



THE UK PRIVATE RENTED SECTOR: LOOKING BACK AT A YEAR OF PRSI

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OVERVIEW

Having grown by over 1 million households in a decade, the private rented sector is now worth in the region of £500 billion; which dwarfs the value of the commercial sector. In light of further population growth and underlying affordability issues, we expect continued strong rental demand.

The current economic climate provides an ideal opportunity for investors. In particular, a combination of stable rents and lower capital values have pushed yields out. In addition, in this credit constrained environment, institutional investors can provide an alternative source of funding which can provide a fillip for development.

It may be that current market circumstances have created the breathing space to allow institutions to gain a foothold. However, the real opportunity is much longer term, for both investors and renters. Importantly, a strong private rented sector will provide benefits to the UK economy at-large, contributing to a more flexible housing market and providing a desperately needed alternative source of finance to drive new housing supply.

INTRODUCTION

In June 2009, the Homes and Communities Agency (HCA) solicited expressions of interest for its 'Private Rented Sector Initiative' (PRSI). Even before this time, CB Richard Ellis was actively engaged with institutions and banks considering the opportunities for residential investment. Our experience enabled us to take a leadership position in partnering with Aviva Investors.

Our 'front and centre' role in PRSI has meant we have been deeply engaged in the debate; the facts, myths, challenges and opportunities. With this in mind, we have sought to summarise the key issues that have arisen in the past 12 months and to look at the likely outcomes for the UK private rented sector going forward.

An Apartment Building in Nottingham, UK



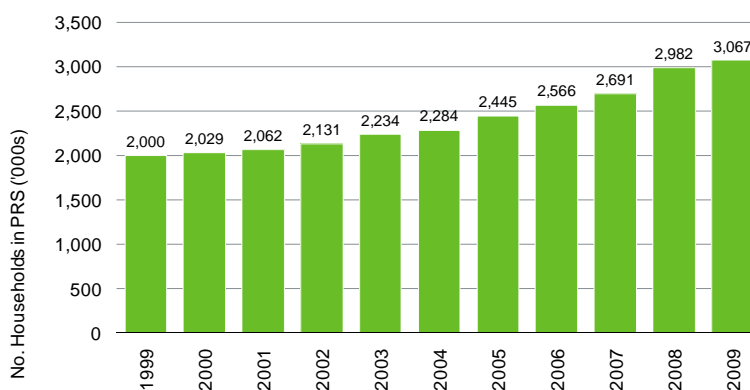
Source :Fotolia.com; Alison Bowden

JUST THE FACTS

Opinions about the private rented sector in the UK are full of false assumptions. Renting is a fact of life for a growing number and this fact is often borne out of choice, not necessity. The Englishman's home may still be his castle, but increasingly he rents it rather than owns it.

Two-thirds of all households created in 2008/09 were in the private rented sector and over the past decade it has grown by 1.1 million homes. It now represents 14.2% of all households in England. Conservatively, the sector is worth close to £500 billion, more than the entire UK commercial property sector.

Chart 1: Growth in PRS



Source :English Housing Survey

A RENTAL REVIVAL

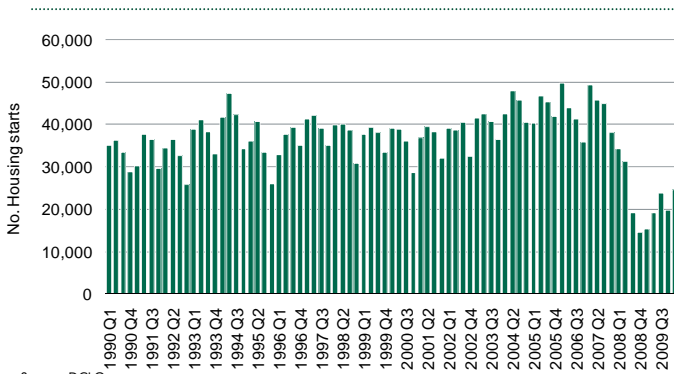
The change in tenure preferences reflects a number of issues, including:

- Declining affordability; despite the downturn, the average house price to income ratio remains uncomfortable for many (and their mortgage lenders). However, with average first-time buyer deposits currently at around £33,000, the entry costs to home ownership are also prohibitively high. The affordability problem is exacerbated in London, where the private rented sector is most prevalent.
- Changing household composition, including more singles through divorce, an aging population and delayed family formation (later marriage and birth of first child).
- Immigration into the UK has increased, notably since 2004 when the accession countries joined the EU. Net migration was over 1 million people in the 5 years to 2008.
- Increasing student numbers and student debt. This includes international students; for example, 175,000 people came to the UK for formal study in 2008.
- The growth of Buy to Let investment, with more than 1.8 million new mortgages of this type since 2000. This has increased the stock of good quality properties available for rent and has also improved choice. PRS accounts for 20% of new build stock nationally and up to 60% in London.

WHY ARE INSTITUTIONAL INVESTORS SO IMPORTANT?

In the current market, debt funding for development remains scarce, and where available is expensive. In addition, the economic and housing market downturn has virtually eliminated off-plan sales for all but the best schemes. This has meant that many developers and banks not only need a credible and secure exit route, but also require equity partners in order to build.

Chart 2: Housing Starts



Source: DCLG

Equity from institutional investors can provide a number of clear benefits to the sector. In the first instance, it was hoped by the HCA that institutions would fulfil the funding gap that has prevented housing supply from being maintained through the downturn. This would provide support to the housebuilding industry and may have reduced job losses.

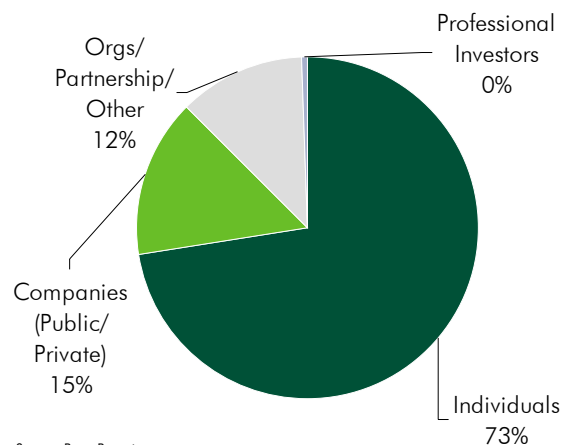
However, there are longer term benefits that represent the real value of institutional investment in residential. By diversifying the funding options used for residential development and reducing the dependence on debt, the sector should become more resilient to future market shocks. In turn, the impact on housing supply due to a lack of finance should be diminished.

The presence of institutional checks and balances within the private rented sector will also bring about a professional management approach that the sector sorely needs. While the quality of rental stock has been improving through the growth of buy to let investment, the quality of management widely varies. This is because the market is unsophisticated. For example, 73% of UK residential portfolios contain less than 10 units. Institutions are more tightly focussed on income returns through rents, and the biggest risk to income is void periods. The best way of preventing voids is to ensure that tenants are happy, choosing to renew their lease rather than move on.

WHY ARE INSTITUTIONS INTERESTED IN RESIDENTIAL?

The returns available from UK residential property are, at least, in line with other assets. According to the Investment Property Databank (IPD), the five year average total return of 6.8% is ahead of equities (6.5%), commercial property (1.8%) and bonds (5.5%).

Chart 3: Make up of PRS



Source: Rugg Report

More importantly, investors are eager to spread their property exposure and risk profile. IPD data show that commercial property values fell significantly more from peak to trough than residential values.

In addition, recent research from CB Richard Ellis shows these returns are associated with a lower relative level of risk (as measured using a Sharpe Ratio). This means these stronger returns can be achieved despite being 'safe' investments.

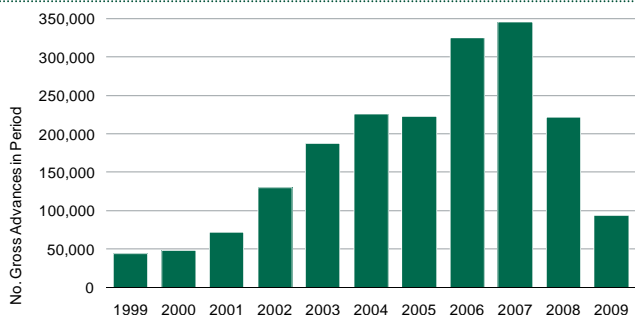
There are a number of other reasons that make residential a compelling investment opportunity in the UK:

- **Rental income is closely correlated with wage growth.** For pension funds, wage growth is the key determinant of defined-pension payout liability. Therefore, investment in residential is a very good way to offset this cost.
- **Residential investment in the UK is currently very unsophisticated, with highly fragmented ownership due to the growth of buy to let investment.** This presents an opportunity for institutions to drive a more professional approach to lettings and management and attract higher levels of demand. In turn, operating efficiencies should improve the returns.
- **The economic and market downturn has led to capital values falling.** With strong rental growth prospects, the traditional problem of very low yields has eased slightly. This is also helped by the shortage of available development funding, meaning that institutions can drive deeper discounts from developers that need partners in order to build out stock.

WHAT ARE THE CURRENT HURDLES?

Small transaction sizes: Access to 100% private rental blocks of scale has not previously been possible in the UK. However, critical mass generates procurement and operating cost savings. This might include lower costs associated with the maintenance or leasing of units as this can be managed through an in-house team. It also provides the potential to offer a superior product for tenants, including function rooms, fitness facilities, swimming pools etc. This helps with marketing and tenant retention, therefore reducing void periods and turnover.

Chart 4: Buy to Let (Gross Advances)



Source: CML

Overall, a critical mass of units contributes to more efficiently managed properties as noted above. This is the central reason why many institutions are considering developing out 100% rental properties rather than acquiring existing properties.

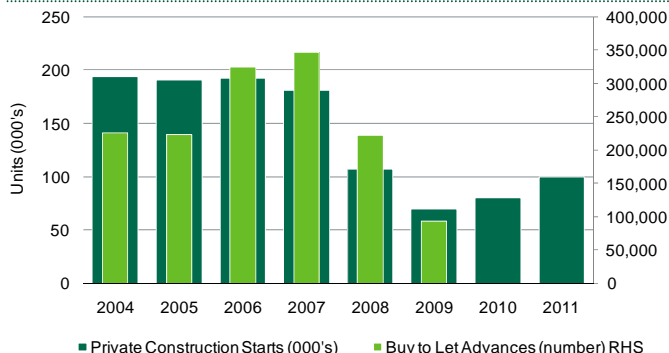
A lack of transparency including reliable market information: The residential sector lacks sophistication and robustness when compared with commercial property, in terms of analysis and raw data collection. However, the presence of big institutions is already driving a more sophisticated approach to rental and yield projections. This challenge is likely to solve itself as the sector matures.

Uncertain regulatory regime: The residential market has a history of political interference. The instability of planning policy is recognised as one of the major impediments to new development. It is hoped that the new Government will address this as a way to improve housebuilding volumes.

Returns based on capital growth, not income-derived yields: Traditional commercial investors are less comfortable with returns that are primarily based on capital growth rather than income. The current market need for equity financing for development has created an opportunity to purchase at a strong discount to open market values. This has improved yields well above market norms. However, net residential yields remain, on the whole, well below the level for commercial property.

Reputation risk associated with tenant management: There is a misplaced perception that reputations could be tainted by making hard business decisions about housing people; 'kicking granny out in the cold' if she is unable to pay the rent. However, there are strong contrary arguments that demonstrate how a positive property management 'brand' can drive higher demand and rents. For example, the US model refers to 'residents' instead of 'tenants' and applies the North American approach to strong customer service.

Chart 5: Buy to Let and Delivery



Source: DCLG, Experian and CML

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SO, WHERE DO WE GO FROM HERE?

Continued Demand for PRS: The UK population is expected to grow by nearly 16% (10 million people) over the next 25 years. Coupled with weak house price affordability levels and changing tenure preferences, demand for rental properties will continue to be supported.

The Government: Through the HCA and the PRSI, the Government has been very active in supporting the sector. It is recognised by most current actors that this is as a facilitator role rather than through a direct grant approach; in any event, there is no money in the public kitty to consider 'rental top-ups' or other direct forms of sector support.

However, the role of Government is still vital with respect to indirect support; educating local authority planning officers on the merits of 100% private rental blocks and creating the right 'fit' for this product within communities are both examples of the value it can add. There are ongoing discussions with the industry regarding the harmonisation of stamp duty costs between purchasers of multiple units (taxed at the full 4% rate) and individual units. This change would provide a modest benefit to institutional investors, but more importantly provides a strong signal to the market that the Government is committed to the sector.

Not About Planning: This is not about a separate planning use class, as some have suggested. A separate use class would only serve to reduce land value for 'PRS land' and encourage landowners to seek out open market residential land buyers. The net impact of a separate use class would be very little if any Build to Let stock being built.

Not if But When: It may be that current market circumstances have created the breathing space in the market to allow institutions to gain a foothold. However the real opportunity is much longer term, for both investors and renters. Importantly, a strong private rented sector will provide benefits to the UK economy at-large, contributing to a more flexible housing market and providing a desperately needed source of money to drive new housing supply.

We are aware of a significant number of investors actively considering this market. This includes not only the well publicised institutions, but also a number of private equity funds. We are confident that this level of interest will feed through to actual transactions in time. However, this is a new market and investors are naturally undertaking a thorough assessment of the rental market and the potential returns on a site by site basis. This due diligence process quite rightly takes time.

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