M&G REAL ESTATE

Investment case

The UK Private Rented Sector (PRS)

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.

There are now 139,508 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 strong, stable income streams and proven diversification benefits. Our research suggests that the investment case for PRS is backed by:

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

Demographics and demand

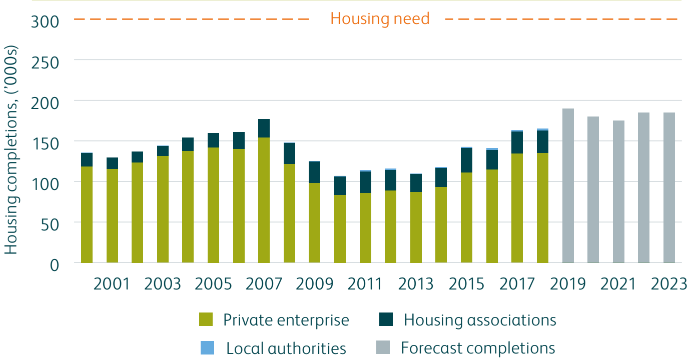
Demographic trends suggest that demand for housing will continue to rise. The UK population is expected to expand by around 0.5% per annum in the medium term (2018-2028)[2] – much faster than the European Union average of just 0.2%[3]. London is growing even faster. At the same time, household sizes 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 a 10-year high of c.220,000 in England in 2017/18[4], this still leaves new supply lagging behind rising demand.

The resulting supply/demand imbalance means upwards pressure on house prices and rents over the long term. Barriers to homeownership 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 market, other sources of rental supply are sorely needed.

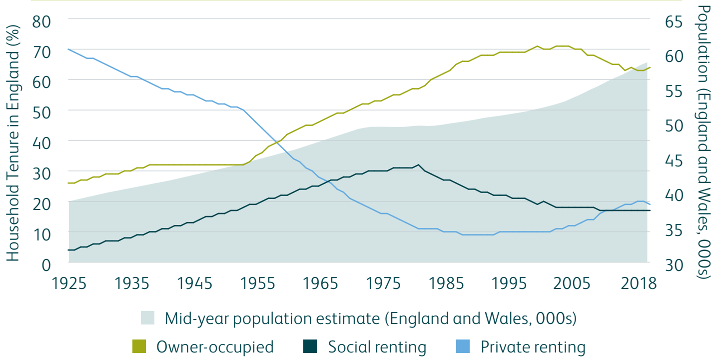
The PRS has been growing over the past decade, and – at 4.5 million households – now represents c.20% of the English market[5], up from 10% in 2001. In addition, a significant proportion now see themselves as permanent renters, with fewer than 60% of the PRS households surveyed as part of the 2017-18 English Housing Survey expecting to move into owner-occupation in the future.

House building in England



Source: Ministry of Housing, Communities and Local Government (March 2019), JLL (February 2019).
Note: completion forecasts are for UK as a whole, not England.

Tenure over time (England)



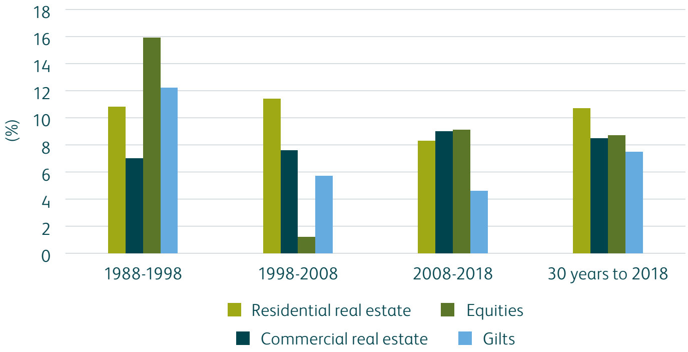
Source: English Housing Survey (March 2019).

[1] BPF, Q4 2018.
[2] ONS, October 2017.
[3] Eurostat, 2018.
[4] Ministry of Housing, Communities and Local Government (March 2019).
[5] English Housing Survey, 2017-2018.

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.

Total returns by asset class



Source: IPD Residential Digest 2018, IPD Annual Digest 2018, Bloomberg (March 2019), ONS (March 2019).

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 1000%), likely reflecting a combination of restricted supply and strong demand fundamentals.

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 3.2% 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 property[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, 4.1 years, according to the 2017/18 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 the long-term income stream from residential can be maximised through more efficient property management.

Diversification benefits

Property has different market drivers to those of 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	0.3	-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: IPD UK Residential Digest 2018, IPD Annual Digest 2018, Bloomberg (March 2019), ONS (2019). (Inflation-adjusted total returns, 1981-2018).

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

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: IPD UK Residential Digest 2018, IPD UK Annual Digest 2018. (Inflation-adjusted total returns, 1981-2018).

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 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.

[6] MSCI Annual Digest 2018.

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. This is illustrated by the partnerships between M&G UK RPF and Crest Nicholson, and M&G UK RPF 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 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 institutional 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 duplicate with the creation of BTR. Indeed, this is already proving to be the case, with institutional investment volumes in the PRS having reached £3.1 billion in 2018[7], a rise of one third compared with the previous year. With significant money 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. 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 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 as a result.

Investment opportunities

London vs the regions

London is an obvious focus for PRS investors, reflecting the city's very strong underlying fundamentals. However, some bigger regional cities are drawing the attention of big players thanks to their potential for significant house price growth and/or robust rental fundamentals.

London will no doubt continue to see the most extreme supply/demand imbalances and the greatest issues around housing affordability, therefore ensuring it should remain a fundamental part of any investor's portfolio. However, selected major regional cities are also suffering from similar challenges and therefore offer the potential for healthy rental growth. 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

There remains significant ambiguity surrounding the path to Brexit. As such, the uncertainty that has been affecting the UK's economy and residential market looks set to continue in the short term at least. However, the UK economy is expected to continue to grow. At the same time, monetary policy continues to be accommodative, with the potential to be loosened if required, while the labour market is also strong. This should help to provide a floor beneath house prices.

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 stamp duty land tax changes and buy to let legislation. In contrast, major regional cities, like Birmingham and Manchester, are likely to be affected to a lesser extent. As with the wider economy, the largest impact from the ongoing Brexit uncertainty appears to be the standstill approach of owner-occupiers as they 'wait and see'.

Uncertainty has also impacted the PCL rental market, albeit to a much lesser degree, with sentiment now appearing to have stabilised. As such, rents in London – both in PCL and more widely – have now bottomed out and started to grow again. London's supply/demand imbalance appears to be growing as the flexibility offered by renting looks increasingly attractive in the current uncertain environment. A focus on flexibility in the face of uncertainty should continue in the run up to Brexit and into the first few years thereafter as people may look to rent, rather than buy.

[7] CBRE, January 2019.

While the reduced flow of migrants from the EU will to some extent reduce growth in tenant demand, a restriction on migration would be unlikely to cancel out the supply/demand imbalance for housing, especially as lower housing demand would likely spark a similar reduction in construction 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 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 stable or rising rents. This is a significant benefit for investors when compared against commercial real estate for example, whereby rising yields are often twinned with falling 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 other 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.

For more information

UK and Ireland

Lucy Williams
+44 (0)20 3977 1035
lucy.williams@mandg.com

Switzerland

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

Benelux

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

Nordics

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

www.mandgrealestate.com

M&G REAL ESTATE