9 March 2021

WHEN LOCAL COUNCILS TRIED THEIR HAND AT REAL ESTATE INVESTING: REDUX

In our March 2018 letter, we reported on a surprising trend that had gained steam in UK property markets. Local councils were increasingly buying up large volumes of commercial real estate assets—mainly yielding properties like business parks, shopping centres, small industrial parks, and retail warehouses. From 2008 to 2015, local authorities spent, on average, about £150 million to £200 million on investment property each year. In 2016, that figure jumped to £1.7 billion. Over the next three years, from 2017 to 2019, local councils poured £6.6 billion into commercial property investment.

What inspired the councils' spending sprees? Well, proximately, their investments were financed by the Public Works Loan Board (PWLB), which historically allowed councils to borrow on extremely generous terms—at about 2.5% for up to 50 years at 100% loan-to-value. But, as we suggested in 2018, a more interesting explanation lurked deeper. Three years earlier, in 2015, the British government slashed grants to local authorities. With limited powers to raise tax revenues, local councils depended on national-government grants. When these grants were cut, local budget shortfalls ballooned, and councils had to generate some income of their own to fill the gaps. Yielding properties could help do just that. By financing local councils' real estate ventures (in place of funding the authorities directly), central government would save a few billion pounds. It seemed like a clever workaround.

However, as we wrote at the time, "a number of assets being purchased require considerable future asset management work," and "in nearly all cases, the [councils] do not have the capabilities to do this." Combine that worry with the fact that many of the councils' investments were concentrated in asset types with structural challenges, and things did not look promising. As a result, we warned that the scheme would produce "somewhat inevitable losses", which the British government would "socialise […] in the future".

Well, the future arrived sooner than we'd expected. This past November, central government banned local councils from investing in property with funds borrowed from the PWLB. Going forward, before granting a loan, the PWLB must "confirm that there is no intention to buy investment assets primarily for yield at any point in the next three years". The new rule is a belated attempt to de-escalate a situation that has already spiralled out of control. Indeed, some local authorities have floundered for several years now. In recent months, their finances were finally pushed past the breaking point by the pandemic, which decimated local revenue sources and inflated costs. After years of highly leveraged property investing, many councils now face unmanageable debts. Central government has already pledged nearly £4 billion in aid.

Take Croydon, one of the worst-hit councils. When the pandemic dried up much of Croydon's property revenues, the council was left with a large pile of obligations and very little income. In the last few months, the local authority there has twice filed Section 114 notices—effectively declaring bankruptcy after breaching its legal obligation to achieve a balanced budget. Croydon currently owes more than £1.5 billion. A report published by Croydon's external auditors in October blames multiple factors, including poor governance practices that led to the council's ill-fated investment scheme. (Croydon's distressed properties include a hotel and a shopping centre, which together cost the council £80 million.)

Given the scale of the councils' real estate investments—Spelthorne, a small authority with an annual budget of just £11 million, managed to borrow over £1 billion from the PWLB in recent years (!)—we expect to hear many similar stories in the months ahead.

THE RISE OF THE GLOBAL MIDDLE CLASS TOURIST

Seventy years ago, the world counted just 25 million annual international tourist arrivals. By 2018, that figure had multiplied fifty-fold, to about 1.4 billion. Roughly half of that growth happened in the last 15 years. In the next decade, we think that global tourism will continue to accelerate—supported by the historic rise of a global middle class. To see why, let's start with a short history lesson.

Until about two hundred years ago, virtually all human societies languished in poverty. In AD 1, global GDP per capita stood at $792. The destitution was evenly distributed: it made little difference whether you lived in modern-day Rome, Beijing, or Mogadishu; Europeans, Asians, and Africans were almost equally poor. As the next 1,800 years ground on, progress eluded our ancestors. Modest gains in aggregate incomes were constantly undone by population growth, which created a trap that few societies could escape.

When change finally came, though, it came fast. Powered by nineteenth-century innovations, the Industrial Revolution transformed the world economy and inaugurated a new epoch of growth. Just one hundred years later, that growth had enriched what we'd now call the advanced economies, in Western Europe and its off-shoots. As a large middle class surfaced there for the first time, consumption patterns adjusted. Relative spending shifted away from necessary goods, like food, and towards luxuries, like travel and private or higher education. This transformation remade the global economy in fundamental ways. Yet unlike the egalitarian deprivation that characterised human civilisation for thousands of years prior, the new world was an unequal place.

Throughout that long early period, the worldwide income distribution had a single peak, with a mode that hovered around a few hundred dollars. After the Industrial Revolution, the shape of that distribution changed. A second peak formed, as one lump of the population thrust ahead, while the other lagged further and further behind. What emerged was an enormous gap between the global rich and the global poor, and wealth sat firmly in the West.

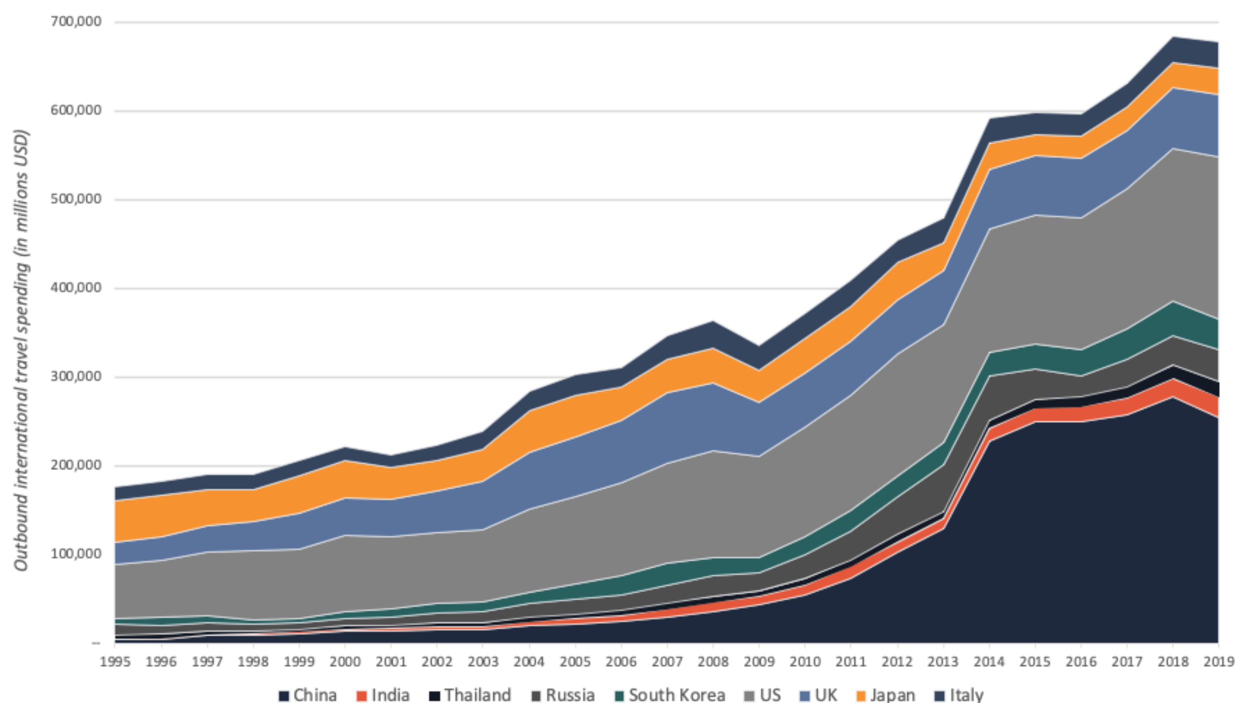
In the late twentieth and early twenty-first centuries, that gap started to close. Fuelled by globalisation, developing countries, particularly in East Asia, pursued catch-up growth. As they did, those twin peaks—which dominated the income distributions of the twentieth century—began to erode. About five years ago, we returned to a one-peak world. Of course, large differences in national averages persist, but they conceal a crucial part of the story, which hides in the top half of the income distribution. That's the emergence of a new middle class—this time, a properly global one.

By 2018, half of the world's population had made it into the middle class. (Definitions vary, but the term usually encompasses households with incomes that range from about $15,000 to $150,000 per year.) The global middle class is now expanding at record pace, with more than 150 million new entrants each year. In the next decade, an additional 1.7 billion people will join; by 2030, the group will contain about 5.3 billion members.

A second important shift will occur in the next decade, too: people within that wide middle-class category will grow much wealthier. In the twenty-first century's opening decade, about one billion people escaped extreme poverty and moved into the bottom rung of the middle class. While that transition improved many lives, most of the beneficiaries remained too poor to participate (as tourists and consumers) in European and North American markets. That's now changing. In the last decade alone, hundreds of millions climbed up the middle-class ladder into relative prosperity; in the next decade, so too will hundreds of millions more. All in all, the upper end of the global middle class—households that earn at least $75,000 per year—will expand by about 175 million people in the next ten years.

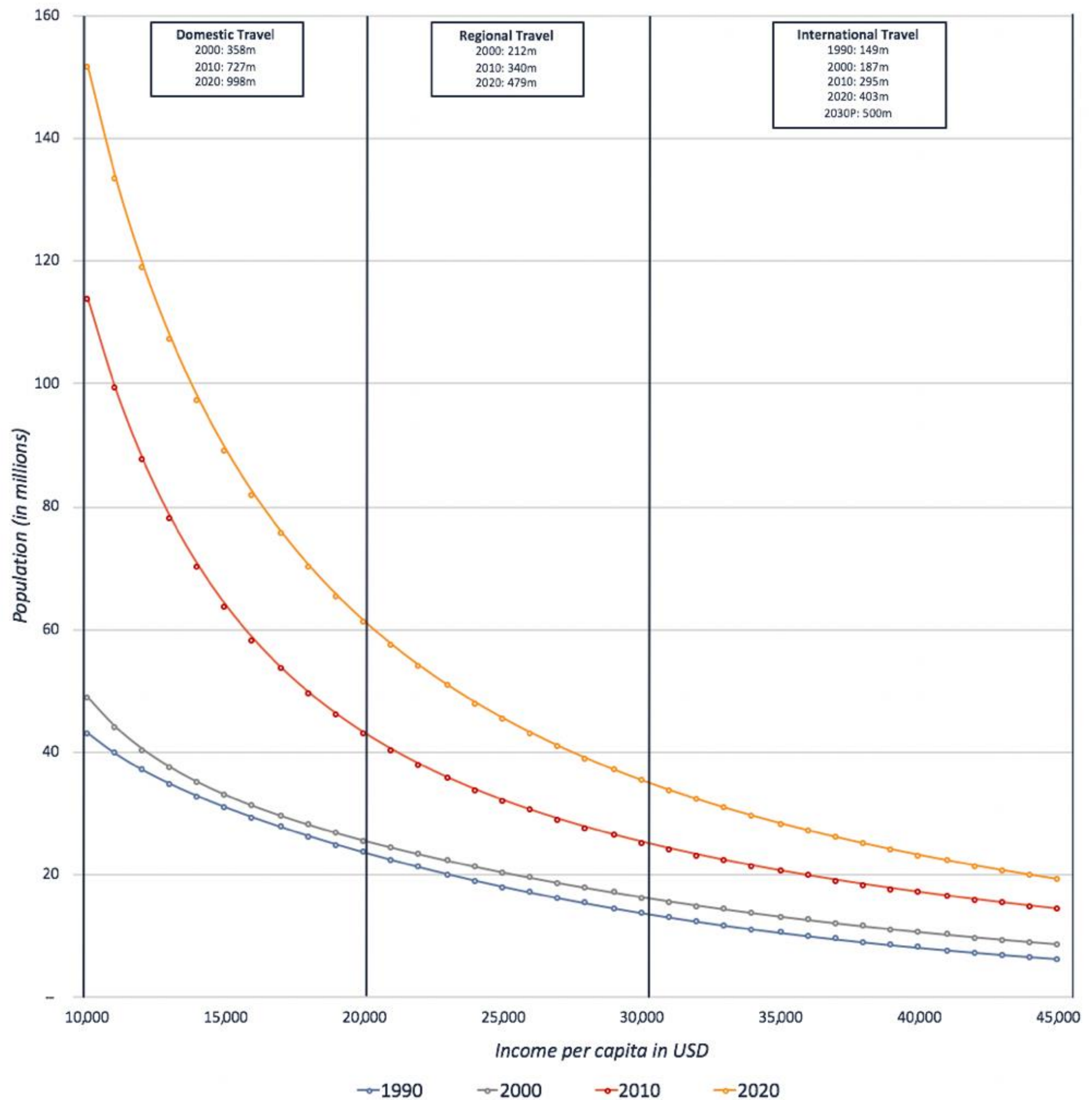
As the world transforms into a more evenly upper middle-class place, global consumption patterns will start to reflect that fact. Notably for us, worldwide demand for hospitality must grow. For a glimpse into that future, it's instructive to consider China, where the upper middle class has prospered in recent years. In 2000, Chinese spent about $14 billion on international travel. Ten years later, that figure rose to about $55 billion—steady but not staggering growth, consistent with our observation that rising incomes hadn't yet translated into mass affluence there (i.e., a large number of households earning over $75,000 per year). By 2018, however, international travel expenditures had jumped to about $277 billion. For comparison, Americans spent (just) $172 billion.

INTERNATIONAL TRAVEL SPEND



What's more, as China's global middle class got richer, spending on foreign travel increased not only in absolute terms but also as a fraction of total consumption, from about 2.6% in 2010 to roughly 6.3% in 2018. Just as middle-class societies in Europe and North America once did, the Chinese middle class now spends an increasing share of its disposable income on luxuries, like holidays abroad. So long as global-middle-class growth continues and spreads to countries like Vietnam, Thailand, and India—and it almost surely will—similar consumption habits will form in those places, too. That means many more international travellers. At first, they will flock to cheaper destinations in Asia, but the wealthier ones will increasingly venture further, often to Europe. In the last century, each new wave of international travel to Europe (e.g., from the United States after World War II or from Japan in the 1990s) eventually found its way into the home country's pop culture. We haven't yet seen the Chinese version of *If It's Tuesday, This Must Be Belgium*, but we don't doubt that it already exists, if only as a figment of someone's imagination.

GLOBAL MIDDLE CLASS TRAVELERS BY BUDGET



Here's the rub, though. Many European cities are ill-equipped to accommodate the influx of visitors. London and Edinburgh, the United Kingdom's top international tourist destinations, are also the markets with the lowest penetration rates for low-cost hotels. Judging by the income profiles suggested in our graph above, we think these low-cost hotels are exactly where many new global-middle-class visitors will want to stay. At the same time, the far-right end of the graph also depicts growth in the global upper class. As that group continues to expand, mid-market and higher-end hotels will benefit, too. Combined, these trends hint at a hopeful path forward for an industry that's now reeling from the pandemic. Enterprising hoteliers should pay attention.

THE GERMANS ALSO HAVE A WORD FOR ARBITRAGE

As urban economists and real estate investors both know, bigger cities tend to extract higher rents. Of course, at least in principle, that discrepancy doesn't generate free lunches for investors in big-city properties. After all, in well-adjusted markets, capital values should reflect that premium and drag down yields. That same precept—again, at least in principle—holds in reverse: lower rents in smaller cities mean that cheaper purchase prices there don't imply easy profits. But all rules have exceptions, and we've recently noticed that the market for office space in Germany provides exactly that.

The standard picture captures the traditional office market in Germany just fine. In Germany's top seven cities, prime rents approach €35 per sq m per month, and prime yields stand at about 2.9%. On the other hand, in secondary German cities, where prime yields come to 4.6%, prime rents are much cheaper, about €15 per sq m per month. In both cases, capital values largely adjust to rents. In the market for flexible office space, though, we've discovered that things look different: namely, desk rates don't vary all that much between primary and secondary cities. For example, monthly desk rates average about €420 per month in Leipzig and €410 in Bremen (both secondary cities) and €431 in Stuttgart and €407 in Dusseldorf (two top seven cities). What explains that parity?

Supply is the likely culprit. While flexible space accounts for about 1.2% of all office space in major German cities, flexible offices command just 0.6% of the total stock in Germany's secondary cities—which means that if you run a start-up in Dresden and want a low-risk, short-term lease, you don't have many options.

Crucially, secondary cities like Dresden do indeed host plenty of start-ups and successful small businesses. Germany's economic geography is famously decentralised; unlike some decaying cities in America's Rust Belt or England's North, Germany's secondary cities contribute substantially to the country's national economy. That's largely thanks to a robust industrial sector, which is spread throughout the German landscape and exports about $1.26 trillion of manufactured goods each year, more than any country except China. (In fact, manufacturing exports comprise about a third of the total GDP in Germany. That figure is about 16% in China and 5% in the US.) The *Mittelstand*—the small and medium-sized enterprises that account for about 59% of Germany's job creation and over half its total output—form the backbone of that economy, and almost 90% of the top 10,000 of these companies are located outside Germany's top seven cities. These businesses provide a deep market for flexible space in secondary cities there. Adequate supply just hasn't arrived (yet).

Now, what's interesting is that entry prices in secondary cities still reflect the lower rents and higher yields associated with the traditional offices there. Our arbitrage opportunity lies there: by converting some of that traditional space into flexible space, operated by Clockwise, we can capture primary-city rents at secondary-city costs. We've figured that, at market rates, we can achieve about €25 in monthly net operating income per sq m per month—about 65% higher than the monthly rents collected by traditional offices in the same cities. That's a pretty good value proposition.

SUPPLY CONSTRAINTS IN THE TIME OF COVID-19

A lot of attention has been paid to the ways in which Covid-19 has negatively shocked demand for real estate. Habitual lockdowns have confined would-be shoppers, office workers, travellers, and diners to their homes for much of the past year—leaving shopping centres and office buildings emptied out, grinding tourism to a halt, and forcing restaurants to shutter. In turn, many in-place tenants have struggled to survive, and many prospective tenants have postponed or reconsidered their plans to occupy new space. Basic economics (and common sense) dictates that, all things being equal, when demand for real estate falls, so too must prices. But all things are rarely equal. In fact, a much-neglected part of the Covid-19 story concerns how the pandemic will constrain the *supply* for new space in the months and years ahead. This complicating factor deserves attention, too.

Several different indicators point to future supply constraints in the United Kingdom. First, construction on new work declined sharply last spring, and it has not yet recovered to pre-pandemic levels, let alone made up for lost output. At the trough of the construction decline, in April 2020, monthly output dropped by 46% (YoY). The bleeding has eased since then, but December's figures (the latest available) still

indicated a monthly decline of 9.4% (YoY). The immediate shock to the construction sector was enormous, and its effects will reverberate for some time.

Even if construction fully rebounds the day lockdowns end for good, last year's output gap won't be filled quickly. Recent data on planning applications indicate why. The number of planning permissions granted by local authorities dropped by 22% (YoY) in Q2 2020 and 13% (YoY) in Q3 2020. The number of submitted applications fell by 23% (YoY) in Q2 2020 and held constant in Q3 2020. Unlike the construction output figures, which capture a month in the past, data on planning permissions look forward, telling us what to expect in the near future. (After all, developers cannot build until they receive permissions.) The point is that construction cannot return to its pre-pandemic trajectory until well after planning permissions do. The longer that takes, the longer new supply will remain constrained. According to the latest planning figures, we shouldn't hold our breaths.

Finally, it's worth considering the long term. There's a well-established correlation between recessions and reduced construction output. Unsurprisingly, that correlation lags. (In a 2013 paper, Jonathan Millar, Stephen Oliner, and Daniel Sichel examine recession data since 1982 and find that commercial construction in the United States bottomed out roughly three quarters after the business cycle trough.) The reason for construction's delayed reaction time isn't complicated. Construction is a drawn-out activity that takes time to plan, and building decisions tend to incorporate information available during that planning period. When the economy contracts, developers often need to change course, forgoing projects that they would otherwise have pursued. These absences don't appear until several months, even years, later. As a result, contractions in construction typically lag broader economic downturns.

Recent history confirms that point. A major slowdown in construction trailed the Global Financial Crisis, but that didn't happen quickly. The UK entered recession in Q2 2008, when GDP growth first plunged below zero. Growth then stayed negative for about five quarters, dropping to a low point in Q4 2008, when national output fell by 2.2%. Meanwhile, construction in Central London hadn't yet seen its worst days. Commercial office construction volumes there peaked in Q1 2008, at about 16 million sq ft, and fell to 10 million sq ft by Q1 2009. It took another year and a half for construction to bottom out. That finally happened in Q3 2010, when volumes in Central London barely reached 3 million sq ft.

As we suggested above, commercial office construction declined sharply last spring, just after reaching peak volumes of 15 million sq ft in Central London in Q1 2020. That contraction mainly reflected the pandemic itself (and the accompanying government restrictions). But perhaps construction will contract again post-pandemic—for more squarely economic reasons—when the sector's output reflects the void created by projects that got scrapped during the Covid-19 outbreak. If so, then we're left with yet another constraint on new supply in UK real estate.

GATEWAY CITIES AND THE DEATH OF INFORMATION MONOPOLIES

The last time Mike visited New York (before Covid-19, of course), he decided to stop somewhere he hadn't been in 15 years: the New York Public Library. A lot had changed since his last visit there. And as he walked into the building—then named after the man who the last time was his boss (ok…boss's boss's boss's…)—he couldn't help but stand there frozen, in awe of its beauty. He'd never even noticed the elegant symmetry of the rows of desks in the main hall, filled with people of all ages on laptops, surrounded by rows and rows of obscure reference books. Very few other cities in the world could boast such a treasure.

At that moment, all he could think was "what a fantastically wonderful… museum".

He recalled that he and Adam were having a debate on the future of gateway cities in the weeks prior and so, never to let 3,500 miles get in the way of having something to say, Mike fired off an email.

From: Michael Kovacs <mkovacs@castleforgepartners.com>
Sent: Thursday, May 30, 2019 10:21:12 PM
To: Adam MacLeod <amacleod@castleforgepartners.com>
Subject: Gateway cities

So I had a thought

I was walking thru the NY public library and was struck by the amount of publicly available information that it had. And also how accessible all this was in person.

And then i thought what a complete waste of information that could be replicated on the computer / internet today. You can probably Wikipedia / google / etc 90% of what's there on your smart phone and anything you couldn't find you could figure out a way to find it in short order.

Imagine trying to data gather for our annual meeting pre internet if you didn't live where all the ONS info was available and held

that doesn't matter so much in a pre knowledge based economy. But as the knowledge economy comes into play the advantage is really stark pre internet and mass communications. Physical agglomeration in centres large enough to support the cost of amassing all that information is expensive (not ever city can afford a NYPL), there are economies of scale, and that implies only certain cities SHOULD have that agglomeration

But that has changed

Mike and Adam weren't debating whether Alpha cities would survive, or even whether they'd fall behind their Beta and Gamma brethren. We think it's silly to suggest that New York or London or Tokyo could recede into insignificance after having been centres of civilisation for hundreds, even thousands, of years. The pandemic doesn't change that either.

We do, however, believe that the monopoly-like power the gateway cities held during the latter half of the twentieth century and into the turn of the twenty-first is being dismantled primarily by improved information and communication technologies, particularly in the face of rising costs of agglomeration in these gateway markets. Moreover, we think Covid-19 will serve to accelerate this trend.

Gateway cities were by all accounts the big winners of the last 40 years.

For example, from 1980 to 2015, 75th-percentile real wages grew by about 65% in New York and 75% in San Francisco, compared to just 35% in the United States at large. Richard Florida attributes these cities' success to what he calls "winner-takes-all urbanism"—a defining feature of the late twentieth century knowledge economy. Superstar employees moved to superstar cities because it was there that their talents would be appropriately valued (wages after all, approximate productivity), and even enhanced by their proximity to other superstars.

Not only financially, but socially, too, Alpha cities attracted the world's top performers for over four decades. If you were highly productive and you wanted to find a like-minded partner and have access to top-quality amenities, then you could hardly find a better place to live than somewhere like New York or London—two cities which the urban economist Edward Glaeser described as "marriage market[s]" in his 2011 book, *The Triumph of the City*.

And while the world's top cities still hold a material advantage in terms of productivity and social benefit, the world's Beta and Gamma cities have started to close the gap.

Consider the marriage market. When Edward Glaeser wrote those words, he lived in a world where only about 10 to 15% of Americans met their partner through online dating. Today that number approaches 40%, which means that a Nashville resident doesn't only have access to possible mates at the local bar, or at work, or through a friend of a friend, but can search through the entire city's metro population of two million people. If you want to meet a guy with a bachelor's degree or higher, between the ages of 20 and 35, there are probably one or two hundred thousand to choose from, many of whom are single and now use online dating, too.

Or take, for instance, the ways in which productivity gains in the world's gateway markets have been offset by the costs of agglomeration. Many secondary cities—thanks to the technologies we've all depended on in the past year—can now offer a better quality-of-life balance. Sure, wages in London are about 30% higher than wages in Manchester. But because of restricted land use planning over the last 50

years, London's housing prices are nearly double Manchester's. Based on a quick analysis we ran, a typical Londoner earns about £860 per month, after subtracting the costs of housing (a one-bedroom flat rental outside the city centre), public transportation, and taxes. Compare that with Manchester, where a similar person nets closer to £1,075.

And it's not only ordinary people who have had to rethink the value of gateway cities—so too have the workers whom Dror Poleg calls the "10X class", the non-CEOs who nonetheless significantly out-earn their peers. In the UK, for example, this might represent a worker in the top 0.5% of the personal income distribution, who earns about £240,000 per year. There's a strong chance she currently works in London, but now, in a world in which telecommuting allows for jobs to be less location-specific, these 10X-class workers may no longer need to live in gateway markets to earn their higher standards of living. This gives them a considerable incentive to escape the high costs to agglomeration that have made London and New York expensive and inconvenient, even for those in the top half-percent of wage earners.

We could go on all day about what the Alpha cities used to offer that secondaries cities could not <u>at all</u>. And the full experience for most of these things can still only be offered by the world's gateway markets. If one would like to listen to top quality opera or watch the world's premier theatre, that person would have to go to New York's Met or to London's West End. If one would like the best shopping, that person might stroll down Tokyo's Omotesando. If one would like to understand the fashion trends changing the world, that individual might want to be in Milan or Paris. But compared to what existed *only five to ten years ago*, 4G and now 5G-streaming on Spotify, Netflix and YouTube; Amazon prime delivery and other e-commerce options; and tens or hundreds of thousands of food- and fashion-related Instagram feeds to follow—all that means that one is not completely out of luck if that person decided to live in a medium-sized city.

The point of all this? London and New York probably won't slip behind Manchester and Nashville any time soon. But the *monopoly* that Alpha cities held for the past four decades will dissipate. At that point, all the die-hard New Yorkers out there can feel free to start sending the HaTE mAIL...

Best Regards,

Brandon Hollihan   Mike Kovacs   Adam MacLeod

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