THE HUMAN FACTOR
SPECIALIST PROPERTY

2018
After a record year in 2017, appetite for specialist property investment is stronger than ever.

Last year we made the bold prediction that specialist property investment would rise by 18% in 2017. In fact, activity proved even stronger than this, with volumes growing by 40% to reach almost £18bn. Part of this surge reflects renewed appetite for UK commercial property, as investors largely cast aside the uncertainty that followed the 2016 EU referendum. Yet we believe the rapid growth in demand for specialist property also represents a desire to harness the sector’s unique performance characteristics, as well as a growing acceptance of the need to understand the operational demands of these property types.

As we explore in this research, the stability of specialist property’s performance makes it a compelling choice for those with an eye to a period of potentially slower returns in the wider commercial market. Investors are attracted by the granular nature of income streams typically associated with specialist property, as well as for some, the ability to extend and de-risk.

Yet all of this would be moot were it not for the undeniable structural support for specialist property. The human factor — the end user demand that ultimately drives the sector’s performance — is not in question. Demographic trends can be reliably predicted, and combined with expert market knowledge, provide a solid footing for demand projections.

In contrast, the supply of specialist property is not keeping pace with demand. Indeed, we predict a number of subsectors will face an ongoing shortage of modern stock, which will only enhance the rental performance of those assets that make the grade.

Our predictions for wider commercial property investment this year point to a modest slowdown – a function of stock shortages, rather than any significant change in investor demand. Our view on the specialist sectors specifically is more positive: our core scenario sees a 10% increase to £19.5bn. We recognise that anything above 10% will depend on sufficient stock coming to the market, but if last year’s experience is anything to go by, we cannot rule out passing the £20bn milestone.

SHAUN ROY
HEAD OF SPECIALIST PROPERTY INVESTMENT

“We continue to see strong and sustained demand for specialist property, driven by the desire for durable long income investments to good covenants”.

Please refer to the important notice at the end of this report.
THE EVOLVING MARKET

INVESTMENT ACTIVITY REBOUNDS

2017 saw a strong rise in commercial property investment generally, but activity in the specialist property sectors grew even faster: purchases of these property types were up 40% on 2016 levels. With almost £18bn transacted last year, specialist property accounted for a greater proportion of market activity than ever before, eclipsing investment in the retail and industrial sectors. Indeed, in accounting for over 27% of the commercial investment volumes in 2017, specialist property has doubled its share of the market in the space of just three years.

The hotel sector made the greatest contribution to the rise in specialist property investment in 2017, with transactions up by more than £2bn, while PRS saw an increase of around £1.3bn. The healthcare sector recorded the greatest rise in activity relative to 2016, with volumes up almost threefold.

A DIVERSE INVESTOR BASE…

The specialist property market continues to attract a diverse range of investors: owner-operators compete alongside private equity, institutional funds, and many others. Each specialist sector has its own unique investor mix, but in general, overseas investors play an important, albeit somewhat smaller role than in the wider market. However, there is every reason to expect this share to grow over the coming years. One barrier to overseas investment is the relatively small lot sizes that typify some of the specialist sectors, as many cross-border investors require scale to justify transactions. However, as ongoing consolidation creates portfolios and platforms of greater volume, we expect that the attraction to cross-border investors will rise.

We also note that investment from listed real estate businesses accounts for a significant share of activity in many of the specialist sectors. This is in sharp contrast to the wider market, where major REITs and public property companies were net sellers of assets in 2017. The demand from listed real estate companies reflects the fact that a number have successfully raised capital from stock market listings or further share issuance in recent years, which is now being deployed. The ability of these businesses to raise capital in this way demonstrates the appeal of specialist property beyond that of those investing directly in physical assets.

1. THE HUMAN FACTOR

Superior returns from commercial property traditionally come from two sources: identifying occupier demand, and timing purchases to avoid paying excessive prices. The same is true for specialist property investment. However, for many of the specialist sectors, occupier demand is far less cyclical than in the wider market. Because much of the occupational demand for specialist property comes directly from individuals, who do not – or often, cannot – change their need for certain types of property, the ebb and flow of the economic cycle plays a lesser role.

This is an important contrast to other commercial property sectors, where occupational demand is much more finely balanced, and economic conditions can force businesses to make binary choices over the number of properties they occupy. The UK’s population is widely recognised to be aging as it grows, with official statistics suggesting the pensionable age population will increase by more than 30% by 2041, supporting in particular the end user demand for property such as care homes and healthcare facilities. But it is also important to recognise the growth in the working age population, which is directly supportive of residential demand, and indirectly supportive of demand for hotel and automotive property.

The reliance on demographic shifts as sources of demand growth also has the advantage that they are relatively easy to forecast, at least in comparison to the economic cycle, which is the focus of many commercial property forecasts. For investors, an understanding of broad demographic trends does not negate the need for a detailed understanding of local market characteristics, but it does give some comfort that underlying demand is present.

The structural undersupply of many specialist property types is another important attraction to investors in the sector. Unlike many commercial property sectors, in which developers are able to keep supply relatively well balanced with demand, a number of specialist sectors face significant short shortages that cannot be quickly reversed. For example, we estimate there will be a shortfall of 160,000 market standard care home beds by 2021, while there are three times as many students in the UK as the number of purpose built student beds. Even with ambitious delivery pipelines, this level of aggregate undersupply of specialist property would take many years to reverse.

WHAT DRIVES SPECIALIST PROPERTY INVESTMENT?

Over the longer term, we expect investment in specialist sectors to continue to rise, both as a share of the wider commercial property market, and in absolute volumes. There are three main drivers:

2. THE PERFORMANCE APPEAL

The human factor is a compelling rationale for specialist property’s outperformance in theory, but does it translate into attractive returns in practice? In short, the answer is yes. Specialist property’s less cyclical nature can be easily seen from the available market data, which shows a more stable return profile than for the market as a whole. This does not mean that specialist property always outperforms. Indeed, the trade-off for greater stability has been modest underperformance during market-wide boom years. However, MSCI data shows that hotels, healthcare and residential property all offer a better risk-adjusted return than the all-property benchmark over the long term.

The 18 month period following the UK’s referendum on EU membership demonstrated how specialist property performance has remained less volatile than that of the wider market. While all property capital values grew by 10% or more from June 2016 to December 2017, specialist property capital values grew by 4% from June 2016 to December 2017, with a strong preference for yield rather than growth. This was in line with the requirement that capital be deployed in a way that is better aligned with the nature of the property. The sector was not without challenges, however, as the wider market experienced a period of downward pressure on prime yields and rents.

3. PLAYING THE LONG GAME

For some investors, one of the most compelling aspects of specialist property is the prevalence of long leases: operators of healthcare, student housing and hotel properties frequently sign 25-30 year terms at a time when average lease lengths on traditional commercial properties fall to around seven years. These agreements, which normally feature inflation linked rental increases, are particularly attractive to institutional investors, such as pension or insurance funds, which need to match investment income to their long-term liabilities.

3.2. Income strips

This institutional demand for long-term income, combined with the potentially significant cost of maintaining facilities, has seen investors and owner-operators collaborate on agreements that unlock capital in exchange for secure long-term income. Sale and leasebacks are an established method: an owner-operator sells their freehold to an investor, thereby releasing capital, while the investor receives rental income from the property they own. Income strips are an increasingly popular variation on this principle. Investors acquire the right to rental income as a sale and leaseback, but the tenant retains the right to repurchase the property for a nominal sum at the end of the term. This can be highly attractive for institutional investors, as it removes the question of how to deal with the property once the lease ends.

Ground rents offer the longest terms, sometimes stretching over hundreds of years. They typically involve tenants paying an income stream that represents only a small share of the operational rental level, and therefore sit in an over-collateralised position. However, because of the low level of contracted income, ground rents tend to be valued at low levels relative to the market value of the property. Ground rents represent a relatively small share of specialist sector investment, but are gaining traction.

The variety of ways to derive long-term inflation-linked income from specialist property gives the sectors particular relevance in the current market. Fewer long-term commercial property lease are being signed, while fixed income investors are grappling with the negative real yields offered by index-linked bonds. The popularity of this type of specialist property investment is therefore clear, although the pace of growth in transacted volumes will ultimately depend on the ability of investors to source or create such deals.

THE OUTLOOK FOR THE YEAR AHEAD

We expect specialist property’s share of the commercial market to continue to grow over the year ahead, and forecast £19.5bn of transactions in 2018. Overall, we expect less downward pressure on prime yields than in 2017, although do not rule out some compression for the best assets. Solid rental prospects will drive further interest from tactical investors seeking an alternative to the more modest performance expected in the wider market while others will be seeking the safety of property typically less exposed to economic and political risks.

The sector is not without challenges, however. Average lot sizes remain small, and significant amounts of stock remains in the hands of owner-operators, or otherwise outside the investible market. One issue for larger investors will therefore remain the ability to source deals and invest at scale. This is driving ongoing demand for portfolio and platform deals – indeed, 2018 has already seen a number of such transactions. The latter will be particularly attractive to those investors without the in-house expertise required to operate what can be relatively management-intensive assets. The bigger picture, however, is the ongoing structural shift towards increased volumes of specialist property investment. A number of the specialist subsectors are now every bit as liquid as ‘traditional’ property types in terms of aggregate volumes traded. Meanwhile, MSCI data shows that domestic funds allocations to specialist property have increased from less than 14% to almost 18% over the past three years. This is a sector destined to see long term expansion.

SPECIALIST SECTOR REPORT 2018

RESEARCH

Knight Frank Research
The market will see strong investor demand for long-income, with demand comfortably outstripping supply. There is a significant weight of money available for allocation to automotive stock.

The rise of premium brands, combined with increasing interest from overseas dealer groups, will provide good opportunities for covenant windfall.

After somewhat ‘artificial’ record sales numbers in 2016, new car registrations are returning to a more sustainable position, providing opportunity for dealers to make stronger profit margins.

Opportunities are often priced on a cost-recovery basis, proving low rental levels and leading to investments that are almost entirely underpinned by vacant possession value.

There can often be strong underlying land values and alternative use opportunities given the size of plots and prominence to main arterial routes and motorways.

Corporate Identity standards, as enforced by manufacturers upon their dealer partners, create a product in which the tenant will continually invest and upgrade, serving to preserve or enhance reversionary value.

Wavering consumer confidence due to a lack of clarity from Government on diesel vehicles and tax bands could limit sales volumes.

Pressure on personal disposal income alongside a weak sterling is resulting in potential purchasers delaying their purchase or upgrade to a new car. In addition, there is the potential for an increase in the cost of the end-product due to border-crossing levies on materials and components, depending on the outcome of Brexit negotiations.

A lack of investment-grade product being created and released to the market.

Investing in the right franchises in terms of future model line-up and likely market share will be key, as will ensuring current sites are future-proofed.

There will be an increasing variety of forward funding/commitment opportunities as new and highly impressive bespoke ‘destination’ facilities are developed.

Given the appeal of the sector and scarcity of stock, those investors acquiring or able to create an automotive portfolio will witness an appreciation in value as scale increases.

Opportunities are often priced on a traditional ‘rate per sq ft’ basis alone is likely to prove misleading, with occupiers having increasing regard to a ‘sustainable rental overhead’ based on brand and market catchment.

Modern bespoke automotive facilities let to major covenants on long leases are an attractive asset and pricing reflects this: the sector no longer attracts a pricing discount to the ‘core’ property sectors.

The influence and importance of the manufacturer should not be overlooked. Whilst rarely on the lease, they play a key role in value as a ‘silent partner’. An understanding of Corporate Identity standards and the brand’s market position is critical.

We will see a new overseas brand enter the UK car market.

One of the UK’s largest dealer groups will be sold.

Sales of hybrid vehicles will increase two-fold over the next 12 months.

Prime yields for long income will tighten to inside NIY 4.5%.

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### Automotive Demand Drivers

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- The rise of premium brands, combined with increasing interest from overseas dealer groups, will provide good opportunities for covenant windfall.
- After somewhat ‘artificial’ record sales numbers in 2016, new car registrations are returning to a more sustainable position, providing opportunity for dealers to make stronger profit margins.

### Limiting Factors

- Wavering consumer confidence due to a lack of clarity from Government on diesel vehicles and tax bands could limit sales volumes.
- Pressure on personal disposal income alongside a weak sterling is resulting in potential purchasers delaying their purchase or upgrade to a new car. In addition, there is the potential for an increase in the cost of the end-product due to border-crossing levies on materials and components, depending on the outcome of Brexit negotiations.
- A lack of investment-grade product being created and released to the market.

### Opportunities & Value

- Opportunities are often priced on a cost-recovery basis, proving low rental levels and leading to investments that are almost entirely underpinned by vacant possession value.
- There can often be strong underlying land values and alternative use opportunities given the size of plots and prominence to main arterial routes and motorways.
- Corporate Identity standards, as enforced by manufacturers upon their dealer partners, create a product in which the tenant will continually invest and upgrade, serving to preserve or enhance reversionary value.

### Key Attractions

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### THE BENZ PORTFOLIO

SOLD BY KNIGHT FRANK AUTOMOTIVE ON BEHALF OF AN OVERSEAS CLIENT. THE PRICE ACHIEVED WAS IN EXCESS OF £20,000,000 / NIY 5.7%.

A PORTFOLIO OF MODERN DEALERŵSHIPS LOCATED IN THE NORTH WEST AND LET TO THE UK’S SECOND LARGEST DEALER GROUP, PENDRAGON PLC.

TOTAL ACCOMMODATION OF 95,366 SQ FT, WITH A PASSING RENT OF £1,250,000 PER ANNUM, RISING ANNUALLY IN LINE WITH RPI (CAPPED AT 2.77% PER ANNUM).

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**Source:** Knight Frank, PropertyData

**Investment volume 2017** £0.5bn

**Share of UK investment market** 0.8%

**Investment volume 2008-17** £3.4bn

**Prime yield as at end of 2017** 4.50%

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**Adam Chapman**

Head of Automotive

"Investor appetite for prime dealership stock remains unabated and as such yields will likely see further compression."
THE UNDER PROVISION OF UK CARE BED CAPACITY IS NOW AT NATIONAL CRISIS LEVELS. DEMAND FOR HEALTHCARE FIXED INCOME IS AT ITS HIGHEST IN OVER 25 YEARS."

Julian Evans
Head of Healthcare, Hotels & Leisure

HEAD OF HEALTHCARE, HOTELS & LEISURE

JULIAN EVANS

25 YEARS.

"The under provision of UK care bed capacity is now at national crisis levels. Demand for healthcare fixed income is at its highest in over 25 years."

JULIAN EVANS
Head of Healthcare, Hotels & Leisure

25 YEARS.

DEMAND DRIVERS

- Population ageing is a key demand driver within this sector, triggered by extending life expectancy and the ageing of the baby boomer generation. The rate of growth in those over 65 is faster than for those below this age, and the number of elderly people is estimated to reach 13 million by 2021, equal to 19% of the population.

- As the elderly population increases, the gap between those that require care, and the existing provision, will widen further. We estimate a shortfall of almost 160,000 (en suite) market standard beds by 2021.

- There is a lack of modern stock. 53% of UK provision comprises homes of 35 or fewer registered beds, either in older purpose built or converted properties. Furthermore, one third of existing provision does not have an en suite facility.

LIMITING FACTORS

- Ultimately, a lack of stock, not demand, will be the greatest impediment to investment activity. However, 2018 will see further funds invested to support the development of new care homes, with a number of potential large funds on the starting blocks.

- Operators face multiple challenges, including rising staff costs due to the introduction of, and subsequent increase in, the National Living Wage, high staff turnover, and a shortfall of qualified nurses, which may be exacerbated by Brexit. These factors, combined with a social care funding crisis, will have an adverse impact on at least 6,600 homes in the UK and could result in further home closures.

- A shortage of skilled construction labour and price inflation on raw materials will continue to restrict the pace of healthcare developments.

OPPORTUNITIES & VALUE

- Pre-lets, both on a forward-fund and commitment to purchase basis for new build care facilities, hospitals and surgeries are at a record high, with Knight Frank currently mandated to lease over 2,500 beds throughout the UK. We envisage continued forward-fund opportunities for investors in the year ahead.

- We also predict an increase in sale and leaseback transactions as operators take advantage of historic low yields, which allows them to recycle the proceeds to enable platform growth.

- Savvy developers and investors are continuing to target areas of good wealth profiles in regions such as the East Midlands and Yorkshire, where land values are lower and profitability margins are strong. Our 2017 Care Homes Trading Performance Index pointed to profit margins of 28% for homes in the East Midlands region, the equivalent to margins achieved in the South East, where land values are higher.

KEY ATTR ACTIONS

- Investors, both domestic and international, are attracted to the sector’s long-dated income, typically comprising 30-year lease terms, with either Retail Price Index-linking or fixed uplifts. When comparing this with the average lease length of roughly seven years for other UK commercial properties, the care home sector remains a compelling target for investors.

- The sector’s institutional appeal is also heightened by comparatively low yields and quality assurance, to meet regulatory requirements and to save valuable staff time. Acoustic monitors are being installed within care homes to improve the quality of care and improve staff efficiency during night shifts.

- The care sector is innovating more rapidly than ever, influenced by data, technology and improved knowledge of specialist care such as dementia. For instance, electronic care plans are being used within homes for quality assurance, to meet regulatory requirements and to save valuable staff time. Acoustic monitors are being installed within care homes to improve the quality of care and improve staff efficiency during night shifts. Healthcare assets will need to adapt to facilities and technology fit for 21st century care and ensure that they do not become obsolete.

WHAT TO BE AWARE OF

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- A shortage of skilled construction labour and price inflation on raw materials will continue to restrict the pace of healthcare developments.

BOLD PREDICTIONS

- We expect a record year for investment, dominated by the fixed-income market.

- We also estimate that there is circa £3.5bn of UK private equity and circa £20bn of overseas private equity looking to enter the UK care home market this year. Furthermore, an estimated £500m of ground rent transactions are in the pipeline for the year ahead.

- We can expect to see further investment from infrastructure funds and the emergence of new UK REITs and Asia Pacific funds. Attracted by the UK's ageing population, an under provision of care home beds, the attractiveness of long-dated income and a weakened Sterling, we envisage overseas investors to re-enter the market.
The UK hotel sector is far from maturation and requires inward investment in what is still a fragmented arena.

The weight of foreign capital invested in hotels reached new heights in 2017, with a growing acceptance by overseas investors to deploy their funds into assets located in prime regional UK cities. There will be no let-up in 2018 as new international investors enter the sector and existing investors expand their holdings.

**Investment volume 2017**
£31.7bn

**Share of UK investment market**
8.4%

**Investment volume 2008-17**
£5.5bn

**Prime yield as at end of 2017**
3.50%

Source: Knight Frank, PropertyData

Institutional investors spent approximately £1.4 billion on hotels in 2017, attracted by the potential for high returns and the ability to match long-term liabilities with long-term investments.

The hotel sector is well-placed to create ground rent structures, which are considered very secure, long-term income streams. Hotel cash flows typically grow in line with inflation and hotel assets considered less likely to become functionally obsolete, due to the ongoing level of capex invested by the tenant.

The creation of specialist dedicated credit funds and the increased availability of debt from non-traditional banking sources is attractive to investors and offers customised solutions to those seeking financing for hotel development, product repositioning, acquisitions or refinancing.

Private equity investors are likely to continue to divest from their investments during 2018, offering opportunities to new entrants.

As a property sector, hotels are set to remain a strong performer in 2018, benefitting from an attractive risk-return, diversification opportunities, and the ability to capture the demand of a different demographic profile to that associated with other commercial property types.

There is an opportunity for developers to become more creative in their design and planning applications, incorporating other specialist property sectors into mixed-use development. The emergence of hybrid schemes, such as vibrant hubs for student communal living, combined with serviced apartments, is an emerging trend that is set to become far more prominent in the future.

The lack of clarity over post-Brexit UK immigration policy is causing some uncertainty for the hotel sector and its employees, with the British Hospitality Association estimating that around 15% of the sector’s workforce are EU employees, with the British Hospitality Association estimating that around 15% of the sector’s workforce are EU employees.

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Good asset management remains key to delivering the superior returns required by private equity and institutions. Investors must identify the true level of on-going capital investment required, as under-invested hotels will struggle to compete with new or refurbished stock.

General Data Protection Regulation comes into force in May 2018. This can mean amendments to management and franchise agreements and new procedures for owner operators, while investors may require new systems in order to comply with the legislation.

Overseas capital, emanating largely from Asia, in particular Singapore, will continue to seek out prime assets in London and the UK’s regional cities.

Assets benefitting from the proximity to strong demand generators, with a proven income stream and significant upside potential will naturally attract the greatest interest.

The attractive risk-return profile of the hotel sector, combined with favourable and alternative demographics, will continue to fuel strong demand from private equity and institutional investors who seek to diversify their portfolios across multiple asset classes.

The availability of alternative debt sources, through the creation of private equity debt funds is expected to continue to grow in prominence in 2018, allowing private equity capital exposure to the hotel asset class, but with reduced risk.

**HOTELS**

**DEMAND DRIVERS**
- 2017 was a record year for inbound tourism to the UK, with the fall in sterling contributing to demand. Visit Britain is forecasting another strong year of tourism growth, with 2018 visitor numbers up 4% to 41.7 million and spending up 7% to £26.9 billion.
- Stronger global growth and rising business confidence will have a positive impact on UK hotel trading performance. With strong growth from major source markets, in particular the Eurozone and the USA, enhanced hotel RevPAR performance is expected.
- The weight of foreign capital invested in hotels reached new heights in 2017, with a growing acceptance by overseas investors to deploy their funds into assets located in prime regional UK cities. There will be no let-up in 2018 as new international investors enter the sector and existing investors expand their holdings.

**LIMITING FACTORS**
- Higher interest rates, combined with higher inflation and falling real wages, may dampen domestic consumer spend as disposable incomes are squeezed. As a result, the UK hotel domestic market may experience a slowdown, resulting in fewer leisure overnight stays as well as a reduction in incremental revenue spend.
- The hotel sector is well-placed to create ground rent structures, which are considered very secure, long-term income streams. Hotel cash flows typically grow in line with inflation and hotel assets considered less likely to become functionally obsolete, due to the ongoing level of capex invested by the tenant.
- The creation of specialist dedicated credit funds and the increased availability of debt from non-traditional banking sources is attractive to investors and offers customised solutions to those seeking financing for hotel development, product repositioning, acquisitions or refinancing.
- Private equity investors are likely to continue to divest from their investments during 2018, offering opportunities to new entrants.

**OPPORTUNITIES & VALUE**
- Institutional investors spent approximately £1.4 billion on hotels in 2017, attracted by the potential for high returns and the ability to match long-term liabilities with long-term investments.
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**WHAT TO BE AWARE OF**
- The lack of clarity over post-Brexit UK immigration policy is causing some uncertainty for the hotel sector and its employees, with the British Hospitality Association estimating that around 15% of the sector’s workforce are EU migrants. Margins may come under pressure from rising labour costs as well as increased food, utility costs and business rate rises.
- Good asset management remains key to delivering the superior returns required by private equity and institutions. Investors must identify the true level of on-going capital investment required, as under-invested hotels will struggle to compete with new or refurbished stock.
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**BOLD PREDICTIONS**
- Overseas capital, emanating largely from Asia, in particular Singapore, will continue to seek out prime assets in London and the UK’s regional cities.
- Assets benefitting from the proximity to strong demand generators, with a proven income stream and significant upside potential will naturally attract the greatest interest.
- The attractive risk-return profile of the hotel sector, combined with favourable and alternative demographics, will continue to fuel strong demand from private equity and institutional investors who seek to diversify their portfolios across multiple asset classes.
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**THE CROWN HOTEL, HARROGATE, YORKSHIRE**

SINGAPORE’S FRAGRANCE GROUP BOUGHT THE 113-EN SUITE HOTEL, GRADE II LISTED PROPERTY, WHICH DATING BACK TO THE 19TH CENTURY.

LOCATED 0.5 MILES FROM HARROGATE RAILWAY STATION AND 12 MILES FROM LEEDS-BRADFORD INTERNATIONAL AIRPORT. The hotel offers extensive conference facilities with capacity for over 450 guests.

THE PRICE ACHIEVED WAS £7.25 MILLION, REFLECTING A NET INITIAL YIELD OF 6.2%.
Investment into PRS continues to exceed forecasts.

James Monks
Head of Private Rented Sector

**PRIVATE RENTED SECTOR**

**KEY STATISTICS**

<table>
<thead>
<tr>
<th>Metric</th>
<th>Value</th>
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<tbody>
<tr>
<td>Investment volume 2017</td>
<td>£6.3bn</td>
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<tr>
<td>Share of UK investment market</td>
<td>9.6%</td>
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<tr>
<td>Investment volume 2008-17</td>
<td>£27.3bn</td>
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<tr>
<td>Prime yield as at end of 2017*</td>
<td>4.00-4.25%</td>
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*Prime regional cities

**DEMAND DRIVERS**

- A growing share of the population is finding home ownership unaffordable, despite historically low levels of mortgage interest rates. In addition, those opting to rent instead of buy are increasingly attracted to the flexibility associated with the PRS.
- Meanwhile, as the removal of tax reliefs starts to affect profitability, small-scale buy-to-let investors may begin to sell properties, reducing the pool of stock available to let.
- More generally, a structural under-provision of homes regardless of tenure, combined with ongoing population growth, means that demand continues to outstrip supply.

**LIMITING FACTORS**

- While there is a large number of investment funds ready deploy means into the PRS market the number of sites or existing developments is small, with the number of operating BTR blocks even smaller. This creates a bottleneck in the market. We believe that now is the time to increase the capacity of this market and create more product.
- At the same time land supply is limited – there are not many sites available in locations attractive to renters such as transportation hubs and urban areas. Competition for land is significant between traditional house builders and BTR developers. One of the solutions could be partnering and developing a product that will deliver the best return for the location.

**OPPORTUNITIES & VALUE**

- Despite seeing strong growth in recent years, PRS housing remains a tiny proportion of the UK’s overall rental market. We see significant scope for investors able to create or back PRS ‘brands’ which prioritise flexibility towards tenant needs and offer superior levels of service and professionalism.

**KEY ATTRACTIONS**

- In addition to the highly attractive supply and demand imbalance, the PRS offers investors a number of other benefits. Income streams are long-term, secure, and typically diversified across a high number of tenancies, making the sector particularly appealing to institutions seeking to match long-term liabilities.

**WHAT TO BE AWARE OF**

- Whether purchasing an existing PRS asset or playing a role in development, investors need to consider how building design can affect operational efficiency and investment performance. This involves identifying a specification and mix of amenities that is appropriate to the location, as well as addressing sufficient number of units to be able to benefit from economies of scale.

**BOLD PREDICTIONS**

- PRS investment activity will grow rapidly over the next five years, with the total invested in the sector reaching £70bn by 2022. Investment inflows from overseas will continue to become a more important part of the market.
- The fastest pace of growth will be seen in the market for single family housing, which caters to the rapid growth in the 35-55 demographic.
The investment market is driven by portfolio consolidators seeking economies of scale."

James Pullan
Head of Student Property

Over £4bn of student property was
especially notable from Singapore
overseas equity, which has been
demand supported by an influx of
students to continue in 2018, with
future relationship with Europe.

Applications from international
hike in 2011/12.

Non-UK domiciled students are currently
forward funding of new developments
to be completed by the start of the
2018/19 academic year, increasing the
stock of PBSA by 4.3%.

The bulk of the portfolio was bought from Carlyle Group by LetterOne in
2015. The sites will be fully integrated and rebranded as iQ in spring 2018.

RESEARCH SPECIALIST SECTOR REPORT 2018

Investment volume 2017
£4.1bn
Share of UK investment market
6.2%
Investment volume 2006-17
£19.6bn
Prime yield as at end of 2017
4.50%

STUDENT PROPERTY

DEMAND DRIVERS

- Student numbers have rebounded since tuition fees were increased in 2012, despite demographics meaning lower student numbers in university age cohorts. There are 1.74m full time students at UK institutions, 3.5% higher than in 2012 and 19.0% higher than the number prior to the tuition fee hike in 2011/12.
- At 36%, the 2018 application rate from UK 18 year olds is the highest on record. Applications from international students have increased, bucking the downward trend seen in 2017 when applications from within the EU declined amid uncertainty surrounding the UK’s future relationship with Europe.
- Over £6bn of student property was purchased in 2017, up 25% on 2016 levels. We expect this strong pace of activity to continue in 2018, with demand supported by an influx of overseas equity, which has been especially notable from Singapore and North America.

LIMITING FACTORS

- A key challenge for investors in 2017 has been stock availability and this will remain in 2018. Portfolio acquisitions accounted for around 60% of the total investment as investors seek to access stock at scale.
- Forward funding of new developments is an established, albeit small, share of the market. Such deals trade at a discount to existing investment stock, allowing new developments to take place. We expect a key challenge for 2018 will be the viability of forward funding opportunities in secondary locations.
- Non-UK domiciled students are currently included within official immigration statistics, but there is considerable pressure on the UK government to amend this. However, any potential reduction in demand from EU students is unlikely to have a significant impact on overall demand. EU students represent 6.3% of full time students in the UK, while 16.5% are from outside the EU, providing investors with some comfort during the Brexit negotiation period.

OPPORTUNITIES & VALUE

- The fundamentals of Purpose Built Student Accommodation (PBSA) remain in place: the market is structurally undersupplied at the UK level, and servicing a thriving Higher Education sector.
- UK universities recognise that they are independent businesses operating within a highly regulated environment. As such, there is now more focus on the role of PBSA within the Higher Education sector.
- Student accommodation demonstrated solid occupational demand in 2017. Rental growth averaged 2.55% as student numbers remained stable and supply struggled to meet demand. Over the last decade, PBSA has been one of only a few asset classes to deliver rental growth every year.
- Across the UK as a whole, full-time student numbers outweigh current PBSA bed spaces by 3:1. Despite the volume of student accommodation either planned or underway, this supply/demand imbalance will remain evident in a number of key cities.
- It is increasingly recognised that whilst Universities focus on education and research, the undersupply of accommodation will be met by the private sector. Furthermore, tax changes within the ‘Buy-to-let’ sector may also see private rented sector landlords leave the student market, further bolstering demand for PBSA at local levels.

KEY ATTRACTIONS

- Each regional market demonstrates different credentials largely depending on the balance of demand and supply, together with the development pipeline and its delivery in any given year.
- New stock will be driven predominantly by private sector investment. 23,000 purpose-built student bedrooms are due to be completed by the start of the 2018/19 academic year, increasing the stock of PBSA by 4.3%.
- The balance of new stock in 2018/19 is likely to be less expensive, in real terms, than in previous years and this may mark the beginning of a shift in development, as the market reacts to perceived affordability pressures in some key cities.
- The market for PBSA is broadening: the number of first year postgraduates in 2016/17 was up 9.5% on 2015/16 levels and is at its highest point in ten years. This coincides with the introduction of postgraduate loans for those students from England studying a master’s course. Overall, UK domiciled postgraduates from the UK are up by 8.3% on 2015/16 (26,365) levels.
- Rising build and site costs will put pressure on margins, especially at the more affordable end of the market and, subsequently, this will play a key role in shaping the PBSA pipeline in the coming years.

WHAT TO BE AWARE OF

- Yields will compress in central London to 4.25% NIY as the planning pipeline slows due to the implication of affordable housing provision and developing student accommodation in Zone 1 becomes increasingly difficult and expensive. Regional yields will remain stable.
- Regionally there will be a reduction in all studio schemes being developed, this is due to a drop in rental growth for studios in some markets where it is perceived there has been an over development of all studio schemes in the last 2-3 years.

BOLD PREDICTIONS

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STUDENT LIVING FROM LETTERONE.
KF ADVISED IQ.

KF ADVISED IQ.

THE PORTFOLIO COMPRIS 1,644 ROOMS ACROSS 11 SITES IN LONDON, EDINBURGH, YORK, BATH AND BRIGHTON.

The price achieved was £870m, reflecting a yield just above 4%.

The portfolio comprises 1,644 rooms across 11 sites in London, Edinburgh, York, Bath and Brighton.

Goldman Sachs and Wellcome Trust’s Q2 student accommodation has bought pure student living from LetterOne.

KF advised IQ.

The price achieved was £870m, reflecting a yield just above 4%.

SPECIALIST SECTOR REPORT 2018

RESEARCH

90,561

18

19
HIGHLIGHTS

CAPITAL MARKETS

HEALTHCARE

Investment transactions reached £1.32bn in 2017, 88% higher than the 10-year average. It was prepared during the period April 2018. It uses certain data available then, and reflects views of market sentiment at that time. Details or anticipated details may be provisional or have been estimated or otherwise provided by others without verification and may not be up to date when you read them. Any forecasts or projections of future performance are inherently uncertain and liable to different outcomes or changes caused by circumstances whether of a political, economic, social or property market nature.

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