

# Schroder Real Estate Investment Management

## Big City, Bright Lights, Better Returns?



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Real estate investors have a natural affinity for big cities in Europe and North America. Most big cities are forecast to see relatively strong economic and population growth over the next decade and they also have deep and relatively liquid investment markets. In the past the main risk for investors has been that big cities have also seen a lot of speculative development. However, that is less of a concern following the financial crisis because banks are far more reluctant to fund new projects. Instead, we think the main risk at present is the low level of prime yields in many central business districts and we generally see greater value in mixed use areas which border the CBD, or in smaller cities with dynamic economies. Finally, cross border investors need to think carefully about portfolio construction and not accidentally double their bets by focusing on big cities which are all plugged into the same part of the global economy.

### The world is rapidly urbanising

The proportion of the world's population living in towns and cities is forecast to increase from just over half today to two thirds by 2050 (source United Nations<sup>1</sup>). In absolute numbers, the world's urban population is projected to grow by 60%, from 3.9 billion in 2014 to 6.3 billion by the middle of the century. Most of this urbanisation will be in Africa and Asia, as people raise their living standards by moving from subsistence agriculture to paid employment in manufacturing and services. The UN estimates that by 2030 there will be 41 cities with a population exceeding 10 million, including seven mega-cities in Asia with a population of more than 25 million. Four of those mega-cities will be in the Indian sub-continent – Delhi, Dhaka, Karachi and Mumbai. The other three will be Beijing, Shanghai and Tokyo.

While urbanisation in high income countries (e.g. Australia, Japan, North America, Western Europe) is much more advanced, it would be wrong to assume that the process is complete. The UN expects North America's urban population to grow by another 100 million between 2014 and 2050, or by 34% and Europe's urban population to increase by 35 million (7%). Overall, the percentage of people in high income countries living in towns and cities is expected to grow from 80% today, to 87% by 2050. The flipside is that the rural population in high income countries is projected to fall not only in relative terms, but also in absolute terms by around 70 million, or -28%. Rural de-population is likely to be particularly acute in countries like Germany (-40%) whose total population is expected to decline by around 10% over the next 35 years, following a sharp fall in the birth rates in the 1970s.

### The pull of big cities

In general, big cities<sup>2</sup> are expected to see the fastest population growth in both Europe and North America. Big cities have two main attractions. The first and probably more important is that they are major centres of job creation. In most developed economies the fastest growing sectors are knowledge-based industries such as IT, media and professional services and they tend to cluster in big cities. Quite why is a matter for debate, but big cities clearly have scale – they have more people, more world-class universities, more good schools and hence more ideas; big cities also tend to have more of a cosmopolitan culture which attracts skilled

<sup>1</sup> World Urbanisation Prospects, United Nations, 2014.

<sup>2</sup> For the purposes of this article we have defined big city as a metro area with a population of over 2 million..



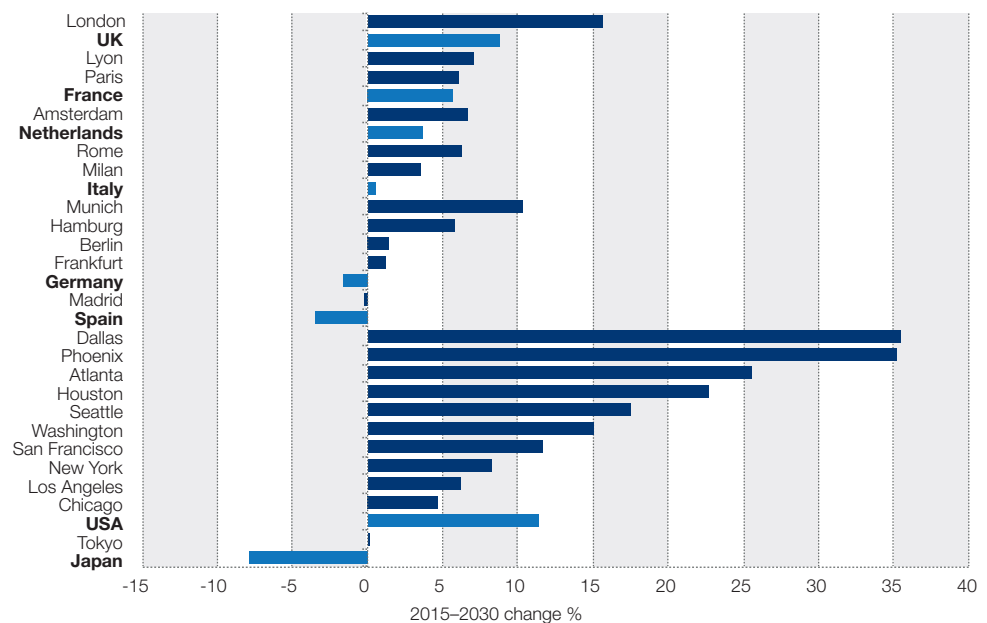
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migrants and encourages collaboration and they also have a healthy mix of large companies and start-ups which helps to disseminate expertise<sup>3</sup>. Moreover, success in one field can spill over into another. For example, London's role as a centre for international law is in part due to the large amount of work generated by investment banks and hedge funds and the city is now also emerging as a base for start-ups in the fin-tech sector. These spill-over effects may explain why people in big cities tend to be more productive and hence have a higher per capita income than inhabitants of smaller cities<sup>4</sup>.

The second attraction of big cities in Europe and North America is that they offer a wide range of amenities. Maslow's Hierarchy of Needs suggests that once people achieve a certain level of prosperity they stop worrying about material possessions and become more focused on their own personal development, their experiences and relationships. Consequently, they are attracted to big cities because there are more like-minded people with similar interests and more bars, restaurants, sporting venues, theatres and museums. This may help to explain why young professionals in Amsterdam, Berlin, Hamburg, London and New York are increasingly choosing to live in inner city areas rather than in the suburbs.

### Forecast population growth, 2015 – 2030

Big cities are generally expected to see the fastest population growth



Source: Oxford Economics, December 2014.

Incidentally, the growing popularity of inner cities in certain European and North American cities is also good for the planet, because the carbon footprint of city dwellers is significantly lower than that of people in the suburbs<sup>5</sup>. City dwellers' homes are typically smaller, they rely more on public transport and probably because they are more tech savvy, they do more of their shopping online.

Yet, living in big cities also, of course, has its downsides. While crime rates in American and European cities have fallen sharply since the 1990s they are still higher than in rural areas and city dwellers also have to contend with frequent traffic jams and over crowded trains. However, perhaps the chief bugbear of people living in big cities is that housing is expensive and accounts for a relatively high fraction of their income, even though wages are higher than in smaller cities and towns. For example, residential rents in Munich are double the German average and New York rents are 3.5 times the USA average. In general, Europeans seem more willing than Americans to pay this premium and in most European cities the capital city has the fastest growing population, despite being relatively expensive. By contrast, in the USA, the fastest growing cities are not New York, or Los Angeles, but places such as Atlanta, Dallas, Houston and Phoenix where planning policies are loose and housing is cheaper relative to incomes. One possible interpretation is that Americans attach less value to the cultural amenities which older, big cities like New York offer, than Europeans. However, intriguingly, France is a notable exception in Europe. Although Paris attracts international migrants as a major "gateway" city, it experiences a steady outflow of indigenous French to smaller cities such as Bordeaux, Lyon and Nantes where the quality of life is perceived to be higher.

3 "Triumph of the City", Edward Glaeser, 2011

4 "Urban Scaling and Its Deviations: Revealing the Structure of Wealth, Innovation and Crime across Cities", Luis Bettencourt, Jose Lobo, Deborah Strumsky, Geoffrey West, PLOS One, 2010.

5 "Spatial Distribution of U.S. Household Carbon Footprints Reveals Suburbanization Undermines Greenhouse Gas Benefits of Urban Population Density", Christopher Jones & Daniel M. Kammen, Environmental Science & Technology, 2014.

### Should real estate investors focus on big cities?

A key question for commercial real estate investors is should they focus on big cities? Clearly, other things being equal, it makes sense to invest in cities with good employment and population growth, because demand for retail, office and industrial space is likely to increase. Cities with weak economies which are suffering from long-term structural decline (industrial cities such as Detroit or Dortmund, or ports such as Liverpool or New Orleans) should perhaps be avoided.

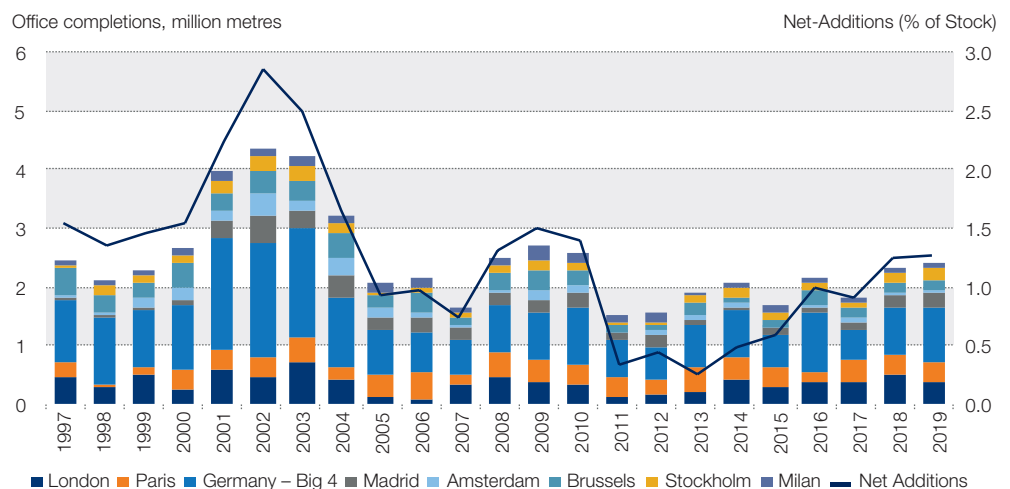
Another strength of big cities from an investment point of view is that they typically attract a healthy mix of domestic and foreign investors with diverse objectives and their real estate markets are comparatively deep and liquid. Thus London's share of UK office transactions rose during the financial crisis from 62% by value in 2006 to 74% in 2009, as liquidity in many regional cities dried up. Therefore, although investment activity in big cities fluctuates broadly in keeping with the economic cycle, their investment markets are less cyclical and more liquid than those of smaller cities and towns.

However, while there are clear advantages to investing in commercial real estate in big cities, there are also limitations. First, a lot of the good news in terms of relatively strong occupier demand and superior liquidity is already in the price. Prime office yields in London's West End and Paris CBD have fallen to 3.50 – 3.75% in the last six months, back to the very low levels seen in 2006 – 2007. Similarly, office cap rates in New York have almost dropped back to pre-crisis levels. In Northern Europe it is now quite difficult for an investor who is targeting core assets<sup>6</sup> with an ungeared net income return of 5% to find appropriate properties in the CBD (central business district) of a big city. At the moment, we tend to see greater value in mixed-use areas which are adjacent to the CBD, which have low vacancy and good public transport and where yields are often 0.5 – 1.0% higher (e.g. Kings Cross in London, La Rive Gauche in Paris, Kreuzberg in Berlin, Hudson Square in New York).

The second concern about investing in big cities is that while they have dynamic economies, historically they have also seen a lot of speculative building. As a result, their real estate markets have some times been blighted by high levels of vacancy, particularly during recessions and in the initial phases of economic recoveries, and office rents in big cities such as London, Los Angeles, Paris, New York have tended to be much more volatile than office rents in smaller cities. However, one of the few positive legacies of the financial crisis for real estate investors is that banks have been far less willing or able to fund new developments in the post-crisis era. In addition, high residential prices, supported by record low interest rates, have encouraged developers in many cities to build apartment blocks rather than offices. Consequently, in several cities (e.g. Chicago, London, Munich, New York) we have not seen the supply response which we would expect at this stage in the cycle, as demand improves and vacancy falls and that could prolong the current upswing in rents.

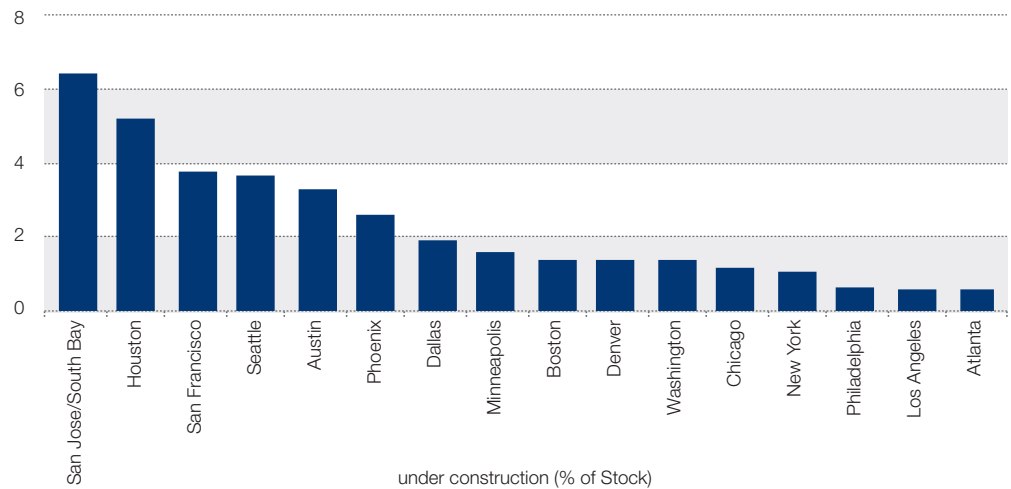
### Office development cycle

#### Building is generally subdued, even in strong markets like London, Munich and New York



<sup>6</sup> For the purposes of this article a core property is defined as one which should track the market and which does not require significant capital expenditure..

### Office space under construction-2015 Q1



Source: Co-Star, PMA. April 2015.

A third caveat is that big cities don't have a monopoly on economic growth and investors who focus on them are likely to miss out on opportunities in smaller dynamic cities. Some of these smaller cities are IT or bio-tech hubs (e.g. Austin, Bonn, Cambridge, Karlsruhe, Lyon, Minneapolis, Oxford, Seattle), while others are the base for a major manufacturer and exporter (e.g. Derby, Fort Worth, Nashville, Toulouse). Many of the tech hubs are based around a world class university, although not in every instance and there are also leading universities which haven't spawned a tech hub (e.g. Yale). These smaller cities also have the advantage that they rarely see much speculative development, so their rents are generally more stable than those of big cities and yields are typically 0.5-1.0% higher. The main risks for investors are that the economies of smaller cities are sometimes heavily reliant on only one or two major companies or industries and their investment markets are inherently less liquid than those of big cities.

Furthermore, it is worth bearing in mind that despite the benefits of being at the heart of a cluster, some companies will inevitably leave and take their skills and knowledge to other towns and cities. For example, many of the new job types<sup>7</sup> which first appeared in the TMT sector in London in the mid-2000s have since sprung up in other UK cities. Big cities therefore need to keep innovating, or else they will lose their economic edge.

Finally, investors who pursue an international strategy need to be careful that they don't inadvertently squander the benefits of geographical diversification by picking cities which have the same economic driver. For example, demand for offices in Frankfurt, Hong Kong, the City of London and New York is linked because the cities have a common exposure to investment banks. Similarly, there is a relationship between office demand in Calgary, Houston, Oslo and Perth (energy, commodities) and a link between demand for warehousing in Hamburg, Los Angeles/Long Beach and Singapore (world trade). Of course, rental cycles are also heavily influenced by local variations in development activity and vacancy and for example, the large amount of vacant office space in Frankfurt between 2003 – 2013 significantly reduced the correlation with office rents in London over that period. Nevertheless, an international portfolio which includes some cities whose economies are largely domestically orientated (e.g. Atlanta, Chicago, Cologne, Melbourne), or which are seats of government (e.g. Brussels, Berlin, Washington), probably carries less risk than one which is dominated by cities whose fortunes are heavily tied to the global economy.

<sup>7</sup> "New job creation in the UK: which regions will benefit most from the digital revolution?", PwC, 2015.