Time to Invest in PRS?

The Rise of the UK Private Rented Sector

The UK Residential Market

The UK is suffering from a major housing shortage. A decade ago, the Government forecast that 250,000 new homes needed to be built every year to keep up with new demand, but ever since, housing output has averaged only 150,000 new homes per annum (Figure 1). Latest Government forecasts predict c.225,000 new households will be required each year for the next decade, but housing completions are still showing no signs of accelerating.

DEMAND FOR NEW HOUSING: HOUSEHOLD GROWTH

Over the next 10 years, the ONS forecast the UK population to rise from 65m to over 70m - a result of an ageing population, improved healthcare and net migration into the UK, placing great pressure on the UK's housing supply. In line with this forecast population growth, the ONS projections suggest that the number of households in England will need to rise to at least 26m by 2027 – an increase of 225,000 new households each year. When other requirements are added, for example for second homes, various government commissioned reports have advised that 240-250,000 dwellings per annum need to be constructed merely to keep house price inflation at a level that matches general price inflation.

SUPPLY AND DEMAND IMBALANCE: THE CAUSE OF AN AFFORDABILITY CRISIS

The supply and demand imbalance in the UK residential market has caused significant house price growth over the last 20 years. Since 1997, the median price for housing in England and Wales has increased by 259%, an average of 7% a year, whilst median annual earnings have increased by just 68% over the same time period.

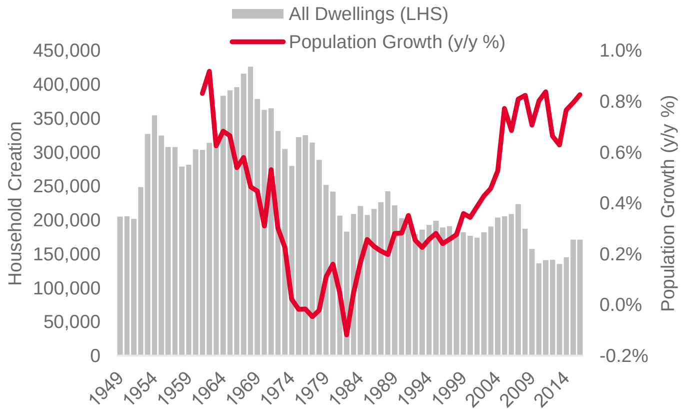
On average, house prices are now at a multiple of 7.6 times annual earnings, more than double the ratio from 20 years ago. This has led to a sharp decline in homeownership levels, down from 71% in 2003 to 62.9% at the end of 2017.

The result of such an imbalance between house price and earnings growth is that the average home buyer is now forced to take on significantly higher levels of debt. Their ability to borrow such large sums has been dependent on ultra-low interest rates. Whilst we do not anticipate that interest rates will increase to the levels seen prior to 2008 any time soon, we do expect to see some more modest increases.

AFFORDABILITY CRISIS PREVENTING FIRST TIME BUYERS ENTERING THE PROPERTY MARKET

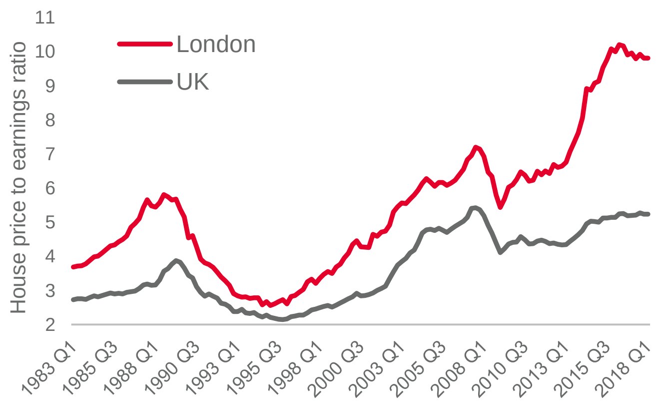
According to Halifax, the average first-time buyer deposit has more than doubled over the past decade from £15,168 in 2007 to £32,321 in 2018. The required deposit now reflects a full year of a first time buyer's gross annual salary, compared to a required 37% of annual salary in 2007. The 113% increase in deposit size for the UK as a whole has been dwarfed by London's rise, where deposits have leaped by 276% from £26,701 to £100,445 over the last 10 years and house price to earnings ratios exceed 10 times (Figure 2).

Figure 1 - Population Growth vs Household Creation



Source: Department for Communities and Local Government & ONS

Figure 2 - Ratio of median house price to median earnings



Source: Nationwide

Private Rented Sector (PRS)

EMERGENCE OF THE PRIVATE RENTED SECTOR (PRS)

Given the owner occupier affordability issues in the UK housing market, an increasing number of people either choose or have no financial alternative than to rent. The DCLG's latest English Housing Survey report (March 2017) suggests 20% of UK homes are now privately rented, up from 11% ten years ago. The situation is even more acute amongst younger age groups, with half of all 25-34 year olds now privately renting in the UK, from just over 20% ten years ago.

Who are the landlords?

The vast majority of rented properties are owned by individual or small scale buy-to-let landlords. Almost all of these properties were not originally designed for renting purposes, with 50% of the existing rental stock being built before 1945. It has only been in very recent years that large-scale institutional investment has come into the sector to provide purpose built, professionally managed accommodation. The residential institutional investment market is growing fast and is now estimated to be worth c.£30 billion, up from £15 billion at the start of 2016 (Figure 3). With recent tax changes forcing many landlords out of the market (additional stamp duty on buy-to-let investments and the curbing of tax relief on mortgage interest), further opportunities are being created for large-scale operators and it is estimated that institutional investment in the sector will increase to £70 billion by 2021.

However, with 98% of all PRS stock in the hands of landlords who own 10 properties or less, there is a significant lack of aggregated investment stock available for institutional investors to acquire. The only route to entry for those investors looking to build up scale is therefore through housing development (known as the build-to-rent market).

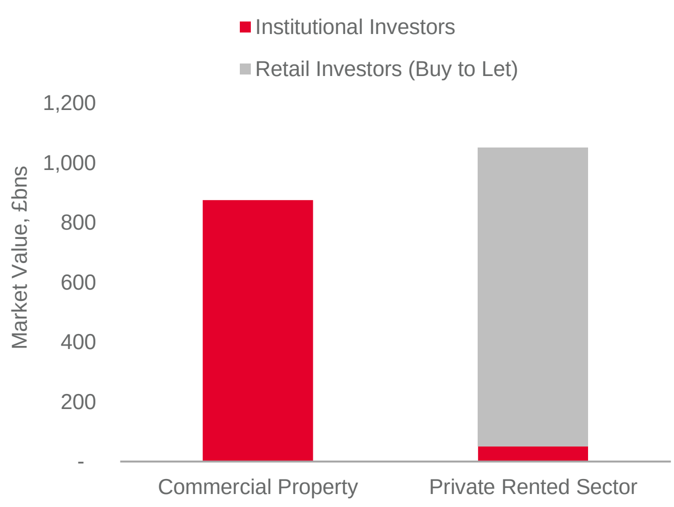
Future potential for institutional investors in the sector

The supply data shows that there are c.80,000 PRS units with planning consent in the UK. If we compare this pipeline to the Government's target for 1.25 million new homes over the next five years, it is clear that purpose built private rented housing is currently only making a very small contribution. Assuming 20% of all new households enter the private rented sector (in line with current tenure splits), over the next five years, there will be a requirement for 250,000 new rented homes. This very large gap between supply and demand is a key reason why investors are seeking to invest in PRS.

There are already a number of aggregators of PRS stock emerging in the market, with the likes of Essential Living, Grainger PLC, Westrock, Sigma and ModaLiving/Apache building significant portfolios of purpose built rental product. It is thought that once these assets are built and stabilised, the portfolios will be sold to the institutional market through large portfolio sales or corporate transactions, as has been done in the student accommodation market over the last 10 years.

Traditional housebuilders are also encouraging institutions into the sector. Recent changes in the legislative and regulatory environment for bank lending, such as reforms set out within Basel III and Solvency II, reduces the debt market's capacity to lend to higher risk investments. In practical terms, this means that banks must hold a minimum ratio of money on their balance sheet to money lent. Speculative development is seen as particularly high risk, therefore banks have less capacity to lend to developers. Consequently, developers have increasingly looked to institutional investors to fund schemes, with investors such as DTZ Investors, M&G, L&G, Invesco and AIG entering the market in this way.

Figure 3 – Size of the Private Rented Sector



Source: IPE

Performance of Private Rented Residential Property

Residential property has different investment characteristics to the other main asset classes. These characteristics have enhanced residential property to outperform the other main UK asset classes over the long-term with lower volatility of returns. Indeed, residential has generally generated superior returns to commercial property. We believe that the key reasons for this are:

- **The residential property market is dominated by owner occupiers** – unlike the commercial property market where owner occupation is lower; residential prices are underpinned by a deep and relatively liquid sales market.

- **Housing is a necessity** – accordingly, pricing will always be supported by the population's need to either rent or own a home. Unlike the commercial property market where demand for commercial space is highly correlated to economic activity, residential space requirements are generally far less sensitive to economic activity apart from in areas with a high degree of overseas workers such as London.

- **Residential is high up the political agenda -** governments have supported the housing market in times of economic weakness to reduce price falls, e.g. reducing transaction taxes. Additionally, in the Global Financial Crisis, the Government pressured lenders not to take possession where residential mortgagors were in default.

- **Few homeowners become forced sellers** – most moves within the residential market are to upsize or downsize, and sellers are not generally under financial pressure to move if market conditions are weak and sales prices are unattractive. Accordingly, the supply of property in the market drops which exacerbates the supply/demand imbalance, and increases price stability.

- **Residential occupiers ultimately have a choice to rent or buy** – as a result, in weak market conditions, potential buyers will consider renting where they expect prices to correct. The additional demand for rented homes then supports rental values.

Performance History

The residential sector has a compelling performance record. Over the long term, residential assets have provided investors with higher returns than both commercial property and the other main UK asset classes. Based on MSCI data since 2001, UK residential property has delivered a total annual return of 170 basis points (bps) above the annual total return from commercial property. Residential property has also outperformed bonds by 450 bps pa over this period.

Central to the sector's performance has been consistently strong capital gains, which have been fueled by the various supply constraints that have inhibited the amount of residential stock. Since 2001, 67% of the total return from residential assets has come from capital growth, significantly higher than the capital return from commercial property, equities or bonds.

Rental levels have also increased steadily and consistently. The Government's RPI (retail price index) inflation calculations show that residential rents have grown at an average rate of around 3% per year since the 1980s – roughly in line with the growth in wages and salaries over the same period. A continued shortage of supply and an increase in demand is likely to maintain upward pressure on rental values. Above average rental growth returns could be advantageous for investors in current market conditions, offering investors an alternative source of low risk, market growth performance at a time when the rental growth prospects from commercial property sectors are expected to slow.

Residential assets provide better risk adjusted returns

Over the last 10 years, the residential sector has proven to be a less risky investment than mainstream commercial property, with lower volatility in returns, despite delivering better performance. Over a longer time frame (since 2001), the trade off between performance and volatility remains favourable with residential delivering much higher risk-adjusted returns.

Where to invest in PRS - London or the regions?

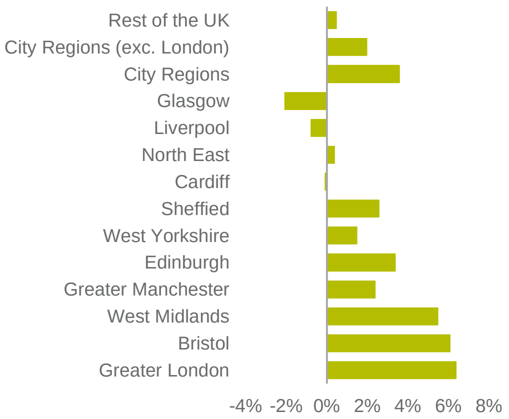
DEMAND: POPULATION AND HOUSEHOLD GROWTH STRONGER IN LONDON

According to the Office for National Statistics (ONS), the population of London grew at twice the rate of that of the UK between 2011 and 2015, growing by 5.7% compared to 2.9% for the rest of the UK. Outside of the capital, Bristol was the city that saw the strongest growth at 4.5%. This rapid and unexpected growth in London has put a major strain on the capital's housing supply.

Looking forward, the ONS predicts that the population of the UK is projected to grow by a further 6.7% by 2025 to 69.5 million people. Over the same time period, the ONS predicts London's population will continue to grow at a faster rate, increasing by 12.7% to 9.8 million people. Again, Bristol is expected to lead the regional charge on population growth, with an increase of 8.9% expected. Birmingham follows closely behind at 7.5% to 2025.

Looking at the population of those aged between 16 - 44 (the group most likely to live in rented accommodation), the ONS predicts growth in the UK of 1.9% between 2015 – 2025 (Figure 4). In London, this growth is forecast to be much higher at 6.4%, but there are some regional cities where growth of this cohort is expected to be just as strong, particularly in Bristol (6.1%) and Birmingham (5.5%).

Figure 4 - Projected population growth of 16 – 44 year olds 2015 - 2025



Source: ONS

Based on this forecast population growth and the Government's prediction that the average household size will fall from 2.35 people to 2.21 over the next 20 years, the ONS has estimated that the number of households in London will grow from 3.5 million in 2017 to 3.9m by 2027 (11.5%). This equates to 40,000 new households each year and is in line with the Greater London Authority's target to build 49,000 new homes each year.

Household growth for the rest of the UK (excluding London) is expected to be slower, with the ONS suggesting the number of households will grow from 23.8 million to 25.65 million by 2027 (7.8%).

WHERE IS THE SHORTAGE OF SUPPLY GOING TO BE THE GREATEST?

In the year to March 2018, the construction of 162,880 new dwellings were completed in the UK, up 5% compared to the year to March 2017. Whilst this does represent an increase over the year, it still falls considerably short of the number of new homes that the Government predicts needs to be built each year to keep up with demand.

In London, 41,000 new homes were built last year, c.17% short of the GLA's target for 49,000 new homes a year. Completions this year are expected to be higher in London, with 59,000 units currently under construction. However, with falling sales rates in the capital, there has been a sharp decline in the number of construction starts, with only 21,500 new units starting over the last 12 months. According to Molior, construction starts are expected to fall further to c.18,000 p.a. for the next two years. As such, looking forward over the next few years, new supply is expected to be less than 50% of forecast demand.

Excluding London, the Government forecasts that 210,000 new homes need to be built each year to keep up with demand. In the year to March 2017, 106,000 units were built, marginally over half the required amount. Over the last 12 months, 130,000 new units have started on site, 40% short of the targeted amount. It can therefore be concluded that the housing delivery shortage will be relatively similar (+/- 10%) in both London and the regions. Contained within these figures though are huge regional variances. The importance is therefore on identifying specific areas of the country that have localised shortages in delivery.

Whilst historic supply data at a local level is limited, the ONS has recorded annual completions by region since the 1980s. Although London quickly returned to healthy levels of construction after the 2008 financial crisis, the larger regional cities including Birmingham, Leeds and Manchester have been very slow to increase construction to the levels that were being achieved before the financial crisis. Good opportunities therefore exist in the cities of Birmingham, Manchester and Leeds, as well as the smaller constrained land markets of Oxford and Brighton, where housing delivery has been extremely slow over the last decade.

Average salaries in a city is also very relevant in assessing affordability of homes, potential rental values and scope for future rental growth. Unsurprisingly, London has the highest average salary. However, there a number of other towns and cities where there are a high number of skilled jobs generating large average salaries, while existing rental levels are relatively low as a proportion of average salaries.

Rank	City/Town	Average Salary	Average 2 Bed Rental Value Per Annum	Rent as % of Annual Salary
1	London	£39,232	£21,600	55%
2	Cambridge	£35,321	£14,400	41%
3	Edinburgh	£34,145	£11,880	35%
4	Reading	£33,210	£12,000	36%
5	Birmingham	£32,833	£9,300	28%
6	Oxford	£32,682	£16,800	51%
7	Aberdeen	£32,280	£8,400	26%
8	Guildford	£32,227	£16,200	50%
9	Stevenage	£32,094	£11,400	36%
10	Luton	£32,067	£10,200	32%

Source: Adzuna, BBC, DTZ Investors

INCOME RETURNS

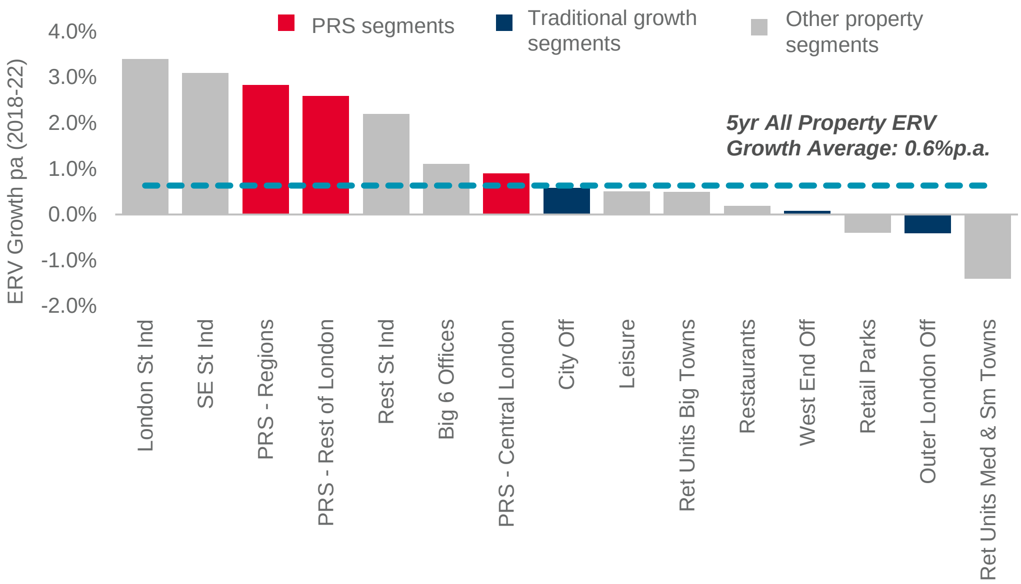
The cost of acquiring residential assets is more expensive in London, with investors accepting a lower net income return. Prime net yields in London are currently 3.5% in the capital compared with 4.1% in Bristol and 4.3% in Birmingham and Manchester. In reality, most private rented sector assets of any scale are developed as part of funding deals, where a c.50 bps discount is typical, placing regional funding yields between 4.5–4.75%.

CONCLUSION AND FORECASTS

Whilst London's household growth projections and affordability issues do point towards devising a strategy of investing in a portfolio of London assets, there are also strong reasons to invest in the key regional cities and the wider South East. Given the rapid house price growth that London has experienced over the last 10 years, consideration must be given to the possibility of a house price correction, or at the very least, lower capital growth over the next property cycle. We therefore see strong merit in building a geographically diverse residential portfolio, with assets in London and the top UK regional markets. London unquestionably has a role to play as a city in desperate need of more affordable rental product, but the key regional cities can offer diversification to risk and an income advantage over the life of the investment.

Our forecasts in Figure 5 indicate that we expect PRS rental growth to be among the outperformers of all property over the next five years. We expect the strongest rental growth to come from the regional cities, followed by the rest of London. Of all the commercial property sectors, only London and South East industrials are forecast to see stronger rental growth over the next five years.

Figure 5 – Property ERV Growth Forecasts: 2018-2022



Source: DTZ Investors

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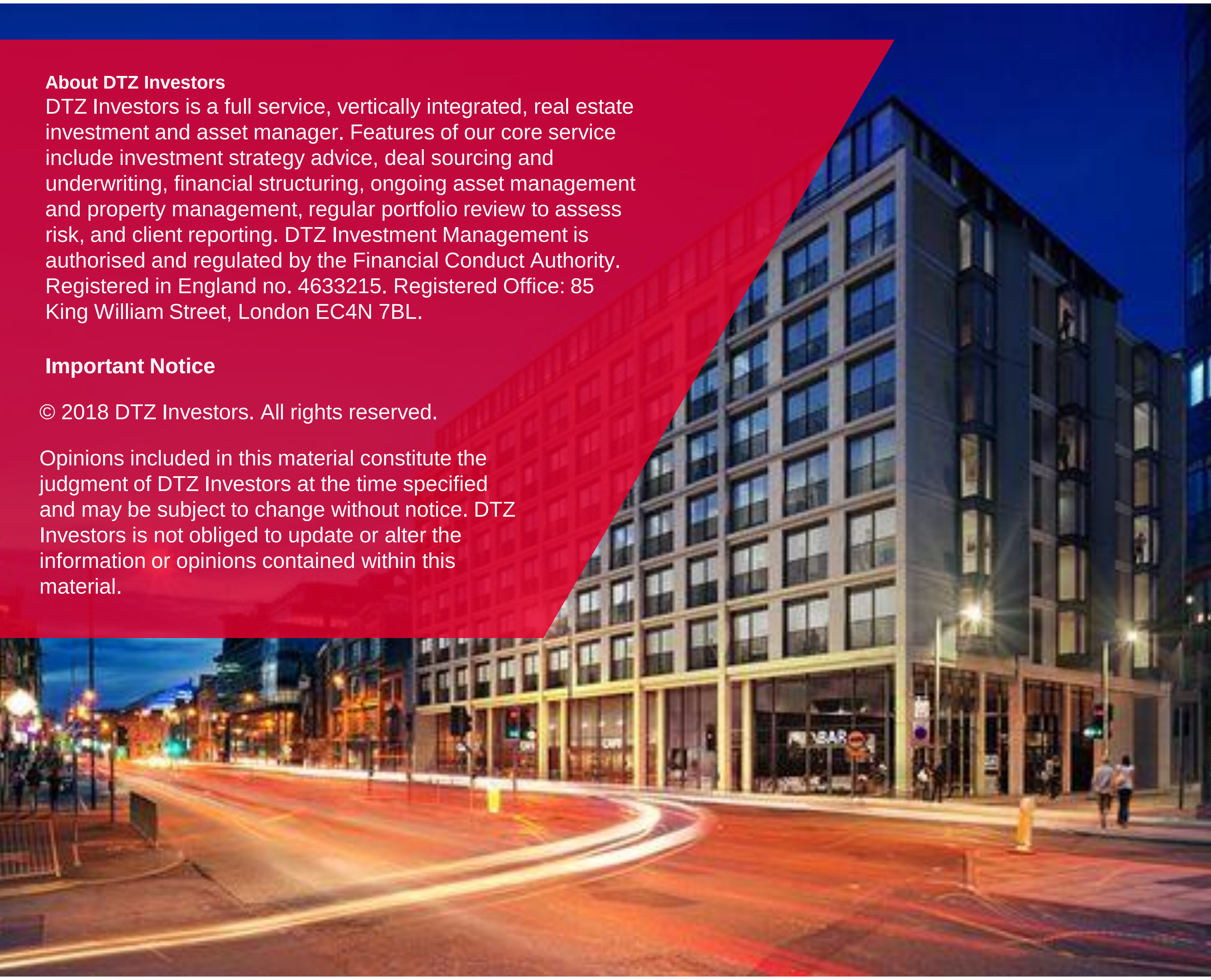

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