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Hermes Real Estate

UK residential property: Accessing the opportunity

Key points

The UK private rented sector has made consistently strong returns since 2001 while demonstrating low correlations with other property sectors and equities, and a negative correlation with Gilts.

Strong demand for rental properties, driven by higher costs of housing and demographic trends, combined with limited supply and cross-party political support underpin the investment case.

To gain a first-mover advantage in this market, execution is key. Investors must be able to access institutional-quality stock and achieve scale through efficient property management to preserve yields.

A strong history of returns, solid fundamentals and vehicles that offer both investment and property management lead us to believe that UK residential property is poised to become a viable allocation.

Seeking strong long-term returns, many UK institutional investors have entered private markets – acquiring assets like commercial real estate, private equity and, more recently, infrastructure equity and debt – in order to exploit strong yields, capital growth and the embedded illiquidity premium that can reward a long time horizon. Many of these investors have benefited, and as more pension funds mature, sources of enduring return will continue to be in demand.

Key peers of UK institutional investors – like those in the United States, the Netherlands, Germany and Switzerland – have gained from investing in residential real estate, which has delivered stronger risk-adjusted returns than commercial real estate; is driven by powerful demographic trends; and enjoys cross-party political support. Currently, 1% of residential real estate in the UK is owned by institutional investors, compared with about 10-15% in continental Europe.[1] One of the main roadblocks to greater institutional participation has been the absence of suitable investment vehicles. Pooled funds specialising in residential real estate are relatively new, but a number of joint ventures between fund and property management experts now enable access to a growing part of the market: the UK private rented sector (PRS).

Here we examine the case for investing in UK PRS: historical and projected returns, correlations with other property sectors and asset classes, supporting fundamentals and key risks, and ways of accessing this opportunity.

Strong, uncorrelated returns

In a low interest-rate environment, investors need to look at a wider spectrum of investments whose returns can help match their long-term liabilities. Real estate is a popular asset class, but institutions have focused on office, industrial and retail assets and currently allocate just £12.7bn to residential property from an aggregate allocation of £204bn[2]. But a strong case can be made for UK PRS: attractive risk-adjusted returns; stable cash flows; real capital growth; low correlations with other property sectors; and inflation-hedging characteristics. With increased demand for rental homes across UK cities, greater construction of purpose-built PRS stock, and the emergence of investment vehicles enabling access to this market, the opportunity becomes more attractive. Investors who act quickly also stand to benefit from first-mover advantage.

From 2000-13, capital growth for residential real estate in the UK was 6.7% compared to 0.9% for all commercial real estate.[3] This was mainly due to the nature of commercial stock, which is characterised by aging buildings and changing occupier preferences. By contrast, residential assets rarely depreciate and prices can rise depending on location. In addition, residential assets are not always a pure capital-appreciation play: the rental market can strengthen even in an economic downturn as mortgages become less affordable and home buyers delay purchases.[4]

Residential properties also provide a moderate inflation hedge, and this correlation increases with time, which should suit pension funds with long-term liabilities. The table below shows that this link with inflation increased over a three-year period in the six markets where investing in residential property is well established, particularly France and the US.

Figure 1. Correlation between local inflation and annual house price growth, 1970-2013

	1-year period	2-year period	3-year period
Australia	0.23	0.44	0.55
Germany	0.39	0.42	0.49
France	0.52	0.56	0.59
Netherlands	0.30	0.35	0.41
United Kingdom	0.11	0.17	0.26
United States	0.29	0.36	0.44

Note: Correlations based on BIS (2014) data. For Australia, the data is from 1987-2013
Source: IPD UK Residential Property Index, IPD U.K. Annual Property Index. Inflation-adjusted total returns, 1981-2013

Figure 2. Correlations between property sectors, 1981-2013

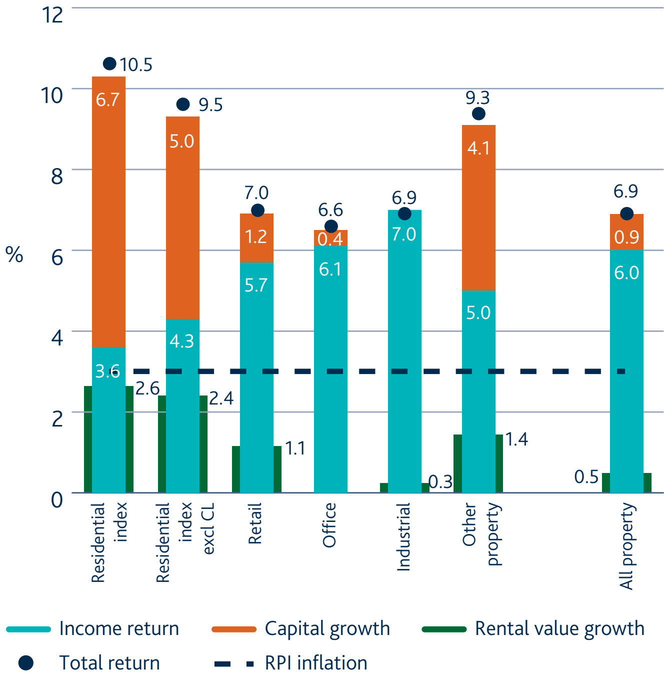
Intra-property correlations				
	Residential	Retail	Office	Industrial
Residential	1.0	0.6	0.7	0.5
Retail	0.6	1.0	0.8	0.8
Office	0.7	0.8	1.0	0.9
Industrial	0.5	0.8	0.9	1.0

Source: IPD UK Residential Property Index, IPD U.K. Annual Property Index. Inflation-adjusted total returns, 1981-2013

[1] "Laying the Foundations: A Housing Strategy for England," published by HM Government in November 2011
[2] "Residential Investment in International Markets," published by the IPF Research Programme, 2011-2015
[3] IPD All Property Index
[4] "Residential Investment in International Markets," published by the IPF Research Programme, 2011-2015

On a total-return basis, UK PRS has consistently generated better risk-adjusted returns with lower volatility than all other real estate sectors over most time frames in the past 30 years.[5] It has been the best long-term performer among major real-estate sectors from 2000-13, returning 10.5% against the 6.9% of the IPD All Property Index and outperforming retail, office and industrial property (see figure 2). This outperformance extended over a much longer period, from 1971 to 2009, as residential assets delivered a 13.4% average annual return to surpass the 12.6% gain by equities, the 10.8% posted by commercial property and the 10.1% return of Gilts.[6]

Figure 3. The performance of UK PRS v other property sectors, 2000-13

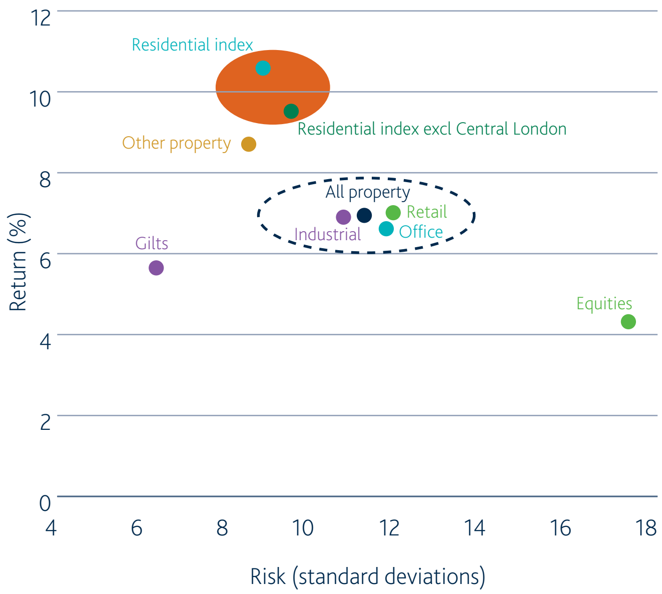


Source: IPD All Property Index

While capital values in commercial property have declined by less than 40% in real terms since 1980, those for residential property have increased significantly, which likely reflects the combination of restricted supply and strong demand – a supportive fundamental for the sector.

In addition, residential real estate is a strong portfolio diversifier with a low correlation not only to other real estate sectors but also to equities and bonds. This is due to its different performance and risk characteristics. Returns are driven by fundamentals: strong demographics, supply-and-demand imbalances and UK government reforms that support investment in the sector, such as increased funding and reduced stamp duty for PRS properties.

Figure 4. Risk and return profile



Source: MSCI, JP Morgan 7-10yr

Residential real estate has also proven to be a diversified source of return. In the UK, it exhibits a limited correlation with commercial property, a low correlation with equities and negative correlation with Gilts, aiding diversified investors (see figure 5). But international PRS investors could also benefit as the UK market has a low correlation with those in Europe (see figure 6).

Figure 5. Correlation of PRS returns with UK commercial property, equities and bonds, 2001-13

Total return by asset type	Correlation (%)
UK residential property	–
UK commercial property	65.7
UK property equities	34.8
UK equities	31.6
UK gilts	-47.9

Source: IPD UK Residential Index, IPD UK Annual Property Index

[5] "Investing in residential property: A British Property Federation guide for asset allocation", published by the British Property Federation
[6] Nationwide, IPD, DataStream and LaSalle Investment Management

Figure 6. Correlation of European PRS markets by total return, 1999-2013

	UK	DEN	FIN	FRA	GER	NE	SWE
United Kingdom	1.0	0.42	0.06	0.47	0.11	0.47	0.82
Sweden		0.60	0.27	0.47	-0.19	0.67	1.00
Netherlands		0.53	0.17	0.42	-0.35	1.00	
Germany		-0.42	0.22	-0.06	1.00		
France		0.64	0.17	1.00			
Finland		-0.23	1.00				
Denmark		1.00					

Source: IPD, Catella

The average total return on residential property varies between countries, ranging from 5.2% for Germany to 11.8% for the UK over the last 15 years. This divergence is due to the higher volatility in the UK market compared to Germany, which has the best risk-return ratio. The rising demand for private rentals in the UK contrasts with the situation in Europe, where PRS is fully mature in many countries and has stopped growing, or is even shrinking.

Figure 7. Annual residential property performance, 1999-2013

	AUS	FR	GE	NL	UK	US
Total return	7.6%	8.7%	5.2%	7.1%	11.8%	8.2%
Risk	7.6%	5.2%	1.8%	6.1%	8.0%	11.2%
Return-risk ratio	1.00	1.68	2.88	1.16	1.46	0.73

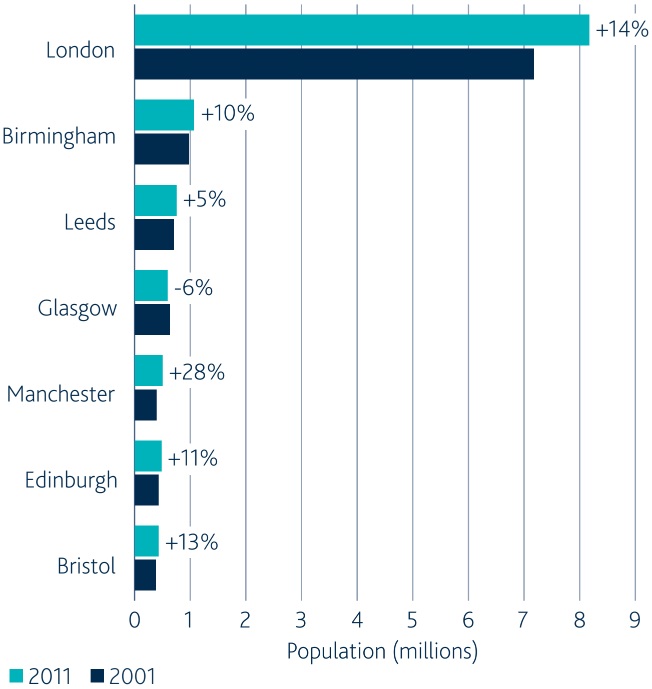
Sources: IPD Multinational Index Spreadsheet – Update 3, 2013; BIS data as at 2014 for Australia's house price performance

UK PRS fundamentals

A classic story of increased demand and limited supply underpins the UK PRS market. Strong urban population growth in UK cities, where much of the new PRS stock exists, and the high cost of home ownership are key drivers of demand.

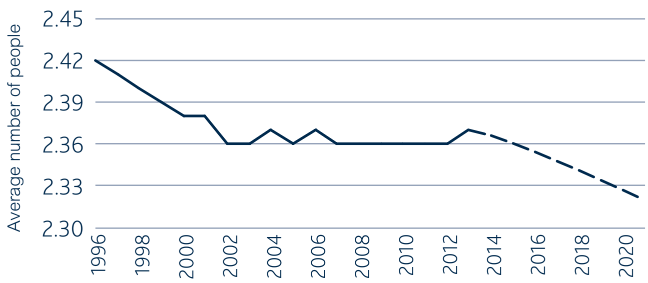
The populations of London, Leeds and Bristol rose by 14%, 5% and 13% respectively from 2001-11, and should continue to be supported by an overall UK population forecast to swell to 73.2m by 2035 (see figure 8). Amid this surge in population, the average household size is shrinking from 2.42 people in 1996 to 2.37 in 2013, and is forecast to continue to decline (see figure 9). To match the current rate of household creation, the amount of new dwellings completed per year must rise by 64%. In a further boon to the PRS market, 77% of all new households sought rental accommodation.[7]

Figure 8. Urban population growth in some of the UK's cities



Source: Office for National Statistics, General Register Office for Scotland

Figure 9. Average UK household size



Source: 2011 Census. Estimates calculated by Hermes using 2011 Census data

We see three broad categories of renters in the UK PRS market:

— **Unable to buy:** people who are permanently locked out of the home-buyer market as house prices have accelerated faster than median annual incomes. Across the UK, the average house price for first-time buyers was 4.4 times average earnings in November 2014. In London, this increased to 6.8 times and in northern England declined to 3.2 times.[8] One researcher has found that 37% of people in the UK do not intend to buy a home.[9]

[7]Department for Communities and Local Government

[8]Nationwide House Price Index, November 2014

[9]Money Supermarket, 29 May 2014

- **Saving to buy:** the growth in house prices is forcing many who aspire to own property to wait – and save – for longer in order to accumulate a mortgage deposit. That 10% of people aged 16-24 years currently own homes, compared to 36% in 1991, reflects this. In a time when 34% of the UK population has savings of £250 or less and many young people have substantial university debts, the average UK deposit of £29,000 required by a first home buyer is increasingly difficult to achieve. In London, the average deposit for a first home buyer is £79,000.[10]

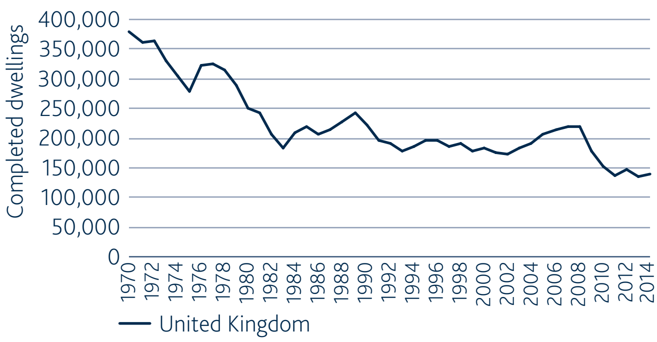
  Simultaneously, mortgage regulation has become more stringent and lenders are imposing tougher standards. Notwithstanding the UK Government's Help to Buy scheme, deposit requirements remain high and mortgage approvals have slid 49% from the 1.4m peak reached in 2006 to 735,000 in 2013.[11] Prospective new powers for the Bank of England's Financial Policy Committee, which could force lenders to restrict mortgages to no more than 15% of new loans where borrowers are taking out more than 4.5 times their income, could extend this decline. Under the proposals, banks would stress-test borrowers' ability to repay loans if their mortgage rate is 3% higher than the base interest rate at the time the loan was approved, and could further the time spent by aspiring home buyers in rented accommodation.[12] The latest UK census, in 2011, shows that private renters under the age of 35 accounted for 46% of all households across England and Wales. This figure rose to 54% in London. Among 35-49 year olds, the level of private renting almost doubled between 2001 and 2011, to account for one in five households nationally.

- **Lifestyle choice:** preferring to live in locations with more convenient transport connections, amenities and desirable nightlife options, an increasing number of people choose to rent instead of buy in places without the same concentration of lifestyle factors. Also, more people are prioritising flexibility in accommodation and employment and are reluctant to commit to a place of work or residence for long periods. Much of the UK's population of international workers, which has increased as cumulative net migration has more than doubled to beyond 6m in 2013, also requires rental accommodation.[13]

A persistent shortage of housing supply intensifies this demand for rental properties. House building starts and completions have been at historically low levels for several quarters. This means that even as the UK economy continues to recover, there will not be enough new homes to meet increasing demand and prices will climb further. From 1973 to 2014, as the population grew, the number of UK dwellings completed per year has more than halved to less than 150,000 in 2014 (see figure 10). The National Housing and Planning Advice Unit estimates that 291,000 additional homes are needed each year to 2031 in order to keep pace with growing demand.[14]

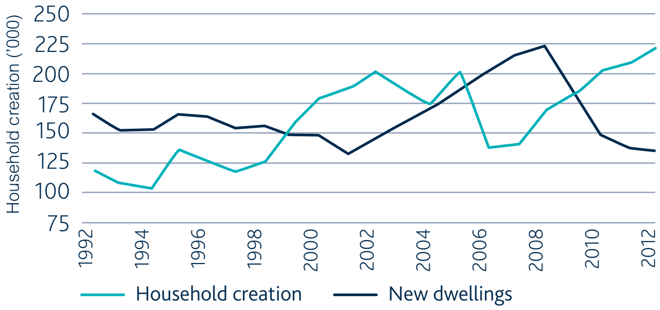
Private builders have seen a 45% drop in completions due to lack of financing, onerous and local planning regimes, as well as government bureaucracy targeted towards developers. This combination of factors has pushed the housing stock replacement cycle to a new record of more than 175 years compared to the-long term average of 125 years.[15]

Figure 10. Supply constraint: the decline in completed UK dwellings, 1973-2014



Source: Department for Communities and Local Government

Figure 11. More households are being created than dwellings



Source: Department for Communities and Local Government

Cross-party support for UK PRS

The UK government is encouraging large institutional investors including asset managers, pension funds and insurers to invest in PRS properties given the country's housing shortage. There have been several initiatives and reforms over the past few years, the most recent being the increase in the size of the Build to Rent Fund from £200m to £1bn in the April 2013 Budget. The fund provides equity or loan finance to developers building homes to privately rent, creating opportunities for investors, and was launched in response to 2012's Montague Report of PRS. Aside from the fund, a further £10bn of debt guarantees are being made available to provide cheap debt financing for long-term investment of both social and market rental homes. The guarantees are available through two programmes: the Affordable Housing Guarantee Scheme and Private Rented Sector Guaranteed Scheme. Each provides £3.5bn in debt guarantees while an additional £450m in government grants is available. There is also £3bn being held in reserve to support the schemes in the future.

[10]Source: ONS, Halifax, Council of Mortgage Lenders, HSBC

[11]"Project Castle: An Investment opportunity in the UK private rented sector", published by Countrywide

[12]"Residential and Risk Monitor Q4 2014", published by Knight Frank

[13]Labour Force Survey, The Migration Observatory at the University of Oxford

[14]"Project Castle: An Investment opportunity in the UK private rented sector", published by Countrywide

[15]"Project Castle: An Investment opportunity in the UK private rented sector", published by Countrywide

Other key developments include the National Planning Policy Framework (NPPF), which was launched in 2012 to slice red tape in the planning process, thereby expediting the construction of new homes and the regeneration of disused land and buildings (some of the regulations dated back to 1948). To date, the NPPF has been successful: the number of permissions granted for housing projects of 10 or more dwellings increased by 24% to 4,900 from the average seen in 2010-12, while refusals rose only 3% despite a sharp increase in applications. The number of permissions for small residential schemes of three to nine units also rose sharply with almost 10,500 applications being approved, a 29% increase on the annual averages in 2010-11 and 2011-12.[16]

Also, the reduction in the rate of stamp duty for purchases of multi-dwelling residential properties introduced in the 2011 Budget is supporting development. Stamp duty is now based on the average cost of the individual units rather than the aggregate value of a multiple-dwelling property.

The outlook for PRS

Rental growth will continue to rise amid supply and demand imbalances, tougher mortgage requirements as well as an eventual rise in interest rates. The number of private rented households in England and Wales is forecast to increase by 1.2m over the next five years while levels of owner occupation will fall by 202,000 households. This would mean that by the end of 2019, over 24% of all households across the UK would be in the private rented sector. Most renters will continue to be in the under-35 age band. The proportion of households in PRS is expected to jump to 66%, with home ownership falling to just 16% by 2019. However, even those in the next age band – 35-49 – will see percentages climb with home ownership dropping to just 55% of all households, with private renting accounting for 28% of households. The hike will be 38% in London.[17]

Figure 12. Knight Frank's five-year residential market forecast, Q4 2014

Residential rental markets							
	2014 (%)	2015 (%)	2016 (%)	2017 (%)	2018 (%)	2019 (%)	2015-2019 (%)
UK Overall	2.0	2.2	2.3	2.3	2.4	2.4	12.1
Prime Central London	4.0	3.5	3.3	3.3	3.0	3.0	17.1
Prime Outer London	0.5	4.0	3.3	3.0	2.8	2.8	16.8

Rental growth: London and the regions

London tends to capture the most property-related headlines but investors should not ignore regional UK cities. Rents may not increase as much as those in the capital, but higher growth in rents is forecast in cities such as Manchester, Birmingham, Leeds and Liverpool due to improving economic conditions, rising populations, fewer house completions, affordability and other mortgage constraints. Rising employment, earnings and lifestyle preferences are also contributing factors. In addition, the number of private rented homes in these cities has increased by at least a quarter since 2001.[18]

Cities that offer the most opportunities are either home to a university, technology hub or have a connection to London and the financial sector. For example, Reading and Slough, which generated respective 5.9% and 6.3% gross yields in the first quarter of 2014, have benefitted from people seeking more reasonably priced accommodation than what is available in London. Oxford and Cambridge, which both produced gross yields slightly higher than 5% in the first three months of 2014, are part of the so-called 'Golden Triangle' with London. Both not only have consistently large student populations needing rental homes but also benefit from technological innovation and have experienced significant growth in financial and business services employment. These two cities are forecast to experience above-average growth in household disposable incomes, boosting the likelihood of higher rents.

Northern cities, particularly Leeds and Manchester, with respective gross yields of 6.6% and 6.7% in the same period, are also poised for rental growth on the back of relatively strong increases in incomes. In the Midlands, the fundamentals are looking robust. Birmingham, which generated a gross yield of 6.3%, is forecast to experience a surge in its population by more than 85,000 in the next decade as it undergoes further gentrification. It should also benefit as its financial and business services sectors grow.

The Dutch experience

There are five European countries – the Netherlands, Switzerland, France, Germany and Sweden –where residential property has played a significant part in institutional investors' portfolios. Although house prices fell during the financial crisis in most of these countries, total returns for residential property have remained positive due to the steady income streams they generate.

However, the markets differ in terms of regulations, culture, investment opportunities and offerings from product providers. For example, the Netherlands has a long-established tradition of institutional investment in housing that manifests as a 49% weight in the Dutch IPD index, which has been tracked since 1995.[19] Compared to other asset classes and real estate sectors, it has produced good risk-adjusted returns, a moderate inflation hedge and provides diversification.

One of the contributing factors to the success of the Dutch residential real estate market is the experience and diversity of asset management firms focused on this sector. Institutional investors can choose from a wide range of investment approaches, size and specialisation. There were 30 unlisted residential funds with a combined market value in 2013 of €18.2bn.[20]

The sector is undergoing a period of change due to regulatory reforms. Currently, the number of Dutch households living in non-regulated rental housing is a minute 5% but this is expected to grow substantially over the next 20 years due to new social housing policies as well as less favourable tax treatment for mortgages. Institutional investors plan to capitalise on the shift and increase their real estate allocations to this category from the current 55% as new housing is built and released. The legislation limits social housing providers to the regulated rental market, often forcing them to sell part of their housing stock to other investors.

[16]Glenigan, Construction Project Leads and Industry Analysis, March 2014

[17]"Staring into the crystal ball: What next for house price growth?", published by Savills in Q4 2014

[18]"Where are the next Rental Hotspots?" A Residential Rental Market report published by CBRE

[19]"Dutch residential investments: a European perspective", published by IPD

[20]"Dutch residential investments: a European perspective", published by IPD

Challenges and solutions

Key external risks include changes in the political agenda or economic conditions. On the micro level, a lack of available institutional-grade investment stock, small deal sizes that increase transaction as well as holding costs across a portfolio, historically low yields compared to commercial real estate and gross-to-net yield erosion are some of the major problems. Institutions also prefer investing in proven assets that are in full income-production mode. In addition, there is a dearth of quality data and metrics compared with commercial property, in no small part due to the lack of institutional investor involvement.

Another challenge is finding investment managers who have the right skills to manage the acquisition and management of properties from beginning to end. This was not always a problem in the UK. Pension funds and insurers had been active landlords until the 1970s when rent controls had become widespread. Although they were scrapped under then Prime Minister Margaret Thatcher in the 1980s, her government promoted home ownership. This gave rise to individual buy-to-let investors who still dominate the market, with institutional investors accounting for only £1.3bn traded out of the £865bn PRS market as of the third quarter of 2014.[21]

The experience in overseas markets shows the importance of established fund managers with in-depth local knowledge and strong operational platforms capable of managing PRS stock and delivering professional services to tenants. In the UK, the PRS market is changing as investment firms build dedicated teams or form partnerships with property managers to source tenants, minimise vacancies and maintain assets.

Experienced fund managers can help investors overcome the main obstacles that have barred access to the PRS market. For example, take the problem of perceived low yields. Working with local property management specialists, managers are better placed to source the appropriate assets as well as identify new and emerging markets that are ready to be gentrified. They can also help to increase the size of investments by targeting well-managed multiple-dwelling properties, generating scale in a market where asset sizes are small in comparison to commercial real estate. This local presence enables strong relationships with landowners and developers, who can provide information and access to suitable stock, to be forged.

The PRS sector is fragmented, and inefficient management or lack of scale can drive property management costs higher, which negatively impacts yields. Firms with an integrated property and asset management platform can reduce vacancy periods, increase economies of scale and retain tenants by delivering professional property management. Such collaborations help to identify and prudently invest in assets, and deliver services to multiple properties and tenants in an efficient way.

Opportunity knocks

The UK PRS investment opportunity has been compelling for some years, and we believe that it is poised to become a viable allocation for institutional investors.

The PRS market's track record of strong performance with low correlations to other real estate sectors and asset classes make it a potentially attractive, diversified source of return within a real estate portfolio. The market is underpinned by solid fundamentals: the high cost of home ownership, increasing number of households and declining rate of dwelling completion create a long-term supply and demand imbalance. Cross-party support and incentives provide opportunities for investors to become involved in delivering purpose-built PRS properties, earn appealing long-term returns and support the social benefits of increased high-quality PRS stock.

However, obtaining these benefits requires accurate execution. The UK PRS sector has been difficult to allocate to, but an increasing volume of institutional-quality properties and a new breed of investment vehicles that recognise the necessity of professional property management is changing this situation. Given the specific characteristics of the market, it is important that investors select experienced real estate fund managers with access to in-depth local knowledge, strong property management capabilities and prudent investment methods.

[21] "Investing in Rental Britain", published by Savills in 2013

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