group 2021 (in %)[8]



In particular, the slump in the labour-intensive construction industry during the crisis caused the unemployment rate in Spain to skyrocket. With the onset of the euro crisis, it amounted to more than a quarter of the Spanish working-age population. While it almost halved in line with the economic recovery, the problem is even deeper in the young adult group. With about 20 % of the population between 18 and 24 neither studying nor working, Spain occupies an inglorious second place in the EU. Only Italy shows a higher rate.

However, access to affordable rental markets in the metropolises is the key to overcoming the lack of perspective. The development of a substantial rental sector that is able to cope with structural change,

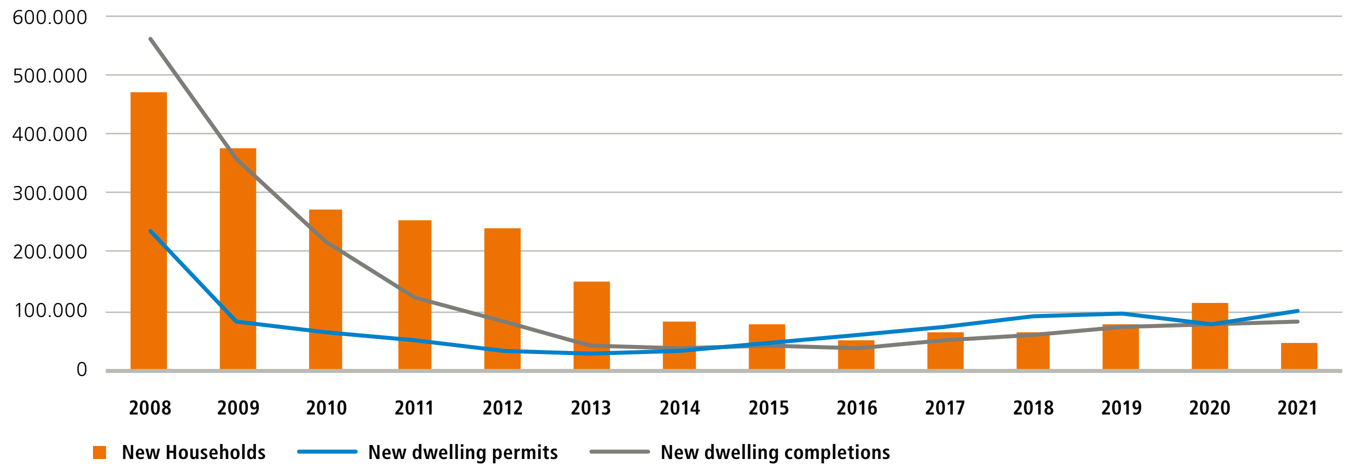
[7] *Colliers (2022)*
[8] *Eurostat (2022)*

however, requires an institutionalisation of the sector in order to provide the corresponding financial resources and to ensure the professionalisation of the management.

3.4 Construction activity

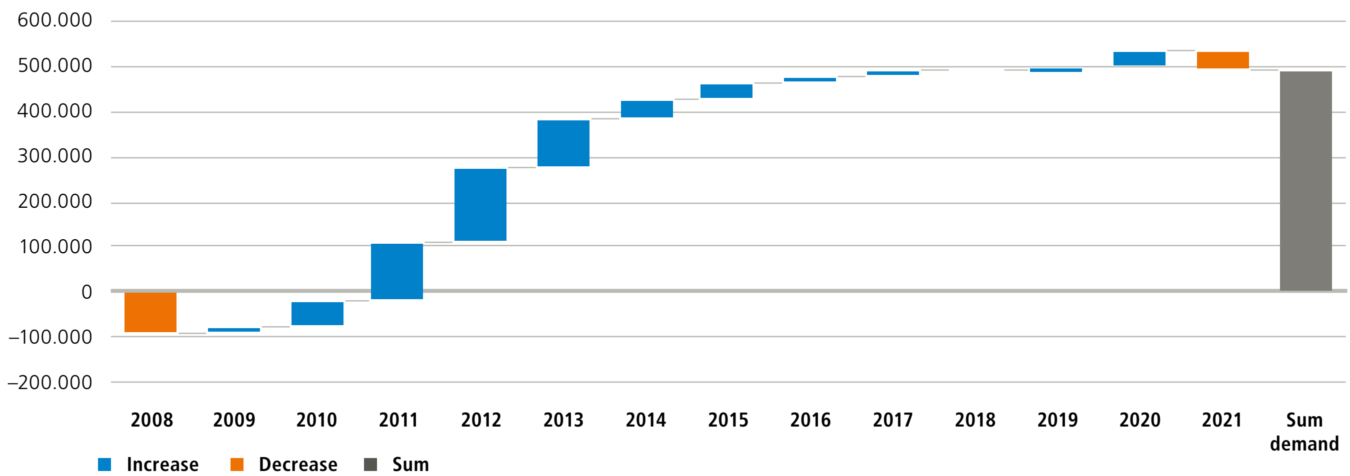
However, the developments are contrasted by low activity in the construction sector. After the peak of the construction boom, which came to an end with the onset of the crisis in 2008, the number of new dwellings fell drastically. From around 600,000 new dwellings in 2007, only slightly more than 5 % remained in 2014.

Chart 9: Building permits and housing completions in relation to household growth in Spain[9]



Limited by the lack of housing, the growth of new households also declined as a result of these developments. Nevertheless, the increase in households was significantly higher than the increase in supply for a decade, creating a significant imbalance in the housing market.

Chart 10: Supply and demand imbalance (number of households in relation to housing completions)[10]



[9] *INE (2022)*
[10] *Aquila Capital Research (2022)*

In the period from 2008 to 2021, household growth exceeded new housing construction by a total of half a million. These households had to be absorbed by the existing stock. The housing market in Spain is correspondingly tight, reflected not only in rising rents but also in existing housing conditions due to a lack of supply.

The pent-up demand for housing, especially in the rental segment, is additionally present and at historically high levels. An existing excess demand for rental housing of about 2.5 million households can be assumed.

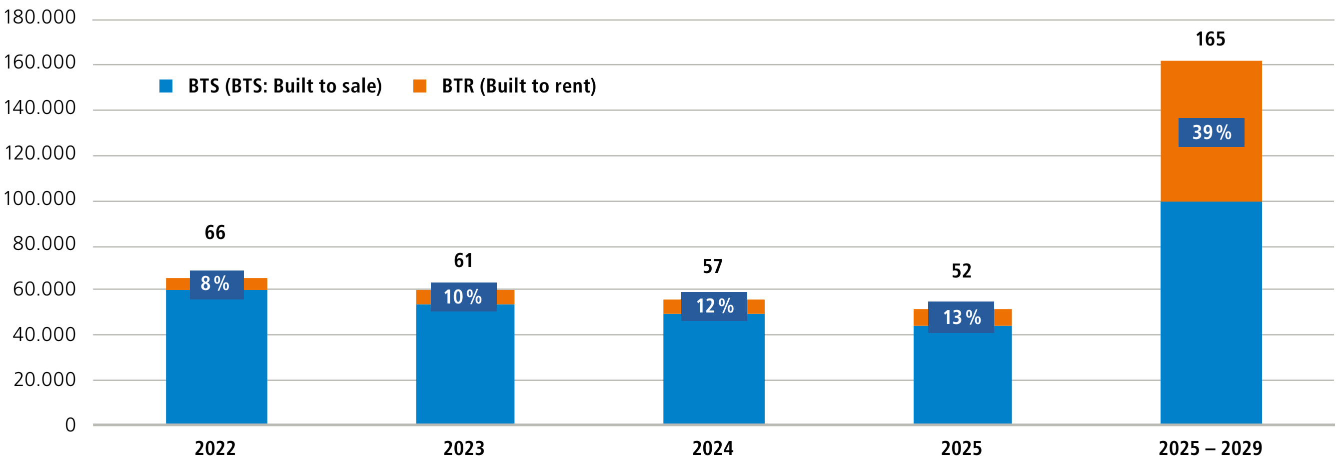
In this context, the lack of institutionalisation of the segment is also a barrier, but offers opportunities for project developers who combine international capital with local networking and expertise.

BOX 1

Aquila Capital
Our expertise and experience in the residential segment in Spain is characterised by an exclusive partnership with AQ Accentor. AQ Accentor is specialized in developing projects in metropolitan areas mainly in Madrid, Barcelona, Malaga and Valencia. AQ Accentor is operating in the Spanish market since 2014. The portfolio consists of over 6,100 housing units. It is split in 40 % affordable housing; 60 % free housing. In addition, we are the first group to develop Build to Rent (BtR) in social housing. In Catalonia, we are currently the largest developer with 2,000 homes in different phases of development. In Madrid, we developed the largest affordable housing project by a single developer, Parque Ingenieros, with some 1,350 homes. In Valencia, we are developing the new neighbourhood Turianova, with 1,200 homes and 113,000 sqm of tertiary facilities. It is the largest residential urban development project carried out by a single developer, with an investment of more than 350 million euros. In Málaga, we have more than 1,000 homes under development, including the two highest residential towers in Andalusia, AQ Urban Sky, which is over 110m high.

Although investment activity on the market is increasing due to the positive framework conditions, no necessary easing can be expected in the short to medium term.

Chart 11: Pipeline of new flats by segment (in 1,000) [11]



[11] *EY (2022)*

Thus, although around 235,000 flats are expected to be built in the next few years, only 10 % of these are designed to expand the rental segment. Only from 2025 onwards is an adjustment of supply likely to follow the structural change. Therefore, companies that have already anticipated the development earlier will continue to benefit from the surplus demand and future development potential.

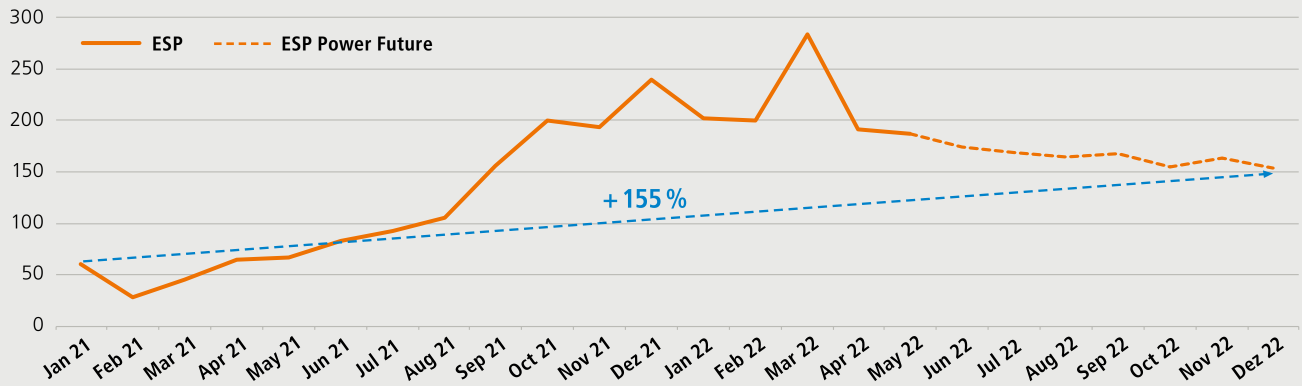
Construction activity is also under pressure from burgeoning inflation. Continuing supply chain disruptions and the war in Ukraine are leading to a severe shortage of supply of construction materials, resulting in sharp price jumps. In addition, a tightening of monetary policy on the part of the ECB is to be expected, which will lead to persistently rising financing costs. As a result, only moderate new construction is to be expected in this environment, which means that the housing market will also be characterised by strong excess demand in the medium term.

Due to the lower wage pressure in Spain and the availability of labour compared to other European markets, the increase in construction costs is still moderate in European comparison. Nevertheless, the change is significant and must be compensated for investors by higher rents. In connection with the increases in rent levels already realised due to demand, this raises the question of the affordability for private households, which are also heavily burdened in other areas by inflationary developments.

BOX 2

Power price futures Spain (EUR pro MWh)[12]

Starting with commodity prices, especially gas, energy prices in Europe have skyrocketed. The price levels are putting companies, private households and even the central banks under massive pressure.



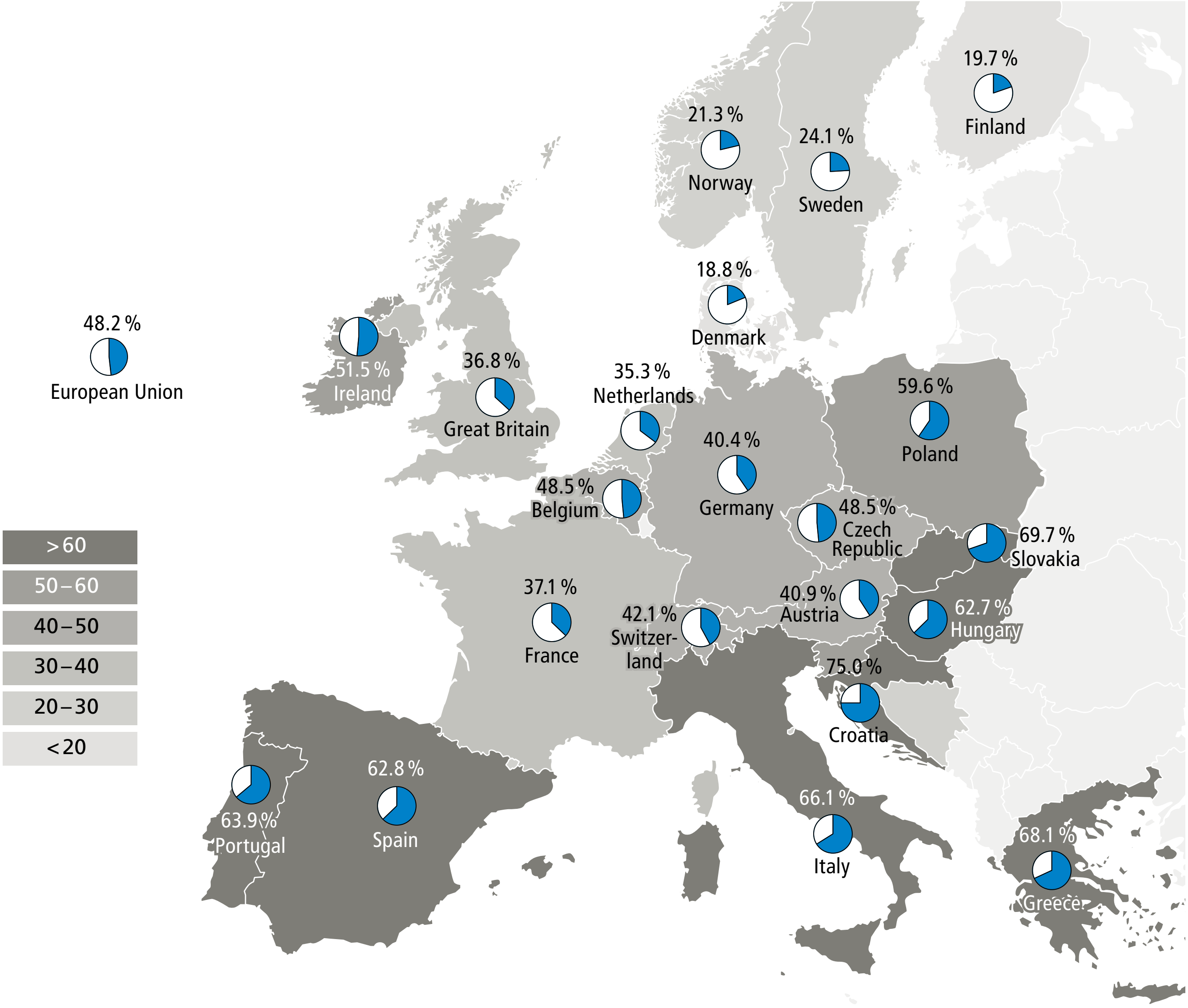
However, based on energy costs, which are the main driver of inflation and are already causing second-round effects, opportunities and risks are close together. The only solution to this tension is the institutionally organised construction of new buildings. Due to higher efficiency standards, the energy demand of new buildings is about 50 % lower compared to buildings that are 20 years old or older. In this context, high savings potentials can be realised elsewhere through further energy efficiency measures as well as self-supply with renewable energy. Companies with the appropriate know-how can thus significantly reduce the burden in the area of ancillary costs and compensate for the additional burden of higher rental costs.

3.5 Generation rent

The limited supply situation makes it difficult for young adults in particular to leave their parents' home. It is not so much cultural differences, but the fundamental housing supply in Spain and the other southern European countries affected by the financial and currency crisis that has led to around two thirds of young adults still living in their parents' house.

[12] *ENTSO-E (2022); eex (Stand 17.06.2022)*

Chart 12: Proportion of 18–34 year olds living in their parents' house [13]



However, in addition to economic reasons, affordability, especially in the big cities, and the limiting supply situation, demand will continue to rise in the future. Especially among young people, the desire for a home of their own is less pronounced. On the contrary, flexibility and mobility have gained enormously in importance. In this context, the "generation rent" is not exclusively forced to rent from an economic perspective. The avoidance of high financial burdens as well as binding responsibility is giving way to the desire for freedom and flexibility in the broad European population.

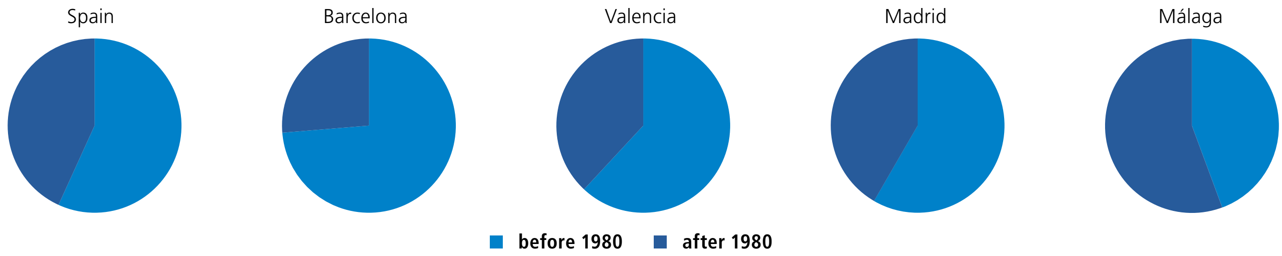
The experiences from the pandemic, especially the testing of new working models, are doing the rest.

3.6 **Pandemic effects – Reassessment of living conditions**

In addition to flexible, digital working models, the pandemic also acted as a catalyst for existing trends. The restrictions led and lead to a reassessment of one's own housing conditions. Spanish metropolitan areas in particular, meanwhile, are characterised by a very old building stock.

[13] *Aquila Capital; Eurostat (2019)*

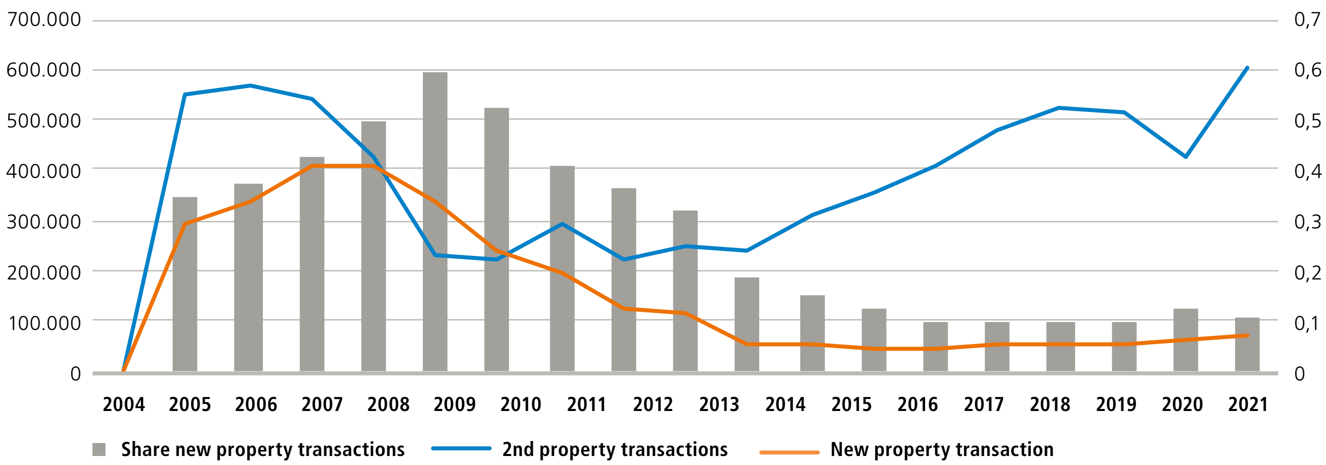
Chart 13: Age of the building stock [14]



As the chart illustrates, around 50 % of the existing buildings were constructed before 1980, with a corresponding impact on the standard of these flats. In particular, the fragmented private rental sector, the majority of which is privately owned, shows deficiencies in this context. Since most of the flats were originally intended to be sold and there is a lack of professionalisation in the segment, maintenance and modernisation have been neglected.

The focus on one's own housing situation, forced by the restrictions during the pandemic, results in a higher value. Modern flats, with balconies and surrounding outdoor space, are in demand, but also severely limited by the low level of new construction.

Chart 14: Transactions in the Spanish housing market [15]

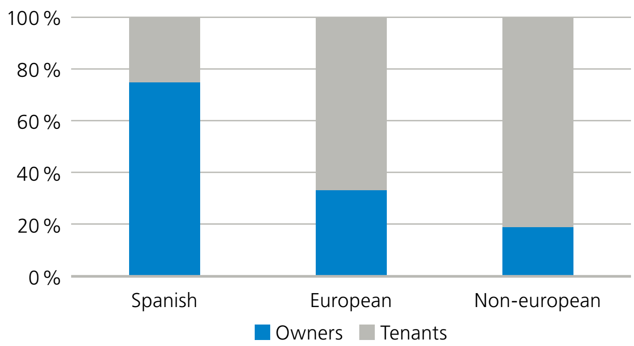


In the absence of substantial new construction, market activity is particularly channelled to the existing stock. The limited supply situation also results in significant price jumps in this area.

In addition, Spain has always been a centre of attraction for international tourists. However, with the revolution in working models, Spain is also becoming more interesting as a place to work for an increasing number of employees. Even companies are increasingly looking to the Mediterranean coast to compete for talent. For example, the city of Malaga, which increasingly attracts technology companies and boasts more than 320 days of sunshine a year, has become the "Silicon Valley" of the Mediterranean coast.

While residential purchases by foreigners recorded a share of more than 12 % in the fourth quarter of 2021, demand for rental properties is also expected to increase from this perspective.

Chart 15: Preferred housing type by nationality in Spain 2020 [16]



[14] Eurostat (2020); [15] Ministerio de Fomento (2022); [16] INE (2022)

In view of these developments, the situation in the Spanish housing market will increasingly worsen. An institutionalisation of the segment is urgently needed to follow Spain's structural change.

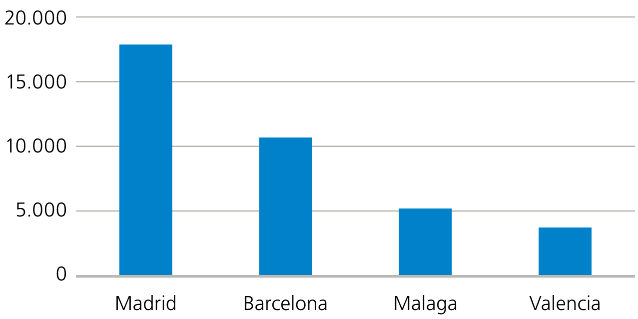
In addition, new development quarters need to be created, as there is a lack of available land in the mostly historically grown cities. New developments are therefore increasingly becoming sought-after properties in the outer areas with very good connections to the infrastructure.

4. Effects on the real estate markets

The imbalance between supply and demand in the Spanish housing market offers enormous potential. The focus is particularly on Spain's economic centres, which are characterised by progressive gentrification. In addition to Spain's three largest cities, Madrid, Barcelona and Valencia, the focus is also on Malaga, which is showing increasingly positive dynamics due to its attraction for international companies.

The structural reorientation towards the rental sector offers opportunities, especially in a European comparison. While there is already an enormous surplus demand, no trend reversal is expected in the long term.

Chart 16: Household growth (2021-2035) [17]

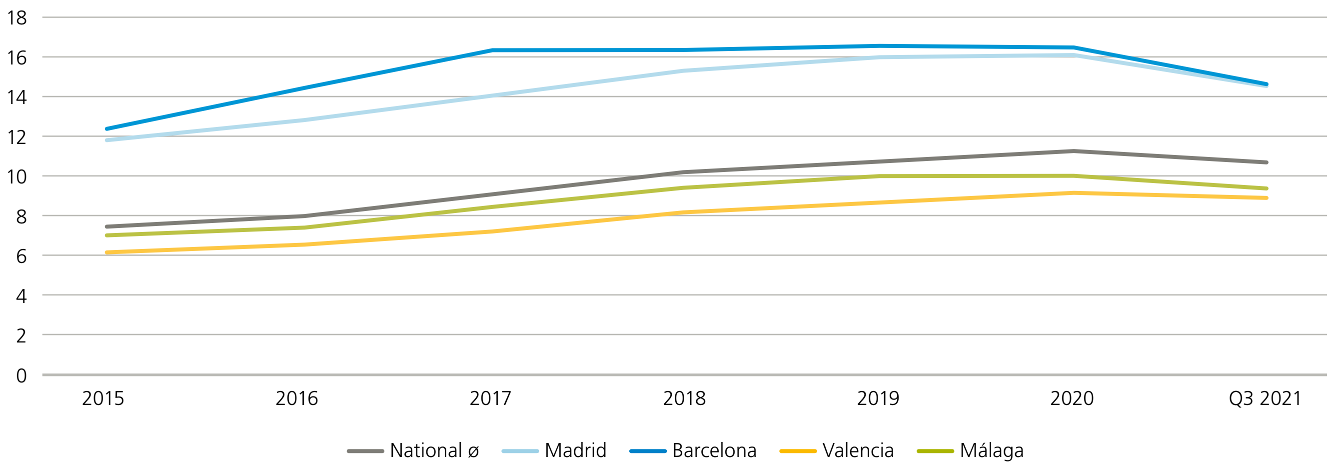


In the cities shown in chart 16 alone, an annual increase of almost 40,000 households can be expected in the next decade. This new demand, supplemented by the lack of new construction in the last decade and a resulting backlog, means that demand will continue to meet a shortage of supply, opening up attractive opportunities for investors.

4.1 Rental price development

The market situation and competition for scarce living space have triggered a price rally in the rental market.

Chart 17: Rental price development (average rent EUR/m²) [18]



[17] *INE (2021)*
[18] *Idealista (2021)*

In the period of only 5 years, rental prices increased by 50 % on national average until 2020. Malaga and Valencia with 44 % and 34 % growth, even outperformed Madrid and Barcelona in this period respectively, of 23 % and 17 %. The slight declines in 2021 are due to the restrictions during the pandemic and will most likely be overcompensated in the coming months. It must be added that average rents can only illustrate part of the overall development, as they show significant differences depending on the quality of the housing.

Considering the low level of new construction as well as the absorption of part of the demand by very old existing properties, it becomes clear that the potential in the new construction segment can significantly strengthen these dynamics.

The national average, which significantly exceeds the rental growth of the cities, gives an indication of the limited land availability within the cities. As a result, new developments are increasingly focussing on the peripheral areas. At the same time, the development of new neighbourhoods, with more spacious areas and appealing outdoor facilities, also corresponds to the appreciation of individual living situations driven by the pandemic.

4.2 Yield potential

The focus on real assets triggered by low interest rates, especially in the real estate segment, led to considerable compression of purchase yields in the European residential market. In this case, prices increased much faster than rents, driven by investor demand. Since the yield is calculated as the quotient of annual rent divided by purchase price, investors are faced with persistently declining yield potential.

Chart 18: Price to rent ratio in European comparison [19]

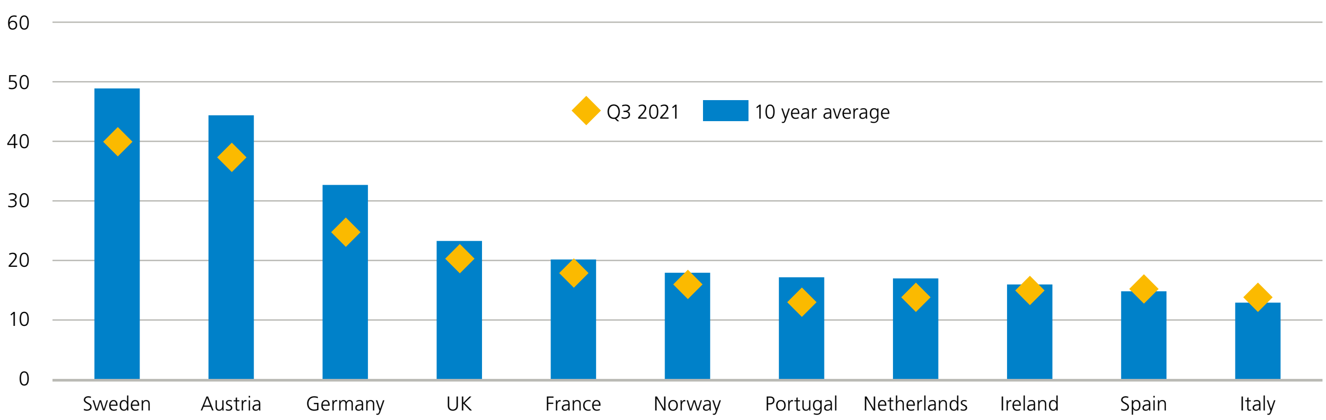


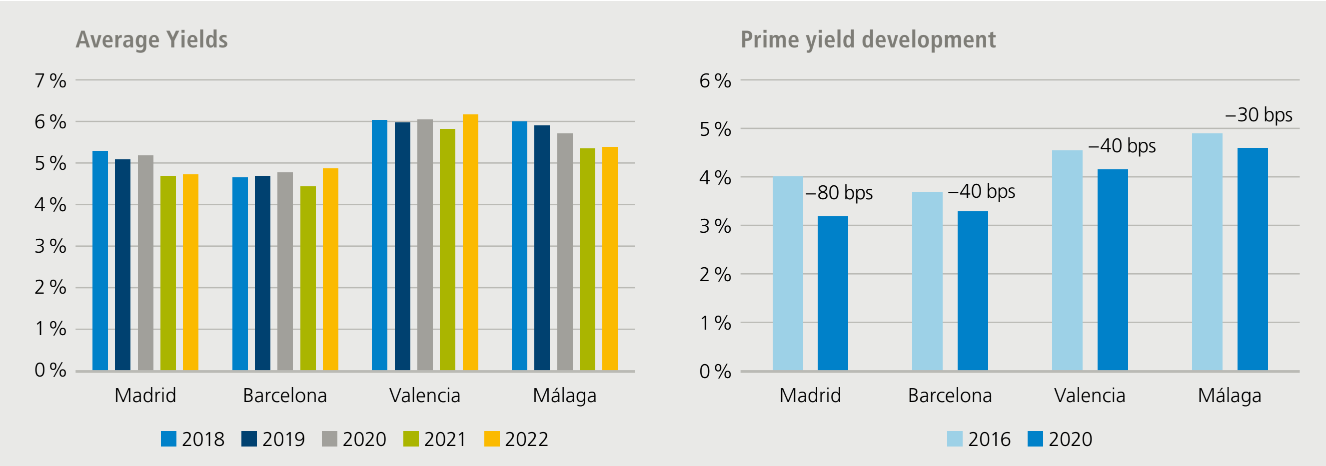
Chart 18 illustrates significant shifts in most European markets, which prove that the development of purchase prices significantly exceeds the dynamics of rents. In the past year alone (Q3 2020-Q3 2021), the median price-to-rent ratio in Europe increased by almost 6 %.

However, in contrast to the European trend, Spain shows an inverse ratio. Due to the enormous excess demand for rental flats, the dynamics of rental prices exceeded those of purchase prices. As a result, the yield compression observed throughout Europe did not occur in the Spanish market as a whole.

In the result, Spain has one of the highest return potentials within the European residential real estate segment. The individual domestic markets within Spain also reflect this development.

[19] *BNP (2022)*

Chart 19: Yield development in Spanish cities[20]

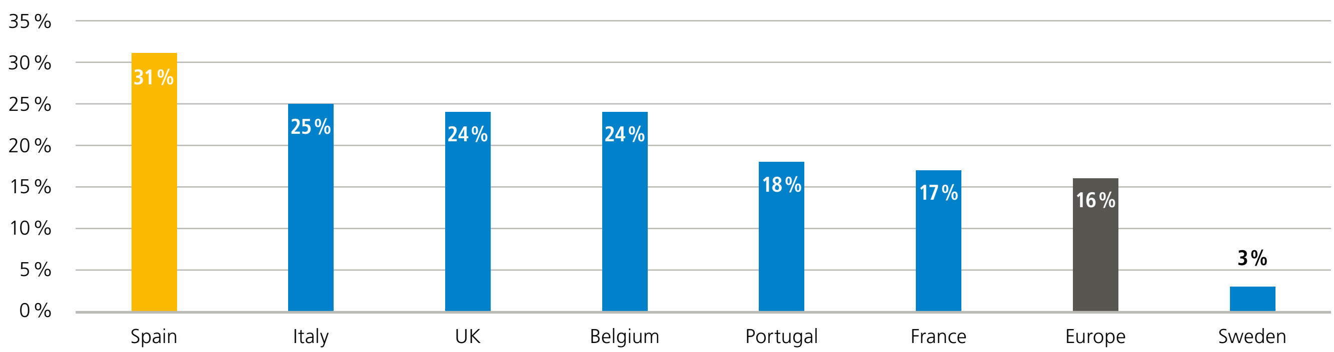


While yields in the economic centres are also below the national average, the average yields (i.e. including second hand transactions) illustrate a high degree of stability, as prices and rents show similar dynamics. But even with reference to the prime yields (1 % of transactions with the highest price achieved), yield compression remains at a moderate level. This correlation is underlined by the fact that the compression of prime yields in Spanish metropolitan areas over the 5-year period between 2016 and 2020 is in line with the decline of the overall European market in the past year alone. On average, European yields fell by 5.6 % between Q3 2020 and Q3 2021, which corresponds to a compression of 40 basis points.

4.3 Investors demand is rising

The positive framework conditions in the Spanish residential market, characterised by an enormous surplus demand for rental flats and attractive yield potential in a European comparison, results in increasing investor interest.

Chart 20: Development of transaction volumes in a European comparison Q3 2020–Q3 2021[21]



Accordingly, the growth of the transaction volume in the Spanish residential segment recorded the highest value in the EU.

[20] *Idealista (2022); BNP (2022)*
[21] *BNP (2021)*

5. Conclusion

The Spanish residential market has one of the highest potentials in Europe. Driven by strong structural tailwinds in the market and increasing investor interest, convergence within Europe offers significant upside potential.

However, the strong fragmentation of the market towards institutionalisation must first be overcome. While international investors face challenges due to a lack of investment projects and rising construction prices, among other factors, the focus is on long-term partnerships with project developers.

This creates competitive advantages for companies with strong local networks and expertise. The resulting opportunities to realise economies of scale and favour new construction offer opportunities to benefit first-hand from the development of the market and thus realise the catch-up potential to Western European markets.

For more information please contact:

Aquila Capital
Valentinskamp 70
20355 Hamburg
Germany
Tel.: +49 (0)40 87 50 50 - 100
E-mail: info@aquila-capital.com
Web: www.aquila-capital.com

Follow us on

Hamburg · Athens · Frankfurt · Invercargill · Lisbon · London · Luxembourg
Madrid · Milan · Oslo · Prague · Schiphol · Singapore · Taipei · Tokyo · Zurich

A publication of Aquila Capital Investmentgesellschaft mbH. As of June 2022. Author: Peter Schnellhammer