UK Residential – August 2021

MARKET IN MINUTES
Savills Research

UK Build to Rent

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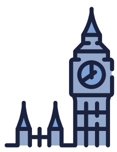
Yield compression ● Scale ● Premiums

Market Monitor

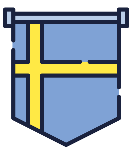
Key statistics for the BtR market

UK BtR yields have remained broadly stable, despite economic headwinds



3.5%

London BtR yields remain low



55bps

Prime BtR yield compression in Stockholm this year

Analysis of other major global markets demonstrates the significant scope for growth in the UK BtR sector

76,300

Number of homes a UK investor would control if they had the same market share as Vonovia in Germany

Yield Compression

In recent years, prime Build to Rent (BtR) yields have remained broadly stable. In spite of the economic headwinds through 2020 and early 2021, the sector delivered resilient income returns. High occupancy levels and rent collection have supported pricing. But there are signs that we are on the cusp of yield compression in the sector.

Downward pressure on yields from new investors entering the market...

The strong performance of the sector over the past 18 months has further burnished its counter-cyclical credentials, driving increased investor appetite and a wave of new entrants.

This year began with Goldman Sachs making their debut, acquiring the Thistle Portfolio. This has been followed in recent months by Heimstaden Bostad's debut in Birmingham and Macquarie Bank launching their own platform, Goodstone.

We expect this increased competition from investors to put downward pressure on yields for the best assets. This will especially be the case for income producing, stabilised assets. A common theme over recent years has been a lack of these opportunities. When they do come to market they attract significant competition, as evidenced by the Thistle Portfolio.

Investor demand is driving down yields

Looking to other parts of UK real estate, in particular industrial, shows how strong investor demand and positive sentiment has driven yield compression. Yields for prime distribution and multi-let estates have been falling since 2016 and are now both at 3.5%, a drop of 100bps and 75bps respectively over the past year alone. As a result, prime industrial assets now attract the same yield as a prime London BtR asset. In 2016, industrial yields were 100-125bps higher than London BtR.

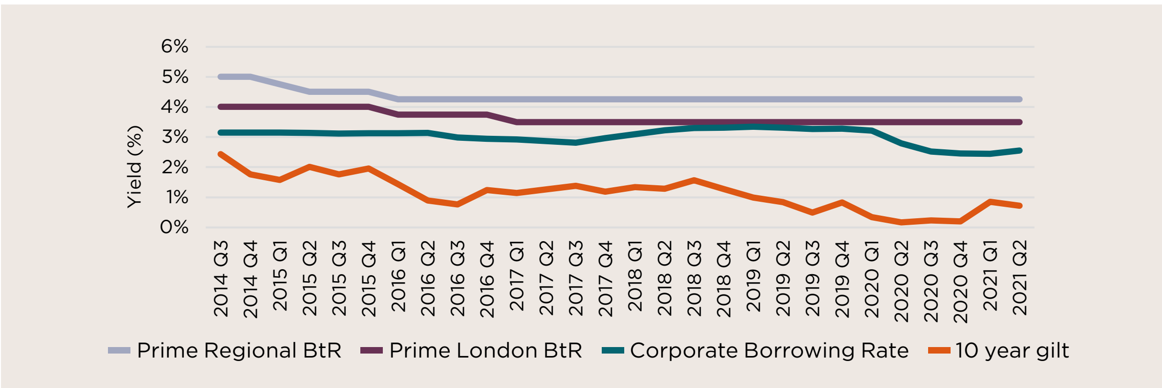
Strong investor appetite and competition has driven down residential yields across other European markets. Berlin has seen prime yields fall by 40bps over the past 12 months, while Stockholm is down by 55bps to 3.25%. This means only Warsaw and Dublin have higher prime yields than London.

Corporate debt rates had previously put a floor under yields

During 2017 and early 2018, a rise in corporate debt rates reduced the spread of BtR yields in London from c.80bps to c.20bps. This level became the new normal throughout 2018 and 2019. As a result, the scope for yield compression was significantly reduced, given the additional risk of investing in residential.

But there has recently been a significant fall in corporate debt rates, which have dropped by 66bps between Q1 2020 and Q2 2021. This means that the spread to prime BtR yields has increased to its highest level in over 6 years, creating room for yield compression.

The spread between BtR yields and corporate debt has widened



Source Savills Research, Bank of England

The economy will be a fundamental driver

As with many things, the direction of travel will be influenced by the UK economy and how it emerges from the pandemic. Recent economic data points towards a steady recovery through 2021, with the jobs market emerging with less damage than feared 12 months ago. This should support wage growth as the economy reopens, in turn underpinning potential for rental growth.

The house price growth seen over the past few months will also put the aspiration of homeownership further out of reach for many would-be first-time buyers - driving demand for rental product.

The potential fly in the ointment is inflation. At present, forecasts are for the current strong inflation to be temporary. But, if it turns out to be persistent then the Bank of England will have to act, leading to a rise in bond yields. This will put upward pressure on yields across real estate.

But as BtR continues to mature as an asset class, we expect greater liquidity and economies of scale will put downward pressure on the sector's risk premium. This means that even if yields don't fall, they will likely remain stable even as the risk-free rate rises.

Scale in UK BtR

Sigma recently announced the delivery of the 4,000th home for the PRS REIT, meaning they have one of the largest operational BtR portfolios in the UK, alongside Grainger (c.6,350 units).

Whilst impressive in terms of scale in the UK context, as we highlighted in our report in December 2020, these pale in comparison to the size of the largest investors in more mature markets. Germany and the USA, for example, both have investors with over 100,000 units.

The differences in the size and structure of rental markets in these countries mean that we can't take as a given that we will see portfolios this large in the UK. But looking at the proportion of rental stock controlled by these investors can still provide an indication as to what scale could really look like in the UK.

Scope for significant growth in scale

At present, Grainger's operational portfolio equates to 0.13% and the PRS REIT's equates to 0.08% of total rental stock in the UK. In contrast, Vonovia, Germany's largest landlord, controls 1.6% of rental stock, while Vesteda, the largest landlord in the Netherlands, controls 2.5% of rental stock.

Across the Atlantic, the USA's largest landlord, MAA, controls around 0.5% of the total rental stock in the country. Irvine Company, who are California's largest landlord, control 1.0% of all rental homes in the state.

This difference in proportional scale shows that there is still significant growth potential for UK investors. For example, applying Vonovia's market share to the UK would equate to a 76,300 unit portfolio. Even the more conservative 0.5% market share that MAA has would mean a portfolio of nearly 25,000 homes, around four times the current number owned by Grainger.

International investors' UK portfolios if they had the same penetration rate as their home markets

Investor	Location of Portfolio	Operational Portfolio Size	Proportion of Country/State's Rental Stock	Size of UK Portfolio if Same Proportion of PRS Homes
Vesteda	Netherlands	25,800*	2.50%	119,200
Vonovia**	Germany	349,500	1.60%	76,300
Irvine Company	California (USA)	58,500	1.00%***	47,700
MAA	USA	100,500	0.50%	23,800
Grainger	UK	6,350	0.13%	-
PRS REIT	UK	4,000	0.08%	-

Source Savills Research, Bank of England British Property Federation, Company Financial Statements, Yardi, NMHC, German Federal Statistical Office, US Census Bureau, ONS, Statistics Netherlands | *this relates only to their market rent portfolio. **this relates to Vonovia's portfolio before any merger with Deutsche Wohnen. ***this relates to California only.

Evidence of localised concentration

Furthermore, there is evidence of investors in other markets being comfortable with pockets of high concentration. In both Germany and the Netherlands, there are a number of cities where investors control over 3% of rental stock. For example, Vesteda owns 3.1% of all rental homes in Amsterdam and Deutsche Wohnen owns 3.4% of stock in Frankfurt.

By contrast, in the UK, the largest landlords in London, L&Q and Quintain, only control 0.2% and 0.3% of rental stock respectively. Even looking at their entire pipeline this only rises to 0.5%. If they were to reach a similar proportion of stock as seen in Germany and Holland, their portfolios would be over 30,000 homes in London alone.

But a need for a diverse product offering

The evidence from mature markets elsewhere overwhelmingly indicates that the UK has not got close to its potential in terms of scale. But to do this, investors will need to ensure their portfolios provide a mixed offering of single and multifamily homes, catering to different tenant groups and across the affordability spectrum.

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