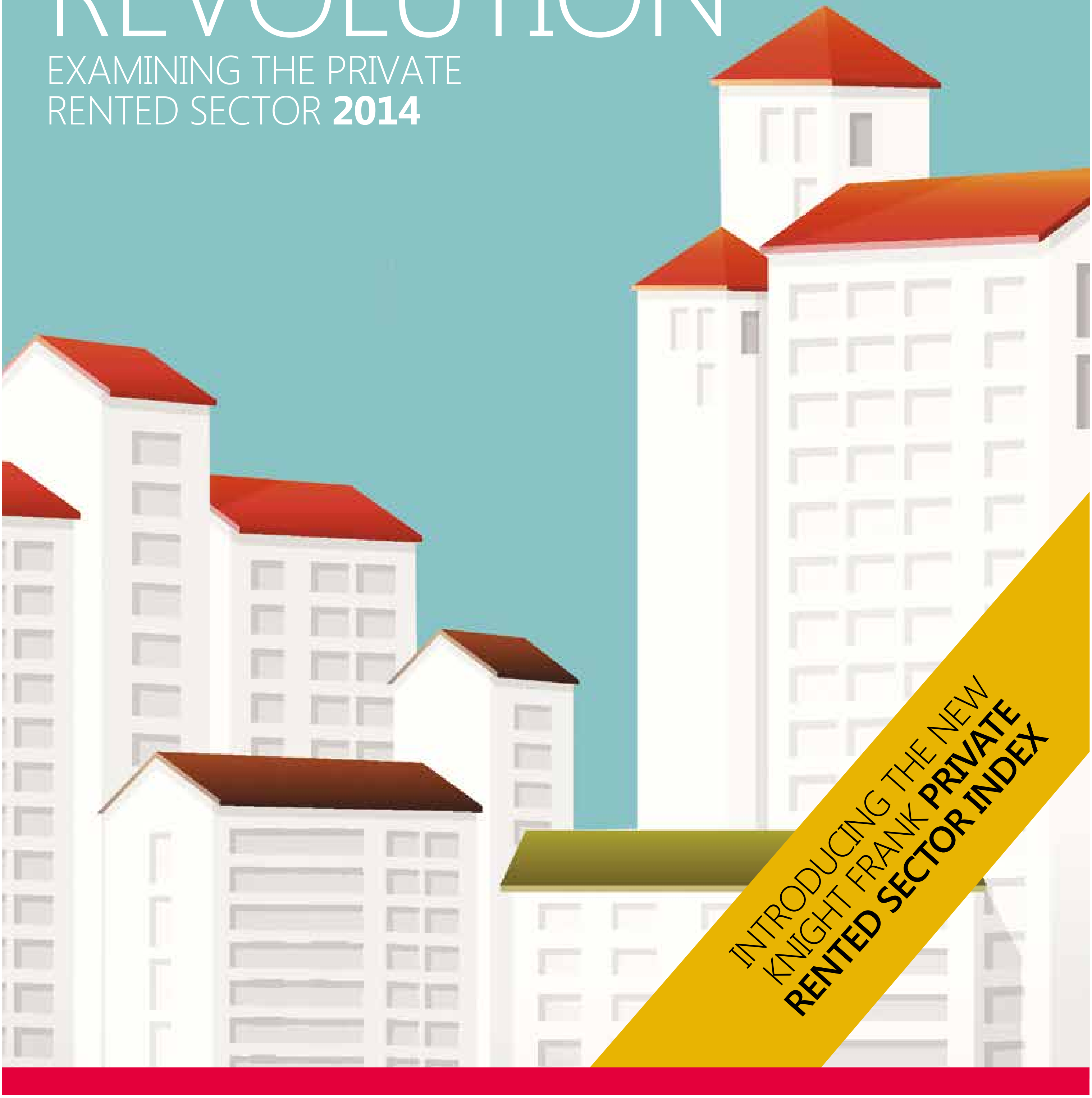
RESIDENTIAL RESEARCH

Knight Frank

THE RENTAL REVOLUTION

EXAMINING THE PRIVATE RENTED SECTOR **2014**



INTRODUCING THE NEW KNIGHT FRANK **PRIVATE RENTED SECTOR INDEX**

THE PRS: A GROWTH STORY

INSTITUTIONAL INVESTMENT IN PRS

RENTAL PERFORMANCE 2013

"Institutional investors are starting to look at the regions given an increased emphasis on income yields."

GRÁINNE GILMORE
Head of UK Residential Research

134%

Increase in dwellings in private rented sector in UK 1991-2011

INTRODUCTION

The UK's private rented sector (PRS) has more than doubled in size in the last 14 years, and it is set to keep expanding. Within the sector, there is increasing scope for institutional investment, which we see gathering momentum in the future.

In this report we examine the supply and demand factors in the private rented sector, and consider how these might move in the future. We also track how demand in the PRS is robust in urban centres, and that targeting workers looking for flexible tenure may at this stage offer the biggest benefit to investors.

We also introduce **Knight Frank's Private Rented Sector Index**, measuring the yields and capital growth of rental blocks in the UK's key rental markets.

We have monitored the private rented sector investment market in London, Birmingham, Manchester, Bristol, Leeds and Glasgow over the last year, and can now share the results of our findings:

- **Residential rental blocks delivered average capital growth of 6.4% in 2013**
- **Average initial gross yields in Q4 2013 were 6.6%**
- **Rental growth averaged 2.9% across the markets covered by our index**

Our data also illustrates how competition among investors for rental blocks has affected the discounts on offer with the average discount shrinking from 19.8% at the beginning of 2012 to 11.2% in the final quarter of 2013.

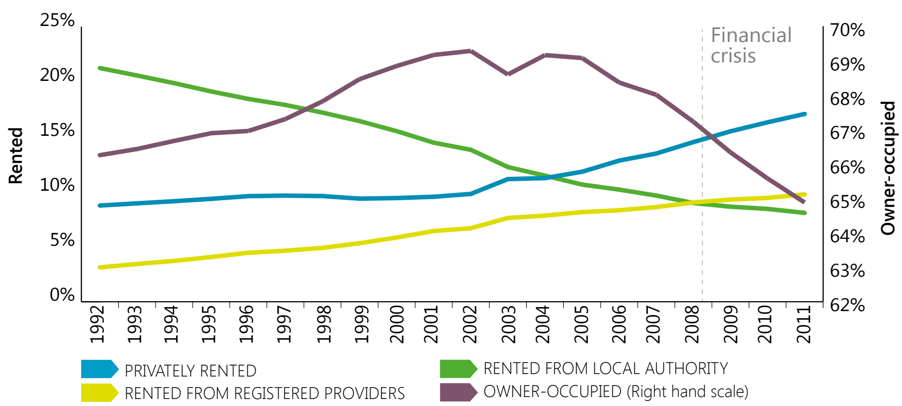
There is more detail and a full geographical breakdown from our new index on pages 7-11.

James Mannix, Head of Residential Capital Markets, also shares his views on how investors can make the most of current market opportunities on page 12.

The idea of institutional investment in the rented sector to more closely mirror the tenure trends of other countries such as the US and Germany has been around for some time. But there has been significant progress in this area over the last year or two. Although moving to a market where institutionally managed rental blocks become much more common will necessarily take some time, it seems as if the market is now on the cusp of moving towards this goal.

Investment will not only be targeted at existing blocks, but also development opportunities and buildings which have the opportunity for change of use.

FIGURE 1
How the private rented sector has grown
Proportion of dwellings, UK



Source: Knight Frank Residential Research / DCLG

THE PRIVATE RENTED SECTOR IN CONTEXT

More than 10 million people – around a sixth of the UK population – are living in privately rented accommodation. The sector accounts for around four million households, some 17% of the total number of households in the UK. We forecast that the number of households in the private rented sector will continue to rise over the next 10 years.

Drivers of growth

It has sometimes been said that the growth of the private rented sector has been purely down to the clampdown in mortgage lending after the financial crisis. There is no doubt that this event, which forced would-be homebuyers into the rental sector – creating "Generation Rent", has had a significant impact in the market. However as figure 1 shows, the growth in the private rented sector preceded the financial crisis, indicating that other factors were at play, a mix of the scrapping of rent controls, the proliferation of buy-to-let mortgages and rising house prices in relation to earnings.

It is also worth noting that in the wake of the 2007 financial crisis, those with high levels of equity or cash were much less affected by the credit crunch, and as such, were in a position to invest in rental properties, underlining the role that equity has played in the expansion of the sector.

On the demand side, population growth has outstripped the delivery of new homes for decades, creating a structural undersupply of accommodation across the country. Added to this, increased labour mobility has meant a rise in demand for rental accommodation among workers looking specifically for flexibility of tenure especially in urban centres (figure 2). Almost 50% of all households in the PRS are classified as 'high income', and a third of these have children. This underlines that increasing numbers of families are also moving into the private rented sector – it is being seen as more of an alternative to home ownership. The total proportion of homeowners in the UK fell between 2001 and 2011 for the first time in a century.

Housing affordability remains a key factor in the growth of the PRS. House prices rose more quickly than earnings in the years leading up to the financial crisis, helping to push house price to income ratios to new highs and putting the hopes of home ownership beyond many. Although the house price to income ratio has fallen slightly since the financial crisis, it is still well above the long-term average.

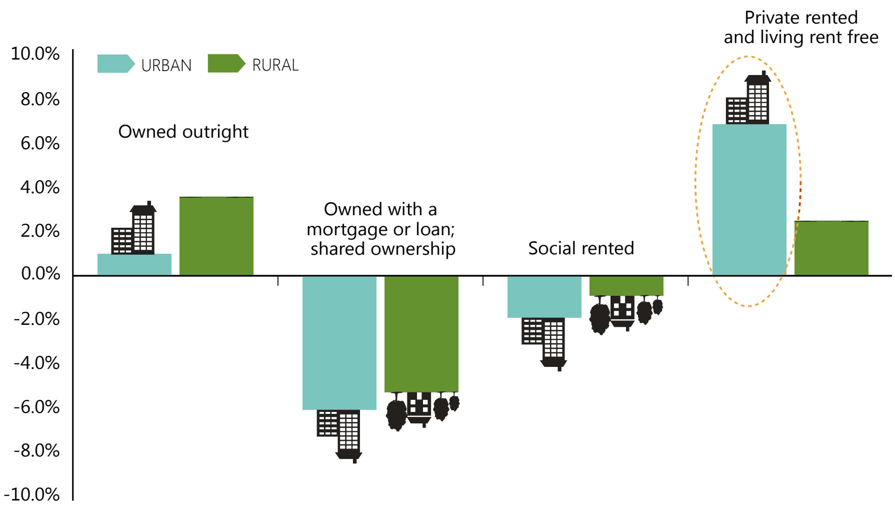
The rise of the PRS has also coincided with a dramatic fall in the number of homes being rented out by local authorities, in large part due to the selling of local authority stock coupled with a lack of new development. While the number of rental properties offered by registered providers, such as housing associations, has risen, (as shown in figure 1) the PRS is now also meeting housing need to a greater extent at the lower-cost end of the rental scale. We expect this trend to continue.

The recovery of the UK economy over the last year has increased confidence in the housing market, and mortgage lending has started to pick up. A significant factor in this was the Funding for Lending Scheme for mortgages, although this has now ended. The introduction of Help to Buy, especially the second part of the scheme has also played a part. Help to Buy 2 will ease the

10 m

Number of people living in the private rented sector, UK

FIGURE 2
Change in tenure in urban and rural areas, 2001-2011
Percentage point change



Source: Knight Frank Residential Research / ONS path to home ownership for borrowers with smaller deposits over the next few years. However, the chances that the full £12.5 billion in mortgage guarantees offered under the scheme will be used currently look slim, as banks and building societies are being vigorous in their affordability checks. It is also possible that the scheme may be scaled back by the Bank of England. In essence, Help to Buy is unlikely to reverse the direction of travel of the private rented sector.

As the economy starts to gain momentum, urban areas are where job creation is likely to be most robust, increasing the need for rental accommodation for a new generation of workers to add to those already in the private rented sector. Our index focuses on London, Leeds, Glasgow, Bristol, Birmingham and Manchester (pages 8-11).

We forecast that the number of households in the private rented sector will grow to more than 5 million by the end of 2016. Help to Buy may affect the pace of growth in the short-term in some markets, but this will be countered when interest rates start to rise – which many anticipate will happen next year. While the economy is set to gather momentum in the coming years, helping earnings growth, rising rates will put even more pressure on those hoping to buy a home.

This could encourage the 'equity-rich' to move further into the PRS, increasing stock levels, and further enhancing the growth of the sector.

FIGURE 3 **Growth in the UK private rented sector**

Source: Knight Frank Residential Research / DCLG

PRS DYNAMICS

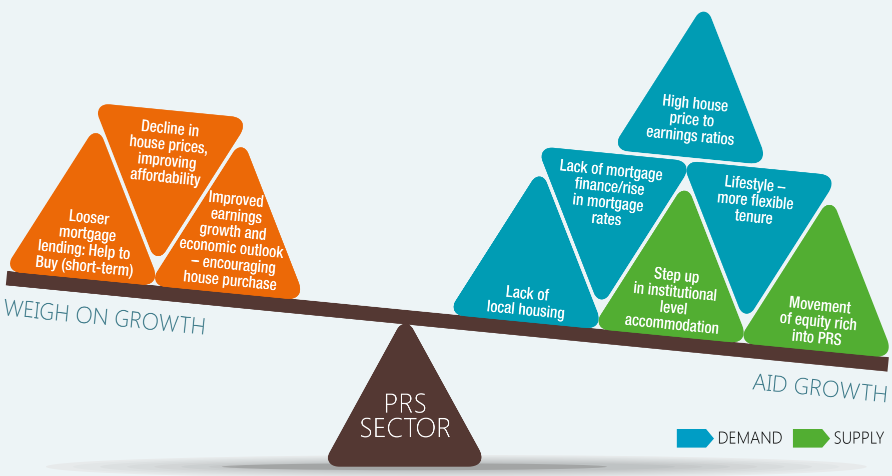
Housing supply is limited, and is set to remain far below levels which can begin to address the structural undersupply of housing in the UK. While large-scale rental development will boost supply in this sector to some extent in the coming years, the overall size of the private rented sector will still be linked to the movement of equity in the housing market.

The elevated house price to earnings ratio – has acted as a spur growth in the private rented sector and will likely continue to do so. The demand created by the difficulty in accessing mortgage finance has been another key feature of the market, but this will to some extent be eased temporarily by the Government's new Help to Buy scheme. However when interest rates start to rise, accessing finance will again become more expensive and will likely spur more demand for rental property.

There will also be continued demand for rental property as a more flexible tenure, especially among urban workers.

If house prices were to fall sharply in the future, this could weigh on the growth of the rental sector as home ownership becomes more affordable for potential buyers. At the same time however, a steep fall in house prices could lead to lower land prices, which could swing the development economics back in favour of those developing new PRS schemes.

FIGURE 4 **Key factors affecting the PRS**



Source: Knight Frank Residential Research

MARKET ACTIVITY

The demand for rental property has been reflected in rental growth in recent years (figure 5).

It is clear that the movement of equity and the strength of the residential sector as an investment proposition have helped boost the private rented sector in recent years.

The performance of residential property as an investment class has started to attract the attention of large institutional investors such as pension and insurance funds. They join the buy-to-let landlords and the larger landlords already in the market. These institutions have traditionally focused on commercial property, but are now looking at the residential sector with much more interest.

As shown in figure 5, rental growth tracked earnings growth, and outpaced inflation up until the financial crisis – and as the economy recovers after the financial crisis, this trend is likely to continue making it an attractive option for institutions looking for long-term income plays.

There has also been a push by policymakers to encourage investment in the private rented sector, which, after all, will help boost housing supply which is so lacking in the UK.

As part of this initiative, the Government last year set up the Private Rented Sector Taskforce, a group of property specialists who are working to bring together investors, developers, housing associations, local authorities and policymakers to establish institutional investment as a going concern in the UK.

The Taskforce says it has identified a pool of more than £10 billion which institutions would like to invest into the PRS. If this investment is realised, it could lead to more than 50,000 units coming into the sector.

Some institutions, such as Ivanhoe Cambridge, a Canadian pension fund, has been investing in existing residential blocks via their partners, Residential Land, for some time, and this trend is set to widen. The interest of overseas wealth funds in the PRS has been well demonstrated, not least by the move by the Abu Dhabi Investment Authority to invest £300 million into Fizzy Living, a specialist PRS operator late last year.

Essential Living, a UK developer and operator of rented homes with a pipeline of over 1,500 rental properties across Greater London, are backed by $200m of equity from M3 Capital Partners, who manage U.S. Institutional funds, again underlining the global interest in the UK PRS.

There has been further exploration in "build to rent" across the industry. Rather than purely building units for sale, developers, backed by institutions, are increasingly looking at developing residential blocks designed specifically for the rental market.

Some of the first to become involved were Qatari Diar and Delancey, who, after redeveloping the East Village, the former Olympic Village, opted to rent out the units.

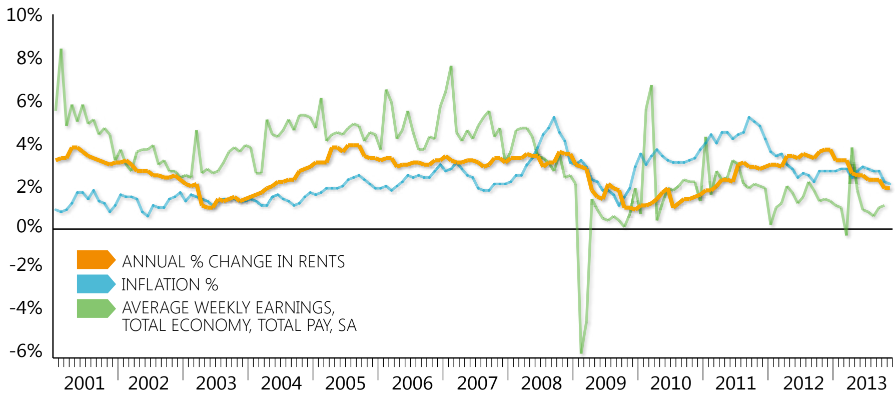
While the Olympic park delivered existing scale, achieving this level of scale elsewhere in the UK is tricky. For institutions to become key players, they need high levels of stock – preferably blocks of rental units or units clustered together, rather than properties pepper-potted around a city or region.

This question of scale is just one of the reasons why policymakers have stepped in to kick-start the market, with the Government offering inducements to build under its £1 billion Build to Rent fund. The first recipient of this funding was Centenary Quay in Southampton, which will be developed by Crest Nicholson. More than 100 of the 1,600 unit development

£10 bn+

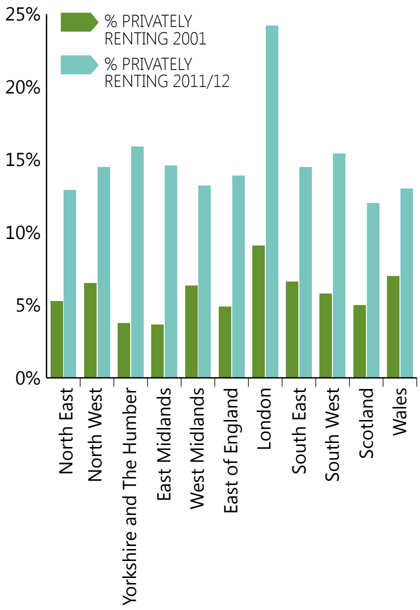
Potential pool of institutional investment for PRS, identified by the PRS taskforce.

FIGURE 5
Annual UK rental growth, compared to inflation and earnings



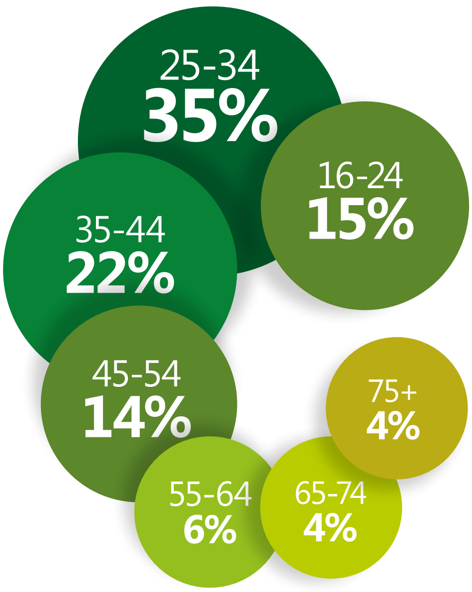
Source: Knight Frank Residential Research / Macrobond

FIGURE 6
Regional growth in private rented sector
2001-2011



Source: Knight Frank Residential Research / DCLG / ONS Census Scotland, Census Wales

FIGURE 7
Average age of tenants in private rented sector



Source: EHS 2011/12

will be homes in the private rented sector, and these will be sold to and managed by A2 Dominion Group, one of the largest housing associations in the UK. This deal is an example of the key role that housing associations can play in this developing part of the PRS sector.

The interest in this sector is again underlined by the scale of interest in the Build to Rent fund. Applications worth £4.2 billion were received for the £1 billion funding, suggesting that the Government should perhaps consider extending the £1 billion limit. It is also worth noting that 50% of units in the applicant schemes were outside London and the South East, underlining the appeal of the PRS in other key markets across the UK, which can offer higher income yields.

It is understood that the Government is also set to select an aggregator for the Loan Guarantee Scheme shortly, although direct discussions over these guarantees have already started with some parties.

Given the undersupply of housing in the UK, the demand for privately rented property is set to be high. Yet, such schemes must be carefully placed, and priced, in order to ensure returns match investment requirements. Urban centres have shown the biggest growth in the PRS (figure 2), and as the UK emerges from recession, this trend is set to continue as job creation picks up.

Investment considerations

There are some key differences for institutions investing in residential property, compared to their experience of commercial property, which has resulted in a sedate pace of entry into the market.

The idea of many short-term tenants in a residential block, as opposed to a single longer-term tenant, or several occupants, in a commercial building has proved a sticking point for some. However the idea that many "rolling" tenants can provide as much security of tenure if not more than one single tenant is starting to gain currency. After all, if a single tenant in a commercial building defaults, all rent owed could be lost, and the relatively time consuming search for a new tenant must begin. However, if one tenant in a residential block moves out, another can be found quickly, and the overall income stream is relatively unaffected.

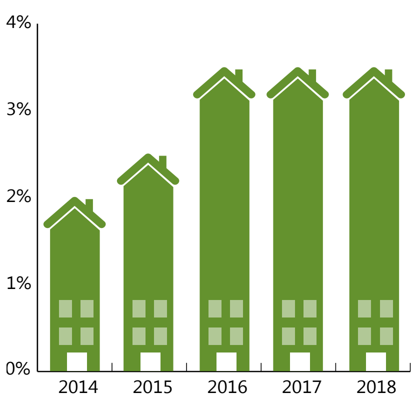
The lack of constriction around the timing of "rent reviews", as well as turnover of tenants, means that the PRS also provides a real-time inflation hedge, as rents tend to grow in line with or at rates above inflation (figure 5). It is increasingly being seen as a source of long-term income among investors.

Reputation is another key factor. While the institutional PRS model is well-developed in some other European countries and the US, some funds looking at the market in the UK may be entering it for the first time. As such, they must navigate being responsible for tenants' homes, with the management issues arising from that. In some cases they will decide to hand over the management of the schemes to experienced third parties. In other countries, institutional investment resulted in a much more professional lettings market – such a development in the UK could help improve the standard of rental accommodation across the board.

There are other key advantages for PRS developers and investors. In large mixed-use schemes, one or more blocks of privately rented stock can be a major attraction, helping to bring the area to life immediately. All prospective tenants and purchasers will also be reassured that the development will remain in top condition; after all, this is necessary to attract new tenants. As a result, units will be built to the very highest specifications and maintained to these levels.

As James Mannix highlights later in the report, there is real opportunity for investors to "brand" their rental units, much like student accommodation or even boutique hotels, making them instantly recognisable as a reliable source of housing.

FIGURE 8
Forecast for UK annual rental growth



Source: Knight Frank Residential Research

THE PRIVATE RENTED SECTOR INDEX

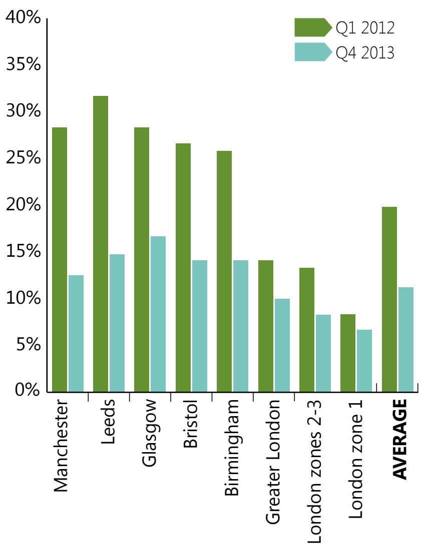
Our PRS investment index shows the performance of rental units in residential blocks in key rental markets in the UK: Leeds, Bristol, Birmingham, Glasgow, Manchester and London.

Our index is comprised of rental data collected from properties classed as prime, median and economic. The classification of these blocks takes into account their location, but is perhaps more a reflection of the type of unit on offer – a prime block will have the most desirable units. In contrast, economic blocks are the least expensive for tenants, but their capital value is also lower, indicating higher initial yields for investors.

These key cities are expected to experience a pick-up in economic activity in the coming years – with the forecast pace of growth in Gross Value Added (GVA), a measure of economic growth, outpacing the national average, especially from 2015 onwards.

Our index is not designed to be a benchmark for the industry – but we hope that it will be a useful source of information and help inform key participants in the burgeoning PRS sector.

FIGURE 9
Average discounts on investment blocks



Source: Knight Frank Residential Research

Results

The index shows that average rents paid rose by an average of 2.9% last year – ranging from 0.4% in London zone 1 to 5.27% in Manchester. Capital values for residential blocks rose by an average of 6.4% last year, taking the average gross yield to 6.6% in Q4 2013. Initial yields have not only been squeezed by rising capital values, but also the erosion of the discount on offer for the purchase of residential blocks. At the start of 2012, investors could obtain a discount of more than 30% on the full capital value of some residential blocks reflecting the minimal activity in the market – especially the regions. Today, the discounts on offer are between 7% and 16%, a reflection of increased activity. If the discount is factored into the capital growth of the rental blocks, it rises to 13.8% for 2013. The total return on investment private rented sector blocks in our index was 11.3% in Q4 2013.

For our index we have used an average Gross to Net of 25%, to cover the costs of maintenance, lettings management, repairs, void periods, insurance, utilities and replacement of fixtures and fittings.

6.6%

Average initial gross yield for PRS, Q4 2013

Knight Frank PRS Index

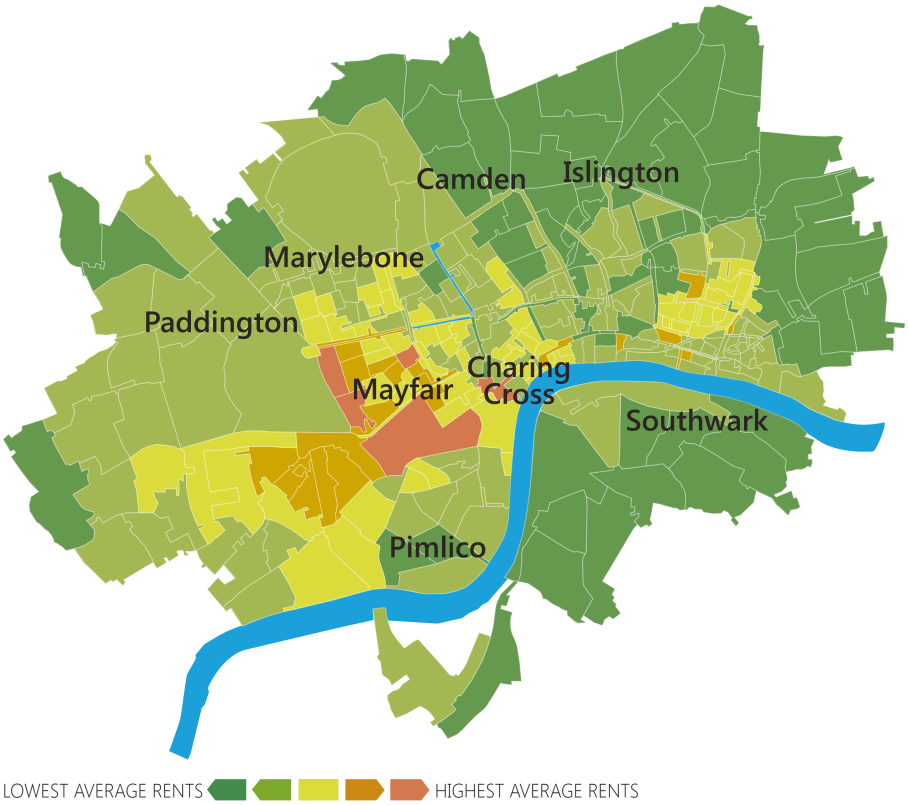
FIGURE 10
Knight Frank PRS index Q4 2013

Average initial gross yield Q4 2013 (Q4 2012)	6.6%	(7.2%)
Average initial net yield Q4 2013 (Q4 2012)	4.9%	(5.4%)
Average capital growth year to end Q4 2013	6.4%	
Capital growth incl discounts year to end Q4 2013	13.8%	
Average rental growth year to end Q4 2013	2.9%	
Total return year to end Q4 2013	**11.3%**	

Source: Knight Frank Residential Research

LONDON ZONE 1

More than 30% of all households in inner London are in the PRS. Rental growth for apartments in rented blocks has been modest in central London, but capital growth is been strong, boosting total returns.



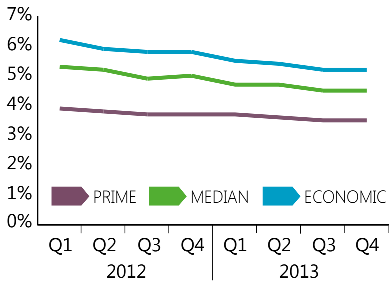
Rents based on 2-bedroom apartments, average rents in 2013. Source: Vizzi

PRS index

AVERAGE RENTAL GROWTH*	0.4%
AVERAGE CAPITAL GROWTH*	9.5%
INITIAL GROSS YIELD RANGE**	3.5%-5.2%
AVERAGE DISCOUNT Q1 2012	8%
AVERAGE DISCOUNT Q4 2013	7%

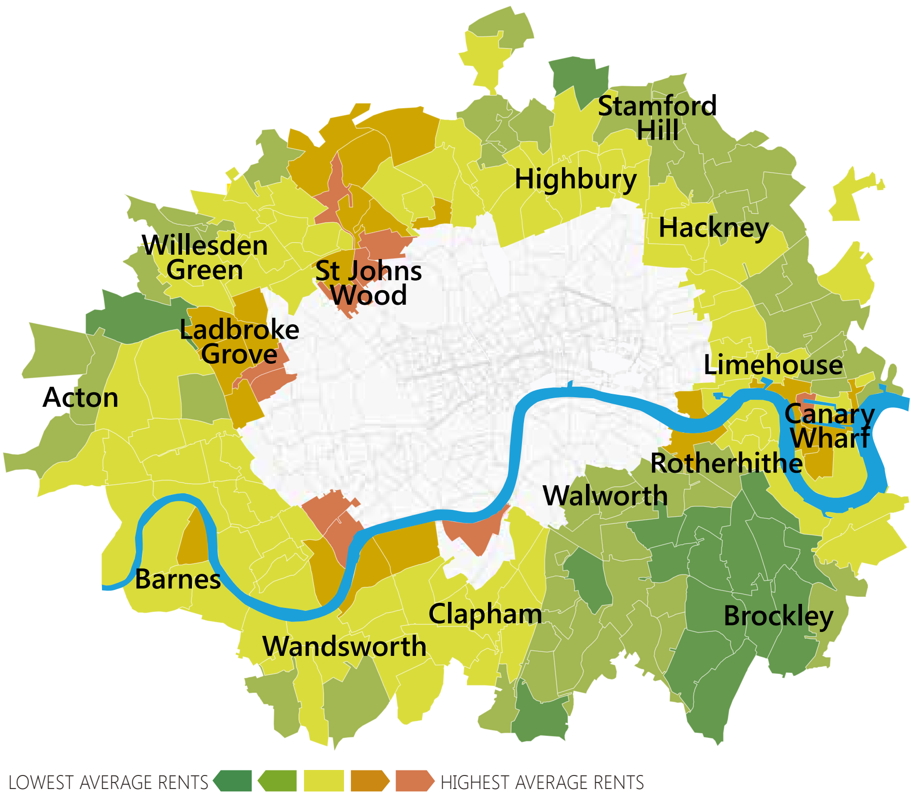
*Year to Q4 2013 ** Q4 2013

Gross yields



LONDON ZONES 2-3

This is one of the key areas of interest for investors, with higher yields on offer than central London, yet good transport links to the centre of London in many areas. The total number of households in London is expected to grow by 16% between 2011 and 2021.



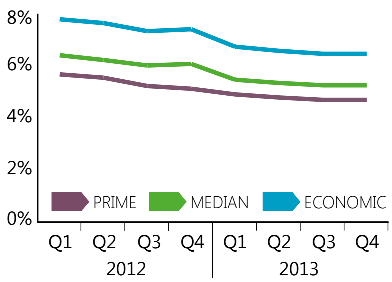
Rents based on 2-bedroom apartments, average rents in 2013. Source: Vizzi

PRS index

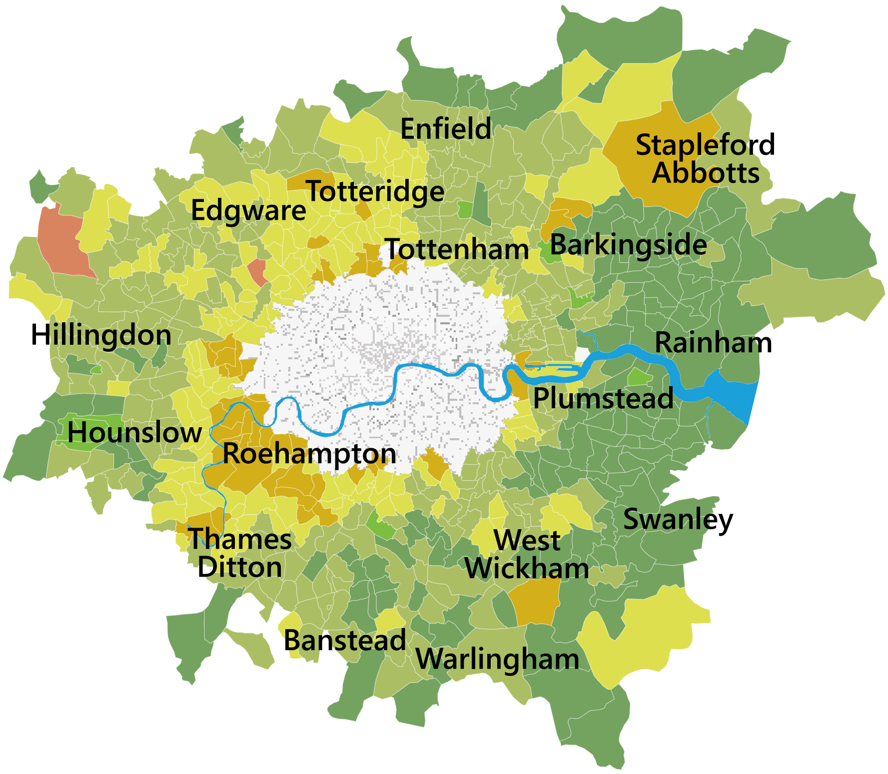
AVERAGE RENTAL GROWTH*	0.8%
AVERAGE CAPITAL GROWTH*	9.7%
INITIAL GROSS YIELD RANGE**	4.7%-6.5%
AVERAGE DISCOUNT Q1 2012	13%
AVERAGE DISCOUNT Q4 2013	8%

*Year to Q4 2013 ** Q4 2013

Gross yields



LONDON ZONES 3-6



LOWEST AVERAGE RENTS — HIGHEST AVERAGE RENTS

Rents based on 2-bedroom apartments, average rents in 2013. Source: Vizzi

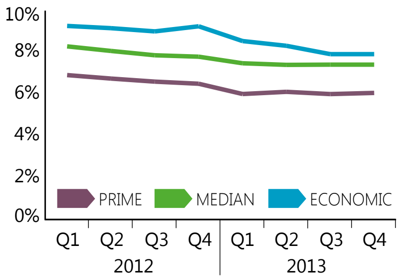
A fifth of households in outer London live in the PRS, and economic growth in London as a whole is set to far outpace that in the UK. Employment across London has risen by 1.5% over the last year.

PRS index

AVERAGE RENTAL GROWTH*	3.4%
AVERAGE CAPITAL GROWTH*	10.2%
INITIAL GROSS YIELD RANGE**	6.1%-7.9%
AVERAGE DISCOUNT Q1 2012	14%
AVERAGE DISCOUNT Q4 2013	10%

*Year to Q4 2013 ** Q4 2013

Gross yields



BRISTOL

LOWEST AVERAGE RENTS — HIGHEST AVERAGE RENTS

Rents based on 2-bedroom apartments, average rents in 2013. Source: Vizzi

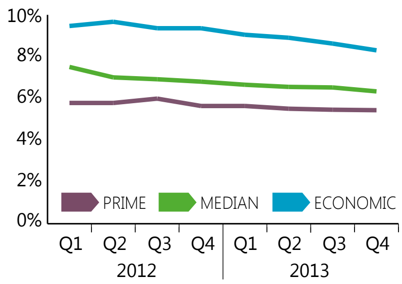
Firm rental growth reflects the demand for rented accommodation in the city, where nearly a quarter of households are in the PRS. The total number of households in Bristol is expected to increase by 11% by 2021.

PRS index

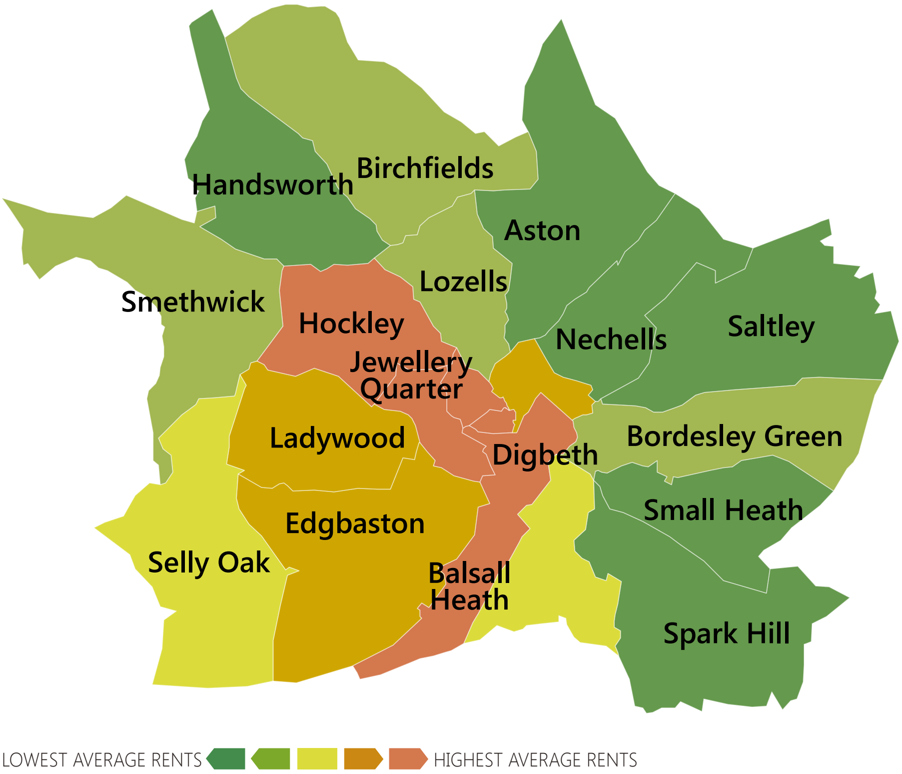
AVERAGE RENTAL GROWTH*	4.6%
AVERAGE CAPITAL GROWTH*	2.7%
INITIAL GROSS YIELD RANGE**	5.4%-8.3%
AVERAGE DISCOUNT Q1 2012	27%
AVERAGE DISCOUNT Q4 2013	14%

*Year to Q4 2013 ** Q4 2013

Gross yields



BIRMINGHAM



Rents based on 2-bedroom apartments, average rents in 2013. Source: Vizzi

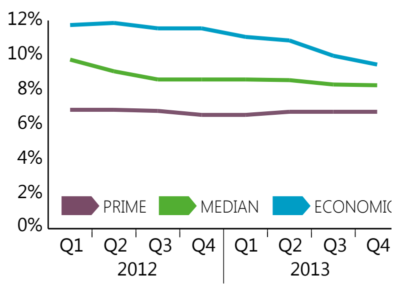
Nearly 18% of households are in the PRS in Birmingham, and private sector job growth in the city centre has outperformed the wider region – 10.8% of private sector jobs in Birmingham are in the city centre, up from 8% in 1998.

PRS index

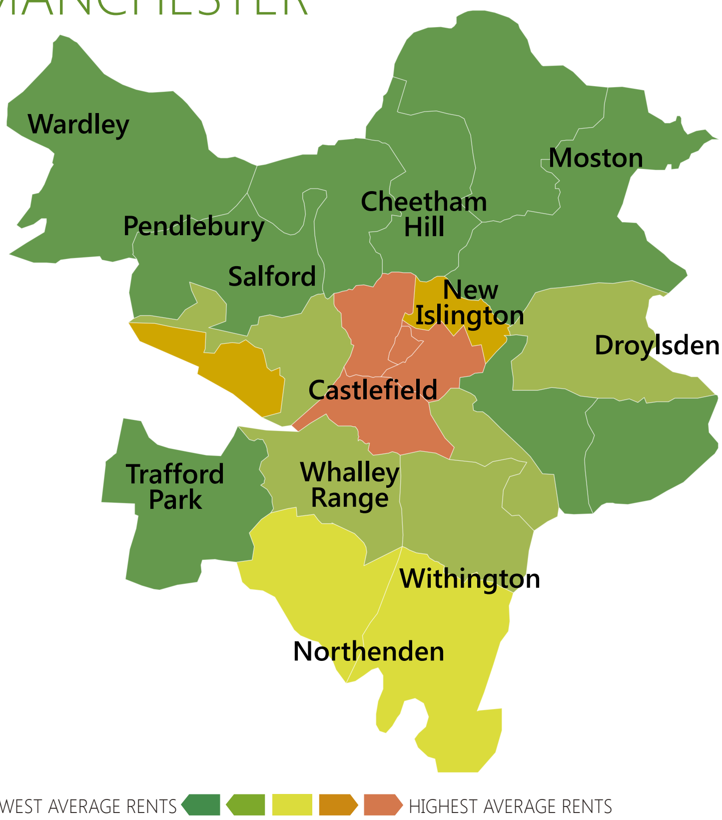
AVERAGE RENTAL GROWTH*	4.1%
AVERAGE CAPITAL GROWTH*	3.7%
INITIAL GROSS YIELD RANGE**	6.7%-9.5%
AVERAGE DISCOUNT Q1 2012	26%
AVERAGE DISCOUNT Q4 2013	14%

*Year to Q4 2013 ** Q4 2013

Gross yields



MANCHESTER



Rents based on 2-bedroom apartments, average rents in 2013. Source: Vizzi

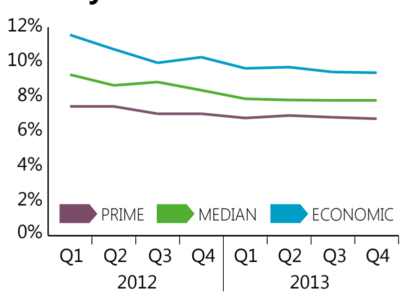
Capital growth has been outpaced by the growth in rents in units monitored by our index boosting yields. Nearly 30% of households in central Manchester are in the private rented sector. The growth in housing stock 2011-12 was among the lowest of any UK city.

PRS index

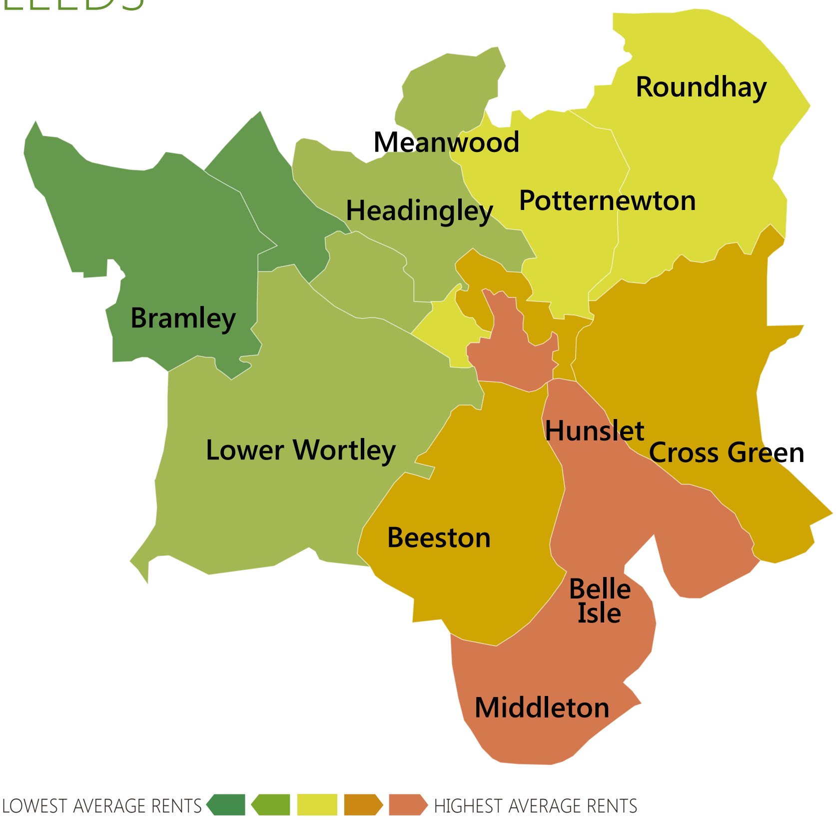
AVERAGE RENTAL GROWTH*	5.3%
AVERAGE CAPITAL GROWTH*	3.1%
INITIAL GROSS YIELD RANGE**	6.7%-9.4%
AVERAGE DISCOUNT Q1 2012	28%
AVERAGE DISCOUNT Q4 2013	13%

*Year to Q4 2013 ** Q4 2013

Gross yields



LEEDS



Rents based on 2-bedroom apartments, average rents in 2013. Source: Vizzi

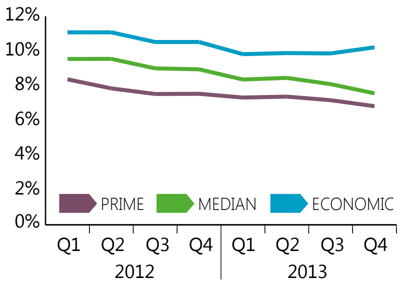
Economic growth in the city is forecast to outperform the UK significantly from 2016. It ranks as one of the top ten cities in the UK for job creation 2010-2012.

PRS index

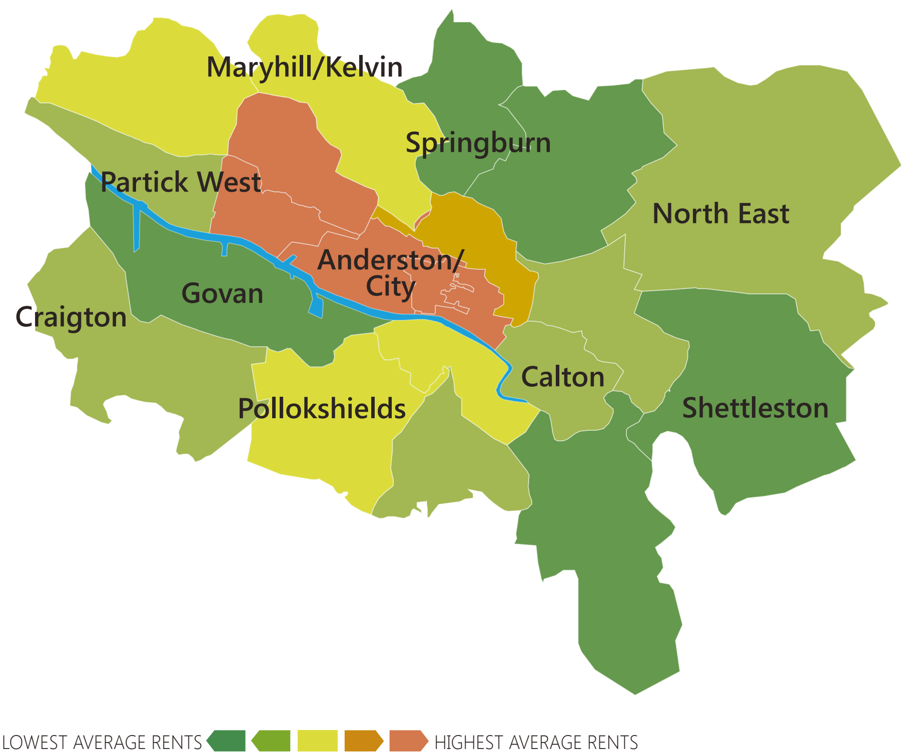
AVERAGE RENTAL GROWTH*	5.1%
AVERAGE CAPITAL GROWTH*	3.0%
INITIAL GROSS YIELD RANGE**	6.8%-10.2%
AVERAGE DISCOUNT Q1 2012	32%
AVERAGE DISCOUNT Q4 2013	15%

*Year to Q4 2013 ** Q4 2013

Gross yields



GLASGOW



Rents based on 2-bedroom apartments, average rents in 2013. Source: Vizzi

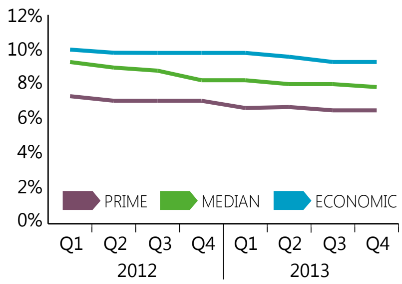
Glasgow is forecast to see one of the largest uplifts in the number of households by 2021, and its economy is also set to outperform that in Scotland as a whole. The population in Glasgow city centre rose by 36% between 2001-2011.

PRS index

AVERAGE RENTAL GROWTH*	4.2%
AVERAGE CAPITAL GROWTH*	3.1%
INITIAL GROSS YIELD RANGE**	6.5%-9.3%
AVERAGE DISCOUNT Q1 2012	28%
AVERAGE DISCOUNT Q4 2013	17%

*Year to Q4 2013 ** Q4 2013

Gross yields



VIEWPOINT

JAMES MANNIX
Head of Residential Capital Markets

There are significant opportunities for investors and developers in the private rented sector. The market is at a juncture where large injections of investment will mean a new level of stock in the market, creating a more vibrant investment market as well as higher quality accommodation for tenants.

Picking the correct location and type of units are critical to ensure the best returns. When it comes to renting, tenants tend to choose accommodation with good amenities and transport links. There is, however, a firm limit on how much they can and will pay for rent on a monthly basis. As can be seen from the accompanying chart, if rent accounts for around a third of gross income, then the largest pool of demand is for individuals paying £1,000 a month or less.

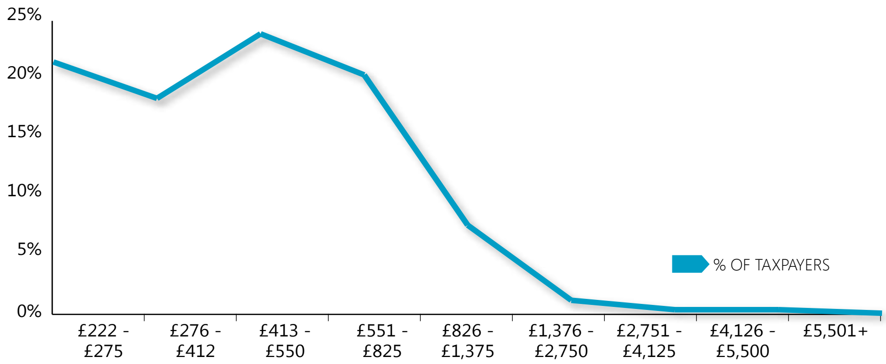
Sometimes the default setting for investors is to look at how to maximise income through rents. But the question should perhaps be how can they create a profitable model taking into account the budget constraints of consumers. The ideal is to pitch the cost of the building where the majority of the demand lies.

For city centre locations, this means more compact units may be more appropriate. Evidence of current schemes show us that there is a deeper pool of demand for smaller – and less expensive – units. They can also provide a higher rental yield than larger units. For tenants, it's about the pounds per week, not the pounds per sq ft.

When thinking about the building, it may be more appropriate to think of a boutique hotel rather than a standard residential block. There will be top-end amenities, such as a roof garden, shared entertaining space and a gym. These shared spaces will maximise the attraction of this "affordable luxury" accommodation.

The boutique hotel analogy also works in terms of branding. There is an opportunity for developers to create a brand in the private rented sector, so that tenants recognise that the units will always be of the highest standard, as will the management of the block.

FIGURE 11
Measuring affordability – by monthly rent
Based on rents at 33% of gross taxpayer income 2012-13



Source: Knight Frank Residential Research / HMRC

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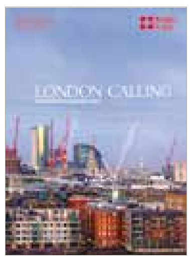

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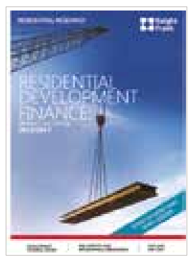

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