Real Estate Insight

The impact of slowing working-age population growth

Standard Life Investments

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Executive summary

- The growth of the working-age population (ages 20-64) has peaked in many regions. In Europe, for example, the size of this population peaked in 2011 and is set to decline 11% over the next 20 years.
- Working-age population growth is one of the key drivers of economic growth, so for developed countries, importing workers through immigration is good policy. However, despite evidence showing the economic contribution of migrant workers, immigration is an increasingly contentious issue.
- While economic growth is an important driver for real estate, slowing growth in working-age population does not necessarily mean lower real estate returns according to our study of US cities.
- In the office sector, core assets should outperform, as companies need to offer attractive packages, including high-end workspace, to attract the best workers from a smaller available pool.
- Looking from another perspective, a declining working-age population should mean more demand for retirement communities and assisted living accommodations. Shrewd developers that meet this demand could do well.

Introduction

The developed world is at a turning point – growth in the working-age population has peaked, economies are slowing, and voters are displaying scepticism for immigration. This raises questions over how economies can grow without more people of working age to wield a shovel or tap a keyboard. In turn, this has implications for real estate and the number of new buildings needed in the future. In this paper, we focus on the economic and commercial real estate impacts of slowing growth in the working-age population.

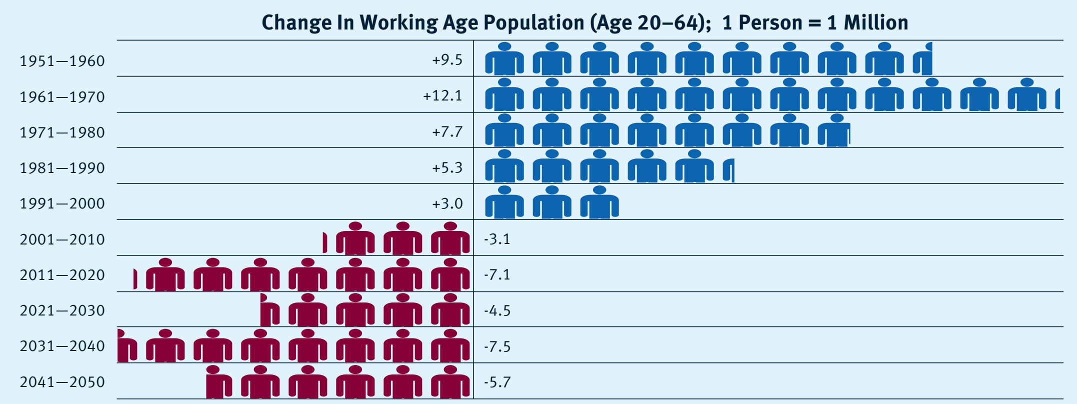
Slowing working-age population - Japan case study

The 'Lost Decade' is the term initially coined to describe Japan's economic woes from 1991-2000. In the following decade, GDP growth again averaged less than 1% per year and the term was subsequently updated to Ushinawareta Nijūnen, the 'Lost 20 Years'. While a massive asset price bubble was the trigger, the peak and subsequent decline in the working-age population further exacerbated and extended the slow growth period that continues in Japan today.

In the 20 years preceding 1990, growth in the working-age population (20-64) amounted to 13 million people, a 21% cumulative gain, or slightly over 1% per year (see Chart 1). However, during the Lost 20 Years, the tailwind of working-age population growth shifted to a headwind. In 1997, the working-age population peaked and began to decline, falling a cumulative 12% from 1997 to 2016. A further 14% decline is expected over the next 20 years.

At some point, no amount of fiscal or monetary stimulus can offset the fact that there are less consumers and workers. So far, commercial real estate landlords have still been able to push up rents for core assets in core locations because there is strong demand for prestigious space. However, the overall market has been less favourable. In aggregate, the long-term risks for commercial real estate in Japan, like population growth, are weighted to the downside.

Chart 1: Japan's change in working-age population

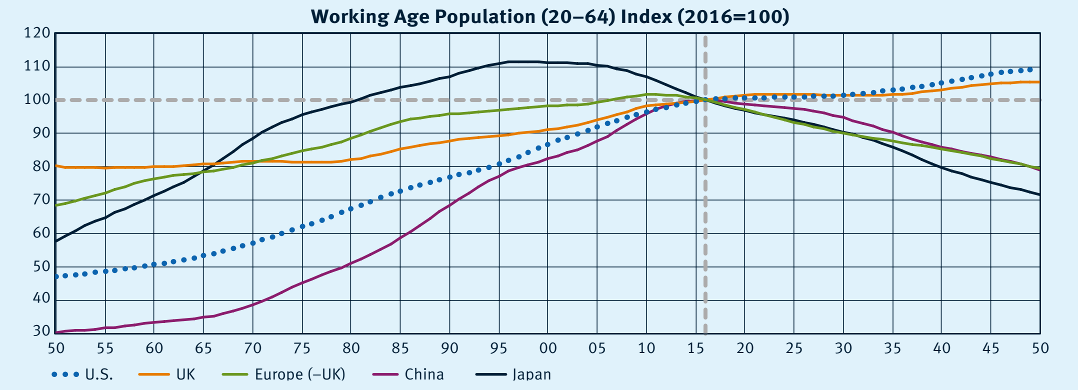


Source: United Nations Department of Economic and Social Affairs; Standard Life Investments, as at 2015

Other developed nations

As the world has become richer, people are having fewer children. As a result, population growth is slowing almost everywhere – a positive development for the environment, but a much harder proposition for economic growth or for the developers of commercial real estate. For example, working-age population in the UK is slowing dramatically, shifting from 10% cumulative growth over the last 20 years to just 1.6% over the next 20 years. The US will shift from 17% cumulative growth to just 3% over the next 20 years. Europe's working-age population peaked in 2011 and is now in decline, with a further 11% loss expected over the next 20 years. It is no wonder that on the first day of 2016, the Chinese government ended its one-child policy – working-age population peaked in 2016 and is set to decline 10% over the next 20 years (See Chart 2).

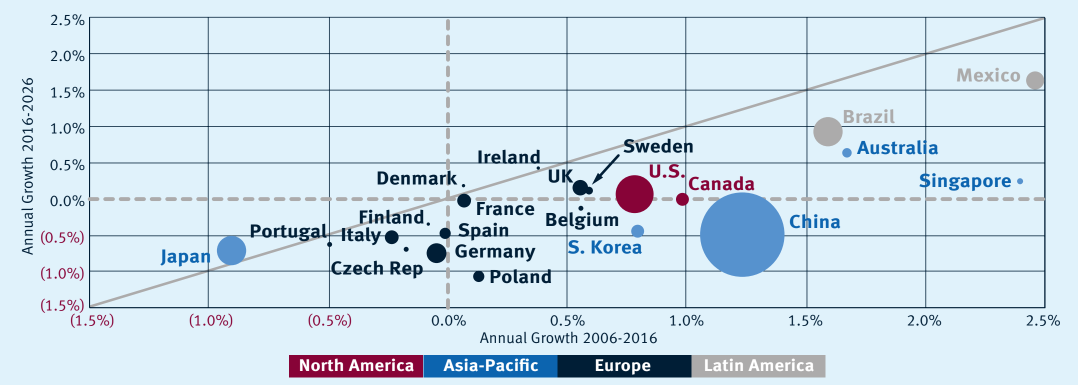
Chart 2: Working-age population index 1950-2050



Source: United Nations Department of Economic and Social Affairs; Standard Life Investments, as at 2015

Very few major industrialised nations will experience stronger growth over the coming decade. Of those that will, shown as above the line in Chart 3, growth is only set to be in the 0.1-0.2% range.

Chart 3: Working-age population growth, last 10 years versus next 10 years



Source: UN Department of Economic and Social Affairs; Standard Life Investments, as at 2015
Note: Bubble size denotes relative size of working-age population.

Could these forecasts be wrong? Consider that a person entering the 20–64 year old cohort in 20 years must already be born. In short, most of these declines are already set and there is little that countries can do to change the outcome in the short term. Over the long term, generous family and social benefits aimed at working parents have proven helpful, but only somewhat. Europe's progressive northwestern countries have generous family leave policies and consequently boast higher birth rates than their southern and eastern European peers.

Although these birth rates are comparatively better, even Sweden's policy that permits 16 paid months of leave per child (eight for each parent) still yielded a birth rate of just 1.88% as at 2014. Of these countries, France leads the pack at a birth rate of 2.01, but even this does little to grow the population.

This leaves no choice – countries must import workers to remain competitive. Yet, in the face of economic slowdown, immigrants are increasingly shunned. The UK's vote to leave the European Union, the election of Donald Trump in the US, and the rise of Marine Le Pen and the French National Front are all largely attributable to each country's citizens calling for less immigration.

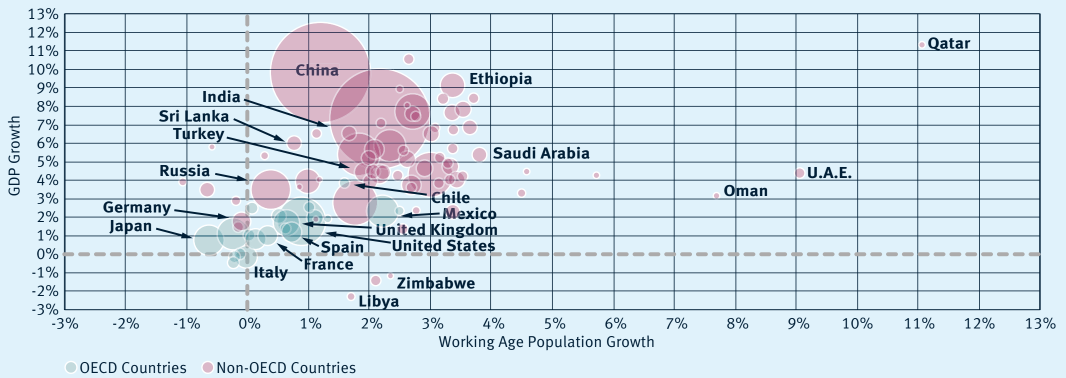
Some of these policies are already quite stringent. Consider that in US graduate programmes, the percentage of foreign full-time students is: electrical engineering – 70%; computer science – 63%; industrial engineering – 60%; chemical, materials and mechanical engineering – all over 50%. Yet, only one-third of the 250,000 annual applicants receive an H-1B work visa. Essentially, the US trains much of the world's highly educated workforce, but does not let most of them stay to help grow the economy. Countries like the UK and the US are in an enviable position where people desperately want to enter their countries. However, voters have essentially decided to turn both highly skilled and less skilled workers away.

Working-age population and economic growth

The two main drivers of economic expansion are population and productivity growth. Around the world, productivity varies greatly due to various factors, including education, industrialisation, technology, government policies, conflict, and more. During the industrialisation period, countries can far outperform the growth implied by working-age population alone due to the virtuous cycle that begins with increasing productivity. For example, from 2001-2015 Sri Lanka had just 0.8% annual growth in working-age population, but achieved an impressive 6% annual economic growth due to productivity enhancements. This is in contrast with post-industrial Spain, which achieved just 1.2% annual economic expansion with very similar growth in the working-age population to Sri Lanka (See Chart 4). Increases in productivity are also the reason why China has had such strong economic growth and why the country will able to continue growing its economy despite a shrinking working-age population.

There are numerous examples like this, as can be seen in Chart 4. The mostly 'rich-world' market economies of the OECD have an orderly relationship between GDP growth and working-age population growth, whereas the non-OECD countries are able to achieve much higher growth as their workers become more productive. The greater economic upside makes emerging countries enticing investment opportunities. However, even allowing immigration of less-skilled workers from these countries can be a boon for a destination country's economy.

Chart 4: Working-age population growth versus GDP growth 2001-2015



Source: UN Department of Economic and Social Affairs; Standard Life Investments, as at 2015

Because of this productivity difference between more and less developed nations, the global economy grows when a worker from a less productive country joins the workforce in a more developed country. According to research from McKinsey & Company, about half of all migrants move to developed nations from developing countries, contributing 40%-80% growth in the labour force in those countries. The same study claimed that migrants contributed about USD$ 6.7 trillion to global GDP in 2015, nearly twice the amount they would have produced in their origin countries. Of this output, around USD$2.5 trillion benefited North America and USD$2.3 trillion benefited Western Europe. Moreover, numerous research studies have shown that these new workers do not harm native wages and employment. Migrant workers often take lower-skilled jobs, which frees native workers for higher-skilled work with proper training, a further boon to the economy.

The impact on real estate – US case study

To help isolate the impact of working-age population from the impact of industrialisation and policy, it is helpful to focus on a single country. The cities of the US provide a useful case study. In Chart 5, the relationship between economic growth and working-age population growth is clear, with few outliers. The correlation between the two factors from 2001-2016 is 65%. Not surprisingly, the cities able to outperform growth in working-age population this millennium were those with a large degree of high-growth technology jobs, such as San Jose, Portland, and Austin.

While economic growth is an important driver for a real estate investor, what investors really want to know is how much demand there will be for space in the market. Working-age population growth can generally predict office demand growth over the long term. Whereas the correlation to GDP in Chart 5 is 65%, the correlation between growth in working-age population and office demand is 80% when measured from 2001-2016. Demand growth is much more volatile due to business cycles but, over the long term, the two factors are inescapably linked (See Chart 6).

Chart 5: GDP growth v working-age population

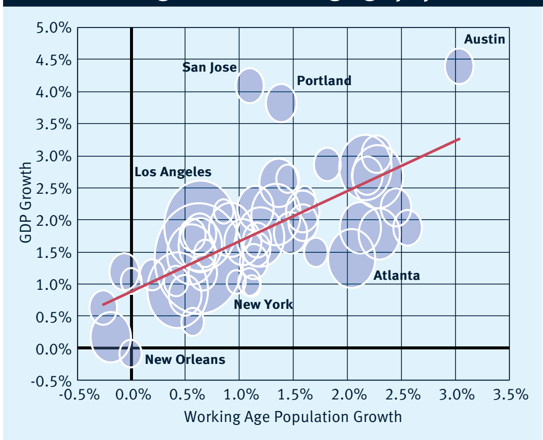
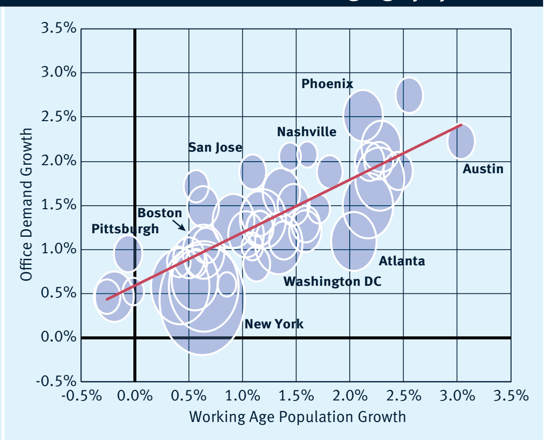


Chart 6: Office demand v working-age population



Source: Bureau of Economic Analysis; US Census Bureau; Standard Life Investments, as at Q2 2016

The good news is that slowing growth in working-age population does not spell disaster for commercial real estate investment returns even though it is highly correlated to demand growth. On the contrary, when measuring growth in working-age population in these cities against total returns, the correlation was essentially zero. Market economics is the ultimate arbiter here. When demand growth slows, commercial real estate developers also pull back. Certainly, developers will occasionally overshoot demand in a market, but the imbalance corrects itself – excess supply leads to reduced rents and a longer expected lease-up period for a developer. These combine to make subsequent new development less attractive, then eventually the positive demand backfills the vacant space, and the cycle begins again. As a result, self-limiting construction has kept these markets mostly in balance, which serves to uncouple growth in working-age population from overall returns.

While this is a positive interpretation, it is critical to note that nearly all the markets in this case study have experienced growth in both working-age population and office demand. The scenario many markets are heading for, where working-age population growth shrinks, is mostly unprecedented. Again, market economics can illustrate how this might play out – less people of working age results in fewer workers, who in turn require less space. Therefore, unless buildings are torn down, vacancies rise, and tenants perpetually have the upper hand in rent negotiations. In short, **negative** growth in working-age population is very different to **slow** growth in working-age population.

Wider real estate implications

Demographic considerations are no longer relevant just for investors in the retail sector and rental housing. All commercial real estate investors would benefit from considering growth in working-age population for their target markets. This may not have been necessary in the past, but many developed markets are at a turning point and working-age population growth (or lack thereof) is a significant driver of the local economy and of commercial real estate demand.

For office investors, core assets are likely to outperform on a risk-adjusted basis. In a 2016 survey of 229 corporate executives by CBRE, 50% claimed that talent availability was the most important consideration in their real estate decision making. Meanwhile, only 31% said real estate cost was a top factor. To lure the best workers in a declining workforce, competitive companies will offer attractive packages, including high-end workspace. Indeed, commercial real estate investors in Japan have been able to achieve rental gains in line with the MSCI global benchmark since the comparison became available in 2001. The properties in Japan's index are mostly core assets in core locations, which reinforces the point that the best quality assets should hold up better than the overall market despite the declining availability of workers. It is important to note that Japan is a unique culture where honour and prestige are particularly valued – not all core assets in markets with declining growth will fare as well. Still, for investors with a mandate in a slowing market, Class A assets in core locations are likely to be the best strategy.

For investors with more leeway, there are numerous markets where growth in working-age population is still rising quickly, although typically these markets are riskier for various reasons (e.g. Brazil, Mexico, South Africa, and India). However, given the long-term correlation to office demand, for an investor with an appetite for risk, there is certainly opportunity. A more moderate approach might be to look towards cities that have strong growth within stable countries (e.g. Atlanta, Charlotte, and Dallas in the US).

Of course, the opposite side to a declining working-age population is an increasing older population interested in retirement communities and assisted living. The social acceptability of assisted living varies by culture and country but, globally, elderly parents and their adult children are increasingly turning to these facilities. Coupled with the organic growth of the older population, demand is poised to increase dramatically. In the UK, growth in the number of people over 75 should more than double over the next 10 years. In the US, growth will triple. Many markets are not set to meet this demand and a shrewd developer aware of these trends could do very well.

Summary

Developed nations are heading into mostly uncharted territory. Analysing population data by age range for your target real estate markets should become an integral part of the investment process. Many real estate investors will not look at the big picture in this way, but those that do will make wiser decisions.

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