

Sustainability analysis of real estate locations

From the Notenstein sustainability series



*“Whoe’er would form eternal bonds
should weigh if heart to heart responds.”
Traditionally, international real estate
investors have focused on locations in
capital cities, often overlooking other
large cities where the return-risk profile is
more attractive. The Notenstein Location
Rating identifies flourishing European cit-
ies with a bright outlook and favourable
conditions for real estate investors. This
rating then forms the basis for pan-Euro-
pean investments in the Notenstein sus-
tainable real estate funds.*

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Real estate involves tangible – in other words “real” – im-
movable property. It is generally fixed in one location for
its entire lifespan, during which it continuously interacts
with its immediate and wider surroundings. Thus a real es-
tate investment involves not just bricks and mortar, but
also the concept of “location”, meaning that buyers must
assess both the building and location quality. Factors affect-
ing location quality include accessibility and local infra-
structure, as well as the demographic, economic and regula-
tory profile. Ultimately, an attractive combination of object
and location quality is decisive in order to lease or sell a
property.

When evaluating location quality, we differentiate between
micro-location and macro-location. The former concerns
the object’s immediate surroundings within the city. This
small-scale analysis is generally conducted in connection
with an assessment of object quality. Macro-location con-
cerns the placement and characteristics of a city or suburb
within a country.

So what are the hallmarks of a good macro-location, and how can location quality be assessed? This publication aims to answer these questions.

Location, location, location?

As the well-known expression goes, there are three things that matter in property: location, location, location. Although there are many important considerations for real estate investors (returns, for example), location is incontestably a key factor. The real appreciation in the value of a property is always based on its land, while the building upon it, absent further investment, is constantly losing value as it ages. When purchasing an object, an investor is also committing to its location, although he subsequently has no direct influence on its quality. Thus it is crucial, as part of the evaluation process, to assess the outlook for the location as well.

Two-tiered analysis

Superficially and intuitively, the characteristics of an attractive location seem obvious. However, when making a subjective assessment of real estate, a buyer does well to set aside personal preferences and instead adopt a systematic valuation approach with measurable indicators. The starting point is a traditional location analysis, supplemented with additional factors. A sustainability approach is helpful here, since the long life-cycle of real estate necessitates a similarly long-term investment horizon. Furthermore, the sustainability approach specifically includes social aspects that contribute significantly to the appeal of a location.

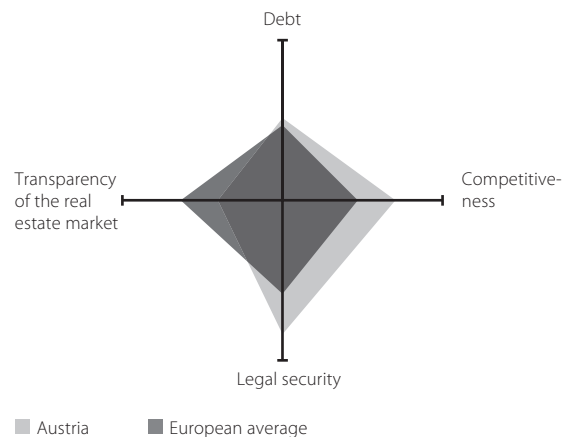
To begin with, the political, legal and overall economic framework – not only of individual regions, but of the country as a whole – must be a good fit for the real estate investor. This is why Notenstein has a two-tiered approach: it evaluates at national level (30% of the total valuation) and at metropolitan level (70%).

At national level, we also include general factors that are not specifically related to real estate. For example, a high level of government debt coupled with low competitiveness wrecks a country's prospects, as the government debt crisis clearly

illustrated. At the same time, we consider factors that are especially important for real estate investors. These include, in particular, all aspects connected with property transactions such as market transparency, transaction processes or the complexity of building permit approvals or litigation. The valuation at country level comprises 18 individually-weighted indicators in the following four categories:

- Debt: government debt, net foreign debt, etc.
- Competitiveness: level of technological development, efficiency of the labour market, etc.
- Legal security: political stability, good governance, enforceability of contracts, avoidance of corruption, etc.
- Transparency of real estate markets: availability of market data, transaction processes, etc.

Figure 1: Sample country valuation: Austria



Source: Notenstein Asset Management

The success of a real estate investment is ultimately measured in economic categories, namely rental income and the change in current market value. In turn, the rent potential itself is determined by a wide array of economic and socio-demographic factors. In our view, a main determinant for the attractiveness of a macro-location is a sustainable population and economic structure, and this can only be maintained – or improved – if the population enjoys a high quality of life. Further, the infrastructure must meet the needs of local people and businesses.

Thus the second part of the location rating applies 53 individually weighted indicators to the metropolitan area that are summarised in the following four categories:

- *Population: dependency ratios, fertility rates, employment ratios, etc.*
- *Quality of life: mortality rates, air pollution, crime rates, poverty risk, etc.*
- *Economy: education levels, purchasing power, innovative drive, etc.*
- *Infrastructure: multimodal accessibility, internet access, etc.*

Much of the data used in this valuation is sourced from Eurostat, the statistical office of the European Union. Other sources include the World Bank, the International Monetary Fund and Transparency International. Most of the data relate to the status quo or the past, but since these data change very slowly they can also give an indication of the future. After all, the basis for tomorrow's trends is already built into today's structures. In some cases (including population statistics), forecasts are also incorporated.

Not all ratings are alike

A city can be awarded different rankings by different rating systems. How is this possible? The answer can be found in the varying objectives, which yield different valuation criteria. For example, a survey tailored to the needs of foreign managers will rightly include aspects such as the availability of international schools. The Notenstein location rating, on the other hand, is oriented towards the needs of real estate investors with a European focus.

When selecting the locations to evaluate, we relied on the Eurostat definition of "metropolitan regions" in the 28 countries of the EU, Norway and Switzerland. Under this definition, a metropolitan region has a minimum population of 250,000, including commuting zones. Such regions are also referred to as "agglomerations". In most cases, metropolitan regions consist of a single (large) city and its commuting zones, though there are cases of metropolitan regions including more than one city; the most striking example being the Ruhr district. In these situations the individual cities are evaluated separately. We have analysed a

total of 294 metropolitan regions that incorporate 314 cities. This includes all 30 capital cities and – depending on the country – up to 87 further cities.¹

Results

Considering the results solely at national level, our analysis indicates that the Scandinavian countries and Finland rank well above the average. Most of the Western European countries also exceed the average. France barely attains an average rating. Belgium, the Baltic states and all the countries of Eastern and Southern Europe are ranked below the average. Greece takes last place.

Not identical to Notenstein's country rating

Notenstein also assigns sustainability ratings to countries (see our publication "Country sustainability analysis"). This analysis is tailored to the selection of sustainable government bonds. In contrast, the national evaluation of our location rating considers the local conditions for real estate investors. Due to the differing objectives and geographical focus, most of the indicators also differ; some, however, apply to both the country rating and the location rating (e.g. government debt).

The aggregation of criteria at the metropolitan level allows us to generate a differentiated ranking of European cities according to certain qualities (figure 2). The cities of Scandinavia take a clear lead, followed closely by the prosperous regions of Northwest Europe. Next come the less dynamic cities of Germany, the UK and France, as well as several Western European capitals.

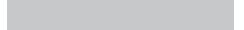
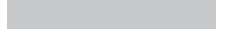
In the lower midfield we find cities from the former Eastern Bloc on the one hand, and Western Mediterranean regions on the other. Locations in Southeast Europe are at the bottom of the list. Surprisingly, not a single city in Eastern or Southern Europe ranks above the average. This cannot be attributed solely to the below-average results at national level, since this makes up only 30% of the total rating. Rather, the Southern and Eastern cities tend to rank below the pan-European average in terms of quality of life, infrastructure and economy.

Although a certain degree of geographical differentiation – particularly along the North-South axis – cannot be overlooked, there are also major regional differences within individual countries.

The widest spread between the best- and worst-rated cities can be found in Germany, where Munich has a rank of 13 and Magdeburg 205. The spreads are similarly wide in the UK, where Reading (rank 18) contrasts with Glasgow (186), and in France, where Paris (34) contrasts with Reims (201) (figure 3).

It is hardly surprising that in each country, the capital city is ranked high on the list. However, attractive investment prospects can also be found in thriving secondary cities – often called “B cities”. The Notenstein location rating is of particular value in identifying such “hidden champions” (figure 4).

Figure 2: Attractiveness of selected locations²

Metropolitan region	Country	Rank	Valuation	
Stockholm	Sweden	1		100%
Oslo	Norway	2		98%
Amsterdam	Netherlands	15		89%
Copenhagen	Denmark	20		86%
London	UK	21		85%
Paris	France	34		83%
Hamburg	Germany	46		80%
Vienna	Austria	101		73%
Dublin	Ireland	105		72%
Berlin	Germany	131		69%
Brussels	Belgium	147		68%
Madrid	Spain	211		47%
Budapest	Hungary	218		41%
Milan	Italy	225		40%
Lisbon	Portugal	227		39%
Constanta	Romania	314		0%

Source: Notenstein Asset Management

Figure 3: Significant regional differences in overall valuations based on examples in Germany, France and the UK

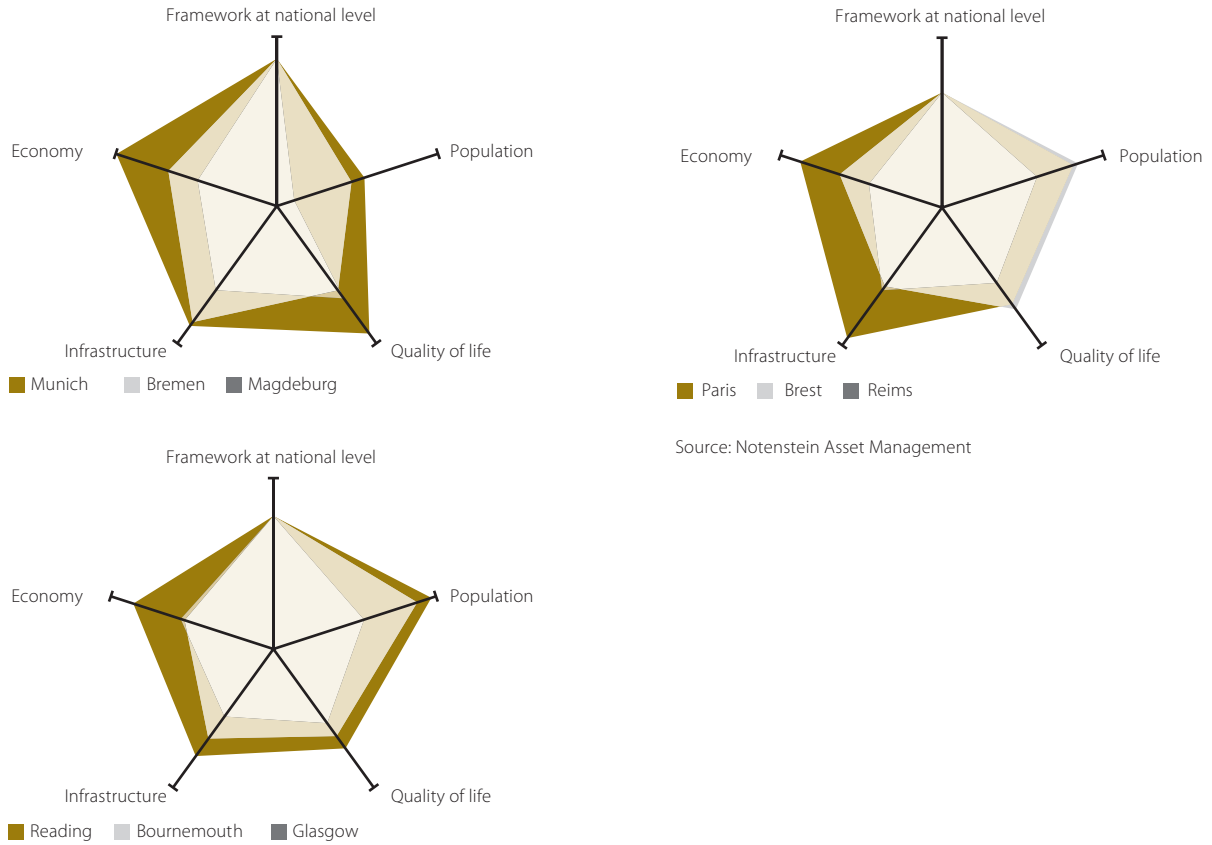


Figure 4: Selected "hidden champions"

Metropolitan region	Country	Urban pop.	Metropolitan pop.	Rank	Valuation	
Malmö	Sweden	300,871	612,023	4		96%
Bergen	Norway	261,979	387,437	8		92%
Utrecht	Netherlands	313,793	654,438	9		91%
Århus	Denmark	317,414	651,524	26		84%
Eindhoven	Netherlands	216,496	688,184	28		84%
Bristol	UK	426,799	891,175	45		81%
Nuremberg	Germany	508,875	1,306,973	57		79%
Cologne	Germany	1,013,939	1,918,999	62		78%
Lyon	France	1,290,487	1,890,460	69		78%
Freiburg im Breisgau	Germany	228,073	638,734	70		78%
Toulouse	France	703,393	1,213,887	82		76%
Leeds	UK	753,759	2,511,462	87		75%
Manchester	UK	497,115	2,765,540	96		74%
Strasbourg	France	468,282	758,258	108		72%
Antwerp	Belgium	502,428	1,074,506	135		69%
Linz	Austria	188,891	756,810	154		67%

Source: Notenstein Asset Management

The location rating represents the first step in any building acquisition by the Notenstein real estate funds in Europe. As part of the investment process, potential locations are further filtered according to characteristics of the local real estate markets. These include, in particular, the size and liquidity of the market (space available, increase in space, transaction volumes, rental space revenues), current returns and rental price levels. The cities thus selected are then examined for investment opportunities. Once a specific object is under consideration, in addition to the usual economic, technical, legal and fiscal assessment, the object itself and the micro-location undergo a comprehensive sustainability analysis. This includes indicators regarding the surroundings, mobility, energy and the environment, comfort and well-being, utility and flexibility. In this way we ensure that both the locations and the objects represented in Notenstein Private Bank's international real estate investments align with our sustainability principles.

Summary

The Notenstein location rating serves to pinpoint thriving (macro) locations in Europe with a bright outlook for real estate investments. In order to profit from the “hidden champions” among them, 294 metropolitan regions in 30 countries undergo a sustainability analysis. The list of criteria complements the usual location analysis with socio-demographic and other factors as well as forward-looking components. Political and legal conditions in the countries of investment and the transparency of the real estate markets are also considered.

“Folly is short, remorse is long.” This line closes the stanza of Friedrich Schiller’s “Song of the Bell” cited at the beginning of this publication. Investments in real estate may not be “eternal bonds”, but mistakes can have grave and costly consequences. Notenstein’s location rating can help to ensure that real estate investments do not inspire remorse.

Endnotes

- 1) Due to Germany’s federal structure, there are altogether 88 cities located in metropolitan regions according to the Eurostat definition.
- 2) The scores are normed so that the best location receives 100 and the worst 0 points.

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