BUILD TO RENT

Aligning the stars

Executive summary

The private rental sector has always been with us, for the most part living in the shadow of our cultural obsession with home ownership. Two catalysts in the last quarter century have shifted the market's centre of gravity. First was the fundamental 'pull' factor: the Housing Act of 1988 deregulated rent controls delivering investment and income growth potential for landlords and therefore wider choice for tenants. Second was the shock 'push' factor: the financial crisis of 2007/08 put the brakes on first-time mortgage lending and thus helped to create today's 'Generation Rent'. Add in the growth of buy-to-let and sharp house price increases relative to earnings and the shape of the UK's 10-million tenant strong rental market has significantly changed.

One result is Build to Rent (B2R) - a residential asset class and distinct property sector that offers huge opportunities to developers and investors interested in the medium and long term return. Well established in the US and Europe, B2R as a proven concept is decades old and an accepted 'tenure-for-life' choice that carries none of the latent social stigma still sometimes felt in the UK.

The plain fact is that UK population growth is outstripping our ability to build, with increasing demand creating an inevitable housing shortage. B2R enables developers and investors to address this shortage in volume and capitalise on the opportunity with an attractive lifestyle choice for the rental generation. A lifestyle built around a community of people with shared amenities that provides a fluid mix of residents with freedom and flexibility. In purely commercial terms it's a single product, supported by a range of excitingly tailored value-added services and consumed by like-minded customers.

In this Briefing Paper, we take a look at how we believe B2R can thrive in the UK as an institutional and corporate grade investment that delivers a very British twist on the American and European experience.

Crunching the numbers

52% of tenants surveyed would be prepared to pay either 30% or 40% of their gross annual income on rent[7]

As of November 2016 Manchester had the highest premium rents at 11.4%

with London at 9.2%[6]

The Private Rented Sector in the UK will rise from 5.3m in 2016 to an estimated 6.7m dwellings by 2020[4]

Between 2005-06 and 2015-16, the proportion of households in the private rented sector with children increased from 30% to 36%.[3]

The private rented sector has doubled over the last decade and is now the largest type of tenure in the country behind owner occupation[1]

The UK housing market will need an extra 1.8m rental homes by 2025[5]

62% of younger renters (18-24 year olds) would prefer to pay all amenities within their monthly rental payments[9]

Nearly half of working tenants would be prepared to commute 15-30 minutes (24%) or 30-45 minutes (25%) to work[8]

In 2005-06, 24% of those aged 25-34 lived in the private rented sector

By 2015-16 this had increased to 46%[2]

1-3. English Housing Survey: 2015-2016 / 4. Savills. / 5. RICS / 6. Colliers / 7-9. Knight Frank Tenant Survey: 2015-2016.

Rationale and challenges

Corporate and Institutional investment in the private rental sector is fundamentally attractive because of the current housing supply/demand imbalance in the UK. The figures paint an encouraging picture that the ground for B2R is fertile. Let's explore its topography...

- What makes a migration to B2R within the sector particularly attractive are the inefficiencies, or opportunities, inherent in the way private rental in the UK is currently geared.
- However the market lacks the scalability to tackle a strategic housing shortage and it lacks the scalability in management to offer a compelling and attractive proposition to potential tenants on a mass-market basis.
- The UK market lacks the level of specialist B2R operators that exist in the US and Germany.
- Data from Real Capital Analytics indicates that without such specialist outsourced management, premium B2R rents will have eroded after just five years.

SCALABILITY

The rental market is becoming a structurally bigger part of the residential market and not just among 25 to 35 year olds. 20% of people rent today compared to 10% a decade ago. However HomeLet's 2017 Landlord Survey revealed that just over 93% of UK landlords owned 10 properties or less. Here's the contradiction: many developers currently retain B2R management in-house when it's often a non-core discipline they cannot properly resource.

However that management is the key success factor that demands a specialist third party model able to deliver nationally available economies of scale – deployable rapidly. One only has to look at B2R in mature US and European markets to see how outsourced development management has unlocked the doors to significantly better standards, environments and tenant propositions.

PREMIUM RENTS

'Premium rents' often include premium services like concierge, gyms, pools and spas but naturally, more amenities means higher rent. In the US, premium renters are happy to pay more for the B2R convenience - however this could be a potential cultural barrier in the UK market.

The US rental model is usually all-inclusive. All-inclusive B2R developments do exist in the UK - like Tipi in London – but such an approach raises questions around sustainability that cut across the demand for smart infrastructure that already enables occupants to reduce their carbon footprint. How can the all-inclusive B2R rental model incentivise tenants to preserve energy rather than waste it irresponsibly?

- The natural solution here would appear to be a hybrid; one where B2R managers cherry-pick what's all-inclusive included and what is not.
- For example whereas broadband may be inclusive, energy and water would not, placing the sustainability onus back on the tenant while giving them the built-in smart tools to consume in an ethical manner.

Just over 93% of UK landlords own 10 properties or less

AVAILABILITY

In the UK there is still a lack of suitable accommodation comprising purpose-built 'unbroken' blocks. Currently, not enough are being developed and retained solely for the B2R market, a situation complicated by planning and development that takes up to 48 months before a new-build development is ready.

FINANCIALS

Land availability, land cost, cost to build, demographics and locations will all have a direct impact on the viability and sustainability of any B2R development. In turn they each have a direct impact on the gross-to-net ratio and yield-return on investment. New institutional investors look not only at the medium to long-term capital growth in the capital values of the property but also at their yield/income return – location is key for the latter.

- In the US less attention is paid to the short-term gross to net ratio because investors there are in it for the longer-term and they do not usually have an exit plan. They have a proven model that is built around the long-term.
- Exit strategies are more common in the UK so it remains to be seen whether or not this difference will affect B2R attitudes. Our sense is that over time, B2R investment decisions will take an increasingly long-term view as the benefits manifest themselves.

Renting is both popular and socially accepted in France, Spain, Germany, Holland, Italy and Greece.

CULTURAL DIFFERENCE AND BREXIT

As the maxim goes, 'an Englishman's home is his castle'. The dominant cultural attitude in the UK is one that strives for home ownership, however in most European countries the opposite is true. Renting is both popular and socially accepted far and wide across France, Spain, Germany, Holland, Italy and Greece.

There's also the potential impact of Brexit. With possible changes to the free movement of labour between countries, we could well see more domestic migration as a result and this will have a direct impact on the demand for B2R accommodation. Renters are transient, B2R is flexible and the experience of human nature suggests in such circumstances, people will want the option to upsize or downsize as they see fit.

The hard risks

Manchester is currently the most popular B2R hotspot in the UK outside of London. Although the demand exists in London, the cost of land in the capital has made Manchester and the North more appealing - with the widespread redevelopment of characterful Victorian buildings an added benefit. B2R doesn't discriminate – all the major UK cities are getting involved and the B2R opportunity in each city will need consideration on its own merits, demands and demography.

While B2R has established early roots in the UK, how it scales the promise of the growth opportunity is another matter entirely. The key risks stem from how developments are managed and how the assets perform.

- Not accurately predicting equipment lifecycles to mismanaging major works, upgrades and decoration.
- Failing to justify long-term premium rents if the development is not maintained to a premium standard and ongoing investment is lacking.
- Failing to predict the appropriate rental values over time.
- Out-of-control costs supporting poorly planned amenities.
- Incorrect profiling of the needs, wants and expectations amongst the target demographic
- Cost or utility leakage from the all-inclusive model that could deter investors

Learning from the US and European experience

Nurturing effective B2R developments means building communities and creating a sense of place, not just managing the development at large. B2R across the Atlantic comprises around 25 million homes – equivalent to the UK's entire housing stock. In the US, each B2R development takes on a personality of its own which starts with the targeting and the marketing - then perpetuates itself through the social activities built around it.

- There is typically an allowance built in to the service charge that is exclusively used for events. Local businesses can showcase their products and services at the development. We have already seen this approach integrated into some specialist UK retirement living developments.

- Clearly there's a performance lesson to be learned for the UK and how we can implement similar – but not slavish – programmes that appeal demographically to help underpin premium rents.

B2R in the UK is still in its early years compared to the US and Europe (and Germany in particular) where it is considered the urban norm. Naturally it makes sense to learn from those who have gone before and develop our own best practice code that innovates and can flex with change. We believe the following criteria to be of central importance...

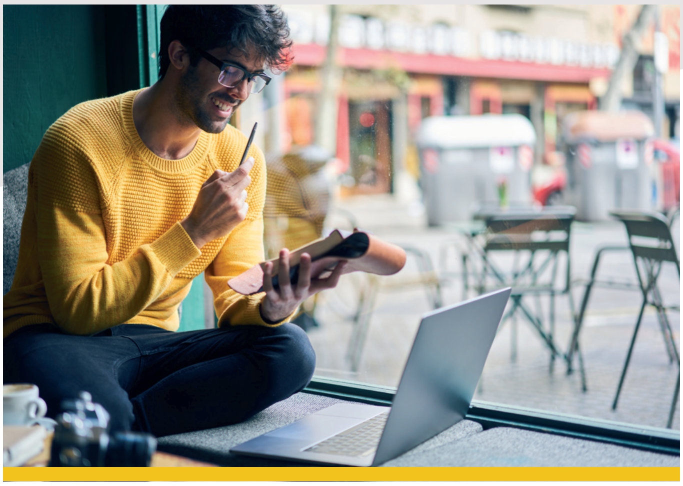
PEOPLE

Modern, plush, technology-laden and well-maintained developments are key aspects of successful B2R. However what breathes life into a successful B2R development is the people who nurture it.

- A dedicated on-site management team delivering excellence in service and amenity but also providing the social glue, activity and appeal that turns an apartment block into a community. In a word: soul.
- Only the right people can deliver this appeal, providing a connection with both external and internal communities.
- Individual personality is also vital; more than just property managers, they are part of the extended family working for investment interests and tenant quality of life.
- Training also has a major part to play. Recognising this, FirstPort have launched the Concierge Academy, a tiered training programme comprising classroom and on-the-job learning that provides all site-based staff with the tools, skills and experience to be able to furnish developments with the unique sense of place – and service – that B2R residents demand.

PREDICTABILITY

American B2R developers classify their assets from grade A to D depending on a number of factors including location, amenities, facilities and services available on site. Each starts at A when new then lifecycles through to D before redevelopment resets status to A. Importantly this grading is embedded and industry-wide. This immediately



makes judgements and decisions easier for potential tenants. We need a similar universal grading system for B2R developments in the UK.

PLANNING

US property management companies are paid for consultancy services that design out faults and design in benefits at the planning stage, helping build-in appeal, flexibility and ease-of-maintenance before the ground is broken. Naturally this is easier in the US with more space and fewer heritage buildings; brownfield refurbishment in the UK demands a more modular approach. UK planning control remains a barrier – sensible planning de-regulation and reform will be key to opening the B2R development taps; however experience dictates this will be a slow process.

SECURITY

Unsurprisingly, hygiene factors such as budget, cost and location are crucial when B2R tenants are deciding where to live, however it's the managed services that make a place feel like home. Apartment living research commissioned by FirstPort in Q4 2015 found that added value services, in particular, on-site security and a concierge, are highly regarded as extras.

No different to our US counterparts, part of the appeal of living in a B2R community is the comfort that comes from the added security of having site-based staff to keep an eye on things. Getting the balance right with residents can reduce churn and encourage longer tenancies.

The package must exceed the value of its individual components

There are six key areas to successful on-the-ground delivery of the B2R development we believe can create strong and sustainable lifestyle brands that keep tenants and investors happy alike.

- **DESIGN:** unique development identities, efficiencies built-in at planning that cut operational cost, create and long term management company relationships that deliver B2R longevity.
- **AMENITIES:** quality drives retention and differentiation that attracts premium rents and helps future-proof the development.
- **SERVICE:** anticipation, predictability, attention to detail and consistency drives tenant experience and memory – as does the judicious use of cross-selling and up-selling.
- **PEOPLE:** visible management that creates community, enhances interaction, understands tenant needs and creates lifestyle appeal.
- **FLEXIBILITY:** universally graded developments that blend the right mix of all-inclusive rents, premium extras and tenant-defined utilities.
- **TECHNOLOGY:** smart metering, keyless entry, app-based fault reporting and ubiquitous super-fast broadband will become the norm in both operation and tenant expectation

Build to Rent is a new residential asset class and distinct property sector that offers huge opportunities to developers and investors. It demands a seamless, end-to-end approach that supports the entire building and the people who live there.

Drawing on our expertise as the UK's premier residential property management group, our Build to Rent proposition for the Private Rented Sector (PRS) delivers an integrated solution that spans skilled consultancy, property management, residential services, tenancy, lettings and asset management.

We are FirstPort

FirstPort is the UK's premier property management group, spanning 180,000 homes across 3,700 developments in the residential, retirement and luxury markets. With a 30-year track record, we offer homebuilders and institutional investors a uniquely scalable combination of residential property planning and management that blends national reach with a local, personal touch.

Join our conversation

If you would like to explore more about how to capitalise on the Build to Rent opportunity and deploy expert property and asset management services, then come and talk to us.

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