

Affordability challenge series #2: Pressure on affordability mounting and large transactions spark hopes of investment revival

JUNE 2023

Introduction

Inflation persistently above central bank targets suggests that interest rates will remain elevated across Europe. These higher rates have reduced the affordability of home ownership compared to renting. This increased relative attractiveness of renting, combined with the tight supply of rental properties, will support medium-term rental growth. The sector’s strong fundamentals have started to draw investors back into the market as witnessed by recent deal activity.

Peak policy rates in sight despite sticky inflation

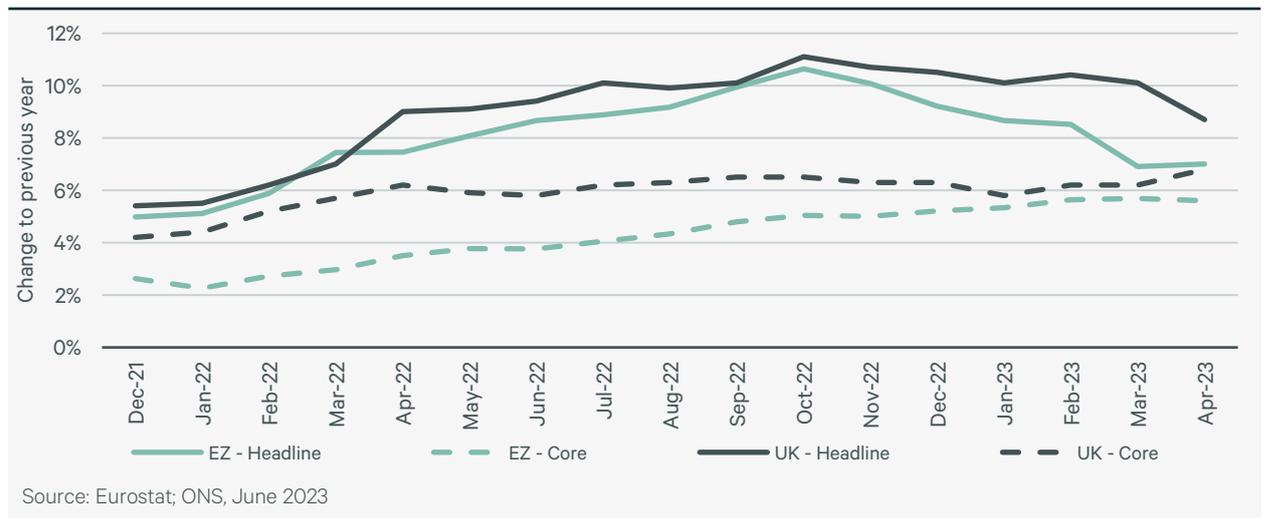
- Food prices in the Eurozone and the UK rose by 15% and 19%, respectively, in the year to April 2023 (Eurostat, June 2023; ONS, June 2023). This added to the already elevated cost of living after a period of steep (energy price) inflation and rising interest rates
- Household earnings have not kept up with the rise in inflation. This means that households have less of their budget left to make rent or mortgage payments, putting affordability under pressure
- Whilst inflation remains sticky for now, Central Banks in Europe are expected to approach a peak in policy rates
- According to CBRE’s latest house view, the ECB’s main refinancing rate is expected to reach its peak in July after a final 25bps increase. In the UK, inflation data will dictate the extent of rate increases with the peak anticipated by year end

The rise in food prices adds to households’ cost of living

Eurozone	UK
+15%	+19%

Food price inflation in the year to April 2023

FIGURE 1: Headline and core inflation in the Eurozone and the UK



Shift towards renting

- The rise in medium and long-term interest rates has impacted mortgage rates. In April 2023, the average mortgage rate was **3.76% in the Eurozone** and **4.46% in the UK** – around 215bps and 260bps higher, respectively, than in January 2022. For first-time buyers who require a relatively higher LTV, the rate is higher
- The increase in mortgage rates has reduced households’ maximum lending capacity and higher mortgage costs mean that some households can no longer afford to buy a home. Compared to January 2022, the average maximum loan amount in April 2023 has declined by 24% in the Eurozone and 28% in the UK
- This has had a visible impact on owner-occupier house prices, mostly in Northern Europe and the Nordics
- However, in most of these markets house prices have now started to stabilise. In Norway and Finland, the housing market has erased losses with house prices having returned to peak values

In Norway and Finland

The higher cost of mortgages is no longer offset by lower house prices

FIGURE 2: House price declines in selected markets in April 2023



Source: Europace, Halifax, Kadaster, Real Estate Norway, SCB, Statbank, Tilastokesus, Valueguard; June 2023

- This means that in Norway and Finland, the higher cost of mortgages is no longer offset by lower house prices. In the other five markets, there are still discounts to support owner-occupier affordability, although figure 2 shows that some of these markets have now likely turned
- The higher cost of mortgages is pushing more households towards the rental segment. In most major cities in Continental Europe, renting has now become more affordable than home ownership
- While mortgage rates are stabilising, they are stabilising at a much higher level and the difference in affordability will persist for some time unless house prices come down or rents move up materially

Affordability under pressure

- Before the influx of these additional households, the rental segment was already overcrowded
- With growing demand and few new sources of supply, market rents are set to rise. This was clearly visible over the Q1 2022-Q1 2023 period, with data showing prime rents increased by 9% and average rents by 10%
- This means affordability will come under pressure, both in the owner-occupier and rental segment
- While there is no uniform international measure of affordability, the European Union defines 40% of disposable income as a threshold to identify overburden on households’ budgets (figure 3)

Cost of home ownership as relative to the average disposable income in major cities in Continental Europe

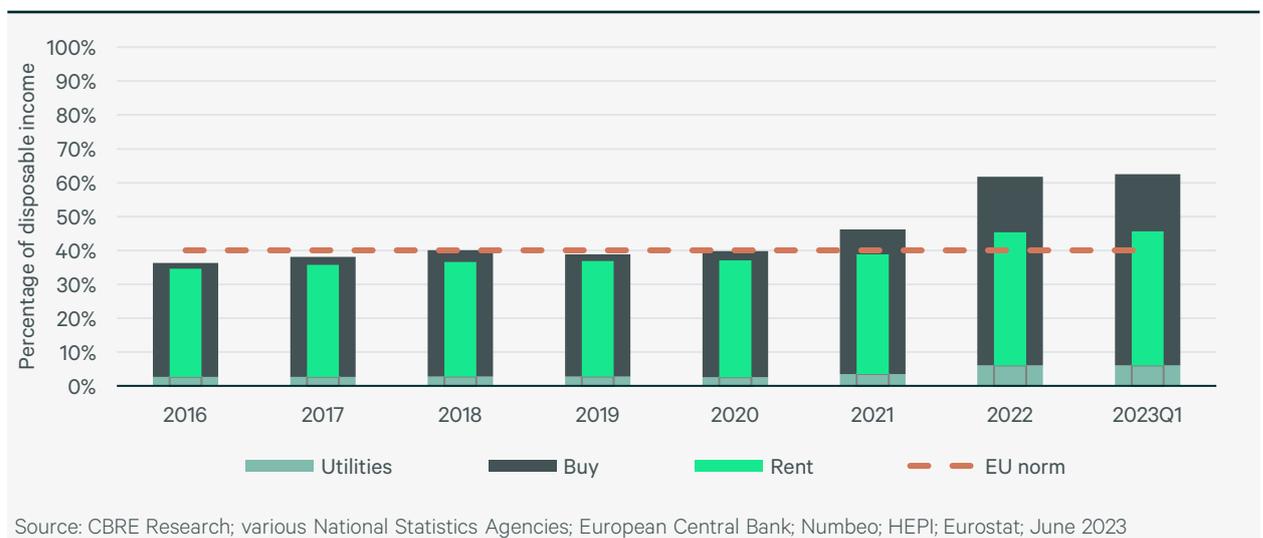
56%

European rental growth driven by already tight market conditions and the influx of additional households to the rental segment

9%

Q1 2023 vs Q1 2022

FIGURE 3: Cost of owning vs renting a 60sqm city centre apartment in major cities* in Continental Europe



Source: CBRE Research; various National Statistics Agencies; European Central Bank; Numbeo; HEPI; Eurostat; June 2023

- **Cost of home ownership:** The cost of buying a 60sqm apartment in the city centre rose to 56% of the average household disposable income in Q1 2023 – well above the 40% EU overburden threshold. Including utilities, this would increase to 64%
- **Cost of renting:** The cost of renting the same apartment amounts to 40% (or 46% including utilities) in Q1 2023. This is the first quarter that the cost of renting has reached the overburden threshold set by the EU

More households are drawn to the rental market

Higher costs of home ownership make renting more attractive, or home ownership may simply become unaffordable

*Amsterdam, Barcelona, Berlin, Cologne, Copenhagen, Dusseldorf, Frankfurt, Gothenburg, Hamburg, Helsinki, Lyon, Madrid, Malmö, Munich, Paris, Rotterdam, Stockholm, Stuttgart, Vienna, Warsaw. Weighted by long-term investment volume. Based on 100% LTV.

Supply expected to remain tight

- The rapid increase in housing costs shows that the supply of affordable low to mid-market rental apartments is critical to keep renting in major cities affordable
- This has resulted in political scrutiny and growing regulatory pressure. However, [new regulations are often aimed at controlling rents](#) instead of facilitating supply, which would be necessary to adequately target the shortage
- New supply is limited. Development activity in the Eurozone is at its lowest level since the start of the pandemic in 2020, and post-GFC development has remained 60% below the levels recorded in the 2000-2008 period ([Eurostat, June 2022](#))
- The supply shortage, in combination with the elevated cost of home ownership, means that the sector has robust fundamentals for occupancy rates and rental. This has drawn interest from investors who are eager to deploy capital in the sector



First large transaction sparks hopes of turnaround

- The slowdown in investment activity in the European residential investment market in the second half of 2022 was caused by a mismatch in price expectations between buyers and sellers following a rapid rise in interest rates
- However, recent transaction activity shows signs that the market is starting to stabilise
- The first large transaction that was agreed after repricing in the market was the provision of €1bn funding by Apollo to Vonovia for its Südewo portfolio (comprised of assets located in the Baden-Württemberg region). Although technically a capital injection rather than a pure real estate transaction, it does provide liquidity indicating where underlying values stand
- As reported by [Vonovia](#), the transaction values the portfolio at a 5% discount to December 2022 book value. However, [it was later reported by Bloomberg](#) that the deal structure included arrangements on dividends and asset management fees that would bring the discount to c.30%
- Shortly hereafter, [Vonovia announced another sizable transaction](#) which concerned the sale of 1,350 newly built residential units in Berlin, Frankfurt and Munich to CBRE Investment Management for €560 million. [According to Vonovia's Q1 2023 earnings call](#), this represented a 7% discount to the cost to build

Recent transaction activity shows signs that the market starts to stabilise

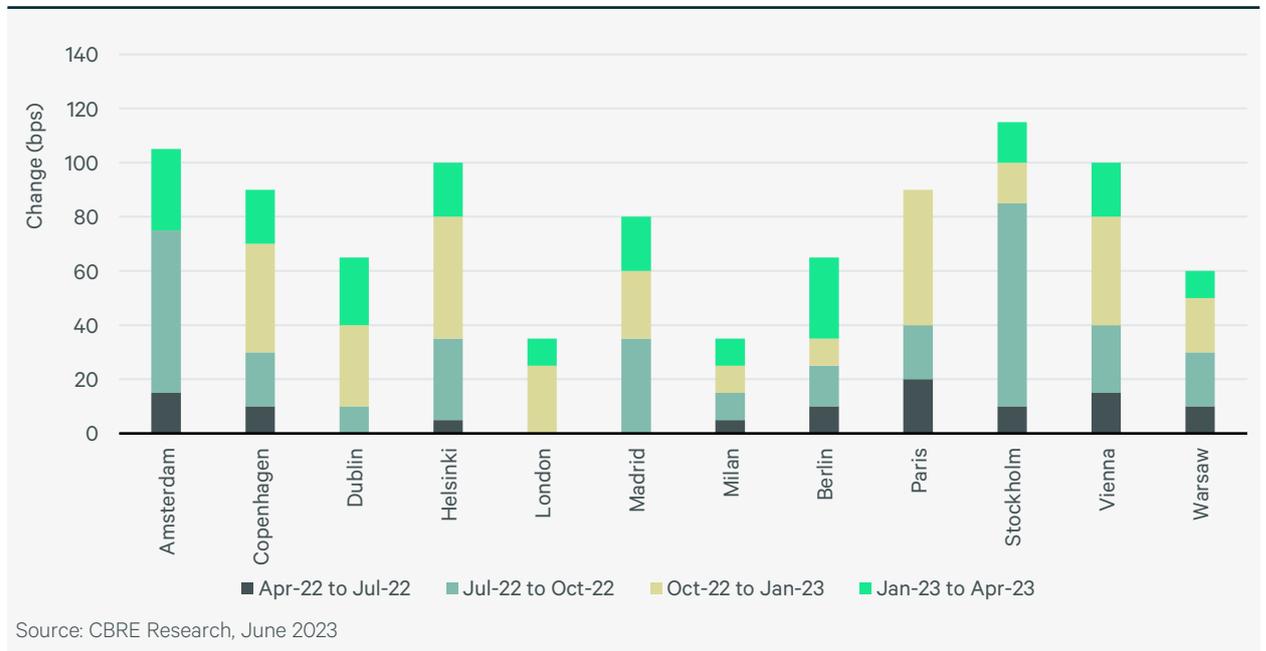


- Renewed deal activity is a positive sign that the market is starting to stabilise, and that buyers and sellers can come to an agreement again. It also shows that there is liquidity in the market

Renewed deal activity

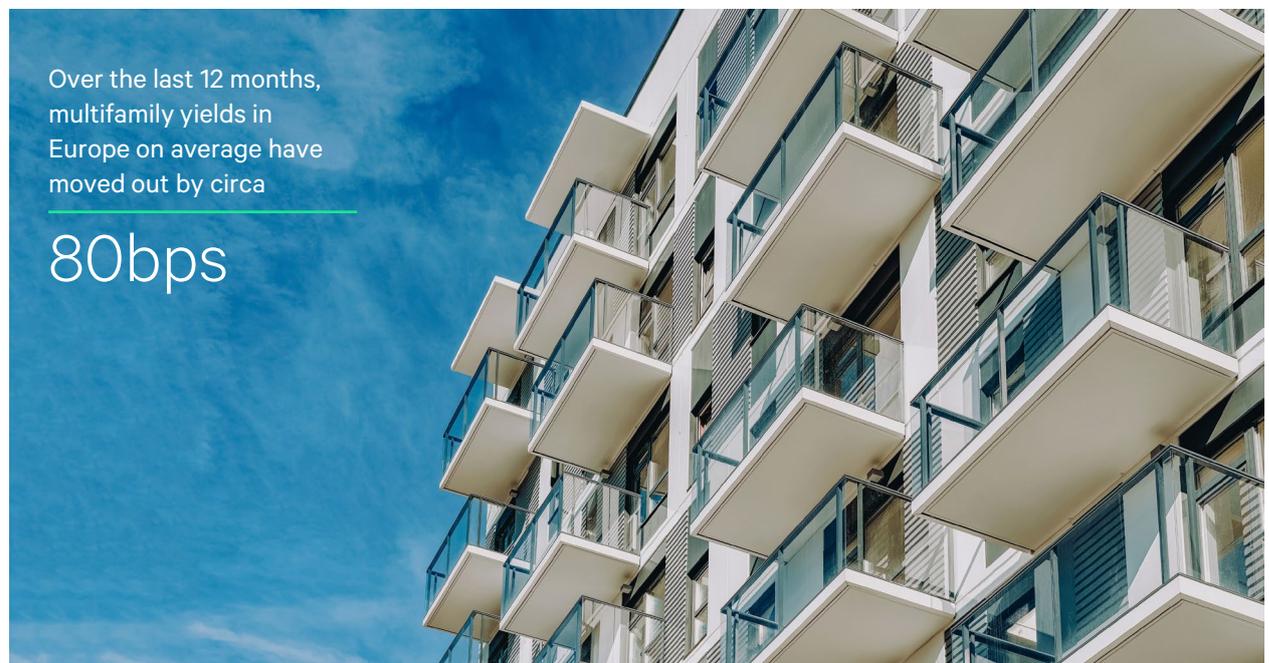
Buyers and sellers find an equilibrium again

FIGURE 5: Multifamily yield change in selected markets in May 2023



Further repricing expected until the end of the year

- In the US, [multifamily underwriting assumptions have begun to stabilise](#). Compared to the 2022 peak, multifamily yields in Europe have expanded by c.80bps on aggregate. Given the lag between financial markets and real estate, property values are likely to see some further repricing before bottoming out later this year
- The extent to which European multifamily will see further repricing largely depends on the interest rate outlook which in turn rests on how well Central Banks will succeed at controlling inflation



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