UK BTR market update

Q2 2023

Knight Frank's quarterly review of the key investment themes in the UK Build to Rent (BTR) market

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Despite a challenging backdrop, investment in UK Build to Rent (BTR) has been robust in H1 2023, supported by an uptick in Single Family Housing (SFH) deals. Meanwhile, supply shortages continue to support strong rental growth.

Investment volumes reflect strength of interest in the sector

Investment into the UK Build to Rent market hit £959.8 million in the second quarter of 2023, taking year to date investment for H1 to just over £2 billion, 7% ahead of the £1.9 billion transacted at the same point last year. In Q2, the number of funding or stabilised deals was 8% lower year-on-year, but the average deal value was up by 5% at nearly £70 million. A larger lot size supported a 13% increase in investment volumes compared with Q2 2022. Increasing investment volumes come despite greater hesitancy in the market caused by current economic uncertainty and the high cost of debt, which has resulted in some investors temporarily pressing pause.

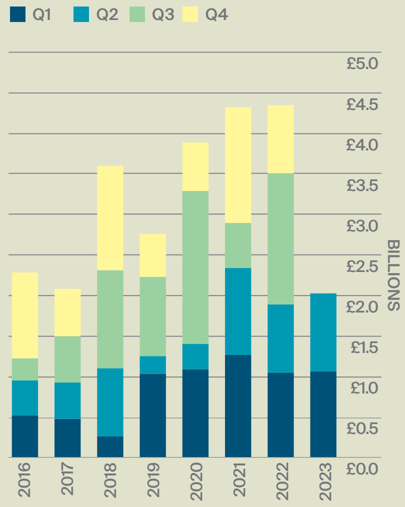
Notable growth in single family housing deals

Single Family Housing (SFH) accounted for 30% of investment in Q2, taking H1 total investment into SFH to £733.6 million – nearly double the figure for full year 2022. Notable growth in SFH investment over the year-to-date has been supported by several deals with housebuilders. The wider economic context makes partnering with an investor to fund projects attractive. More than 81% of investment in the second quarter was via forward funding or forward commitment structures, with the remaining 19% to stabilised operational assets. Our agency and valuation teams are tracking a further £1.4 billion of transactions which are under offer which we expect will trade in H2.

UK capital dominates

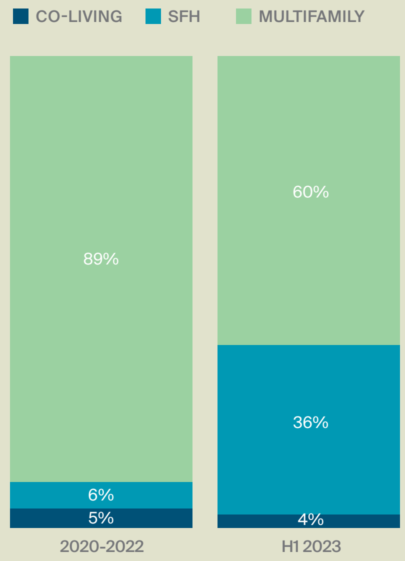
UK investors have been the most active in terms of spend so far this year, accounting for 69% of total investment, up from a longer-term trend between 2020 and 2022 of 45%. North American investors were the second most active at 23% of total investment so far this year, followed by capital from Asia Pacific and Europe. Hedging costs remain a challenge for many core European Investors, but are expected to ease next year which may support an increase in investment.

Fig 1: BTR investment volumes
Quarterly



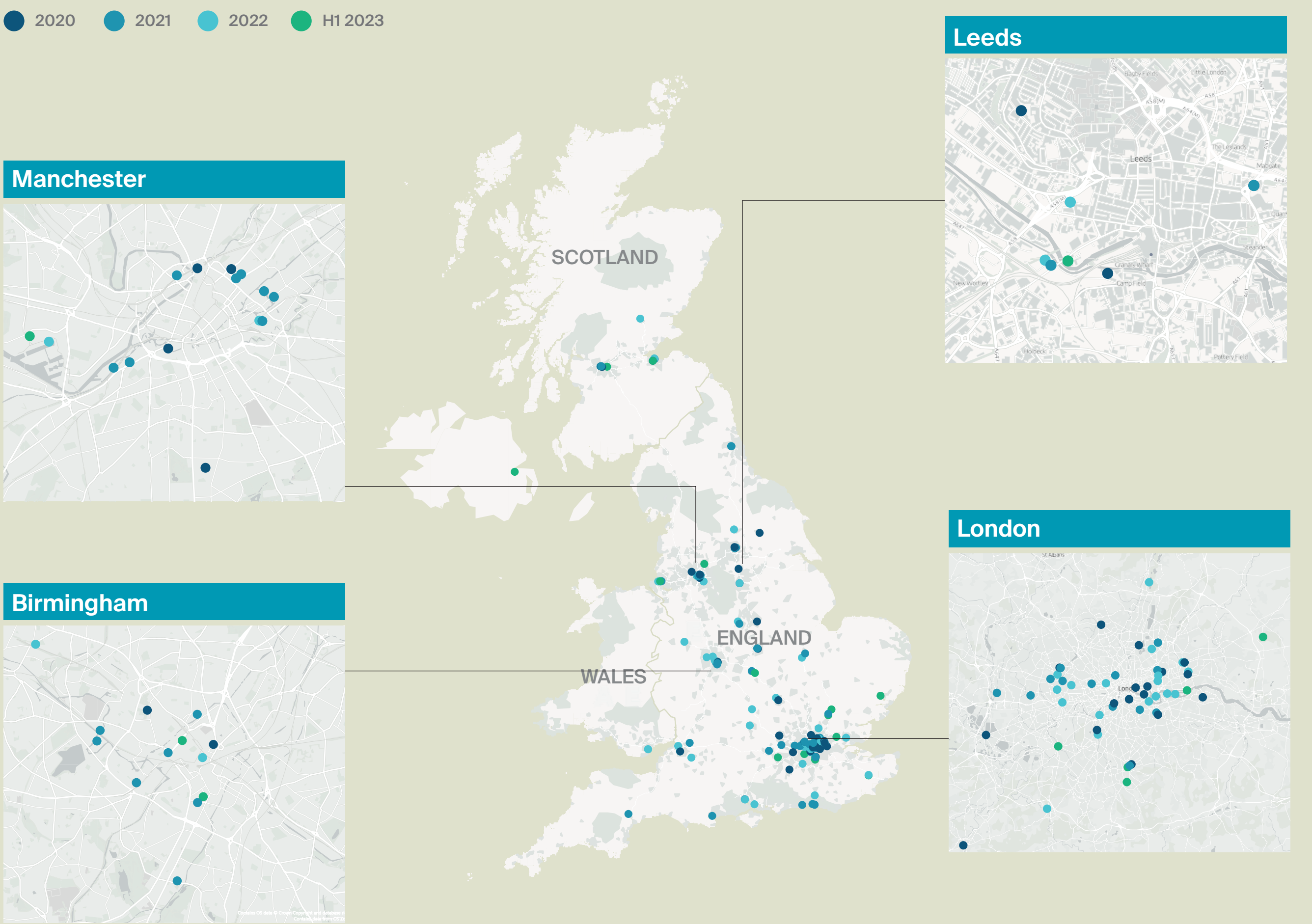
Source: Knight Frank Research

Fig 2: SFH taking a larger share
As a proportion of the total investment



Source: Knight Frank Research

Fig 3: UK BTR transactions
By year



Source: Knight Frank Built to Rent Transactions and Development Database

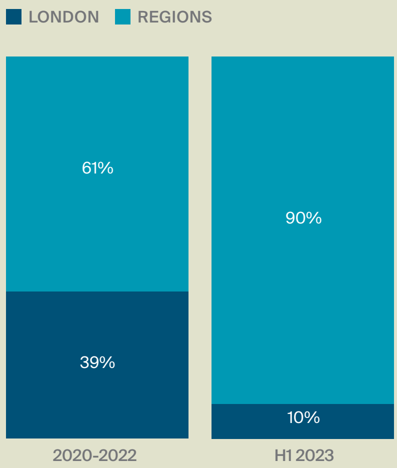
Regional markets leading the way

Activity has been concentrated on regional markets in the first half of 2023, with deals outside of London accounting for 90% of total spend. Regional activity has been led by Birmingham, Belfast & Leeds. This represents a sharp reversal of the longer-term trend, with London having accounted for 38% of total spend between 2020 and 2022. The reduction in deal volumes so far this year in the capital represents fewer opportunities being marketed, as well as the relative tightness of yields. With the slightly softening seen recently, transaction volumes in the Capital are expected to increase in H2 and take a greater proportion of overall transactions for this period.

Macroeconomic challenges remain

UK inflation climbed less than economists expected during the year to June, with the Consumer Prices Index easing to 7.9%, down from 8.7% last month and below expectations of an 8.2% rise. While it remains a long way from the 2% target, an easing should improve sentiment and bring interest rate expectations down. Swap rates have already eased a little from recent highs. That said, the Bank of England has done little to push back on expectations that it will need to tighten monetary policy further in the months ahead. Recent strong readings for private sector pay growth and a better-than-expected outturn for GDP have added to expectations that the base rate will

Fig 4: Regional markets lead in H1 2023
As a proportion of the total investment



Source: Knight Frank Research

rise again in August and hit a peak of between 5.5 and 6%, with cuts unlikely until the second half of 2024, according to economic forecasters. Despite a more challenging backdrop, BTR deals are progressing. The transactional evidence supports a view that yields have softened by between 30bps and 50bps since Q3 last year. Pricing has generally held firm, with ongoing strong rental growth offsetting much of the yield movement.

Supply shortages boosting rents

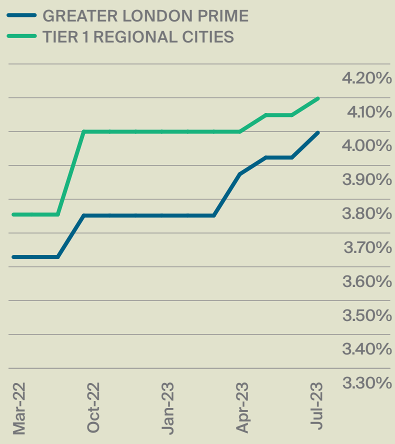
Data from Rightmove suggests that rental supply has reached a plateau, with listings volumes in Q2 2023 in line with the previous year. However, rental listings are some 52% lower than the 2017-19 average. This longer-term drop-off in supply, combined with rising demand and strong wage growth, has contributed to a period of exceptionally strong rental inflation over the last 18-24 months as well as strong occupancy and lease up for BTR schemes. The Knight Frank BTR Rental Index shows asking rents for new leases rose 10.9% in the year to June 2023. While this has eased slightly from its peak in September 2022, it remains well above trend. Despite this growth, renting still remains affordable relative to buying given the recent spike in mortgage costs.

Strong rental growth to continue

A period of above average rental growth is expected to continue into the second half of the year and beyond, with little prospect of either supply picking up, or demand slowing. The outlook for the sales market – with high mortgage rates clipping the wings of would-be first-time buyers – combined with the strength of the labour market and high immigration, will all support increasing rental demand, particularly as we head into the traditionally busier summer and autumn months. Instead, affordability pressures will act as the biggest drag on rental inflation. While our affordability modelling suggests there is headroom for rents to increase further, rents have been growing faster than incomes over the last 18 months. This will contribute to a further moderation in rental growth this year. Our current forecast is for rents to increase by 4.0% in 2023, though there is significant upside to this figure. Longer-term, rental growth will re-establish its long-term relationship with earnings.

Fig 5: BTR yields soften

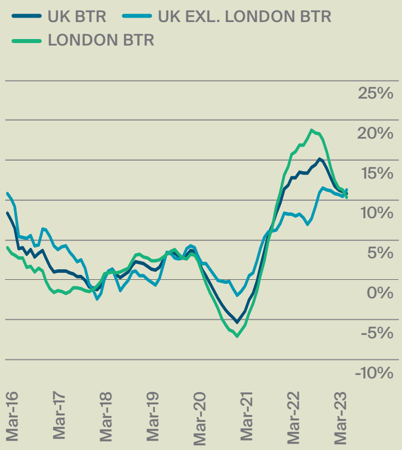
Net intial yield



Source: Knight Frank Research

Fig 6: Rental growth slows but stays ahead of trend

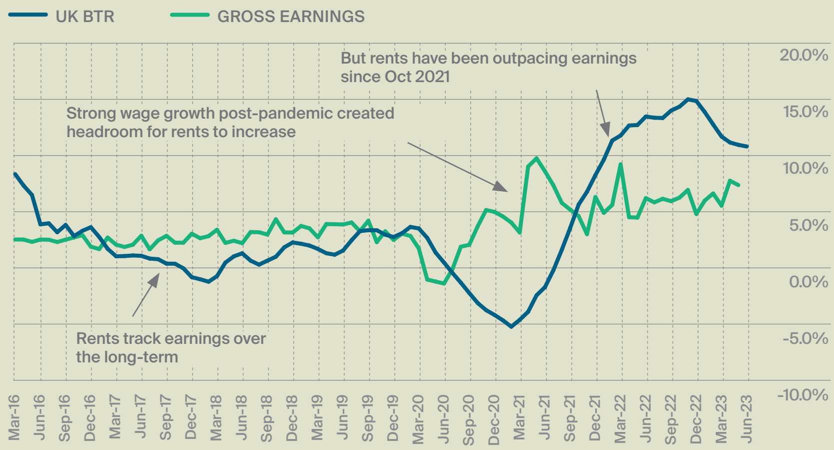
Annual % change



Source: Knight Frank Research

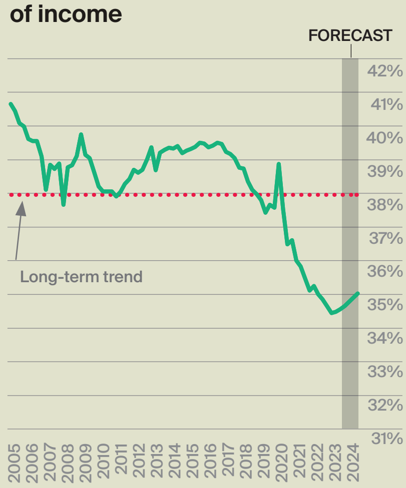
Fig 7: UK BTR rental growth vs earnings growth

Annual % change



Source: Knight Frank Research, ONS

Fig 8: Rent as a proportion of income



Source: Knight Frank Research, ONS

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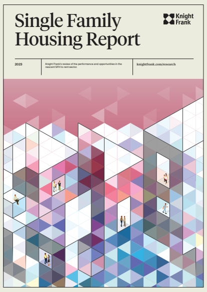

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