4 November 2024

THIS ISN'T YOUR MOTHER'S STUDENT ACCOMMODATION

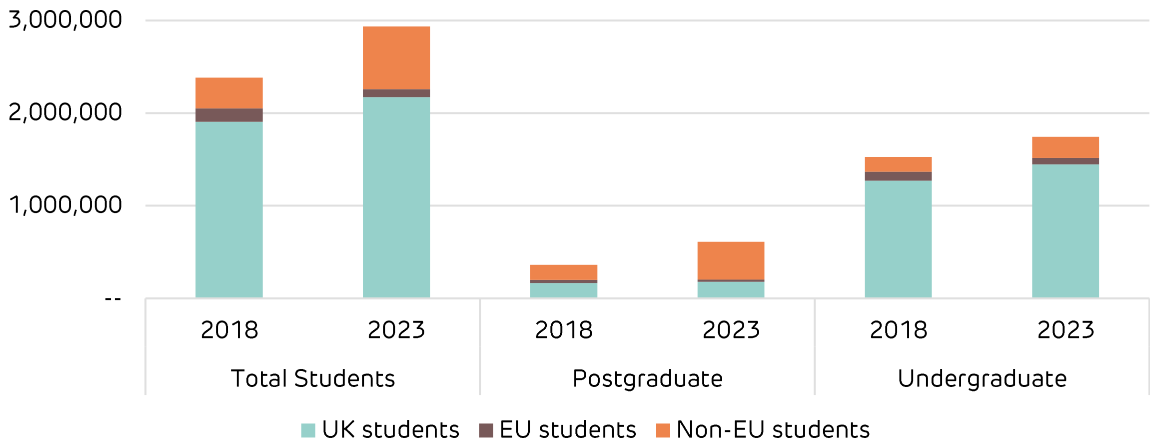
At the start of the academic year, young scholars across the UK engaged in the time-honoured ritual of moving into their new dorms. Contrary to tradition, however, many of these rooms barely resembled the quintessential student hall: utilitarian, modest, and somewhat off-smelling. Today, an increasing number of private university halls target the high end of the market, offering stylish furniture and amenities such as cinemas. Not a bad place to do your homework.

This class of housing is a result of the purpose-built student accommodation (PBSA) sector orienting itself toward record high levels of demand from wealthy international students studying in the UK. Non-EU student populations have grown to more than make up for the loss of EU students after Brexit, and in 2023 they contributed over £40 billion to the UK economy.[1] UK student accommodation developers have struggled to produce enough supply, and the sector has thus become a darling of real estate investors due to its low vacancy rates and strong rental growth.

There's a clear draw to the UK's higher education (HE) system from around the world. The country boasts some of the world's most highly ranked universities, is a global leader in research output, and has educated about a quarter of all current world leaders.[2] As such, students everywhere aspire to grow their credentials with British degrees, and they spend vast sums of money to study here.

However, there have been growing concerns over the sustainability of the UK's higher education system, which could have serious consequences for PBSA investments. Domestic tuition rates haven't been raised in over a decade, and so inflation has eroded the income generating potential of UK-domiciled students. An estimated 40% of UK universities ran a fiscal deficit in 2023/24.[3] As a result, the HE system has turned to raising international tuition fees to compensate for lost income, a strategy that works as long as international student populations continue to grow.

Figure 1: UK full-time enrolments by student domicile[4]



Unfortunately, foreign currency crises, ambiguity over post-graduation employment rules, and restrictions on dependant visas reduced applicant interest this year. Some preliminary estimates

[1] Universities UK
[2] Higher Education Policy Institute
[3] Office for Students
[4] HESA

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suggest that sponsored study visa applications dropped by 17% during this application cycle compared to the same time last year.[5] Postgraduate applications may have fallen further.

The HE sector is therefore facing huge income losses, and multiple industry voices have been urging the government to intervene to save the sector, with a senior VP at QS warning that the UK higher education sector is at risk of "irreversible decline". So, is it time to jump ship from PBSA and write off the university system? While the sector might face some headwinds in the near term, we think the underlying growth drivers are still healthy, and they point to recovery and growth in the longer term.

One reason is the approximately 40% increase in the global population of wealthy individuals from 2016 to 2023.[6] Despite ongoing economic challenges, the population of individuals who can afford an expensive foreign education is only expanding, and this population will continue to demand high-end student accommodation. Furthermore, the UK's relative standing is improving compared to its main competitors. Canada and Australia, for example, have announced steps to limit student migration. Moreover, some international students might turn away from the US as its political environment gets increasingly unattractive to students from certain countries.

While there is little that the UK HE sector can do to fix geopolitical and economic events outside its borders, domestic policies can have a measurable impact on international student arrivals. The Migration Advisory Committee's much-awaited report on the Graduate Route was released in April this year, and it recommended that the policy of allowing recent graduates to temporarily work in the UK remain in place. Additionally, the new Labour government has adopted more welcoming rhetoric toward international students, which has garnered positive responses from applicants and university officials.

In the meanwhile, it's likely that a large portion of aspiring international students (and their families) will continue to accept the growing cost of foreign tuition rates. The past few years have taught us that the UK higher education market functions like a luxury good. Unlike most commodities, raising the price of a luxury good doesn't always reduce its demand – sometimes the opposite happens. Such is the case with fancy handbags and sportscars. A UK education can similarly be viewed as a status symbol overseas, and many universities continue to wield significant pricing power due to the strength of their names. Like with bags and cars, however, not all brands hold their value. We expect that among the universities that will struggle in the next few years, most of them will have less international recognition than those that succeed. PBSA investors should find ways to integrate concepts such as brand power as they examine potential partner universities for signs of financial strain.

While the pace of international student migration will probably moderate from the rapid growth we saw immediately after Brexit, we expect the higher education and accommodation markets to continue to see high demand in the longer term. Keep an eye out for kids going to class with Gucci backpacks.

DEAR USA: IT'S THE HOUSING MARKET, STUPID[7]

As votes were counted around the world during this year of elections, a few common themes have emerged. As we discussed in an earlier letter, economic concerns were a sticking point in democratic contests from South Korea to France. An issue we didn't mention, however, is housing. As "generation

[5] IFS
[6] Capgemini
[7] For those of us too young to recall the 1992 US Election, we aren't just being mean.

rent" takes up a greater share of electorates across countries, candidates have had to make bold plans to fix their countries' housing systems and rectify affordability crises plaguing cities globally.

Debates over housing scored plenty of attention in the UK, with the Labour Party announcing a slew of policies in the run up to the July election, including the re-establishment of government housing mandates, promises to revise the planning system, and new rules for development on public land.

Across the Atlantic, the race for the American presidency is winding down to its final days before November 5th. There, housing policy is more salient than it has been in a long time. The Spring 2024 Harvard Youth Poll, for example, found that the critical 18-24 age bracket placed housing as the third most important issue in the election, surpassing issues like climate change, taxes, and jobs. It's therefore no surprise that the Democratic ticket has announced a broad set of housing reforms as a part of their vision to create an "opportunity economy".[8]

The headlining policy of the Harris-Walz housing plan is a tax credit of $25,000 to serve as down payment assistance to eligible first-time homebuyers.[9] At face value, this is undoubtedly good news for younger Americans, who have had to watch home prices and interest rates grow increasingly out of reach over the past few years.

But would such a plan succeed in making it easier for first time buyers to find a home? A similar policy from the UK might provide an answer. The UK provided government-backed equity loans as a form of down payment assistance through the Help to Buy program, which was in place from 2013 to 2022. At the start, the IMF predicted that inducing demand without creating supply would simply raise house prices. A decade later, a House of Lords report affirmed these predictions, finding that the programs designed to make housing more attainable ended up inflating prices in markets that already faced the most stress.

Over the course of its tenure, the £29 billion spent on Help to Buy represents not only a poorly planned transfer of capital to those who were already wealthy enough to own their homes, but also a huge wasted opportunity to expand social housing across the country. Regardless of who wins in November, the US should consider the lessons it can learn from the UK regarding housing.

Luckily, the Harris-Walz campaign has suggested some steps to expand the supply of available houses by 3 million units over the presidential term. This will be accomplished in part by streamlining bureaucratic processes, creating tax incentives for developers who build affordable and starter homes, and creating a $40 billion housing innovation fund. However, the expansion of new supply in the areas where it is most needed will be a long-term process, while creating a tax credit for homebuyers could potentially be scaled much more quickly for a political win. As the United States teeters toward enacting its own version of Help to Buy – to the effect of a $138 billion budget deficit over 10 years – it should seriously consider learning from the UK and going back to the underlying economic principles that determine whether buyers or sellers will benefit more from the policies.[10]

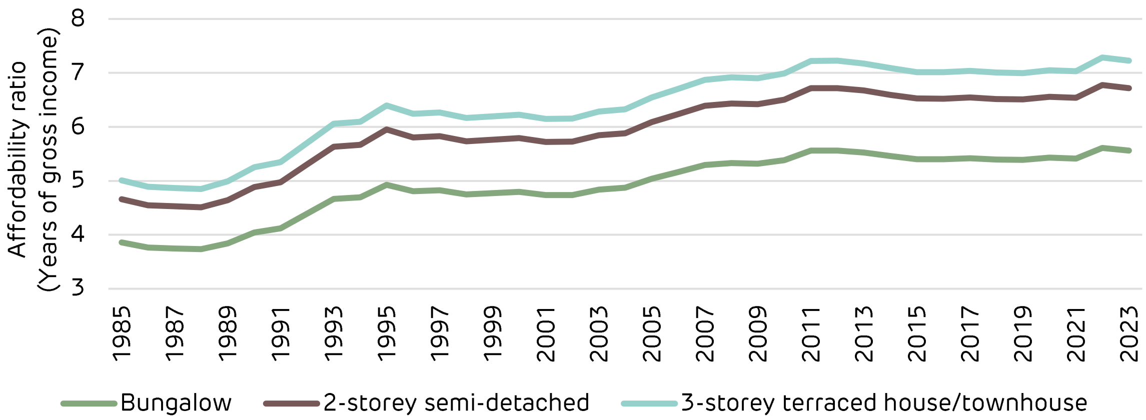
[8] At the time of writing, the Republican ticket has not announced formal plans related to housing system reform. The 2024 GOP Platform pledges to improve affordability, but provides limited details on demand-side programs. The Project 2025 manifesto, meanwhile, mentions protecting single-family zoning and reducing the remit of the Department of Housing and Urban Development to developing affordable or equitable housing.
[9] Harris-Walz Campaign Platform
[10] Penn Wharton Budget Model

DEAR UK: IT'S MORE THAN JUST SUPPLY

There are lessons that the UK can learn from the US, too. The current Labour government must work with developers to deliver new housing and construct new towns, but it also has limited fiscal headroom to do so. Official statements and plans have emphasised affordable housing mandates, but legal mandates alone cannot fix an affordability crisis. Affordable housing, like all other market segments, must be profitable if private developers are to be involved, but it's extremely challenging to generate enough revenue from low-income renters to justify new construction. This fact is likely to pose a roadblock to official efforts to expand housing supply, especially in the areas with the highest divergence between market rents and median incomes.

The following graph illustrates the evolution of the problem over four decades by using income and house construction cost indices. Each line tracks how many years of a median income would be needed to pay for the construction of a given type of house. It does not account for land costs or sale markups, which are highly dependent on geographic and macroeconomic factors.

Figure 2: House construction cost affordability[11]



The steady upward growth of the line shows that the cost to construct a home has generally grown faster than median gross wages in Britain. The results suggest that even if land were free and sale markups were 0%, the housing market would still be facing an affordability crisis, with earners generally seeing worse affordability outcomes than they would have 40 years ago. Reasons for this include the fact that houses have gotten larger, more regulations have been imposed, and the planning system has complicated the process of gaining permissions.

However, the more consequential driver might be on the demand side. UK productivity growth has been poor for decades, falling out of step with Germany and France in the 1960s and essentially flatlining since 2008. [Analysis by the FT] estimates that the UK's output per hour worked would be 25% higher than it is if the country had maintained its 1980-2007 productivity trend after the GFC.

Harking back to ye olde days when government and industry collaborated to maximise annual house completions neglects to take affordability ratios into account. It's not enough to simply build more homes (a challenging proposition already). Rather, new supply must account for elevated construction costs and stagnant wages.

[11] MyBuilder, ONS, BCIS

Both lowering construction costs and raising incomes are difficult goals that will demand years of sustained commitment. We don't have a bulletproof solution to this dilemma, but what's clear to us is that the current government should make the best of its rare electoral mandate to focus on scalable, long-term solutions to this issue. As building costs continue to rise relative to incomes, we expect that refurbishment strategies and government-led housebuilding will become crucial to normalising the UK's broken housing system.

The confluence of a global housing crisis and the year of elections ought to give political leaders old and new plenty to think about. Governments – be they in Westminster, Washington, or Windhoek – must come to understand the role of housing as a form of public infrastructure. A well-functioning housing market is crucial for society and culture, but it also has a measurable impact on economic performance. For example, a 2019 study estimates that suboptimal housing allocations in the United States prevented migration into high-productivity cities and may have lowered aggregate US growth by 36% from 1964 to 2009.[12] As the UK tries to claw out of its decade of lost productivity, the nation should consider the housing system's role in creating and solving those problems.

WHAT RECESSION?

As we wrote in March, the European tourism industry has had a surprisingly long crawl back to pre-covid levels of demand. The "revenge travel" boom took a while to materialise as inflation and geopolitical uncertainty made some travellers opt for alternative holiday plans. Yet, steady progress paid off, and European international flight arrivals finally reached pre-covid levels earlier this year, a crucial milestone for the tourism industry's recovery.[13] But now, fears of a slowdown in American consumer spending could threaten to erase that progress.

After over a year and a half of being the envy of the world, the US economy shuddered in the last quarter, prompting concern from some investors. Job growth was mixed, fears of an AI bubble led to a 15% dip in the Nasdaq, the yield curve dis-inverted, and recession indicators such as the Sahm rule flashed red.[14] The mood has stabilised quite a bit since then, so at this point we'll leave it to our readers to place bets on the likelihood of a US recession in the next 6-12 months. From our view, however, we're interested in the effects of a potential US downturn on the European economy, with a focus on the tourism and hospitality sector in particular.

On one hand, US consumers cutting back on spending could be quite bad for the Europe, which benefits from a trade balance of +$110 bn with the US. American consumption fuels a variety of sectors across Europe, including food exports, high-end machinery, and pharmaceutical products.

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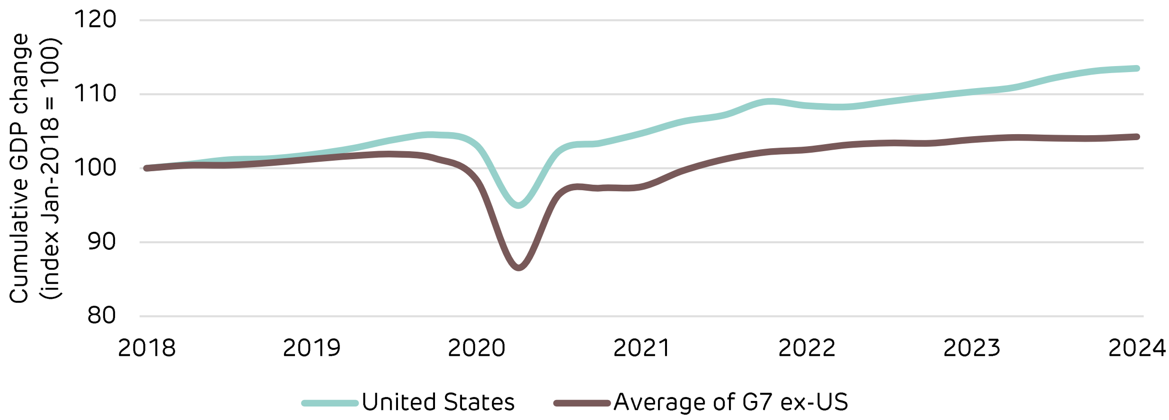
[12] Hsieh, Chang-Tai, and Enrico Moretti. "Housing Constraints and Spatial Misallocation." *American Economic Journal: Macroeconomics*, vol. 11, no. 2, Apr. 2019.
[13] UNWTO Tourism Tracker
[14] According to FRED, "[The] Sahm Recession Indicator signals the start of a recession when the three-month moving average of the national unemployment rate (U3) rises by 0.50 percentage points or more relative to the minimum of the three-month averages from the previous 12 months."

Figure 3: A tale of two recoveries[15]



There are a few factors that would suggest that if a slowdown were to occur, it would be mild and limited to the US. Most major economies outside of the United States have already stagnated or entered recession. America is an exception to its peers in the G7, which saw depressed consumer spending and confidence as inflation spiked. While economies in the UK and Europe aren't booming yet, they are improving as inflation has eased, and the ECB and Bank of England cut interest rates before the Federal Reserve. These drastic differences across the Atlantic in the time since lockdowns were lifted lowers the likelihood that the effects of a recession or hard landing in the US during the next few quarters would cause severe damage to economies in other global regions.

More narrowly focusing on hospitality, however, reduced activity from US spenders on holidays could threaten the European tourism industry, which makes up 8% of the UK's GDP and about 10% of the EU's.[16] That is, if Americans actually curb their spending. Buoyed by pandemic-era savings, US consumers powered through the inflationary crisis in stark contrast to their global counterparts, a trend that only began to wind down a few months ago. Yet, spending may be supported by another source: rising home equity. Americans may choose to unlock soaring home value as interest rates drop through HELOCs or other similar credit instruments. Alternatively, falling mortgage rates could lead to a wave of refinancing or downsizing, which would leave households with extra cash that could be put toward activities such as tourism.

Overall, then, we expect the effects of economic decoupling to limit the likelihood of global financial downturn on the scale of 2008. Within the US, leverage from the housing market is waiting to be unlocked as interest rates fall, which could bolster consumer spending. While the European travel sector may still face some challenges in the near term, the structural supports we mentioned in our March letter will still hold. A growing wealth gap between Europe and the United States, as well as persistent interest in post-covid travel, will serve as a backstop to a severe devolution of the European hospitality sector.

[15] FT, OECD
[16] OECD, Bloomberg

ARE WE THERE YET? RETURN OF THE INSTITUTIONAL INVESTOR TO THE LONDON PRIME OFFICE MARKET

Lately, Mike's been having flashbacks to the early days of Castleforge.

Over the past few weeks some big London office buildings have sold with price tags between $100 - $150 million, with prices paid particularly steep in the West End. Delancey and Aware Super purchased a building in Marylebone for a 5% cap rate (even though it was a 110 year leasehold with a nearly-20% gearing) and L&G purchased a building in Soho for 4.5% (and over £2,200 per square foot!). Sure, most of 2024 – and certainly 2023 – was reflective of the market back in "2009" when pretty much only private capital was buying at knock-down prices, happy to take a long term view on a market like Mayfair. But we've now entered "2010" territory, where institutions are creeping back into the market and the trickle of capital to the West End has the potential to turn into a small flood.

Over the past few years, we've regularly commented on the evolving role of offices in urban spaces. While they're no longer the everyday locations that we were used to before the pandemic, they haven't been relegated to antiquity, either. Occupiers have demonstrated a need for more high-quality, grade-A space in prime locations like London, where workers now spend on average half of their worktime in the office. While new supply is coming through, many assets are also leaving the market due to new environmental regulations. This supply and demand imbalance has caused the best office assets to differentiate themselves from the rest of the market, benefitting from low vacancy rates, long leases, and strong rental growth.

Gone are the days when we could credibly claim that offices were dead from a tenant perspective. Has anyone told institutional investors?

The best offices in London might be doing well now, but institutional investors continue to keep their distance from the sector. Transaction activity in the first half of the year was worse than it was in the wake of the GFC, and even worse than during the pandemic.[17] Many institutional investors may continue to feel that they are over-allocated to commercial real estate, or they may be more interested in alternative strategies such as logistics or private credit lending. However, depressed office values in great locations present huge potential value for those who are willing to look for them.

While the office market continues to be a black sheep, there is a growing number of institutional investors who are willing to take on a selective approach to entering the market during this disjuncture. For example, Great Portland Estates raised £350m to fund central London office projects earlier this year. Grosvenor, meanwhile, is planning to more than double its current flexible office portfolio to over 300k square feet. Even the UK pension funds are getting in on the action: Royal London bought an empty 250,000 square foot building at Holborn Viaduct for almost £700 per square foot, and recently an empty office building at Finsbury Square was purchased by L&G, one of the bellwethers of the UK domestic institutional market, for a speculative office refurbishment to commence in 2025. It might not even be "2010"...it could very well be "2011".

JLL's most recent UK Capital Markets survey found that offices ranked third in a survey of the most promising asset classes for a five-year horizon, signalling that some investors may be coming around.[18] At the height of lockdowns, it'd be tough to predict that London offices would stand toe-to-toe with the current favourites of the commercial property industry: data centres and student housing.

[17] FT
[18] JLL

The recovery in offices has been slow, but we're starting to see evidence that some investors are (re)discovering the potential of the sector's best assets to deliver strong rental and capital growth over the next few years. If current trends regarding interest rates and occupier demand for best-in-class continue to grow, we expect the market to heat up significantly, and for institutional investors to get the message soon.

Michael Kovacs	Adam MacLeod	Mathew Chemplayil
		
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