Research bulletin

Residential investment

An increase in demand for private rented accommodation creates opportunity for investors

- **20.5%** Forecast residential rental growth over the next five years across the UK
- **290,000** Increase in the number of private rented sector households in both 2008/09 and 2009/10 in England
- **1 million** Forecast increase in the number of private rented sector households in the UK between 2009/10 and 2015/16
- **6.1%** Average gross yield for residential property in the UK in 2016 on the basis of current forecasts.
- **9.0%** Average gross yield for grade C stock in the North of England in 2016 on the basis of current forecasts.

The dramatic increase in demand for private rented accommodation since the credit crunch should provide an opportunity for large scale investment in the residential sector, particularly given a lack of activity among buy-to-let borrowers. By 2015/16 we expect one in five households in England to be in the private rented sector.

New entrants such as London & Stamford and Capital & Counties and joint ventures between the likes of Grainger and Bouygues are evidence that new investment in the sector is starting to materialise. Currently it is not the institutions leading the way, something the previous Government hungered for during their investigations into the sector.

Despite an increase in the amount of marketed investment stock, new investors' income yield requirements remain above those that are available across the majority of the market. In particular, geared investors are struggling to operate a sustainable model outside of hybrid sectors such as student housing.

Equity-rich investors are leading the charge in the conventional residential investment market, but still seek to balance yields with underlying break-up value and effectively acquire with wholesale discount.

A longer term, income driven model is yet to be fully established in the private rental sector. However, the prospect of increased yields in sectors of the market where owner occupiers are set to become much less dominant should pave the way for a progressive increase in activity.

Within this document we:

- Review the current market in the context of historic limitations on the expansion of the residential investment sector.
- Examine the key drivers behind the increase demand for rental accommodation that are expected to improve income yields.
- Look at innovation within the sector that may facilitate much wider corporate and institutional investment.

Investment proposition

While total returns driven by capital growth have made residential investment look like an attractive proposition on paper, the reality of low income yields and a significant management burden has restricted institutional investment in the sector.

While residential property has delivered annualised growth of 9.6% on average over past 10 years the number of large scale investors in the market is low, with many having been in the market for decades.

The experience of the past year has reflected this. Despite historically high levels of marketed investment stock, relatively few new entrants have entered the market for portfolio acquisitions and decision making has been as much around vacant possession value as it has been net operating income.

Much of the investor activity has been focused on London, where rental yields are comparatively low but capital growth prospects comparatively strong.

Yields considerations

The IPD Residential Performance Indicator shows that in June 2011 the average gross income yield of 5.4% equated to a net yield of 3.4%

This reflects the fact capital values, essentially fixed by the dominant owner occupier purchasing group, have dictated residential income yield. By contrast in the commercial property market the reverse is true; capital values being dictated by investors yield requirements.

Against this context it is unsurprising that over the noughties new residential investment was largely the domain of the buy-to-let investor, as opposed to the large scale investor who is more at home with the commercial property investment model.

Importantly a significant reduction in the accessibility of home ownership is likely to make values in the lower tiers of the residential market increasingly dependent on income yield.

Already much higher rental yields are achievable in parts of the market where the purchasing power of homeowners is at its weakest.

Where owner occupiers are fewer in number and where they are heavily dependant on mortgage finance, lower capital values prevail and income returns increase.

GRAPH 1

Annual return on residential investment property

Graph source: Savills Research

Our analysis of data provided by Rightmove suggests gross yields for 1 bedroom properties in the North East of England stand at 6.0%, while 4 bedroom properties in the South West of England stand at 3.6%. Similarly gross income yields for 1 bedroom properties in say Barking and Dagenham of 7.0% compared to income yields of 3.9% for four bedroom houses in Wandsworth.

Investors are yet to fully appreciate the availability of these higher yielding assets, though reduced yields on other asset classes and a scarcity of blue chip commercial property investments should change this position.

Widening yield differential

Assuming the key areas of influence remain unchanged, we expect these differences in yields to widen in the future, as constraints on mortgage finance limit the ability of households to buy lower grade properties in secondary or tertiary locations .

This is set to push the balance of occupational demand further towards renting in such locations, thereby suppressing capital but fuelling rental growth. Correspondingly, yields are expected to rise progressively making the lower tiers of the market in particular more accessible to large scale investors.

Upon the basis of our current forecasts for capital growth and rental income this suggests the income yield profile shown in Table 1 below.

This distinction between high yielding; low capital growth investments and lower yielding higher capital growth investments; is already influencing investor behaviour.

Portfolio investments in the north of England are more likely to be acquired as long term holds on the back of current yields and future rental growth,

TABLE 1

Gross income yield projections

	Rental Yield					
	2011	2012	2013	2014	2015	2016
UK Mainstream	5.4%	5.7%	5.8%	6.0%	6.1%	6.1%
Grade C stock in Northern England	7.0%	7.4%	7.9%	8.3%	8.8%	9.0%

Graph source: Savills Research

while in the South East they are more likely to be medium term holds with returns extracted though a break-up and managed sale of stock back into the owner occupied sector, capitalising on prospective capital growth.

We expect this distinction to be a key feature of the market over the next five years, with investors increasingly looking to the lower tiers of the market to deliver income yield and differentiating the investment potential of their stock by grade and location.

The here and now

For the time being low income yields continue to constrain any inward investment into the private rented sector. Against this context, those investors who are active in the market are looking to secure discounts on vacant possession values to meet their income return objectives within a blended returns model.

These discounts vary between 10% to 30% of value for bulk investment deals, the precise discount being dependent on the size of the portfolio, the location and the nature of the stock offered to the market.

This means portfolio yields vary from 5% for stock in London and the South East where the prospects of sales to owner occupiers are relatively good, to 8% and above for stock with relatively low capital growth prospects in the north of the country.

However, even at these discounts there has been insufficient demand to match the increase in supply of stock brought to the investment market over the past 12 months. Certainly more repossessed stock has come to the market, though this tends to be concentrated in secondary and tertiary locations often within the northern metropolitan belt where repossessions and yields are at their highest.

Here transaction levels are often at their lowest limiting the capacity for a phased release of stock into the owner occupied market.

Investor friendly

Beyond yield constraints there have been a number of factors that have discouraged investment in residential property. Measures such as the change in the stamp duty regime, with the tax charged on the average value price per unit rather then the aggregate value of the transactions, indicate a desire within Government to provide a more investor friendly environment.

Combined with proposals for a review of the REIT regime, which we have looked at in detail elsewhere in this report, and the scrapping of plans to introduce new regulations proposed by the Rugg review, will overcome some of the investment hurdles.

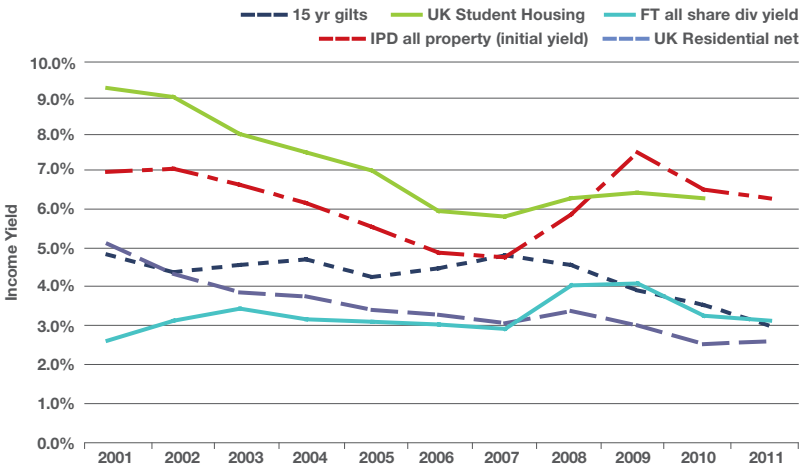
Industry innovation

Together these measures are likely to make residential property a less illiquid investment although they are unlikely to substantially alter the yield dynamic. This is likely to require more innovation from within the sector.

Already we are seeing institutions looking to joint venture with registered

GRAPH 2

Comparable investment returns



Graph source: IPD, Savills Research

RENTAL DEMAND UP, BUY-TO-LET INVESTMENT DOWN

The demands on the private rented sector have increased dramatically since the onset of the credit crunch. With housing transactions continuing to run at between 50% and 55% of their pre crunch levels, levels of private renting have risen significantly. The fall in housing transactions reflects a heavily constrained mortgage market and a significant increase in the deposit requirements for first time buyers and second steppers.

The consequences of this are borne out by the Survey of English Housing which shows that both far fewer newly formed households are entering home ownership (in 2009-10 the figure was less than one third of the average in the period from 1999-00 to 2007/08). Even though the number of new households forming has fallen, more new households are renting (up by 16%).

Among existing households a greater proportion of movers are renters indicating that households are also staying in the private rented sector for longer. But perhaps most telling is that in 2009-10 more households moved from owner occupation into renting, than graduated from renting into home ownership, as would normally be the case.

All of this has meant that the number of households in the private rented sector has increased by in the order of 290,000 in each of the years 2008/09 and 2009/10.

Prior to the credit crunch the less aggressive rise in levels of private renting in the lower rungs of the housing ladder was accommodated by the growth in the buy to let sector. However, the expansion of the buy to let sector has decelerated as more restrictive buy to let lending criteria has been applied and small scale investors have become more cautious.

Whereas the number of outstanding buy to let mortgage increased by 190,000 in 2007, in the year to the end of September 2011 stood at 82,000.

The corresponding supply demand imbalance is reflected in the RICS rental survey. This indicates there has been a significant gap between tenant demand and the supply of new rental property since mid 2009, as the accidental Landlord became less evident in the market. Rental growth has resulted; though the measured extent varies form index to index.

As changes to mortgage availability seem to have become entrenched we believe that this imbalance between supply and demand of rental accommodation is likely to drive average rental growth of 20.5% over the next five years across the UK.

providers of social housing to provide economies of scale on the management of private sector housing stock to improve net to gross yield ratios.

Branding of larger scale private residential managers is also a key factor, an improvement which would echo the more service based approach taken in the US. However, this is constrained by scalability of build-to-let product and dispersed, smaller scale nature of existing portfolios.

The housebuilding industry has recognised the need to deliver rental stock into the market, if it is to increase levels of housebuilding and offset reduced levels of owner occupied demand.

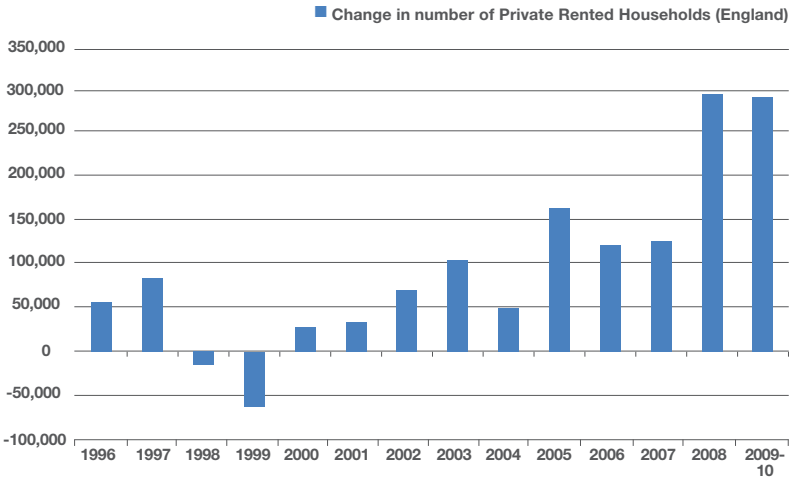
Equally, lessons are being learnt from the student housing sector where long term secure income streams have proved attractive to institutions. Within the private rented sector this would require the creation of an overarching head lease.

Given the investment requirements of each party within this arrangement this is likely to limit the capital value generated, that may limit its application to new investment product within say the build to let sector.

However, such an approach may be used to release capital amongst existing large investors to expand their portfolio in a period of restricted access to debt. ■

GRAPH 3

Growth in private renting



Graph source: Savills Research

TIME TO COME OF AGE?

The Real Estate Investment Trust (REIT) regime introduced in 2007 has to date failed to act as a catalyst to residential investment. This is despite initial objectives to improve the quality and quantity of finance for investment into the residential investment sector that are assumed even greater importance in the current environment.

Offering a more liquid means of investing in residential property as an asset class could have real benefits.

From a tax perspective the main advantage of a REIT is a much simplified tax structure where qualifying activities only incur tax liabilities at the point dividends are paid to shareholders. Accordingly no corporation tax is paid on the income or capital profits from these activities by the corporate body holding the property within the REIT creating important investment efficiencies.

Generally, the 2% charge on the value of property put into a REIT has been one of the main disincentives for the creation of these vehicles. Effectively this has only been viable in cases where it has allowed latent capital gains tax liabilities to be discharged on the property transferred into the REIT. As a result activity has been confined to lager companies so affected, including the likes of British Land and Brixton Estates.

However recent government consultation has the potential for REITs to play a much greater role in the expansion of the residential investment sector.

Critically among a series of proposed measures to relax regulations and qualifying conditions are proposals to abolish the 2% conversion charge, allow listings on a wider range of stock exchanges and relax the application of close company rules to make investment by, for example pension funds, much easier.

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