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Sixty second summary

Investing in UK housing

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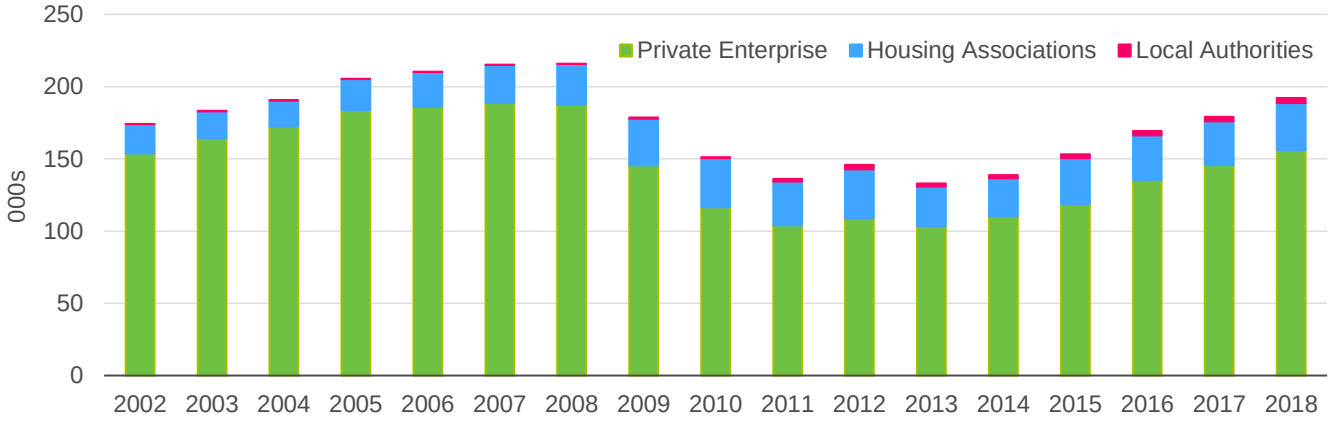
UK pension schemes have little exposure to the residential sector, but interest seems set to grow as opportunities expand, both in the private rented sector and various strategies linked to affordable housing.

Market backdrop

Population growth, together with a changing demographic structure, underpins the ongoing demand for residential property. The latest ONS projections show the number of UK households increasing from 20.5m in 2001 to 23.2m in 2018 and to 25.2m by 2030. The private sector and, to a lesser extent, Housing Associations have been responsible for housing supply since the 1980s. The provision of new homes is therefore sensitive to wider market financing conditions. Supply dropped sharply after the global financial crisis (GFC) in 2008 and has not yet climbed back to pre-crisis levels.

Chart 1: House building: permanent dwellings completed in UK



Source: Ministry of Housing, Communities and Local Government

Housing affordability worsened after the GFC, particularly for first-time buyers, due to a tightening of mortgage lending criteria, rises in house prices and lower rises in wages. Based on statistics from UK Finance, the number of mortgage loans for first-time buyers almost halved between 2007 and 2008. According to the Institute for Fiscal Studies, home ownership rates have decreased across all UK regions for 25-35 year olds since 1995, with London dropping from 47% then, to 20% in 2018.

A fall in UK owner occupation has been more than offset by growth in the private rented sector (PRS). This now accounts for about 20% of all households. According to Savills, the sector has doubled in value over the last decade and is now worth over £1.5 trillion. However, the rise of PRS does not help those who cannot afford to pay market rents or those trying to get a foot on the property ladder.

In response to the changed conditions, a number of government-run initiatives have been launched to help deliver 300,000 new homes a year by 2022. Many are directed at “affordable housing”, which currently makes up less than 20% of the UK housing market, but is projected to account for around 40% of the 300,000 target.

By controlling the planning regime, Local Authorities are influencing the type of housing that is built and made available. Local planning policies typically oblige developers to allocate a proportion of any new build site to more affordable housing. There are a few tenure types included under the affordable housing umbrella: social housing, made available at around 50-60% of prevailing market rent; affordable renting, offered at 80% of market rents; and shared ownership, allowing home buyers to purchase a percentage of the equity in their home, with a third party also owning a stake.

Investment Opportunities

Asset managers have used the opportunities arising from the changing structure of the UK housing market to offer an increasing variety of strategies providing exposure to the sector. These typically involve institutional investors providing capital in exchange for receiving rental income. Data from Real Capital Analytics suggest that there had been c£30bn of capital inflows into the sector in the 10 years to the end of 2017. The opportunities cover several tenures outlined below.

Private Rented Sector

Historically, the UK PRS has been fragmented and dominated by landlords with relatively few properties under management. This has typically meant that income leakage (the proportion of gross rental income required to meet management costs) has been high. However, the growing number of long-term renters has led to the rise of purpose-built, private rented accommodation, which allows asset managers to generate efficiencies of scale, both by reducing income leakage, and in negotiating discounts from developers. Established PRS funds are generating net yields of c3.5% p.a. with a total return target of c6%-7% p.a. In some cases, there may be an overlap of potential tenants with the affordable housing strategies outlined below, and so the success of the latter could be a headwind for PRS.

Social housing

There are almost 1,700 Registered Providers (RPs) in the UK and, since 2012, they have raised over £14.4bn of debt in capital markets. Products have been established for institutional investors to invest in RP debt, which tends to be long-term, inflation-linked and have a quasi-government covenant. In our view, yields are often low for the accepted level of illiquidity.

Affordable renting

Homes for affordable renting are leased, typically for 20 years or more, to a RP which sublets to the underlying tenants. The investor receives an income yield from the RP. Income leakage is typically 20-30% (slightly below typical leakage from PRS). Grants can be provided by the Government to RPs when additional funding is required to make a development scheme viable. This can lower the investor’s purchase cost and result in a higher income yield than other parts of the residential property market. Investment carries some risk of changes to government policy. Annual rental growth is currently capped at CPI -1%; that will be lifted to CPI +1% next year, but could well be amended below CPI again at some point in the future.

Shared Ownership

Institutional investors in shared ownership schemes will usually fund between 25% and 60% of the property value through a lease agreement with the occupier. Shared Ownership lease agreements are usually for 100 years or more. Rental income is currently set to grow at an annual rate of RPI +0.5%, but again there is a risk of changes to government policy. The right of the occupier to increase their ownership stake gradually means investors also face prepayment risk.

Conclusion

Residential property strategies offer investors a means of diversifying existing UK property exposure, offering a combination of income, income growth and the potential capital growth. So far, allocations have been small, but we anticipate that interest will pick up as the number of viable options in the sector expands. A growing number of PRS pooled funds are already available and a number of strategies are in the process of being launched to target a combination of affordable housing tenures. Please contact your usual consultant if you would like further information.

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