

Bricks and Mortarboards

The student accommodation review • 2008

Contents

The Knight Frank view	2
Growing demand	2
The importance of international students	3
A growing sector	3
Main players	4
Investment opportunity	4
Location analysis	4
Investment returns	6
Prime student markets	7

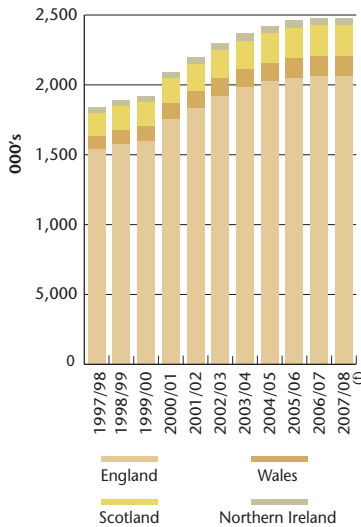


Kirby Street, London (computer generated image – details may vary)

Executive summary

- With mainstream residential and commercial property under significant pressure, we believe that the student accommodation sector offers investors and developers an attractive alternative opportunity.
- Whilst values have risen recently the sector is still immature, and with a limited number of operators in the market there is scope for new entrants and new products.
- In this review we report on the current state of the sector and identify the key locations for future growth in both demand and value.
- We examine the impact of international students on the market, in particular on the pricing potential for accommodation in London and other key regional centres. International demand is supporting capital values of the best new accommodation, with rents and yields pointing towards capital values of over £1,200 per sq ft in central London.
- Finally, we introduce the Knight Frank Student Accommodation Investment Index, which reveals the strength of historic performance and which underpins our outlook for the sector.

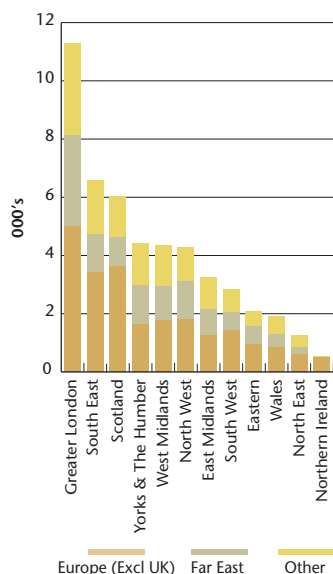
Figure 1
Higher education student population



Source: HESA, Knight Frank Residential Research

“We would expect future student numbers to continue to show growth.”

Figure 2
International student acceptances, 2007



Source: UCAS, Knight Frank Residential Research

The Knight Frank view

Our opinion is that professionally managed student accommodation will provide one of the most exciting prospects in the UK property market over the next three years; we believe that the potential for both capital and rental growth is well above the level we are anticipating for the mainstream residential and commercial property sectors.

Set against this very positive view is a warning for new entrants – the risk of oversupply of accommodation is always present in this sector. Thorough local market research is of critical importance due to the size and scale of new build proposals. The winners over the next few years will be those operators who are able to identify under supplied locations, and act quickly to deliver product before competitors respond. The weakening city centre apartment market offers the potential for site acquisition which could bode well for those looking for a rapid response to opportunities.

For those interested in the central London market in particular, a clear understanding of the international student market will pay dividends. The rewards for designing and delivering a product which appeals to high value international students are obvious – whilst the prime student market in London typically sees values of £700 to £900 per sq ft being achieved, rental levels and investment yields are pointing towards capital values breaching the £1,200 per sq ft barrier in Bloomsbury. We believe that the £1,500 per sq ft barrier may be broken over the next two years.

Over the following pages we explain the key fundamentals underpinning the market and point to the main areas for potential growth in both demand and pricing. In summary we believe that investors and developers would be best advised to concentrate on the larger regional centres and to shift towards higher product specification. There is a significant opportunity in this sector – but understanding local market permutations has become critical and those operators who take time to research gaps in the supply pipeline will perform well over the next few years.

Growing demand

The total UK student population has grown consistently over the past ten years and this trend is expected to continue. Total student numbers in the UK have grown from 1.8 million in 1997 to 2.5 million in 2007 representing an average annual growth rate of 3.3% over the period. The majority (83%) of both institutions and students are based in England, a ratio that has remained unchanged over the past decade (Figure 1).

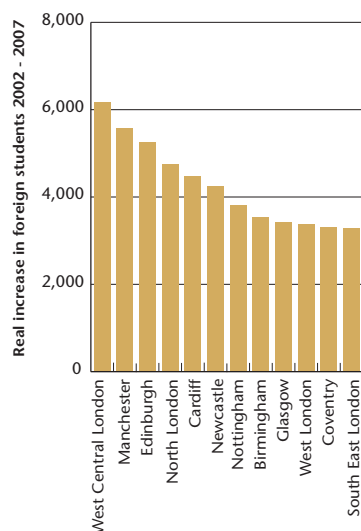
Data from the Office for National Statistics shows that the higher education initial participation rate was 40% among 17 to 30 year olds in 2006/07. This figure was down on the 43% achieved in 2005/06, although this high proportion coincided with a surge in applications as students rushed to enrol before the introduction of £3,000 top-up fees. Government targets stipulate a higher education participation target rate of 50% by 2010, and if we believe that the Government will make steps to meet its target it is reasonable to expect that future student numbers will continue to show steady growth over time.

The growth in the student population has been driven in the main by domestic UK undergraduate demand. Two groups of central importance to the operators of private halls are overseas students and postgraduates which have also seen strong growth in numbers. These tend to welcome the convenience of the professionally managed sector and are to some extent less price sensitive when compared to other student categories. The international market has seen numbers grow at above average rates and whereas in 1997 they accounted for 11% (international students) and 21% (postgraduates) of all students, by 2007 these figures had increased substantially to 15% and 24% respectively.

European market has led the growth in international students, with their share of the overall student population rising from 3.3% in 2002 to 5.2% in 2007. Over the same period non-EU students grew their share of the overall student population from 6.6% to 7.2%. Figure 2 shows that Europe and the Far East represented the key source markets for international students in 2007.

We believe that student numbers will continue to rise by an average of 2.9% per annum over the next decade meaning that there will be an additional 93,000 students in higher education by 2018.

Figure 3
Key locations for international students



Source: HESA, Knight Frank Residential Research

The importance of international students

Demographic projections suggest that whilst a greater proportion of young people will enter higher education, the overall pool of young people in the UK is set to stabilise and even shrink over time. As a result, universities will need to capture new markets, particularly older, part-time, work-based and international students.

The problem for UK institutions is that whilst international students are one of the most important groups to target for future expansion, competition from overseas institutions is rising significantly over time. European institutions are increasingly altering their education programmes to increase their attractiveness – running business courses in English for example. There is growing competition from Anglosphere locations such as the US, Australia, New Zealand and Canada, but also from Asian countries keen to expand their higher education offer and also to retain valuable students.

Despite this increasingly competitive environment the UK still has significant success in attracting international students. London provides the main draw, with the range of academic institutions, especially the specialist universities and institutes such as the London Business School, the London School of Economics and Imperial College, and its 'global city' status is viewed very positively.

The number of international students varies greatly between institutions. Figure 3 shows where there has been significant growth in numbers in the five years to 2007. Over these years growth in the number of international students has been most marked in West Central London, Manchester, Edinburgh and North London.

We believe that international students will rise as a proportion of all students from 15% in 2008 to 21% by 2018, led largely from non-European locations.

A growing sector

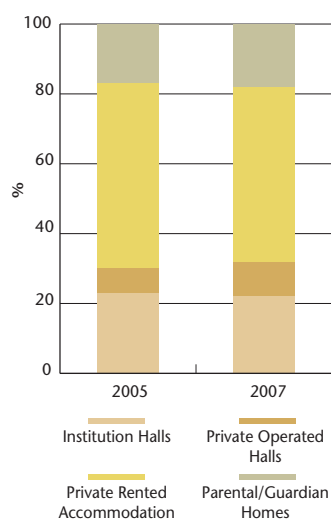
The professionally managed student accommodation sector, concentrated in the relatively new purpose built blocks, competes for student occupiers with: institutional halls (typically outdated accommodation provided by the institutions); traditional private rented accommodation (flats and houses let by private landlords) and the family home, for those students who remain living with their parents.

Figure 4 shows how the accommodation profile has altered between 2005 and 2007. Private operated halls have seen the greatest growth in market share. In 2005 this type of accommodation accounted for around 7% of all bed spaces and this figure has grown to around 10% in 2007.

Several factors have helped to drive up the privately operated halls share of the market. First, many institutional halls are outdated and provide little real competition for the newer blocks. Second, many private landlords who target the student market, are becoming disillusioned by new HMO (Housing in Multiple Occupation) regulations which came into effect in 2006. These regulations have had the effect of making the business of being a landlord more costly and created a barrier to entry into this subsector. Finally, the introduction of top-up fees in the past decade, does not appear to have led to more students living at home, in fact there is some evidence that a smaller proportion of students have chosen this route over the past two years.

Demand and supply trends have therefore conspired over recent years to encourage the expansion of the private operated halls. Indeed, our estimate is that during 2008 well over half of new accommodation will be developed in private partnerships or directly by the private sector. The National Union of Students (NUS) predict that private providers and private sector partnerships will account for the majority of all higher education accommodation by 2010. Currently, the greatest concentrations of private sector bed spaces can be found in Yorkshire and Humberside (23%), the North West (21%), and the East Midlands (17%).

Figure 4
Accommodation options



Source: HESA, Knight Frank Residential Research



Opal Court, De Montfort Street, Leicester

Main players

The student accommodation market is still embryonic, whilst there has been substantial growth in development volumes, the number of active participants in the market is still limited. The five leaders (by market share) within the private operated halls subsector currently account for approximately 66% of all bed spaces, Table 1 shows the top five providers

Each of the major providers has spread their product across a number of locations, although each has slightly different geographical focus. For instance UNITE, with by far the greatest number of bed spaces in the market, is spread across a wide area with 10% of bed spaces each in London and Sheffield, 9% in Liverpool, 8% in Bristol and a further 7% in Leeds. UPP, with fewer bed spaces has approximately 25% of bed spaces in Nottingham, 16% in Plymouth, 13% in Leeds, and 9% in Loughborough. Opal is located primarily in Manchester (21%), Leeds (13%) and Sheffield (10%). Liberty Living are focused predominately in Liverpool (18%), Manchester (14%), Cardiff (9%) and Birmingham (9%). We estimate that there are a total of around 130,000 bed spaces in private operated halls nationwide.

Investment opportunity

Overall interest in student accommodation investment property has grown due to a number of central factors. Firstly, across most other property sectors in the UK in recent years there have been declining returns on investments. At the same time the student accommodation sector has remained healthy with attractive returns. Demand (i.e. the number of students) has grown year-on-year over the last 10 years without exception (and is expected to continued to grow). Increasing financial gains, particularly in terms of rents, and secure covenants, with distinctive lease structures and rent review patterns, are some of the factors making this subsector attractive. Rental growth within the student accommodation sector has consistently outstripped RPI inflation and, given the current market conditions, this trend is expected to continue.

The UK economy and the property market is moving in to a cooler phase which in turn is leading to a higher risk investment climate within the traditional property sectors. In light of these shifting market conditions, the student sector is likely to continue to be attractive, with a growing rental stream and positive future demand.

In general, across London there are a huge number of students and relatively few available bed spaces within institutions. However, London sits within a large local catchment area and therefore more students come from within the area and are more likely to live at home with their parents.

Table 1

Key players in Private Operated Halls market

	Current (April 2008)	Pipeline
UNITE plc	37,522	10,164
UPP	16,000	3,550
Opal	15,500	5,800
Liberty Living	10,300	800
Victoria Halls	5,100	1,000

Source: Individual companies

Location analysis

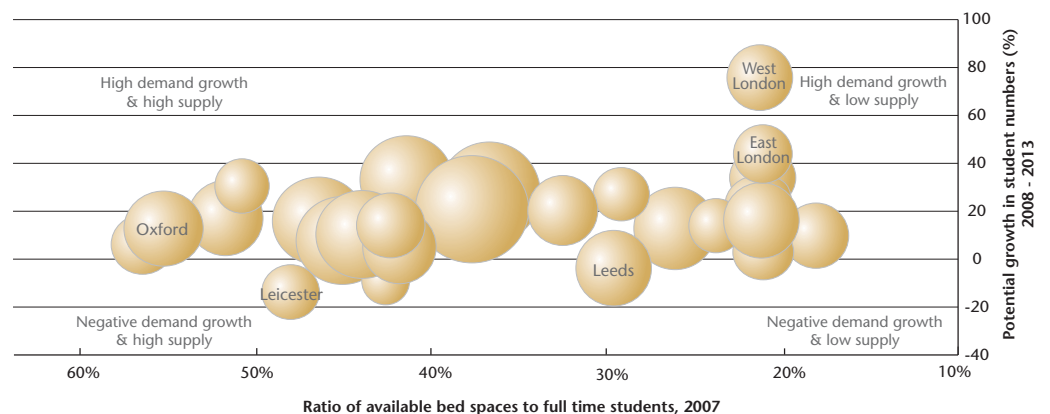
In this section we assess the relative attractiveness of different markets across the UK as locations for future student accommodation investment.

Figure 5

Demand for student accommodation

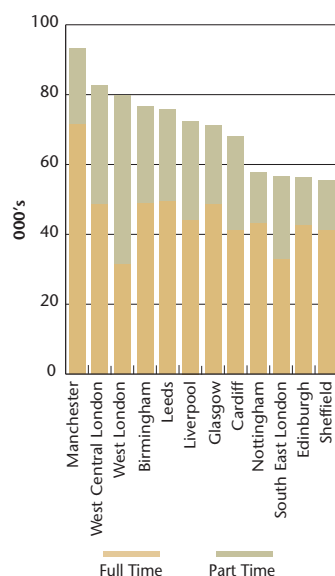


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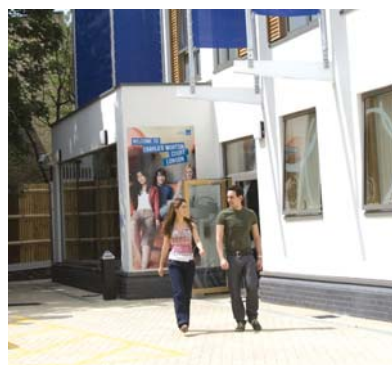


Source: Knight Frank Residential Research

Figure 6

Total students by location, 2007

Source: HESA



Charles Morton Court, London
(computer generated image – details may vary)

Figure 5 shows an assessment of latent demand for student accommodation by location. The relative size of the bubble represents total number of full time students (the local market). The inverted horizontal scale shows the ratio of total private and institution hall bed spaces to full time students and the vertical axis shows potential growth in student numbers. Any location in the top right of the chart is displaying a strong performance with strong student population growth and few available institutional and private hall bed spaces per full time student, whereas those locations in the bottom left of the chart show the opposite characteristics, with static population numbers and a high number of available institutional and private hall bed spaces per full time student.

Table 2

SWOT Analysis – Private Operated Halls**Strengths**

- Relatively stable, tangible, certain demand
- Offers a lower risk profile than some other commercial property asset classes
- Availability of accurate, reliable market data
- Opportunity to create high density developments – keeps costs down and meets planning targets
- Unlike private residential development less need to provide parking places thus opening up the opportunity to build at a higher density
- End product is good quality, secure accommodation that can be let at a premium
- Able to build a standardised product with a simple, basic specification – lower costs
- Specialised operators and investment funds opening up the market and making investment easier/more secure

Weaknesses

- Projected rental growth levels lower than the private residential letting sector
- Limited alternative uses of end product
- No or minimal car parking on site might limit appeal of the units in the future
- Short-term lets (although fixed-term)
- Potentially onerous management processes and costs associated with the often large scale nature of many student schemes

Opportunities

- Capitalising on less active residential investment market
- Possible regeneration of poor quality/run down areas where pure commercial or residential development would prove unviable
- Providing diversification of investment product
- Creation of retail demand
- Growth of international market
- REITs may help the sector mature and become a serious, divisible, accessible alternative asset class
- Incorporate student accommodation within a wider mixed-use development or mixed student and private residential development
- Enter guarantee agreements with universities to secure a source of demand, manage the development etc

Threats

- Impact of ever increasing student debt
- Sustainability of the sector
- Impact of tuition fees
- Increasing competition for sites from other student and private residential developers and other uses
- UK demographics
- Globalisation of international student market i.e. students can choose almost anywhere in the world to study

Source: Knight Frank Residential Research

Table 3

UK locations ranked according to potential investment opportunity

	Rank
Edinburgh	1
North London	2
East London	3
South West London	4
West London	5
South East London	6
West Central London	7
Newcastle	8
Manchester	9
Birmingham	10
Glasgow	11
Cardiff	12
Oxford	13
Bristol	14
Nottingham	15
Brighton	16
Leeds	17
Plymouth	18
Canterbury	19
Southampton	20
Coventry	21
Sheffield	22
Liverpool	23
Leicester	24

Source: Knight Frank Residential Research

It appears that the various London markets such as West London and East London show the greatest potential demand. Indeed, as highlighted earlier, London is also a core location in terms of the international sector. Areas with relatively little opportunity for potential investors include Oxford, where accommodation is already provided for a large proportion of students, Leicester, where student numbers are static, and Leeds, also where student numbers are seeing negligible growth and where existing accommodation provision is strong.

In order to gain a further understanding of the locations which hold high potential growth in the UK we have indexed major student locations by the factors described above in addition to other weighted variables. In consideration of the fact that it is mainly full time students who reside in student accommodation, we have only included locations with over 20,000 full time students (24 locations). In order to carry out this assessment we have ranked each location by:

- Potential growth in full time student numbers (high growth = positive indicator)
- Proportion of international students (high proportion = positive indicator)
- Potential growth in international students (high growth = positive indicator)
- Ratio of full time students to available private and institution hall bed spaces (low ratio = positive indicator)
- Number of students living away from home in private housing (high number = positive indicator)

Based on these variables, it appears that in addition to the London markets, Edinburgh offers one of the strongest opportunities for prospective investors (Table 3). This is predominately driven by the fact that there are relatively few institutional and private hall bed spaces in relation to the full time student population and an increasing number of international students. The opportunity in London is driven by a combination of the volume of international students and the high proportion of students living away from home in private rented accommodation. Whilst there are schemes in the pipeline in both Edinburgh and north London the current pipeline does not significantly impact on the ranking of each location.

Investment returns

Average weekly rents for student accommodation has increased from £67 in 2003/04 to £82 in 2006/07 representing an average annual increase of 5.2%, a significantly higher rate of growth compared with the Retail Price Index (RPI) over the same period. Private Operated Hall baseline rents are typically lower than the overall average, but this figure does not reflect the true cost to the student as it does not include, for instance, internet and energy costs. Factoring in these additional costs increases the average rents for Private Operated Halls to £88. As one might expect, average rents for Private Operated Halls are highest in Inner London (Table 4).

We believe that over the next three years student accommodation rents will continue to show strong growth of over 4.5% per annum.

Despite this being an embryonic sector, there is a growing availability of transactional data which we have brought together in the Knight Frank Student Accommodation Investment Index, which allows for a like for like comparison against other property assets.

From Figure 7 it is clear that compared to other property assets, student accommodation has performed strongly over recent years with total annualised returns of 10.2% over five years and 12.2% over three years, a stronger performance than the retail, industrial and residential property sectors. We believe that over the next three years we will see a similar outperformance of this sector.

Table 4

Average rents at Private Operated Halls, 2006/07

	Average rent
Scotland	£70
Wales	£68
North West	£72
North East	£80
Yorkshire and the Humber	£75
West Midlands	£80
East Midlands	£76
South West	£77
Inner London	£117
Outer London	£112

Source: NUS and individual operators

Prime student markets

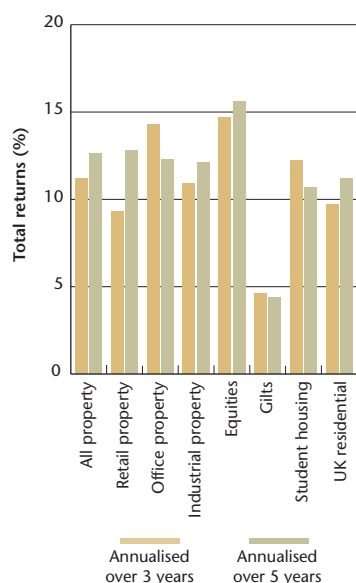
As we noted earlier, apart from Edinburgh, most areas of London rank highest in terms of latent demand for student accommodation and therefore for Private Operated Halls. Achieved rents and capital values are also highest in London.

Figure 8 shows indicative capital values of Private Operated Halls across London. Values are highest in West Central (WC) London and the areas of South West (SW) London which lie to the north of the River Thames, where capital values above £1,000 per sq ft are potentially achieved. West Central London includes some of the city's most renowned universities such as University College London (UCL), King's College and the London School of Economics and Political Science (LSE). Halls in these areas are not only close to major colleges and universities but they also benefit from being close to London's major entertainment hubs and attractions in the West End.

The areas in South West London where the highest capital values are realised include the well-established residential areas of Kensington, Chelsea and Pimlico. The high values achieved within the student accommodation sector in these areas reflects the wider housing market, where prices are the highest of all London sub-markets. These areas form the core of Knight Frank's Prime Central London (PCL) definition, indicating the attractiveness of the area. Students living in these areas also have relatively easy access to the Central London universities mentioned previously in addition to Imperial College. Demand for student accommodation within these prime residential areas is driven largely by the high value international student market.

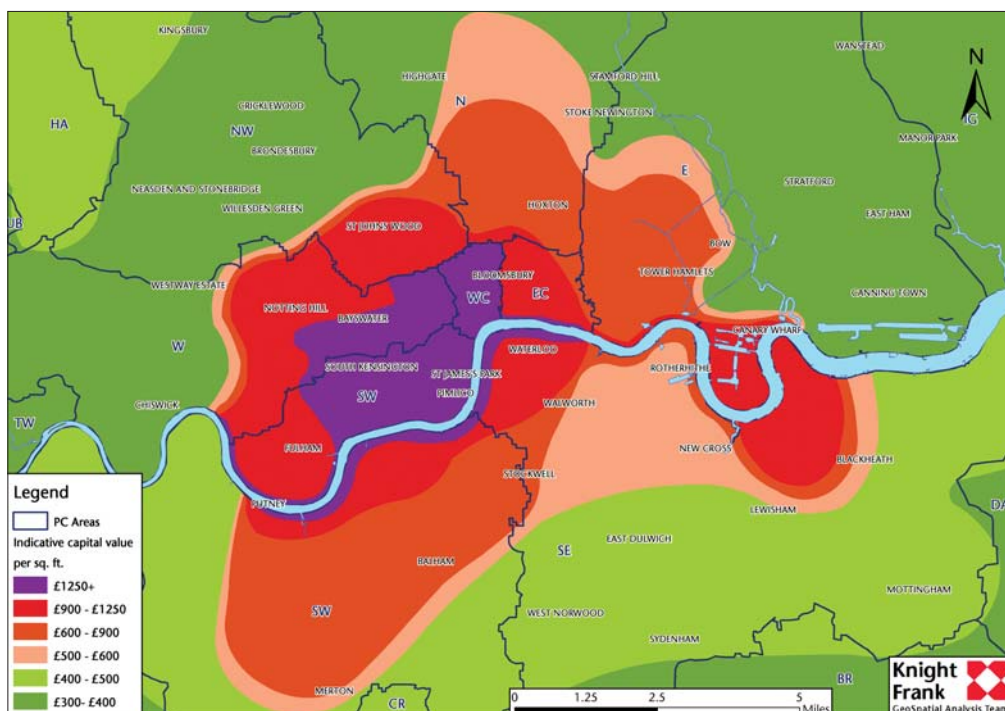
Capital values generally decrease as you move further away central London, with Private Operated Halls in areas such as Maida Vale and Fulham, typically achieving capital values between £800 and £900 per sq ft. South West London (south of the River Thames) is also an attractive location for students, achieving between £600 and £900 per sq ft, as is North London, which also achieves between £600 and £900 per sq ft, where London's largest university, London Metropolitan University, is based. Values in East London at between £500 and £700 per sq ft, are driven up by the presence of the University of East London and Queen Mary and Westfield College. Similarly, in Greenwich the University of Greenwich has pushed up values in the immediate area.

Figure 7

Total returns (%) by asset

Source: IPD, Knight Frank Residential Research

Figure 8

Indicative capital values 'potential'

Source: Knight Frank Residential Research

Residential Research

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