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Urbanization Reimagined

Increasing and changing urban density continues to shape real estate markets, as anticipated by LaSalle's DTU+E framework of secular drivers. In this short white paper, we look beyond the simple story of more tenant demand in urban places and consider how its repercussions on land prices and rents will change metropolitan areas in the future - and our investments in them.

The interaction of more demand for urban places and limited space - which varies based on each market's regulations, existing buildings, and natural barriers - has driven up rents and land values in city centers to varying degrees. The developed world's gateway cities in particular have become much less affordable, relative to prior decades, especially to first-time job seekers. In the city of San Francisco, the median home sales price increased 59% in just the last five years, to USD1.3 million. In Hong Kong, home prices have surged by 232% since 2008. Faced with being priced out of their location of choice, residents, corporate occupiers, and retailers are reacting in a variety of different ways.

The Bid-Rent Curve Framework

A useful framework for imagining how these reactions will drive land prices and rents - going forward is Alonso's classic "bid-rent" land price curve. The curve plots land prices in the city center - which are higher due to lower transportation costs, more amenities, and higher allowable density - out to the urban periphery, where land costs are lower due to higher transportation costs, more supply, and fewer amenities. See our stylized example of this curve to the right, showing high land values in the city center, then values declining as one moves farther out toward the far suburbs and then undeveloped land beyond the metro boundary, where agricultural land typically creates a "floor price".

Of course, no city's land economics look exactly like this stylized bid rent curve - each has its own natural barriers, regulations, and history - but, as the 3D map of Greater London on the following page shows, it is frequently observed in reality to a greater or lesser extent. London home prices peak in the central location of Mayfair, then drop off steeply as one moves away from the city center, albeit with a variety of ridges, canyons, and intermediate peaks.

Moreover, the curve gives us a conceptual model for understanding the pricing mechanism for trade-offs between competing attributes like proximity to amenities, employment centers and a preference for low or high density living. Understanding these changing preferences and prices can help us predict how cities and real estate values may change. Consider, for example, how the curve has shifted over the last decade. Land transactions and home price data suggests that urbanization caused the curve to shift up more in central cities and walkable suburban centers.

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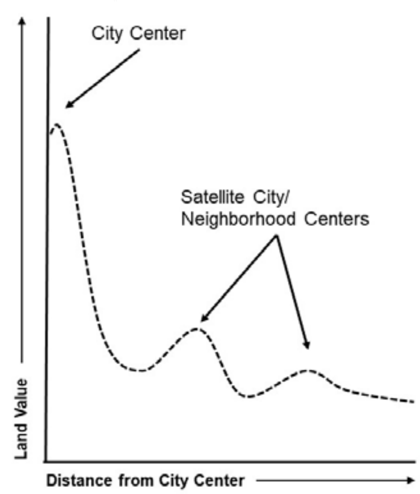
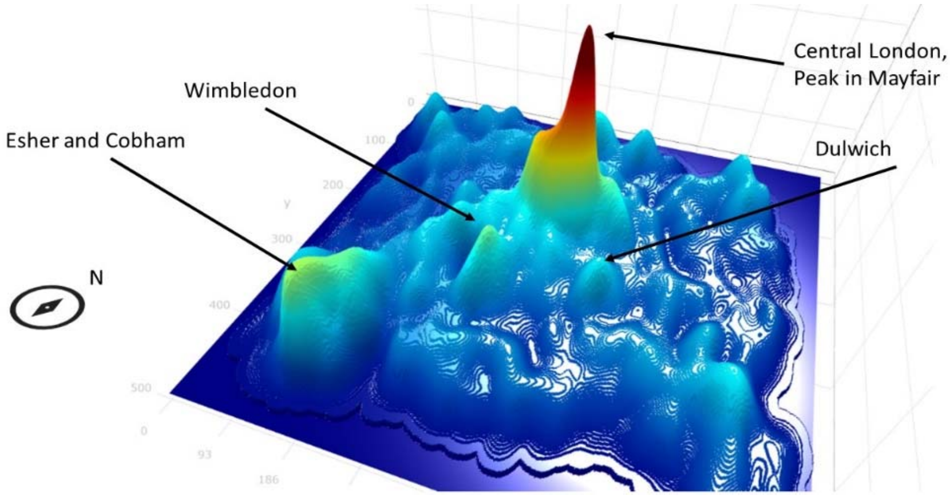
Bid-Rent Curve



Source: LaSalle Investment Management

Coping with Rising Urban Land Values

3D Map of London Home Prices



Source: LaSalle analysis of HM Land Registry data

The curve will move and shift in myriad other ways that are locally driven, determined by each metro area's distinct economy, dispersion of income, resident preferences, infrastructure, and barriers to supply. Rental housing gives many the opportunity to live in central locations that they would not otherwise be able to afford as owners. Increasing density is of course a reaction to that high land value. Office tenants in Central London occupy significantly less space per worker than those in Sydney or Atlanta. Millennial renters with a preference for the experience of living near the center city can also choose to live in a smaller space or with more roommates. In response, the concepts of micro-units - already the norm in Tokyo and Hong Kong - and co-living are gaining traction in European and North American cities, making living centrally more affordable and also generating high rents per square meter for their owners.

The rent levels and supply-side growth attained by owner/developers and experienced by tenants is often a direct result of constraints placed on building density by natural barriers and by regulation. These barriers can result in both higher rents in desirable US suburbs due to Not-In-My-Backyard (NIMBY) zoning restrictions and through open-space conservation in gateway cities such as Hong Kong, Los Angeles, Munich, Tokyo, Paris, and London. These gateway cities, many of which, are in the early stages of a price correction remain the least affordable places to live in the world.

Market Rate Housing with a Value Proposition

Rental housing that is affordable to the median resident is in high demand in gateway cities – and will achieve steady occupancy, high tenant renewal rates, rental growth, and lower volatility in net operating income. This has led to increased investor interest in what certain countries loosely categorize as workforce, key worker, social or affordable housing. In the US, the Urban Land Institute defines workforce housing as having a rent level such that those earning 60 to 120 percent of the area median income are spending no more than 35% of their income on rent. Across the US, this definition encompasses apartment rent levels in a wide range between $1,000 and $2,000 per unit per month. In practice, most of the apartments that fit this definition are market rate Class B and C units in suburban locations. Pressures on housing affordability means that housing that can offer a value proposition – like Class B and C apartments – are well positioned investments for the next decade, provided that capital expenditures are thoughtfully underwritten. This will play an important role in the emergence of Impact Investing.

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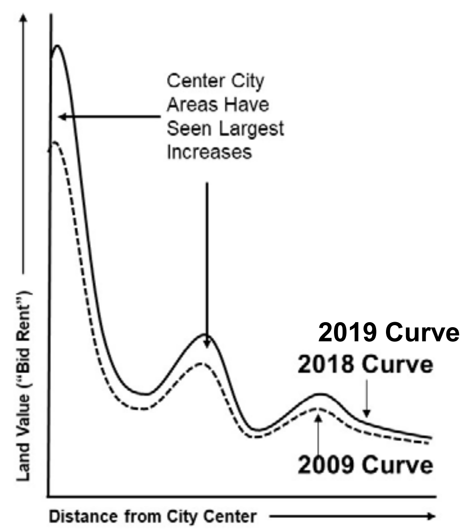
2009-2019 Change



Source: LaSalle Investment Management

Moving into the Fringe

Time and again we have seen previously run-down central or fringe districts regenerate into trendy edge of CBD neighborhoods as high prices in the center provide strong incentives to seek out these neighborhoods. Using London as a case study, since 2012 there has been an increase in net movers from both inner London to outer London, and from Greater London to commuter towns in the wider South East region. Many households without children will do what they can to stay close to their urban district of choice, usually for employment or social network reasons. Others make the decision to trade off a longer commute for better social services like schools and parklands. How these trends play out in different markets depends largely on the proximity to the CBD of affordable districts and the reach of the public transport network.

Further afield, the more traditional "bedroom" suburb is also undergoing a more modest version of densification, with planning regulations allowing more walkable, mixed use commercial projects interspersed among the residential areas. These changing preferences and evolving approaches to urban planning have opened up new real estate investment opportunities in areas that were thought to be fully built out.

Rising central district land values set the stage for movement and anomalies in the bid-rent curve. The direct catalyst for rapid neighborhood change can come from several sources at once. Sometimes, it is government-driven, such as in the case of building a new transit line or rezoning a central area or a suburban node for higher density, but it can also be driven organically by corporate relocations, small businesses wanting to co-locate, or cultural attractions like restaurants and trendy shops. LaSalle's investments in London's Southbank, Osaka's Chayamachi district, San Francisco's SoMa neighborhood, Amsterdam's South East, and Madrid's Méndez Álvaro have benefited from these changes.

Forecasting Urbanization: Within Metro Areas

Over the next decade, high prices and low affordability in the center city combined with changes in transportation technology suggests that the shape of land prices in many metros is likely to change in three key ways - each reflected in the potential future (top) bid-rent curve in our figure to the right. Firstly, improvements to public transportation –in small and medium-sized cities will make previously less accessible locations more attractive. Innovations like ridesharing, bikesharing, and electric scooters, also help the "last mile" of commutes. This should boost relative values in edge-of-CBD neighborhoods and in cities with less transit like Nashville and Austin in the US. New delivery services - some beginning to use airborne or ground-based autonomous drones, or secure lockers– may also improve the effective amenity levels for those within a few minutes bike or drive from the center of the action.

Second, low affordability in the center city is likely to support more demand, and higher land values, in secondary business districts, decentralized areas and suburban town centers. Therefore, we expect the secondary peak in graph to the right to rise more than the average.

And third, autonomous or semi-autonomous vehicles are likely to gradually increase land values across the suburbs and exurbs because they lower both the time cost and opportunity cost of road travel and will make it possible to commute from greater distances

For investors, we recommend targeting locations where future supply is tightly controlled by planning regimes or prevailing policies of NIMBYism. Enduring attractive local characteristics, such as the presence of a top-performing school, are also important features. Our experience to date shows that these factors have yet to be priced in to the same extent as transport infrastructure and retail amenities.

Due to the rapid strutural change ongoing in the retail sector in the US, UK and increasingly in Continental Europe, the next decade will also see the repurposing of significant swathes of redundant urban retail space. Whilst some may convert to become urban logistics in order to satisfy changing demand in that sector, the locations and sizes of the buildings are more likely to suit residential or mixed-use concepts that include co-working or health care delivery. In the UK, LaSalle has mapped thousands of single-storey retail parks in the major cities, and ranked them by surrounding building density, house prices and house price growth. The result is a list of target assets where, should the current source of income fail in future due to the threat of online sales, there is downside protection from the residential redevelopment potential.

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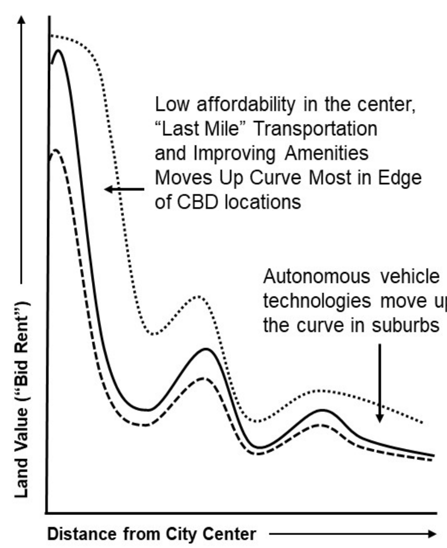
Future Curve



Source: LaSalle Investment Management

Forecasting Urbanization: Between Metro Areas

Escalating labor and occupancy costs in gateway markets makes second-tier cities relatively more attractive, especially if they can offer similar urban amenities and job opportunities. Examples of this “spillover” effect can be found all over the world, especially in cities that attract technology workers. Revisiting our UK case study, net migration from major secondary cities to London has fallen consistently in recent years, before turning negative in 2016-17. A major component of this reversal was Londoners aged 28-38. High living costs undoubtedly contributed to this tipping point. We also note that the net migration away from London includes young children up to the age of five, implying that young families are leaving the UK’s capital with a desire to purchase their first home – most likely near a good school.

In the US, tenants pay the highest share of their income on rent in three metros: New York, Los Angeles, and San Francisco. In each of these markets, the average rent is greater than 40% of metro median income. Among these, the San Francisco Bay Area has seen the fastest change over the last decade. The surging cost of living in the Bay Area is reverberating across the western US as a result, fueling migration to lower cost metros that can offer a similar mix of outdoor lifestyle, mild climate, and access to fast-growing tech companies. Among skilled technology workers, growth in remote working from home for all or part of the week has enabled this trend.

In Asia, a decentralization trend in Seoul is underway, with occupiers relocating out of the CBD. Tech hubs outside of the Sydney CBD (Surrey Hills and Macquarie Park) and Brisbane (Fortitude Valley and life sciences near UQ) are all growing rapidly. Emerging secondary submarkets markets have their own set of risks and opportunities, with rising occupier demand in many cases as well as less tenant depth and liquidity. Investors should expect some return to compensate for these risks.

Across many developed countries, we are seeing historical differences between gateway global cities and the next tier of desirable metros narrow, particularly when it comes to residential amenities. Cluster analysis using LaSalle’s Location Amenity Tool (LAT) shows that the densest submarkets in secondary cities have similar amenity density to many gateway city neighborhoods. These districts in select second-tier cities are equally vibrant places to live as any gateway market. For example, our LAT analysis of amenity density demonstrates that Central Manchester has a similar number, type and distribution of amenities as the West End of London. The strategic implications are broad and not confined to residential strategies. Office occupiers and retailers are reacting to these changes too, and over the long term we expect countries and rapidly growing industries to become less reliant on any single gateway city.

Key Takeaways

- High occupancy costs in the city center and changing transportation technology are likely to result in higher land values in edge-of-CBD locations, in the most desirable suburbs, and will contribute to increased demand for locations in second tier metros, where districts offer amenity density on par with gateway cities.
- Market rate rental housing that is affordable to the household with median income has become a smaller segment of the market in gateway cities, and it is an attractive target for investment due to our expectation of lower volatility and higher renewal rates.
- Structural change will see more investors repurpose redundant urban retail as residential or co-working space.
- Urbanization remains an important long-term secular trend. However high occupancy costs in central areas, changing demographics, new transit options, and densification will all contribute to a flattening out of the bid-rent curve in the world's largest cities, as land costs rise more quickly outside the highest-cost central district.

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