The case for UK Private Rented Sector

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Investing in UK residential property through its Privately Rented Sector (PRS) is a compelling opportunity today. The sector has a place in a balanced diversified investment portfolio, given its low historical correlation with other asset classes and the potential to deliver attractive risk-adjusted returns. PRS is backed by strong market and demographic fundamentals, a long-standing supply and demand imbalance and, more recently, broad government support to its development as a sector for institutional investors.

It is widely recognised that the UK has a long-term housing shortage,1 which has persisted for over 40 years.2 This lack of supply has caused house price growth to exceed general price inflation by 2.1% p.a. since 1970, in comparison with commercial property whose capital value has undershot inflation by 1.6% p.a.3

The UK is viewed by many international investors as having one of the most developed real estate markets globally. Given that the residential sector is a significant part of most developed countries’ institutional investment universe (see chart below), it is reasonable to ask why UK institutions have largely ignored it – until very recently.

![Residential as a % of Institutional Real Estate Portfolios Globally](chart.png)

Source: IPD, 2014
History and background

UK pension funds and insurance companies have mostly ignored the PRS for historical and operational reasons.

The PRS was a ‘political football’ throughout the post-war period until the mid-1990s. During this time, Labour governments legislated to provide PRS tenants with both security of tenure and controlled rents. If increases were permitted at all, they were severely below inflation levels. Conservative governments reversed this legislation to make letting attractive again for landlords. However, the proportion of the total housing stock in the PRS steadily declined to just 9% in 1992 from 20% in 1971 (see chart right).

The first indication of a change occurred in 1997 when the new Labour government (led by Tony Blair) announced that it wanted a vibrant PRS, recognising that the Assured Shorthold Tenancy and other changes brought in by the Conservatives in the previous decade should be preserved.

This change encouraged one or two institutions to invest in the PRS, for example, the Wellcome Trust. However, most institutions remained sceptical that Labour would not interfere eventually, and/or decided that investing in the PRS was just too difficult, especially relative to commercial real estate.

Commercial property leases in the UK are probably the most landlord friendly in the world: the tenant virtually always bears the cost of all repairs, insurance and taxes. Investors are used therefore to the gross rent paid by the tenant equating to the Net Operating Income.‘

By contrast, residential property is let on gross rents with the landlord responsible for all outgoings including repairs and taxes, in common with residential lettings in most countries. This lease structure is a management challenge to investors who are not used to optimising net operating income from their real estate. Moreover, residential leases are typically annual tenancies, so much shorter than commercial, thus requiring more reletting activity.
The UK PRS has grown significantly since 1997 and now comprises 18% of the housing stock (see chart right). Having said that, the vast majority of this growth has come from private individuals deciding to become ‘Buy to Let’ landlords. Landlords that own only a single property hold 40% of the PRS stock and just 8% describe themselves as full-time landlords. Thus, the market is highly fragmented and landlords with over 100 units hold only 10% of the PRS stock (see chart right).

As a result, the residential property management industry has developed to service multiple ‘Buy to Let’ small landlord customers rather than institutions. Institutions looking to invest in the PRS have found it hard to appoint a manager capable of servicing their more demanding requirements. As the demand develops, existing managers are adapting their business models to meet the needs of institutional investors. We are expecting to see new service providers emerge as this demand develops, just as has happened in the UK student-let market.

In the last 10 years, the Government has introduced a number of measures to encourage institutional investors to enter the PRS market. These include the introduction of Real Estate Investment Trusts in 2007, the amendment of Stamp Duty Land Tax (SDLT) in 2009 so that portfolio buyers pay the same SDLT as ‘Buy to Let’ investors acquiring a single unit and, in 2013, the creation of a PRS Taskforce, staffed with high-calibre professionals experienced in the sector, to identify barriers and promote solutions. These actions are starting to bear fruit and a number of institutions are entering the market, for example, local authority pension funds.
Diversification and access to inflation-correlated investment

Despite the lack of institutional investment, residential property has outperformed both commercial property and the other main UK asset classes over the long term. These returns have been achieved both with lower volatility and low correlations versus other UK asset classes so that residential can play a very valuable role in a multi-asset portfolio (see table below).

These high returns have been driven more by capital appreciation than income. UK House Price Inflation (HPI) has consistently exceeded general price inflation and matched wage growth so provides an excellent hedge for inflation-linked liabilities.

Such price outperformance is attributable to the lack of house building since the 1970s. The UK government drastically reduced funding for new social housing after 1975 and the private sector has not increased its output to meet the shortfall. This is widely blamed on the UK land use planning system that severely restricts the release of greenfield sites for urban development and for housing in particular.
Various government-commissioned reports have advised that 240-250,000 dwellings per annum need to be constructed merely to keep HPI at a level to match general price inflation but this level of output has not been delivered consistently for 40 years. Moreover, output recently has been below (see chart right) 150,000 units p.a. We therefore expect HPI to continue to grow faster than general inflation and for rents to increase similarly, so ensuring that the attractive historical performance trend of the sector is continued (see chart right).

Furthermore, given the fragmented nature of the PRS market, there is ample scope for institutional investors to provide an enhanced product and customer service to the tenants.

UK dwelling output is currently running about 40% below advised rates.
Location and market dynamics

Demand for residential in the UK tends to be strongest in London and its immediate commuting hinterland. This is due to two main factors: employment opportunities are greatest there and the constraints on new development are at their tightest. However, today we believe the returns prospects are much better in the rest of the country. **This is because prices have increased much faster in London than the rest of the country over the last five years, stretching the differential to record levels.** We expect this pattern to reverse as the regions catch up (see chart below), because the same fundamental drivers are present. Moreover, rental yields are materially higher outside the capital and are currently adding to the regions’ expected outperformance.

In the past, residential prices have increased first in London and this growth has rippled out to the regions. The gap between London prices and the rest of the country has only once been as wide during the last 40 years. LaSalle expects that capital value growth is likely to be superior in the regions over the medium term, despite London’s economy continuing to expand at a faster rate.

The demand for renting is strongest among the 25-40 year old cohort, and it is a trend recognisable all across UK. This cohort is forecast to grow by 6% until 2025, twice the rate of the general working population. This group both appreciates the flexibility that the PRS offers and it is finding it extremely difficult to become owner-occupiers.

Mortgage lenders have introduced far more stringent lending criteria following the Mortgage Market Review and now require higher deposits than in the past. Furthermore, most graduates are paying off student loans as university tuition fees have been increased significantly; this is further impeding their ability to save for a deposit and the proportion of people saving for a deposit has dropped by 6% over the past year to 43%.

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Drivers, approach and attractive risk adjusted returns

Virtually all UK PRS housing today has been designed for sale to owner-occupiers rather than rental and ‘Buy to Let’ landlords tend to invest in individual units. As a consequence let apartment blocks typically have a number of landlords competing for tenants and no overall management plan. Institutions seek to invest in stock designed for rent and at scale, with multiple units within the same building, so that management can be much more efficient.

While existing PRS stock is occasionally offered for sale on the investment market, it is unrealistic to presume that an institutional-scale portfolio can be assembled by relying on market offerings of standing assets alone. **We believe that engaging with developers and housebuilders to secure stock in scale ahead of its construction is the right approach to executing a successful UK PRS strategy today.** This can ensure that the design of the property meets the needs of the target customers (i.e. its tenants), will achieve the best energy performance standards and can be managed cost effectively. Moreover, the construction risk can be substantially laid off to the developer through not paying for the property before practical completion though first letting risk is assumed by the investor.

LaSalle believes that there are currently better prospects for PRS investing outside of London because pricing has become stretched within the capital, especially in Central London. The cities with the best PRS prospects outside London include Bristol, Manchester and Milton Keynes that have vibrant business service employment opportunities in combination with a well-established PRS market.

LaSalle has developed a multi-factor model that ranks locations as PRS target markets, based on demographics, employment and economic prospects. The key variables are:

- size of the PRS market, as an investor needs to be confident that there is sufficient demand to absorb a large number of units in a short period,
- areas with growing populations particularly among those of working age, and
- centres with strong local employment prospects particularly in business and financial services, where wage levels tend to be highest.

London continues to be a strong PRS market too; we favour the more peripheral suburbs with improving transport links rather than Central London. There has been a significant increase in new supply in the centre, partly in response to a sharp price rise. A supply response is less evident in the rest of London, where 82% of 20-45 year olds in London say they will never be able to buy a property and the lower levels of value make rents much more affordable for young professionals. Thus, the prospects for rental growth are enhanced.

High class asset management is essential with all real estate but especially so with residential. The objective is to maximise net rental income in a sustainable manner through minimising voids and controlling costs. Investors should partner with managers who understand the standards that institutions expect and recognise that returns can be enhanced by providing excellent customer service to occupiers so optimising net income, replicating the US multi-family model.

We believe that the resulting PRS investment should deliver returns of 8% p.a. at the asset level, with significant contribution from recurring net income and income growth.

This forecast assumes that rents will grow at around 3% p.a., which we believe is realistic for new residential properties designed to be rented and in good locations. We forecast returns at a level likely to outperform commercial property over the next five years, as residential has consistently done over the last 40 years (see table on page 5).
Conclusion

Supply, demand and location

The UKPRS offers institutions a compelling combination of reliable income growth and robust capital values.

Furthermore, PRS returns have shown low correlations with those from other asset classes, making the PRS an ideal component within a UK diversified portfolio. Investors who participate in the early phases of this new market are likely to harvest the best rewards.
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Notes:

3. Source: Nationwide, Office for National Statistics & IPD. Reliable long-term data on rental growth is lacking but the longest reputable series for PRS lets starts in 2000 and shows a real change of -0.3% p.a. since inception, in comparison with all commercial property that shows -2.3% p.a. (IPD UK Residential & All Property Indices 2014).
4. Often the only deduction is the cost of rent collection, though this ignores voids and rent free periods because ‘gross rent’ is usually less than total potential rental income.
5. In fact, all the UK REITs created invest in commercial property even though this was not the Government’s intention by permitting this type of vehicle.
6. UK Residential Returns based on Nationwide House Price Index plus long-run income return of 3.4% to IPD Residential.
8. As measured by deviation from linear trend.
11. Halifax op.cit.
12. i.e. on the basis that IPD measures direct property returns.

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