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MANAGEMENT SUMMARY

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.

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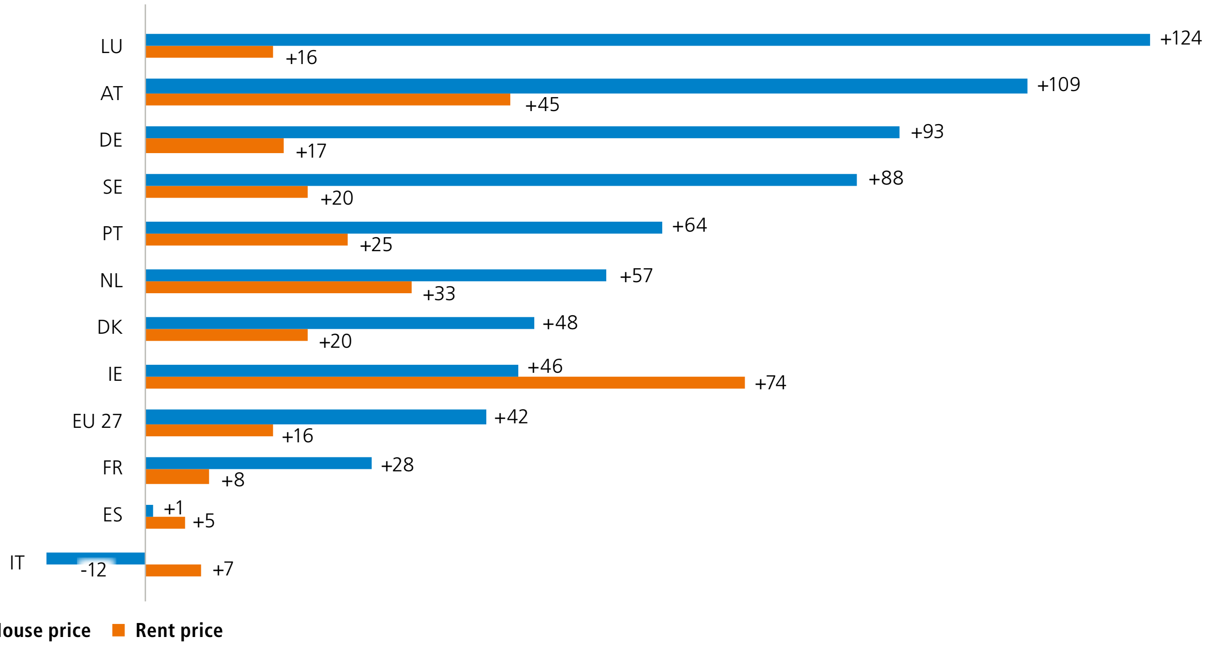
Till Schulz-Eickhorst joint the Board of Directors of Aquila Capital Investmentgesellschaft mbH in March 2022. Mr. Schulz-Eickhorst oversees the portfolio and asset management of Aquila Capital Investmentgesellschaft as Chief Portfolio Manager.

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.

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 in Europe as well as throughout the western world. 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.

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



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 a structural change.

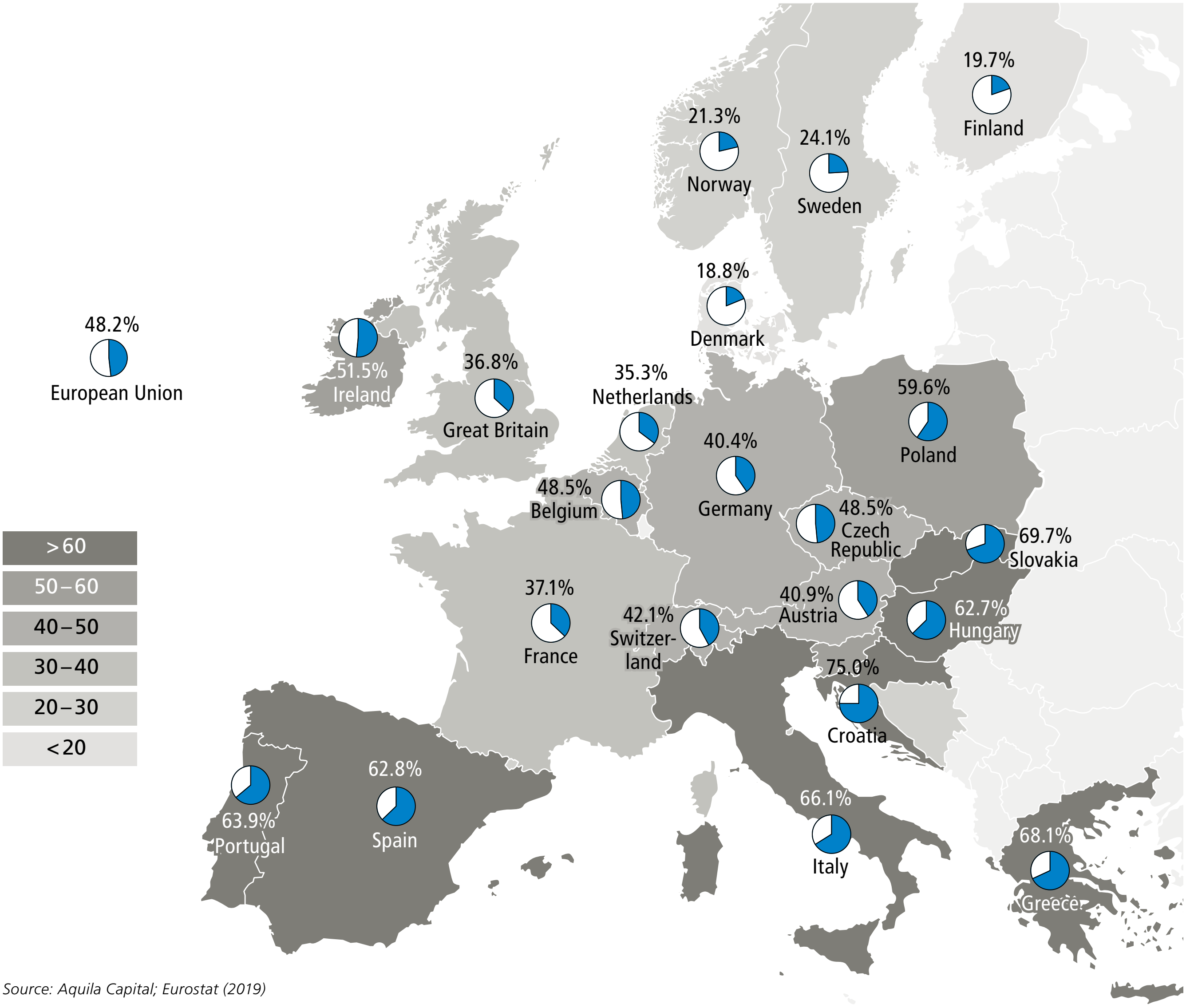
What a required equity share of 30 % means

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.

[1] *Eurostat (2022)*

Proportion of 18–34 year olds living in their parents' house

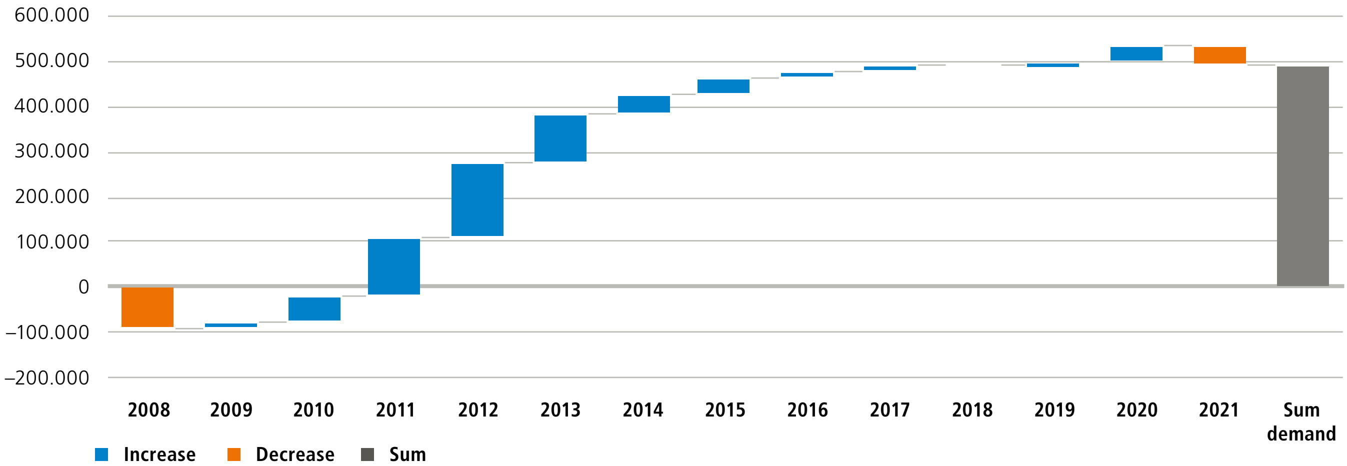


Source: Aquila Capital; Eurostat (2019)

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 apartments fell drastically. From around 600,000 new dwellings in 2007, only slightly more than 5% remained in 2014.

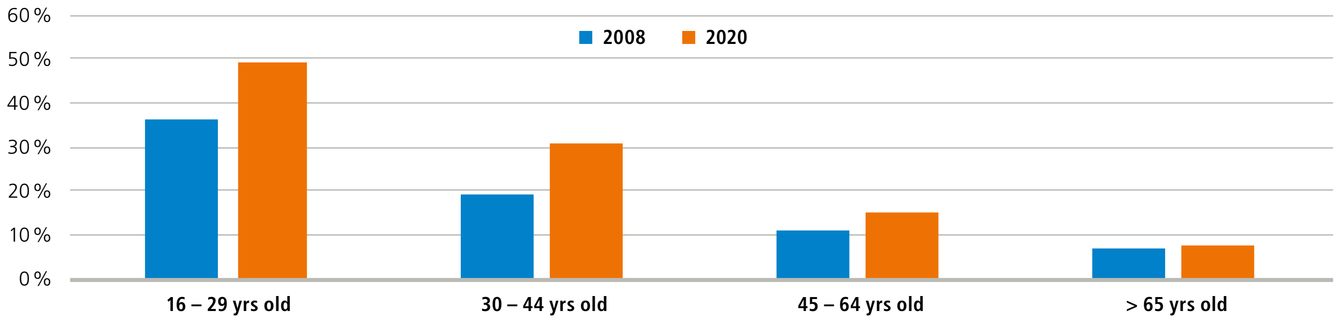
Supply and demand imbalance (number of households in relation to housing completions) [2]



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.

Development of tenure by age group (% of households renting) [3]



The chart above 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?

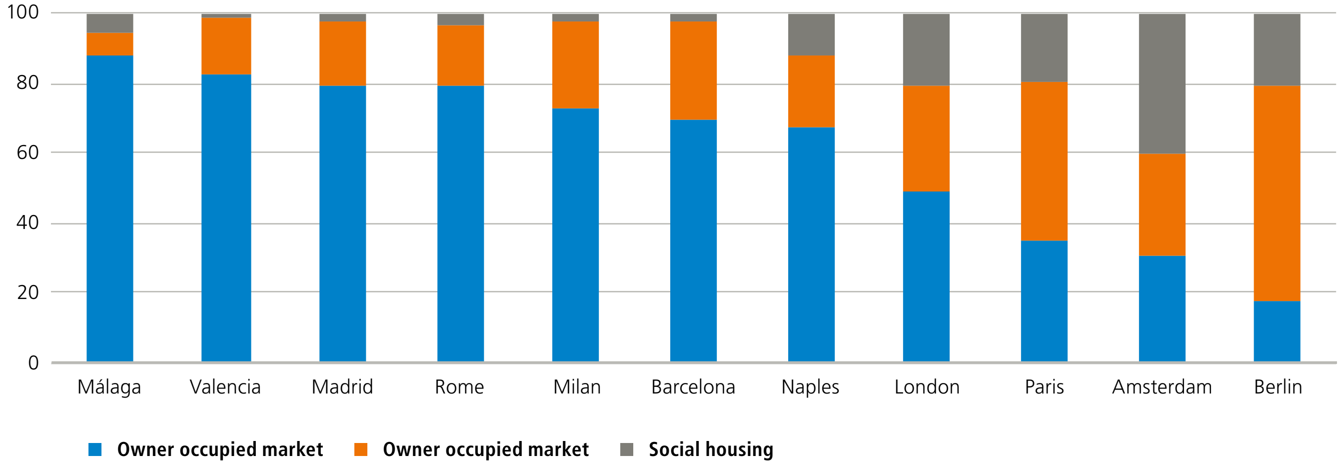
Not at all!

[2] *Aquila Capital Research (2022)*
[3] *INE (2022)*

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.

Market structure of European metropolises in comparison (in %) [4]



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.

Yield potential

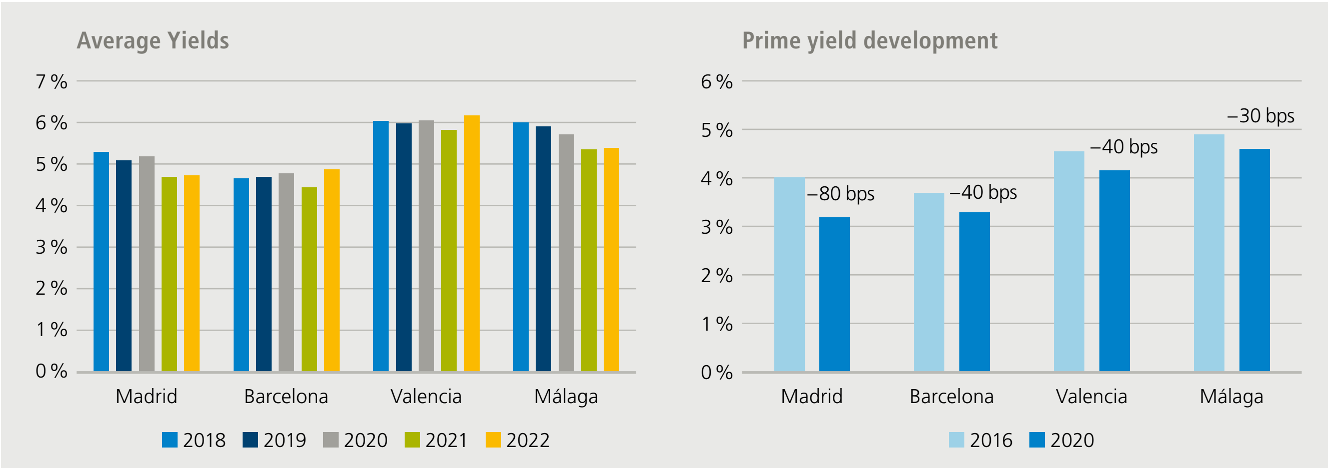
The focus on real assets triggered by low interest rates, especially in the real estate segment, led to considerable compression of purchase yields in the European residential market. In this case, prices increased much faster than rents, driven by investor demand. Since the yield is calculated as the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

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.

[4] *Colliers (2022)*

Yield development in Spanish cities[5]



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.

Conclusion

The Spanish residential market has one of the largest 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.

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[5] *Idealista (2022); BNP (2022)*

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