Jones Lang LaSalle

Real value in a changing world

advance

Multifamily: is the UK ready for a new asset class?

September 2012

Summary

After decades of decline, the Private Rented Sector is undergoing a remarkable period of growth. For most young people, high prices and deposit requirements make homeownership a distant dream, and the main destination for new or moving households has become a private tenancy. Over the five years since 2006, the number of households in the PRS has increased by 47.9%, or 8.2% per annum – while at the same time rates of owner occupation have fallen.

Given the constraints on mortgages and the limited supply of housing for sale, it seems that the PRS is destined for further expansion. A shortage of supply – particularly in London – is contributing to strong rental growth. If the sector is to continue to grow and to provide affordable accommodation for a mobile, young workforce, some 1.7m additional private rented units will be required by 2016.

This implies annual investment of circa £57bn – over eight times the size of the current buy-to-let market and more than double its size in 2007. While some of this will be provided by individual equity, it is clear that additional sources of funding will be required if the sector is to continue playing its important role.

The Government clearly recognises this, and has rapidly accepted the recommendations of the Montague Report into the barriers to institutional investment in the Private Rented Sector. Published in August, it recommended some radical measures aimed at attracting large-scale investors, including allowing planners to specify that schemes should contain PRS units that remain as such in the long-term. Indeed, the Government has gone further and will provide £10bn of debt guarantees for those institutions investing in the sector.

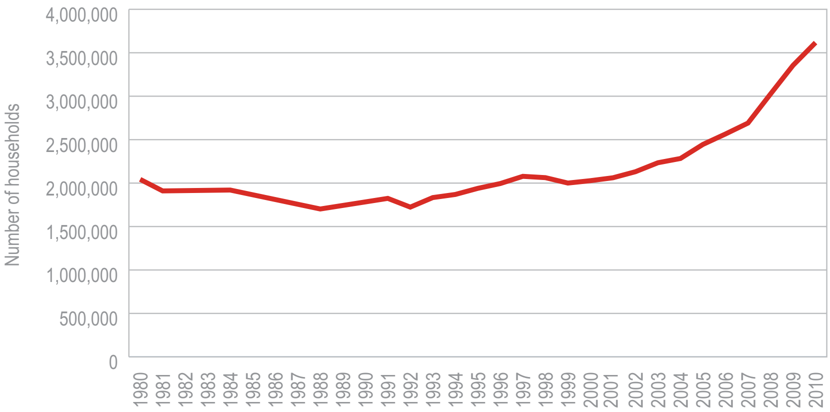
Other barriers to institutional investment are gradually disappearing. Management within the sector has improved and become more diverse, stamp duty has been reformed, and the REIT legislation made more appropriate for residential assets.

The case is clear – residential investment has outperformed other property asset classes, and indeed most other investments, over both the short and the long term. In the US, multifamily is now an established sector, attracting comparable levels of trading, investment and development to the retail and office markets. The time seems right for this model to gain a foothold on this side of the Atlantic.

Introduction

In recent years, the Private Rented Sector (PRS) has become overwhelmingly the main tenure for new households. It is now the norm for whole swathes of Britain, particularly younger households, and even the relatively affluent. For many, moving into homeownership (or, indeed, a social rented home) is very much the exception to the rule. Yet the market – developers, house builders, investors and funders included – does not yet appear to have entirely digested this radical change.

Size of the English private rented sector



Source: DCLG

Politicians may have called for the continued expansion of a 'property-owning democracy', but the past decade has been characterised by the rapid growth of the Private Rented Sector (PRS). As of the beginning of 2011, there were some 1.2m more households renting from private landlords than just five years previously – representing an astonishing growth rate of 47.9%, or 8.2% per annum. This growth appears to have been concentrated in urban areas, ranging from Inner London to Manchester, Brighton, Oxford and Cambridge.

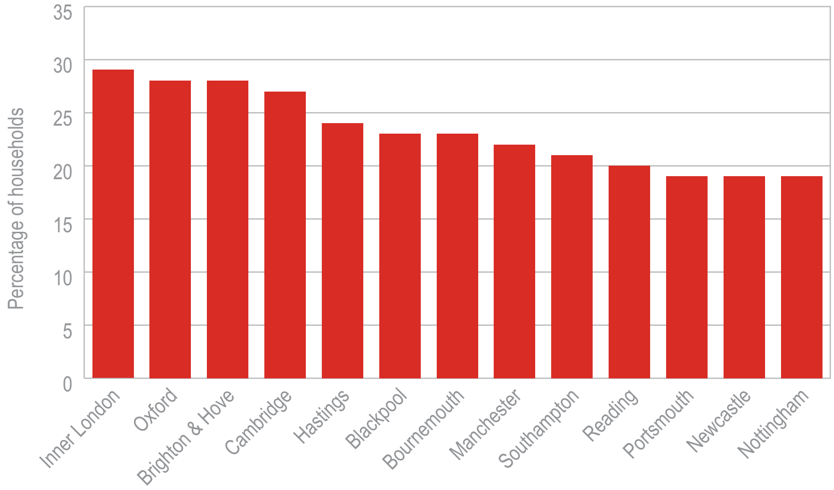
During the same period, the number of owner-occupiers fell by 130,000, although this headline figure obscures rising outright ownership and falling numbers of mortgagees. It is now likely that there are more private tenants than social tenants in England.

This reverses the trend of increasing home ownership that had been in place since the Second World War. Until relatively recently, it had generally been assumed that the PRS would become more marginal, and that the vast majority of households would become owner-occupiers (or, until the late 1970s, social tenants).

As late as 1953, more than half of the English population rented from private landlords; by the time of the Housing Act 1988, which set the ground for its revitalisation, the sector had shrunk to 9% of the total stock, a result of overregulation, among other factors. The Act's introduction of the Assured Shorthold Tenancy (AST), together with the later emergence of specific buy-to-let mortgages, encouraged and enabled individual investment in the stock.

Although growth was slow at first, the percentage of English households renting had risen to 17% by 2011. As this document explains, there are very good reasons for believing that the PRS will continue to expand, and that by 2020 as much as a third of the population could be private tenants.

Estimated size of Private Rented Sector, 2010 - larger towns and cities



Source: DWP

In large local authorities, such as Birmingham or Leeds, the prevalence of PRS may be understated as they cover a far larger number of suburban areas than more tightly bounded city centres such as Manchester.

The demand for rental accommodation

Undeniably, the high cost of owner-occupation has been one of the main drivers for the growth of the PRS. Across England, the ratio of median house prices to median incomes rose from 3.5 in 1997 to 7.2 in 2007, and despite the financial crisis had only eased to 6.7 by 2011.

The Montague Report

The Montague Report proposals - which the Government has indicated it will act on - are all aimed at creating a new residential asset class, in which land and homes are priced on the basis of rental income streams, rather than open market sales values. This would attract funds while also making the tenure more viable for stalled development sites.

The specific recommendations are:

- Local Authorities should proactively plan for the PRS, in accordance with assessments of local needs;
- They should ensure such homes are kept in the sector through the use of planning conditions and restrictive covenants;
- Councils should consider lowering or even waiving affordable housing requirements for PRS schemes, or the PRS component of mixed schemes;
- The greater effective demand for the PRS could drive greater volumes, unlocking stalled sites;
- The Government should work with councils and the Greater London Authority to earmark public land that could be sold to developers on the basis of a pre-determined PRS component;
- For the sale of such sites, the wider conception of a 'best value' should be adopted rather than simply accepting the highest price;
- A task force should be set up to enable private rented, and voluntary standards put in place for landlords;
- Some limited direct Government investment could be involved, to seed funds and to provide a business model for the industry;
- The schemes should not be confined to London, and should be spread across England

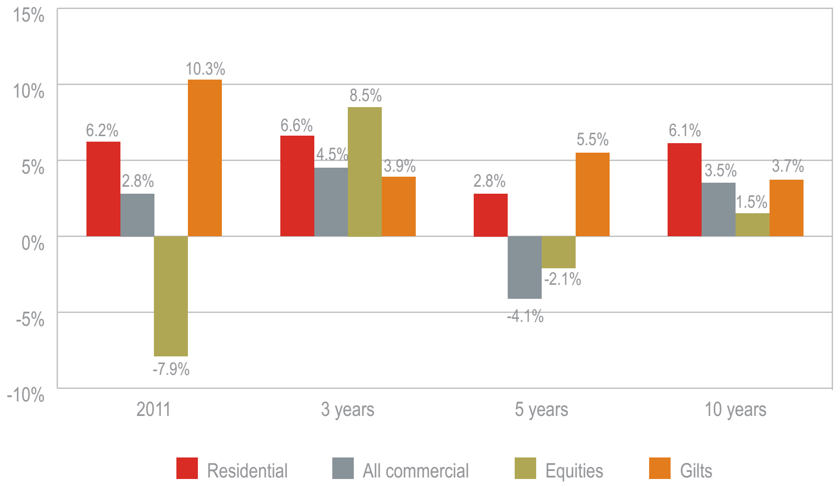
The overall framework appears robust, and is designed to stimulate the sector while, in effect, insulating it from owner-occupied values; the two sectors would operate according to entirely different dynamics. This may deter some, as many existing investors are attracted by the opportunity of selling units on the open market at some point in the future – although nothing in the recommendations would stop such funds from buying conventional PRS stock that could be sold at any time on the open market. However, the volume of potential investors who would wish to take advantage of a stable income stream in a growing sector would be much larger.

The Government has also announced £200m of funding to unlock sites for PRS as well as £10bn of guarantees for those institutions looking to invest. However, it is worth noting that the recommendations are still localist and it will be individual councils who decide whether to take the programme forward in their area. Much will also depend on how the institutions react to the measures - and whether the areas they target coincide with where the model is both viable and desirable to the local council. Nevertheless, the Montague Report - and the remarkable speed and clarity of the Government's response - provides a massive incentive for those institutions and other large-scale investors looking to enter the sector.

Since 2007, it has become extremely difficult for many would-be first-time buyers to access the mortgage market, with a deposit of at least 25% required to access reasonable rates, and lenders far more conservative on the multiples of income they will lend. The number of first-time buyers in England dropped from almost 600,000 in 1999 to around 360,000 in 2007, and for the past few years has dropped to below 200,000 per annum. It is also likely that many existing homeowners have chosen to let their properties out and rent elsewhere, rather than attempt to transact in a slow market or move to a more expensive mortgage product.

Affordability and mortgage shortages have obviously been instrumental, but they are not the only reasons for the sector's growth. London and other major cities have a much more international and transient population than twenty years ago; those intending to remain in this country for just a few years are unlikely to buy. Meanwhile, with more young people attending university, acquiring debts and starting work later in life, it may take longer for many to enter owner-occupation than in the past.

Inflation-adjusted residential performance - compared to other asset classes



Source: IPD

Furthermore, there is evidence that many expect to work abroad during their careers, and do not wish to commit to this country by purchasing a property. Finally, the major source of household growth is the increasing number of single-person households; they are simply not as likely, or as able, to access owner-occupation as couples or families.

Given the wider context of low mortgage availability, increasing regulation and poor affordability, it seems likely that demand for the rental sector will continue to grow. However, it is unclear where the supply of new stock that will allow the sector to expand will come from. The number of new homes built in recent years, at a little under 100,000 per annum in England, has been the lowest since the Second World War. Buy-to-let volumes, at 122,000 loans in 2011, are clearly growing, but remain at around a third of the level seen during the rapid expansion of the sector in 2006 and 2007. Individual landlords typically buy from the existing stock, so there is little direct stimulation of house building in the current system.

Rental Growth

The lack of new supply to the sector has coincided with the increased demand resulting from a dearth of mortgage finance and a slow housing market. Consequently, for much of 2010 and 2011, rents were rising at an annualised rate of more than 4% across the country, although in recent months the rate of growth has slowed substantially. This can be attributed to the squeeze on disposable incomes produced by high inflation over the past two years. Jones Lang LaSalle forecasts that rents will begin rising again once inflation subsides towards the end of this year.

London, however, has been a case apart. The continuing economic strength of the capital, and its status as a global magnet for a skilled, affluent workforce, has bolstered demand for accommodation. Given the shortage of both new build and second-hand supply, it is perhaps unsurprising that, according to Digital Property Group, rents rose by 9.3% over the 12 months to March 2012, having risen by an astonishing 16.8% over the previous 12 months. Indeed, average rents in the capital are now over 27% higher than in March 2010.

In the longer term, the returns from residential investment have been extremely healthy. As the IPD figures in the graph to the left show, it has consistently outperformed commercial on all time bases. On a 10-year basis, it is easily the best performing asset of all those listed, although on more recent measures Gilts or Equities outperform it. However, the performance of residential has been notably more consistent than these other asset classes, which have proved far more popular among institutions.

The bulk of residential returns has been driven by capital growth, rather than income return. This has traditionally deterred institutional investors as they prioritise the latter and are concerned that capitalising on the former is a matter of timing the cycle correctly. According to IPD, of the 11.3% total return registered for 2011 (not adjusted for inflation), 8.2% came from capital growth and just 2.9% from income. This is partly because rents have historically not kept pace with capital growth, and this has depressed yields (although recent years have gradually begun to change this picture).

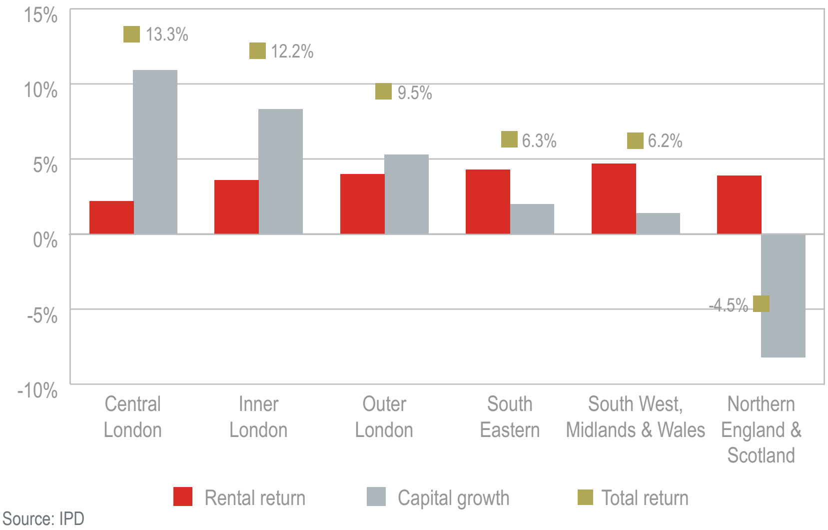
However, the IPD index is biased towards London and it is worth noting that some English regions have much higher income returns, as shown below. Consequently it is possible to create a portfolio which mixes high capital growth London stock with higher yielding stock from the regions. Moreover, as pressure on the rental stock grows amid a continued shortage of mortgages, it seems likely that returns will continue to rise, particularly in the capital.

The Opportunity

Until now, the growth of the PRS has been driven by individual private investors. According to the Government's survey of the sector, the majority of landlords own just one property. As a consequence, ownership is highly fragmented, with few large portfolios available, and even these are often spread around a wide geographic area. Leasehold flats present particular problems, as the management of the block may be out of the investor's control. Consequently, management is difficult and expensive, partly explaining the low net-to-gross ratio that characterises the sector. It also partly explains the lack of activity among institutional investors, who fail to find lot sizes that match their acquisitions in, for example, commercial property.

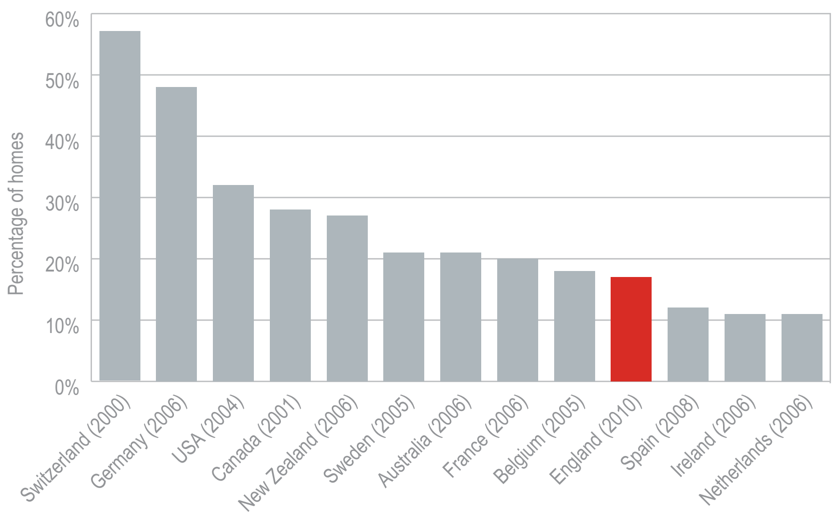
In the US, funds have developed large, single blocks which generate huge management efficiencies and provide a wide variety of high-quality accommodation and facilities for tenants – 'the multifamily model'. They are specifically built to let – unlike the vast majority of properties in the UK PRS, which were constructed with an eye on the owner-occupier marketplace. This has become a transparent market in which buildings are regularly developed and traded, with income return the deciding factor.

3-year residential performance, UK regions



Source: IPD

Size of PRS, international comparison

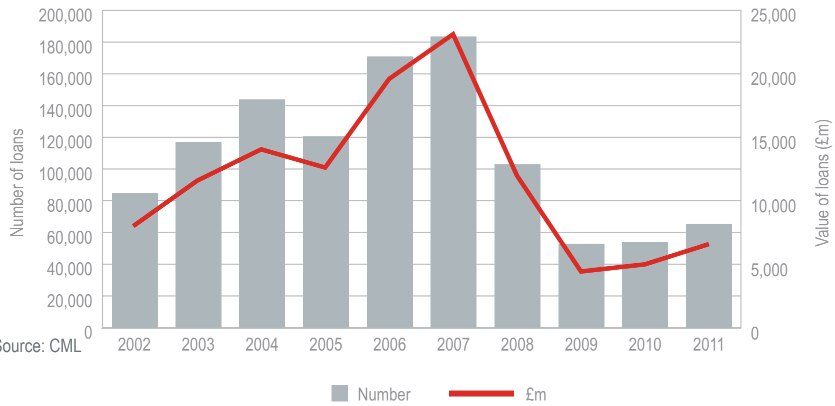


Source: DCLG

Despite recent growth, the UK PRS remains small by international comparisons. At 17%, it is not only smaller than countries such as Switzerland and Germany, where the sector accounts for around half of the entire stock, it is also smaller than in many other English-speaking countries, including the USA, Canada and New Zealand, where between a quarter and a third of homes are rented from private landlords. This suggests that there is substantial room for growth.

If the growth trend of the five years to 2010 (a 48% increase) is continued to 2015, then there will be 5.4m private tenants, equivalent to 23% of English households. This will have required some 1.7m additional private rented units, equivalent to £284bn at current average house prices. Buy-to-let lending for house purchase in 2011 (as opposed to remortgaging) amounted to around £6.6bn. Although this is a significant increase from £4-5bn in 2009 and 2010, it still remains below the £23bn seen in 2007. However, even this pre-crisis level of activity would have to more than double to meet the £57bn annual investment that will be required if the PRS is to expand to meet demand. Given the constraints on landlord finances and bank funding – alongside the increased regulation of the mortgage market - it seems impossible that the buy-to-let market could sustain over a 750% increase in lending over the next few years. There will clearly be a need for new forms and sources of funding if the sector is to continue to provide affordable accommodation and assist labour mobility.

UK buy-to-let mortgage market



Source: CML

Some of the barriers that institutions used to encounter when considering residential are beginning to weaken. For example, management has generally improved, and there are now a handful of organisations offering value for money, professional services for portfolios. This will reduce the chance of bad publicity while also improving the net-to-gross ratios.

Policy Shifts

Historically, UK Government policy has actively discriminated against the large-scale landlord. For example, until recently, purchasers of portfolios were liable for higher rates of stamp duty than individual investors. A buyer of ten flats worth £150,000 would pay stamp duty at 5% on the entire value, whereas if those flats were bought by individuals, they would be exempt as it would fall below the threshold. This made it difficult for bulk buyers to compete with individuals.

Legislation for tax-transparent UK Real Estate Investment Trusts (REITs) was introduced in 2006/7 after they were recommended in the Barker Report as a way of increasing housing supply. However, the regulations made it difficult for REITs to be used for residential, notably the restrictions on trading, listing and conversion charges. While the trusts are now the norm in the commercial property world, there is, as yet, no UK Residential REIT.

This presents a stark contrast with the US, where the multifamily REIT sector is booming. There are now more than ten such funds active across the country, including the largest, Equity Residential, which operates 550 “apartment communities”. Another major player is Aimco, which operates across 36 states and has around 250,000 residents in 520 blocks. There are also well-developed “apartment REIT” markets in Australia and Singapore.

There are, however, signs that the Government is listening to the sector and is beginning to make significant concessions in order to stimulate investment in the PRS. Stamp Duty was reformed in the 2011 budget, and is now chargeable on a portfolio at the average rate for the individual properties. The finance bill currently going through Parliament contains clauses that will reform REIT legislation, relaxing restrictions on trading and income distribution, abolishing the conversion charge, and allowing funds to list on alternative exchanges.

However, the most important step so far has been the Government‘s unconditional, rapid and clear acceptance of the recommendations of the Montague Report. It is clear that it does want to encourage greater institutional investment, which it believes can stimulate housebuilding. With the cooperation of Local Authorities, institutions will be able to create a separate, long-term, built-to-let private rented sector which is valued differently to the owner-occupied market (although there will be a chance of upside reversion at the end of the set period). As it grew, funds would trade portfolios and blocks in a similar way to the US multi-family model.

The detail on how the reforms will be enacted, and how the £200m of funds and £10bn of guarantees will be used, is yet to be emerged. Moreover, much will also depend on how institutions react to these changes, and the attitudes of local authorities. Some may continue to prioritise affordable housing which could be an issue for the development of the PRS. It will also be interesting to see how development appraisals and site valuations adjust to the new model.

Nevertheless, this would not prevent private rented funds from operating within the conventional owner-occupied market, buying land, blocks or units on the open market, and benefitting both from rental income and short-term capital growth. Such activities would most likely be concentrated on high-value markets in Central London and elsewhere, where capital growth is expected to be highest. In contrast, the dedicated PRS sector is likely to emerge in lower-value areas where demand for rent from frustrated first-time buyers is highest, and viability for schemes for open market sale is most difficult to achieve.

Many funds and investors have already begun acquiring and building portfolios in the expectation that they will be able to convert to REIT status at some point in the medium term. Others are considering their options, including developing specific build-to-let products along the lines of the US multifamily model. However, the prospect of an eventual conversion to REITs is an upside to an overall strategy which focuses on the superior returns associated with residential investment.

The Current Market

At the moment, there is a once in a cycle opportunity for investors to seed residential portfolios with income producing, unbroken blocks of a scale that rarely trades in a normal market. Recent conditions have resulted in a number of completed schemes that cannot be absorbed by a weak and low-volume market within acceptable timeframes. Consequently, lenders and in some cases developers are electing to sell ‘in bulk’ to the growing number of domestic and international funds targeting the sector.

Given the ongoing shortage of development finance, there are likely to be opportunities for investors to bolster these emerging portfolios by building properties specifically for the rental sector – the so-called ‘Build to Let’ model. If institutions were to fund bespoke buildings on a sufficient scale to drive management efficiencies, significantly higher net yields would be produced than with fragmented stock designed for the owner-occupied market. It would also deliver much needed new homes while satisfying demand from the burgeoning private lettings market.

As end user demand continues to shift from homeownership towards the private rented sector, there is an overwhelming business case for exploring the ‘Multifamily‘ model of housing development for long term rent – a model that is increasingly commonplace in much of the rest of the developed world.

Some facts about the US Multifamily market

- Over the three years to 2011, the market has delivered 211,603 units – around 15% of all residential construction in the US
- In 2011, transactions in the multifamily market totalled $43.3bn, more than in the Industrial or Retail markets
- This means that the US apartment market accounted for 30% of all investment in 2011, with volumes 50% above the previous year
- Multifamily REITs have increased their portfolios of assets by 10% over the past two years
- The average vacancy rate over 10 years has been 6.9%, and it currently stands at circa 6.5%
- Across the US, rental growth during the first few months of 2012 stood at 3.4% across the country
- Total multifamily sales volume for the first half of 2012 was $24bn, up 16% on the same period in 2011
- REITs accounted for 16.1% of multifamily acquisitions during the first half of 2012 – a total of $3.8bn
- Across the US, the volume of permits for multifamily development increased by 61.7% over the past twelve months to June 2012

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