

UK residential – Europe's rising star



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It is nearly four hundred years since lawyer Sir Edward Coke, writing in *The Institutes of the Laws of England*, coined those immortal words: 'For a man's house is his castle'. These days, the English are as proud of their homes as ever. But social and economic shifts mean that an increasing number rent rather than own the flats, bungalows and houses that have become the modern day castles.

For investors, that creates a great opportunity to benefit from England's growing private rented sector (PRS), capitalising on favourable demographics, historical outperformance over commercial property and the prospect of cross-party political support for PRS.

Indeed, the UK gets the highest score for its PRS out of all European countries according to M&G Real Estate research, which also factors in the size of the market, population growth, the tenure trend, diversification potential and regulatory regime.

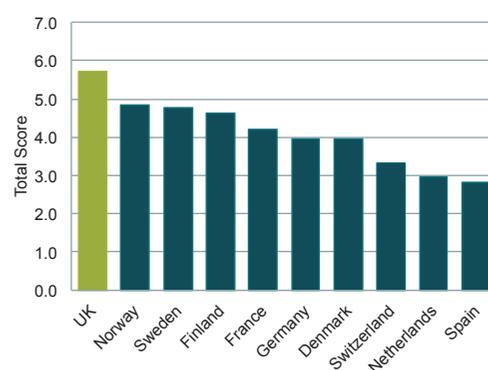
The sector has been on the rise since troughing at the end of 20th century, gaining prominence as social renting has plateaued and owner occupation has started to decline. Backed by a growing population and a limited supply of new houses, the trend looks set to continue.

English private rentals are now at their highest level since the early 1990s, at 3.8 million households and rivalling that of the social rented sector. At the same time, only around two-thirds of households are now owner-occupied, according to official statistics, the lowest proportion for a generation.

While the professional, institution-backed PRS may still be a part-unknown in the UK, the sector has a long history elsewhere. Institutions across Europe have immense experience generating strong income and capital returns.

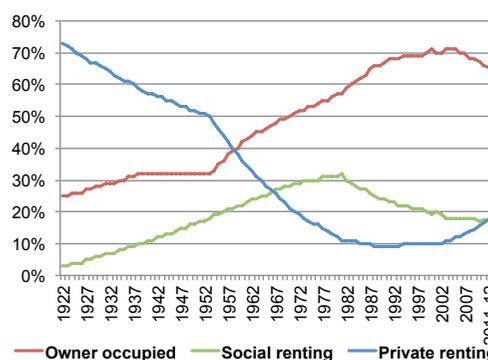
The UK offers new opportunities in this area, benefiting from less regulation in areas such as rent caps and security of tenure, than some of its continental peers.

Figure 1: Pan-European PRS Score



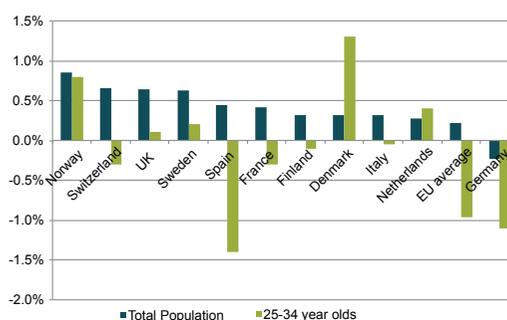
Source: M&G Real Estate, November 2013. Potential maximum score is 8, based on the unweighted results of the eight categories detailed above.

Figure 2: Tenure over time (England)



Source: Eurostat (as at 2011); Department for Communities & Local Government (as at 2012). Comparable data for Scotland, Wales, Northern Ireland is not available.

Figure 3: Population projections across Europe



Source: Eurostat, October 2013

Reflecting on the growth of the domestic rental market, the need for higher standards and fundamentally, for more development, the UK government has already made many welcome policy noises, such as reducing stamp duty on bulk purchases and the build to rent fund. Friendly policies are expected to continue across parties in the face of demographic pressures.

And as London's housing market has sprung back to life, buoyed by low interest rates, enhanced levels of confidence and massive foreign investment, the eyes of global institutions have begun to fire up with the opportunity to create a new platform for those seeking housing as a service rather than an investment.

The high volatility in equities and record low income performance of bonds have propelled money into other areas, such as real estate, still dubbed an 'alternative' investment.

Yet where traditional real estate asset managers have focused on offices, retail and industrial sites, large residential schemes for rent are now increasingly in focus in the hunt for good value, diversified investments.

Historical returns support the cause. IPD's Residential Index has now been running for more than a decade, consistently revealing favourable performance against the commercial sector.

Four Ds: Demographics, Demand, Defensiveness, Diversity

For M&G Real Estate, investing in property has always been about looking beyond the bricks and mortar and working in partnership with customers. We believe there is value in broadening our investment approach to include demographically-driven real estate, catering for the most basic human need: a home. As such residential has the advantage of being relatively impervious to structural changes.

PRS returns display an extremely low, or even negative, correlation with the returns of equities or government bonds, while correlation analysis against traditional real estate shows residential can be a strong diversifier for commercial investors.

In terms of protecting against downside risk, historic figures show that residential rents correlate more closely with wages than GDP – offering further diversification from traditional real estate income streams. They are, after all, a feature of de-

mand that is not wholly reliant on consumer spending or financial services.

This demographically-driven investment is a growing global trend: in the US and mainland Europe, the PRS, or multi-family housing sector, along with student accommodation, is a well-established market – due to a focus on future demand.

Looking across Europe, many of the UK's counterparts now have fully matured PRS markets and so have either seen their proportions of private rentals remain broadly stable or even decline over the last 30 years. A report by the LSE and the University of Cambridge noted that the UK was the only European country out of 11 that it studied where the general trend was one of on-going growth of the private rented sector. The UK also has some of the best prospects for population growth within Europe, according to Eurostat estimates.

The supply-side fundamentals of the UK also favour investment in housing in general and the PRS in particular, compared to the rest of Europe. Housing construction in the UK has been on a downwards trend in recent decades and there is growing concern that the UK will become undersupplied in terms of housing, particularly in London and other major cities, given the expected rate of population growth.

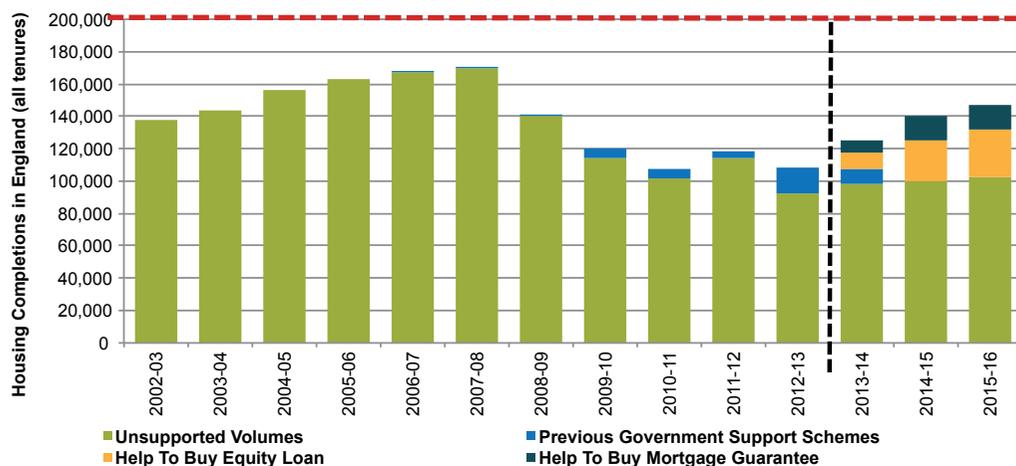
Over the 10 years to 2012, housing completions in England have only formed 6.2% of total housing stock (including vacant/ uninhabitable buildings), according to government statistics. This has been markedly weaker than in many of the other core European countries, the exceptions being Germany, where the population has declined in the past 10 years, and Sweden, a country with only 4.7 million households in total across all tenures. Meanwhile, countries such as Finland, France and Switzerland, to name but a few, have seen construction of more than 10% of their housing stock over the same period.

The specifics of the UK market, as described above, mean there is high capacity to absorb a comparatively large supply of new stock, which is unlikely to occur given the many complexities in the land market and planning system. M&G Real Estate's PRS investment strategy is focused on low risk income returns actively managed over the long term. Our firm foothold in the UK real estate market, underpinned by the strength of our parent company's brand, brings with it immense benefits earned through trust at all levels.

With the structural supply-demand imbalance set to continue, we believe there is a great opportunity to invest our 150 years of expertise in bringing Britain into line with its neighbours, creating the first UK institutional platform to truly realise the potential of the residential real estate sector.

Today, residential real estate may still be considered an 'alternative' asset class. But tomorrow we believe it will be an essential part of any diversified investment portfolio.

Figure 4: House building in England



Source: DCLG, Savills 2013

Why is now a good time to invest in UK residential?

The UK rental market is thriving thanks to demographic, socio-economic and economic trends. There is an ongoing supply-demand imbalance present in the market, which has been exacerbated by the recent economic downturn. We are an island, with fewer homes being built than are needed, and with those homes being chased by a record number of single-person households. Now, at a time when labour mobility is crucial to economic growth, people need a wider range of places to live. That is why M&G Real Estate is the first UK fund manager to offer institutional investors a dedicated platform for investing in the country's private rented sector. And I believe many of our investors recognise, as we do, the long-term opportunities afoot.

How does it compare with commercial property?

One of the attractions of demographic-driven real estate comes from its relative stability in terms of demand. While the financial services sector, for example, will expand and contract in line with broader economic performance, housing demand will more closely reflect wage growth and population, which in many respects is easier to predict. The leases tend to be much shorter than in the commercial sector, meaning that the market is much more linked to the real economy. There is also a strong correlation between wage growth and rental growth in residential. That makes this market appealing to investors such as pension funds, whose liabilities are closely linked to wages.

What is the attraction for European investors?

A combination of factors mean that capital is being allocated more globally than it was before, and UK real estate has already benefited from this, particularly in London. In parallel, appetite for the 'alternative' real-estate sector has blossomed. Investment into student housing and leisure is pretty mainstream, and we think the private rented sector (PRS) could be next. PRS is already

broadly established in Europe, and European investors already recognise the benefits and are comfortable with such investments. For them, the UK market opens up more opportunities, with much lower regulation and favourable demographics.

What role does M&G Real Estate play?

M&G Real Estate's reputation has been founded on its long-term approach to investment, its low appetite for risk and strong focus on active asset management. Building on 150 years' experience in property investment, we are looking to invest in residential real estate that specifically meets rental needs – focusing on location, sturdy, rental-friendly design, environmental efficiency and communal amenities. Our focus is, of course, on total return, but driven by income. I think the key to a long-term income product is to try and maximise the growth in revenue and minimise the leakage, ensuring net distribution is enhanced as far as possible. That means active management to make sure that flats are empty for as little as possible, with timely marketing and low ongoing costs. Service standards, location and quality of product will be key drivers. Activity around the PRS is certain to grow, with every likelihood that a variety of different products could emerge. But our vision will be tightly focused on a stable, long-term income play. And in another 20 years, there's no reason why PRS will not have moved into being a genuine mainstream sector in the market. We have the opportunity not just to deliver for its investors, but to also deliver a product that will fulfill a genuine social need: well managed, professionally serviced, quality housing invested in for the long term.



Tony Brown
Chief Investment Officer

Important information

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