Liquidity constraints imply few other asset classes require as much long-term thinking as real estate. This tempts real estate market analysts to look for clues in long-term historical data to shed light on future performance. This report investigates ways of approaching long-term assumptions of rental value movements.

Inflation = Long-term rental growth?

It has long been believed that inflation is real estate's best friend. Whenever real estate cash flows require a 10-year horizon assumption of rental growth, appraisers regularly plump for inflation forecasts. In most European markets, rents tend to be indexed by CPI inflation, making the 'long-term rental growth equals inflation' assumption particularly attractive to the appraiser.

The use of consumer price inflation as a predictor of commercial rents is actually quite far-fetched. The price development of potatoes, lawn mowers, baby food and all the other 700 consumer items in national CPI baskets, will have little bearing on the price of office accommodation in a particular city. In theory, long-term rental values for offices should be driven by construction costs and land prices:

• As construction costs depend on raw materials to a significant extent, it tends to be much more volatile than CPI inflation, instead determined by global commodity prices and respective dollar exchange rates.
• Land prices should be driven by the relative scarcity of land at a location in relation to the money value of economic activity. In the absence of structural shifts, local land scarcity should remain fairly stable, which means it is implied in rental values (but should not drive growth). The value of economic activity should reflect local GDP growth.

The following analysis suggests strong growth or decline periods are usually down to one-off structural breaks at the city or macroeconomic level, and as such, ought to have scant predictive power for future growth rates.

Is past growth a guide to future performance?

Rather than simply assuming a relationship between rents and inflation, we prefer to examine how rents have moved in real terms (after inflation) across business cycles; in essence, the deviation of rents from inflation movements.

Fig.1: Top five real rental growth markets
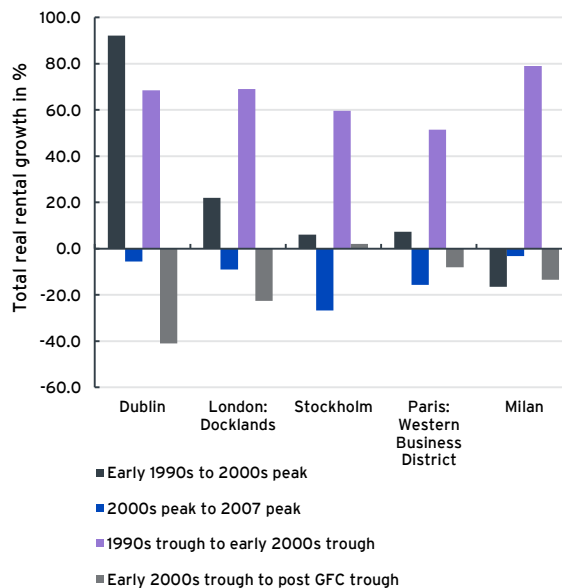
Source: TIAA Henderson Real Estate, 2015

Ideally, this could help us to identify markets that may deliver long-term rental value growth, or at least something close to inflation-adjusted stability. We use real terms because investors usually target inflation-adjusted returns.

If we examine prime headline rents from the late-1980s, essentially incorporating three cyclical peaks and three troughs, it becomes apparent that CPI is of little use in estimating rental value movements at the city level (which means it will be even less useful at the asset level). In fact, in over 40 European office markets, rental growth differed on average by 1 to 2 percentage points a year from CPI inflation movements across all three cycles. In some cities, rents were highly correlated with CPI in one cycle, only for the relationship to disappear in the next.

The only exceptions, in which rents moved close to inflation over the long term, are the Randstad cities in the Netherlands and in the UK's regional centres.

Fig. 1 shows the five markets which have achieved the highest real rental growth over the past 25 years. With the exception of Dublin, all the growth came through in the period from the early-to-mid-1990s into the noughties. Three-quarters of the 40 markets achieved real rental growth over that period, and in many cases, quite substantial real increases.

This pattern indicates that this growth was highly influenced by wider macro trends. It would be hard to argue that Milan's single growth spurt, as impressive as it might be, serves as an indication that Milan will be more likely to experience another real rental growth push than any other European city.

Fig. 2, which shows a selection of differently performing cities, illustrates this point further.

Vienna had the opposite experience to the long-term top performers in Fig. 1. After a hype in 1989, which pitched Vienna as the new gateway to Eastern Europe, sending rents skywards, rental values went into a long downward spiral as these hopes failed to materialise. This gives Vienna an overall bad record in terms of delivering long-term real rental growth, even if that is largely down to one specific event. Another bottom performer was Warsaw, which was exacerbated by a typical emerging market building frenzy.

Munich is perhaps a surprising poor performer, and is consistent with the fall in real rents observed in many other German office centres.

Fig. 2: Selected weak growth cities
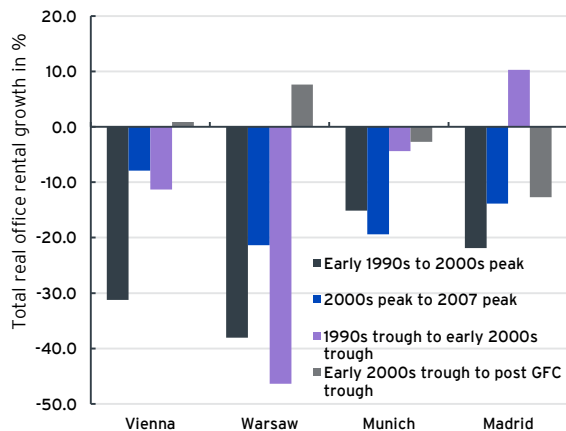
Source: TIAA Henderson Real Estate, 2015

Notably, over most of the time period covered by this analysis, Germany's economy was weak. However, in line with the economic renaissance since 2007, German city rents have started to outperform.

Instead of regarding it as a proof of decline, long periods of rental softening in real terms could in fact be viewed as an opportunity for strong rental growth as the economy recovers. A case in point would be Madrid, which was hit hard by a crash in the 1990s and later the GFC recession, which more than wiped out all gains in the previous growth phase. The question remains as to whether rents in markets, like Germany and Spain, are justifiably low, for whatever reason, indicating higher future growth potential. On the flip side, are the frothy rental values in Stockholm and Milan actually evidence of a much needed price correction?

Fundamental rental values

This brings us back to the original question of land scarcity and GDP growth as fundamental drivers of rental growth. It seems implausible that land has become any more restricted in the outperforming centres of Stockholm, London Docklands, Dublin and Milan, than it has in underperforming Vienna, Munich and Madrid. Economic performance might be a better explanation of growth, although this clearly fails to explain the outperformance of Milan.

An analysis of relative rental levels to city per capita GDP is also of little use to explain growth, due to most cities having wildly different levels of rental value per capita GDP.

However, what is possible is that land scarcity is already reflected or priced into rent levels. This fundamental level can of course change over time. Madrid and Warsaw rents are fundamentally cheap today, but less obvious examples of cheap rents can be found in London and Stockholm. German cities' rents don't look particularly cheap compared to historic rental level per capita GDP, but on a pan-European comparison, German rents are low, while Italian rents are persistently high.

This piece covers selected aspects of our research into historic long-term rental growth. The old saying "past performance is not a guide to the future" sums up our analysis quite accurately. We therefore seek to cast our net as widely as possible, and incorporate both cyclical and fundamental analyses of cities, or even sub-markets, in order to project where future rental values might be heading.

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