Amsterdam — the top end of the Randstad

From zero to hero

Dutch residential has all the makings of a place to call home

by Brian Klinksiek and Zubaer Mahboob

The Dutch residential sector is one of the most promising segments of the European property market. It is characterised by a unique blend of cyclical turnaround potential, constructive structural reform and favourable supply/demand fundamentals. The sector is quickly transitioning from being a niche market — the preserve of domestic investors and housing associations — into one of the most discussed "outside-the-box" targets in European real estate. This is reflected in investment activity; transaction volume in the sector for the year ending Q3 2014 exceeded €1.6 billion, up 128 percent over the prior 12-month period. Nevertheless, the sector remains at an early stage of its recovery compared with other property sectors and has considerable room left to run.

In this article, we lay out the basic case for investment in Dutch residential. It rests on four key factors: (1) a cyclical rebound in Dutch macroeconomics, home prices and apartment rents; (2) fundamental housing demand that outstrips supply; (3) government policy changes that cut regulatory red tape and drive more households into the private rented sector; and (4) a major ownership transition away from challenged legacy structures toward more-sophisticated, value-driven investors.

Cyclical turnaround underway

The Dutch residential sector is positioned to benefit from parallel rebounds in home prices, in apartment rents and in the broader national economy. All three are now building momentum and recovering from cyclical low points, suggesting that today offers an attractive entry point into the market.

Starting in the mid-1990s, Dutch for-sale housing experienced a prolonged boom, with prices more than doubling in the decade preceding the global financial crisis. As in the United States, the housing market was boosted by aggressive mortgage lending; LTVs routinely exceeded 100 percent and interest-only loans were common. However, consistent with other debt-fuelled housing bubbles, Dutch home prices dropped sharply as credit became scarce. Between 2008 and 2013, nominal house prices fell by around 20 percent.

At the national level, home prices finally reached an inflection point in Q2 2014, recording positive year-on-year growth for the first time since 2008. As of September 2014, prices were 3 percent higher than the cyclical trough reached in June 2013, and the number of home sales was up by 38 percent year-over-year. In Amsterdam, prices were up around 8 percent and home sales volumes increased by almost 50 percent.

Several factors have contributed to this turnaround. Higher consumer confidence has boosted demand, especially from first-time buyers who had been putting off purchases. Affordability has improved thanks to lower valuations and historically low borrowing rates. The removal of longstanding uncertainty over the tax treatment of mortgage interest has also encouraged more buyers to commit to purchases, as its tax-deductibility will be scaled back more slowly than had been feared.

The history of apartment rents in the Netherlands has been less tumultuous than that of prices, with no rent declines recorded even during the global financial crisis. National annual rental growth reached a low point of 1.9 percent in 2011, down from run rates of around 3 percent in the early 2000s and around 5 percent in the mid-1990s. Rental growth has since recovered to 4.5 percent per year in 2013–2014. Conditions are even stronger in the "liberalised" (non-regulated) segment of the market and in the Randstad (the conurbation encompassing the four cities of Amsterdam, Rotterdam, The Hague and Utrecht). Rental growth for liberalised units in Amsterdam was running at around 5.5 percent as of mid-2014.

On the macroeconomic front, the Dutch economy is expanding again after years of stagnation, and is expected to be one of the euro zone's outperformers. The Netherlands has long been among the world's most open and innovative economies, boasting a highly-skilled workforce and deep-seated strengths in business services, transport, energy and industry. These are enduring advantages; the EIU expects average GDP growth of 1.7 percent per year over the next decade, faster than growth of around 1.4 percent for neighbours such as France and Germany.

Considerable supply/demand imbalance

The Netherlands has a shortage of housing units; the number of households exceeds the number of housing units by around 3.5 percent. As a result, the vacancy rate in the rented housing sector is extremely low, at around 2 percent and falling. The shortage will be amplified by both strong demographic demand and low supply. Over the next 25 years, the number of households in the Netherlands is expected to rise from 7.6 million to around 8.5 million, an increase of 12 percent, with nearly all of the growth accounted for by single-person households.

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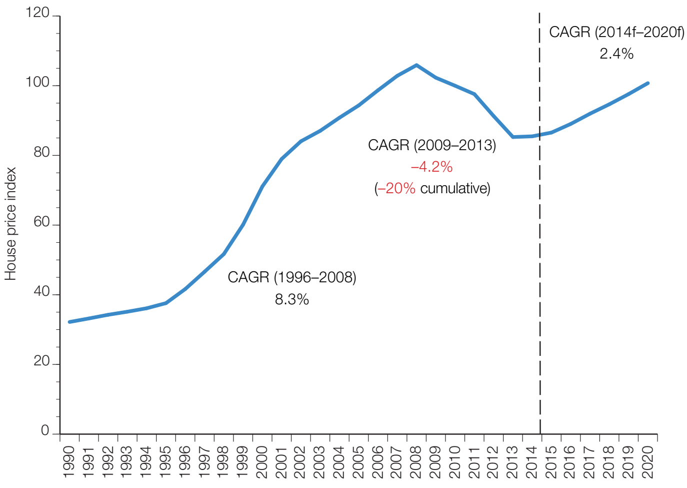
Supply, meanwhile, is very weak. In 2013, only 26,000 building permits were granted, down by a third from the year before. New permits reached their lowest level since 1953, which means that the number of completions will remain restricted, at least over the next couple of years. Supply should eventually pick up, although the country's unique geotechnical conditions as well as planning controls in historic city centres will constrain supply in the most attractive urban locations. Indeed, the shortage of housing is particularly acute in the Randstad and especially in Amsterdam, where the frustration of trying to find an apartment rivals that experienced by households in Manhattan.

Policy reforms drive demand

Multiple changes to government policy toward the mortgage market and rental regulation are underway that should have a positive impact

Dutch nominal house price index, 1990–2020f



Sources: Thomson Datastream; Heitman Research

Heitman, in a joint venture with Orange Capital Partners, recently acquired two separate residential portfolios in central Amsterdam for around €76 million. The portfolios comprise 400 rented residential units and 12 retail units across 24 buildings, with a total area of 28,400 square metres.

on investors in rented housing in the Netherlands. These reforms should shift demand from homeownership to the rental market, while moving supply from the regulated to the liberalised sector.

First, the favourable tax treatment of owner-occupation is being scaled back, cutting the government's implicit subsidy of homeownership and likely making renters out of more households. Historically, all interest paid on mortgages was fully tax-deductible, giving homeowners a generous tax shield. This boosted demand for interest-only loans, which became widespread, contributing to the boom-and-bust in house prices. From 2013, tax-deductibility of interest on new mortgages is available only to fully amortising loans. In addition, tax-deductibility on amortising mortgages will decrease gradually over time. As a related measure, the maximum permitted LTV will fall.

Second, ending the abuse of regulated housing will lead to the dropping of rent controls on many qualifying flats. Estimates suggest that up to a quarter of the regulated market is occupied by households with incomes above the qualifying threshold of €34,000 per year. Although these tenants technically have security of tenure, landlords are now permitted to increase their rents at a fast pace (CPI plus 1.5–4 percent per year, depending on income). This is expected to equalise the price differential between regulated and non-regulated housing for around 700,000 tenants, pushing them to seek flats in the non-regulated sector. Many of the units that they will free up are in urgent need of refurbishment and renovation. Once vacant, there is an opportunity to upgrade these units to the extent that they can be removed from the regulated sector and converted into non-regulated apartments.

Transitioning ownership base

Traditionally, the ownership of Dutch rental apartments was dominated by housing associations and domestic pension funds, which together held 2.39 million units in 2013, around 75 percent of the rental stock. Their presence has helped to create a degree of transparency in the sector. Indeed, IPD tracks €16.4 billion of for-rent residential assets in the Netherlands, more than for any other European country.

However, it does not follow that the existing *institutional* ownership base has necessarily been *sophisticated* in the sense of actively seeking to add value to its holdings. Many owners have underinvested, missing opportunities to grow rents, including those created by ongoing changes to the regulatory environment. We expect many of the existing owners to sell to value-driven investors over the next few years; this is already evident with the entry of international groups such as Patrizia Immobilien and Qatar Holdings into the market.

Housing associations, in particular, are expected to be major sellers; they are under a mandate from the government to sell more than 1 million units. This directive is rooted in the peculiar history of these supposedly nonprofit associations. They began as government-funded entities, although when subsidies were cut off they were set free to make for-profit investments to subsidise their social mission. All too often, however, these took the form of risky ventures such as speculative development of for-sale housing. Moreover, excessive leverage was used to improve returns and dabbling in derivatives created risks. Now that housing associations are being forced to refocus on providing social housing, they are bringing large and small portfolios to the market. Vestia Group, for example, sold more than 17,000 units in eight separate transactions in 2014.

A targeted approach

We believe that now is an especially attractive moment for investment in the Dutch rented residential market. The economy is rebounding and investors have the chance to buy at the bottom of the cycle. Deregulation and liberalisation will boost demand for deregulated rental apartments. The size and liquidity of the investment market is also expected to undergo a step change. Investor interest is increasing, but the opportunity to buy and accumulate rented residential portfolios in the strongest regions of the Netherlands will exist for the foreseeable future. That said, it is wrong to assume that national trends will apply equally across geographies and assets. Experienced residential investors partnered with local experts will show their edge in asset selection and value creation. ❖

Multiple changes to government policy toward the mortgage market and rental regulation are underway that should have a positive impact on investors in rented housing in the Netherlands.

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Residential accommodation in the Netherlands can be almost as hard to come by as car parking spaces. It is no coincidence that public transport is so comprehensive or cycling so popular.