Investment case:

The UK private rented sector (PRS)

The UK private rented sector (PRS) has doubled in size in the past decade and is now increasingly attracting the attention of pension funds, insurers and other institutions.

Over the past year alone, institutions have invested £2.65 billion[1] in UK PRS – a 15% increase on 2014. We expect this to continue to grow thanks to the sector's potential to generate a strong, stable income stream and proven diversification benefits. Our research suggests that the investment case for UK PRS is backed by:

- Low correlations with commercial real estate, equities and bonds
- Attractive rental growth prospects
- Potential to outperform commercial property during economic downturns
- Support from the government for the sector
- A long-standing supply/demand imbalance in the UK housing market backed by strong population growth
- Scope for professional investors to add value through active management and economies of scale

Demographics and demand

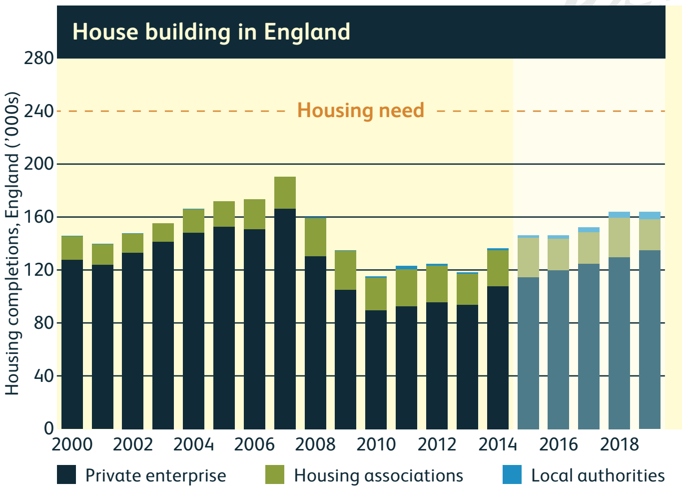
Demographic trends suggest that demand for housing will continue to rise. The UK population is expected to expand by around 0.6% per annum in the medium term (2015-2025) – much faster than the European Union average of just 0.1%. London is growing even faster[2]. At the same time, household size is continuing to fall, with more people living alone.

As a result, the government estimates that some 240,000 new homes need to be built annually. Supply is lagging far behind, with just 152,450 homes built in the 2014-15 financial year[3].

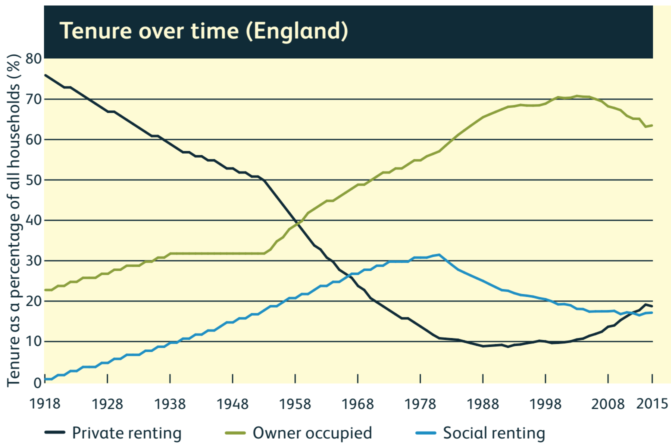
The resulting supply/demand imbalance means upwards pressure on house prices over the long run. Barriers to home ownership remain high, with significant affordability constraints (particularly in London). This, in turn, is likely to fuel demand for rented accommodation – a sector which is increasingly dominated by private rather than social landlords.

The PRS has been on the rise over the past decade, and – at 4.3 million households – now represents 19% of the English market, up from 10% in 2001. In addition, a significant proportion now see themselves as permanent renters, with the 2014-15 English Housing Survey suggesting that only just over half of the PRS households surveyed expect to move into owner occupation.

The rising demand for private rentals in the UK contrasts with the situation in Continental Europe, where in many countries the sector is now fully mature and has stopped growing or is even shrinking. Indeed, the UK was the only European country out of 11 studied where the general trend was one of on-going PRS growth, according to a report by the London School of Economics and the University of Cambridge[4].



Source: DCLG, Savills.

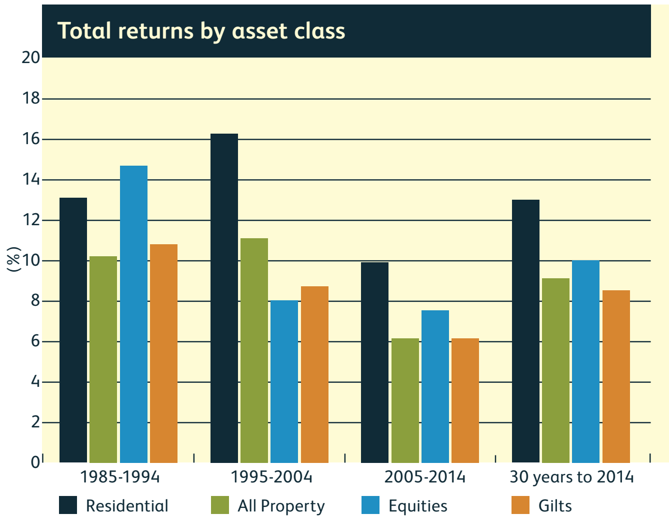


Source: English Housing Survey.

[1]Savills. [2]Experian, December 2015. [3]Department for Communities and Local Government (DCLG). [4]"The private rented sector in the new century – a comparative approach", September 2012.

Strong risk-adjusted returns

According to IPD, UK residential property has outperformed commercial property over each decade since the 1980s. It has also fared well against other asset classes.



Source: IPD, Bloomberg.

While capital values in commercial property have declined by just over 30% in real terms since 1980, those for residential property have increased significantly, likely reflecting a combination of restricted supply and strong demand fundamentals.

Going forward, our research forecasts healthy investment performance for the UK PRS.

Attractive rental growth prospects

Alongside capital growth, the residential sector can also offer a strong stream of long-term income, backed by attractive rental growth prospects.

We forecast average residential rental growth of 4.3% pa in Greater London and the South East over the next five years, supported by a robust economic outlook, improving consumer spending power and rising employment.

The prospects for generating an income return from residential are supported by the lower voids that the sector enjoys compared to commercial property. In 2014, voids for All Market Let residential property were just under 6.5% – some 200 basis points below the level for All (commercial) Property. The length of residential leases is shorter than in commercial, but the gap is getting smaller. Almost two-thirds of private renters stay beyond the standard one year lease and the mean tenancy length is in fact 3.2 years, according to the IPD.

For institutions and other large scale investors, the long-term income stream from residential can be further maximised through greater efficiencies in property management. One issue for investors has been that management costs tend to eat up around one-third of the income from privately rented residential. Such costs, though, can potentially be reduced through the economies of scale available to large investors, compared to what can be achieved through management on a "flat by flat" basis.

Investment opportunities: London vs the regions

London is an obvious focus for PRS investors, reflecting the City's very strong underlying fundamentals and its position as one of the most important economic and financial markets in the world. However, the bigger regional cities are now also drawing the attention of big players who are attracted by the potential for significant 'house price' growth in those markets.

Our own research shows that, while the likes of Bristol and Manchester do have the scope to deliver healthy investment returns, these are likely to hinge on the path of potentially volatile capital values. For investors seeking a strong and stable income stream, the best opportunities are still to be found in London and the surrounding commuter belt of the South East.

London boroughs claim eight of the top ten spots for the highest proportion of PRS tenancies, and the capital also leads in terms of future job creation prospects. Over the next 10 years, it is expected to add circa 240,000 jobs in the finance/insurance/professional services sectors alone, according to Experian – nearly seven times as many as Greater Manchester. This highlights the significant gap between London and the regional cities in terms of prospective tenant demand.

Further away from the capital, housing affordability is by no means as stretched and the potential for new housing supply is arguably less restricted due to greater availability of space.

Rental growth prospects, meanwhile, are supported by the higher pay and better wage growth prospects found in London.

Given this difference in underlying fundamentals, investors should be wary of overpaying for the income streams on offer in the regions, particularly as yields in some cities start to rival London pricing.

As such, we believe that London and the South East should remain the core focus of any PRS investor's strategy and, where a regional strategy is considered, investors must take care to ensure that pricing reflects each city's fundamentals and not an overriding drive to buy into the PRS story more generally.

Diversification benefits

Property has different market drivers to those of more traditional investments such as equities and bonds, and consequently shows very low correlation with those asset classes.

Multi-asset correlations

	Residential real estate	Commercial real estate	Equities	Gilts
Residential real estate	1.0	0.7	0.3	-0.2
Commercial real estate	0.7	1.0	0.3	0.0
Equities	0.3	0.3	1.0	0.1
Gilts	-0.2	0.0	0.1	1.0

Source: IPD UK Residential Property Index, IPD Annual Property Index, Bloomberg. (Inflation-adjusted total returns, 1981-2014).

Analysis also suggests that residential could prove to be a suitable portfolio diversifier for commercial property investors, given that it has much lower correlations with most traditional property segments than those segments show with each other.

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 UK Annual Property Index. (Inflation-adjusted total returns, 1981-2014).

As such, adding residential property into a multi-asset or commercial property portfolio would be expected to improve risk-adjusted returns.

Defensive characteristics

Unlike commercial property, residential real estate is not purely an investment play. People always need somewhere to live. Therefore, if there is a downturn in the economy, the rental market will generally strengthen as the economic environment encourages, or even obliges, people to rent. This potentially lessens capital decline for rented accommodation investments.

As such, in our view the residential sector has also proved a less risky investment than mainstream commercial property. Although the statistical volatility of the two property types has been similar over the past 30 years, this mainly reflects the upside volatility of residential property. When looking just at downside volatility (in this case, the risk of negative total returns), residential has actually shown a much lower level of risk than commercial. During the steep market downturns in both the 1990s and 2000s, residential property recorded a smaller capital decline than commercial and also recovered its initial value faster.

Purpose-built, efficient stock

Obtaining the level of scale required to make institutional investment viable has been one of the prevailing barriers to entry for the PRS. Whereas the equivalent US sector (known as multifamily) is mature, this took time to develop.

Forward funding and forward purchase offer an attractive route for large scale investment in the sector, with house builders and developers increasingly open to such transactions (as illustrated by the recent partnership between M&G Real Estate and Crest Nicholson, which has the potential to result in up to 2,000 new PRS units across the UK). By focusing on blocks and units designed specifically for rent and taking an active interest in the development of these products, experienced professional investors can ensure greater efficiencies for operation, energy and maintenance. Similarly, by ensuring consistency across developments, they can maximise economies of scale to reduce costs of repairs and enhance overall returns through greater customer satisfaction.

The prospects for growth in the institutional PRS are supported by the trends seen in the student accommodation sector. This has only very recently become a truly institutional market as developers took the plunge and started to provide the kind of stock investors want to add to their portfolios. As a result, last year saw investment in the sector reaching up to £6 billion according to Cushman & Wakefield. It is not hard to imagine that the same will be true of the PRS in the years to come.

Liquidity advantage

Liquidity is another potential advantage for residential property over its commercial counterpart. In commercial property, the only exit route is to sell a building to another investor. That means if there is a downturn in the market and large-scale investor interest falls away, it may not be possible to sell a building (at least for a reasonable price) until market confidence returns, potentially years down the line.

Although the same problems may apply to selling a whole block of flats at some points in the economic cycle, residential property benefits from the potential to ‘break up’ a block of flats and sell them individually to either smaller buy-to-let investors or owner occupiers. The potential pool of such investors likely far outweighs the number of institutions in any market. Moreover, when selling to owner occupiers, investors do not have to sell at vacant possession value (VPV) as they would to another investor, potentially enabling them to secure a higher price and thus boosting investment returns. This double exit route makes the PRS increasingly attractive as an investment as a result

Political support

Given the importance of quality housing to the wellbeing of Britons, the sector attracts a lot of attention from politicians, and political support is key to continued institutional investor interest.

UK politicians have welcomed large-scale investment to help plug the housing supply gap through the build-to-rent market, along with the professional management and high quality that such developments bring to the sector. Such backing runs in tandem with the government's support for first time buyers to move on to the housing ladder – a focus which we do not see as a threat to future PRS growth prospects.

Frederick House, Bath (photo courtesy of Crest Nicholson)

Most notably, large scale investors have been exempt from the planned 3% increase in stamp duty on buy-to-let investments. This demonstrates that while the government is looking to restrain the growth of the buy-to-let sector (to prevent private landlords from crowding out first-time buyers from the housing market), it is not seeking to deter institutions from entering the PRS space.

The government also continues to encourage the build-to-rent sector via lending and debt guarantee schemes.

Conclusion

Overall, our research suggests that the investment case for UK residential is supported by the fundamentals of the favourable demographic trends, the supply/demand imbalance in the housing market, and attractive rental growth prospects. To this, the sector adds the benefits of diversification from other asset classes and other real estate sectors, defensive characteristics and a strong returns history. Professional investors have the scope to further optimise returns through economies of scale and greater efficiency. Taken together this makes a compelling case for investing in the UK PRS.

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