CUSHMAN & WAKEFIELD

Q2 2023

BUILD TO RENT REPORT

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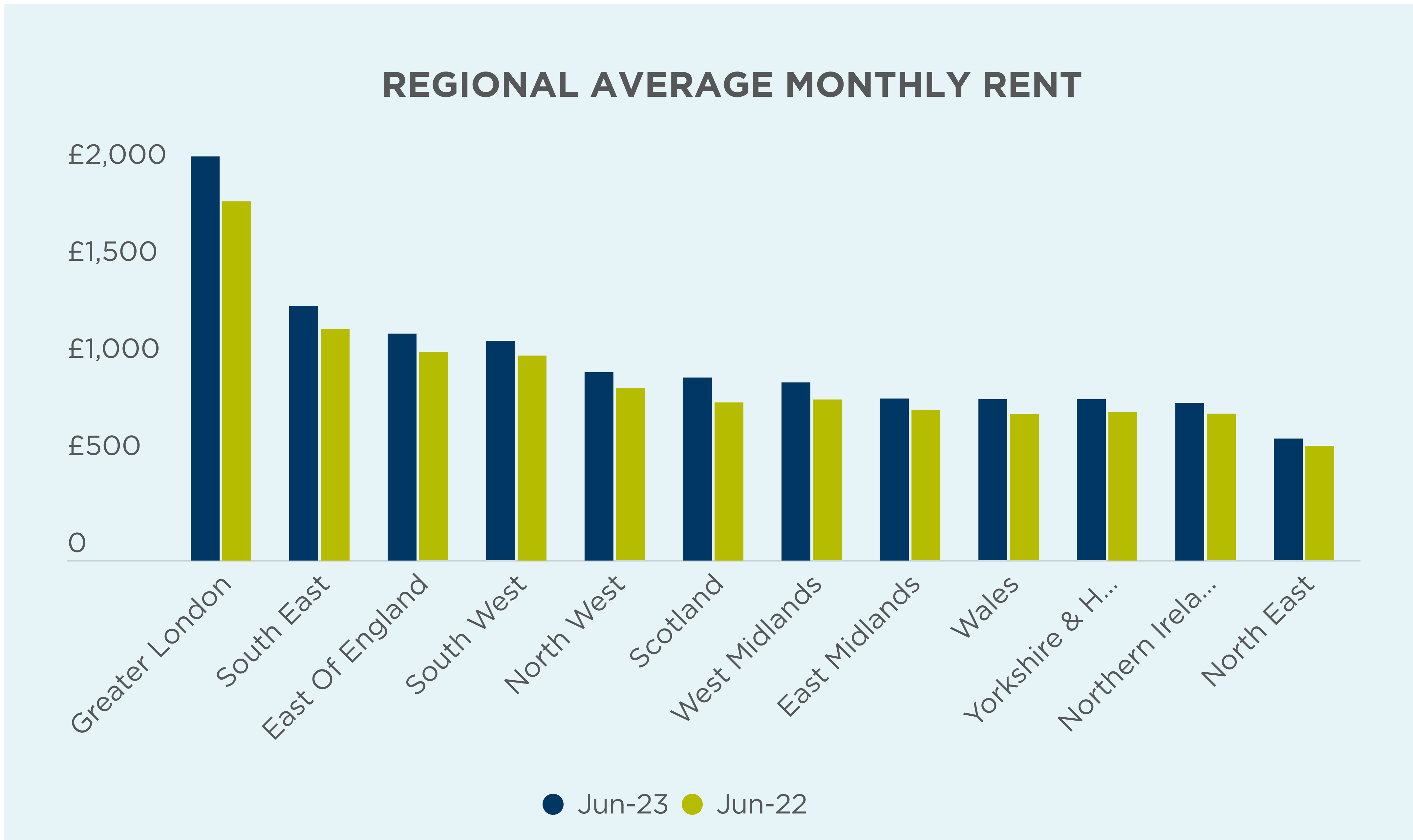
RENTS CONTINUE TO RISE

The UK (excluding London) has seen 9.7% growth in rents over the last 12 months, making the average rent £1,027 pcm as of June 2023.

London has seen 12.5% growth in rents over the last 12 months, making the average rent £2,077pcm, as of June 2023.

Scotland (at 15.8% annual growth), London (12.5% annual growth), and the West Midlands (10.8% annual growth) were the top performing regions. The North East was the only region to experience negative monthly growth in rents in June, -1.1 %.

Build to Rent (BTR) rents have also seen strong rental growth, with Grainger reporting 8.2% annual growth on new lets across their portfolio in HY 2023 and 6.1% on renewals in HY 2023. Overall, HY annual rental growth was at 6.9%, with this at a similar rate to wage inflation, affordability in BTR has remained broadly stable. Grainger renters spend an average of 29% of their income on rent.



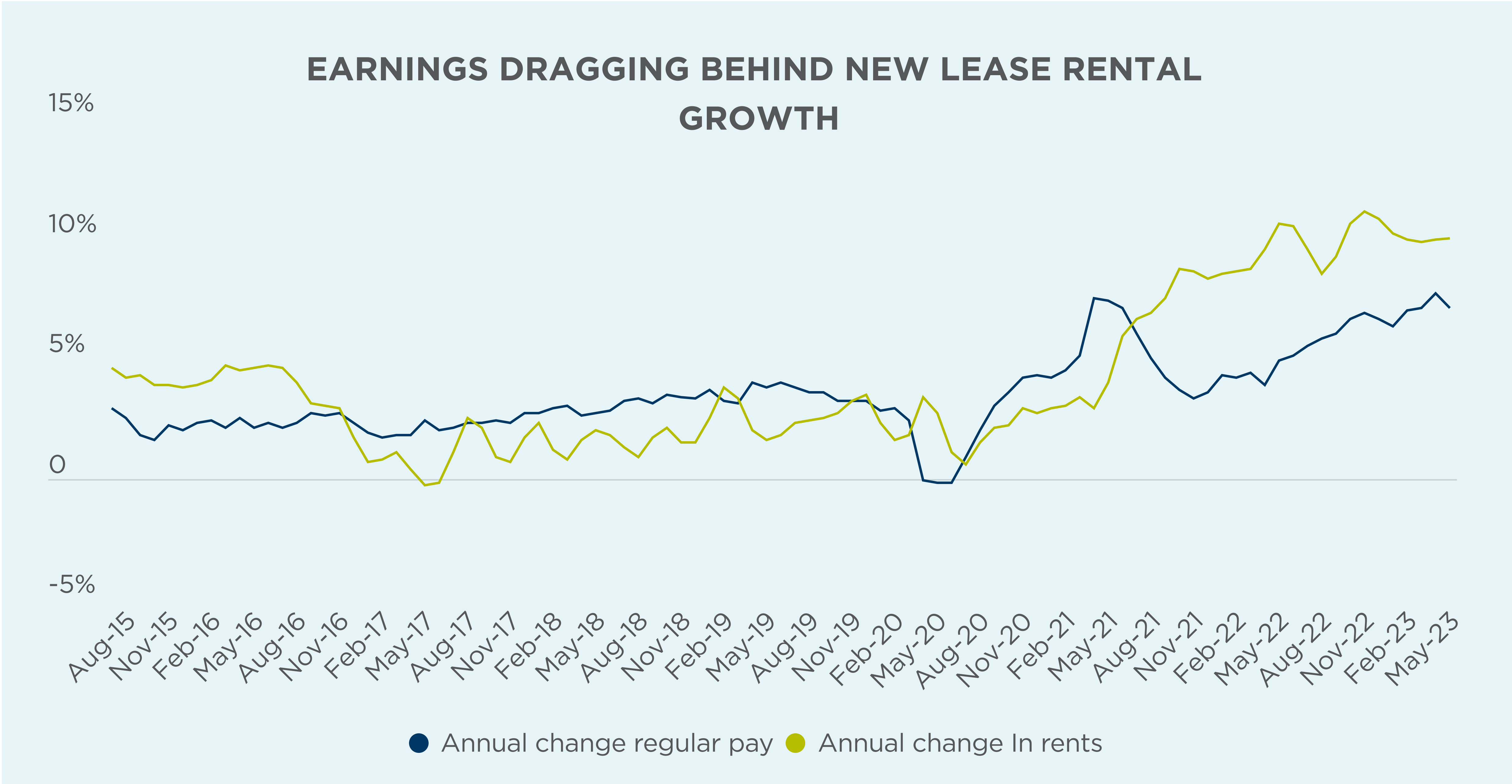
Source: Cushman & Wakefield, Homelet

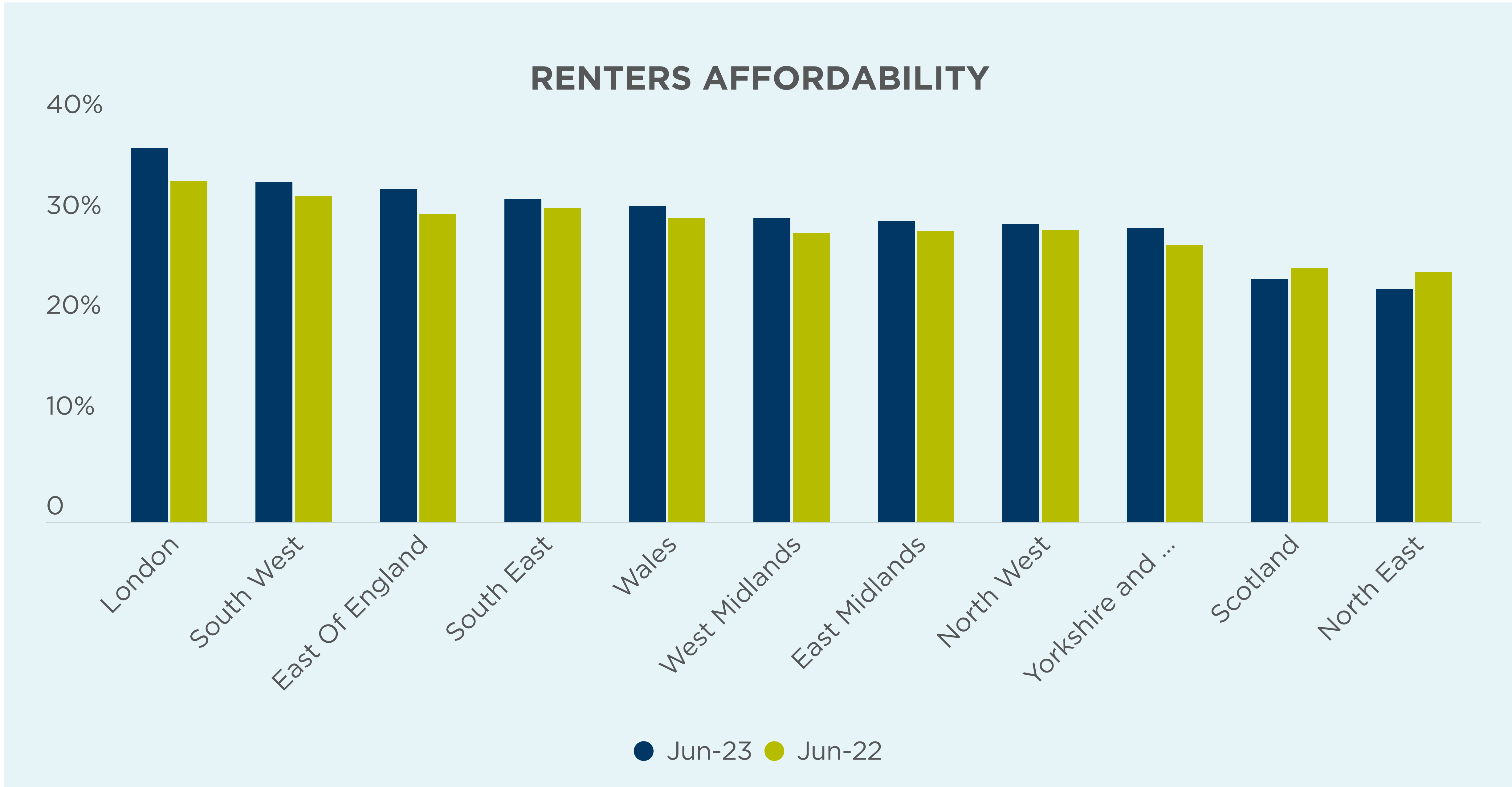
SOME RENTERS ARE FEELING THE SQUEEZE

In the wider rental market, new lease rental growth has been rising at a faster rate than earnings growth (10% vs 7.1% annual growth in May 2023), so affordability has worsened for renters looking for new homes.

In the UK (excluding London), renters spend an average of 30.4% of their gross income on rent a month, an increase from 29.5% the same time last year. London renters spend a higher proportion of their income on rent, 37.3%, up from 34% last year.

Rental affordability is at or above the recommended 30% of income spent on rent in more than half of the UK's regions. There are certain areas in the UK where increased rental growth will put considerable financial pressure on renters.





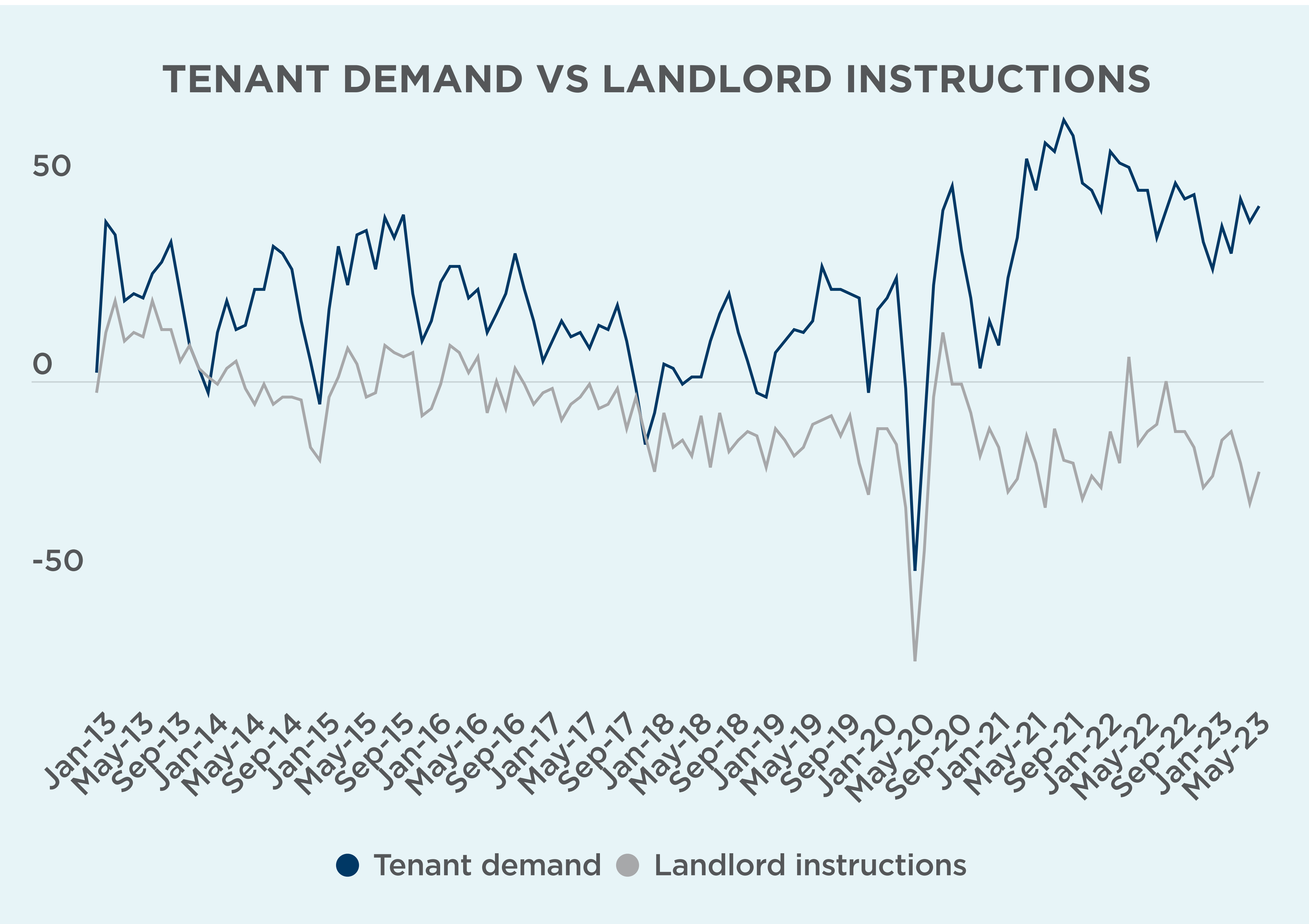
Source: Cushman & Wakefield, ONS, Homelet

DEMAND CONTINUES TO OUTWEIGHT SUPPLY

Rental growth has been supported by the ongoing imbalance between tenant demand and landlord instructions.

The RICS May 2023 residential survey showed a net balance of +44% of respondents reporting an increase in demand. New rental supply continued to fall, with a net balance of -23% of respondents reporting a decline in landlord instructions (more on this later).

The BTR and Buy to Let (BTL) sectors are a long way off solving the rental supply crisis, and given worsening affordability constraints for First Time Buyers, tenant demand is only going to increase.



Source: Cushman & Wakefield, RICS

RENTER DEMAND WILL CONTINUE TO INCREASE

Social Housing: The proportion of households living in social rented homes (for example, through a local council or housing association) has declined. Today, 17.1% of households live in social rented homes vs 17.6% in 2011 (Census 2021). A shortage of social rented households increases the number of private renters using housing benefits or universal credit in the Private Rented Sector (PRS). It is estimated that almost 40% of PRS households have government support with rents (Ray-Chaudhuri and Waters, 2023). These renters will be more exposed to the cost of living crisis.

Home Ownership: Saving for a deposit is the first hurdle and with renters disposable income being eaten into, this has become even more of a challenge. The average First Time Buyer deposit in the UK in 2022 was £62k and £125k in London (Halifax).

Then there are affordability metrics. In the UK, First Time Buyer house prices are 5.5 times earnings, similar to 5.4 during the Global Financial Crisis (even higher in London at 8.9 vs 7.2).

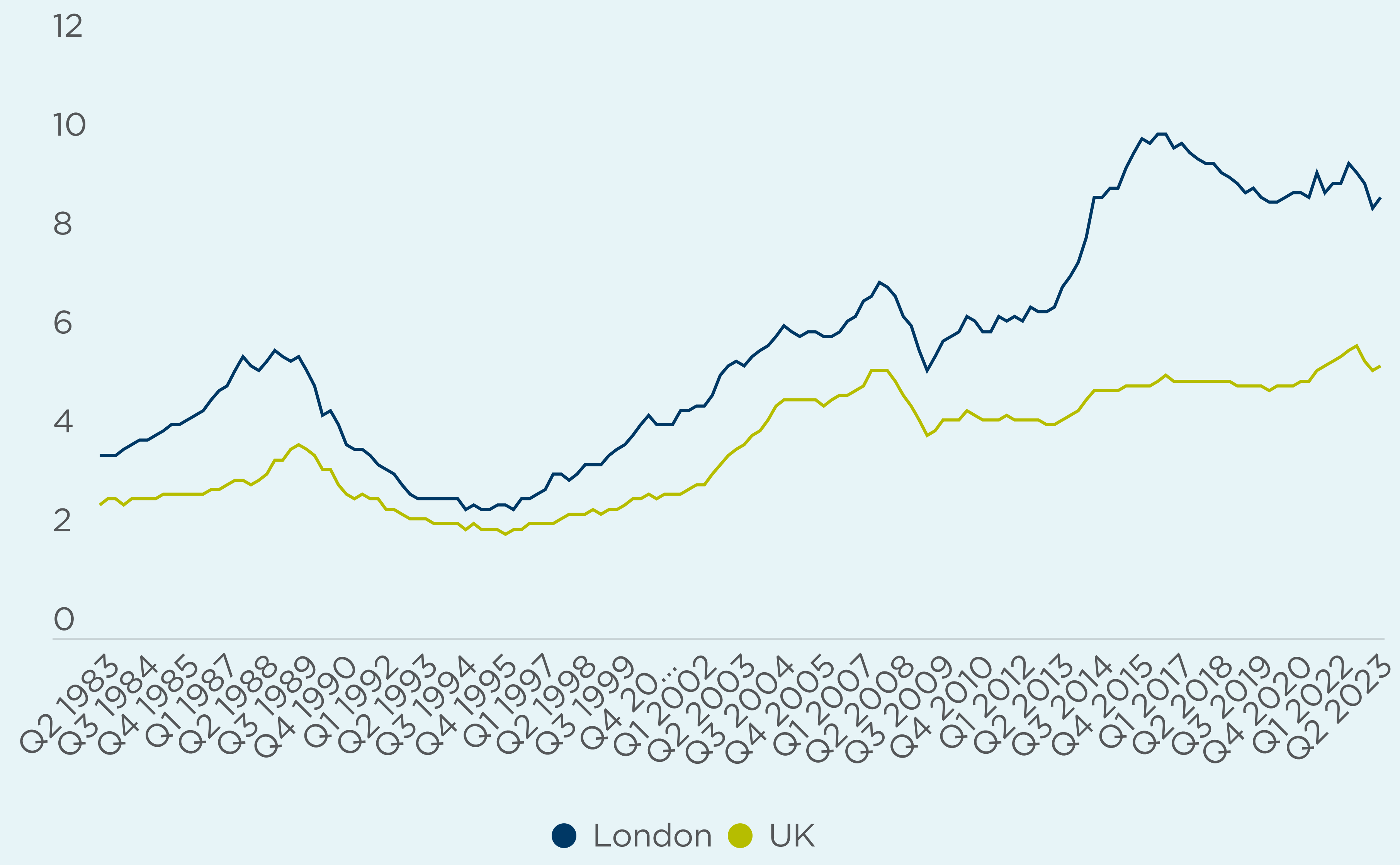
Even if a potential First Time Buyer is able to purchase a home, mortgage rates continue to climb, making paying a mortgage more expensive than renting. Average mortgage payments in the UK are 17% more expensive than renting, and in London they are 29% greater.

In addition, there is increased uncertainty in the housing market, with house price falls expected in the short to medium term as high inflation, rising interest rates, and a weaker economy erode buyer demand.

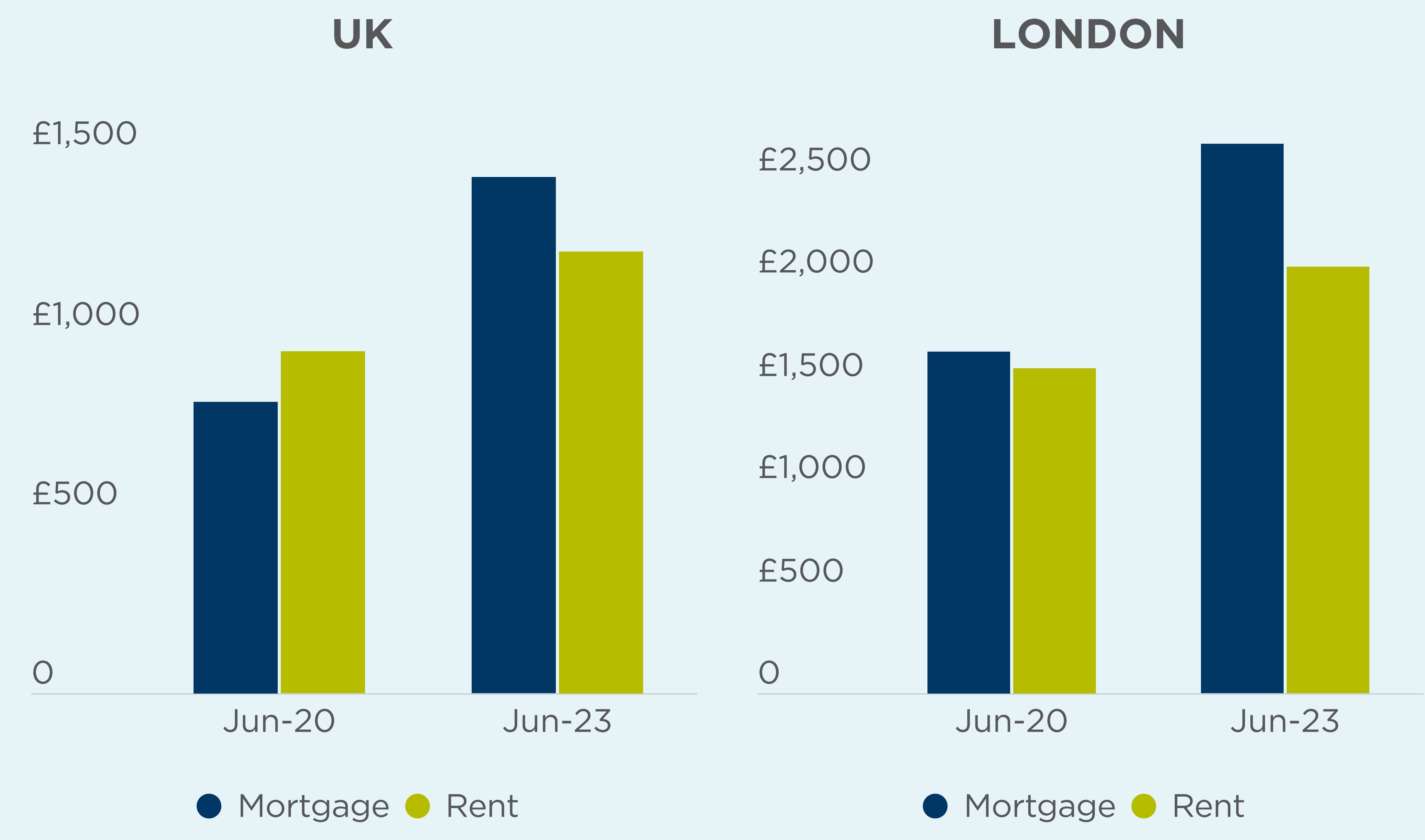
Latent Private Renter Demand: Then there is the untapped market. The number of adult children living with their parents has increased from around 4.2 million in the 2011 Census to around 4.9 million in the 2021 Census. These young adults either can't afford to rent or are skipping the rental sector to save for a house deposit. This is a pool of potential renters that a more affordable rental product could serve.

All these factors, as well as a growing population, are only going to create greater demand for privately rented homes.

FIRST TIME BUYER HOUSE PRICES TO EARNINGS RATIO



MORTGAGE VS RENT



Source: Cushman & Wakefield, Nationwide, Homelet, BoE, UK HPI
Mortgage analysis: Assuming an average mortgage interest rate on 75% and 90% LTVs, on a new 2 & 5 year fixed mortgage, with a term of 25 years

BUY TO LET LANDLORDS EXITING THE MARKET

There has been considerable discussions in the media around landlords exiting the market. The broad consensus is that Buy to Let landlords are exiting, but perhaps not to the extent the media reports.

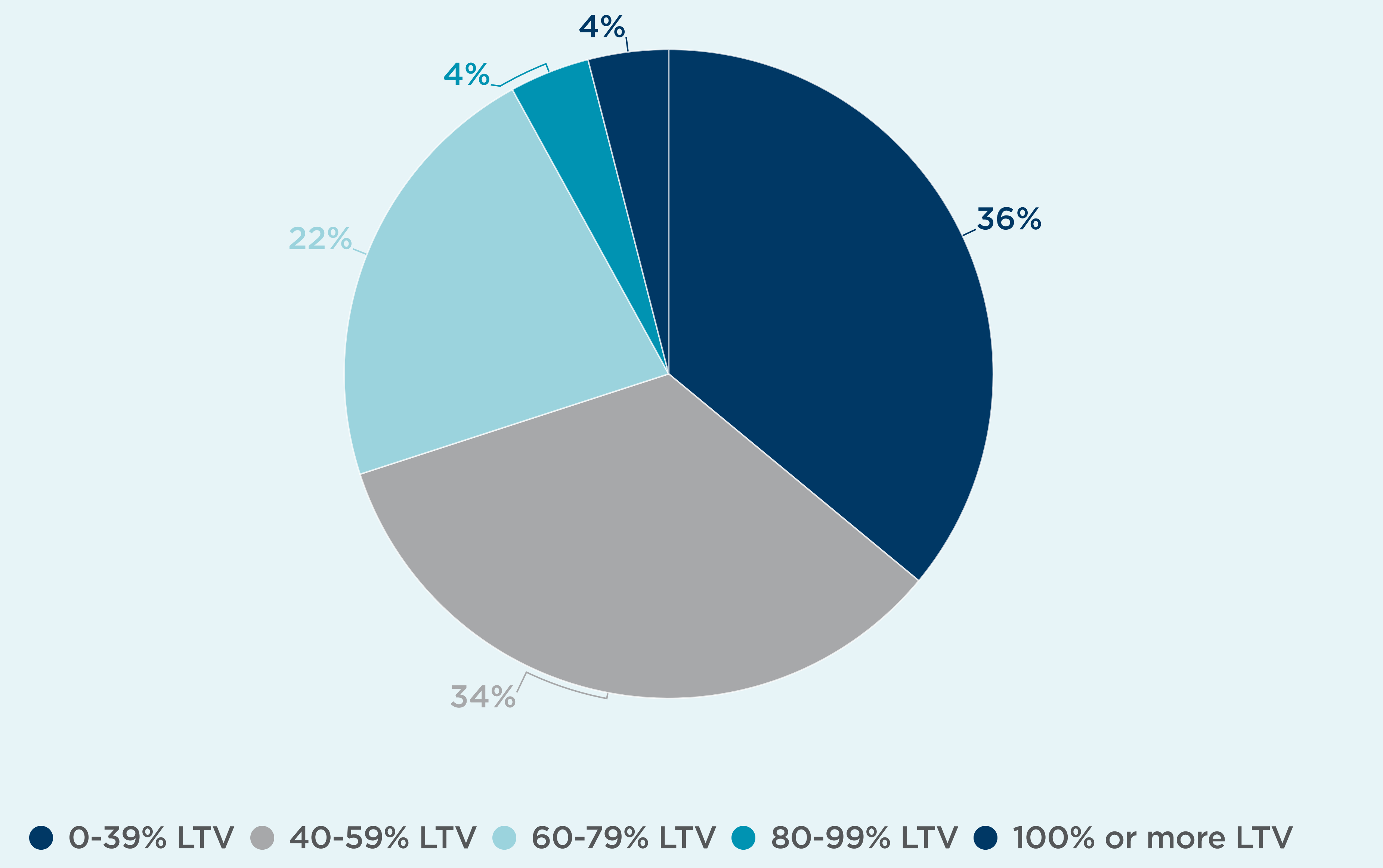
'Talk of landlord exodus overdone but some are selling'. Zoopla's sales data shows a steady, constant flow of private landlords selling up – this has been the case since 2018 but it's not accelerating. This combined with investment into BTR, has led to Zoopla reporting no change in the number of private rented homes since 2016.

Increasing mortgage costs. 62% of landlords have debt (English Private Landlord Survey), and many of these will be coming off fixed mortgages and exposed to increased mortgage rates. Those landlords who are exposed to higher mortgage rates might be more likely to sell as their profit margin is squeezed.

Not all landlords are heavily leveraged. Those landlords who do have debt, tend to have lower loan-to-values. 36% of landlords with debt having a loan-to-value of 39% or less, 34% with a loan-to-value of between 40 to 59%, 22% with a loan-to-value of between 60 to 79%, and 8% with a loan-to-value greater than 80%.

A weaker sales market. With house prices falling, now isn't an optimal time for landlords to sell. Only landlords who are financially stretched are likely to accept lower capital values.

PORTFOLIO LOAN TO VALUE RATIOS FOR LANDLORDS WITH DEBT



Source: Cushman & Wakefield , English Private Landlord Survey

An increase in accidental landlords. There is likely to be an increase in the number of 'accidental' landlords, as buyers struggle to sell their homes. Everyday life events mean home moves remain on the agenda for some households (moving in with a partner, having children, divorce, death, etc.).

Renter Reform Bill might further discourage some Buy to Let landlords. The Renter Reform Bill was introduced to parliament in May 2023 to create a fairer, more secure, and higher quality PRS. The Bill proposes a number of changes; section 21 "no fault" evictions to be abolished, periodic tenancy system to be standard, rent increase notice period to be doubled, more tenant rights to keep pets in properties, a government approved ombudsman to settle disputes without going to court, and a property portal for landlords and tenants.

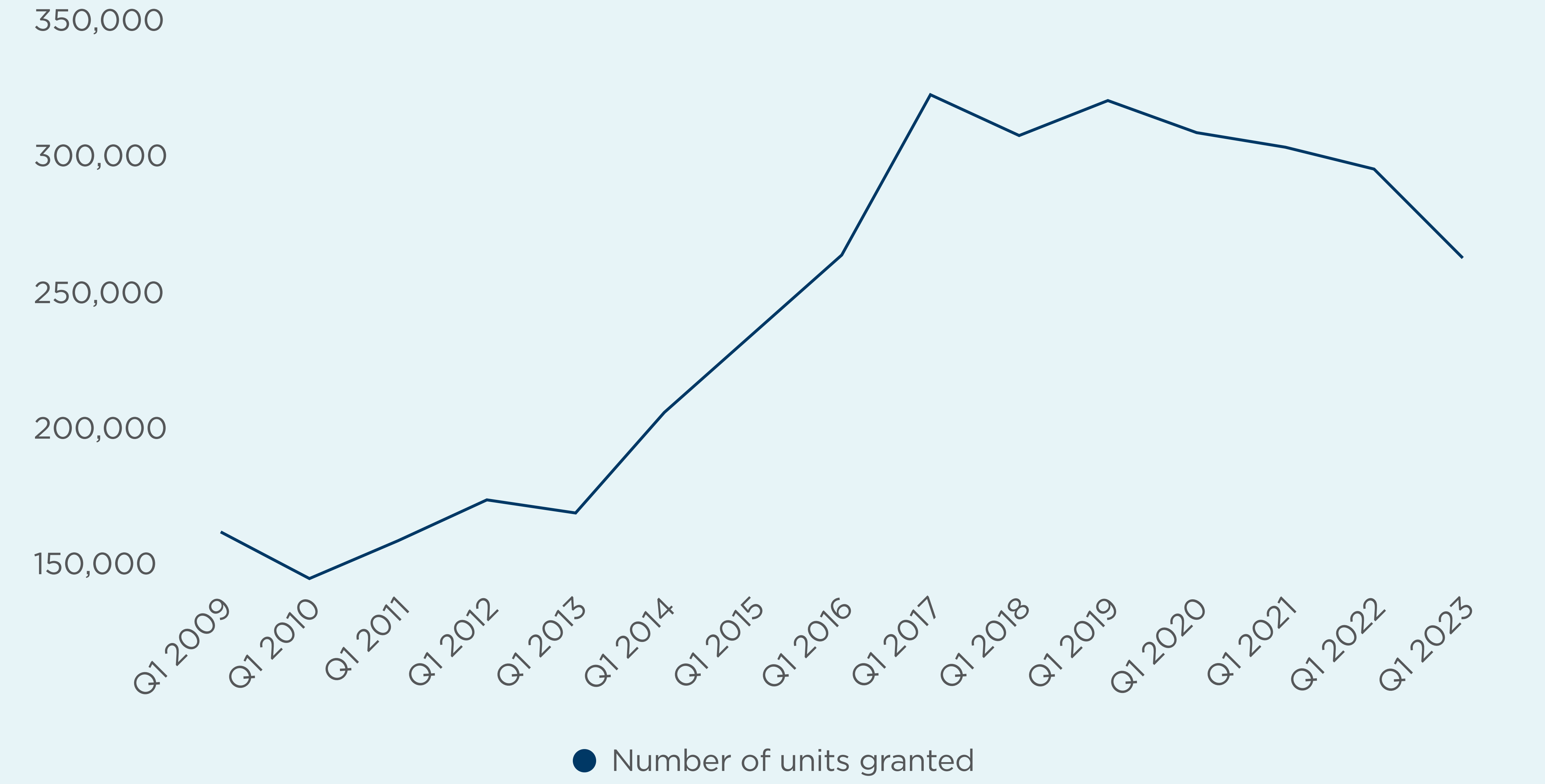
A SLOWDOWN IN NEW HOMES DELIVERY

Planning permissions have slowed. In Q1 2023, annual new homes planning permissions were down 11% on last year. Local authorities have been receiving fewer planning applications than normal, with developers deterred due to a weaker economic environment and ongoing changes to the planning system.

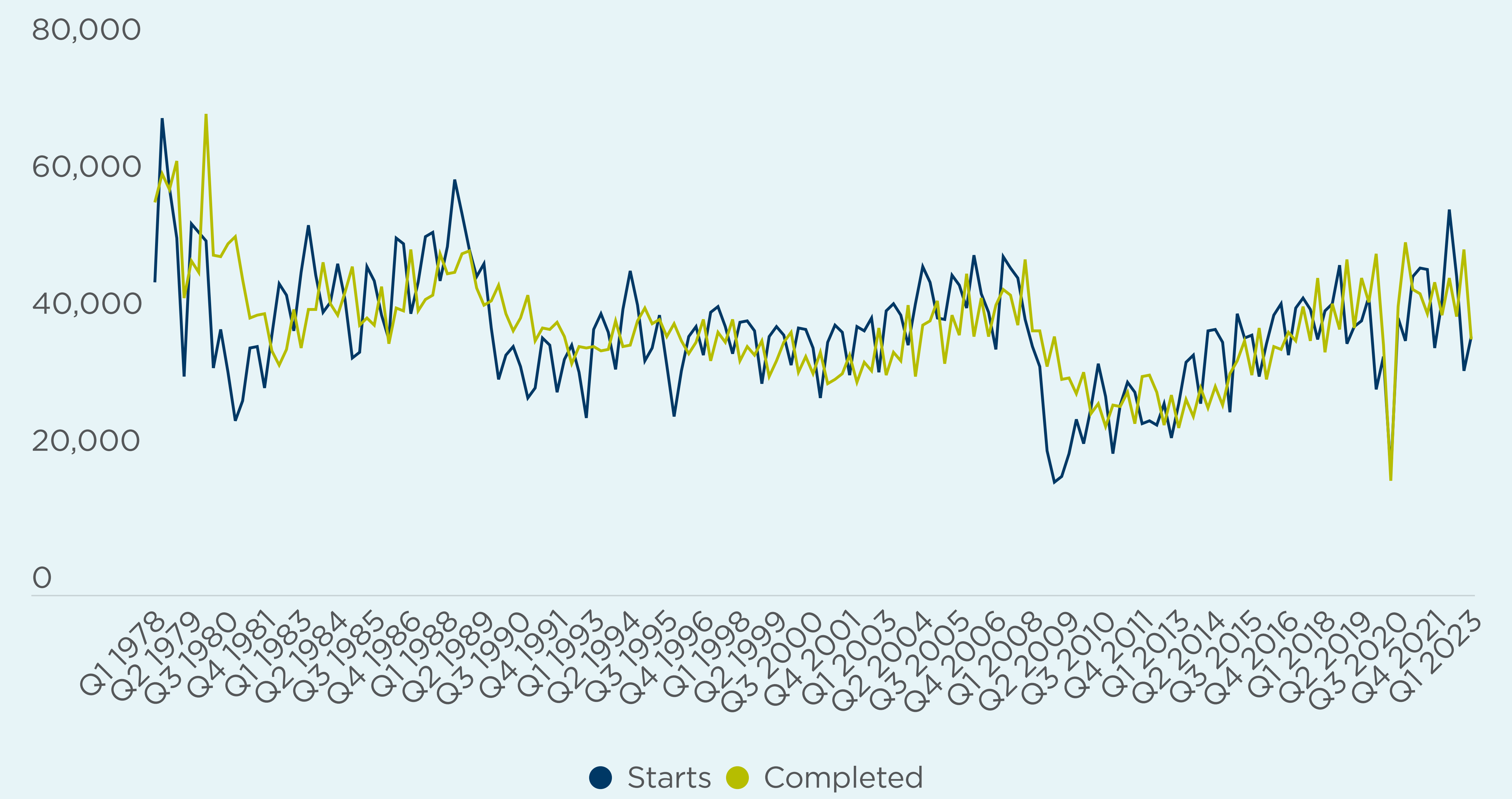
Construction starts and completions have also slowed. In Q1 2023, construction starts were down 12% on the same period last year, however, new homes starts increased 16% over the last quarter. Construction completions in Q1 2023 were down 8% on the same time last year, and fell 26% over the last quarter.

A slowdown in planning permissions and new homes construction is going to put greater pressure on the PRS.

ROLLING ANNUAL HOUSING UNITS GRANTED PLANNING PERMISSION



NEW HOMES STARTS AND COMPLETIONS



Source: Cushman & Wakefield, GOV.UK

BUILD TO RENT CONSTRUCTION SLOWS

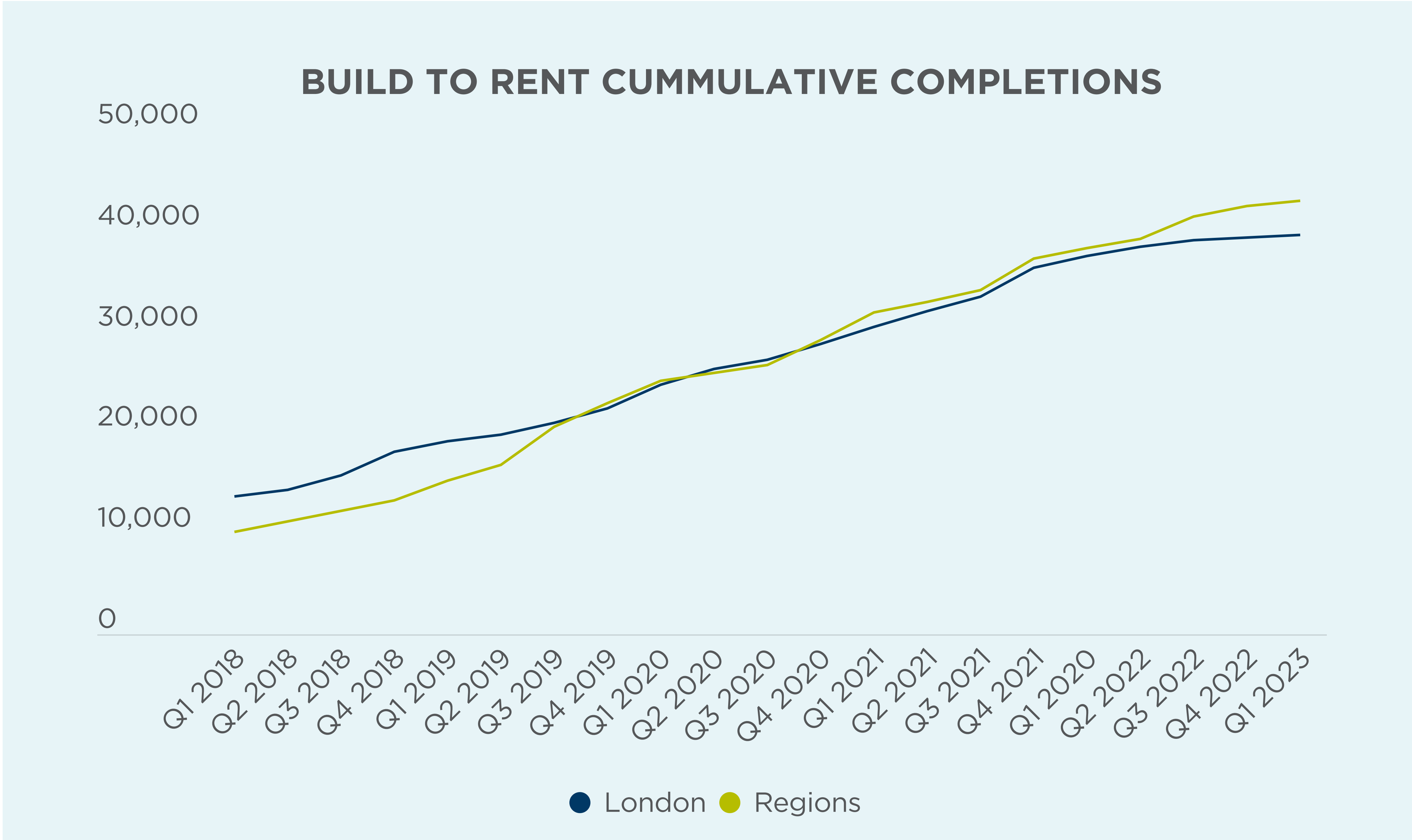
In the UK, there are now 82,505 complete BTR units, up 9% on last year. Despite the increase, BTR still only makes up c.1.6% of the PRS market.

There has been a slowdown in the number of units under construction in the regions. There were 33,882 BTR units under construction in the regions in Q1 2023, down from 34,267 in Q4 2022.

London hasn't seen a slowdown in BTR construction starts yet, but this is coming off of a lower base. There were 15,605 BTR units under construction in Q1 2023, down from a peak of 18,317 in Q3 2019.

A slowdown in BTR construction reflects the current economic headwinds, as well as Building Regulations and Fire Safety causing schemes to return to planning. A greater number of BTR homes need to be delivered if we are to plug the supply gap.

On a more positive note, Single Family Housing (SFH) is one area which is growing. There are now 9,566 completed SFH units in the UK, 5,210 under construction and 9,751 in planning. The number of SFH units is expected to increase rapidly as housebuilders look to diversify exit routes in light of a weaker sales market. Two key SFH deals happened in Q2 2023 (Citra & Barratt and MJ Gleeson & Carlyle & Gatehouse), with a discount of around 5% to 10%, making it attractive to both investors and housebuilders.



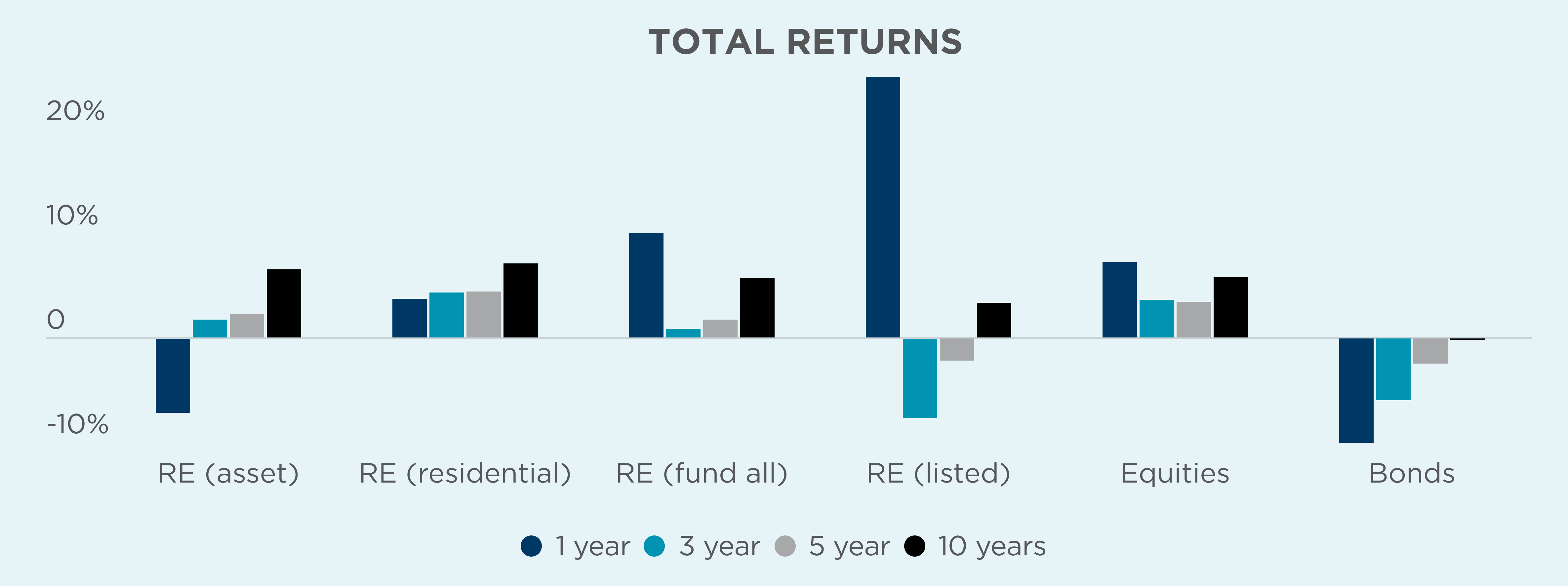
Source: Cushman & Wakefield, BPF

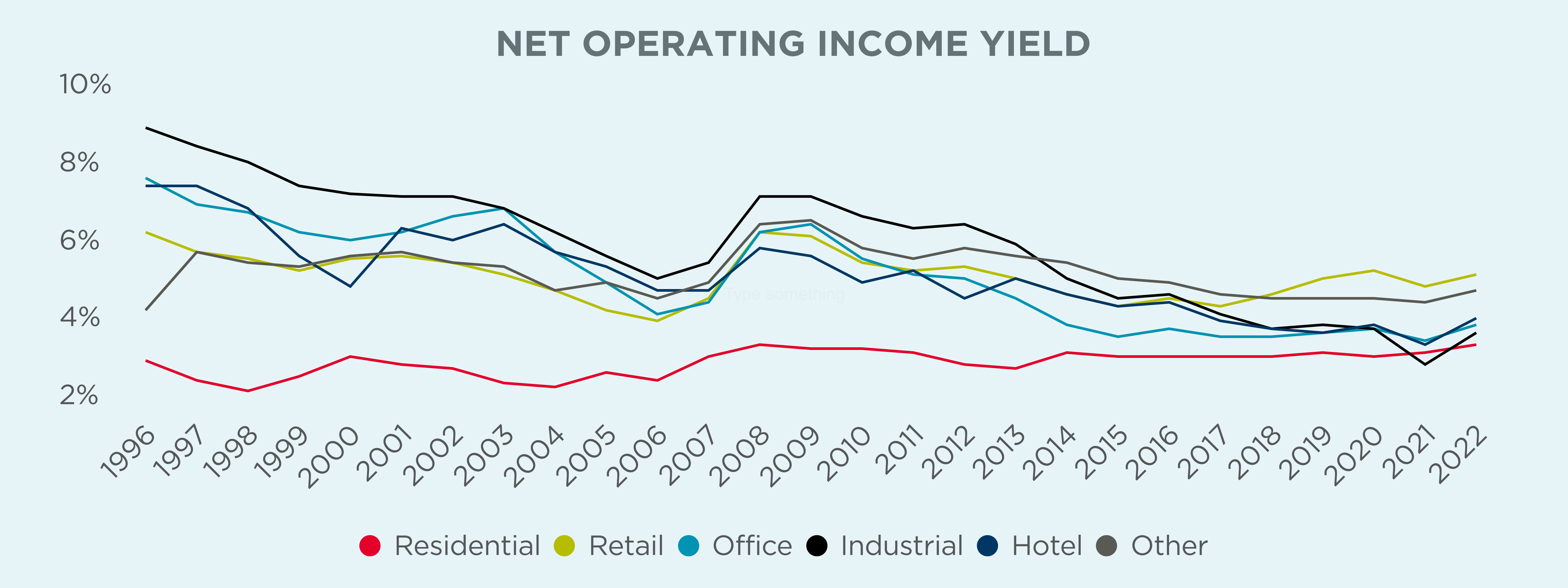
INVESTORS ATTRACTED TO STRONG STABLE RETURNS

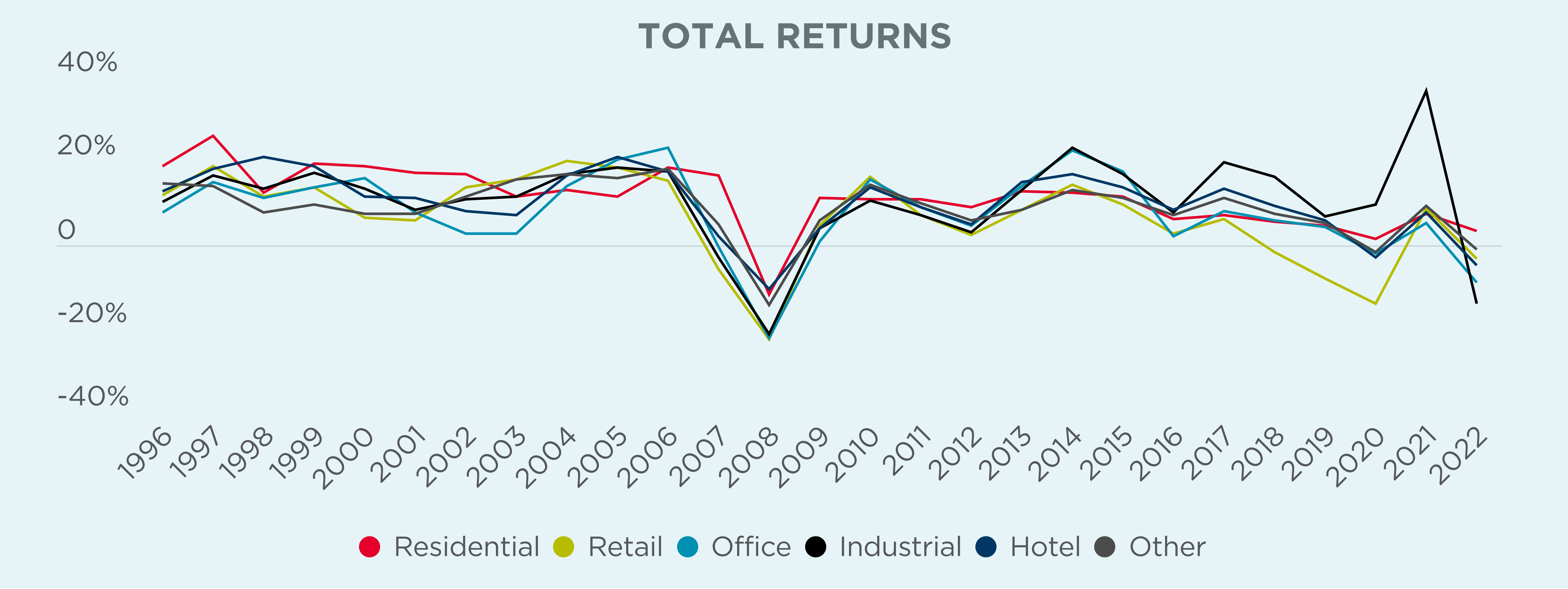
While the investment market remains challenged as a result of significantly increased debt costs, we continue to see investor appetite for BTR. In fact the current environment has highlighted the defensive qualities of the sector, with a number of major investors looking to increase exposure to the residential asset class. There are a number of clear reasons as to why – with the sector outperforming equities, bonds and other real estate investment vehicles – seeing 7.1% annual total returns over the course of the last ten years compared to -0.1% in bonds and 5.8% in equities – highlighting the attractiveness to institutional and long-income investors.

With the business environment constrained, CPI-linked, annually renewed income in the sector hedges the asset class against inflationary pressures, protecting against income security and falling values. Other asset classes are tied to longer leases and are therefore unable to rebase rents as frequently, this causes net operating yields to move out, particularly when capital values are weaker.

This has thus far protected total returns. In the year to May 2023, the MSCI monthly index shows residential being the only sector with a positive total return of 4.6%, against a track record of relatively low volatility, and quick rebounds in comparison to traditional commercial property sectors.

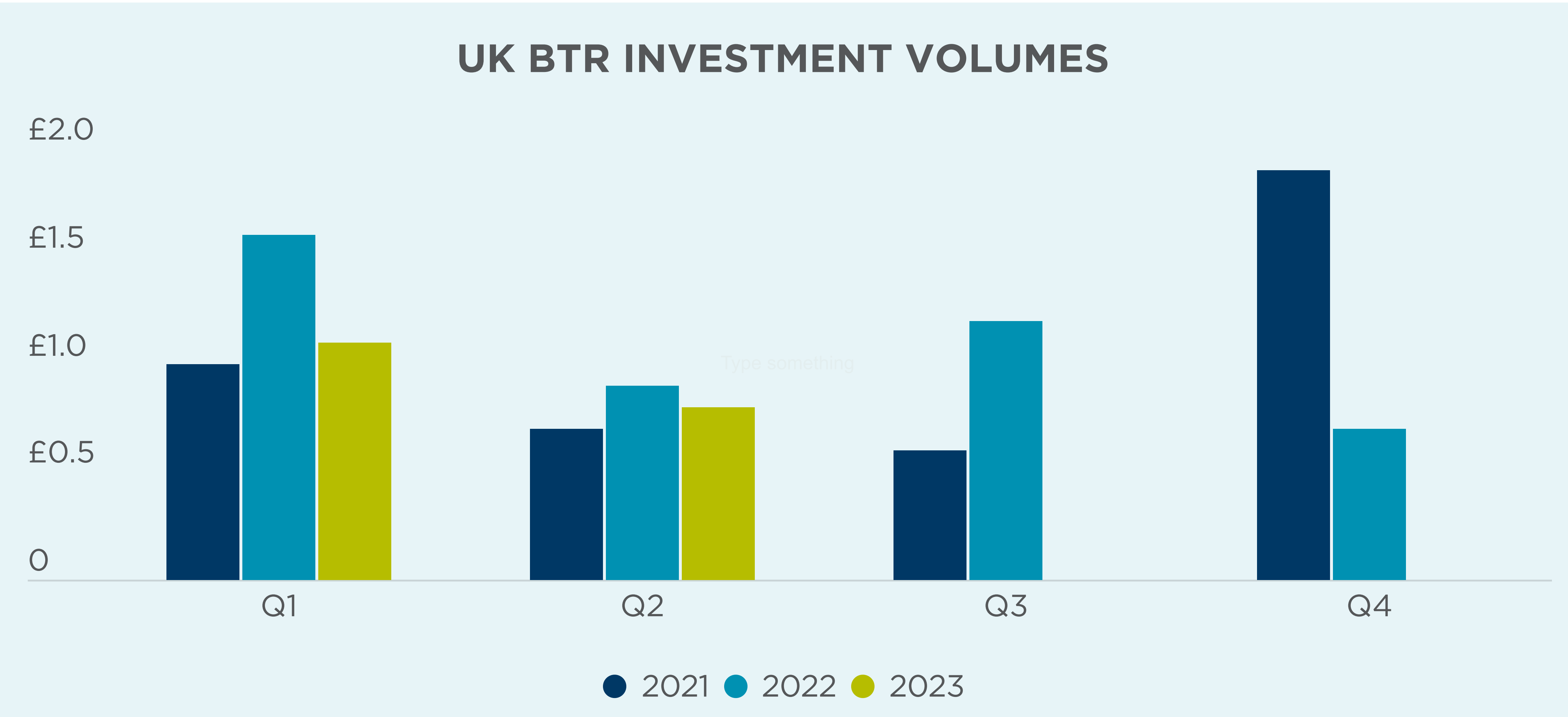






Source: Cushman & Wakefield, MSCI

SINGLE FAMILY HOUSING IS BOOSTING INVESTMENT VOLUMES



Source: Cushman & Wakefield & RCA

Despite the strong investor rationale, there has been a fall in investment volumes as persistent inflation continues to push interest rates. In Q2 2023, £0.8bn was invested, down from £0.9bn the same time last year. SFH accounted for 47% of investment in Q2 2023.

The cost of borrowing is at the highest level for the last 15 years, and the outlook remains uncertain, fuelled by the recent disappointing inflation figures.

While investors continue to seek exposure to the market, the increased cost of debt continues to put pressure on deal structuring, particularly in the forward funding market. While a number of forward funding deals are on the market and under offer, most of these are likely to complete in the latter part of the year, given the complex nature of these deals and the time taken to complete.

As well as the economic backdrop, discussion around increasing regulation in different forms is also continuing to cause investor uncertainty. Further regulation in the rental market is on the horizon; for example, the anticipated requirement for a secondary means of escape has meant many potential forward funding opportunities have had to revise planning consents, again causing further delays. This has particularly impacted the market for flatted led schemes whereby build cost inflation has been compounded by increased costs associated with Building Regulations and Fire Safety measures. Given the greater height and density, London is particularly impacted by the advice from the National Fire Chiefs Council that all residential buildings of 18 metres / 7 storeys should have a second stair core which impacts efficiency. Any existing consented schemes over this height, with a single stair core, is now of little interest to the majority of institutional grade investors and therefore most developers are going back into planning.

More positively, investors that paused activity following the mini-budget and its ramifications have started to return to the market, albeit tentatively. Constrained supply for the past few years has opened up opportunity for the more established and new market players as best in class funding opportunities have seen competitive bidding processes resume. There has been greater demand for stock in core cities, as existing BTR products demonstrate strong performance.

Traditional housebuilders are continuing to explore the BTR sector with a number looking to de-risk some of their existing schemes, as they see individual sales slow, by selling block opportunities to active investors. As the mortgage affordability issue continues to bite, we are likely to see more opportunities for investors with housebuilders in both the BTR and single family.

Overall, the investor rational for BTR remains strong and money remains committed to the sector. However, cost of debt and a changing construction environment, is temporarily dragging the pace of investment.

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