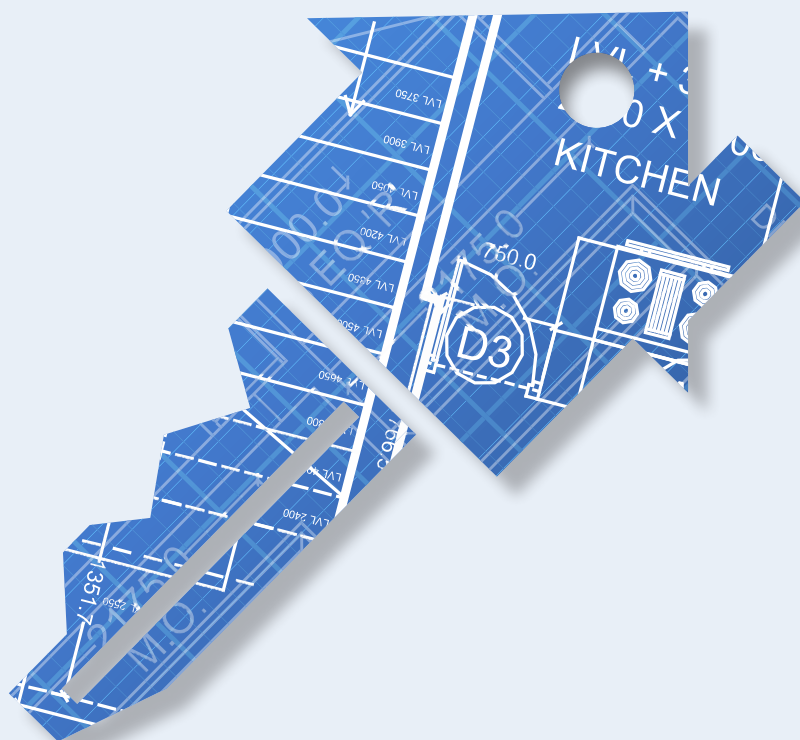


Spotlight Rental Britain

February 2016



SUMMARY

Demand for rental homes will continue to rise despite Government policies

■ The rental market will still expand by more than one million households over the next five years despite measures to turn “generation rent into generation buy”. P2/3

■ The supply of rental homes is set to be constrained by the introduction of a Stamp Duty surcharge of 3% on buy-to-let properties and the restriction on tax relief on mortgage interest payments. Both measures are likely to limit the ability of private investors to expand their portfolios. This presents a major opportunity for

large-scale investors to step into the gap created by a fall in off-plan sales to buy-to-let investors. P2/3

■ Mismatch between supply and demand will continue to underpin rental growth and attract increasing numbers of institutional investment at scale. We recorded investment deals worth a total of £2.6 billion in 2015 – a third of which was supported by institutional investment. P2/3

■ The lack of available stock is prompting an increase in deals to

forward fund development for rent. We outline some of the routes to market that large-scale investors are using. P4/5/6

■ Investors are looking beyond London to cities with concentrations of households in the rental market. Our investment matrix highlights the cities with the best investment potential. Manchester, Reading, Edinburgh and Bristol top the chart. P7

Market dynamics

RENTAL BRITAIN HERE TO STAY

The rental market will still expand by more than one million households over the next five years despite the Government's drive to boost homeownership

The economic recovery and ongoing low interest rate environment have done little to reverse the expansion of the rental market. In fact, house price inflation, which has surpassed wage growth, has served to push homeownership further out of reach for many.

The requirement for sizeable deposits and stricter lending criteria, as a result of mortgage regulations, have continued to act as barriers to the property ladder. As a result, demand for rental homes is still rising, underlining the long-term trend which predates the financial crisis of 2007. According to the Government's English Housing Survey, the rental market has been growing by a staggering 17,500 households per month on average over the 10 years to 2014.

Policy changes

Government housing policy seeks to reverse this trend with the target of delivering 400,000 affordable homes for sale aimed at helping people access the property ladder over the course of this parliament. Measures include the delivery of 200,000 Starter Homes, the building of 135,000 new Shared Ownership homes and access to larger equity loans through Help to Buy in London.

Without policy interventions, we forecast that the rental market would grow by an average rate of 260,000 households a year in the UK. The Government target of building 400,000 affordable homes for sale would enable an average of 80,000 new households a year to access homeownership over the next five years.

Of the 80,000 new households a year which may be helped onto the property ladder, 40,000 are likely to come out of the rental market with the balance shifting out of other sub-market tenures. This would reduce the growth of the rental market by 15% from 260,000 households a year to 220,000 new households a year. Hence the sector will still grow by 1.1 million by 2021.

However, we would question whether policies can accelerate house building enough to deliver 400,000 affordable homes for sale in the first place. Given the overlap between the schemes, which are focused at similar parts of the market, it is possible that one scheme would simply replace the other rather than providing additional homes. Without the higher house building numbers, it is unlikely that the Government will achieve these targets.

Supply constraints

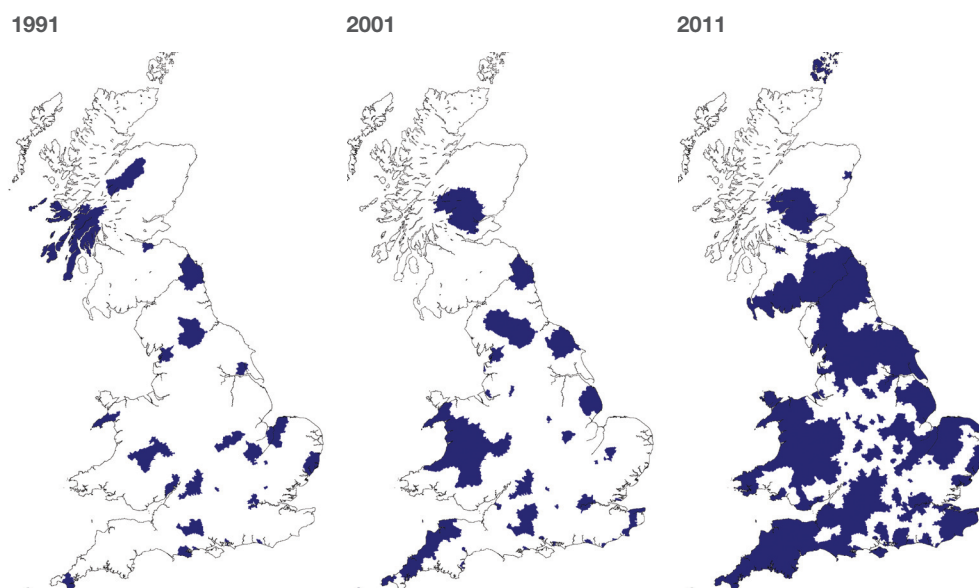
Policy changes aimed at residential property investors are likely to put further pressure on the already constrained supply of rental homes.

From April 2016 purchases of residential properties over £40,000 for investment will attract an additional surcharge of three percentage points above the current rate of SDLT. Hence a buy-to-let investor acquiring a property worth £500,000 would pay an additional cost of £15,000.

This stamp duty increase follows a restriction of tax relief on mortgage interest payments for buy-to-let investors with debt set against their property. Both measures are likely

FIGURE 1

The growth of the rental market Areas where more than 15% of households rent privately



Source: 1991, 2001, 2011 Census

to limit the ability of some private investors to expand their existing portfolios or buy their first investment property. The withdrawal of tax relief may also prompt some to rationalise their portfolios although we are not expecting a mass exodus from buy-to-let. The experience of the last downturn suggests that most are long-term investors.

The Government is consulting on the policy detail, including whether an exemption for corporates and funds owning more than 15 residential properties, is appropriate (see Policy Response: Additional Homes Stamp Duty Surcharge).

We think it highly likely that corporate investors will remain exempt from these tax changes and that the appetite from housebuilders to secure deals with large-scale investors will grow strongly in 2016.

Housebuilders have relied heavily on off-plan sales to buy-to-let investors, particularly as their banks and debt funders very often require evidence of sales to de-risk the development. As a result, there is a big opportunity for large-scale investors to fill the gap through forward funding structures.

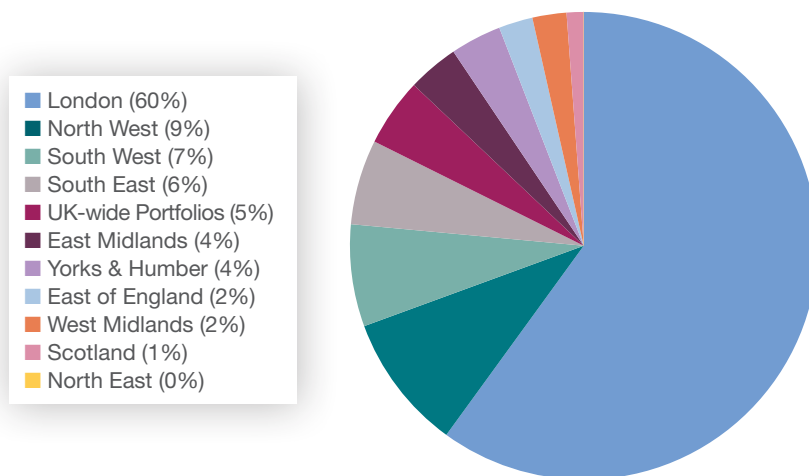
Large-scale investment

The mismatch between supply and demand for rental homes is likely to underpin rent rises, particularly in undersupplied markets. It also represents an opportunity for institutional investment at scale which has been growing steadily. Some big domestic and international players have entered the rental market and the flow of capital is building up.

The overall value of deals recorded by Savills own investment database has increased from £2.3bn in 2014 to £2.65bn in 2015. The number of deals backed by institutions doubled between 2014 and 2015. Last year (2015) over 30% of all rental market deals were backed by institutions compared with 22% in 2014. Private companies also represent a significant part of the sector, accounting for 40% of deals.

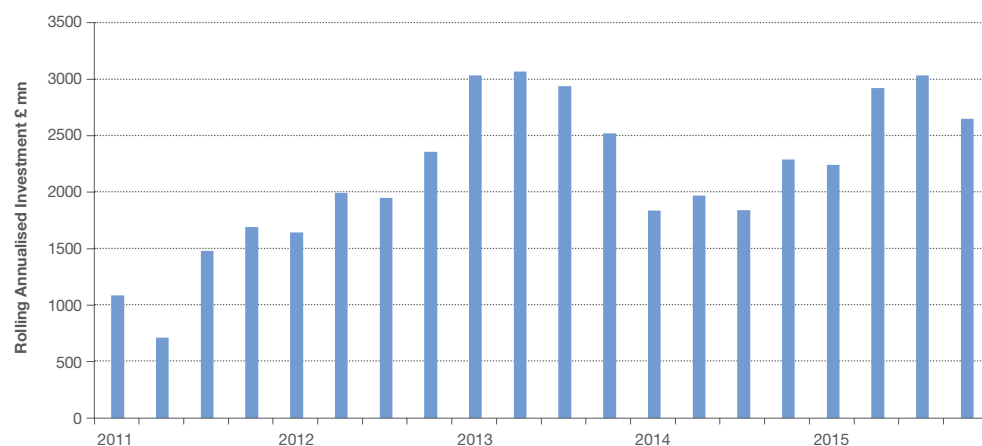
As the market evolves, we are seeing a shift in the corporate-backed rental market from one in which investors purchase ready-made schemes to one in which forward funding development is becoming increasingly prevalent. This document outlines opportunities for investment and development in the rental market as demand is here to stay. ■

FIGURE 2
National spread of deals 2015



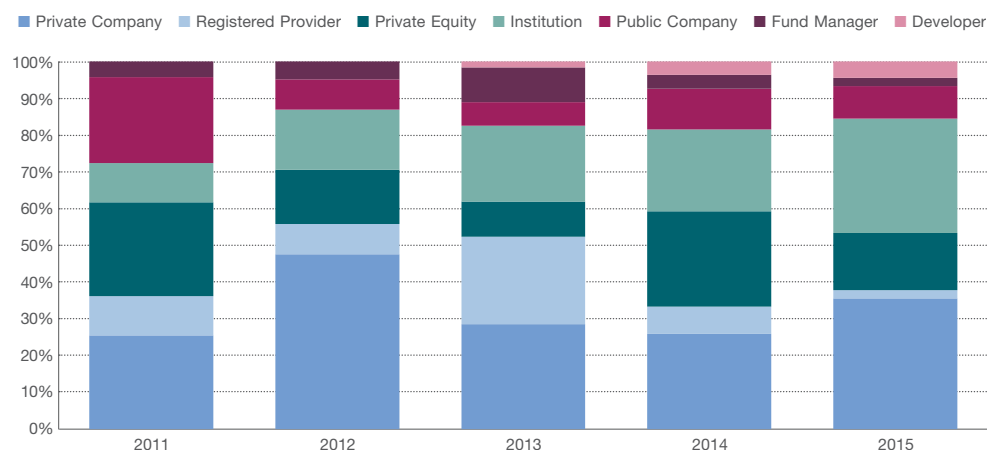
Source: Savills Research

FIGURE 3
Rising levels of investment



Source: Savills Research

FIGURE 4
Institutions becoming more dominant players



Source: Savills Research

Investment ROUTES TO MARKET

There is more than one way to invest in the residential market for large-scale investors

FIGURE 5
Routes to market



Source: Savills

Traditionally, larger investors in the rental market have built up portfolios through the acquisition of existing residential stock. Since the introduction of the buy-to-let mortgage, the market has grown through buy-to-let investors acquiring a high proportion of newly built residential stock that was built and designed for the owner-occupier sales markets.

Developing new stock for private rent is a relatively new feature of the residential investment market. It is a response to the reintroduction of institutional capital seeking investment grade assets and the limited supply of good quality stabilised portfolios. It is also a result of the recognition that delivering a customer-focussed service to tenants requires a variation in the design and construction of residential buildings.

For larger, institutional investors, gaining exposure to the UK residential market in its broadest sense, is likely to see various investment strategies being deployed. In simple terms, this can be achieved through developing bespoke buildings on an asset by asset basis. This does, however, take time and require appropriate resources and skills to identify, negotiate and transact in a market that has largely delivered housing for development sales.

Increasingly, the larger equity houses who have significant access to capital are seeking opportunities which provide a higher level of control over delivering large volumes of residential. Corporate transactions, either through acquisition of companies or share capital where a degree of influence can be applied over the direction of the delivery organisation, are likely to be seen going forward.

Examples of this are the acquisition of a number of house builders including Oaktree Capital's acquisition of Countryside Properties and L&G

and Patron Capital's acquisition of Cala Homes. Further to this, the acquisition of Quintain by Loanstar has the potential to see a large amount of rental market stock being delivered through the development opportunities in Quintain's pipeline.

Aggregators of rental stock are also increasing in numbers with the likes of Essential Living and others, where we may find that once developed and stabilised, these portfolios may be sold to the institutional market through large portfolio sales or corporate transactions.

A key challenge for investors is the identification of an operating partner to manage the portfolio. The aggregators are tending to create new branded management services developed alongside the asset pipeline whilst the institutions are more likely to outsource the management function.

As the institutions get more comfortable with residential as an asset class we are likely to see a range of markets emerge from prime bespoke stock to secondary and even tertiary stock. As these investors are primarily driven by income returns – as long as the net income from a portfolio can be proven, assessed and priced, taking into consideration all operation and capital costs – the larger fragmented portfolios, which historically have been the target of trading investors, may start to appeal to the income investors. As property management services to residents are increasingly delivered through IT solutions, the make-up and location of assets will become less relevant.



Developing new rental product is a new feature of the market

From an asset perspective, the main deal structures evident in the market are set out below. Each will have a different risk reward profile.

■ LAND ACQUISITION AND DEVELOPMENT

Acquiring land and developing rental market stock allows for complete control of the product and delivery of the scheme. This is the approach now being used by Essential Living. The approach is considered resource-intensive and involves the investor taking planning and development risk. Competition for land can be fierce, particularly against traditional housebuilders.

■ ACQUISITION OF EXISTING BLOCKS AND/OR PORTFOLIOS

A number of large portfolios have traded over the past two or three years which have allowed new investors to acquire significant portfolios of existing stock. Examples include the Maison Portfolio, which saw Apollo acquire the West Register portfolio, and the GRES portfolio, which was effectively refinanced through an acquisition by the European pension fund APG.

The shortage of good-quality existing rental portfolios means that competition is high for fully let stabilised rental stock. Risk is low but commensurate with the level of returns achieved from investing in the sector.

■ FORWARD COMMITMENT/ PURCHASE OF COMPLETED STOCK

This is a simple and fast way to aggregate a portfolio, requiring only a down payment when a deal is agreed with a developer and payment of the remainder on practical completion of the scheme. Fizzy Living effectively used this approach to aggregate their portfolio of rental market stock and it allowed them to quickly aggregate stock and a management platform.

The downside of investing using this mechanism is that the investor has very little control over the product and delivery of the scheme.

■ JOINT VENTURE

Joint ventures and co-investment vehicles have largely replaced traditional funding arrangements in the aftermath of the credit crisis, predominantly because of the high cost of finance.

Residential Land, backed by Ivanhoe Cambridge, is an example

of this approach in the UK market. Developers have sought joint venture partnerships where risk is shared on the basis of the level of equity provided.

■ FORWARD FUNDING

The structure of forward funding transactions varies widely. In general, an investor will make an initial payment up front which reflects the transfer of the interest in land. This is followed by stage payments that will cover construction costs, a percentage of profit and a development manager's fee.

Stage payments covering construction costs, particularly when funded from an income fund, are likely to attract a coupon akin to development finance costs. The funding structure may also include an "End Bullet" upon completion, usually covering the developer's outstanding profit.

The advantage of a forward funding structure is that it de-risks the development by effectively guaranteeing a block sale to an investor at building completion. From an investor's perspective, development risk is more evenly shared between

the developer, main contractor and the investor, thus making it less resource-intensive for the investor. As a result, an investor with a large allocation to residential can spread investment more easily across schemes and markets making the approach more scalable than straight development.

An important upside is that the approach allows for more control of the product and of the delivery of the scheme. We have seen a number of build-to-rent schemes using a forward funding approach, including the M&G scheme in North Acton being developed by Hub Residential.

As the number of players building for the rental market grows, new business models are emerging. At the heart of these models is the trade-off between risk and return. In a strong sales market, traditional build-to-sale models deliver higher returns but the absorption rates can differ.

Given the cyclical nature of the property sales market, the risks are greater in a market downturn. Forward funded build-to-rent deals diminish sales risks greatly and are especially suited to large projects with multiple phases of development. ■

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 "Forward funded build-to-rent deals diminish sales risks greatly"

▼ Hub Residential development Victoria Square North Acton, Ealing London



Case studies

WHY FORWARD FUND?

ACCELERATE HOUSING DELIVERY



BATH RIVERSIDE, BATH CITY CENTRE

M&G Real Estate purchased 97 new private rental homes in Bath Riverside from Crest Nicholson. The transaction forms part of a longer term relationship with Crest. The partnership is designed to accelerate housing delivery by unlocking future phases of land. M&G will provide finance to fund the development of 97 apartments while Crest Nicholson acts as developer and contractor of the scheme.

CITY CENTRE REGENERATION



FRUIT & VEG MARKET, SOUTHAMPTON

Rockspring and its joint venture partner Atlas Residential have agreed a deal to purchase a rental market development site from local developer Hampshire and Regional Property Group (HRPG). The site originally owned by Southampton City Council has planning consent to deliver 211 units. The impact of more rapid letting rates on delivery times for new developments is a key attraction.

INVEST IN UNBROKEN BLOCK



VICTORIA SQUARE NORTH ACTON, EALING LONDON

M&G and HUB Residential have renegotiated the S.106 agreement for this scheme which required 20 of the units to be allocated for shared ownership housing. M&G sought to purchase the freehold interest of an unbroken block so that the block could be managed and maintained as a single asset. LB Ealing agreed to allow the conversion of the original S.106 requirement to 20 discounted market rental units.

DE-RISK REGENERATION



LEWISHAM GATEWAY

Lewisham Gateway is a major urban regeneration project in Lewisham in London. As part of the funding strategy for the development, Fizzy Living agreed to purchase 136 units in Phase 1 on a fully forward funded basis which helps give certainty to the developer Muse. It helps to de-risk the significant infrastructure costs associated with this large-scale regeneration project.

Market dynamics

OPPORTUNITIES FOR INVESTMENT

The search for higher yields and fresh opportunities is prompting investors to look beyond London. There are high concentrations of households renting privately in a number of regional cities following significant growth in the tenure this century.

We have analysed the fundamental factors driving the rental market. The 29 cities listed below represent some of the most attractive cities for investment in the rental market, although opportunities will vary on a site by site basis. Manchester, Reading, Edinburgh and Bristol top our list because of their strong economic growth prospects and reputation as vibrant, desirable places to live. Whilst

this is not an exhaustive list, we have also sought to highlight investment prospects in cities set to experience a significant housing shortfall, such as Oxford. The cities are rated on four groups of criteria.

First, we considered the economic prospects of each city, which included analysis of historic and future employment growth and major growth sectors. Cities that performed well in this category not only had high levels of forecast job growth, but also saw growth in sectors where advance levels of education are required and where pay is relatively high, such as finance or the technology sector.

Second, we considered the investment potential of each city by looking at the net income return, rental growth prospects, and capital value growth. Cities that performed well here have seen comparatively strong rental growth but prices remain relatively low, leading to stronger yields.

Next, we considered relative levels of housing supply and demand in each city, looking at objectively assessed need, household projections, population growth forecasts and dwelling completions. Most of our top cities have experienced a major shortfall in housing supply over the last few years, and this appears likely to continue.

Finally, we looked at how the rental market has evolved and grown in these cities. Growth in the number of households renting privately reflects a nationwide trend that has been very pronounced in most of our top cities. This criterion also considers the affluence of rental market households, prioritising cities where renters are in well-remunerated, highly skilled jobs that will support future rental growth. These industries bring well-paid employees who can support higher rental levels and help to reinvigorate cities and make them more attractive places to live. ■

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 “These cities represent some of the most attractive opportunities”

FIGURE 6

Regional Investment Rating

Strongest ■ ■ ■ ■

Manchester	Brighton	Chelmsford	Leicester
Reading	Leeds	Southampton	Norwich
Edinburgh	Glasgow	Sheffield	Aberdeen
Bristol	Cardiff	Northampton	Cambridge
	York	Portsmouth	Newcastle upon Tyne
	Milton Keynes	Liverpool	Bradford
	Salford	Nottingham	Bath
	Birmingham		Bournemouth
	Oxford		Plymouth

OUTLOOK

■ **Rental Growth:** Rents are now on average higher across the UK than a year ago. Data from HomeLet, which records rents on new buy-to-let tenancies, shows that London saw the bigger rent rises of 7.5%. At a national level rents grew by 3.8% in the year to November 2015. This masks the growth seen in the core regional markets such as Manchester city centre, where we have seen rents rise by 7%.

■ **Investors' yields:** Competition for investment stock has led to yield compression. The gap between vacant possession values and investment values has narrowed, which has increased the number of sellers looking at block sales as opposed to piecemeal break-up. While yields remain higher outside London, the sheer weight of capital chasing regional opportunities has driven yields down.

UK-wide residential portfolios of existing assets traded in 2015 were priced off a 5% to 5.5% net yield based on a 28% gross to net deduction. New build-to-rent stock in regional cities is being priced off a 4.5% to 4.75% net initial yield, based on a limited number of deals.

■ **Looking Ahead:** We expect that an undersupply of rental homes, which is likely to be exacerbated by policy changes affecting buy-to-let investors, will continue to underpin rents in markets where demand is strong. These include popular city centres where there is higher value employment and limited options to get on the housing ladder. The prospect of wage growth is likely to support rent rises, particularly among young professionals who are most likely to benefit from an improved labour market.

■ **More sharers likely:** Despite Government measures to help first-time buyers, we expect to see the traditional rental demographic of sharers and young professionals continue to grow, where the supply of housing is tight, costs are high and options to move into homeownership remain limited.

■ **Benefit cuts:** Our rental forecasts do not include tenancies that are reliant on housing benefit. Rental markets that are heavily dependent on housing benefit tenants, such as some of the seaside towns along the south coast and parts of the northern urban belt, will come under renewed pressure as a result of Government policy to limit welfare.

FIGURE 7

Mainstream rental growth forecasts

	2016	2017	2018	2019	2020	5 years
UK	3.0%	3.0%	3.0%	3.0%	3.5%	16.5%
London	4.0%	4.0%	4.0%	4.5%	4.5%	22.8%

Source: Savills Research

NB: These forecasts do not apply to housing benefit dependent tenancies. They also only apply to average rents in the second hand market. New build rental values may not move at the same rate

Savills team

Research



Jacqui Daly
Director
UK Investment
020 7016 3779
jdaly@savills.com
@jacquidaly



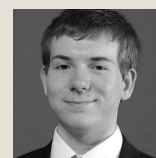
Susan Emmett
Director
UK Residential
020 3107 5460
semmett@savills.com
@saemmett



Neal Hudson
Associate Director
UK Residential
020 7409 8865
nhudson@savills.com
@resi_analyst



Lawrence Bowles
Investment Analyst
020 7299 3024
lbowles@savills.com



Andrew Smith
Investment Analyst
020 7016 3834
ajsmith@savills.com

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