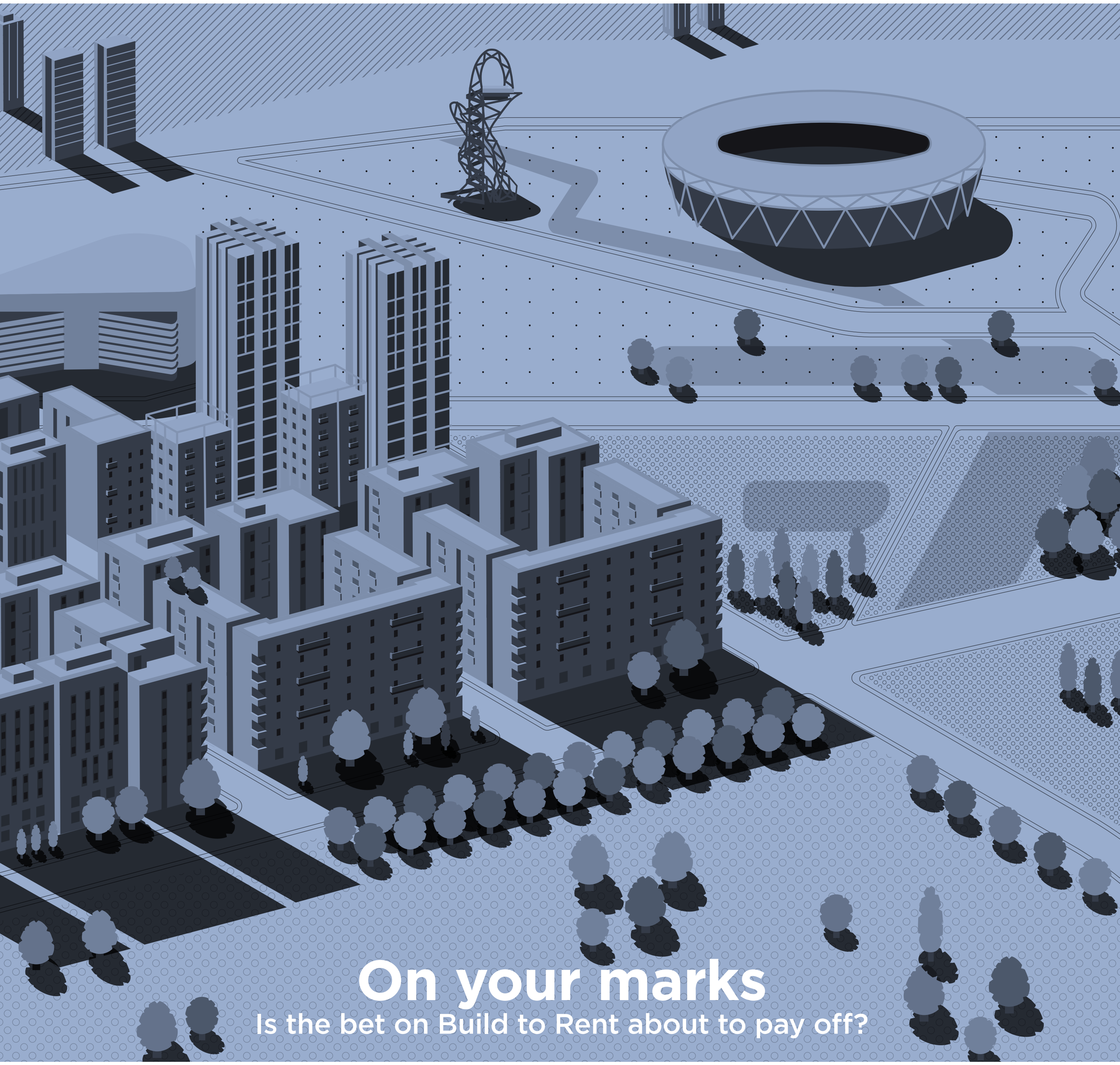
Savills Research
savills.com/research

Report | 2018

Investing in Private Rent



Cover source: illustration based on Get Living's East Village development, Stratford

Into the mainstream

Have we entered a new age of institutional residential investment?

Institutional investment in the UK residential property market has been a slow burn. Much talked about and vaunted for the last 20 years, only in the last five years has it truly gained traction.

Compared to the student housing sector, institutional investment in privately rented homes for the wider population remains relatively immature. But it is developing fast, with a switch in focus to stock built specifically for the rental market. The amount of operational Build to Rent stock has increased by 26 per cent in a year. The amount under construction has increased by 33 per cent.

The case for investment has been made many times before: restricted access to home ownership entrenched by mortgage regulation; changing lifestyle choices underpinning growing rental demand; potential for secure, inflationary income streams from an asset underpinned by a strong track record of capital growth, and so on, and so on.

Five years ago, this was being set against the barriers to entry. The lack of oven-ready portfolios of scale, the challenges of developing without recognition or support from housing and planning policy, the granularity of the asset management and the need for new finance models.

Endless reports and conferences, not much real action. There was no single identifiable catalyst for change. However, M&G's acquisition of the Berkeley residential portfolio in 2013 was evidence that UK funds were in the game. Delancey grasping the opportunity presented by the Athletes' Village at Stratford was perhaps an even more important moment. It turned the theory into practice and delivered proof of concept for the first time.

This has been supported by a group of pioneers such as Sigma, Quintain and Long Harbour who have worked through the issues of planning, design, delivery, management and branding, while long term players such as Grainger have evolved to keep pace in a changing market. At times it has been a process of trial and error. But that has fuelled innovation in all of these areas, learning lessons from the well-established student housing sector and the multifamily sector in the US along the way.

Starting to shift

And so the mind-set of investors has begun to change. They have increasingly committed to the idea of delivering truly long-dated income streams, letting go of the comfort blanket offered by potentially flipping stock back into the 'for sale' market.

Indeed, we have seen this turned on its head as an active diversification strategy. Developers are actively looking to incorporate Build to Rent product in what otherwise would have been for-sale developments.

At the same time, we have seen the beginnings of a shift in government policy, one which is much more supportive of delivering new housing stock across a much wider range of tenures, as a means of effecting a step change in housing delivery.

So are we on the cusp of an explosion in activity?

Fundamentally, this depends on the economics. Do the returns justify the risks? Not just for mature portfolios but also for those entering the sector via forward funding transactions or direct development where there are additional planning, development and stabilisation phases, with their associated risks?

Can the sector compete for investors' attention when the returns from other asset classes, not least of which cash, are set to rise? What is needed to accelerate deployment of the oft referred to 'wall of money' pointed at the sector?

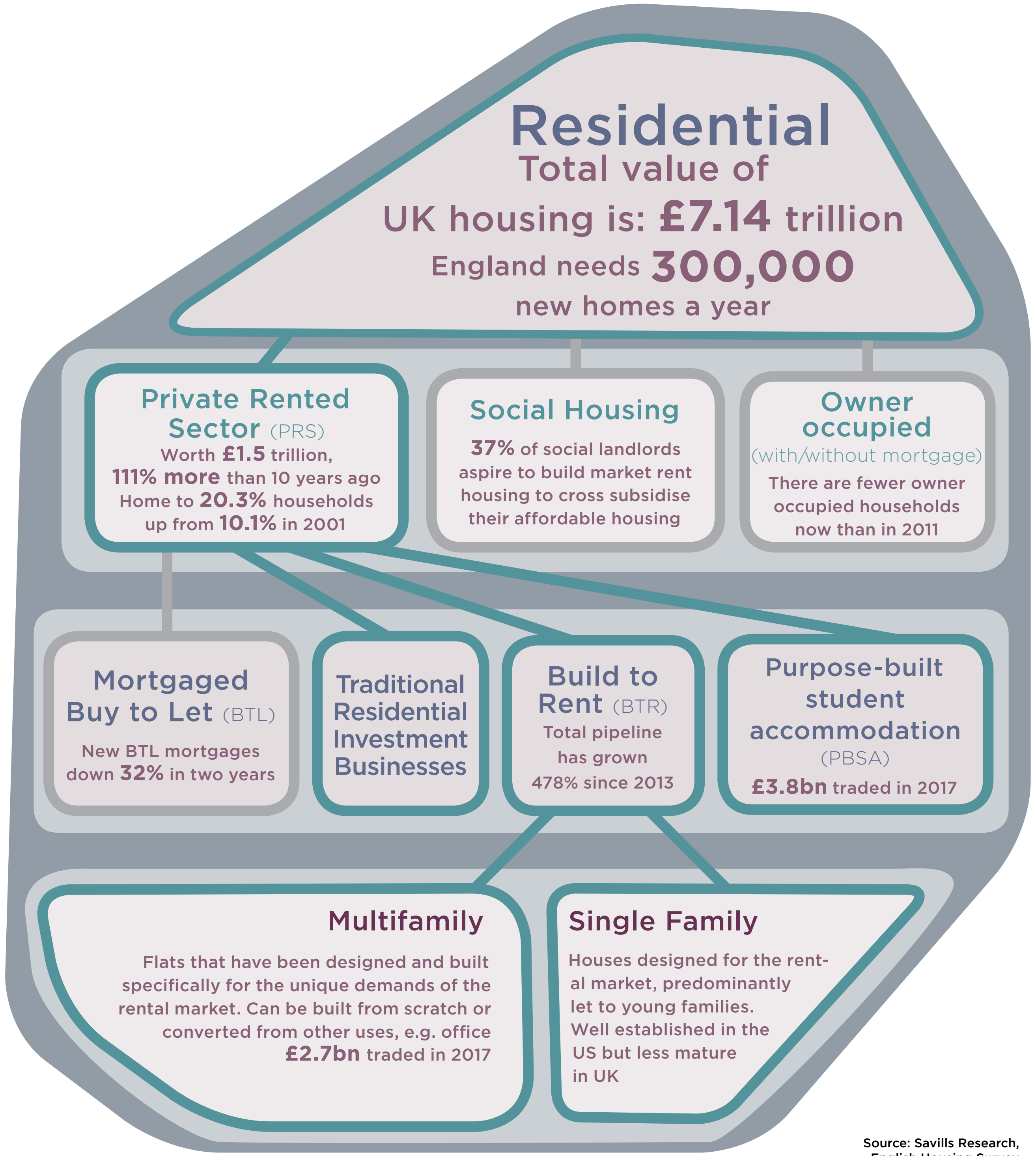
Lucian Cook
Director, Residential Research

Contents

The residential Rosetta Stone

Multifamily. BTR. PRS. PBSA.

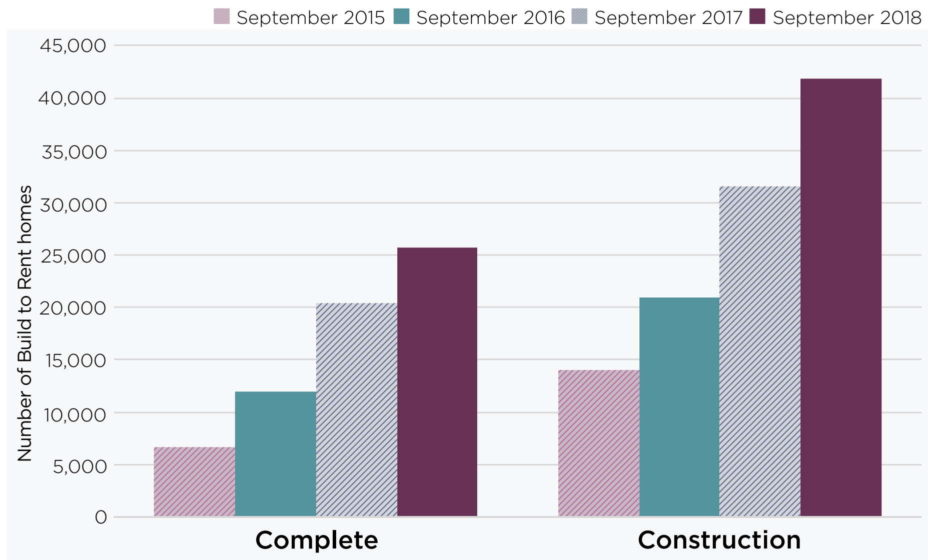
Figure 1 Structure of the residential sector



Source: Savills Research, English Housing Survey

Build to Rent: where are we now?

Figure 2 Growth in the Build to Rent pipeline



Source: Savills Research using BPF, Molior

Figure 3 Largest owners of UK BTR stock

Company	Units completed	Company	Units planned or under construction
	2,181		6,092
	2,091		5,491
	1,950		4,984
	1,656		3,575
	1,562		3,359
	1,559		3,231
	1,347		3,183
	1,059		3,152
	831		3,005
	727		2,750

Where possible, these figures cover only purpose-built rental stock

Source: Savills Research using BPF, Molior

Key takeaway

The past five years have seen the Build to Rent sector grow rapidly. At the end of the first quarter this year, over 50,000 multifamily & single family units were complete or under construction. This figure has risen 30 per cent in a year, with activity spreading across a number of cities.

Build to Rent fact file

30%
annual increase in units complete or under construction

32,000
more have detailed planning

52%
of completed units are in London

56%
of these under construction are outside London

15
schemes with plans to deliver over 1,000 homes

49%
increase in regional units under construction

248
Average size of scheme under construction

Motivation: why are investors looking at Build to Rent now?

With a stronger focus on income yield, returns from purpose-built rental assets stand up well against competing investments

Like all pioneers, the leaders of the UK's BTR sector have had to make several leaps of faith.

They've bet that the chronic undersupply of good quality, well-managed rented homes means the market will absorb large quantities of rental supply.

They've bet that demand for secure, long-dated income means there will be a market for stabilised rental portfolios when they're ready to sell.

And they've bet that the income return these schemes will deliver and the prospects for rental growth will adequately compensate them for the risk of developing stock from scratch.

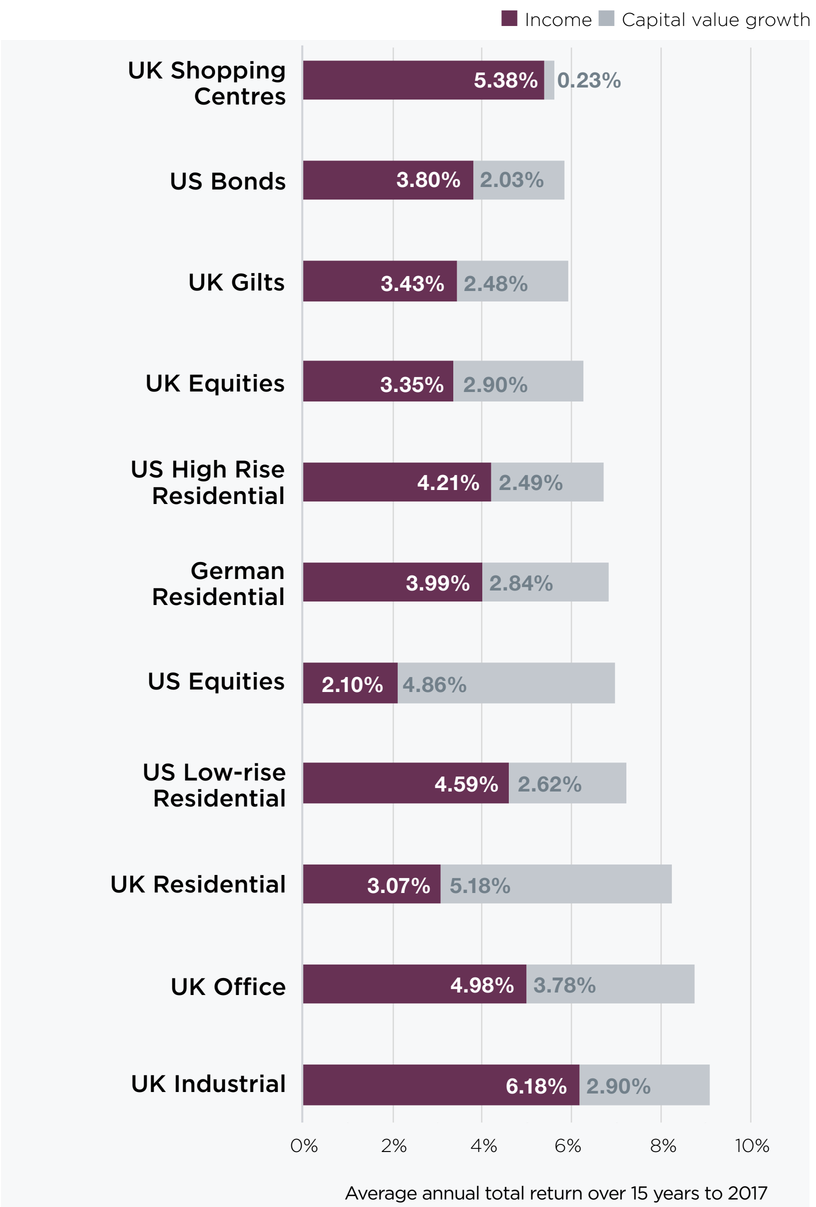
As the market reaches critical mass, we're going to see whether those bets pay off. The results will be key in unlocking the oft-quoted 'wall of money' targeting the BTR sector.

Setting the record straight To date, evidence of professional, large scale investment in built residential assets is largely limited to a handful of mature portfolios. They're mostly owned by large landed estates and they trade infrequently.

Over the last fifteen years the total return from this narrow band of residential assets has averaged 8.25 per cent per annum. This stands up well in the context of UK commercial property investments and the much larger body of residential investment evidence in Germany and the US.

But returns in UK residential property are driven by capital growth more than in other asset classes and international markets. That's largely been a function of rising capital values in the for-sale market.

Figure 4



Source: Savills Research using MSCI, Barclays Equities & Gilts Study

Income in focus

We predict this balance is due to shift. Investors now place greater focus on income with this making up a greater proportion of the total return.

As the sector matures and investors increasingly view it as long-dated income, there will be greater scrutiny on the premium deliverable over the risk-free rate (see pg 8).

Prior to 2010, net residential income returns were lower than gilts, as capital value made up such a large proportion of total return.

But as gilt rates have fallen and capital growth eased, it has been possible for income-producing residential property to deliver a premium over gilts. In 2017, an average net income yield of 2.75 per cent on mature portfolios delivered a premium of 156bps over gilts.

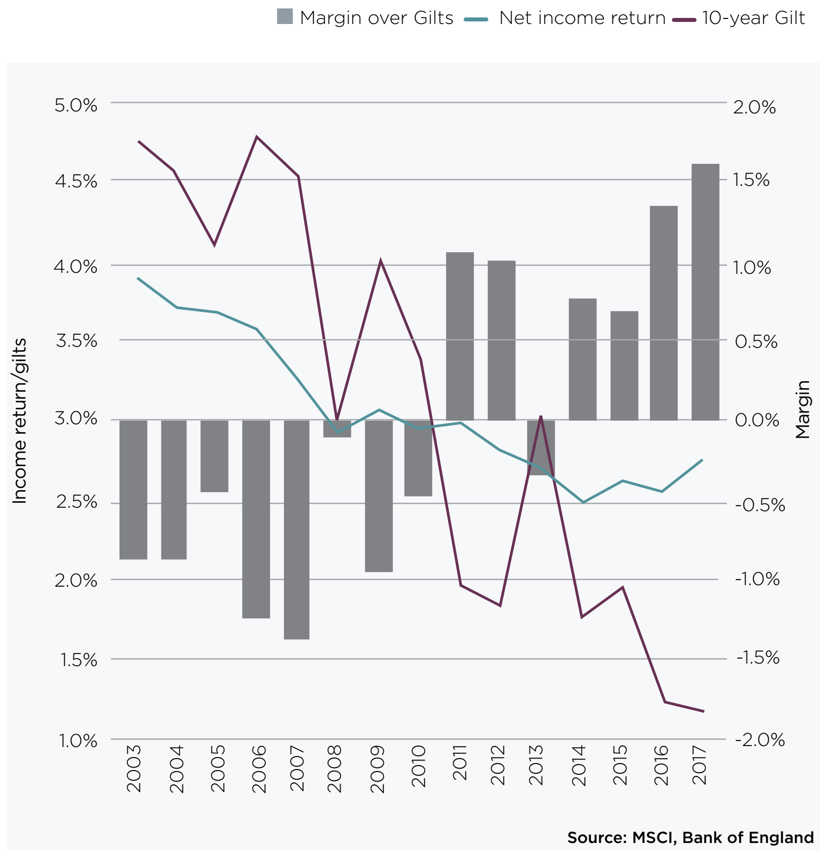
> Between 2015 and 2017, portfolio investment deals on new stock averaged a net initial yield of 4.3%.

Our analysis shows this figure underplays the yields available in the market for BTR stock. Between 2015 and 2017, portfolio investment deals averaged a net initial yield of 4.3 per cent, in line with multifamily deals in the US. Over this period, 18,500 units with an aggregate value of £4.1 billion changed hands. Two thirds were forward funding deals where investors fund the construction of purpose-built rental homes.

The challenge for residential property will be whether it can maintain – or even shrink – that premium as the risk-free rate rises.

Our analysis suggests that it can.

Figure 5 Residential income returns compared to gilts



Source: MSCI, Bank of England

Key takeaway

Long-established residential portfolios have delivered highly competitive total returns over the past 15 years, though this has been weighted to capital growth. Net income yields for new, purpose-built stock of 4.3 per cent show a premium both to gilts and mature portfolios, which will be important as the focus shifts to income returns.

BUILD TO RENT

Value fundamentals

Going back to fundamentals, the yield of a residential asset consists of three things: start with the risk-free rate, add in a risk premium, and cut back to account for future income growth.

All three of these ingredients look set to change over the next five years. Looking at each of them in turn, we show that while rising risk-free rates will put upward pressure on yields, BTR can offset this by reducing its exposure to risk and delivering income growth.

1 Risk-free rate

Over the last 30 years, the returns investors could expect from the lowest risk investments – government gilts – have followed a distinctly downward trend. Black Wednesday, the Dot Com Bubble of the early noughties, the Global Financial Crisis of the late 2000s: each appears as nothing more than a brief blip on gilt yields' journey towards zero. Close behind, returns for other, riskier assets have fallen too, driving a corresponding increase in asset values. This direction of travel is about to change.

We have already seen the Bank of England raise base rates, and central banks across the world have made clear their intentions to tighten monetary policy further. However gradual and limited base rate rises are, any increase will leave us in the highest rate environment since 2009. Bank of England analysis shows how its quantitative easing and corporate bond buying programmes have depressed yields in corresponding markets. It does not take a wild leap of faith to predict rising yields as those programmes ease off.

These trends aren't just confined to the UK. Whether pricing off US Treasuries or the German Bund, investors face the prospect of rising risk-free rates.

All else being equal, this means asset values will fall.

2 Risk premium

The risk premium attached to BTR currently reflects a trade-off. On one hand you have the much-heralded 'security' of income stream. On the other, you have the risks associated with a relatively immature asset class, uncertainty over the scale of the opportunity, and the threat of regulation.

Comparable evidence, trading opportunities, and suitable sites are all in short supply. The premium associated with these risks will naturally shrink as the UK BTR market matures. Planners will become more familiar with the BTR model. We will see a growing body of evidence showing how fast the market can absorb large volumes of new rental stock.

This will help determine the size of different submarkets and the need for diversification of product. Some of these risks, such as regulation, will be outside of the control of investors. Other risks, such as those relating to finance and construction, can be offset by an active mitigation strategy. This will be crucial at a time of rising gilt rates.

If the BTR sector can offset any growth in its risk-free rate by compressing its risk premium, we will see values maintained relative to other asset classes. But fundamentally, rental growth prospects are crucial to value growth.

3 Income growth

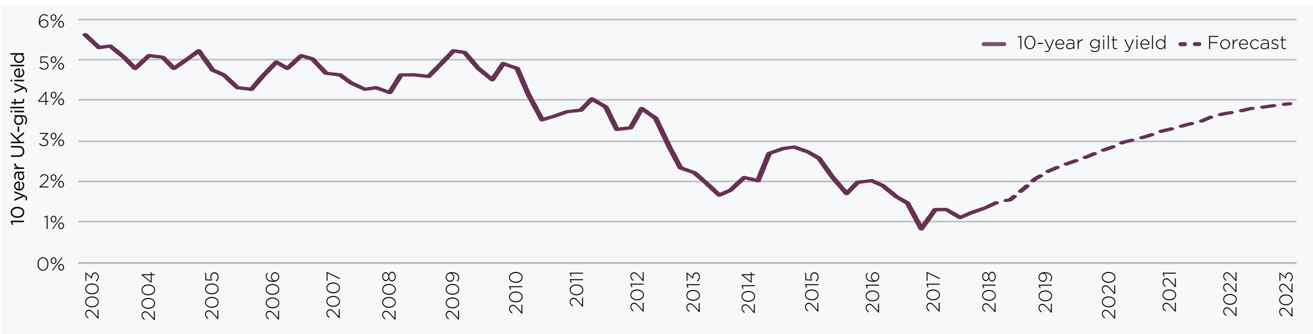
Residential property can boast a long track record of rental value growth. Residential rents grew 20 per cent over the last decade, compared to just 8 per cent for 'All Property' rents (dominated by commercial assets). While commercial property can show stronger rental growth in individual years, it is far more volatile than the residential sector. For long-term investors seeking stable income returns, steadily growing residential returns are a much more attractive proposition.

In particular, residential rental income will appeal to anyone who needs income that grows in line with wage and pension liabilities: residential rents grew approximately in line with wage growth over the last five and ten years.

The fundamentals supporting the residential rental market are strong. The population in the UK continues to grow. Housing availability is constrained and access to home ownership and social housing limited: deposit affordability and access to mortgage finance is restricting owner occupation, while access to social rented housing requires a long spell on the local housing waiting list.

Meanwhile, unemployment is at a record low and rental growth is starting to pick up. Oxford Economics predicts that average earnings will increase 17 per cent by 2022. In strong employment markets with limited housing supply, rents are likely to follow suit. With all that in mind, robust rental growth looks set to continue.

Figure 6



Source: Oxford Economics

Figure 7

	5 years	10 years	Source
UK Residential	10%	20%	ONS
UK All property	12%	8%	MSCI
UK Wages	11%	21%	ASHE
UK CPI	8%	24%	ONS

Source: MSCI, ASHE, ONS

Do we undervalue development risk?

How much of a discount should investors apply when funding development compared to acquiring operating assets? Evidence from recent transactions suggests investors are assuming a yield discount of as little as 50 basis points for entering the market via forward funding transactions.

That's a small discount, given the additional indirect construction risk and direct market risk in letting entire schemes, and indeed on the sheer delay to the income stream (albeit many investors are electing to charge a 'coupon' to combat this).

It's a demonstration of just how much competition there is amongst investors to access bespoke BTR investments that they're willing to price such risks so competitively. As the development cycle moves on, and we see more stock available to trade, we expect development risk pricing to move away from 50 basis points.

Key takeaway

While the risk-free rate is set to rise, we believe that as the BTR sector matures, the risk premium attached to the asset class will narrow. Rental growth prospects should therefore underpin capital growth and ensure competitive returns.

BUILD TO RENT

Risk and mitigation

What are the risks specific to the BTR sector?

All investments carry some level of risk, as 75 per cent of adverts on the London Underground are obligated to remind you.

Some of that risk is unavoidable, at least for investments within the UK. Brexit uncertainty and rising interest rates will leave their mark on all asset classes in one way or another.

Some risk is inherent to property and development. Construction and planning risk are common to all kinds of development, regardless of use class.

Here, we've chosen to focus on three flavours of risk specific to the BTR sector: namely, planning, letting rates, and regulation.

Planning

There's a risk that BTR schemes will take longer to get planning consent because local planning authorities don't have experience with them. That risk will decrease over time as we gather evidence of how BTR developments work and as investors and developers get better at communicating the sector's advantages and benefits.

The planning system has already evolved considerably to accommodate BTR. But we think there's still more to be done to help the sector flourish. For the first time, national planning policy recognises 'Build to Rent' and, in fact, requires local authorities to allocate sites for privately rented homes. However, as before, Affordable housing remains a sticking point.

Changes to the National Planning Policy Framework and associated Practice Guidance will help with this. In particular, Affordable Private Rent (Discount Market Rent in London, just to keep things simple) has begun to deliver an Affordable tenure that provides the control and security that BTR investors need over their building, management, and income.

There are challenges ahead, however. While the Draft New London Plan advocates "a positive approach to the Build to Rent sector", it imposes a blanket 35% Affordable housing threshold and a new concept of London Living Rents. Rather than mitigating the recognised viability constraints of BTR compared to development 'for sale', this could do the opposite.

London BTR developments also face the threat of late stage reviews. The structure of these reviews allows developers to fix their profit, passing on risk to the investors who acquire the asset. There's also inconsistency in how reviews are imposed, with some boroughs even seeking to include rental income within the review stage valuation. This puts BTR at an even greater disadvantage to 'for sale' development than before.

Letting Rates

BTR schemes can release large numbers of rental homes onto the market at once. Generally, that means you have an initial letting period as the scheme fills up, during which it won't generate its full potential income. It's in the interests of investors to keep this period as brief as possible.

There's a few ways investors can mitigate the risk of a lengthy letting up period. They can register potential tenants before the scheme reaches completion. But the short-term nature of residential tenancies precludes the kind of lengthy pre-let agreements we see on commercial developments.

They can phase the development, releasing blocks of homes to the market in chunks as they're completed. This is simple if the scheme comprises houses or several smaller blocks: larger schemes such as East Village released as few as 15 homes to the rental market at a time to avoid overwhelming the market. But phasing may not be an option on large, individual blocks of apartments.

And they can price schemes so they're affordable to the deepest part of the market. Letting evidence suggests that tenants are willing to pay a higher rent for the higher level of service and convenience in BTR homes. But increasing rental values substantially restricts the pool of potential tenants. Restrict that pool too far, and schemes will struggle to let.

Regulation

Housing now sits near the top of the political agenda, raising the risk that Government could introduce new regulations to the rental market.

We've seen a range of initiatives from across the political spectrum aimed at improving the private rental market. To date, these changes have largely benefited the institutional landlord. Plans to abolish tenants' letting fees will align the rest of the market with what is now common practice in the BTR sector.

The Conservatives pledged to explore ways to encourage longer tenancies, while Labour has called for three-year tenancies as standard. That's not a problem for long-term investors seeking a secure income stream, who are generally happy to offer longer tenancies with tenant-only breaks. And policies aimed at restricting amateur Buy to Let investors leave a gap in the market for professional landlords.

Perhaps the greatest potential risk is of rent regulation.

One look at the regulated rental markets of Germany and the US will confirm that BTR investors are comfortable with modest caps on rent inflation. They provide greater certainty of income while reducing perceived risk.

We have yet to see detailed proposals in the UK from either major party. Labour has proposed rent unions and an inflationary cap on rent increases within tenancies, while the Conservative party has repeatedly ruled out support for any form of rent control.

The fastest way to decrease regulatory uncertainty would be for Government to publish policy setting out how it intends to oversee the rental market. Until we have that clarity, the threat of stricter measures remains.

Key takeaway

The last five years have seen much greater recognition of 'Build to Rent' within planning policy, which lays the foundation for its expansion.

This reflects much greater political recognition of the benefits of and need for the sector, especially with pressure on private Buy to Let landlords. Over-regulation presents a risk, though proposals for rent control have been relatively light touch to date.

Investors can minimise their initial letting period by releasing homes in phases and pricing in line with the local market.

TALKING HEADS What the industry experts think

Rental growth

"There is a process of evolution which comes from direct experience of BTR. When our next generation of purpose-built, truly built to rent homes come through, we'd expect to see a design premium emerging in the rent. That will grow as the market becomes more familiar with the offering." **Angus Dodd, Quintain**

"The upshot of building at scale is that we are creating new neighbourhoods with amenity to back it up, albeit ones that sit within the existing urban fabric. In doing that we seek to add a regeneration uplift as the quality of the area improves. Beyond that, any performance adjustment comes from a compelling resident proposition and operational efficiency." **Rick de Blaby, Get Living**

Gross to net

"Pushing up rents but underinvesting in your asset might improve your leakage in the short term, but it will harm your investment in the long run. Schemes or businesses that don't have regard to these factors could easily become unstuck." **Angus Dodd, Quintain**

"We find you need an operating income of at least £2 million a year to justify having staff on site full time. Once you get beyond that point, there's opportunities to scale up without significantly increasing costs." **Alex Greaves, M&G**

"There are areas where we could cut costs in the short term: landscaping, the retail side, the events team, and so on. But all these things form part of our wider proposition and brand: if we weaken that, it weakens our ability to attract and retain residents." **Rick de Blaby, Get Living**

Regulation

Rather than regulation, the BTR sector needs support from Government if it is to maximise housing supply. That support should recognise the social value created by BTR schemes over the Buy to Let market, such as the greater flexibility and security for residents. **Dan Batterton, L&G**

"It's important both the physical product and the tenancies you offer match what your residents need. We offer longer leases, but most of our current demand is for one-year tenancies. We may find in later phases, where we're building larger, family homes, longer tenancies become more popular." **Angus Dodd, Quintain**

Who's missing?

"Student housing developers build a similar kind of product, they have experience of providing the amenity space and services we're trying to develop, and they've got a track record in using modern construction methods. You'd think BTR would be a natural step for them." **Alex Greaves, M&G**

"There's a lot of players active in the market now who want to build a pipeline, show that the concept works, and exit. I think the biggest buyers of that kind of stock will be pension funds." **Dan Batterton, L&G**

"BTR is a long-term business where the best returns are derived from patience, operational skill, and long-term commitment. This means it's better suited to long-term, patient investors. **Rick de Blaby, Get Living**

"I'm surprised by the number of people who think they can make BTR work. The investment that's required in recruitment, training, and IT infrastructure to establish a BTR operating platform is huge. Not a lot of companies have the size or the conviction to make that investment." **Angus Dodd, Quintain**

BUILD TO RENT

Who's investing...

Build to Rent is still a young sector in the UK, with plenty set to change over the next few years. The range of investors will evolve dramatically as the risk profile of investment changes. There's a good chance that the investors who will dominate tomorrow's Built to Rent market haven't made their first step into the sector yet

Investment into UK BTR reached £2.7 billion in 2017, up 23 per cent on 2016 and 4 per cent on 2015. It's a sign of investors' confidence in the sector that these volumes have held up, despite the headwinds of Brexit uncertainty and a surprise General Election.

But still, the value of BTR stock traded last year is essentially the same as it was five years ago. What happened to the 'wall of capital' looking to invest in BTR?

While the value invested hasn't increased substantially, the type of investors and how they deploy their funds has changed enormously.

Building for the future

In 2014, 87 per cent of deals by GDV were for stabilised, income-producing assets. Last year that proportion was just 27 per cent, as existing investors held onto stock to build platforms upon which to aggregate portfolios.

Just under £2 billion of last year's investment was in forward funding and forward purchase deals.

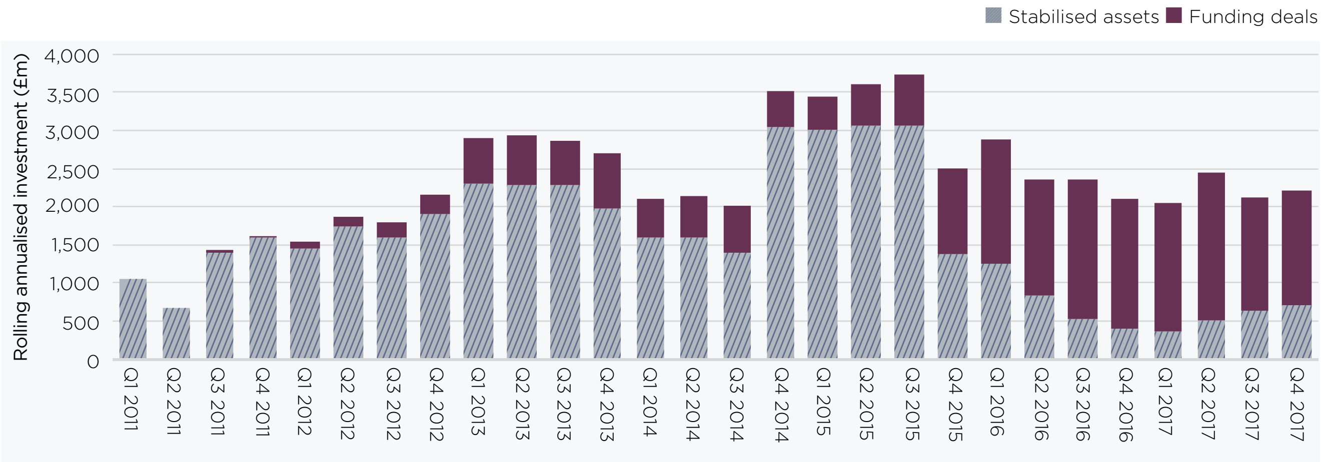
This reflects where we are in the development cycle. There simply aren't enough stabilised assets to meet demand, so investors have turned to funding development of their own stock – betting that strong rental growth prospects and the funding yield discount will compensate them for taking that risk. This has the added benefit in giving them a say in design and branding.

As these assets are let and start generating income, we expect to see more deals. Fully let assets will command a premium to vacant blocks for long income investors, just as we see in commercial property sectors. And there's also likely to be a premium on larger portfolios where investors can achieve scale quickly, just as we see in the student housing market.

The North-South divide

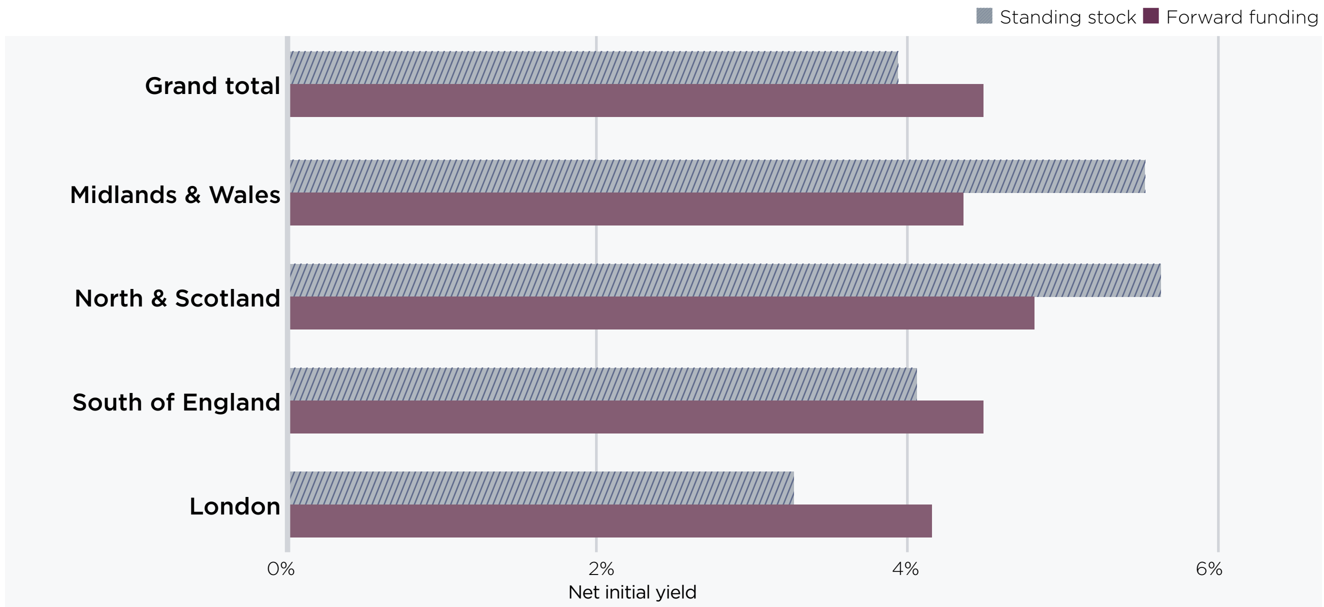
Net initial yields on BTR deals averaged 4.3 per cent between 2015 and 2017. But that hides substantial regional variation. While half that investment took place in London, where yields averaged 3.8 per cent, across Scotland and the north of England the average yield was 4.9 per cent. In London and the South, the income returns from funding deals are higher than on standing investments, as you might expect. In the North, this is not necessarily the case, given issues over the quality of some of the existing rental stock and the rental covenant attached to it, all limited by the fact that we're yet to see any of the purpose-built kit trade yet. As investors focus more on the potential growth of the income stream and less on the track record of local house price growth, we expect yields from purpose-built assets to show less regional variation.

Figure 8 Rolling annual professional investment into residential for rent



Source: Savills Research

Figure 9



Source: Savills Research

New faces

In 2013, institutional investors had only just entered the scene. M&G, APG, and Legal & General all bought hundreds of units, ploughing just under a billion pounds into the sector.

Since then the range of institutional investors has broadened somewhat, with LaSalle IM, Invesco, and Realstar all funding deals or where possible buying up income producing assets that had accidentally found themselves in the sector.

But some firms are still notable by their absence. Investors such as AXA and Goldman Sachs have shunned the sector so far. Some of the largest owners of multifamily in the US, such as Equity Residential and Essex Property Trust, have yet to be tempted across the Atlantic.

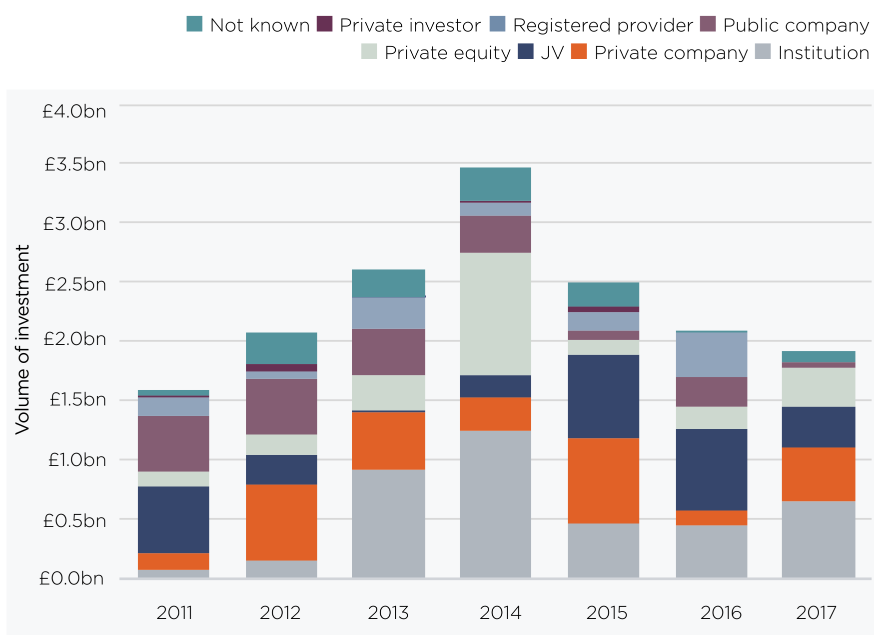
...and who isn't

By contrast, UK registered providers of affordable housing, such as L&Q and A2Dominion are already involved in the sector. Much of their experience developing and managing social rented stock is transferable. Those skills will let them develop portfolios at scale and run them efficiently.

Perhaps the greatest opportunity is for pension funds. A few funds have made their mark on the sector – APG from the Netherlands, for instance.

As we progress through the development cycle and see more stabilised assets brought to market, we can expect to see pensions play a much larger role.

Figure 10 BTR investment by source of capital



Source: Savills Research

Key takeaway

Of the £2.7bn invested in BTR last year, just under £2bn was by way of forward funding or forward purchase deals. 2017 saw an increased range of institutional investors active, such as Invesco and Aberdeen Standard.

However, we believe the greatest opportunity is for pension funds. Long-term wage-linked income growth is increasingly used to match pension liabilities.

STUDENT HOUSING

Challenges for student housing investment

While the BTR market in the UK is still in its infancy, the student accommodation market has come a long way in the last 27 years. Since Unite Students first started trading in 1991, we've seen the Purpose-Built Student Accommodation (PBSA) market grow to maturity, with 40,000 student beds worth £3.9 billion traded last year.

Investment volumes in 2017 were down 14% on the previous year. This was more a reflection of 2016's strength rather than any weakness in last year's performance – we still saw four portfolios with more than 1,000 beds trade, each of which sold for more than £100 million. Some of those larger, more complex deals slipped into the first quarter of 2018, which will help drive performance this year.

Based on transactions undertaken to date and those still to complete, we predict that 50,000 PBSA beds will trade in 2018, with a total value of £5.25 billion. Once again, this has been driven by major national portfolios, such as the Enigma, Colorado, Mayflower and Stellar portfolios.

Yields tightening

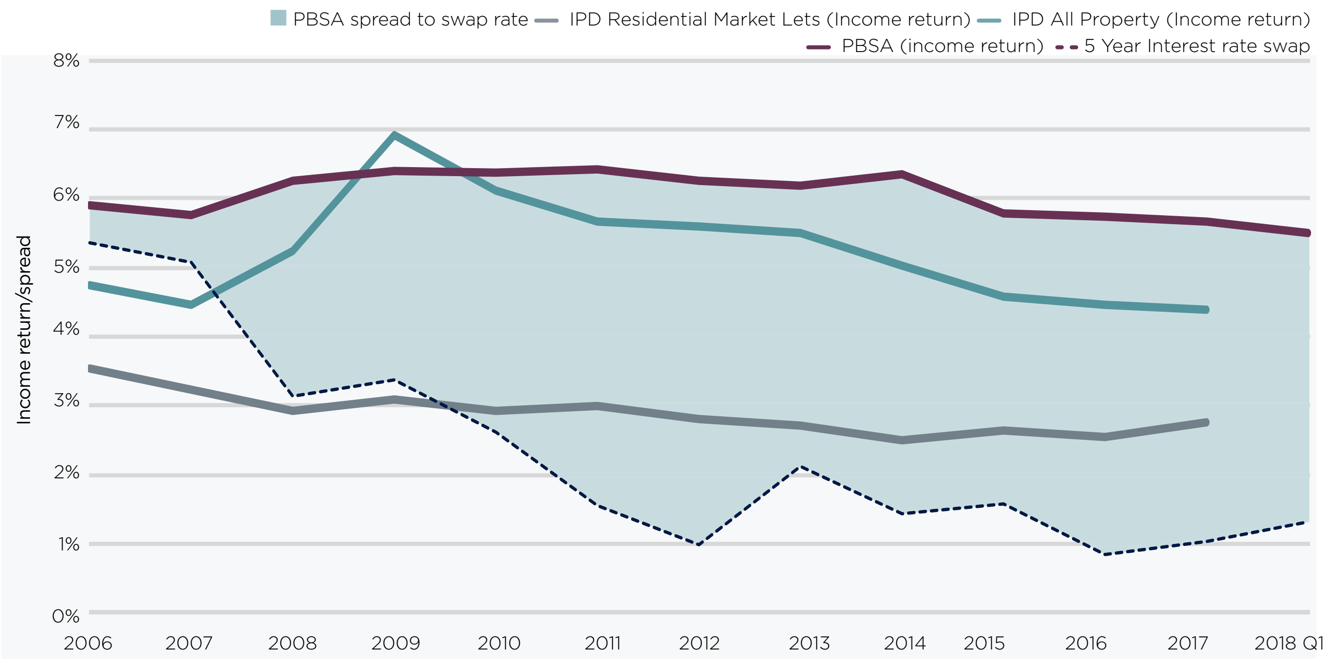
Yields on PBSA deals continued to track down last year. The volume-weighted average yield in 2017 was 5.7%, reflecting a 4.5% spread to 10-year gilts.

The first half of 2018 suggests yields are tightening further, with yields averaging 5.5%. That also represents a narrower spread to gilts, 4.0%, which had already begun to rise in anticipation of higher Bank of England base rates announced in August.

There are many elements to PBSA's attractiveness as an investment. The student demand pool is constantly evolving as student numbers generally continue to increase, as planning consents become harder to achieve and build costs rise (limiting competition), and as the affordability, location and specification requirements of students broaden.

However, PBSA faces its fair share of challenges and obstacles too. We delve into two of the main hurdles here: tightening **planning** policy, and the shifting shape of **demand**.

Figure 11 Yield trends in the purpose-built student accommodation market



Source: Savills Research, MSCI, Bloomberg

Planning

London

Sitting outside the traditional use classes, historically, PBSA hasn't had to face significant hurdles in the form of Section 106 affordable housing contributions. In London, that's all set to change with the draft New London Plan.

For some time, new student developments in the capital have had to satisfy one of two criteria to get planning permission: providing affordable student housing, or showing they have a nominations agreement with a London university. As it stands in the draft New London Plan, schemes will now need to satisfy both these criteria.

Schemes will be eligible to use the Fast-Track Route through viability if at least 35 per cent of beds are affordable. Any fewer, and developers will have to take their scheme through viability testing.

While these changes make it harder to develop PBSA in London, that doesn't mean a complete stop to PBSA investment and development activity. In last year's Spotlight we suggested PBSA investors may want to diversify their offering into Build to Rent or co-living. The draft plan appears to support this approach. Schemes that don't have a nominations agreement in place can still ago ahead as large-scale purpose-built shared living.

This could open up the range of potential residents to more than just students, just as The Student Hotel has done across mainland Europe. It allows investors to make their affordable contribution as a cash payment in lieu, rather than providing beds on site.

However, it still leaves schemes subject to late-stage review mechanisms and planners understanding the economics of schemes designed to drive rental income rather than sales values, as discussed above.

These planning proposals sit in direct conflict with the latest National Planning Policy Framework. Whether inspection dilutes the proposals or the Mayor is forced to back down.

We'll have to wait and see whether consultation on the New London Plan dilutes these proposals. Regardless, they suggest the direction of travel is changing. PBSA developers can no longer count on being exempt from affordable housing contributions or other planning obligations.

Regions

Outside London, the planning outlook is somewhat rosier. The new National Planning Practice Guidance clarifies that local authorities need to account for housing need from students in their local plans. It also allows them to count student housing toward their housing delivery targets, on the basis that it frees up existing housing elsewhere.

New planning policy puts greater pressure on local authorities to meet their housing need. Given that they can count PBSA toward that figure, this should mean we see local planning authorities take a more proactive approach to working with student housing developers - as in the BTR sector.

Demand

Demographics

We predict that domestic demand for full-time undergraduate courses is likely to dip in the short term. That's simply down to demographics: there's fewer people just below university age getting ready to apply.

The number of 18 year olds is set to reach a trough in 2020, with a knock-on effect on student numbers. But beyond this blip, the trend is for the number of UK 18 year olds and university applicants to carry on growing over the next 20 years.

There are three levers the Government and universities can pull to help deal with falling numbers of 18 year olds in the short term.

They can increase university participation rates. Full-time undergraduates accounted for 47 per cent of the 18-20 population in 2011; by 2017 that proportion was 53 per cent. If universities can broaden their appeal to more of the population, they could attract a high enough proportion of younger people to counter the demographic dip. Government assistance, in the form of maintenance grants for lower income students, for example, may help further.

Universities may be able to attenuate the effect of this shortfall by increasing acceptance rates. But that presents its own set of risks: undergraduate demand is most robust at universities with high entry requirements and strong academic outcomes. Balancing accessibility with exclusivity will be an ongoing challenge for providers.

And they can increase international student numbers. The Government has offered to continue welcoming EU students to the UK through Erasmus in the latest Brexit White Paper. Pressure to exclude international students from immigration targets continues to pile on Government, whether from universities, the House of Lords, or their own ministers. With strong rankings on international league tables, the UK's universities are well placed to grow their share of the international student market if they're given the freedom to do so.

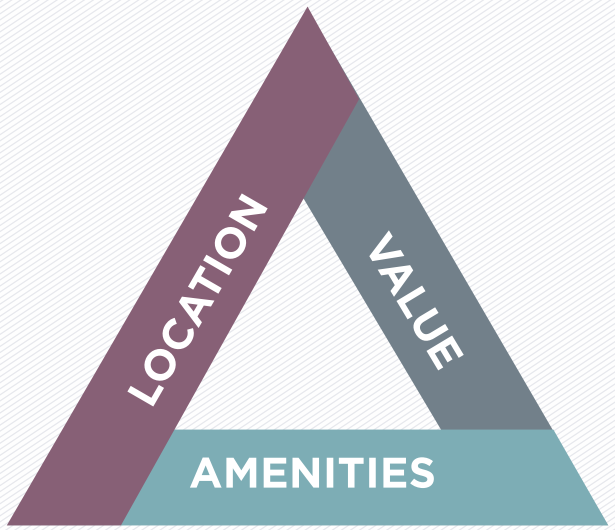
Obsolescence

Not all student schemes are created equal. Across multiple university cities, we've seen the supply of PBSA edge closer and closer to meeting current local demand. With that aforementioned demographic dip approaching and Brexit uncertainty still hanging overhead, this will lead to competition between schemes to attract residents.

That's unlikely to be a problem for the best located schemes, situated right on campus or in the heart of the town centre. Nor will it be an issue for the more affordable, value schemes, nor the best designed.

But for schemes that don't satisfy one (or more) of these criteria, maintaining high levels of occupancy will be challenging.

Figure 12 Three criteria for attracting student demand



Source: Savills Research

Lots of movement in the league table

Once again, we've seen significant change in our student housing development league table this year. Just like last year, more cities have fallen down the rankings than risen, reflecting an increasingly challenging market for developers.

The First Class category holds those cities with the very best prospects for student housing development. Nottingham and Reading join this rank this year. They've seen relatively subdued levels of PBSA supply in the last few years while student demand has grown, creating opportunities for new schemes in those cities.

London remains in the top tier, in spite of the greater challenges imposed by the draft New London Plan. While it will become more difficult for schemes to get planning permission, those that receive approval will be especially attractive opportunities.

The universities of Exeter, Leeds, and St Andrews have all dropped into the Upper Second category as a result of strengthening supply pipelines there. They're joined by Glasgow, Leicester, Northampton, Norwich and Stirling moving up the league.

Derby and Loughborough have climbed to the Lower Second category, to join cities such as Cambridge, Canterbury, and Portsmouth from above.

Liverpool has experienced a reversal in fortunes this year, bouncing back into the Third Class category. While the pipeline of new PBSA development there still looks large, several schemes have gone through a change of use into mainstream residential or Build to Rent, meaning a less crowded market.

We develop our league table by looking at the ratio of student housing to full-time student numbers, the PBSA development pipeline, affordability, rental growth prospects, local planning policy, and demand for competing land uses.

As such, it is helpful as a general indicator of how attractive a city is for PBSA development, but the suitability of specific schemes within each city will vary.

Figure 13 Student housing development league table

First	Upper Second	Lower Second	Third	Pass
Bath	▼ Exeter	Bangor	Aberdeen	Bolton
Birmingham	▲ Glasgow	▼ Belfast	Aberystwyth	Bradford
Brighton	▼ Leeds	Bournemouth	▼ Cardiff	Carlisle
Bristol	▲ Leicester	Buckingham	Chelmsford	▼ Chester
Edinburgh	▲ Northampton	▼ Cambridge	Cheltenham	Cirencester
Guildford	▲ Norwich	▼ Canterbury	Dundee	Hull
London	▼ St Andrews	▼ Chichester	Falmouth	Ipswich
Manchester	▲ Stirling	Colchester	Farnham	▼ Kingston-upon-Thames
▲ Nottingham	Winchester	Coventry	High Wycombe	Luton
Oxford		▲ Derby	Huddersfield	Middlesbrough
▲ Reading		Durham	Inverness	Newport
		Egham	Lancaster	Paisley
		Hatfield	Lincoln	▼ Plymouth
		▲ Loughborough	▲ Liverpool	Pontypridd
		▼ Portsmouth	▼ Newcastle	Preston
		Sheffield	Salford	Sunderland
		Southampton	Stoke on Trent	Uxbridge
		Swansea		Wolverhampton
		Twickenham		Worcester
		York		Wrexham

▲ Up ▼ Down

Source: Savills Research

Our 10 key findings

1 **Historically, income from residential assets has made up a much smaller proportion of total return than for other property investment classes. We expect that to change.**

2 **Residential investors are switching their focus from capital growth to long-dated income.**

3 **Risk-free rates will rise over the next five years, which will put upward pressure on yields.**

4 **Investors can shrink their risk premium to compensate:** they can minimise exposure to planning risk through covenants and to stabilisation risk through proactive letting strategies and realistic pricing. The Government can help by providing regulatory certainty.

5 **The outlook is positive for rental growth in strong employment markets.** We forecast 17 per cent growth in London over the next five years.

6 **£2.7bn of BTR assets traded in 2017, 23 per cent more than in 2016.**

7 **Many of the investors who will dominate the UK BTR sector in five years' time may not have entered the market yet.**

8 **Performance in 2018 so far suggests 50,000 student beds will trade this year, at a value of £5.3bn.**

9 **Yields on student housing investments continue to sharpen due to strong investor demand.**

10 **Student housing development prospects are strengthening in cities such as Nottingham, Reading, and Leicester.**

Savills Residential Research is a dedicated team with an unrivalled reputation for producing well-informed and accurate analysis, research, and commentary across all sectors of the UK property market.

Lucian Cook
Head of Residential Research
+44 207 016 3837
lcook@savills.com

Jacqui Daly
Head of Investment Research & Consultancy
+44 207 016 3779
jdaly@savills.com

Lawrence Bowles
Associate Director
+44 207 299 3024
lbowles@savills.com

Savills Operational Capital Markets is among the largest and most proficient deal makers in the market. We have an unparalleled track record in brokering deals across the UK and Europe, having advised on over £10bn of investment in 2016 and 2017.

Peter Allen
Head of Operational Capital Markets
+44 207 409 5972
pallen@savills.com