OCM Residential Investment & Development – September 2022

SPOTLIGHT
Savills Research

Single Family Rental

A Key Component Of UK Housing Delivery

• Market growth • New investors • Geographic diversification

KEY POINTS

30%
Fewer flats and houses listed on Rightmove compared with the 2017-2019 average, emphasising the enormous need for increased delivery of rental housing

15,000
SFR homes currently in the planning pipeline – more than doubling from just a year ago

103 homes
The average size of schemes now in planning, as the number of homes per scheme continues to rise

60%
Of SFR households have children, compared with just 30% of households across the wider PRS

31
Additional SFR schemes have become operational in the last year, providing 2,200 homes

58%
Of properties in the UK rental market have an EPC rating between D and G, and will need to be improved by 2028 to meet Government requirements

Growth of the market

Since the launch of our Single Family Rental (SFR) report in September last year, the market has continued to grow at scale, with a host of new entrants to the sector.

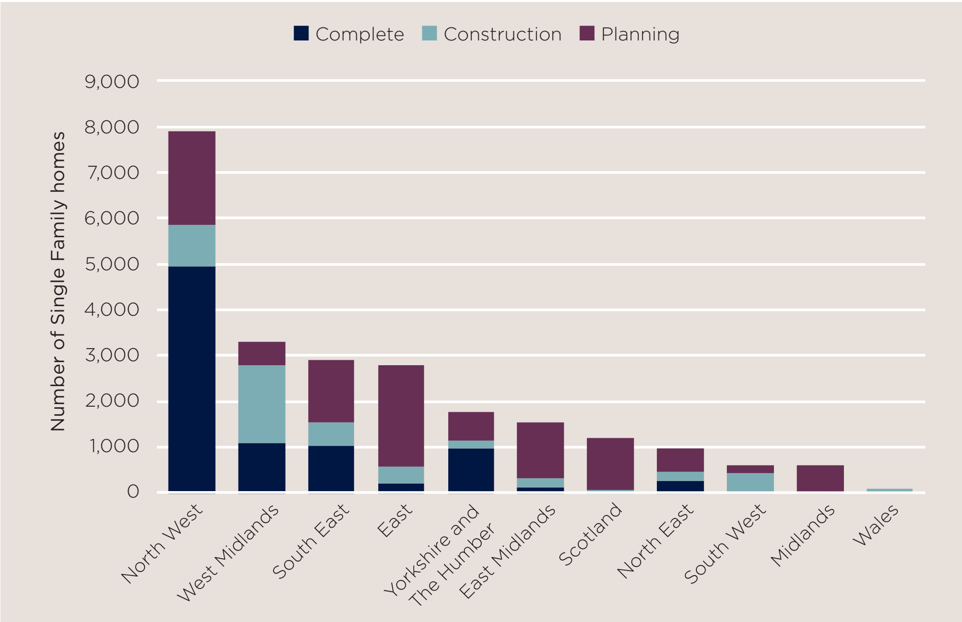
Investment activity is ramping up across the country, with deals to fund new developments nationwide. With the private sales market slowing, widespread supply shortages in the rental market and a Government policy geared towards higher quality and more energy efficient homes, this is SFR's moment to establish itself as a key component of UK housing delivery.

Over the past 12 months, 31 additional SFR schemes have become operational across the UK, delivering 2,200 homes. At the same time, the planning pipeline has doubled in size, meaning there are now over 15,000 SFR homes either under construction or in planning.

SFR development was initially limited to the North West, concentrated across just 14 local authorities, with the partnership between Sigma Capital and Countryside Properties responsible for the vast majority of SFR delivery across this region.

Now, due to the significant influx of interest from others in the sector, SFR is coming forward in over 100 local authorities across the UK, and is anticipated to continue to rise.

Fig 1: Majority of completed stock is located in the North West but pipeline is spread more widely



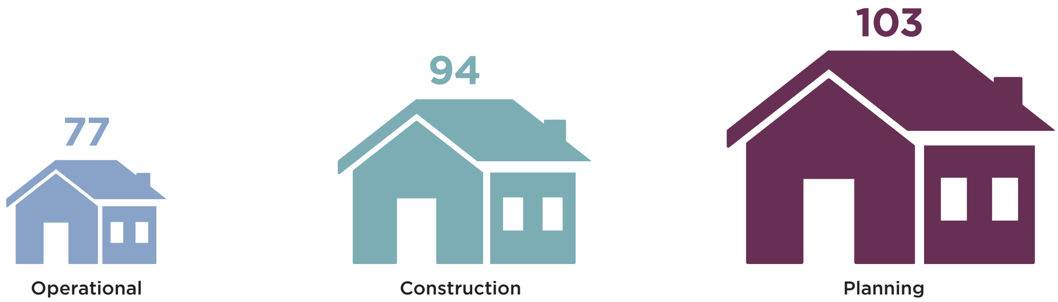
Source: Savills, British Property Federation

This geographic expansion has been supported by the improved viability of the South, combined with investors seeking geographically diverse schemes in order to have balanced portfolios. In the past two years, we have identified at least 30 investors looking to deliver SFR homes over the next five years. Interest has come from core, domestic investors such as Aviva and Legal & General, as well as international private equity firms including TPG and Blackstone.

As new investors enter the space, we are likely to see an evolution of the SFR model. We are already seeing an increase in the average number of homes on SFR sites (Fig 2). Operational schemes have grown to an average of 77 homes, with sites under construction and in planning set to deliver an average of 94 and 103 homes respectively. This clearly shows the direction of travel, with investors seeking larger SFR schemes where economies of scale can be driven. There has been a clear change in the last 12 months alone, with the average site under construction growing by a third in size and the average site in planning growing by 52%.

“SFR is coming forward in over 100 Local Authorities across the UK”

Fig 2: The number of homes on SFR sites continues to increase



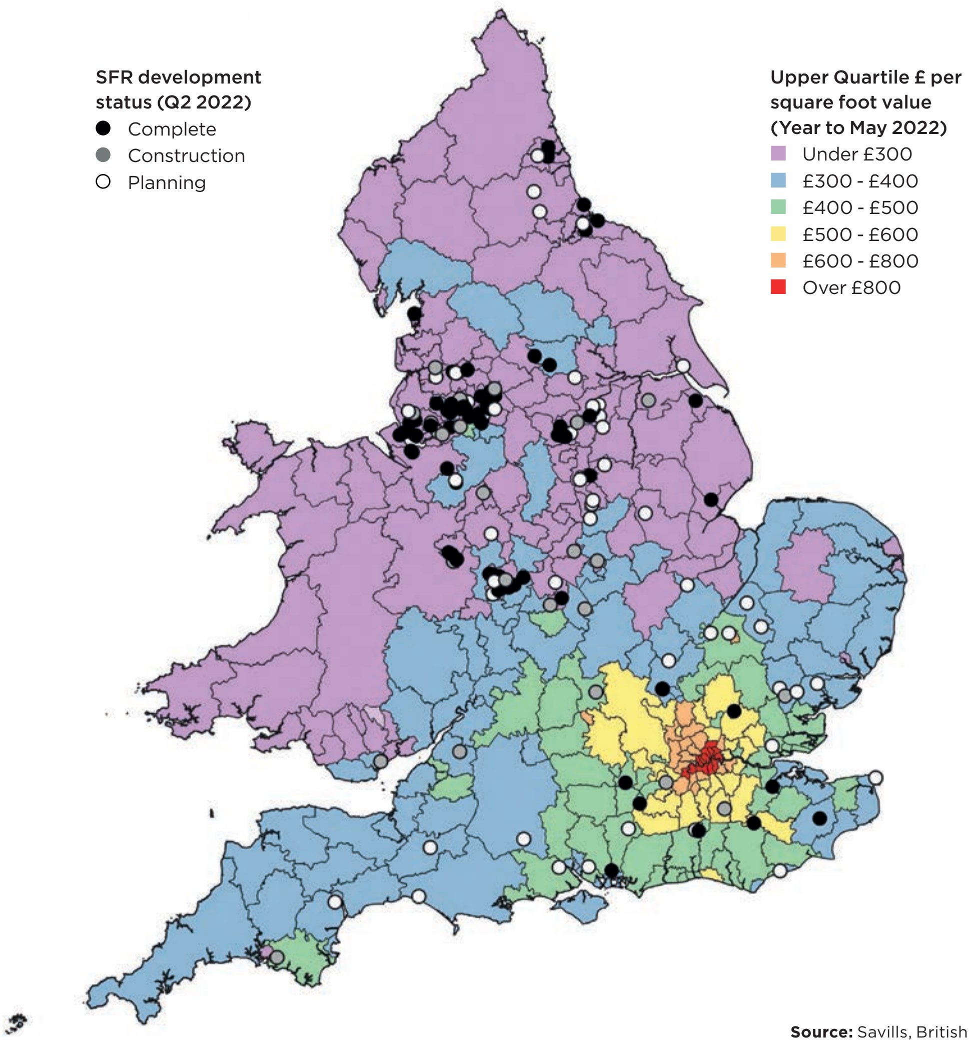
Source: Savills, British Property Federation

The increased focus on the South has resulted from investors recognising that this is where housing need is the greatest, and many have concentrated their strategies on markets with the greatest need for new rental supply.

As shown in Fig 3, SFR is now coming forward in higher value markets due to improved viability. There are now 40 sites coming forward in the South (South West, East, South East) compared to just eight only a year ago.

Fig 3 shows the clear shift in geography between completed SFR schemes (black dots) and schemes in planning (white dots).

Fig 3: The Single Family Rental pipeline is coming through in a wide range of markets by value



Source: Savills, British Property Federation

We analysed 4,547 households across 59 operational SFR developments to better understand the households that are occupying these schemes

Who lives in SFR?

SFR, with its huge growth potential, can play a key role in helping to meet housing need and reduce the significant supply shortages in the rental market (see Fig 7).

So, what type of households are attracted to SFR developments? To answer this question, we analysed 4,547 households across 59 operational Single Family developments.

Our analysis shows that 60% of SFR households have children, compared with just 30% of households across the wider PRS. This demonstrates that SFR has the potential to play a key role in family housing provision nationally. Site design and location is therefore key in attracting and retaining the core SFR demographic. While many SFR homes to date were designed with homeowners in mind, there is significant overlap between the living preferences of owner occupiers and SFR tenants. These include extra space, both inside and out, as well as car parking and easy road access to schools, employment, retail, leisure and supermarkets.

SFR tenants are mostly aged between 26 and 45 (66%) and stay for three years or more. This makes sense, as families are naturally less transient than households without children, being less inclined to disrupt their children's studies. This is beneficial from an investor perspective, as "stickier" tenants mean reduced void levels, minimising loss of income.

Giving tenants the freedom to redecorate their own home after the first year has proven to be a very successful initiative in reducing churn. This minor change provides tenants with more control over their personal space and is likely to encourage them to stay for longer. Fostering a sense of local community through the hosting of seasonal events and organising initiatives such as food truck visits has also helped SFR operators maintain incredibly high occupancy rates.

SFR operators should continue to adapt to changing tenant requirements. In SFR markets, 64% of renters commute to work via car. Parking provision is therefore crucial. With an additional 471,000 Ultra Low Emissions Vehicles (ULEVs) on the road in 2021 vs 2019, provision of charging points will also continue to rise up tenant's priority list. ESG specification items (e.g. Solar, Non-gas solutions) are becoming an increasingly important consideration for investors seeking to future-proof their investments. Creating more energy efficient homes will also deliver added benefits to tenants, in the form of lower energy bills, so this is an area where tenant and investor priorities are aligned.

66% of SFR tenants are aged between 26 and 45

60% of SFR households have children

SFR tenants tend to stay for three years or more

64% of SFR households drive to work

SFR is entering its next phase of growth

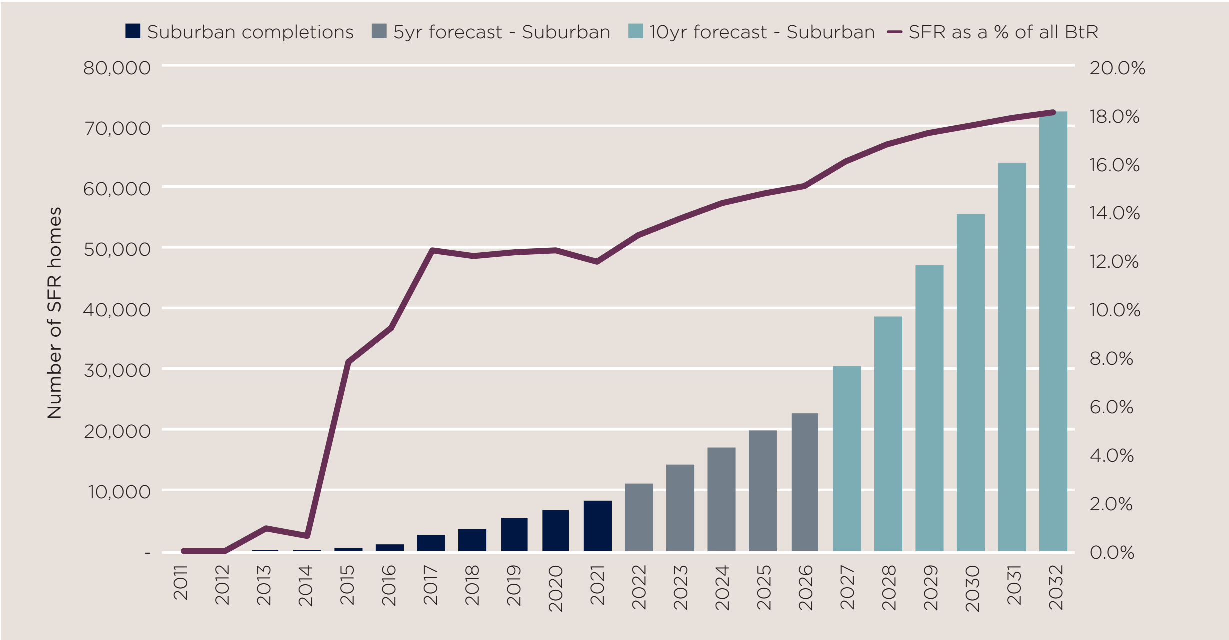
Growing pool of investors chasing SFR opportunities

The SFR market is gathering momentum and will continue to do so given its appeal to investors as an inflationary hedge. It is worth noting that, in the current inflationary environment, we have seen several private equity funds who require debt funding pause their SFR strategies, due to their rising cost of capital. While this has made some investors less competitive in the shorter term, a number of new institutions with a lower cost of capital have entered the space. Their requirement to deploy capital is generating increased competition for SFR schemes. Therefore, despite the headwind of inflationary pressure, the growing pool of investors and consequent weight of capital targeting SFR means pricing for assets has remained competitive.

SFR also provides a degree of diversification for Multifamily (MF) investors, who can capture a more varied tenant base and diversify their portfolio in terms of locations and property type. Investors have the potential to establish a long-term brand and move tenants between MF and SFR schemes as their lifestyles change. We believe this will increasingly be a trend as the sector continues to scale.

The number of operational SFR homes has expanded by 6.6x over the past five years. We estimate that with current momentum, and the weight of capital chasing the sector, there could be 30,000 SFR homes in operation by 2027 and more than 70,000 by 2032 (Fig 4). This will see SFR take an increasing share of the UK Build to Rent market, growing from 12% to 18% over the next 10 years. But even with this projected growth, SFR would still be a relative drop in the ocean given the 2.23 million renters who live in suburban locations in the UK.

Fig 4: SFR predicted to grow to more than 70,000 completed homes by 2032, taking an increasing share of total BtR



Source: Savills Research, British Property Federation

To reach more than 70,000 SFR homes over the next decade, 2,900 homes will need to be funded annually between 2022 and 2027, rising to 8,300 per annum between 2027 and 2032. Developer appetite and capacity will be crucial in this growth being realised, with successful partnerships an important aspect of future delivery.

A number of national housebuilders are set to diversify their businesses into SFR delivery in the coming years, including Barratt, Countryside and Vistry, with more likely to follow suit. Investor ambitions are more than sufficient to drive this expansion. Based on current new build sales values, we estimate this could amount to nearly £25 billion of SFR stock.

Challenges in the new homes market can be a catalyst for SFR expansion

There is considerable scope for SFR delivery nationally. In the absence of operational, stabilised assets, new investors are aggregating portfolios by partnering with housebuilders to fund the delivery of new homes.

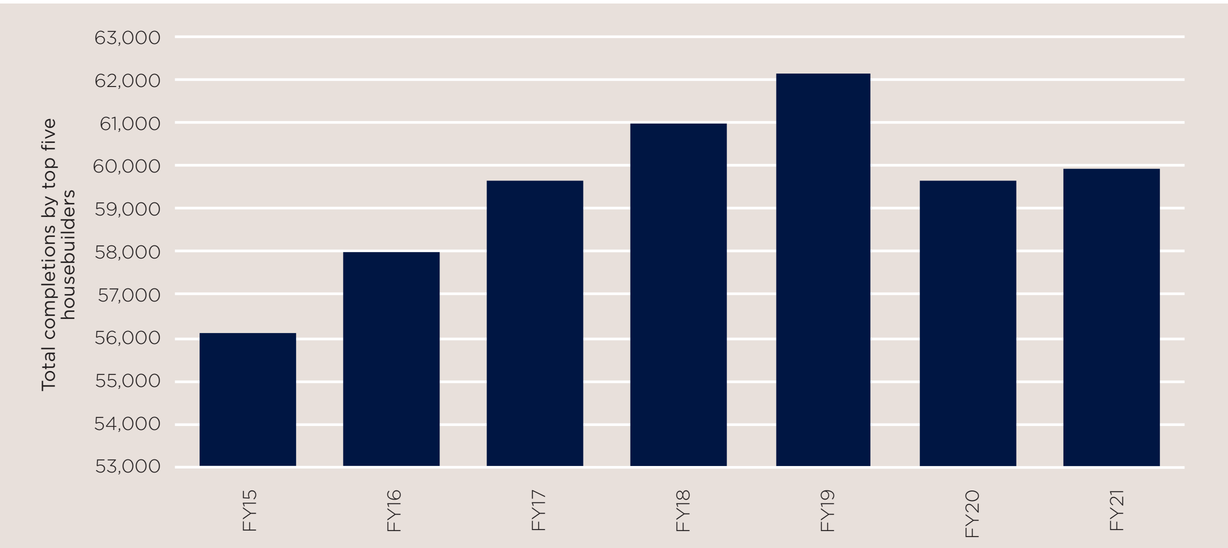
There have been barriers to entry in recent years, including lack of access to 'oven ready' development sites and schemes not stacking up from a viability perspective in markets where house price inflation has outstripped rental growth.

However, the market has now reached a turning point, with the level of rental growth and rate of yield compression making schemes more viable and attractive for both investors and developers.

In addition, Help to Buy (HTB) supported the sale of c.53,000 homes per year over the past three years, but reservations for potential buyers end this October, so we are likely to see a softening of the private sales market in its absence.

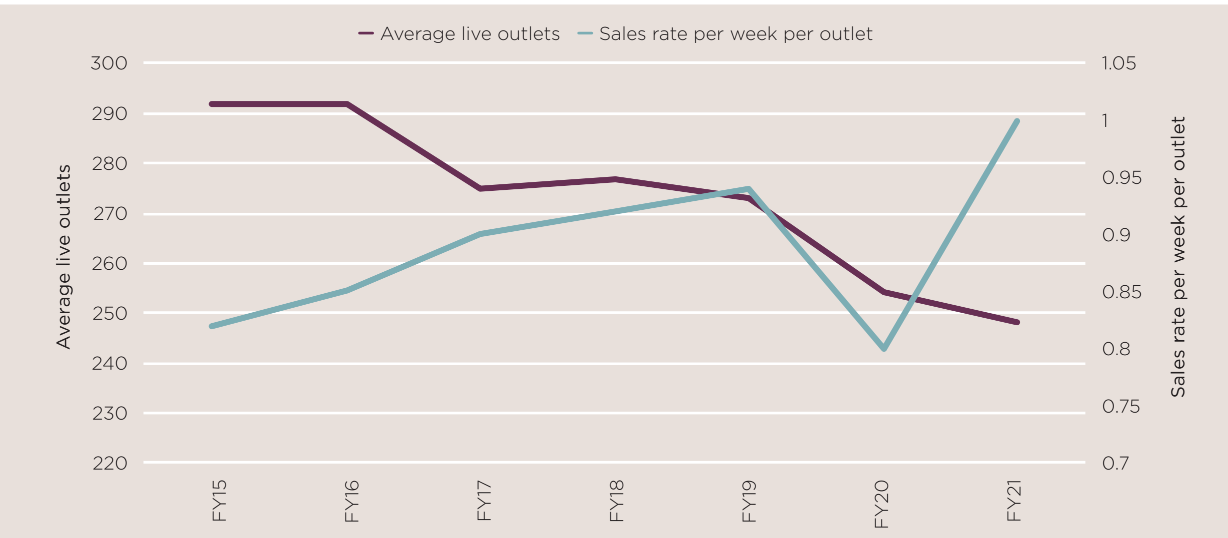
Since 2015 the number of active sales outlets across the top five UK housebuilders has been decreasing (Fig 6). Despite this, total completions have continued to rise (Fig 5), primarily driven by increasing sales rates per sales outlet (Fig 6). With HTB's absence, private sales rates are likely to soften and housebuilders are now seeking alternative delivery and exit strategies to maintain output. They will need more active outlets (more land), more tenure diversity (SFR) and to operate in more regions (M&A / land).

Fig 5: Total completions by top five volume housebuilders



Source: Housebuilder annual reports

Fig 6: Average live outlets and sales rates



Source: Housebuilder annual reports

> **"Several housebuilders have announced partnerships with investors to capitalise upon the market opportunity to deliver SFR"**

With development schemes increasing in size, housebuilders are likely to require a cash injection upfront in order to maintain margin. Where they might have previously sold a sub-parcel to a competitor, many are now considering SFR as an additional outlet, to accelerate delivery whilst not directly competing with their own private sales. With land being paid for upfront and construction costs fully funded, this strategy is accretive to housebuilders' financial performance, specifically Return on Capital Employed (ROCE).

As a result of the increasing viability of SFR across the UK in the past 12-24 months, investment pricing is now broadly in-line with housebuilder's private open-market sale pricing (meaning limited 'discount'), making an investment exit a more viable and attractive route for housebuilders to pursue. Many are capitalising on this opportunity and diversifying their business plans to include SFR moving forwards.

Some of the most recent evidence of this has included Barratt Developments partnering with Lloyds Banking Group (Citra Living) to deliver 150 homes at its 2,000 unit Ladden Village Scheme near Bristol. Vistry also announced its partnership with Aviva (Packaged Living) to deliver 195 homes in Telford, whilst Legal & General has secured 117 units from Countryside Properties at its scheme in Great Haddon. In addition, a number of the larger housebuilders and master developers have already earmarked portfolios at scale for SFR, with an increasing number of partnerships between investors and developers likely to be seen over the coming months.

The majority of operational SFR units have been designed for private sale. However, housebuilders and investors have become more targeted and are now designing bespoke rental products. For example, providing unit mixes and unit sizes to meet local demographic demand, and turn-key specifications which are durable and attractive for tenants, with items such as fitted wardrobes and white goods.

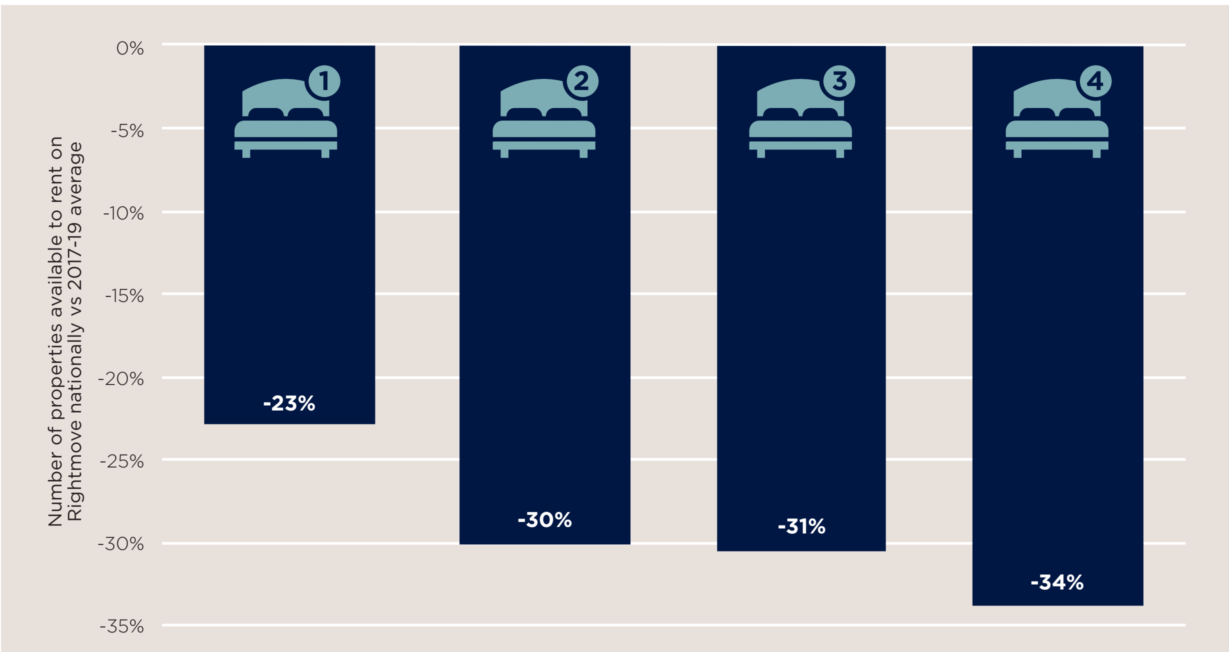
We anticipate bespoke SFR units will become more typical moving forwards, providing additional value to developers, more efficient management for investors, and most importantly better homes for tenants. Present Made are one of the parties leading the way in this respect, delivering 3,000 modular smart-tech homes across Southern England.

Government consultation on energy efficiency upgrades could lead to a further contraction of the Buy to Let rental market

There are currently 30% fewer properties (flats and houses) listed on Rightmove, when compared with the 2017-2019 average.

This supply shortage is particularly acute for 2-4 bedroom properties (Fig 7). The unit mix for SFR developments varies by location but would typically comprise c. 30% 2 beds, 60% 3 beds and 10% 4 beds. SFR therefore has an important role to play in delivering homes for rent in the most undersupplied parts of the market.

Fig 7: The fall in properties available to rent has been most acute for 2-4 bedroom properties

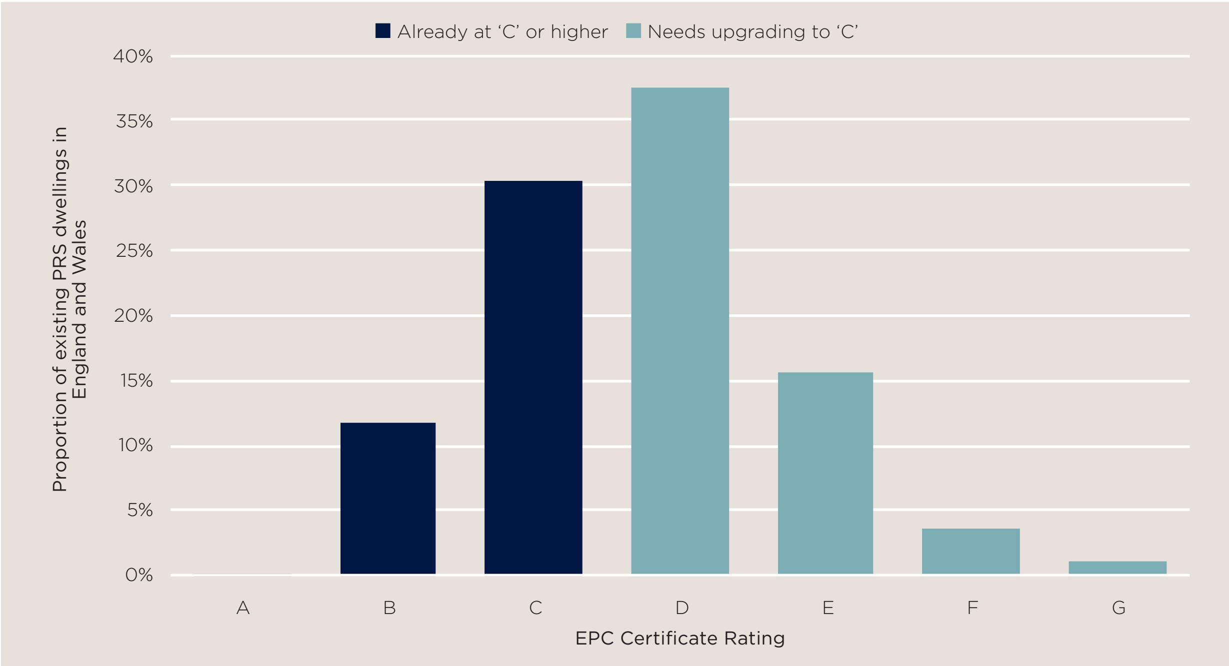


Source: Savills, Rightmove

We are unlikely to see supply come back to a rental market that has witnessed nearly 250,000 Buy-to-Let mortgage redemptions in the last five years. Landlords have been under increasing tax and regulatory pressure since 2016 and recent Government consultation looks set to continue this trend.

By 2025, all new tenancies must have an Energy Performance Certificate (EPC) rating of C or above, extending to all tenancies by 2028. This is part of the Government's commitment to reach net zero by 2050. Savills analysis of DLUHC data shows that 58% of properties in the rental market are currently rated D to G and will need to be improved to meet future standards. SFR is shielded from this, with the vast majority of operational and pipeline assets being rated EPC B or above.

Fig 8: The majority of existing PRS dwellings are rated 'D' or below and need upgrading to 'C' under new Government proposals



Source: Savills, DLUHC

A survey of landlords carried out on behalf of Paragon Bank has found that 77% of landlords are willing to spend up to £3,000 to upgrade each property they own to EPC C in order to meet new regulation. But in reality, the costs of upgrades are likely to be much higher. Through analysis of the latest DLUHC data, we estimate that the average cost of bringing a property rated D to G to EPC band C is £10,730.

Government proposals do include a proposed maximum investment cap of £10,000 where landlords are expected to make all the improvements which can be made up to that amount, then register an 'all improvements made' exemption. But this blanket investment cap doesn't consider the regional disparities in rental income and in many locations this £10,000 will exceed an entire year's rental income. It is in these markets that we are likely to see the greatest number of landlords sell out of the sector.

SFR has shown that it can work in a wide variety of markets and it can therefore play a crucial role in replacing homes being lost from the rental market across the country. At the same time it can improve the overall quality and energy efficiency of housing stock, at rents that are affordable to middle income households.

Against a backdrop of a slowing sales market, widespread supply shortages and a Government policy geared towards higher quality and more energy efficient homes, this is SFR's moment to establish itself as a key component of UK housing delivery.

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