

Investment Case

The UK Private Rented Sector (PRS)

February 2020

The UK Private Rented Sector (PRS) has doubled in size in the past decade and is now increasingly attracting the attention of pension funds and insurers.

We expect this to grow thanks to the sector’s potential to generate strong, stable income streams and proven diversification benefits. Our research suggests that the investment case for PRS is backed by:

- **Low correlations with commercial real estate, equities and bonds**
- **Defensive characteristics with improved capital preservation**
- **A long-standing supply/demand imbalance in the UK housing market**
- **Attractive rental growth prospects, particularly in London**
- **Scope for professional investors to add value through active management and economies of scale**

Diversification benefits

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

Figure 1: Multi-asset correlations

	Residential real estate	Commercial real estate	Equities	Gilts
Residential real estate	1.0	0.7	0.3	-0.1
Commercial real estate	0.7	1.0	0.3	-0.1
Equities	0.3	0.3	1.0	0.2
Gilts	-0.1	-0.1	0.2	1.0

Source: MSCI Annual Property Digest 2018; MSCI Residential Property Digest 2018; Bloomberg, March 2019; M&G Real Estate.

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

Figure 2: Intra-property 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: MSCI Annual Property Digest 2018; MSCI Residential Property Digest 2018; Bloomberg, March 2019; M&G Real Estate.

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

Defensive characteristics

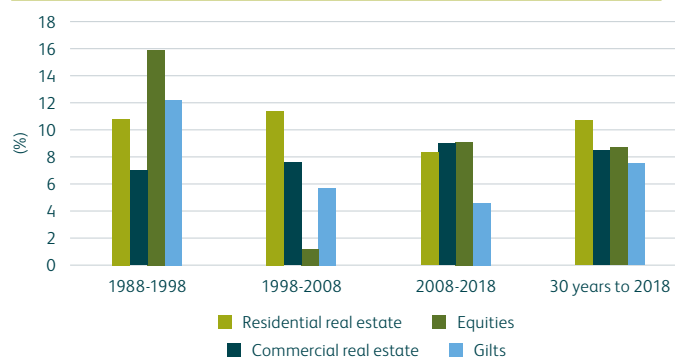
People always need somewhere to live and the robust nature of the rental market is never more evident than in a downturn, as a weak sales market can encourage, or even oblige, people to rent. This more stable, or even strengthening, demand pool potentially lessens capital decline for rented accommodation investments.

The statistical volatility of the commercial and residential property types has been similar over the past 30 years, largely because of the strong positive performance shown by 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.

Strong risk-adjusted returns

According to IPD, UK residential property has outperformed commercial property over the past 30 years. It has also fared well against other asset classes.

Figure 3: Total returns by asset class



Source: MSCI Annual Property Digest 2018; MSCI Residential Property Digest 2018; M&G Real Estate.

While capital values in commercial property have declined by 30% in real terms between 1980 and 2018, those for residential

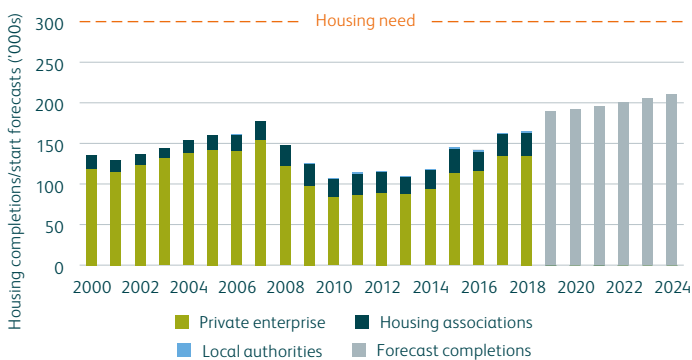
property have increased significantly (by more than 1,000%), likely reflecting a combination of restricted supply and strong demand fundamentals.

Demographics and demand

Demographic trends suggest that demand for housing will continue to rise. The UK population is expected to expand by around 0.4% per annum in the medium term (2018-2028)¹ – much faster than the European Union average of just 0.1%². London is growing even faster. At the same time, household sizes have fallen over the last ten years, with more people living in one- or two-person households.

The government estimates that some 300,000 new homes are needed annually. Although the number of net additional dwellings reached its highest level for more than 19 years at c. 240,000 in England in 2018/19³, this still leaves new supply lagging behind the stated housing need.

Figure 4: House building in England

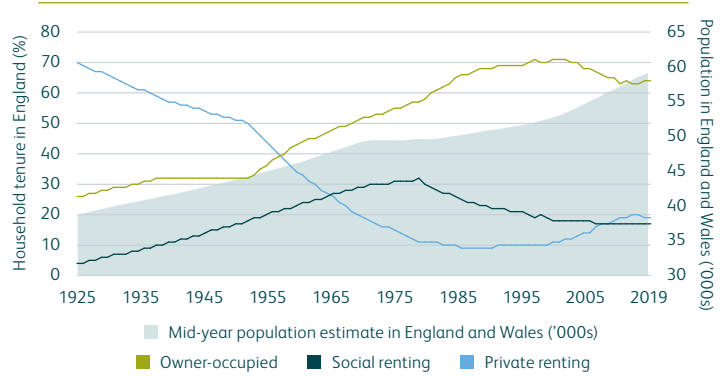


Source: www.gov.uk, October 2019; JLL, November 2019.
 Note: Housing start forecasts are for UK as a whole, not England.

The resulting supply/demand imbalance means upwards pressure on house prices and rents over the long term. Barriers to home ownership remain high, with significant affordability constraints (particularly in London). This is likely to continue to fuel demand for rented accommodation. With recent government policies acting to curb the growth of the Buy to Let (BTL) market, other sources of rental supply are sorely needed.

The PRS has been growing over the past decade, and – at 4.5 million households – now represents 19% of the English market⁴, up from 10% in 2001. In addition, a significant proportion now see themselves as permanent renters, with only around 55% of the PRS households surveyed as part of the 2018/19 English Housing Survey expecting to move into owner-occupation in the future.

Figure 5: Tenure over time



Source: English Housing Survey, January 2020.

Attractive rental growth prospects

The residential sector offers a strong stream of long-term income, backed by attractive rental growth prospects as well as capital preservation.

We forecast average residential rental growth of 3.1% pa in Greater London and the South East over the next five years, supported by continued supply/demand imbalances and 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 8.7% for commercial property⁵. 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, 4.1 years, according to the 2017/18 English Housing Survey.

For private landlords and individual BTL investors, management costs typically absorb 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 the long-term income stream from residential can be maximised through more efficient property management.

¹ ONS, October 2019.

² Eurostat, July 2019.

³ www.gov.uk, March 2019.

⁴ English Housing Survey 2018/19.

⁵ MSCI Annual Property Digest 2018.

* Forecast relates to end-2019 to end-2024.

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 multi-family) 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.

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 ensure greater efficiencies for operation, energy and maintenance. Similarly, by ensuring consistency across developments, they can maximise economies of scale to reduce costs of repairs and enhance overall returns through greater customer satisfaction, which impacts occupancy.

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 PRS are supported by recent experience in the student accommodation sector. Institutional investment into student accommodation has been steadily increasing as developers have started to provide the kind of stock investors want to add to their portfolios. This is a trend that the PRS has been looking to replicate with the creation of BTR. Indeed, this is already proving to be the case, with institutional investment volumes in the PRS having reached £2.1 billion in the first nine months of 2019⁶, despite a backdrop of political uncertainty which has acted to restrain investment volumes generally. With significant capital still targeting the sector, it is likely that volumes will continue to rise as the PRS, and BTR in particular, becomes more established.

Liquidity advantage

Liquidity is another potential advantage for residential property over its commercial counterpart. For 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 not 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 BTL investors or owner-occupiers. This potential pool of investors likely far outweighs 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.

Investment opportunities

London vs the regions

London is an obvious focus for PRS investors, reflecting the city's strong underlying fundamentals. The capital 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 fundamental part of any investor's portfolio. However, some bigger regional cities are drawing the attention of big players thanks to their potential for capital value growth, underpinned by robust rental fundamentals.

Cities such as Manchester, Birmingham and Bristol have also been seeing strong PRS growth, driven by population growth and demand for low-cost housing. This is putting pressure on house prices, suggesting a healthy outlook for rental growth. Certain cities are seeing rising development pipelines, reflecting increased investor interest, however this could impact the potential for rental growth in selected markets in the medium term so careful understanding of affordability and scale of pipeline are key.

Brexit and the PRS

The residential market has seen a sharp rise in sentiment since the general election result and, by extension, greater clarity around Brexit. An anticipated rise in transactions by owner-occupiers, together with continued low interest rates and a strong labour market, could drive up house prices, particularly in London.

In contrast, major regional markets like Manchester and Edinburgh have remained more insulated from Brexit uncertainty, and continue to see house prices rise.

While positive for underlying capital values, a recovering housing market may exacerbate affordability issues for would-be first-time buyers.

Within the rental market, the demand and supply imbalance is growing. A focus on renting, particularly in the face of uncertainty, mirrors a shift towards greater flexibility in the way people live and work.

Customers increasingly expect high quality, professional services embedded within their living space, at a cost they can attain. Yet this type of space represents only a small proportion of existing stock.

There is also greater demand for rental accommodation from an older demographic, reflecting affordability issues as well as the trend for flexibility and experience-led living.

At the same time, government reform around BLT property is prompting a number of landlords to exit the market, placing further pressure on rental supply. According to Hometrack's Rental Market report for Q4 2019, the UK saw an 8% increase in rental demand over 2019 while the supply of homes available to rent has contracted by 4% over the last two years.

While the reduced flow of migrants from the EU will to some extent reduce growth in customer demand, net long-term international migration into the UK remained healthy at 212,000 in June 2019, with a growing number coming from outside the EU.

⁶ CBRE, January 2019.

Furthermore, a restriction on migration would be unlikely to cancel out the supply/demand imbalance for housing, especially as lower housing demand would likely prompt a similar reduction in activity from housing developers. In London, we estimate a net supply shortfall of at least 10,000 households pa over the next five years as a result of overall population growth.

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 seen in previous downturns, the PRS has proved to be a relatively defensive part of the housing market, with falls in house prices often counterbalanced to some degree by rising or stable rents. This is a significant benefit for investors when compared against commercial real estate for example, whereby rising yields are often twinned with significant falls in rental values.

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 versus other asset classes and real estate sectors, defensive characteristics and strong 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.

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