Investment Case

The UK Private Rented Sector (PRS)

March 2021

M&G Investments

The value of investments will fluctuate, which will cause prices to fall as well as rise and investors may not get back the original amount they invested. Past performance is not a guide to future performance.

The UK Private Rented Sector (PRS) has doubled in size in the past decade and is now increasingly attracting the attention of pension funds and insurers. Its resilience as an asset class and defensive characteristics have shone through in recent times, given that housing is a necessity.

We expect its appeal to grow thanks to the sector's potential to generate strong, stable income streams, improved capital preservation and proven diversification benefits. Our research suggests that the investment case for PRS is backed by:

- Low correlations with commercial real estate, equities and bonds
- Defensive characteristics with improved capital preservation
- A long-standing supply/demand imbalance in the UK housing market
- Attractive long-term rental growth prospects, particularly in London
- Scope for professional investors to add value through active management and economies of scale

Diversification benefits

Property has different market drivers to those of more traditional investments such as equities and bonds, and consequently shows very low correlations with those asset classes.

Figure 1: Multi-asset correlations

	Residential real estate	Commercial real estate	Equities	Gilts
Residential	1.0	0.6	0.3	-0.1
Commercial real estate	0.6	1.0	0.3	0.0
Equities	0.3	0.3	1.0	0.2
Gilts	-0.1	0.0	0.2	1.0

Source: MSCI Annual Property Digest 2020; MSCI Residential Property Digest 2020; Bloomberg, March 2021; M&G Real Estate.

Analysis also suggests that residential could prove to be a suitable portfolio diversifier for commercial property investors, based on its lower correlations with most traditional property segments than those segments show with each other.

Figure 2: Intra-property correlations

	Residential	Retail	Office	Industrial
Residential	1.0	0.7	0.6	0.4
Retail	0.7	1.0	0.8	0.7
Office	0.6	0.8	1.0	0.9
Industrial	0.4	0.7	0.9	1.0

Source: MSCI Annual Property Digest 2020; MSCI Residential Property Digest 2020; Bloomberg, March 2021; M&G Real Estate.

We believe adding residential property into a multi-asset or commercial property portfolio would therefore be expected to improve risk-adjusted returns.

Defensive characteristics

People always need somewhere to live and the robust nature of the rental market is never more evident than in a downturn, as a weak owner occupier sales market can encourage, or even oblige, people to rent. This more stable, or even strengthening, demand pool potentially lessens capital decline for rented accommodation investments.

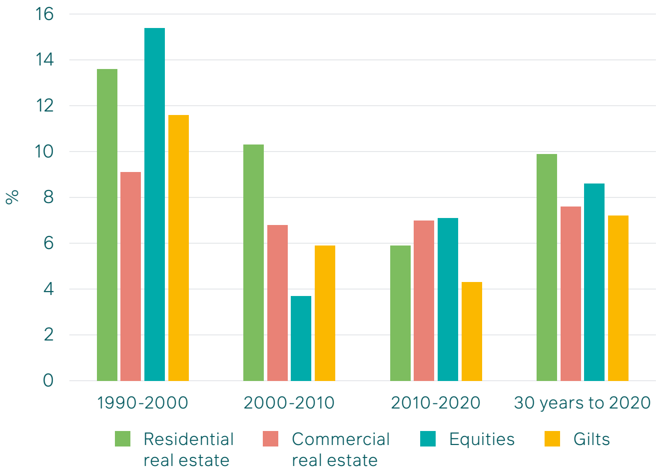
The statistical volatility of the commercial and residential property types has been similar over the past 30 years, largely because of the strong positive performance shown by residential property. However, when looking just at downside volatility (in this case, the risk of negative total returns), residential has actually shown a much lower level of risk than commercial. During the steep market downturns of the 1990s and 2000s, residential property recorded a smaller capital decline than commercial and also recovered its initial value faster.

Furthermore, residential property has demonstrated both a high level of income collection – above almost all other types of real estate – and extremely low default rates. Income is characteristically robust owing to diversification of employment among occupiers.

Strong risk-adjusted returns

According to MSCI, UK residential property has outperformed commercial property over the past 30 years. It has also fared well against other asset classes.

Figure 3: Total returns by asset class



Source: MSCI Annual Property Digest 2020; MSCI Residential Property Digest 2020; Bloomberg, March 2021, M&G Real Estate.

Past performance is not a guide to future performance.

While capital values in commercial property have declined by almost 50% in real terms between 1990 and 2020, those for residential property have increased significantly, reflecting a combination of falling interest rates, restricted supply and strong demand fundamentals.

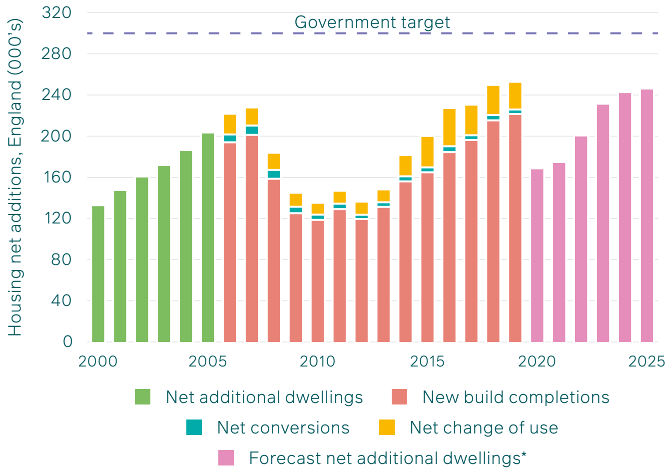
Demographics and demand

Demographic trends suggest that demand for housing will continue to rise. The UK population is expected to expand by around 0.4% per annum in the medium term (2020-2030)[1] – compared with 0% growth in the European Union[2]. London is growing even faster. At the same time, household sizes have reduced with more people living in one- or two-person households.

The government estimates that some 300,000 new homes are needed annually. Although the number of net additional dwellings reached its highest level for more than 20 years at c.245,000 in England in 2019/20[3], this still leaves new supply lagging behind the stated housing need.

[1] ONS, March 2021.
[2] Eurostat, March 2021.
[3] www.gov.uk, March 2021.

Figure 4: Housing supply in England

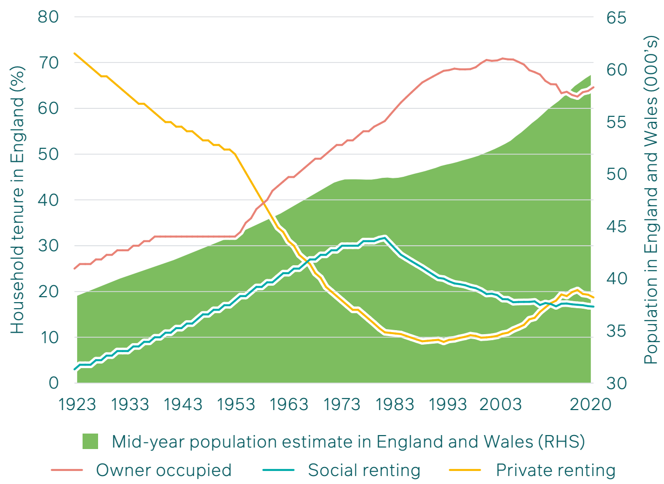


Source: Ministry of Housing, Communities and Local Government; Office of Budgetary Responsibility, both November 2020.
*England assumed to account for 90% of forecast UK net additions.

The resulting supply/demand imbalance means upwards pressure on house prices and rents over the long term. Barriers to home ownership remain high, with significant affordability constraints, particularly in London. This is likely to continue to fuel demand for rented accommodation. With recent government policies acting to curb the growth of the Buy to Let (BTL) market, other sources of rental supply are sorely needed.

The PRS has been growing over the past decade, and – at 4.4 million households – now represents 19% of the English market[4], up from 10% in 2001. In addition, a significant proportion now see themselves as permanent renters, with only just under 60% of the PRS households surveyed as part of the 2019/20 English Housing Survey expecting to move into owner-occupation in the future.

Figure 5: Tenure over time



Source: English Housing Survey, ONS, January 2021.

[4] English Housing Survey 2019/20.

Attractive rental growth prospects

The residential sector offers a strong stream of long-term income, backed by attractive rental growth prospects as well as capital preservation.

We expect healthy rental growth in Outer London in the medium term*, supported by continued supply/demand imbalances and earnings growth.

The prospects for generating an income return from residential are supported by the sector's tendency to have a lower level of voids than the mainstream sectors[5]. The length of residential leases is shorter than in commercial, but the gap is getting smaller. Although the standard initial lease length of an Assured Shorthold Tenancy (AST) is one year, the average actual tenancy is, in fact, 4.3 years, according to the 2019/20 English Housing Survey.

For private landlords and individual BTL investors, management costs typically absorb around one third of the income from privately rented residential. However, these costs can be reduced through the economies of scale available to institutions and other large scale investors, compared to management on a flat-by-flat basis. This is because the long-term income stream from residential can be maximised through more efficient property management.

Purpose-built, efficient stock

Achieving the necessary scale to make institutional investment viable is one of the prevailing barriers to entry for the PRS. While the equivalent US sector (known as multi-family) is mature, this took time to develop.

Forward funding and forward-purchase offer an attractive route for large-scale investment in the sector, with housebuilders and developers increasingly open to such transactions.

By focusing on blocks and units designed specifically for rent and taking an active interest in the development of these products, experienced professional investors can ensure greater efficiencies for operation, energy and maintenance. Similarly, by ensuring consistency across developments, they can maximise economies of scale to reduce costs of repairs and enhance overall returns through greater customer satisfaction, which impacts occupancy. The ability to embed service personnel on site, for example, allows managers to adapt services to residents' needs and foster a sense of community spirit.

The impact of housing on the environment is also coming under increased scrutiny as governments look to reduce people's impact on the planet. Energy use in homes already accounts for almost 15% of all UK greenhouse gas emissions[6], and with increasing housing supply forming an important part of government policy, demands to make the nation's homes more environmentally friendly will only increase. Whilst the government is mandating that all new PRS tenancies should be a minimum of EPC rating Band C by 2025, it is vital to ensure that any new rental product not just meets this target but is also built to the most sustainable and energy efficient standards possible. The forward funding route presents a clear opportunity to put green credentials at the heart of every development to ensure that this goal is achieved.

The forward funding route also offers greater tax efficiency than purchasing existing properties as the Stamp Duty Land Tax (SDLT) is based on the lower, pre-development land value.

Growth prospects in the PRS are supported by recent experience in the student accommodation sector. Institutional investment into student accommodation has been steadily increasing as developers have started to provide the kind of stock investors want to add to their portfolios. This is a trend that the PRS has been looking to replicate with the creation of Build to Rent (BTR). Indeed, this is already proving to be the case, with institutional investment volumes into BTR having reached almost £3.5 billion in 2020[7], despite the backdrop of a global pandemic. With significant capital still targeting the sector, it is likely that volumes will continue to rise as BTR becomes more established.

*Forecast relates to end-2020 to end-2025 (forecast as at October 2020).
[5] The birth of Build to Rent – how did it become the PRS's Biggest Trend, PropertyInvestorTODAY, August 2020.

[6] Committee on Climate Change, 'UK housing: Fit for the Future?', February 2019.
[7] Savills, UK Build to Rent Market Update, Q4 2020.

Liquidity advantage

Liquidity is another potential advantage for residential property over its commercial counterpart. For commercial property, the only exit route is to sell a building to another investor. In a downturn, where large-scale investor interest falls away, it may therefore not be possible to sell a building (at least not for a reasonable price) until market confidence returns, potentially years down the line.

Although the same problems may apply to selling a whole block of flats at some points in the economic cycle, residential property benefits from the potential to sell flats individually to smaller BTL investors or owner-occupiers. This potential pool of investors likely far outweighs the number of institutions in any market.

Moreover, when selling to owner-occupiers, investors do not have to sell at investment value as they would to another investor, potentially enabling them to secure a higher price and thus boosting investment returns. In our opinion, this double exit route makes the PRS increasingly attractive as an investment.

Investment opportunities

London is an obvious focus for PRS investors, reflecting the city's strong underlying fundamentals. The Capital will no doubt continue to see the most extreme supply/demand imbalance and the greatest issues around housing affordability, therefore ensuring it should remain a fundamental part of any investor's portfolio. However, with BTR evolving as a sector, there is increasing opportunity away from London; from the 'Big Six' regional cities, where strong employment markets underpin tenant demand, to second-tier markets, like Bournemouth, which have similarly attractive fundamentals as well as a potential early-mover advantage.

In addition to increasing diversity of target locations, the BTR sector is expected to evolve in terms of its underlying tenant base. More than one third of households in the PRS are families, equating to over 1.5 million. This already rising demand for a suburban, family-based product is likely to have been accelerated by the pandemic. The increased tendency to work from home in the future may encourage more families, who prioritise space and schools over social opportunities, to leave core areas of big cities for more suburban locations. This presents a significant future opportunity for BTR.

Market outlook

Disruption caused by the pandemic will only exacerbate the UK's chronic lack of housing. No matter the economic climate, people always need somewhere to live, yet housing demand continues to outstrip supply. The recent slowdown in new housebuilding, owing to an interruption of supply chains, will compound the problem.

Within the PRS, the demand and supply imbalance is growing, partly reflecting affordability pressures in the wider housing market. According to Hometrack's Rental Market report for Q4 2020, much of the UK has seen rental demand rising while rental supply has contracted (Jan 2021 vs. Jan 2020). Government reform around BTL property is placing further pressure on rental supply, by prompting a number of landlords to exit the market.

A focus on renting mirrors a shift towards greater flexibility in the way people live and work. Customers increasingly expect high quality, professional services embedded within their living space, at a cost they can attain. However, this type of space represents only a small proportion of existing stock.

There is also greater demand for rental accommodation from an older demographic, seeking access to better amenities in proximity to an efficient transport network.

While we are likely to see normality gradually return as a result of the government's vaccination programme, there will still be significant uncertainty around the path of economic recovery in the short term. During periods of uncertainty, the defensiveness of the PRS is clear. As seen in previous downturns, falls in house prices are often counterbalanced to some degree by stable, or even rising, rents. This is a significant benefit for investors when compared against commercial real estate for example, whereby rising yields are often twinned with significant falls in rental values.

Conclusion

Overall, our research suggests that the investment case for UK residential is supported by defensive investment characteristics, long-term attractive rental growth prospects and potential strong returns, owing to the essential nature of residential property and the supply/demand imbalance in the housing market. The sector also offers diversification versus other asset classes and real estate sectors. Professional investors have the scope to further optimise returns through economies of scale and greater efficiency. Taken together, this makes a compelling case for investing in the UK PRS. □

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