For Investment Professionals only

Investment case

The UK Private Rented Sector (PRS)

M&G REAL ESTATE

The value of an investment and the income from it can fall as well as rise and you may not get back the amount you originally invested.

The UK PRS has doubled in size in the past decade and is increasingly attracting the attention of institutions including pension funds and insurers.

There are now 97,500 Build-to-Rent homes complete, under construction or in planning across the UK.[1] We expect this figure to grow thanks to the sector's potential to generate a strong, stable income stream and proven diversification benefits. Our research suggests that the investment case for UK PRS is backed by:

- Low correlations with commercial real estate, equities and bonds
- Defensive characteristics with improved capital preservation
- PRS is the fastest growing tenure type
- A long-standing supply/demand imbalance in the UK housing market, backed by strong population growth
- Scope for professional investors to add value through active management and economies of scale

Demographics and demand

Demographic trends suggest that demand for housing will continue to rise. The UK population is expected to expand by around 0.5% per annum in the medium term (2017-2026)[2] – much faster than the European Union average of just 0.2%.[3] London's population is growing even faster. At the same time, household size is continuing to fall, with more people living alone.

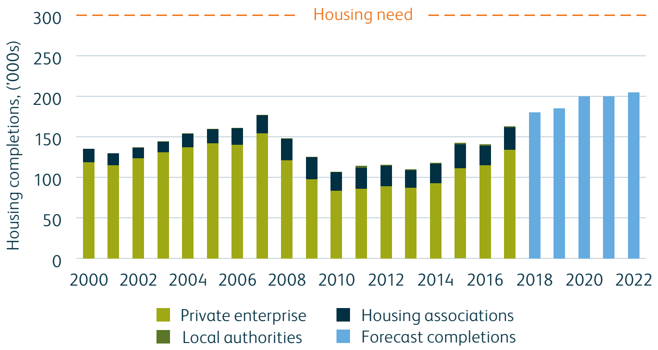
The government estimates that some 300,000 new homes need to be built annually. However, supply is lagging behind, with 163,190 homes built in 2017.[4]

The resulting supply/demand imbalance creates upwards pressure on house prices over the long run. Barriers to home ownership remain high, with significant affordability constraints (particularly in London). This is expected to fuel demand for rented accommodation – a sector which was dominated by private landlords.

The PRS has been growing over the past decade, and – at 4.5 million households – now represents 20% of the English market,[5] up from 10% in 2001. In addition, a significant proportion now see themselves as permanent renters, with the 2016-17 English Housing Survey suggesting that only 60% of the PRS households surveyed expect to move into owner-occupation in the future

The rising demand for private rental in the UK contrasts with the situation in continental Europe, where in many countries the sector is now fully mature and has stopped growing or is even shrinking. Indeed, in a report by the London School of Economics and the University of Cambridge, the UK was the only European country out of 11 studied where the general trend pointed to ongoing PRS growth.

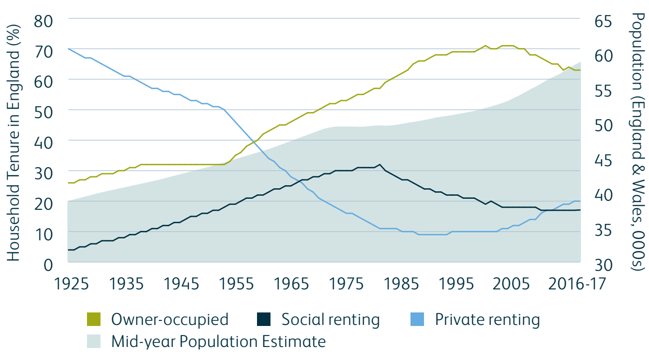
Housing supply (England)



Source: Ministry of Housing, Communities and Local Government (August 2018), JLL (March 2018).

Note: completion forecasts are for UK as a whole, not England.

Tenure over time (England)



Source: English Housing Survey 2016-17.

[1]Savills and British Property Foundation, Q2 2018. [2]ONS. [3]Eurostat, 2018. [4]Ministry of Housing, Communities and Local Government (August 2018), JLL (March 2018). [5]English Housing Survey, 2016-2017.

Strong risk-adjusted potential

According to IPD, UK residential property has outperformed commercial property over each decade since the 1980s. It has also fared well against other asset classes.

Total returns by asset class

Source: IPD, Residential Digest, IPD Annual Digest, Bloomberg, ONS.

While capital values in commercial property have declined by 30% in real terms since 1980, those for residential property have increased significantly, likely reflecting a combination of restricted supply and strong demand fundamentals.

Going forward, our research forecasts healthy investment performance for the UK PRS, with a 5-year average total return of over 6% expected outside of Central London.

Attractive rental growth prospects

The residential sector offers strong prospects for long-term income, backed by attractive rental growth potential as well as capital preservation and capital growth.

We forecast average residential rental growth of 3.2% p.a. in Greater London and the south east over the next five years, supported by the continued supply/demand imbalance and steady economic growth.

The prospects for generating an income return from residential are supported by the sector's lower level of voids. According to JLL's 2018 Build to Rent (BTR) survey, the average vacancy rate for BTR schemes is 5.2%, compared to an average of 6.9% for all property in the MSCI index.[6] The length of residential leases is shorter than in commercial, but the gap is getting smaller. Although the standard initial lease length of an Assured Shorthold Tenancy (AST) is one year, the average actual tenancy is in fact 3.9 years, according to the 2016-2017 English Housing Survey.

For private landlords and individual buy-to-let investors, management costs typically eat up around one-third of the income from privately rented residential. However, these costs can be reduced through the economies of scale available to institutions and other large scale investors, compared to management on a "flat by flat" basis. This is because more efficient property management can maximise the long-term income stream from residential real estate.

Investment opportunities: London vs the Regions

London is a clear focus for PRS investors, reflecting the City's very strong underlying fundamentals. However, some bigger regional cities are drawing the attention of large investors thanks to their potential for significant house price growth, while others also look attractive from an investment perspective due to robust rental fundamentals.

London will no doubt continue to see the most extreme supply/demand imbalance and the greatest issues around housing affordability, therefore ensuring it should remain a key and, arguably, the most significant part of any investor's portfolio. However, selected major regional cities also possess similar conditions and therefore offer the potential for healthy rental growth, such as Manchester and Bristol where strong PRS growth is being driven by population growth and housing affordability. This is putting pressure on housing prices, suggesting a healthy outlook for rental growth. However, investors should be wary of overpaying for the income streams on offer in the regions, particularly as yields in some cities start to rival London pricing despite the fact that their supply/demand imbalances are generally less acute.

Diversification benefits

Property has different market drivers to those more traditional investments such as equities and bonds, and consequently shows very low correlation with those asset classes.

Multi-asset correlations

	Residential Real Estate	Commercial Real Estate	Equities	Gilts
Residential	1.0	0.7	0.2	-0.2
Commercial Real Estate	0.7	1.0	0.3	-0.1
Equities	0.2	0.3	1.0	0.2
Gilts	-0.2	-0.1	0.2	1.0

Source: IPD UK Residential Digest, IPD Annual Digest, Bloomberg, ONS. (Inflation-adjusted total returns, 1981-2017).

Analysis also suggests that residential could prove to be a suitable portfolio diversifier for commercial property investors, based on its much lower correlations with most traditional property segments than those subsectors show with each other.

[6]MSCI Annual Index, 2018

Property subsector correlations

	Residential	Retail	Office	Industrial
Residential	1.0	0.6	0.6	0.5
Retail	0.6	1.0	0.8	0.8
Office	0.6	0.8	1.0	0.9
Industrial	0.5	0.8	0.9	1.0

Source: IPD UK Residential Digest, IPD UK Annual Digest. (Inflation-adjusted total returns, 1981-2017).

Adding residential property into a multi-asset or commercial property portfolio would therefore be expected to improve risk-adjusted returns.

Defensive characteristics

People always need somewhere to live. Therefore, if there is a downturn in the economy, the robust nature of the rental market is demonstrated as it counteracts the sales market when the economic environment encourages, or even obliges, people to rent. This potentially lessens capital decline for rented accommodation investments.

The statistical volatility of commercial and residential property types has been similar over the past 30 years, which mainly reflects the upside volatility of residential property. However, when looking just at downside volatility (in this case, the risk of negative total returns), residential has actually shown a much lower level of risk than commercial. During the steep market downturns of the 1990s and 2000s, residential property recorded a smaller capital decline than commercial and also recovered its initial value faster.

Purpose-built, efficient stock

Achieving the necessary scale to make institutional investment viable is one of the prevailing barriers to entry for the PRS. While the equivalent US sector (known as multifamily) is mature, this took time to develop.

Forward-funding and forward-purchase offer an attractive route for large-scale investment in the sector, with housebuilders and developers increasingly open to such transactions. This is illustrated by the partnerships between M&G Real Estate and Crest Nicholson, and M&G Real Estate and Telford Homes, which have created much-needed PRS units across the UK.

By focusing on blocks and units designed specifically for rent and taking an active interest in the development of these products, experienced professional investors can aim to generate greater efficiencies in operation, energy and maintenance. Similarly, by ensuring consistency across developments, they can maximise economies of scale to reduce the costs of repairs and enhance overall potential returns through greater customer satisfaction, which impacts occupancy.

Brexit and the PRS

With 29 March 2019 the official date Britain is expected to exit the EU and move into its transitional period, uncertainty surrounding the outcome of Brexit is likely to persist. Nevertheless, the UK economy continues to grow. While monetary policy is accommodative and the labour market remains strong, the wider housing market should remain on a relatively firm footing.

The Prime Central London (PCL) owner-occupier market is likely to be most exposed to any negative effects from Brexit negotiations, given its links to global business and financial markets. Furthermore, the PCL market continues to adjust to the stamp duty land tax (SDLT) changes and buy-to-let legislation. Major regional cities, such as Birmingham and Manchester, seem to be largely unaffected by Brexit-related uncertainty. As a result, the largest impact from the ongoing negotiations appears to be the stand-still approach of owner-occupiers as they ‘wait and see’.

Uncertainty has also impacted the PCL rental market, albeit to a much less significant degree as rents have started to see signs of stabilisation. Away from PCL, the demand is still outstripping supply, as the flexibility offered by renting is increasingly attractive in the current environment. This should continue throughout the Brexit negotiations and into the first few years thereafter as people may look to rent, rather than buy.

While the reduced flow of migrants from the EU will to some extent restrict growth in tenant demand, constrained migration would be unlikely to cancel out the supply/demand imbalance for housing, especially as lower housing demand would be likely to spark a similar reduction in activity from housing developers.

Going forward, the PRS is expected to be one of the least affected sectors in the real estate market by the departure of the UK from the EU. As has been seen in previous downturns, the PRS has proved to be a relatively defensive part of the housing market, with falls in house prices counterbalanced to some degree by rising rents. This is a significant benefit for investors when compared to commercial real estate for example, whereby rising yields are often twinned with falling rental values.

The forward-funding route also offers greater tax efficiency than purchasing existing properties as the stamp duty land tax (SDLT) is based on the lower, pre-development land value.

Growth prospects in the institutional PRS are supported by the trends seen in the student accommodation sector. This has only recently become a truly institutional market, as developers have started to provide the kind of stock investors want to add to their portfolios. As a result, the student accommodation sector saw investment volumes of c. £4 billion in 2017 alone.[7] It is not hard to imagine a similar future for the PRS in the years to come.

[7]Knight Frank Q1 2018

The Green, Kilnwood Vale near Crawley, UK

Liquidity advantage

Liquidity is another potential advantage for residential property over its commercial counterpart. In commercial property, the only exit route is to sell a building to another investor. In a downturn where large-scale investor interest falls away, it may therefore not be possible to sell a building (at least for a reasonable price) until market confidence returns, potentially years down the line.

Although the same problems may apply to selling a whole block of flats at some points in the economic cycle, residential property benefits from the potential to sell flats individually to smaller buy-to-let investors or owner-occupiers. This potential pool of investors is likely to far outweigh the number of institutions in any market.

Moreover, when selling to owner-occupiers, investors do not have to sell at investment value as they would to another investor, potentially enabling them to secure a higher price and thus boosting investment returns. This double exit route makes the PRS increasingly attractive as an investment.

Conclusion

Overall, our research suggests that the investment case for UK residential is supported by favourable demographic trends, the supply/demand imbalance in the housing market, and long-term attractive rental growth prospects. The sector also offers diversification benefits versus other asset classes and real estate sectors, defensive characteristics and strong potential risk-adjusted returns. Professional investors have the scope to further optimise returns through economies of scale and greater efficiency. Taken together, this makes a compelling case for investing in the UK PRS.

For more information

Lucy Williams
UK and Ireland
+44 (0)20 7548 6585
lucy.williams@mandg.com

Stefan Cornelissen
Benelux
+31 (0)20 799 7680
stefan.cornelissen@mandg.co.uk

Manuele de Gennaro
Switzerland
+41 (0)43 443 8206
manuele.degennaro@mandg.com

Robert Heaney
Nordics
+46 7 0266 4424
robert.heaney@mandg.co.uk

www.mandgrealestate.com