

2022/23



Multihousing Report

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SECTION ONE
INVESTMENT

BTR MARKET PROVING ITS RESILIENCE

Investment into UK Build to Rent has been strong so far in 2022, with a significant level of capital committed in the first three quarters of the year.

Almost £3.2 billion of capital has been committed to the UK Build to Rent (BTR) sector during the first three quarters of 2022, up 10.2% year-on-year. Some £1.5 billion was spent in the third quarter alone, the second strongest quarterly investment figure on record and 60% higher than the quarterly average for the last five years.

Investors have been undeterred by a macroeconomic backdrop characterised by soaring inflation and rising interest rates, but higher financing costs since September's 'mini-budget' mean we expect a slowdown in investment in the final three months of the year as some highly leveraged investors take a pause.

That said, deals are still progressing. Investors previously looking to use debt to finance their purchases are drawing on cash reserves with a view to refinancing later. We have identified a further £650 million in deals in solicitors hands which could trade by year-end, which would take the full year investment figure to £3.8 billion. While that would be slightly down year-on-year, it would be 31% higher than the 2016-20 long-term average.

Our Q4 estimate is a conservative one given ongoing strong demand and the large pipeline of deals currently on the market or under offer, but it accounts for the fact that some of these deals may take longer to complete and be

pushed into early 2023. Should access to finance get easier, or other pressures ease, that figure will rise significantly. BTR is a proven counter-cyclical asset class. Investors continue to be attracted to the sector for a number of reasons:

- **Low volatility and resilience of the rental market in times of economic turbulence;**
- **Structural supply shortfall of rental homes and subsequent opportunity for scale;**
- **Growing tenant demand;**
- **Positive rental outlook.**

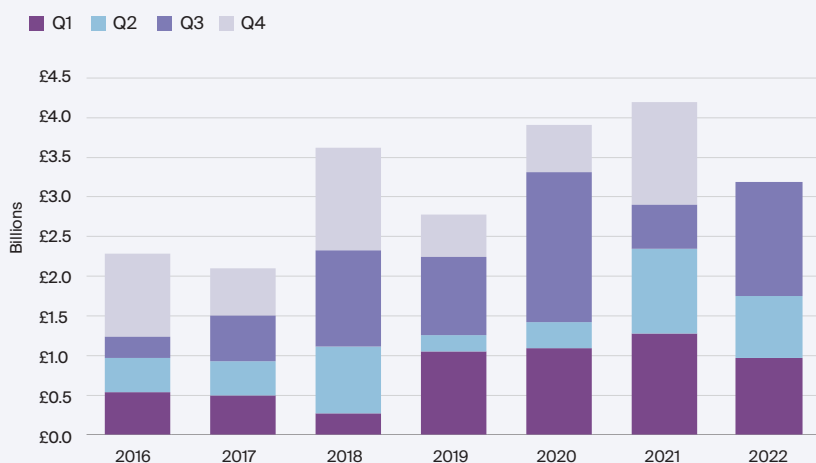
Build costs have been a challenge to scheme viability, exacerbated by supply chain delays, as well as labour availability post-Brexit. Current expectations are that costs are easing (BCIS forecasts 3% growth in build costs in 2023, down from 11% currently), which should support development activity and improve viability.

Short term volatility vs long term performance

There are plenty of other reasons to be optimistic. For investors, the rental market has proven its resilience before, most recently through the pandemic, but also through the Global Financial Crisis, where the peak to trough fall in rents was just 1.4%. The fact that 25% of capital committed since 2020 has come from new entrants to the UK market is evidence of more investors looking to the sector for diversification and defensive long-term income.

UK BTR investment volumes

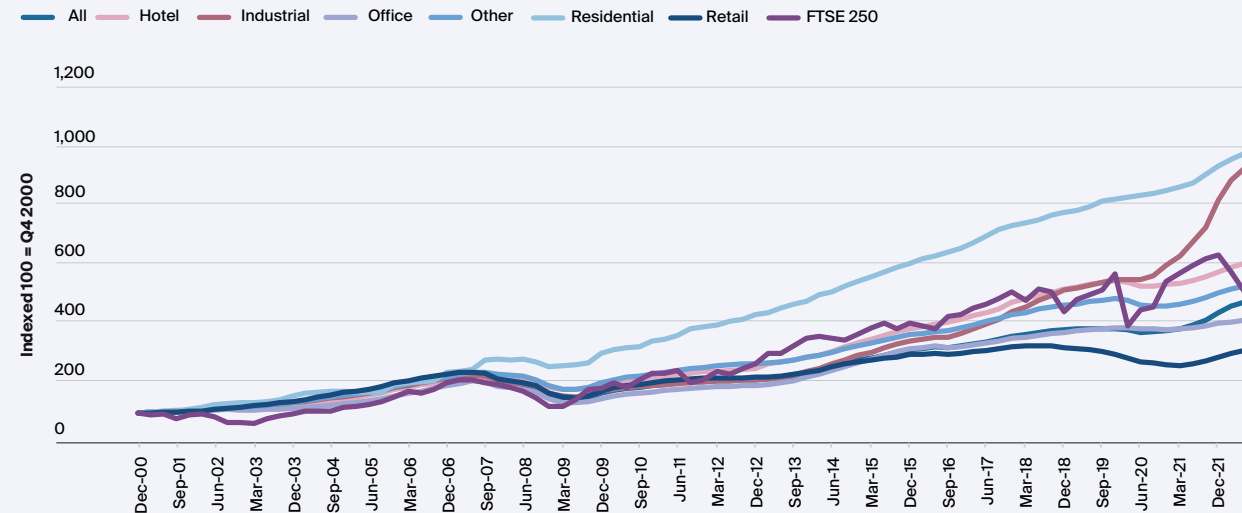
Quarterly totals



Source: Knight Frank Research

Residential outperforms other asset classes

MSCI Total Return Index, 100 = Q4 2000



Source: Knight Frank Research / MSCI

Data from MSCI suggests that over the last 20 years the UK residential sector has delivered the highest total return of all other property types (retail, office, hotels and industrial).

Rental markets also offer some hedge against spiralling inflation thanks to the presence of shorter leases and a frequent turnover of tenants. While the sector is not immune to the more challenging backdrop, we expect that it will again prove its resilience. In turn, this will lead to increased competition for assets and support yields.

Strong renter demand

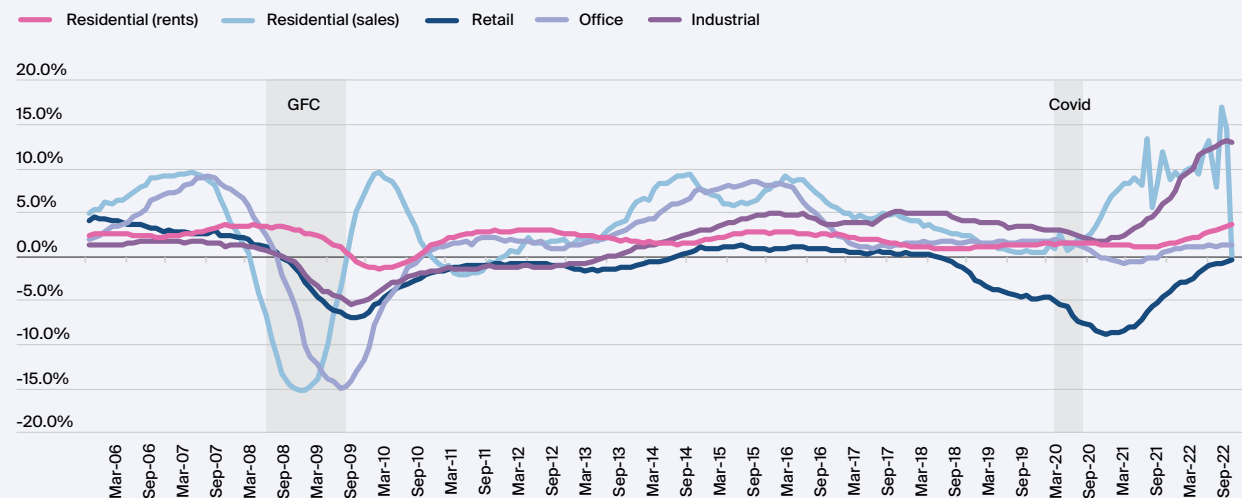
On the operational side, the supply and demand dynamics in the sector are rock solid. This is reflected by the fact that lease-up and occupancy for schemes launched in the last year has been incredibly impressive. Many schemes stabilised well ahead of expectations in Q3, according to data from Molior London, including some which leased at more than 100 units per month.

Furthermore, the labour market in the UK is tight. The unemployment rate stood at 3.6% in October. Wages are also rising – particularly among the 25 to 34 age cohort – supporting current strong rental growth.

Challenges facing the private sales market, including affordability constraints as a result of spiralling mortgage costs will prevent many first-time buyers from getting on the housing ladder.

Historically residential rental markets have proven resilient during downturns

Annual % rental growth (UK)



Source: Knight Frank Research / ONS / MSCI

The prospect of further reform is impacting the buy-to-let sector which could reduce private landlord numbers further.

Strong wage growth

Annual change in mean pay from PAYE (year to September 2022), by age



Source: Knight Frank Research / ONS

Supply squeeze

Added to this are supply-side pinches. The RICS Market Survey continues to report falling landlord instructions, while listings volumes across the UK in October were 43% lower than the five-year pre-pandemic average for the month.

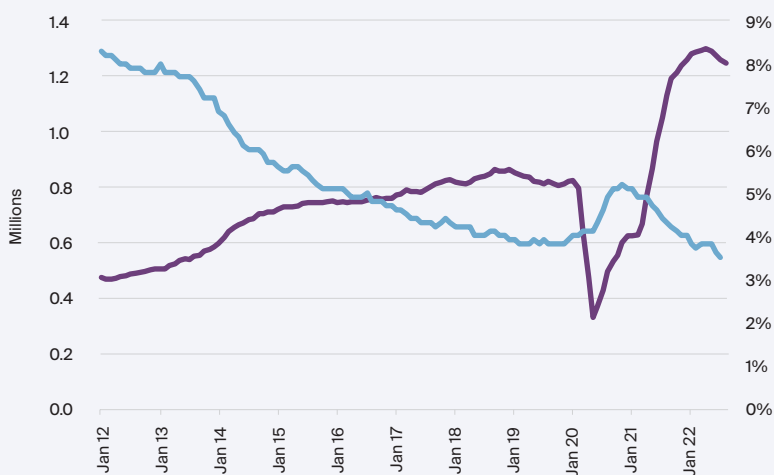
The prospect of further reform impacting the buy-to-let sector could reduce private landlord numbers further. Data from the latest English Private Landlord Survey suggests that recent and forthcoming changes to legislation are the most common reason for landlords choosing to decrease their portfolio size or to leave the sector, a move which will put further pressure on new supply of rental accommodation.

One such legislative proposal is to implement a minimum requirement for letting a property to EPC 'C' rating from 2025 (on new tenancies) and 2028 (all tenancies). Our analysis suggests that nearly 60% of existing rental stock falls under that threshold.

Labour market resilience

UK unemployment and unfilled vacancies

Vacancies (LHS) Unemployment (RHS)



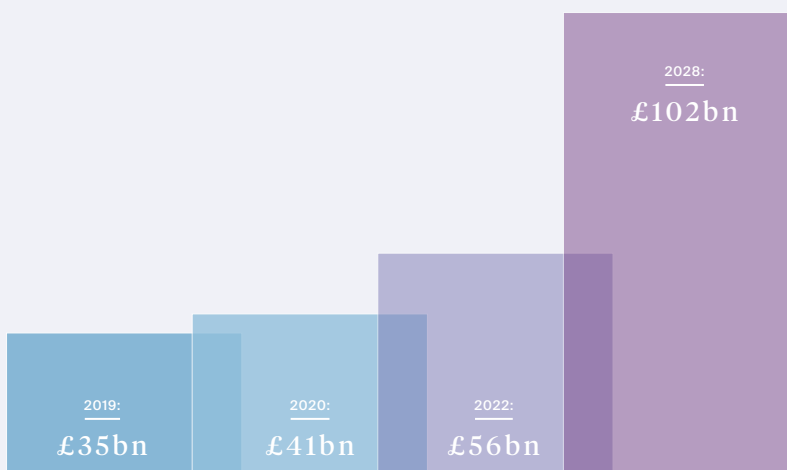
Source: Knight Frank Research / ONS

Valuing the market

Based on our analysis of current operational BTR stock, and stock under construction, we estimate that the value of the market for professionally

managed rental accommodation in the UK is £56 billion, up 60% from £35 billion in 2019. Looking at the future pipeline, we believe this figure has the potential to nearly double in size to £102 billion by 2028.

Estimated capital committed to UK BTR



Source: Knight Frank Research

YIELDS REMAIN STABLE

As recently as early September, BTR yields represented a significant risk premium over 10-year gilt rates. But with the risk-free rate recently jumping to 4% over a very short period, that gilt-yield gap has all but disappeared. What is left are lots of questions as to what it means for the direction of travel for residential yields.

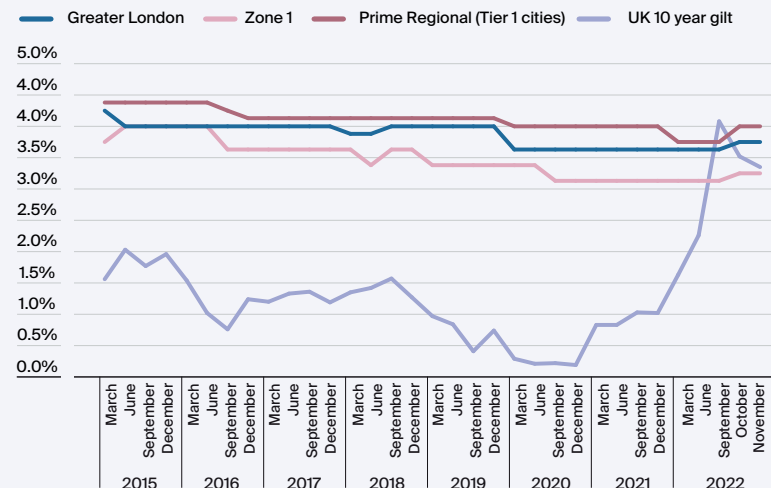
These questions come after a period of gradual yield compression as the BTR sector matures and investor demand has strengthened. Yet while other property sectors can draw conclusions on what happens next based on how assets performed in previous downturns, the same is not true of the BTR market in the UK, given its nascency.

With the absence of representative long-run data on UK BTR yields, it is useful to look to more mature markets as a guide. Take the US, for example, where multifamily yields have been hardening for the last decade. Like in the UK, the cost of US-based debt has risen dramatically in recent months (proxied on the chart by the BAA corporate bond rate), and the risk-free rate has shot up.

Debt costs have spiked in the past, most notably post-GFC, yet multifamily cap rates proved extremely stable. The data also suggests a lack of relationship to government bond markets, as well as relative stability through the GFC.

UK BTR yields v risk-free rate

MSCI Total Return Index, 100 = Q4 2000



Source: Knight Frank Research / BoE

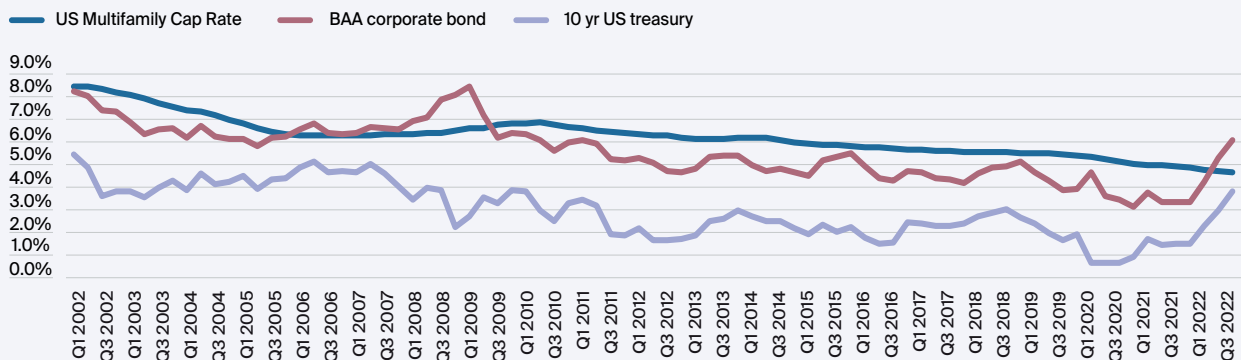
We expect to see a similar pattern in the UK. Whilst the recent sharp increase in long-dated bond yields is starting to have a knock-on effect on property yields, they are unlikely to increase in parallel, given that rental growth is accelerating at the same time. Therefore, any softening in yields towards the end of the year is likely to be sentiment driven, reinforced by limited transactional evidence.

Longer term, we expect to see further yield compression driven by strong

investor demand and the supply/demand dynamics of the sector which continues to drive competition for assets. The prospect of weaker rental growth in other property sectors is also likely to lead more investors to pivot to residential in search of long-term income.

Indeed, as we outline elsewhere in this report, prospects for rental growth are positive, which should compensate for any comparison to risk-free assets which offer a fixed bond coupon.

US multifamily cap rate v corporate bonds and 10-year US Treasury yields



Source: Knight Frank Research / RCA / Moody's / Federal Reserve

SECTION TWO
RENTAL PERFORMANCE

WHAT IS THE OUTLOOK FOR RENTS?

By analysing data on asking rents and matching these to our bespoke market-leading database of BTR developments, we have been able to isolate the change in rental values for BTR-specific assets.

BTR investors can point to a strong track record of rental growth in the UK, with rents having risen by 21% over the last decade.

Future rental growth prospects are key to ensuring competitive returns, particularly given recent increases in the risk-free rate. Yet current measures of rental growth track performance within the private rented sector (PRS) as a whole. While this is a useful guide, our analysis of more than 50,000 unique BTR listings from more than 180 operational schemes, offers an insight into how BTR-specific assets are performing.

How have BTR rents performed?

Rental growth for new leases on BTR schemes over the last 12 months has averaged 12.1%, in line with the strong performance of other indices which track change in market rents for new tenancies.

Growth has been driven by high rental demand and limited supply; trends that are currently more pronounced in city centres.

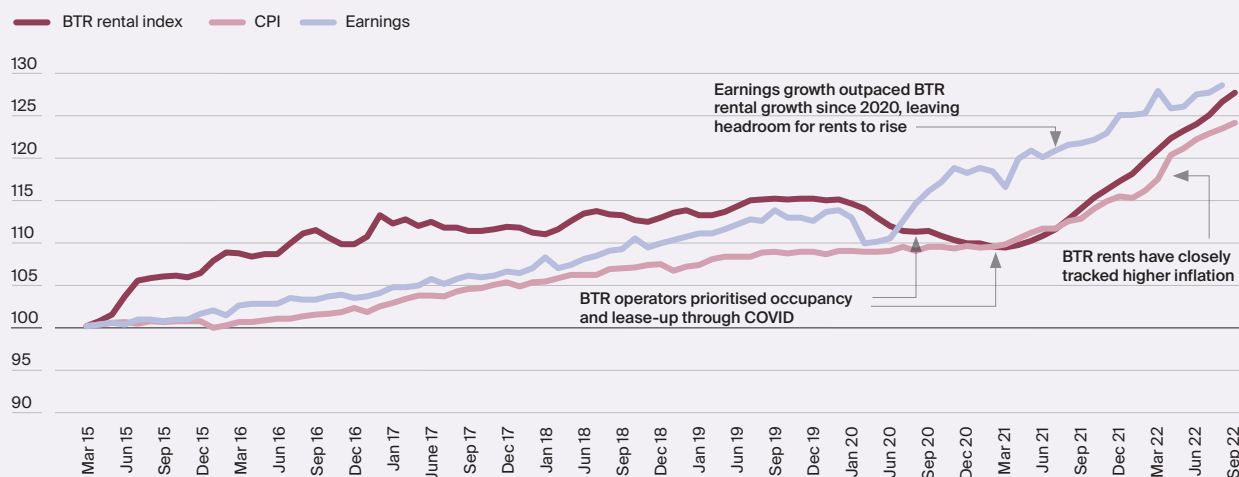
Longer term, the data suggests that rental growth for BTR assets has been more measured, with an annualised rate

of growth of 3.4% per annum for new BTR leases since 2015. Cumulative BTR rental growth over that time stands at 28%, outperforming inflation and slightly behind the increase in average earnings.

A dip in rents in 2020 reflects the emphasis by operators through the pandemic on maintaining occupancy and lease up, as well as a focus on supporting tenants through the pandemic. This was in addition to the comparatively weaker performance of more urban markets through lockdown as cities shut down.

Long-term BTR rental performance v CPI and earnings

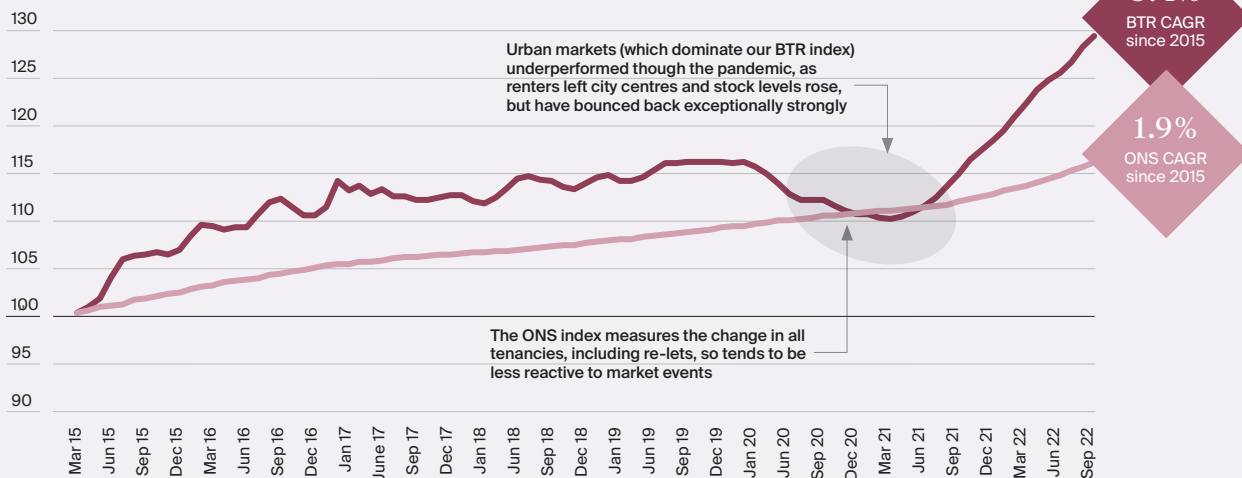
Indexed 100 = March 2015



BTR rents v PRS rents

Indexed 100 = March 2015

— BTR rental index — ONS rental index



Source: Knight Frank Research / ONS

How does that compare to the PRS?

On both a short and longer-term basis, BTR rental growth has outperformed the official UK rental index from the Office for National Statistics (ONS), which tracks rental growth across all rented homes. The ONS index has averaged 1.9% annual growth since 2015, below the 3.4% recorded for BTR.

Over time, and as assets stabilise, there will come a point where any premium over local market performance will end and BTR rental performance will run in parallel with the local market. Future analysis of this data will allow us to analyse rental performance by scheme age, market, and price point.

What's the outlook for rents?

There is little possibility of rental supply increasing significantly in the short term, even as BTR supply increases. There have been more than 260,000 buy-to-let mortgage redemptions over the last five years alone as private landlords look to exit the sector. Meanwhile, unemployment is near record lows, the population continues to rise, wage growth remains strong and access to mortgage finance

is restricting owner occupation – which will support rents.

Current forecasts from Oxford Economics suggest that average earnings will grow by 20% between 2022 and 2026, but with energy costs set to spike in the near term, there will be a ceiling to what renters can afford. Tenants in newer, more energy efficient BTR developments, will be less exposed to spiraling energy costs.

Prospects for rental growth will also be supported by the fact that the proportion of earnings spent on rent

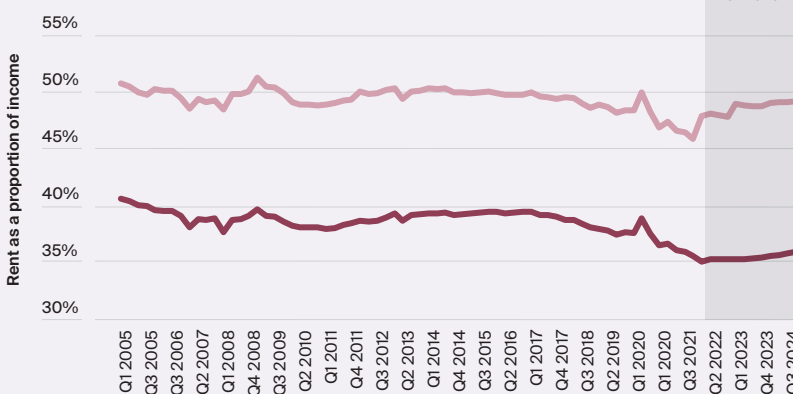
has been steadily declining in recent years and sits below the long-term average. The average renter spent 35% of their pre-tax income on rent in 2022, down from closer to 40% five years previously. For couples and sharers, this figure will be even lower.

Whilst we expect our BTR rental index will slow from its current highs into 2023 as a result of wider cost of living pressures, the analysis suggests that there is headroom for above average rental growth to continue.

Monthly rental payments and bills as a % of income

All PRS stock, indexed 100 = March 2015

— Rent — Rent and Bills



Source: Knight Frank Research / ONS / Oxford Economics
NB. Bills = energy, water and council tax

SECTION THREE
SUPPLY

WHICH LOCATIONS OFFER THE MOST POTENTIAL?

The number of complete BTR units across the UK has tripled within the last five years, and the pipeline continues to grow. Some 24% of local authorities now have at least one scheme open and operational.

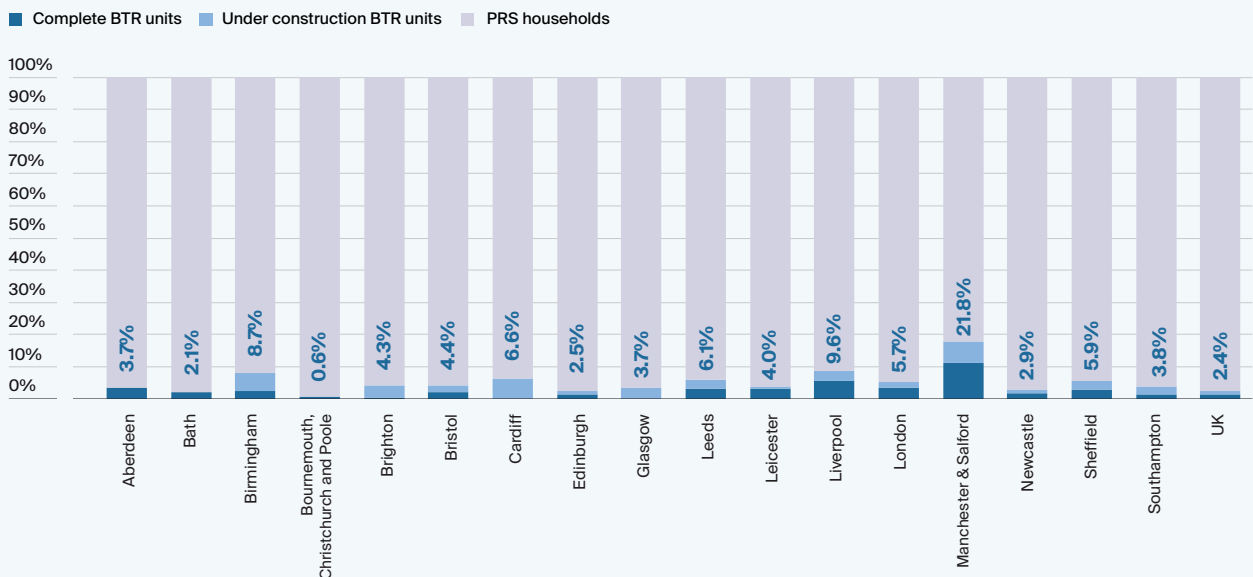
There are just over 72,000 complete and operational BTR homes in schemes of 75 or more units across the UK, according

to our database. A further 57,000 units are currently under construction and an additional 61,000 have full planning

permission granted. This brings the total BTR pipeline to 190,000 homes, not including sites in pre-planning.

Market penetration rates remain low in all locations

BTR supply as % of PRS market



Source: Knight Frank, Local Planning Authorities, Experian

◆◆

There are just over 72,000 complete and operational BTR homes in schemes of 75 or more units across the UK.

◆◆

Which markets should investors target?

When considering specific opportunities, it is important to emphasise a rigorous and site-specific approach, but some locations will naturally boast stronger fundamentals than others. To provide some guidance, we have analysed key BTR metrics relating to supply, demand, value, and market potential for local authorities across the UK. The data has been overlayed with market knowledge from Knight Frank's investment, development, and valuation teams on factors including viability and scale.

Established and growth markets

The maps overleaf outline the results of two modelled scenarios, one based on our recommended weighting across metrics, and one more heavily weighted towards market potential (ie. locations with strong demand-side fundamentals, but a small pipeline of BTR units).

In the first scenario, established BTR markets such as London, Birmingham and Manchester score well, supporting the growth trajectory of the market to date. In the second scenario, the list includes a number of Tier 2 towns and cities which boast strong demand drivers but typically have small pipelines, presenting a strong case for development. Some, such as Oxford and Cambridge, have been on investor's radars for a while, but it has been challenging for BTR to compete with open market sales schemes.

UK BTR supply

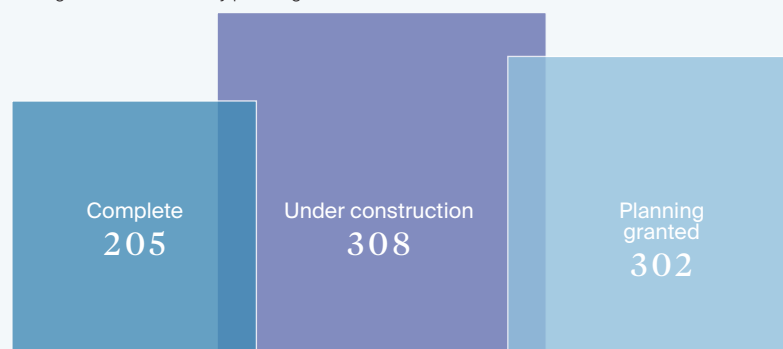
By planning status

STATUS	# UNITS	# SCHEMES
Complete	72,208	353
Under Construction	57,688	191
Planning Granted	62,260	202
Total	192,156	746

Source: Knight Frank Research

BTR schemes are getting larger

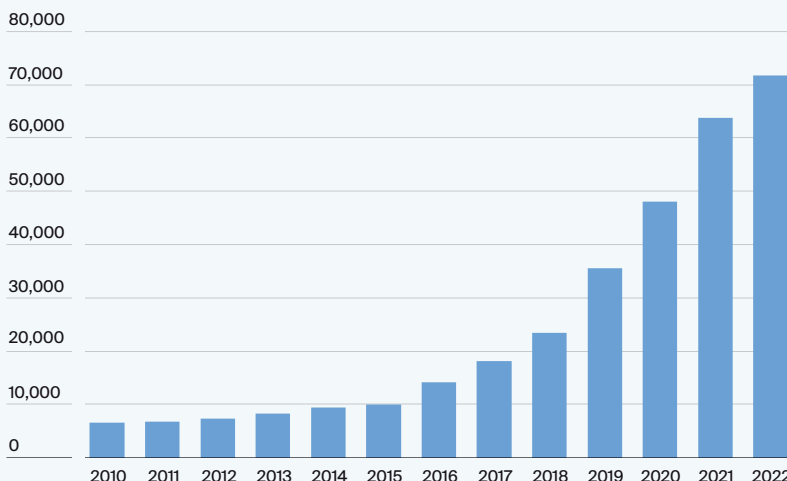
Average number of units by planning status



Source: Knight Frank Research, Local Planning Authorities

UK BTR supply has more than tripled within five years

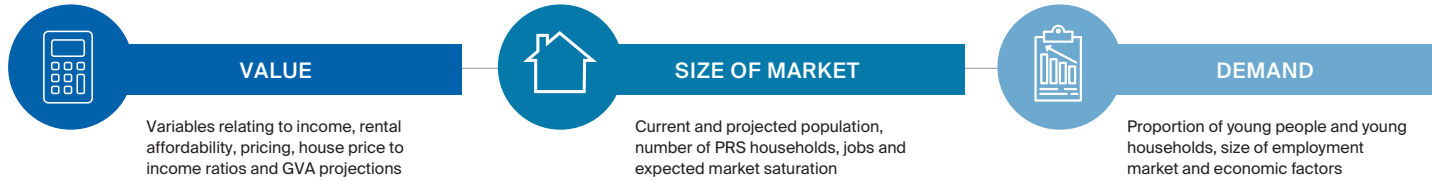
Number of units in complete schemes



Source: Knight Frank Research, Local Planning Authorities

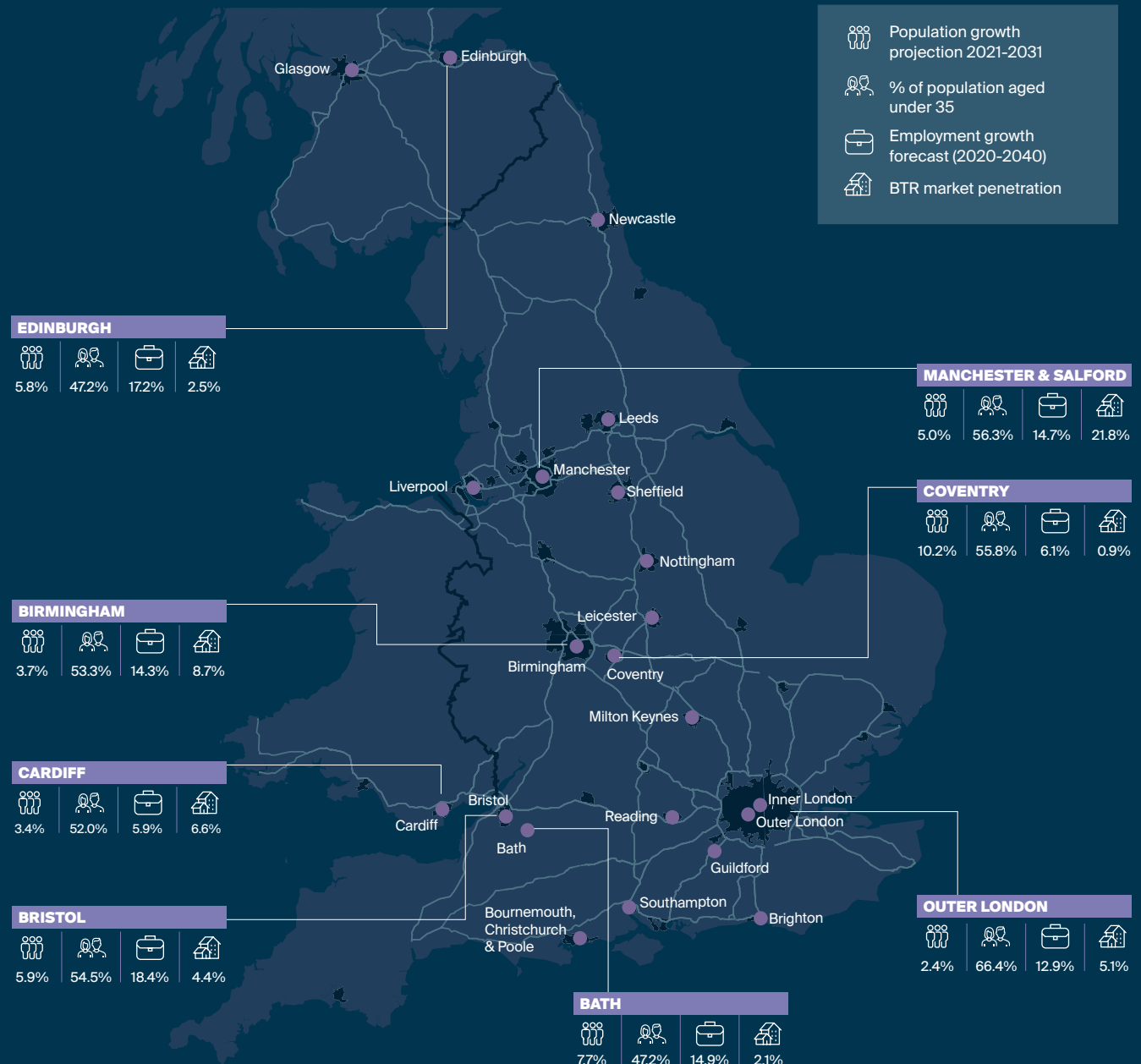
OUR APPROACH

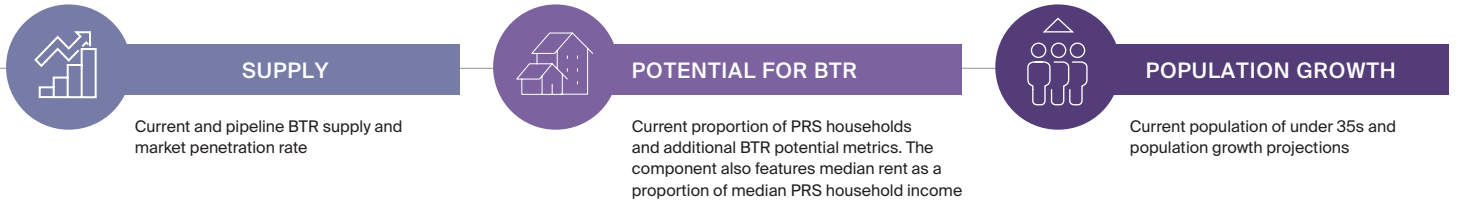
Our study of local authorities across the UK analyses 40 economic and demographic indicators relevant to BTR investment and development grouped across six components: value, size of market, demand, supply, potential for BTR and population growth. While we have put forward two scenarios below which we believe can help with prioritising opportunities for investment and development, the locations highlighted are by no means exhaustive. Different investors will have different priorities, both in terms of returns but also tenant profile, and accordingly the weightings for each of the components can be adjusted.



Established BTR locations

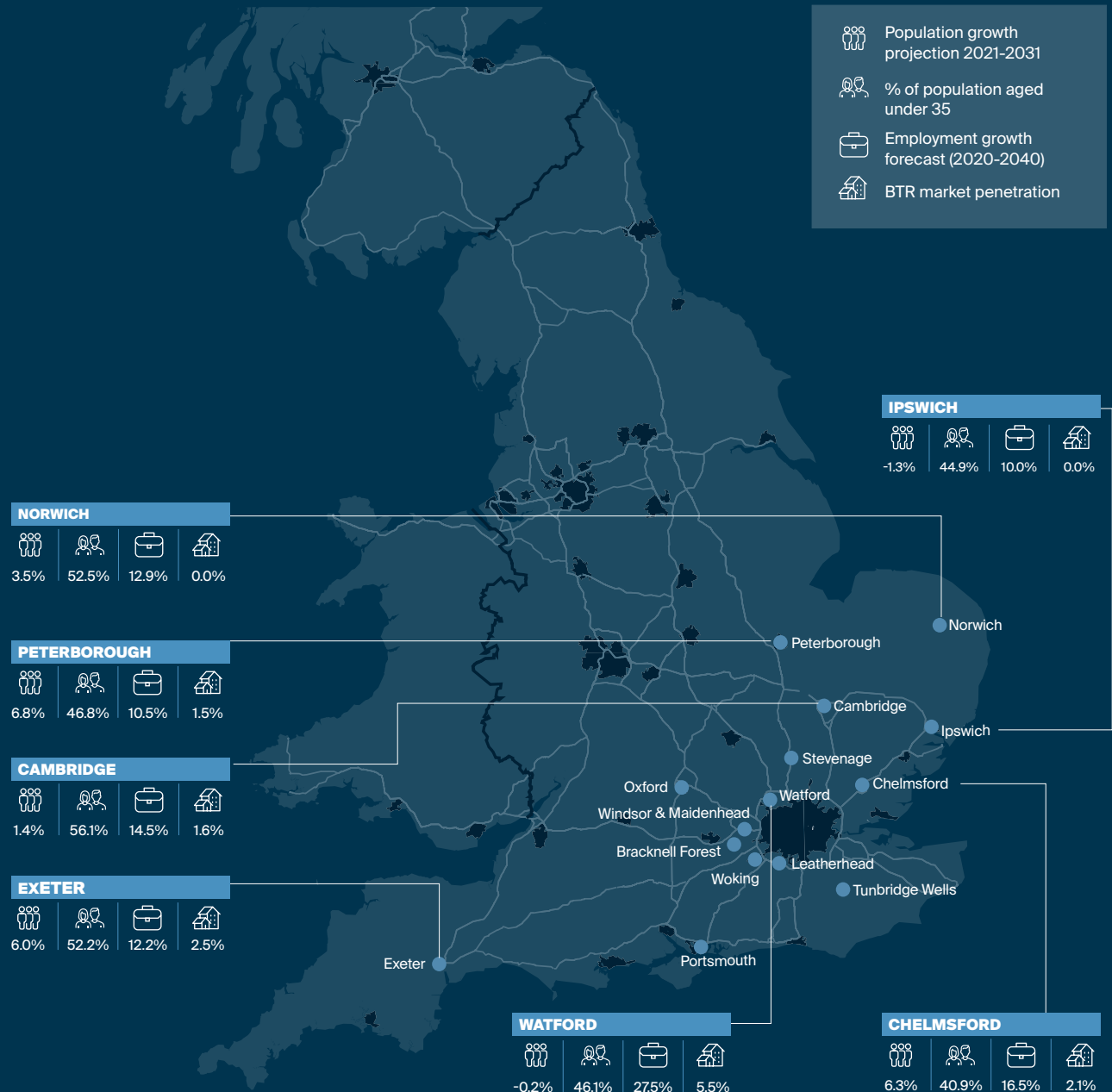
Based on a recommended weighting across components





High growth markets

Based on a weighting more geared towards 'Potential for BTR' and 'Demand'



Residential Capital Markets**Nick Pleydell-Bouverie**

Head of Residential Investment Transactions

+44 20 7861 5256

nick.pleydell-bouverie@knightfrank.com

Jonny Stevenson

Head of Build to Rent Funding

+44 20 3909 6847

jonny.stevenson@knightfrank.com

Guy Stebbings

Head of Operational BTR

+44 20 7861 5413

guy.stebbing@knightfrank.com

Research**Oliver Knight**

Head of Res Dev Research

+44 20 7861 5134

oliver.knight@knightfrank.com

Lizzie Breckner

Head of Build to Rent Research

+44 20 3640 7042

lizzie.breckner@knightfrank.com

Knight Frank Research
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