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How to identify growth potential in European cities

Certain cities have substantial growth potential

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As we observe the real estate markets across Europe, there is a noticeable shift in dynamics that suggests certain cities hold substantial growth potential. The challenges faced by these urban areas–ranging from the need to expand and upgrade existing housing stock to supporting a retail sector struggling through a sluggish recovery and finding innovative solutions for evolving office space requirements–are common across the continent. Yet, within these challenges lie opportunities, particularly within the broader living sector, which can cater to diverse residential needs.

In my role as managing director of Arrow Lending Opportunities, I've seen firsthand how investors can navigate these complex environments and our approach to identifying cities with growth potential is guided by a few key indicators. Arrow Global, which acquired Maslow Capital last year, has funded more than £5.1 billion ($6.8 billion; €6.1 billion) of real estate projects across the UK and Western Europe, and can draw on invaluable lessons learnt over this period.

The first critical factor is infrastructure spending. Take the UK, for example, where infrastructure projects that enhance connectivity to London, such as the High-Speed 2 (HS2) rail project, are of particular importance. The anticipated reduction in travel times between major cities and London is already generating increased business and developer interest in cities like Birmingham. Great Manchester Mayor, Andy Burnham, most recently warned that failing to boost rail capacity on an axed section of HS2 would be “anti-growth policy.” This is a clear demonstration of how infrastructure investments can spur demand for both office and residential spaces, offering a model that can be applied across various European cities.

Education, specifically student retention rates, also plays a pivotal role. In cities boasting strong universities, the number of graduates who choose to remain in the area often reflects job availability, quality of life, and the adequacy of housing. Additionally, the relocation patterns of major employers, particularly from capital cities to secondary or tertiary cities, further influence these dynamics.

Local council policies on housing development also cannot be overlooked. Cities like Manchester exemplify a pragmatic approach, where the city council’s flexible planning consents have facilitated dense development and revitalised areas like the Northern Quarter and Ancoats. In contrast, Leeds, which has historically struggled with restrictive planning relative to land prices, is now seeing renewed interest as it begins to relax these constraints, leading to significant urban transformations like the South Bank regeneration project.

These factors must be monitored over time. For instance, significant increases in capital investment and university applications, as well as the absorption of graduates into the local economy, are all signs of a city poised for growth. While a year of data might not indicate a trend, a three-year track record begins to paint a convincing picture.

When it comes to structuring investment strategies, I maintain that the principles of lending remain consistent, regardless of market conditions. The lessons learned from past crises, such as the Global Financial Crisis (GFC), remind us that overextending in terms of cost thresholds or deal structures can have detrimental effects. Today, we adhere to a disciplined approach where equity is invested upfront, sponsors are committed, sensible covenants are established, and loan-to-value ratios are kept in check. This strategy is essential regardless of the city or market conditions.

In terms of sectors offering the best opportunities and long-term resilience, the living sector stands out. Both build-to-rent and student housing have shown strong occupancy statistics across economic cycles. Senior living, while promising, remains a challenging asset class to operate effectively. There is a clear demand for affordable housing, but making the financials work in this sector is often difficult. Despite government rhetoric around affordable housing, practical implementation at the council level is hampered by funding constraints, bureaucratic obstacles, and local opposition.

Retail, on the other hand, presents a mixed picture. While high street retail continues to struggle, out-of-town shopping centres and specialised retail have seen somewhat of a resurgence in certain cities. As interest rates stabilise and yields become more attractive, these sectors could offer compelling investment opportunities.

The office sector is undergoing a significant transformation. The demand for highly efficient, ESG-compliant office spaces is outpacing supply, while older, less efficient buildings face obsolescence. Canary Wharf in London, originally developed as a financial hub, is now facing the challenge of repurposing some of its older office buildings. These buildings, once state-of-the-art, are now considered inefficient by modern standards, particularly concerning ESG credentials. To address this, some buildings are being retrofitted to meet higher environmental standards, while others are being converted into residential or mixed-use spaces. This approach not only modernises the area but also diversifies its use, enhancing its resilience to economic shifts.

Technology and innovation also play a crucial role in determining the future investment potential of cities. The presence of large, dynamic employers like Google or Facebook in a city can have a profound impact, driving demand for housing and spurring economic development. Google's decision to establish its new UK headquarters in King's Cross, London, exemplifies this trend. The presence of such a major employer has not only boosted the local housing market but also attracted a range of smaller tech companies and startups. This transformation has turned King's Cross from an underdeveloped area into one of London's most sought-after locations. However, the lack of attention to initiatives like smart cities or technological plans in urban development can limit a city's ability to fully capitalise on the influx of tech-driven employment and investment.

In the real estate debt space, we see significant demand for bridge acquisition, refurbishment, inventory loans and development financing. Demand for specialist financing is strong, and the collective bridging loan book for the industry shows robust growth. In Cambridge, for example, the demand for life science facilities has surged, offering investors stable growth opportunities as traditional sectors like retail and offices face challenges. The living sector, in particular, is attracting more equity investment, and the progress we see in new developments and refinancing indicates a healthy market. I'm pleased with the progress we've made in new development opportunities and in redemptions, which indicate a healthy refinancing market. This also reflects buyer demand, mortgage availability, and the sector's confidence in the market. While it may take longer to complete new developments or move an asset, progress is being made.

As real estate values begin to bottom out across Europe, it's essential to position debt strategies in a way that maximises returns while managing risks. Land prices have adjusted to make new developments viable. As we move forward, the hope is that local governments will adopt more pragmatic approaches to urban development, allowing cities to revitalise and capitalise on emerging opportunities.

In conclusion, while the challenges facing European cities are significant, they also present unique opportunities for growth. By focusing on infrastructure, education, local policies, and technological innovation, investors can identify cities with the potential for outperformance. With a disciplined approach to lending and investment, the real estate sector can navigate these shifting dynamics and emerge stronger in the years ahead.

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