BlueCastle® Capital

CATCHING THE WAVE

The UK Build to Rent Mega-trend

This institutionally funded, professionally developed and managed nascent sector is now in a generational "Mega-Trend." This paper explores the background to the emergence of the UK BTR sector, as well as the key drivers which will shape its development over the decades ahead.

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Summary

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THE UK RESIDENTIAL PROPERTY MARKET is undergoing a quiet revolution which is gaining in momentum. Driven by a combination of macro-economic factors, government policy, and legislation, we are witnessing the emergence of a new asset class within the private rented sector (PRS) called Build-to-Rent or "BTR".

IN THIS REPORT, we will review the current state of play in the UK residential housing market, and explore the reasons behind the shift away from home ownership towards a private rental model. We will also investigate the reasons why the existing model of private rental homes in the UK is not fit for purpose, both in terms of meeting the aspirational demands of tenants, and attracting the level of investment capital into the sector which will be needed in order to meet the demand for housing in the UK.

We will go on to explore the features which distinguish the BTR product from the wider PRS sector, and why it represents such a powerful proposition to tenants with their ever-expanding demands and requirements. We will also summarise the key characteristics of BTR as an investible asset class, and provide an insight into what is driving the wall of capital which is seeking ways to gain exposure to this emerging asset class.

Whether you are reading this report as a home occupier, or assessing the sector as a potential investor, we hope that you will enjoy learning more about what is undoubtedly going to be one of the key "mega-trends" of the decade.

The UK Housing Market Landscape

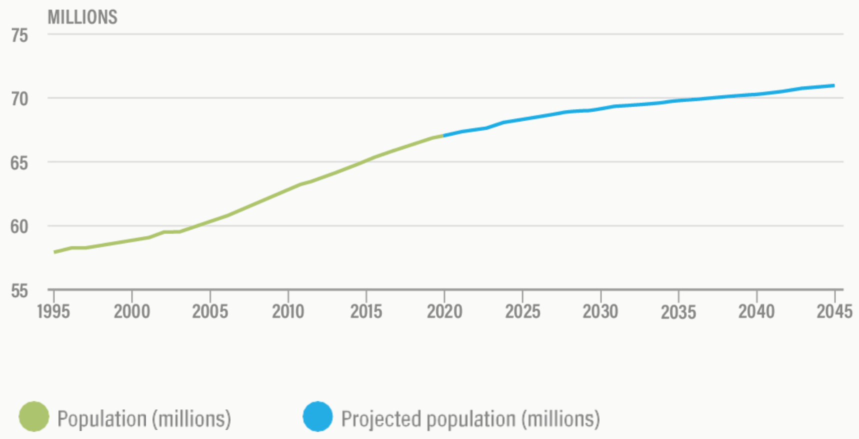
BETWEEN 2008 AND 2018 the UK population grew from 61.8 million to 66.4 million, representing an increase of around 7.4%. During the same period, the number of households grew from around 26.0 million to 27.8 million, which represents an average increase of around 175,000 per year. Looking forward, the UK population is projected to reach 71 million by 2045 (fig. 01).

From a housing supply perspective, there have been a number of reviews carried out over the last 10 years to establish how many new homes in the UK need to be built, in order to meet both the backlog, as well as future housing demand through the growth of households and population. The Barker Review **(1)** in 2006 recommended that 250,000 houses needed to be built annually over the following 25 years. More recently, a survey by the National Housing Federation suggested that in order to meet current demand for housing in England alone, the number was in fact 340,000 annually until 2031. Illustrated from the graph below (fig. 02), new house building in the UK has been running well below these estimates of future demand by a considerable margin with an annual average of around 115,000 new homes being built every year.

FIG. 01

UK POPULATION PROJECTED TO RISE TO 69.2 MILLION BY MID-2030 AND TO 71.0 MILLION BY MID-2045

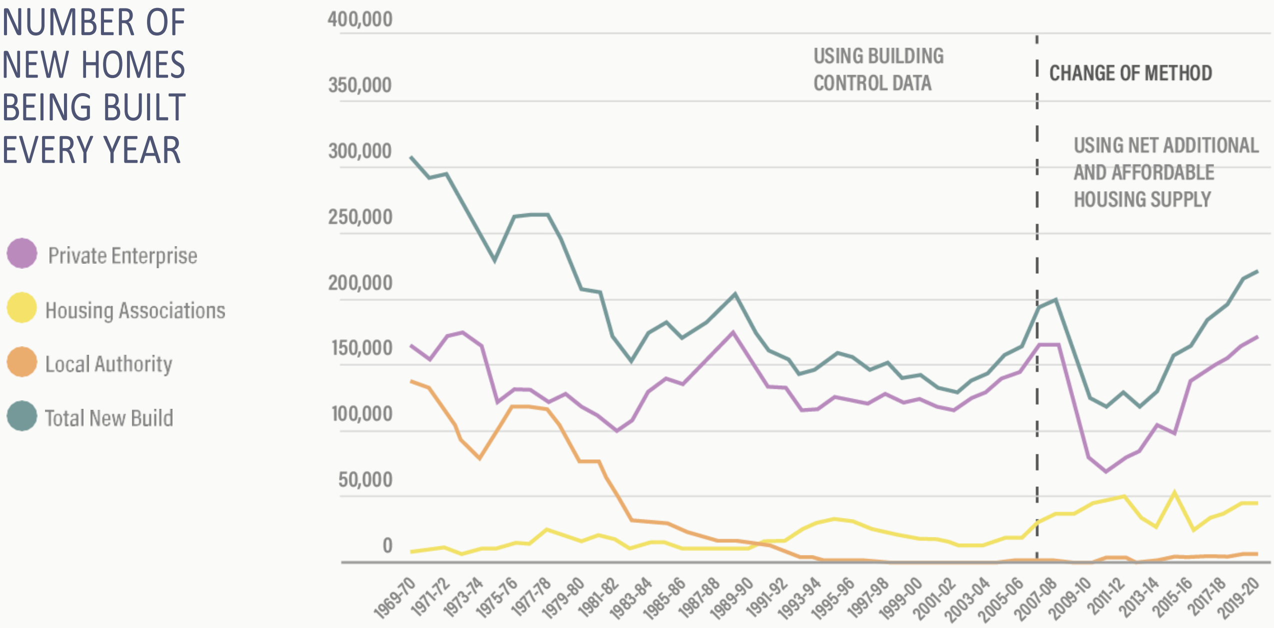
UK population estimates, mid-1995 to mid-2020, and projections to mid-2045



Source: Office for National Statistics - Nation population projections

FIG. 02

NUMBER OF NEW HOMES BEING BUILT EVERY YEAR



Source: Office for National Statistics Data

FIG. 03

AVERAGE UK HOUSE PRICE WAS £296,000 IN OCTOBER 2022

Average house price, UK January 2005 to October 2022

Source: HM Land Registry, Registers of Scotland, Land and Property Services Northern Ireland. Office for National Statistics - UK House Price Index

Based upon the above data, the UK housing demand – supply deficit has been running at an average of at least 65,000 homes a year for at least the past ten years.

In addition to an under-supply of housing, affordability has been stretched. During the past 10 years average UK house prices have risen by around 75% - as of October 2022, the average house price in the UK was £296,000 – an increase of £125,000. In London the average cost of a home in 2022 was a staggering £467,225. Deposit requirements have also risen, with the average first time buyer deposit in the UK currently standing at £61,000 and £100,000 in London.

During the same time period UK average earnings have only grown by around 10% from £34,175 to £37,62, leading to the cost of a typical UK home now standing at a ratio of 7.1 times average earnings which is an historic high.

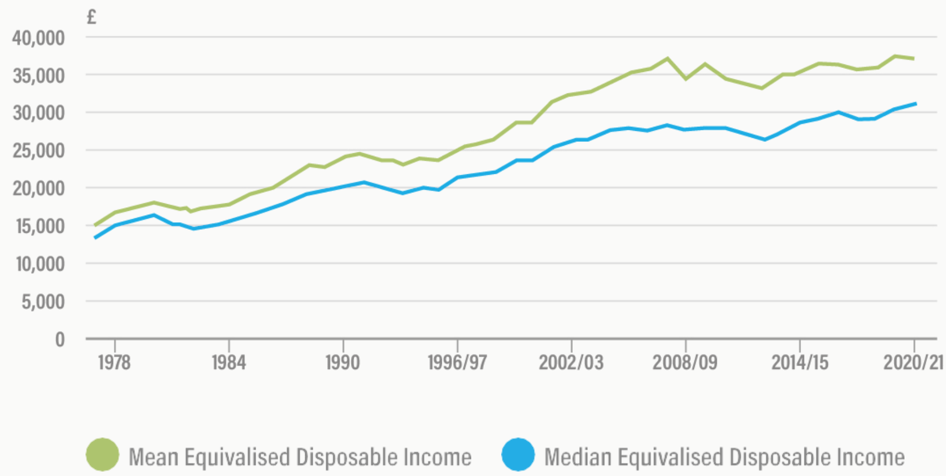
As well as wishing to address the supply and demand imbalance in the UK housing market, the government recognises that housebuilding is also a major contributor to economic growth. Every £1m of new housing output supports 12 additional jobs – 7 directly and 5 indirectly per year. Therefore, new housing not only serves the purpose of providing more homes for people to live in, but it also supports the wider UK economy. Successive governments have focussed on the owner-occupied market in order to boost house building and the supply of new homes, through policies such as the “Help to Buy” scheme which is now closed to new applicants. As we will explore further in this paper, we are now seeing a government policy pivot towards the private rented sector as the government looks for other solutions to boost the supply of new housing in the UK.

Source: Office for National Statistics - Household Finances Survey

FIG. 04

MEDIAN INCOME INCREASED DURING THE 10-YEAR PERIOD LEADING UP TO FINANCIAL YEAR ENDING 2021

Median and mean real equivalised household disposable income of individuals, UK, 1977 to financial year ending 2021



The UK Private Rented sector

DESPITE THE POPULAR belief that an Englishman's home is his castle, home ownership in the UK has been in decline since 2001 when it peaked at 69% of all homes, with it currently standing at around 65%. During the same period the private rented sector (PRS) grew from around 9% of all homes to a current level of around 19%, which equates to around 4.4m homes providing accommodation for over 11 million people **(2)**. Private renters are also getting younger with those aged between 16-34 currently accounting for 43.5% of renters, with only 8.6% of private renters being of retirement age.

The supply of private rented homes has for the past several decades been primarily served by private individuals buying investment properties to rent out. Introduced in 1996, the "Buy to Let" mortgage has been a hugely popular product. However, more recently, a number of changes have taken place which have made the appeal of being a private landlord diminish. These include; landlords being restricted on their ability to off-set their mortgage interest costs against their rental income for the purposes of calculating their personal tax liability, an increase in stamp duty rates on privately held buy to let properties, a requirement to meet more stringent energy efficiency standards (see inset box on EPC certificates), and an increase in mortgage costs as interest rates have risen significantly. Capital gains tax (CGT) is also a factor with overseas landlords now being subjected to capital gains upon disposal of their UK based real estate assets. The net effect of these key drivers has seen over 170,000 Buy to Let mortgages redeemed in the last 18 months adding to supply issues within the sector.

In addition to the above headwinds which are facing the PRS sector in the UK, there is also a shortage of high quality, modern rental stock. In a recent survey from the Department for Levelling Up, Housing & Communities published in June 2022 **(3)**, 21% of homes in the PRS were classified as "non-decent". Worse still the sector has the highest prevalence of Category 1 hazards, (those that present the highest risk of serious harm of death.) This means that 1.6 million people are living in inadequate and often unsafe housing.

It is in the current Government's manifesto to improve the safety, quality, and reliability of the PRS sector. It plans to do this by introducing a new single government Ombudsman covering all private landlords who rent property in England. Additionally, it is planned to launch a new "Property Portal" that will require landlords to register their properties, ensuring they are in compliance with a range of environmental standards and health and safety criteria. The policy also aims to give local councils greater powers to enforce these new rules against "rogue" landlords.

A combination of the above factors has led to a shortage of rental homes in the UK, with demand exceeding supply. According to the November 2022 RICS Residential Market Survey **(4)**, "tenant demand continues to rise, at the same time the flow of fresh supply becoming available on the rental market continues to dwindle – consequently, the ongoing misalignment between rising demand and falling supply continues to exert upward pressure on rents". Although the BTR market is growing, it only represents a fraction of the supply of privately rented properties. At the same time demand for suitable rental products is likely to increase, and therefore demand will continue to outstrip supply in the medium to long term.

FIG. 05

Energy Performance Certificates (EPCs) – is a rating scheme that measures energy efficiency of properties. Individual properties are rated on a scale of A-G to inform prospective buyers and tenants regarding the energy efficiency of the property they are considering occupying. As of 2007, EPC certificates were a legal necessity for anyone trying to construct, sell or rent out a building. As the UK Government looks to deliver on its "Carbon Net Zero" policy by 2050, these energy standards are changing, and, if approved, will require landlords to make improvements to their rented properties. The proposed timetable for the rule changes are as follows:

1st April 2023 – The minimum EPC rating for both new and existing tenancies will be "E". Previously the" E" rating was required only for new tenancies.

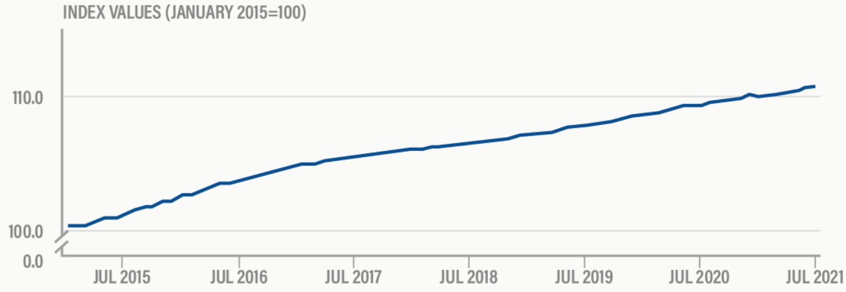
1st April 2025 – 1st April 2028 – The minimum EPC rating for both new and existing tenancies will increase to "C". If a landlord has an older EPC certificate lower than "C," there is a window until 1st April 2028.

Property data specialist, **Sprift**, have analysed the last ten years of EPC data on its platform and highlight that almost 60% of homes in England and Wales have EPC ratings of between D to G. Consequently, there is a significant cost implication for those landlords that will need to comply with the proposed new EPC rules. Estimates vary but landlords can be expected to pay between £2,000 and £10,000 to bring their properties up to the required standard.

FIG. 06

UK RENTAL PRICES HAVE INCREASED BY 10.7% SINCE JANUARY 2015

Index of Private Housing Rental Prices Indices, UK, January 2015 to July 2021



Source: Office for National Statistics - Index of Private Housing Rental Prices

Property specialists Savills, recently published a forecast of rental growth for 2023-27 **(5)**. The report concludes that having recovered from the rent falls seen during lock-down, "surging demand and dwindling supply are driving rental growth.". The Savills report predicts that UK rents will have risen by 10% by the end of 2022. Slowing to 6.5% in 2023, before returning to more normalised historic trend growth of approx 2.5%. According to data from Rightmove, there were 26% fewer homes available to rent in Q3 2022 than the pre-pandemic average. The monthly RICS survey for November 2022 **(4)**, highlighted that demand from prospective tenants nationally had increased in every month since May 2020.

FORECAST RESIDENTIAL RENTAL VALUES 2023-2027

	2022	2023	2024	2025	2026	2027
UK	10%	6.5%	4.0%	2.0%	2.4%	2.3%

Source: Savills Research using Oxford Economic

As we will see below, the government's aim is to increase both the supply and quality of the private rented housing stock, although as we explain, their focus is to achieve this not through the private landlord sector, but through the creation of a professionally managed, institutional build to rent product.

Build to Rent - A purpose Built Rental Market

IN 2012 THE UK Government recognised an increasingly significant role for the private rented sector in both meeting people's housing needs, and in supporting economic growth by enabling people to move to take up jobs elsewhere, and to respond to changing circumstances. As a consequence, the Government recognised the need to increase the supply of private rented housing, and the fact that institutional investment would need to be attracted to the sector.
In 2012 the government established the Montague Review **(6)** to identify ways to remove barriers and encourage large scale institutional investment into the sector. The development of the UK BTR sector can be traced back to the report, with many of the key contributors such as Legal & General and Grainger becoming some of the leading players in the sector.

Build to Rent is a distinct asset class within the PRS sector, and has been defined in the UK National Planning Policy Framework, in order to simplify its treatment within the planning system. The key distinction is that a Build to Rent scheme is purpose built for renting, typically having at least two hundred individual units. Furthermore, the schemes are owned and operated by one property owner as opposed to multiple landlords. The design and architecture of a Build to Rent scheme is one of its most distinguishing features. The schemes are typically designed to create a community and raise each resident's quality of living. Common features of BTR schemes include:

PROFESSIONAL BUILDING MANAGEMENT AND A CURATED TENANT EXPERIENCE

Professional management of the day-to-day functions of the building are fundamental to the build to rent experience. Tenants deal directly with property management professionals who manage all aspects of the tenancy including the management of the property and its associated maintenance issues as well as tenancy agreements.
The tenancy agreements in a BTR scheme also tend to be more flexible than traditional PRS tenancies, both in terms of the length of commitment and the notice periods. They also tend to require lower deposits to be pledged, instead relying upon intelligent referencing of a tenant's credit worthiness.
In addition, annual increases in rental levels tend to be more predictable and are disclosed in the tenancy agreement from inception. This provides a high level of certainty for the tenants, as well as flexibility should their circumstances change.

COMMUNAL SPACES

The inclusion of communal facilities and co-mingling spaces are common features of BTR schemes. These facilities serve as communal areas where residents can meet and include Gyms, Cafés, Social Lounges, work from home areas, and communal gardens etc. Not only does this engender a sense of community amongst the tenants, but it also means that the unit sizes can be designed with lower space requirements, thereby increasing the density of units within the building.
It is common for a BTR scheme to have up to 10% of the building dedicated to communal and amenity provisions.

CONCIERGE SERVICES

Most BTR schemes offer a dedicated concierge service. The services provided by, and managed by the concierge include receiving deliveries, greeting and providing access to visitors, and generally taking care of basic aspects of the building's operation.

PROFESSIONAL TECH-ENABLED BUILDING SERVICES

A full building services package is usually included in a BTR offering with tenants often being provided with an app that can be used as an interface between the tenant and the building management team in order to provide a range of services. These may include call outs for repairs or general building services. The emphasis is on ease of use, timely professionalism, and quality of service. The apps often also offer a community chat functionality allowing residents to easily communicate with each other, further creating a sense of community.

FIXED AND PREDICTABLE COSTS

One of the benefits of a BTR scheme is that tenants usually pay a fixed monthly cost for their service charge, energy and other utility bills. Most BTR buildings are recently constructed and therefore have been designed and built to comply with the most recent EPC regulations and building standards. This enables tenants to keep their energy bills as low as possible and is a feature of BTR schemes that is proving especially popular. BTR operators are also increasingly fielding enquiries from a new generation of potential tenants that aspire to live in the most energy and environmentally efficient homes.

FLEXIBILITY OF SPACE REQUIREMENTS

Some BTR schemes will offer a range of accommodation to its tenants. This will enable existing occupiers to "upsize or downsize" as their requirements change. The advantage of this is not simply one of cost, but it also enables tenants to maintain their networks of friends and neighbours within the communities that have been built.

BTR – The Emergence of a New Asset Class

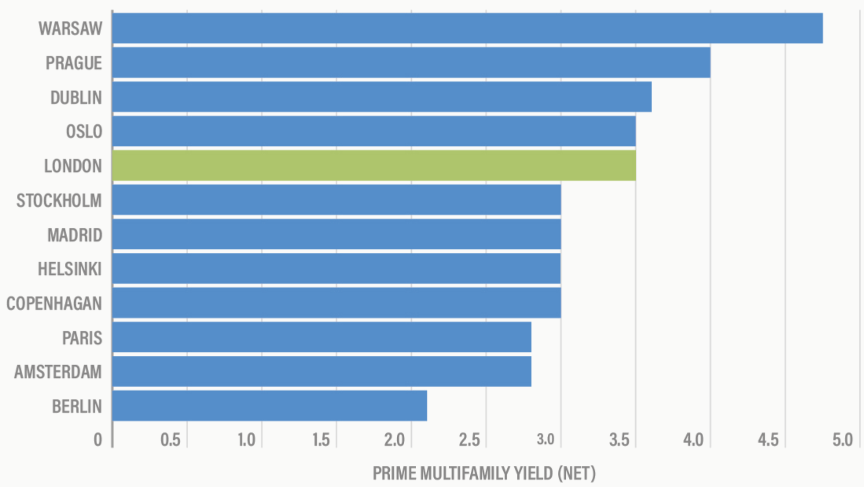
A FACT WHICH is often overlooked by investors is the fact that whilst there are multiple investible assets where the income is linked to inflation, there are very few that can provide a hedge against inflation both in terms of the principal investment and the income produced by the underlying asset. Real estate is one of those asset classes, and residential real estate and its associated rental income offers perhaps the best proxy for long term cost of living inflation. As a result, it is no surprise that pension funds and insurance companies are being attracted to the sector. The biggest problem historically has been finding assets to invest in which are of a sufficient scale and quality, and which are managed efficiently and professionally in a consistent manner. Over the last 18 years, rental levels in the UK have increased on average by 2.6% annually, outperforming inflation by 0.7 % which has historically been 1.9% p.a. during the same period (MSCI, 2019). In the 12 months to December 2022, Savills predict that UK rents will have grown by 10% **(5)**. Despite the recent spike in UK inflation, rental growth continues to be consistent and attractive for those investors looking for long term, inflation linked and protected, stable returns.
A further key attraction of the UK BTR asset class are the yields that the income streams produce which is attracting interest from a variety of investors, both domestic and international. Despite the considerable headwinds in the domestic economy and upward movement in UK interest rates, levels of demand for completed projects remains high. Savills highlight in their Q3 2022 BTR update **(7)** that, "we have seen income producing assets and portfolios come to market and achieve premium prices, especially those specifically designed for long term rental." This has placed further downward pressure on yields." Prior to the emergence of the BTR asset class, there was no reliable way for investors to gain at scale exposure to UK residential investment yields. The BTR asset class has enabled this. If you compare the yields in the UK to Europe there is a considerable spread and the potential for future yield compression in UK BTR yields.

In the 2012 Montague Review **(6)** the report states that, "There are strong synergies with liabilities. Rents in the private rented sector have tended to rise roughly in line with real average earnings. This is widely seen as an excellent match for liabilities arising in pension funds. Large-scale portfolios of rented homes can also offer a spread of risk through investment in a range of locations". This "excellent match for liabilities" is a key driver and motivation for pension funds to allocate more funds to the emerging UK BTR asset class.

The BTR asset class has also proved that it can be a "counter-cyclical" asset class, performing strongly in economic downturns. This was highlighted during the pandemic, with investors reporting strong rent collections and quick recovery in occupancy levels following an initial dip in Spring 2020. Regulation also plays an important role in supporting the BTR sector as an emerging institutional investible asset class. Findings from a report conducted by Cambridge University titled "Understanding the Role of Private Renting" **(8)** found that deregulation does not lead to growth in the PRS sector. On the contrary, during the 1980's when the PRS sector was deregulated in England, it took over a decade before growth returned. The report highlighted that those countries with more sophisticated regulation such as Germany and Switzerland enjoy a much larger and successful PRS sector. This research is backed up by the recommendations of the Montague Review **(6)** where introducing a public body to promote best practice was among the five key recommendations. More recently the UK government's June 2022 review of the PRS sector in England **(3)**, laid out their plans to introduce a new Ombudsman, requiring landlords to register their properties and further reforms of tenancy agreements.

> *"BTR as an Asset Class performed better and was more resilient than almost anything else during the pandemic"*
>
> **BILL HUGHES, GLOBAL HEAD OF REAL ASSETS,** LEGAL & GENERAL INVESTMENT MANAGEMENT

FIG. 07 UK OFFERS ATTRACTIVE YIELDS COMPARED TO ITS EUROPEAN PEERS



Source: Savills

The UK BTR Market Today

FOLLOWING THE PUBLICATION of the 2012 Montague review **(6)**, the BTR sector has enjoyed elevated levels of growth. One of the key recommendations from the review was to recognise BTR projects as a separate asset class within the broader PRS sector. The reasoning for this recognition was to ensure that Local Planning Authorities could start to incorporate BTR schemes into their overall planning and provision of housing requirements.

The aim of the review was to encourage institutional investment into private rented homes. This has certainly taken place with a broad range of capital flowing into the sector from a variety of providers. One of the UK's largest BTR investors is Legal & General Investment Management. They have been an active investor in the BTR market since 2016. The firm's BTR investments total around £1.7 billion, and they operate over 13,000 homes across 38 schemes with a pipeline of future schemes of over £1bn.

Bill Hughes, LGIM Global Head of Real Assets in an interview for Property Week in September 2022, said, "Nearly 500 apartments means lots of tiny little bits of income, but if you're good at letting and keeping your occupiers happy, you get retention and build a thriving community, then that income suddenly starts to look safe, long term and secure" (Reference to the LGIM Blackhorse Mills BTR scheme in Walthamstow, East London).

Other significant investors include Grainger PLC, the UK's largest listed residential landlord, with a portfolio of over 9,500 rental homes. The company has a further 6,838 homes in their investment pipeline (worth over £1.8bn) which will be delivered over the next 3 years. Other entrants into the BTR market include the John Lewis Partnership who have teamed up with asset manager Abrdn to build 1,000 new BTR homes.

The investor base for UK BTR assets is broad and includes both domestic and overseas insurance companies, pension funds, REITS, private equity funds and sovereign wealth funds. The weakness of the British Pound relative to other currencies, has added to the appeal for some of those overseas investors.

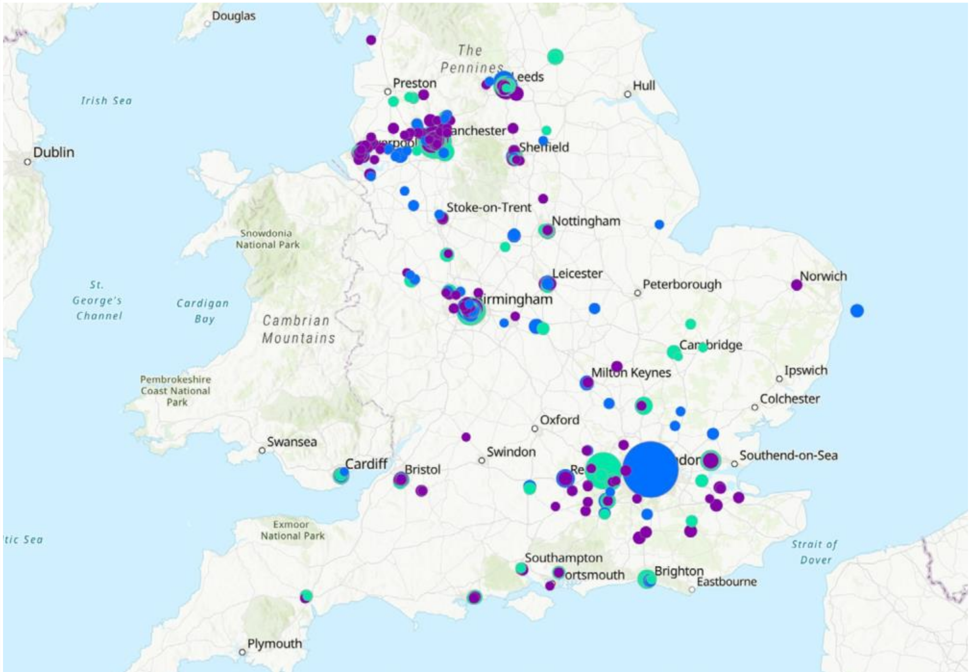
Typically, these investors work directly with property development companies, house builders and construction companies, who take responsibility for the origination, design, build and construction of the projects. There are also some "brand builders" in the BTR space that operate in a comparable way to the branded hotel companies. Examples of the emerging brands include, Get Living, Moda, Real star (UNCLE) and the HUB Group. The brand builders, or operators, let and manage the building in return for a management fee, with the underlying asset being owned by one of the above mentioned sources of capital.

FIG. 08

THE BUILD TO RENT MAP

The Build to Rent Map is produced quarterly by the British Property Federation and plots BTR schemes across the UK aimed at the institutional investment market.

You can ***view the interactive map here****. By following the link, you can click on the coloured dots of the individual locations to see the name of the project and at what stage the project has reached. (The research is produced by Savills for the BPF)*



The Future of The UK BTR Sector

AS STATED ABOVE, despite record levels of investment into the sector in recent years, there are still only around 77,000 completed, professionally managed BTR units in the UK, which accounts for less than 2% of the total UK PRS market, which itself only represents 19% of the total housing market. This compares with Germany, for example, which has the highest proportion of renters in Europe with over 50% of the population living in rented accommodation, and 40% of those rented homes being institutionally owned. If the BTR sector in the UK provided a similar proportion of homes in the PRS sector, that would equate to around 5.6 million homes, over 72 times the size of the UK Build-to-Rent sector today.

According to Cushman & Wakefield in their Q3 2022 Build to Rent report **(9)**, total BTR investment in 2021 amounted to £4.2bn. In 2022 up to the end of Q3, total investment was running at 3.67bn. Q3 saw £1.17 bn of investment, a 95% increase over the same period in Q3 2021.

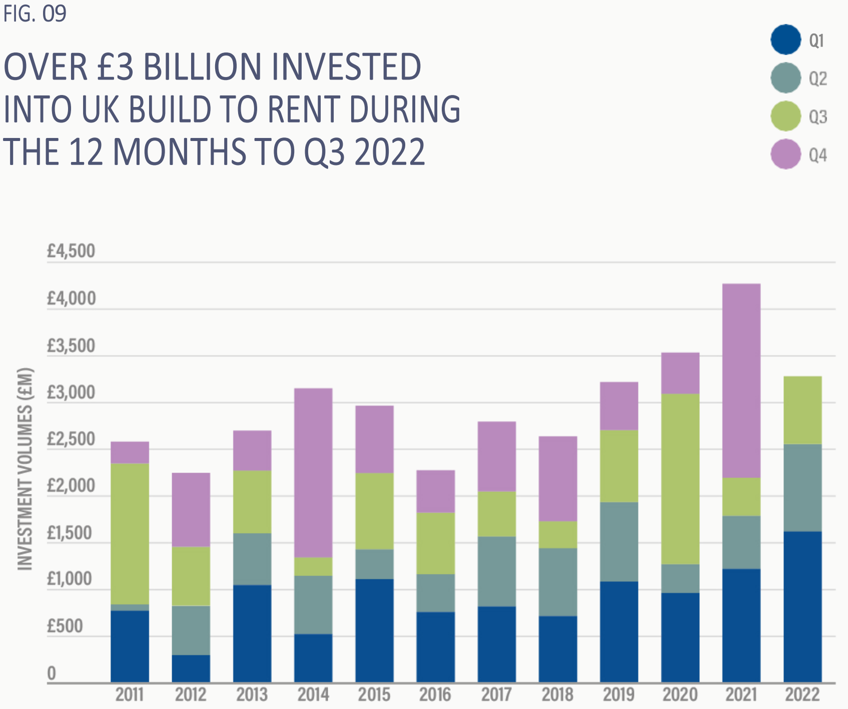
To illustrate the scale of the BTR opportunity in the UK from a capital investment perspective, using an average rent across a BTR portfolio of £1,500 per month per unit, and an average capitalisation yield of 4.0%, the total capitalised investment value of the UK BTR sector today is around £26 billion. However, if the market reaches the same level of maturity as Germany has currently achieved, using the same rental and yield assumptions, the UK BTR sector would be valued at around £1.8 trillion. At the current rate of inward investment into the sector, that would take some 440 years to achieve.

In terms of future development pipeline within the sector, the British Property Federation estimate that approximately 162,000 units are either under construction, or in planning **(10)**. Including the 77,000 units which are already in operation the UK BTR sector – existing units, planned and under construction represents a capital value of around £81bn. This further illustrates how far the sector still has to go in the UK before it even begins to become mature.

The future growth of the UK BTR sector is likely to be driven by a number of factors, both Macro-economic and government policy. Over time the proportion of professionally managed schemes will replace individual PRS landlords who are choosing to and being encouraged to leave the sector, together with a general shift towards a rental model within the UK housing sector.

FIG. 09

OVER £3 BILLION INVESTED INTO UK BUILD TO RENT DURING THE 12 MONTHS TO Q3 2022



Source: Savills

> *"If the market reaches the same level of maturity as Germany has currently achieved, using the same rental and yield assumptions, the UK BTR sector would be valued at around £1.8 trillion."*

Conclusions

THE UK HOUSING MARKET CONTINUES to evolve. As population growth leads to more households, demand for housing and accommodation will continue to grow beyond what is currently being supplied by the market. The UK government has identified that the role of the private rented sector needs to evolve and become more professional, with appropriate levels of regulation and oversight. This in turn has led to creation of the UK BTR sector as a new, investible institutional asset class.

With the capital value of the existing and planned UK BTR sector standing at around £81 billion, and with the potential to grow to an investment value in excess of £1 trillion, it is clear that we are at the very beginning of the UK BTR journey. As mega-trends go, this is likely to be the biggest real estate trend in the history of the UK real estate market.

BLUECASTLE CAPITAL
FEBRUARY 2023

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BlueCastle Capital

Unit 12, 16 Porteus Place,
Clapham Old Town, London,
SW4 OAS

+44 (0) 204 558 8074
bluecastlecapital.co.uk