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.

To institutional investors PRS offers diversification both from other asset classes and from other types of real estate investments, alongside the potential for a strong, stable income stream.

Our research suggests that the investment case for UK PRS is backed by:

- A long-standing supply/demand imbalance in the UK housing market;
- Low correlations with equities and UK government bonds (gilts);
- Attractive rental growth prospects;
- Scope for professional investors to add value through active management and economies of scale;
- One of the highest population growth rates in Western Europe;
- Potential to outperform commercial property during economic downturns;
- Support from the government for the sector.

Demographics and demand

Demographic trends suggest that demand for housing will continue to rise. The UK population is expected to expand by around 0.8% per annum in the medium term (2012-2021) – one of the fastest growth rates across Western Europe. London is growing at an even faster 1.3% pa.[1] At the same time, household size is continuing to fall, with more people living alone.

Supply is already lagging behind demand, and this trend is expected to continue. Indeed, housing construction has been on a downwards trend since the 1970s. Only 138,070 homes were built in 2013 – well below the level consistent with new demand[2].

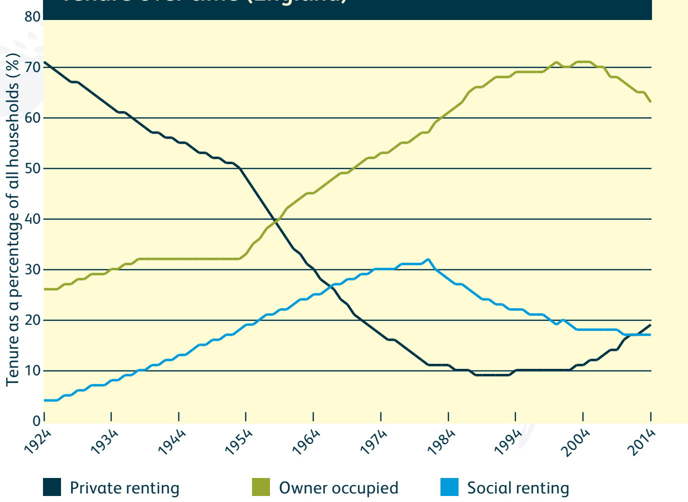
This demand/supply imbalance will place upwards pressure on house prices over the long run. Barriers to home ownership remain high, with significant affordability constraints (particularly in London). This, in turn, is likely to fuel demand for rented accommodation – a sector which is increasingly dominated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

The PRS has been on the rise over the past decade, and now represents 19% of the English market, up from 10% in 2001, according to Department for Communities and Local Government (DCLG) data.

At 4.4 million households, English private rentals are at their highest level since the 1960s and have overtaken the size of the social rented sector. At the same time, less than two-thirds of households are now owner-occupied.

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[3].

Tenure over time (England)



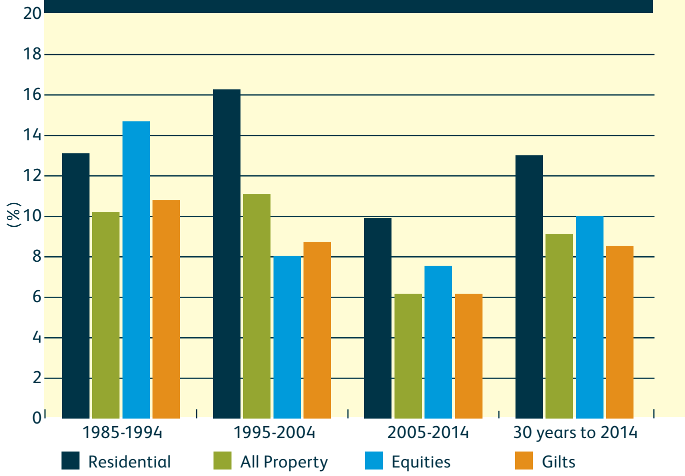
Source: English Housing Survey.

[1]Office for National Statistics, 2012. [2] Department for Communities and Local Government (DCLG). [3] "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.

Total returns by asset class



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 market, with returns driven by continued yield compression as well as rental growth.

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 (particularly in Greater London and the South East area).

We forecast average residential rental growth of 5% per annum 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.

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
(Inflation-adjusted total returns, 1981-2014)

	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.

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
(Inflation-adjusted total returns, 1981-2014)

	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.

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.

Political support

Over the last few years there has been a sea-change in the UK government's attitude towards the private rented sector, welcoming professionalism from landlords and looking to large-scale investors to plug the housing supply gap through the build-to-let market. They have started offering incentives to encourage investors into the PRS. This is key, as government backing for other tenure types over private renting was one of the most significant reasons for the withdrawal of institutions from the PRS in the first half of the 20th century.

Political backing for the sector is expected to continue, with the recently elected government advocating its support.

Advantages of institutional investment

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. After many years, opportunities are now gradually beginning to emerge in the UK PRS – particularly around London, the South East and other areas of strong economic activity.

By focusing on blocks and units designed specifically for rent and taking an active interest in the development of these products, investors can ensure greater efficiencies for operation, energy and maintenance. Similarly, by ensuring consistency across developments, experienced professional investors can maximise economies of scale to reduce costs of repairs and enhance overall returns through greater customer satisfaction.

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.

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.

Kidbrooke Village

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