Residential Research – January 2024

SAVILLS RESEARCH

UK Build to Rent Market Update

2023 marked the second highest year of investment

2023 saw a total of £4.5 billion of investment into UK Build to Rent (BtR), signalling the second highest year on record down c£100m (-2%) on 2022 and ahead of 2021. This is in spite of the macro-economic challenges that have weighed on investment activity across all real estate sectors.

Investors have navigated a year of elevated debt costs and continued material and labour-cost inflation, which have limited development opportunities, while operational assets were also constrained by changes to regulation . Many have had to carefully consider investment strategies in the short term as they adapt to changing market dynamics.

In this environment the robust investment volumes in the living sectors affirm their comparative attractiveness. The BtR sector has been able to capitalise on a continued supply and demand imbalance and high levels of rental growth. This has led to inflation-matching returns while yields have proven comparatively resilient.

The fundamentals of investing in BtR remain sound with growing possibilities to leverage operational efficiencies from better data on portfolio performance and experience. This has put the sector in good stead for its next phase of growth.

Build to Rent houses took up a record-breaking share of total investment in 2023

BtR Houses, otherwise known as Single Family Housing, saw £1.9 billion worth of investment, up significantly from £360 million in 2022. This represented 42% of total BtR investment, shattering the previous record of 8% in 2022.

This is at a time when elevated mortgage rates and the end of Help to Buy have subdued the private for sale market. The record number of investors and housebuilders in the space over the past year is expected to grow further, with appetite to substantially expand portfolios and partnerships as confidence grows.

The planning pipeline has also expanded beyond concentrations in the North West, especially around Liverpool and Manchester. Emerging sites in the Midlands and South East, where land prices are higher, demonstrate the sector's evolution and diversification.

Development deals continue to dominate

The majority (81%) of deals in 2023 were to fund the construction of over 12,000 new homes, totalling over £3.65 billion worth of investment. This is compared to just 19% of deals for the purchase of standing assets worth £850 million.

These deals notably highlight the sector's expansion not only outside of London, but also beyond the core cities. 55% of deals were directed towards sites outside these areas, driven mainly by growth of BtR Houses in more suburban and edge-of-town locations. The high rental growth seen in recent years has helped improve viability as shown by recent deals in the likes of Ely and Wintringham, Cambridgeshire.

The high proportion of development deals, the largest since 2019, is partially due to the lack of operational institutional-grade schemes to purchase. Investors have been keen to hold on to their assets as record leasing rates and rental growth have provided stable returns in an uncertain economic backdrop. Opportunities have therefore been centred on development.

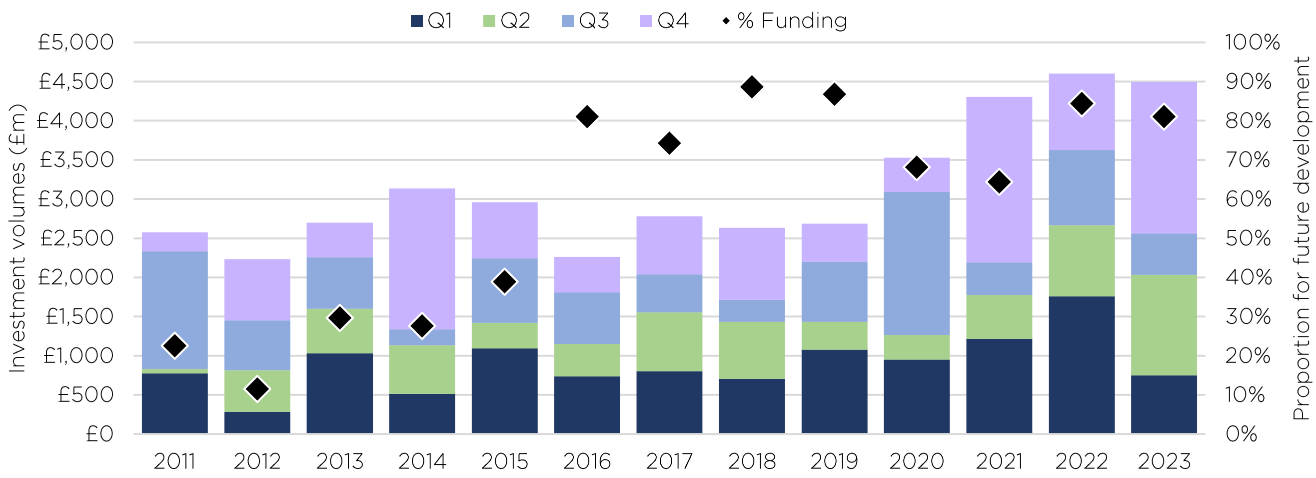
Although we expect the number of operational deals to improve over 2024, development deals will continue to dominate, maintaining the sector's growing contribution to new build development in the UK.

Navigating the routes to market

Build to Rent is not the solution for every development facing challenges. The investment fundamentals must stack up and location, scale, design and counterparty covenant strength are all key factors in investor decision-making.

More recently, investors have developed innovative transaction structures outside of traditional forward funds. This is ensuring equitable returns for all parties involved with returns linked to ultimate asset performance rather than fixed in the context of the current market dynamics.

Figure 1 Investment in Build to Rent recorded the 2nd strongest year with high proportion for new development



Source: Savills

Indicators suggest we will be past peak pain in 2024

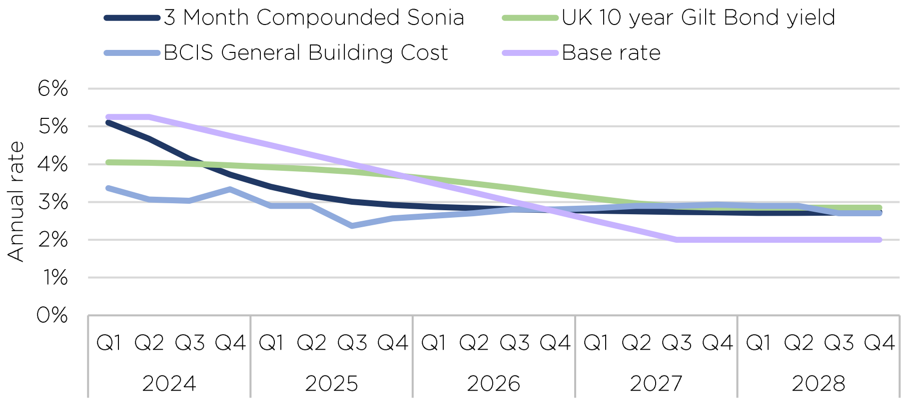
The tail end of 2023 saw inflation consistently fall more than expected, slowing sharply to 4.0% in December according to the ONS. Consequently, economic commentators are now expecting the base rate to be cut from its current peak at 5.25% much earlier in 2024 than previously anticipated.

The SONIA forward curve (useful for forecasting floating-rate debt) shows financial markets are expecting a substantial decrease in the cost of debt throughout 2024. Combined with an expected gradual reduction of Gilt yields, this will shift the current investment landscape. While we are not out of the woods yet, these indicators point towards an improving environment that will open up opportunities for new deals, especially for first movers.

Development of new homes will also be boosted by the continued slowing in build-cost inflation which has hampered construction since the pandemic. All-in tender price inflation was down to 3.5% in Q4 2023 from a peak of 10.3% in Q2 2022, according to BCIS. Materials inflation even turned negative, down -0.8% at the end of 2023, and is expected to fall further.

However, the key challenges of increasing labour costs and skills shortages in all sectors of the construction industry remain. While these have also begun to abate, they still threaten to weigh down on delivery in 2024.

Figure 2 Costs of debt and construction are expected to fall further



Source: Savills Research using Chatham Financial (27 December 2023), Oxford Economics, BCIS

Contraction of Buy to Let sector to worsen supply and demand imbalance

Reduced tax relief on mortgage interest and additional stamp duty for landlords have made it harder than ever to make Buy to Let stack up. This is compounded by the increase in mortgage rates, putting off potential new investors and forcing existing landlords to rethink their portfolios or exit the sector.

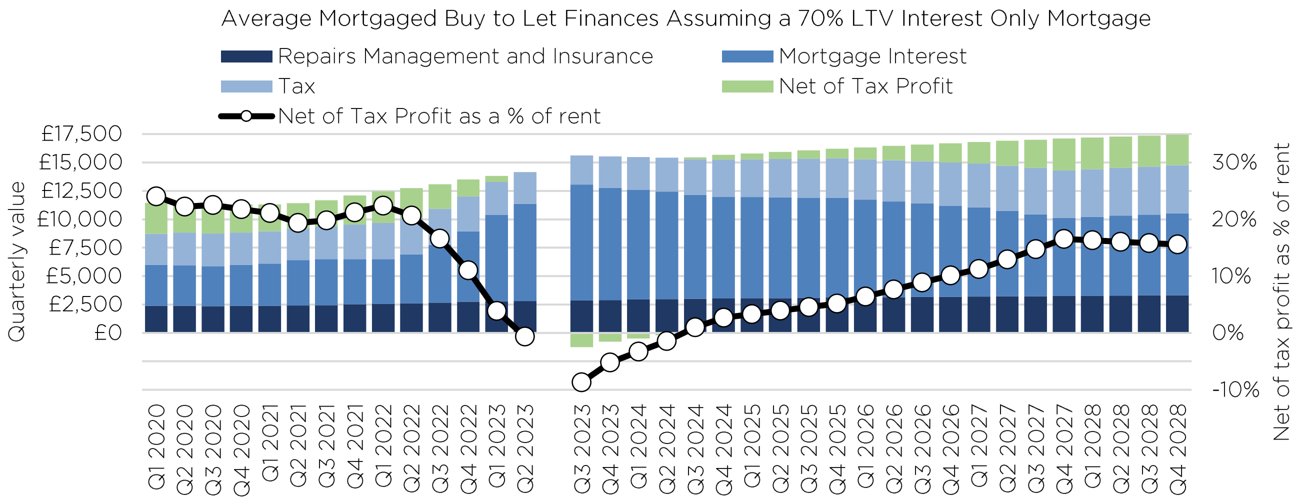
According to our modelling, landlord profitability for a new 70% LTV interest-only mortgage at the end of 2023 remained negative. Even with our forecasted high rental growth, this does not turn positive until the end of 2024 and never reaches the previous levels of profitability of over 20%, peaking instead in 2027 at 16.5%.

Reduced profitability has meant that the first 9 months of 2023 saw an average decline of -4,400 outstanding Buy to Let mortgages per month. If this trend continues in 2024, assuming each is not a sale to another landlord, we could see the sector contract by a further -50,000 properties.

Existing landlords are now much more likely to leave the sector, with the NRLA 2023 survey showing 20% of respondents selling in the previous 12 months, up from c.15% in 2020 and 2021. This looks set to continue, at least in the short term, as far more landlords intend to sell property in the next 12 months (43%) than buy (10%). The exodus will place increasing strain on markets already grappling with a supply-demand imbalance.

In recent years we have seen an increasing consolidation of the rented sector, with larger portfolios in fewer, more professional hands. These are replacing the homes held by smaller and sometimes highly leveraged investors. The proposed Renters Reform Bill will amplify this trend in 2024 due to the increased requirements for landlords. Institutional operators will be in a much stronger position to act on these potential changes.

Figure 3 Landlord profitability for new buy to let supply will remain muted



Source: Savills Research

Long-term tailwinds will keep demand for rental properties high over the next decade

The UK is not building enough new homes to meet long-term demand. If the Government is to reach its 300,000 homes a year target, the Private Rented Sector (PRS) will need to play a key role. Based on existing tenure distributions, 60,000 homes per year will need to be delivered for private rent.

Government data suggests the PRS has remained broadly static since 2016. This stagnation, combined with the need to replace homes lost from the Buy to Let sector, means a pressing need to find new sources of private rent delivery.

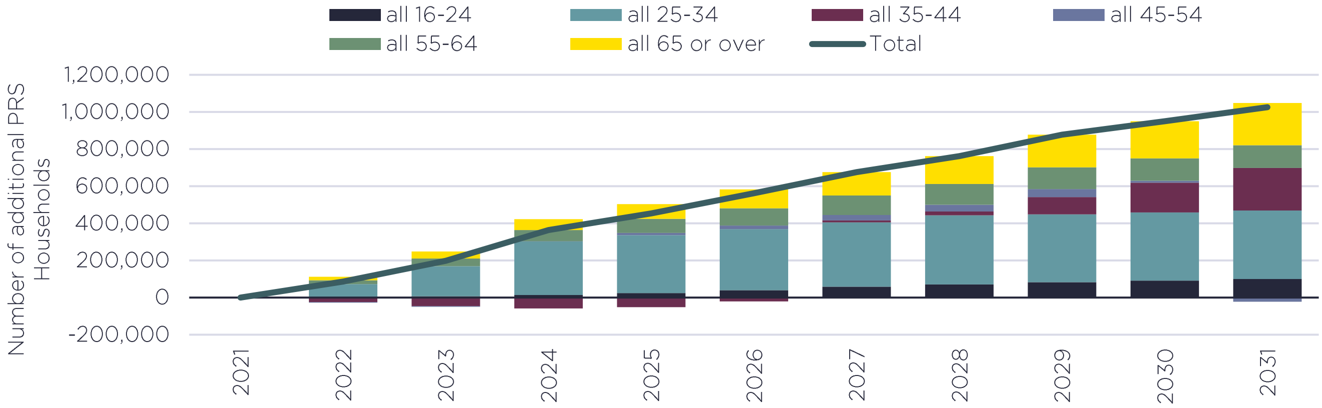
And PRS demand will continue to grow. Using data from the English Housing Survey and the ONS we project an additional 1 million PRS households by 2031, a similar numeric increase as was seen between the 2011 and 2021 Censuses (c. 1.1 million).

The greatest increase will be in 25-34 year olds, with an extra 370,000 households over the next decade, as more struggle to get onto the housing ladder in a post Help to Buy world and so must remain in rental accommodation for longer.

A larger proportion of 16-24 year olds will also rent between 2021 and 2031 as we expect to see greater participation rates in higher education. There is substantial overlap between these age groups and those who are most likely to live in Build to Rent developments. According to Savills 'Who Lives in Build to Rent' database, half of households living in Build to Rent are aged between 18 and 35.

Demand is also being bolstered by high levels of immigration. The ONS recently revised up net migration figures for 2022 to 745,000, far above the pre-pandemic figure of 184,000 in 2019. The Office for Budget Responsibility (OBR) are now forecasting net migration to be 150,000 higher than previously predicted over the next five years, which will put place further demand on rental stock in the long term.

Figure 4 Over 1 million additional PRS households projected by 2031



Source: Savills Research using English Housing Survey, ONS

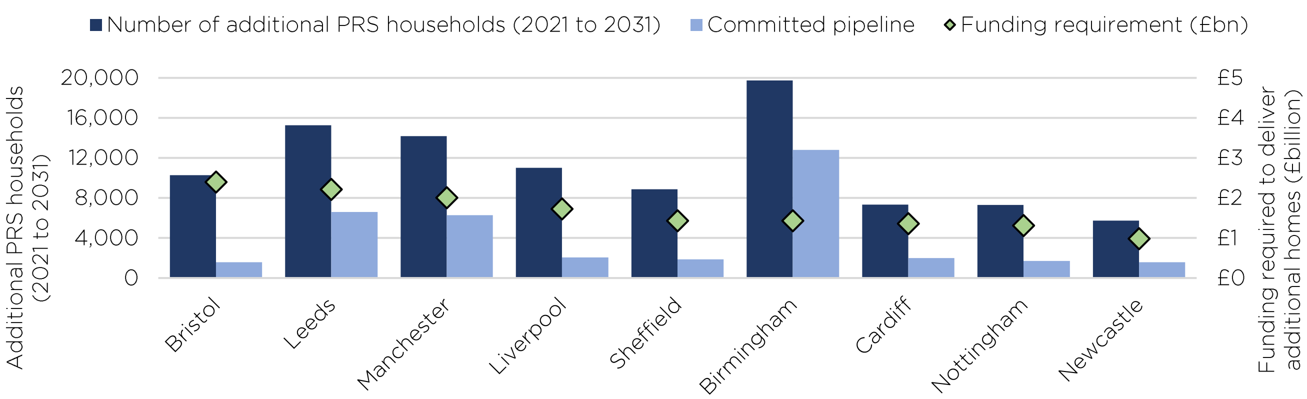
Demand and the financial requirements to meet it differ by geography

Over a third of demand (35%) is projected to come from urban markets, based on the existing distribution of the PRS. London is the region with the greatest projected increase in demand, as the capital continues to act as a focal point for the UK economy. An additional 210,000 PRS households are projected in London by 2031, which will require significant further investment far beyond the 40,000 BtR homes in its existing planning pipeline.

Core cities can also expect substantial increases to demand, which will require large-scale investment of at least £15 billion. Bristol has the greatest discrepancy between projected growth in PRS households and its committed BtR pipeline (consented units plus those under construction). An estimated £2.4 billion is required to boost its current pipeline of just 1,500 homes, the smallest out of the core cities, to meet demand. This is followed by Leeds and Manchester both with funding requirements of over £2 billion.

These projections may also be underestimates, as they are based on current distributions of the PRS and Government household projections. There is potential upside should a city deploy a housing-led strategy for economic development, as has been the case in cities such as Manchester and Leeds.

Figure 5 Core cities require significant funding to meet projected demand



Source: Savills Research using HMLR, ONS, Census, EHS

London and the core cities will dominate the supply pipeline over the next five years

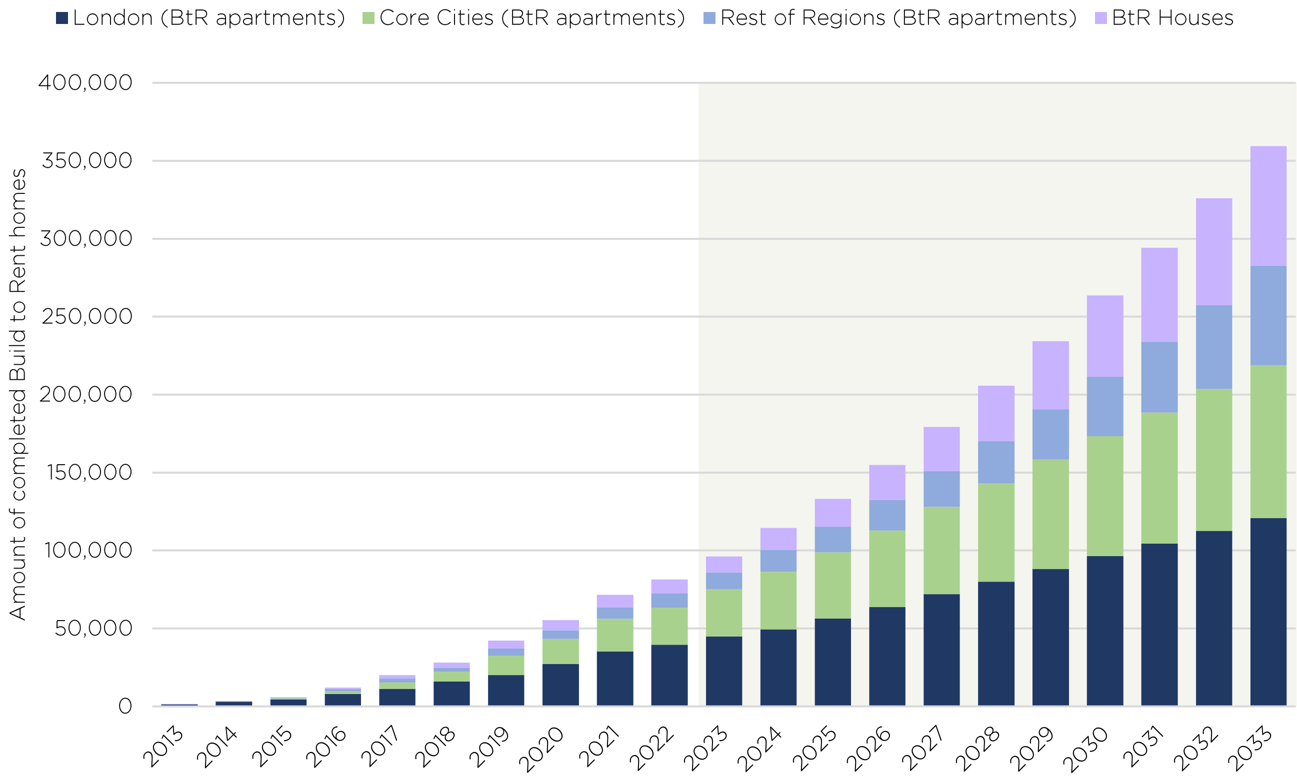
The demand figure of 1 million extra PRS homes far outweighs the 360,000 long-term supply of BtR homes we project to be completed by the end of the next ten-year period. This is calculated through the short-term planning pipeline (2023-2025) and projected growth rates for the years 2026 to 2033.

Over the next five years, London and the core cities are expected to provide the majority of completions (62%). The capital in particular benefits from a strong pipeline of BtR homes under construction that will provide 35,000 homes by 2028. However, it also faces future delivery challenges including persistently high land costs and longer planning journeys.

In core cities, the supply of potential sites is greater than the capital, making financial viability easier to stack up. Planning environments are often more favourable as well. BtR can also help accelerate the delivery of larger-scale masterplans. Mixed-tenure developments provide additional sources of capital and spread risk more broadly.

Because of this, core cities are set to deliver 33,000 new BtR homes by 2028, or around 6,500 new homes a year. Eventually, these cities will also reach a sustained rate of delivery according to available sites and construction output. This will help promote new opportunities in other locations and types of development.

Figure 6 Number of Build to Rent homes expected to reach 360,000 by 2033



Source: Savills Research using British Property Federation, Molior, DLUHC

Growth in supply will then shift more towards regional cities and Build to Rent Houses

In the second half of the forecast period (2029-2033), more completions will be concentrated in Build to Rent apartments in the rest of UK and Build to Rent houses in suburban locations. By 2033, we expect these locations to provide 55% of new supply compared to just 20% in 2023.

A number of investors have already expanded their portfolios to include locations outside of London and the core cities. Between 2029-3033 we expect completions to grow by 19% year on year in these markets.

Build to Rent Houses are also increasingly appearing on the radar for investors. Our September 2023 Single Family Housing survey showed 80% of investors in the space are targeting portfolios of over 2,500 units with over half (53%) looking to reach their respective targets within the next five years.

Lower private sales rates in the new high interest rate environment has helped accelerate timelines. In 2023 over 5,000 homes were sold by housebuilders to institutional operators. The most notable deal came in November with Vistry signing a landmark partnership agreement with Blackstone-backed PRS provider Leaf Living.

This sector is expected to grow significantly as more and more housebuilders weave it into their business models and form partnerships with investors. Initial deals will take time to orchestrate, but once they are complete further deals can progress quickly, allowing delivery to ramp up. This will help housebuilders supplement their core business with stock that can be delivered at the pace of build rather than sale. It will also provide investors new opportunities to enter the sector.

UK Build to Rent Investment

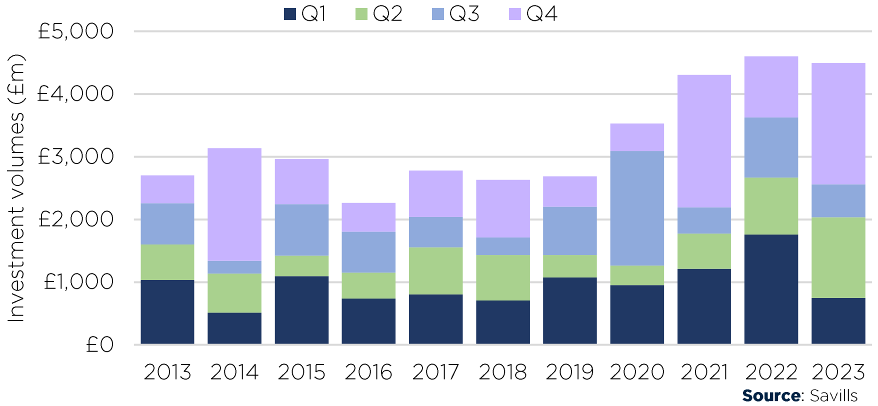
£4.5 billion was invested in 2023, with the majority coming in the final quarter.

Major notable transactions occurring in Q4 2023 include the forward funding of Dandara's Renshaw's Yard, Staines; disposal of part of Quintain's holdings at Wembley to Goldman Sachs / Tene Living, and Leaf Living's commitment to Vistry .

Other annual highlights included the largest single asset transaction - delivered in London between Long Harbour and St George; Aware Super entered the UK BTR market buying Qatari Diar's stake in Get Living and two further single family portfolios changed hands as PGIM purchased the 'Project Domus' portfolio and Citra invested in 604 new homes with Barratt.

Bidding activity remained strong but transactions were slower than in recent years with investors and developers alike grappling with changing macro-economic environments. Notwithstanding this, the commitment to UK BtR and its investment fundamentals remain robust and we expect activity to continue in 2024.

Figure 7 –£4.5 billion invested in 2023, the second highest year on record



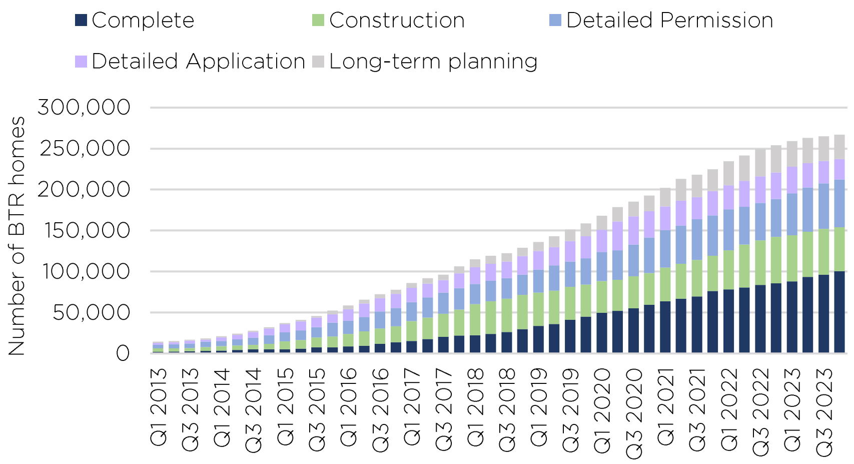
Source: Savills

UK Build to Rent Development

The UK's Build to Rent stock surpassed a significant milestone of over 100,300 completed homes, with a further 53,800 homes under construction. The future pipeline currently stands at 112,800 homes, including those in the pre-application stage. This brings the total size of the sector to 267,000 homes completed or in the potential pipeline.

The latest quarter's data showed a boost to delivery as build cost inflation abated, with 17% more operational stock than Q4 2022. This has meant the number of units under construction has fallen by -5% compared to a year ago as they are completed. However, the number in planning remained static, with the number of detailed applications down -22% compared to Q4 2022. Going forward it will be vital for new applications to replace those moving through the pipeline to maintain adequate future delivery to satisfy high demand.

Figure 8 – Continued Growth in 2023 but applications have fallen



Source: Savills, British Property Federation, Molior

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