RESIDENTIAL
RESEARCH

RESIDENTIAL INVESTMENT 2012

Knight Frank

OVERVIEW

Institutional investment is the life-blood of the UK's commercial property sector. By comparison the exposure of pension funds and insurance companies to residential property is very limited.

"Institutional investment is seen as a much needed source of funding for new homes."

Gráinne Gilmore, Head of UK Residential Research

At first glance, this lack of institutional engagement seems surprising. Historic capital growth has been very strong and the sector provides steady, if not especially, stellar income returns.

Yet institutional investment in the residential sector has still to take off, despite a desire for this to happen among institutions themselves. Policymakers are also keen to promote this activity, seeing it as an alternative and much-needed source of funding for the provision of new homes.

16.5%

Proportion of households in the private rented sector

In this report, we examine the obstacles to institutional investment in the private rented sector (PRS), including sourcing stock and management and securing acceptable yields. We suggest how some of these hurdles might be overcome, highlight how some companies are already addressing them and examine some recent, significant policy changes. James Mannix, head of residential investment at Knight Frank, also outlines a new 'blueprint' for the sector.

Tim Hyatt, head of lettings at Knight Frank, says: "There is no doubt that the private rented sector is flourishing, a trend which started in earnest with the boom in buy-to-let mortgages and which has been boosted in the years since the financial crisis as would-be buyers have been forced into this market."

The proportion of owner-occupier households in England has fallen from 70% in 2001 to 66% in 2011, the lowest level since the late 1980s, while the proportion of private renters has risen from 10% to 16.5% over the same period. Some 3.6 million people in England now live in private rented accommodation.

Rents have risen strongly since 2008, and as we discuss on pages 7 and 8, rental growth will continue, underpinned by the sea-change in the mortgage market facing would-be buyers.

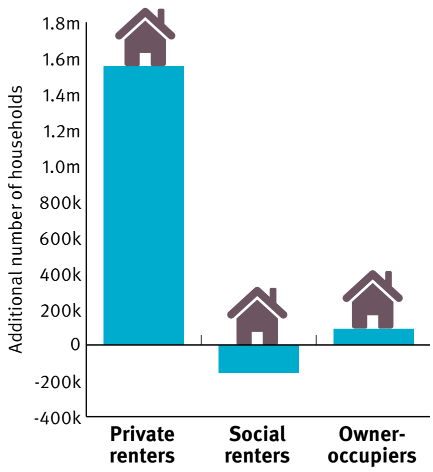
Our view is that the private rented sector will expand further over the short to medium term, primarily in reaction to the economic drivers which are effectively keeping purchasers out of the housing market, as we note in this report.

We don't believe that we are seeing a complete attitudinal shift in the population – the British love affair with homeownership will remain undimmed. But the number of people finding their way to homeownership blocked has undeniably risen, and shows no sign of abating. An expanded and more sophisticated private rented sector will make this form of tenure a more alluring option for those who cannot buy a home, no matter what life-stage they are at.

Figure 1

The private rented sector booms

Changes in tenure, 2001 to 2011



Source: ONS

Institutional investment in the private rented sector

Just 1% of housing stock in the UK is owned by institutions, compared to between 10% and 15% in most European cities. Yet there is an appetite for investment in the PRS among institutions as residential property has outperformed many commercial asset classes over the last couple of decades.

Residential stock can help diversify investment portfolios as rental growth tends to track earnings while having little correlation to movements in other asset classes. There is interest in the sector from other stakeholders, including private equity companies, developers and housing associations.

75%

Increase in number of households privately renting since 2001

Current policy

If debate about regulatory changes are evidence of intent, then policymakers are also keen to encourage additional institutional investment in residential property through the PRS, seeing it as a means to create extra housing. This additional housing is certainly needed. As can be seen from figure 2 – the number of completions in recent years is falling far short of the 200,000-250,000 a year the government believe are needed to meet growing demand.

In the wake of the Rugg review in 2008, the Labour Government launched a consultation on investment in the PRS in early 2010. The findings of this consultation are likely to have influenced the Coalition Government's decision to change the stamp duty regime last year, as examined on page 5.

Grant Shapps, the housing minister, also made his intentions clear in the housing strategy, published last year, in which he said that institutional investment "could help to sustain housing supply at a time when mortgage finance is constrained."

As a result of this, new rules to make real estate investment trusts (REITS) more attractive to residential property funds will be introduced in April (page 5). While commercial property REITs are popular, a UK residential REIT has yet to be set up, despite much talk.

The scrutiny of the sector continues. In December last year, Mr Shapps appointed Sir Adrian Montague to carry out an independent review into investment in the private rented sector, which is expected to report in the summer. The Communities and Local Government Select Committee is also holding its own inquiry into the Financing of New Housing Supply, which Clive Betts MP, who chairs the committee, recently said would look at the changes to the REITS regime as well as the contribution public land could make to boosting housing supply.

The political will and institutional enthusiasm to invest in the residential sector is definitely there, but there remain some key obstacles, some of which are more challenging than others, which we will examine in turn.

Stock

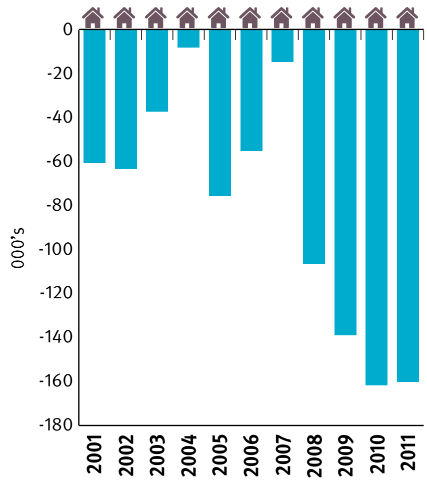
The initial problem is stock availability; institutional investors look for stock where they can implement economies of scale, which usually means blocks of flats, preferably concentrated in one area. We spoke to Neil Gardiner, Fund Manager, Real Estate at Aviva, who confirmed: "We are not really interested in 'pepper-potted' stock. It is important to control a building in its entirety. You can then set the tone of the rent in the building, the services and importantly you don't have individual buy-to-let landlords competing on rents."

This is a problem for both existing players and new entrants to the market. Developers can rarely be persuaded to sell a development in its entirety before completion, since the returns available

Figure 2

Undersupply

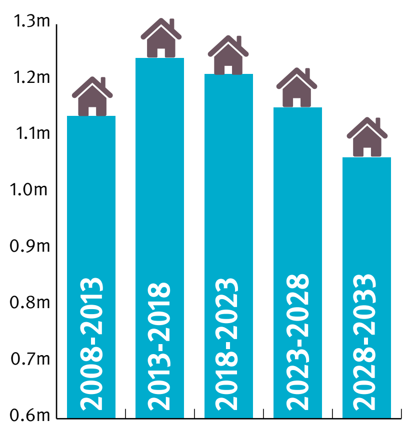
Annual gap between actual new-build residential completions and household growth in England



Source: Knight Frank Residential Research, DCLG, ONS

Figure 3

Forecast household growth in England



Source: ONS, DCLG

> "We think there is potential for institutional investment to diversify the offer to tenants and generate new supply – including homes purpose built for renting."
>
> Communities minister Andrew Stunell speaking to Knight Frank

through individual sales are currently so high, at least in London and the South East. Further, institutions must compete with savvy and fast-moving individual investors to purchase existing residential blocks that may come onto the market.

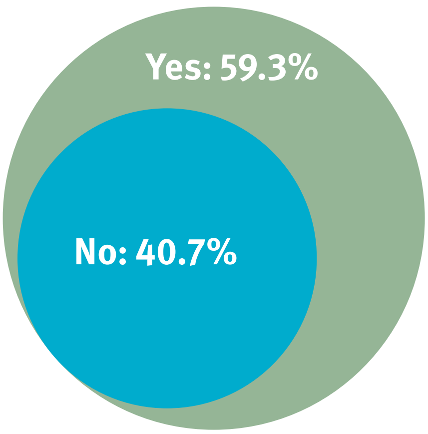
One of the few successful acquisitions is the recent investment by Delancey and Qatari Diar in the East Village – the legacy neighbourhood of many flats which make up the athlete's village next to the Olympic park. The East Village will be primarily made up of private dwellings to rent, a move which Delancey says 'breaks the mould' for UK residential development. Jamie Ritblat, chief executive of Delancey, shares his views below.

Perhaps one way around the problem of stocks is for investors to become developers themselves in a 'build-to-let' model, an option we examine later.

Management

Another problem frequently cited is the difficulty finding a suitable management company to run a residential block. But as Ritblat explains below, residential landlords can benefit from the experience of those in other property sectors, such as commercial, hotels and the burgeoning student sector. It may be difficult to find management along traditional lines, but as the expectations for private rented accommodation rise, so delivery of a

Figure 4
Buying aspirations of private renters
How many expect to buy*



Source: English Housing Survey, full household sample
*At some point in the future

East Village – London's unique opportunity

Jamie Ritblat
Chief executive, Delancey

Delancey and Qatari Diar this year finalised their deal to buy 1,439 flats in the East Village, the legacy neighbourhood from the athletes' village on the Olympic site in East London. The flats, which will become available in 2013/14, will be primarily rented out rather than sold.

Jamie Ritblat, chief executive of Delancey, explains his plans for East Village.

Unique chance

"No-one has really done this before on this scale. Firstly, there hasn't been the opportunity to get this amount of stock, and secondly, in order to make the economics work, you have to be able to deal at a certain price point for developments. The East Village, in terms of capital values, stacks up.

Why renting?

"We believe that there is a pent-up demand for rental accommodation. This is being caused primarily by the current economic circumstances, primarily the availability and affordability of mortgages.

"This comes on top of a longer-term decline in home ownership over the last decade, and looking forward it is hard to see that this decline won't continue. There is an absolute set of circumstances which in our view demands a response.

How the model will work

"Historically, the difficulty with the rental market has been running a business economically, with all the management and other costs involved. The only way to do this is in scale. You need scale and geographical concentration in terms of number of units.

"Then you can set up management almost 'hotel style' and run the maintenance and other needs in the same way as they are run in the office and retail markets. That is the nub of the operation, but in addition, you will have a menu of extra services as optional extras.

Place creation

"In the East Village we will create an area where people want to take up permanent residence. We are ultimately looking for residents who will stay for two to three years, or who move up through apartments to meet their changing needs, and who are still in residence in 10 years' time."

8.33m

Forecast for London population in 2018, up from 7.66m in 2008

The rules are changing for institutional investors:

Stamp duty:

The tax charge on buying multiple properties has become significantly lighter. Instead of paying stamp duty on the combined value of multiple purchases, the duty is payable on the 'average' value of the properties with a minimum stamp duty charge of 1%.

REITs:

The Chancellor last year announced significant changes to the tax-efficient Real Estate Investment Trust (REITs) regime which will come into force this year. The measures include scrapping the 2% conversion charge upon the creation of a REIT, as well as an ability to list a REIT on smaller stock exchanges. This will make it much cheaper to set up such a trust making it a more attractive option for those considering a residential REIT.

The relaxation of the 'close' company rule, which states that a REIT cannot be controlled by fewer than five parties, is also a welcome change, as this was a potential stumbling block for large institutional investors.

In his 2012 Budget, the Chancellor has also pledged to look at whether to change the tax treatment of income received by a REIT which it invests in another REIT, a further move which could help galvanise activity.

different type of high level property management will become more important.

ASTs

Some institutions cite the use of Assured Shorthold Tenancy (AST) agreements as a disincentive for investors, as although there has been a recent trend towards longer two-year tenancy agreements, these are still much shorter than long leases which dominate the commercial sector. However, this highlights a potential mis-understanding of the market dynamic. The number of tenants in the residential sector and the depth of demand mean that length of tenure is not an obstacle, as for the right blocks in the right locations, new tenants can easily be found.

Returns

The final, and perhaps the most important, obstacle for institutions wanting to invest in the private rented sector at present is the issue of income returns.

While the growth in residential capital values over the last 10 years makes the sector attractive, these capital values, especially in the most desirable areas, make the relatively low income returns look lean. Management costs put a further squeeze on income, which can deter investors active in the commercial sector where relative income appears higher.

In addition, some investors are concerned that capital values are determined by the sales market, rather than the investment market and are thereby divorced from income streams. This model favours buy-to-let investors whose business models are generally less reliant on income streams than large institutional investors.

Build-to-let

One way to acquire sufficient mass of the correct stock is for investors to become involved in developing units, in a 'build-to-let' model.

But there are price pressures on this model too.

It is capital intensive as it does not allow for units to be sold in phases during development to release capital, or even at the end of the project. Housebuilders feel this keenly, and this is where there is extra scope for them to work with investment funds who could back the project.

Although the build-to-let model means investors will not have to pay the developers' premium if they purchase an already completed development, land prices in the most desirable locations are still high, which erodes income yields.

As can be seen from our London map on page 8, yields (the relationship between rents and capital values) become more attractive as one moves from the most expensive central areas. With the majority of institutions focussing their attention on the London market, this is a critical issue.

One well-debated solution for lowering the cost of land – by entering into a partnership with a local authority to supply the land in return for an equity stake in the development – is unlikely to work in London. This sort of arrangement is usually undertaken if local authorities cannot raise money by selling the land at market rates for development – something which most local authorities in London can certainly do, given the demand for property in the capital.

Another much discussed option to cut land costs is the creation of a new class of planning for rental property. This would have a two-fold result of cutting the need for affordable housing and would also reduce land prices for development. But the flip side of this would likely be limited growth in underlying capital values as such a planning class would likely cut off the opportunity to sell the individual units in the future.

An alternative, as outlined by James Mannix on page 6, is to move away from traditional development, and to build a property solely designed for lettings, where rental income would be maximised, boosting yields.

In summary, our discussions with those across the industry have shown that the demand is strong for rented accommodation, and that institutions in particular can see the advantages of investment in this asset class.

The sector may well be on the cusp of significant change since some of the greatest hurdles to investment have been somewhat eroded by recent developments and rule changes – in particular to the REITs regime.

In the near term, institutional involvement in the sector is likely to be opportunity driven and over time this will create a critical mass of units and sector experience which could lead to a more significant scale of investment.

"The ideal rental building will look very different from what is currently produced for the sales market."

James Mannix, Head of Residential Investment

A blueprint for residential investment in London

James Mannix, Head of Residential Investment at Knight Frank, explains:

A major problem facing institutional and other investors who are keen to get involved in the private rented sector is that income returns appear poor. A major cause of this is that the units are designed for the needs of the sales market rather than the rental market.

The issue of poor income becomes acute in prime areas since the sums tenants will pay in rent varies relatively little between central areas. This contrasts with the sales market where buyers are driven by emotive factors rather than strict calculations of monthly outgoings as in the rental market. As a result, sales prices can vary significantly between areas and depending on their position and aspect. A flat with a river view, for example, will sell for much more than a flat in the same building without a river view. This variation does not exist to the same degree in the rental market.

Most young professional tenants in good areas of central London have a budget of between around £200 and £350 per week per person and will not be prepared to exceed their budget. Once prices exceed these levels, the prospective tenants are likely to look elsewhere for cheaper accommodation whether it be a smaller flat, or an alternative location.

As a result of these dynamics, rental yields in good areas of central London look low.

So what is the answer to the problem? Given that location and the cost of land cannot be controlled, and ignoring any planning or tax break that may provide a short-term (and unreliable) solution then the answer must lie in the type of accommodation which is being provided.

The challenge for investors is to design a building for the rental market in London which caters for the demands of the tenants and produces good income return.

This building will need to disregard the safety net of the sales market and may, as a result, look very different from the residential buildings which are currently produced.

The basic needs of the rental market are as follows: 1. low monthly rent per person; 2. a central location; 3. good quality accommodation; 4. availability of additional services; 5. communal facilities; 6. transport accessibility.

On this basis, this specially designed building would have between 500 and 2,000 units which would support a high level of service. Most of the units would be for solo (or couple) living, and be around 175-250 sq ft in size to keep the price point low. There would potentially be some larger units on the higher floors, designed for households sharing rent.

Tenants would enter through a large hotel-style lobby on the ground floor, with lounge seating a concierge desk.

In addition to the concierge service, tenants would also benefit from other services such as basement storage, large lifts for moving furniture in and out of the building and Wi-Fi access. There would be an additional menu of services available for a charge, such as laundry services, linen charges, cleaning, room service, gym and food deliveries or fridge stocking. The income from these services would help boost revenue.

While most of the units would be let on standard AST leases, there would also be a short-let licence to enable a proportion of units to be booked on an overnight, weekly or monthly basis, again generating higher revenue.

This type of building will substantially increase the rental returns offered over traditional apartments.

How income yields can be boosted:

Traditional model:
800 sq ft 2-bedroom flat, rented out to 2 people for £300 per week each
Annual income = £31,200

Blueprint model:
4 single units each at 200 sq ft at £300 a week
Annual income = £62,400

Rental market forecast

The private rented sector is growing in the UK. While there will be no cooling in the British love-affair with homeownership, the changing economic and social norms indicate that demand for rental property, especially in urban centres, will continue to rise in the coming years.

The mortgage constraints evident since the financial crisis in 2007 and 2008 have prevented some prospective first-time buyers from climbing onto the property ladder and home movers from moving up the ladder.

Instead those yet to climb onto the property ladder are moving into rented accommodation or staying there for longer, or 'renting to buy', helping push the private rented share of all properties in England up to 16.5% in the year to April 2011. While the constraints in the mortgage market should ease somewhat in the coming years as money flows around the economy more easily, we do not expect a return to the mortgage lending seen in the mid-2000's, where borrowers could get a mortgage with little or no deposit at all. Banks will continue to concentrate on their capital base, as they ready themselves for the new Basel III regulations.

As a result, potential first-time buyers, many of whom are already saddled with large student debts, will have to save up for a hefty deposit. Those leaving university from 2015 will have additional debts, having paid up to £27,000 in tuition fees.

Yet it is worth highlighting that even during the downturn in mortgage activity in recent years, the proportion of first-time buyers has remained close to the 10-year average of 37%, according to the Council of Mortgage Lenders. As the economy recovers, which may not happen convincingly for several years, the number of first-time buyers should rise again. But the housing market will not reach the heights of activity seen back in 2007 for some time, meaning that there will be an increased number of people who might have expected to buy a home entering the private rented sector or staying there for longer.

Added to this short-term shift in dynamics in the market is the longer-term problem of a chronic under-supply of homes. Ideally 200,000 to 250,000 homes need to be built each year to meet the needs of the growing population, but house building has fallen to the lowest levels since World War II, with fewer than 110,000 homes completed last year. This lack of building is not only helping to underpin house prices but is putting upward pressure on rents as demand outstrips the number of properties available, especially in the most desirable areas.

Rental growth is also dictated by regional employment growth, as mobile workers make up such a large sector of the market, and earnings growth is an additional driver, informing landlords' rent negotiations.

But there is also a natural 'ceiling' to rents dictated by affordability constraints.

Tenants who do not want to pay more can simply move to a different area where rents or other costs, such as council tax, are more affordable.

There is evidence that many tenants are bumping against this ceiling at present, with several consecutive monthly declines in average UK rents. We forecast this will lead a slowing in the annual growth of rents this year in the mainstream market. But as employment and earnings growth picks up, we foresee a return to rental growth more akin to that seen over the longer term.

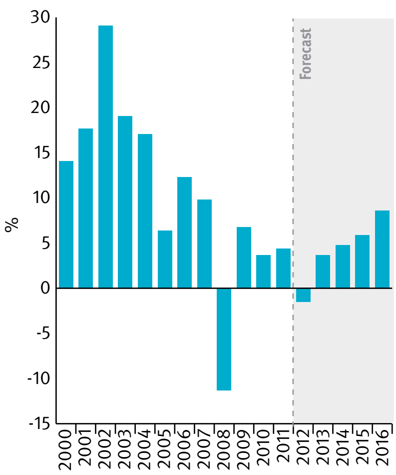
The prime central London rental market is more heavily dependent on the financial sector, and employment of overseas workers by UK companies. There is no doubt that employment levels have dropped over the last year, and this has started to feed back through into rents, with prime rents also falling for several months. However it is worth noting that rents in the 'core' market have fallen much more modestly than rents at the very top-end of the rental scale, as tenants down-scale their living requirements, and we see this market leading the way over the next few years.

Figure 5
Prime London annual price growth forecast

	2010	2011	2012	2013	2014	2015	2016
Prime Central London	15.7%	6.5%	1.0%	5.0%	6.0%	4.5%	4.5%
UK	3.1%	4.5%	2.0%	4.5%	5.0%	4.0%	4.0%

Source: Knight Frank Residential Research

Figure 6
Total returns
UK total return, based on capital growth and net income return



Source: Knight Frank Residential Research

Figure 7
Gross yields
Average annual gross yield, UK

Source: Knight Frank Residential Research

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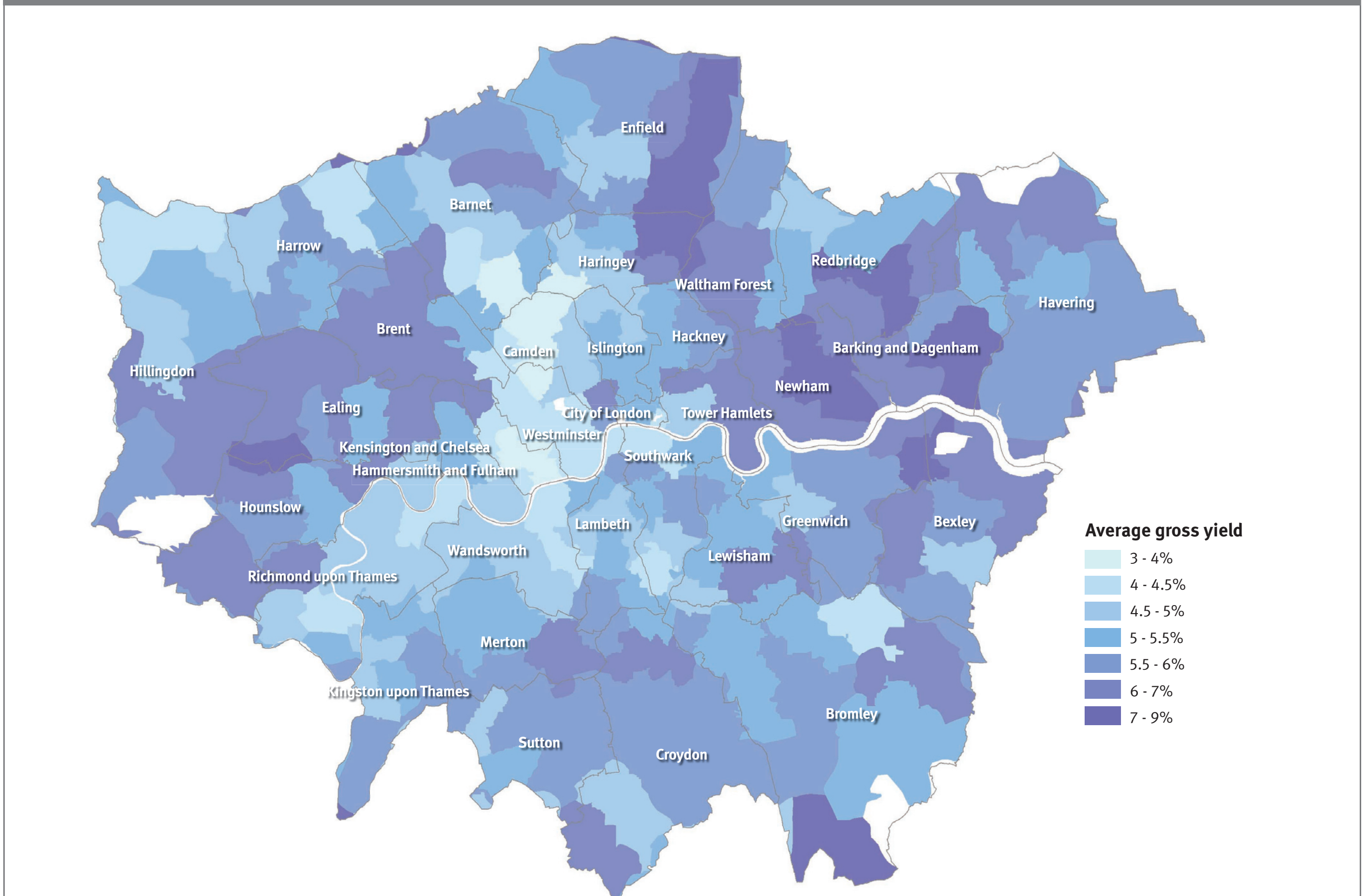
Figure 8

The London yield map

Average gross yields across London, March 2012



Source: Knight Frank Residential Research

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