Can institutional scale rental accommodation help solve the housing crisis?

**Government policy on home ownership coming to an end**

Behind the political headlines dominated by Brexit developments, there has been a key shift with another highly contentious topic – housing. The rhetoric coming from the newly appointed ministers for housing and communities – and even the treasury – have indicated a clear shift away from the pre-election focus of financial support for first time buyers. The new ministers appear to finally accept that providing financial support to an increasing number of buyers is only serving to further inflate demand for the limited volume of new homes coming onto the market, while policies need to focus on addressing the supply, rather than demand side of the housing crisis. Crucially, there is an acceptance that funding should be allocated to all new schemes that can be delivered to meet a gap in the market, regardless of the tenure of ownership of the schemes being built. Although we await the exact details of the new policy in a housing white paper, which is likely to be released in conjunction with the Autumn budget on 23 November 2016, the change in direction away from home ownership is the first key step in unlocking a potentially vast amount of institutional capital into the Private Rented Sector (PRS).

Despite being the second largest real estate investment market in the world, the UK does not have an established private rented sector, which accounts for just 5% of the estimated total UK market.

**PRS as % of total IPD estimated universe**

The lack of institutional investment in the sector is perhaps surprising given the overwhelmingly positive dynamics driving the supply and demand of rented accommodation in the UK. The proportion of households renting privately in the UK has doubled since the turn of the millennium, and numerous professional bodies expect the proportion of renters to continue to rise. In the past month the Royal Institute of Chartered Surveyors released a forecast that at least 1.8 million more households would be looking to rent rather than buy a home by 2025. This is partly driven by the affordability gap, which has widened due to the exceptional house price inflation of recent years fuelled by a lack of development, cheap mortgage rates and the government’s various help to buy schemes. Organic demand is, however, also growing for high quality, professionally managed and convenient rental accommodation. This is particularly true among young professionals and the skilled migrant workforce who do not necessarily have home ownership aspirations, and which are going to continue to fuel the growth in demand for PRS housing.

**UK housing completions ('000) and population**

With very strong demand for PRS expected to continue, there is an opportunity for local authorities and institutions to work together to deliver new high quality rented accommodation to a massively undersupplied market. A fundamental gap, however, needs to be bridged. Perhaps the main reason why PRS has not taken off on a significant scale in the UK is that the current model of housing development significantly favours a build-to-sell (BTS) model. A study by the Investment Property Forum from September 2015 illustrated that for two
hypothetical identical sites both developing 1,000 units (a reasonable size for institutional investors) in zones 2-4 in Central London, the IRR for a PRS development would be circa 7.5% p.a., compared to an IRR of 17.5% p.a. on the traditional BTS model. The returns of 7.5% p.a. for the PRS scheme is well below the 10%-12.5% p.a. that institutions would expect to justify the development risk, particularly in an emerging asset class with all the associated additional risks of a valuation approach inconsistent with other traditional sectors, an absence of a benchmarking index and heavy reliance on third party management. And more specifically to the residential sector, it is and will remain throughout any investment horizon a highly political topic, which means significant changes in policy can have a significant impact on returns. A recent example of this was the hike in stamp duty which was imposed on all rental property in the UK in March 2016.

The strength of house price growth in recent years, particularly in London and the South East, has pushed up land prices for the BTS sector, but PRS developers have to compete for these sites on the same terms. They are both subject to the feasibility assessments from the local authority to determine what proportion of the scheme needs to be classified as affordable. The issue is this doesn’t reflect the different return profiles of the two investments, and in virtually all instances purely on an IRR basis the BTS opportunity will be more lucrative.

We would argue however that there are several strong reasons for local authorities to recognise the differences and attach a different feasibility approach to PRS rather than build-to-sell:

- **Scale of delivery** – to generate sufficient levels of income, investment institutions would only be doing so in very large lot sizes (ca. 1,000 units +). The developments they could be funding would therefore be delivering substantial volumes of new homes to the market from each site.

- **Speed of delivery of new homes** – unlike the BTS model which relies on sales from previous developments to fund future schemes, there is cash already waiting to be spent, which could potentially fund the development of several schemes at the same time without having to wait for sale proceeds to come through.

- **PRS schemes inherently match requirements in the market** – to maintain occupancy levels PRS schemes will be focused in the most undersupplied segments of the market and most will be priced towards lower and middle incomes, bearing in mind most high incomes households will still opt to buy their own homes.

- **Provides a long-term sustainable capital flow into the sector** – should the sector become established as it has in the US and other European markets, it provides a long-term sustainable cash flow into the market which would ride out economic cycles as it originates form long-term investors targeting long-term income rather than capital appreciation.

- **Creates the option for longer term leases with more tenant security** – as there is no upside to sell individual units and profit from capital gains, tenants will receive greater security in their leases and landlords would be incentivised to manage the block efficiently with near 0% vacancy and a high level of customer service.

Three ways of bridging the gap in returns could be as follows:

1) Reducing the proportion of affordable housing required in a PRS scheme compared to a BTS proposal. This would reflect the fact that the vast majority of homes built for PRS would be targeted at the “middle market” with less luxury high-end homes than would be included in a BTS proposal, therefore delivering more homes to the undersupplied sector.

2) Zoning individual plots or sites for rented accommodation so investors intending to develop PRS would only be competing against each other. The value of land would drop accordingly and the return profile would be reflective of what could be achieved through the future income.

3) Selling brownfield public sector land to PRS investors with a discount to market value in return for a commitment to delivering a substantial volume of new units within a specific time frame (and which would remain on the rental market for a set period of time), guaranteeing housing for that local authority.

It is encouraging that the new conservative government is recognising the benefits of a purpose built rental accommodation and is moving away from the obsessive policy of home ownership for all. But for the sector to really move among institutions, there needs to be some firm commitments to recognise the difference in returns on the different models and adjusting their viability models accordingly to make the deliverance of the large scale PRS schemes a realistic proposition. Given the scale of the UK’s institutional investment market there is huge scope for PRS to be a part of a genuine solution to the UK’s housing crisis and meet the rising demand for good quality rented accommodation. Yet the low proportion of PRS in the UK commercial property universe compared to other countries, where the sector has become established, demonstrates there is clearly a mismatch in expected returns in the UK. If the government can recognise the scale that PRS could deliver, they will have to bring something to the table to counter the dominance of BTS on the home building cycle, which has proved over decades that it cannot deliver the volume of homes needed to supply the UK housing market on its own.

**Data Sources:** IPD/Markit, CINS, Oxford Economics, JLP, RICS, Conservative Party Manifesto, UBS Asset Management Global Real Estate Research & Strategy
For more information please contact:

UBS Asset Management
Global Real Estate Research & Strategy
Zachary Gauge
Tel. +44-20-7901-5534
zachary.gauge@ubs.com

www.ubs.com/realestate

This publication is not to be construed as a solicitation of an offer to buy or sell any securities or other financial instruments relating to UBS AG or its affiliates in Switzerland, the United States or any other jurisdiction. UBS specifically prohibits the redistribution or reproduction of this material in whole or in part without the prior written permission of UBS and UBS accepts no liability whatsoever for the actions of third parties in this respect. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith but no responsibility is accepted for any errors or omissions. All such information and opinions are subject to change without notice. Please note that past performance is not a guide to the future. With investment in real estate (via direct investment, closed- or open-end funds) the underlying assets are illiquid, and valuation is a matter of judgment by a valuer. The value of investments and the income from them may go down as well as up and investors may not get back the original amount invested. Any market or investment views expressed are not intended to be investment research. The document has not been prepared in line with the requirements of any jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. The information contained in this document does not constitute a distribution, nor should it be considered a recommendation to purchase or sell any particular security or fund. A number of the comments in this document are considered forward-looking statements. Actual future results, however, may vary materially. The opinions expressed are a reflection of UBS Asset Management’s best judgment at the time this document is compiled and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual security, asset class, markets generally, nor are they intended to predict the future performance of any UBS Asset Management account, portfolio or fund. Source for all data/charts, if not stated otherwise: UBS Asset Management, Global Real Estate. The views expressed are as of October 2016 and are a general guide to the views of UBS Asset Management, Global Real Estate. All information as at October 2016 unless stated otherwise. Published October 2016

Approved for global use.

© UBS 2016 The key symbol and UBS are among the registered and unregistered trademarks of UBS. Other marks may be trademarks of their respective owners. All rights reserved.