Real estate investment

Building your scheme's property exposure, brick by brick

In conversation:
Simon Redman | James Walton | Paul Jayasingha | Antony Barker | Sebastian Cheek

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Homing in on growth through PRS

Institutional investors have long-seen the merit of investing in bricks and mortar, but this has predominantly been through commercial rather than residential property. The need for hands-on management and the reputational risks involved has left many investors keeping their distance.

After years in the wilderness, however, it seems residential property, particularly the private rented sector (PRS), is beginning to generate quite a buzz among the institutional community. PRS has seen a spate of fund launches in the last year as investors search for alternative forms of fixed income to better match their long-term liabilities and a greater variety in traditional real estate portfolios.

According to data from IPD, capital growth for UK residential real estate between 2000 and 2013 was 6.7%, compared to 0.9% for all commercial real estate. Furthermore, last year the PRS in England outgrew the social rented housing sector for the first time. UK real estate market data from the English Housing Survey revealed some four million people in England lived in PRS accommodation compared to 3.7 million in social rented housing – a record high and twice as many as in 2000.

Meanwhile, institutions have steadily increased their investment in residential property over the past four years from £7.6bn in 2011 to £12.7bn in 2015. This may seem a drop in the ocean compared to the £204bn of total real estate assets under management, but it illustrates the growing appetite among investors.

At present, residential is just 4% of the UK IPD index – far lower than for other parts of Europe and the US – and less than 5% of UK PRS property is currently owned by institutions. Until recently then, opportunities to enter this sector were few and far between. However, many believe with the ratio of renting to ownership steadily increasing there is a growing demand for PRS stock which the chronic shortage of housing in the UK is just not meeting. As a result, advocates believe there is no question there will be a wealth of attractive opportunities for investors to access the sector in the coming years.

This roundtable sees a panel of asset owners, managers and consultants discuss investing in PRS, including why its popularity has soared, where the opportunities are, and how it is set to grow as a subset of the property asset class.

Sebastian Cheek
deputy editor, *portfolio institutional*

Northern Sold: real estate in the regions

With London and the south-east largely overpriced, property investors are looking elsewhere and helping to create a Northern Powerhouse in the process. *Lynn Strongin Dodds* look at the UK's Big Six and beyond.

Although more than a few eyebrows were raised when George Osborne launched his "Northern Powerhouse" concept two years ago, commercial property investors have been won over. The same goes for Birmingham, Glasgow and other regional cities which are also in the throes of redevelopment and gentrification. Their main benefits are more attractive and affordable opportunities than the favourite hotspots in London and southeast.

These views are reflected in trade group RICS' 2015 fourth quarter report which showed that 81% of respondents believed central London commercial property had become overpriced, up from 77% in the third quarter. Prime yields in the capital city hit their lowest levels in 2015 with the City averaging around 4% and rents between £60 to £66 per square foot (psf). Those in the popular West End were hovering around 3.25% to 3.5% with rents at about £120 psf. Although many industry analysts do not expect yields to further compress, they all agree that rental growth will have to be the main driver of investment.

MORE FOR YOUR MONEY

By contrast, yields in the "Big Six" – Manchester, Leeds, Bristol, Birmingham, Glasgow and Edinburgh – are between 5% and 5.5%. Rents are also expected to continue their upward climb. Looking at particular buildings in these cities such as the 21-storey Manchester One, rents rose to £21.50 last year from £16.50 in 2014, while the 18-storey Castlemead Bristol has seen a 65% hike to £25 psf in the same time frame, according to Chris Ireland, UK chairman and lead director of capital markets at Jones Lang Lasalle (JLL). Birmingham and Leeds have also enjoyed increases of 20% to 25% for the same type of quality buildings in the central business district.

"There are definitely pockets of fully-priced assets in London and the south east, but I think investment will continue – although selectively," says Chris Perkins, head of business space at M&G Real Estate. "It is a one-sided equation though, because rental growth will be the main factor whereas in the regions, particularly the Northern Powerhouse, it is a two-sided equation – rental growth because of limited supply as well as better returns."

The benefits of living or relocating to the Big Six or the Northern Powerhouse (Manchester, Leeds, Liverpool, Sheffield, Newcastle and Hull) have been well-documented. They not only offer a lower cost of living, rents and staffing but also growing populations and a well-educated workforce. As Perkins points out, construction costs are also less, which means it is feasible to develop a building with the same specifications as in London and generate a return as rents are at £30 psf rather than £60 or £120.

FRIENDLY LOCALS

Equally as important, business executives and local councils have seized the opportunity to promote their strengths and push productivity with growth strategies that align skills, local transport and economic renewal. In some quarters, they are also working more closely together to ensure that national and local initiatives are not just talk, but are translated into material developments. For example, earlier this year, business leaders launched a CBI-backed lobby group called Business North to drive the Northern Powerhouse agenda. One of the first items on its list is to certify that the so-called HS3, the new high-speed east-west rail line, remains a top governmental priority. The multi-billion pound transport plan would see journey times

> **While all markets are currently experiencing degrees of volatility and uncertainty, assets such as real estate and infrastructure have been less impacted upon than stocks and currencies.**

Chris Ireland, JLL

between the north's big cities halved to match those in the south-east.

Against this backdrop, activity has been booming, especially in the office market. The latest report from JLL shows that 2015 was a record year for the sector with volumes in the Big Six hitting £2.76bn, up 17% over the previous year. In total, there were 11 deals over £50m and five deals of £100m and above.

Global investors, particularly from Germany, Singapore, the US and Middle East, featured prominently in the second half, comprising 61% of the purchases and 81% of office deals currently under offer.

Looking more closely, some cities such as Manchester, which was first to receive 'City Deal' funding and regional devolution and Birmingham, are benefiting more than others. The latter accounted for £789m worth of volumes with headline office deals last year including Legal & General's acquisition of a 50% in MediaCityUK and Singaporean REIT Mapletree's purchase of 3 Hardman Street from Aerium Finance for £205m. Also on the list were Deutsche Asset & Wealth's forward funding of 2 St Peter's Square for £100m and M&G's purchase of 3 Hardman Square in Spinningfields from Credit Suisse at a 5.79% yield.

Birmingham saw £712m traded, with the most notable transactions being Ashby Capital's acquisition of Colmore Plaza for £138.3m and Legal & General buying 1 Colmore Square for £87.3m. Over the past few years, the city has reinvented itself as a tech and services hub and is also gaining attention due its infrastructure facelift. The project has seen the refurbishment of New Street station, the extension of the tram line and the forthcoming HS2 high speed railway link to London which would cut the journey time down to around 50 minutes from the current 84 minutes.

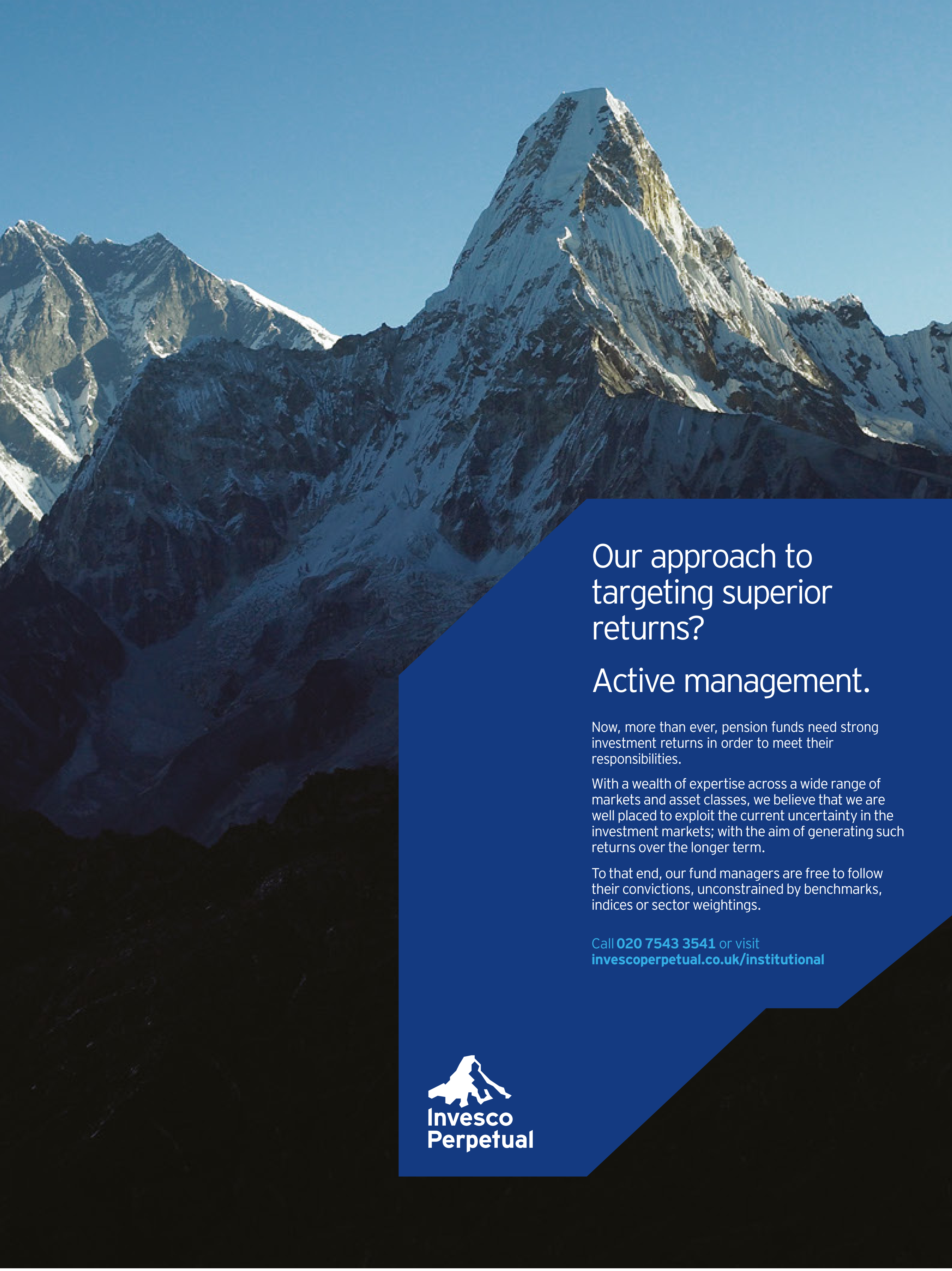
TIDYING UP

A report by CBRE – Core Cities, Core Strengths – shows that Glasgow ranks as the top Scottish city and third highest in the UK outside of London in attracting commercial property investment over the last decade. It has pulled in £5.27bn while neighbour Edinburgh was fourth on the list of 12 regional cities analysed in the report at £4.88bn. They came behind Manchester at £8.23bn and Birmingham at £6.56bn.

Looking ahead to this year, refurbishment is expected to remain a big theme across the Big Six. Figures from JLL show that there are schemes totalling 800,000ft^2 to be delivered in 2016, with a further 10 new schemes of one million ft^2 due to start.

This has resulted in strong rental growth story especially in the secondary office market and given the solid outlook for demand and tight supply, the firm expects headline rental growth across the UK to average 2.7% per annum over the period 2016-19.

Secondary assets or those outside the regional city centres also look poised for repositioning especially as there is a shortage of grade-A properties. "A huge gap between prime and secondary across all sector types opened up after 2008 and although this has narrowed it is still double from the pre-downturn," says Andrew Marston, research director at CBRE. "We have seen demand and there are opportunities in cities such as Leeds to asset manage these properties and do a return play in areas that have not been re-gentrified."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NOT JUST OFFICE SPACE

Although the office market is expected to dominate, other fund managers believe there are better opportunities in the logistic, industrial and student housing sectors.

"We think the office sector could be challenging in that if you are paying 5% yields, you will not get that much growth off £30 psf," says Andrew Friend, director of institutional business for investment management company, TH Real Estate.

"We believe there is better value in student housing, which is yielding 5.5% and 6% especially in cities such as Manchester, Leeds, Glasgow, Durham and Exeter which have top local universities. We also believe logistics is a big growth area because quality properties are yielding around 5% due to the increased demand for online shopping."

Thomas Müller, managing director and portfolio manager within Blackrock's European real estate team also sees good prospects in student housing due to its counter-cyclical nature. "You have to look carefully though at which universities are strong performers and those that have underperformed before making an investment in a particular city. "We also like the light industrial sector because of strong supply and demand imbalances in some select sub-markets."

Although market participants remain optimistic about the regions, there is no doubt that the possibility of Brexit is casting a cloud. The vote is scheduled to take place later this year and as with the Scottish referendum, the uncertainty is causing investors to adopt a wait and see attitude. Investment activity has not stalled but it has definitely slowed down and tenets are less inclined to commit to big letting particularly in London.

LONG TERM OUTLOOK

"While all markets are currently experiencing degrees of volatility and uncertainty, assets such as real estate and infrastructure have been less-impacted upon than stocks and currencies," says JLL's Ireland.

The forthcoming Brexit referendum is currently top of the agenda. For some investors it will be business as usual, while others will be more circumspect about making big decisions ahead of the vote. But many remain optimistic. "The property fundamentals of the UK market are strong and there is a positive outlook for long-term real estate investment," Ireland adds.

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Simon Redman

"We need to bridge the gap between the environment today, where in large cities the average age of housing stock is very old and was never really fit for purpose, to high quality built-to-rent accommodation." Simon Redman

I saw a study at the end of 2015 that showed only 4% of UK institutional property holdings were in residential, compared to about 22% in the US, and 44% in the Netherlands. Meanwhile, a different set of data predicted that institutional investment would reach £50bn by 2020. So what makes the private rented sector a compelling investment opportunity and why are we so far behind other countries?

Simon Redman: We're an active investor in PRS – or multi-family, depending on what you want to call it. We're active not only in the UK, but also in Germany and have been managing residential investments in the US for over 30 years, where it has grown from approximately 2% of the institutional market in the early 1980s to over 25% today. The drivers that caused such growth in the US are probably stronger in the UK today, so it could grow more quickly here.

What were those drivers?

Redman: Pension funds in the UK did historically invest in residential, but rent control regulations, particularly in the 1970s, resulted in reduced allocations. While controls were removed in the Thatcher era, it has taken until recently for the investment environment to become attractive to institutions in the UK. An under-supply of accommodation, a growing population, the growth in demand for rental versus ownership are all catalysts to institutionalise the sector.

Antony Barker: The crucial point is there's been both a cultural and a market shift in the UK and there is now an investible opportunity, which wasn't previously available. In much of continental Europe – and to a lesser extent, the US – people have habitually rented, perhaps as it was a much more transitory population, perhaps because they preferred apartment living to having their own piece of land to build a castle on. The next generation coming through is renting cars, houses, etc. and is not looking to acquire stores of wealth any longer – which is slightly ironic in an almost zero inflation environment.

This creates an opportunity set that wasn't previously available in the UK, but why would a pension fund want to do it now? Pension funds have been looking at the residential sector for decades, but it was the reputational risk of managing the portfolio that put them off. Having the responsibility, on one hand, for providing benefits and welfare to your own pensioners, but then throwing the proverbial Mrs Miggins out on the street for not paying her own rent seems a little incongruous. So, people steered clear of it.

They then looked at mortgage-backed securities as an indirect play as it has a natural inflation and longevity hedge to it. Now the opportunity set – or at least the theory of the opportunity set – has developed. That said, what you want to invest in and can invest in hasn't quite reached the point of perfect harmony.

Redman: We need to bridge the gap between the environment today, where in large cities the average age of housing stock is very old – from the 1940s and 1950s – and was never really fit for purpose as it was converted from original dwellings like terraced houses, to high quality built-to-rent accommodation. We are now at that stage where the overall supply of the investible income-producing stock simply doesn't exist and the only way it will occur is for it to be created. The size of the sector is bigger than all the commercial sectors put together – it's enormous, but it is dominated by individual landlords rather than well-managed, institutionally-owned blocks of purpose-built rental flats.


Paul Jayasingha

Barker: Especially if you realise that the actual universe is a lot wider than most people's original definition. Student housing comes into this, as does social housing. Even some of the sort of 'Staycity'-style apartment living; wherever somebody's looking to rent accommodation for more than one night and is looking for a kitchenette and a range of TV channels.

James Walton: It is interesting watching the sector move from theory to practice. Reputational risk would always shut the conversation down, but there are so many new funds and institutional players, it is now well bedded in. You can have a proper conversation, and find ways to mitigate that risk.

Redman: There's a good precedent for how this works in the US and Canada, and while there will be nuances in the UK, they're not that different. Institutional investors don't need to think it's a huge leap of faith, because you can see the model works well.

Paul Jayasingha: Part of the compelling attraction is the fit within a broader real estate portfolio, as it has typically had a low correlation and acted differently from some other property sectors. In the US, it has been reasonably defensive, so the distinction between the 'for sale' residential market and the rental market is quite important. In the downturn, a lot of people were renting because the idea of buying a house was impossible because they couldn't get a mortgage. And in an environment where property prices were falling, they were happy to rent. So rental levels were quite defensive and in the context of income stability, that is incredibly attractive. If you have an office building and you lose a tenant, there's potentially a big gap in your income if you include the rent-free period. In a residential property, you can manage the lease at a much more granular level, and that leads to a much more defensive income profile. There's obviously an issue of getting institutional quality stock, but there's an element of first-mover advantage here and we think PRS will become more acceptable, as it has in other countries.

When do you see this happening?

Redman: It is happening now, but we're just at the beginning. The number of institutions who are now active, or saying they are actively moving into the space, is still relatively small compared to the size of the residential rental sector, which is valued at approximately £1.1trn. The major insurance companies in the UK will be investing significantly and some major UK and global pension funds are already doing it. We're at the stage between investment to create the product and having, at scale, institutionally-owned properties for people to actually live in.

Jayasingha: It's attractive now, and some of our clients are investing into 'built-to-rent' strategies. PRS could come into its own in a weak market environment and investors see the defensive qualities. Offices are far more cyclical than most property sectors, but residential should hold up reasonably well. It may well take a period of market weakness for investors to really see the merits of PRS relative to other sectors.

Redman: There's a lot of capital being invested, and in three or five years' time, you will see a marked difference to this sector in the UK.

It will need that track record.

Walton: There will be a tracking error right off the bat. Once you get to a certain size you can tolerate a tracking error. When it becomes 10%, 15%, whatever that might be, you won't be able to get away without having exposure to that, or having a very good reason not to be invested there.

Barker: Pension funds have decided to either not hold real estate or reduce their real estate exposures in recent decades, so the available size of the investing cake has reduced and you have to compete against other real estate sectors. The fact that it's a more scalable or sizeable opportunity due to your available capital, might be a way to get pension funds back into this space in the way they wouldn't, say, for £5m, £10m or £50m lot sizes on single office buildings.


Antony Barker

Jayasingha: It isn't just about when it becomes more acceptable to investors, but when it becomes more acceptable to tenants, as well. The professionalisation of the landlord system has massively improved under PRS compared to the current system, where you've got mom-and-pop outfits renting out, where the average landlord is aged 50-something and has a single property. The raising of the service standard in PRS could result in more people wanting to rent and it could take the multi-family approach in the US, where it's just so much easier and customer-


James Walton

"Reputational risk would always shut the conversation down, but there are so many new funds and institutional players, it is now well bedded in. You can have a proper conversation and find ways to mitigate that risk." James Walton

friendly for somebody to renew a lease or a query is dealt with electronically. I can see that improving the overall demand.

Redman: In the UK, a leading indicator is what's happened in student housing, which sets a precedent for former students wanting to live in places that are professionally-managed in the same way that they experienced as students. Rather than getting on the housing ladder many millennials want to pay for services rather than necessarily own assets, but with that comes a level of expectation in terms of service and quality.

Barker: People no longer see geographical boundaries and that's a reason why they don't necessarily want to be tied into any sort of asset purchase, because they have no idea how long it's going to last. Working patterns have changed and people change jobs far more frequently. Family units are also changing in size and dynamic due to divorce and co-habiting rates, starting families later, laws allowing for multiple occupancy, and so you're catering for a different population and their housing needs now. Somebody

who has been living in good student accommodation will naturally consider a similar property elsewhere. I think you're going to see a lot of blurring of units – are these one-year student accommodation or multi-year residential types? For the institution, it will always come down to the return opportunity and real estate looks very attractive compared with other markets. That is going to encourage people at least to review the sector. The challenge is whether pension funds feel they need to invest for income rather than total return. You often find a lot of the perceived IRR is on the basis that, in 10 years' time, you're going to get a great exit value, fuelled by a belief that London house prices will rise in perpetuity.

Redman: It raises a slightly different question in terms of valuations, and the view we have is that you shouldn't be looking at valuing the PRS sector based on the vacant possession value of individual units. It should be on the same basis you value a commercial office, retail, or anything else.

Antony, can you tell us about your relationship with PRS as an investor?

Barker: We've been doing student housing for a few years now and playing the debt side for sev-

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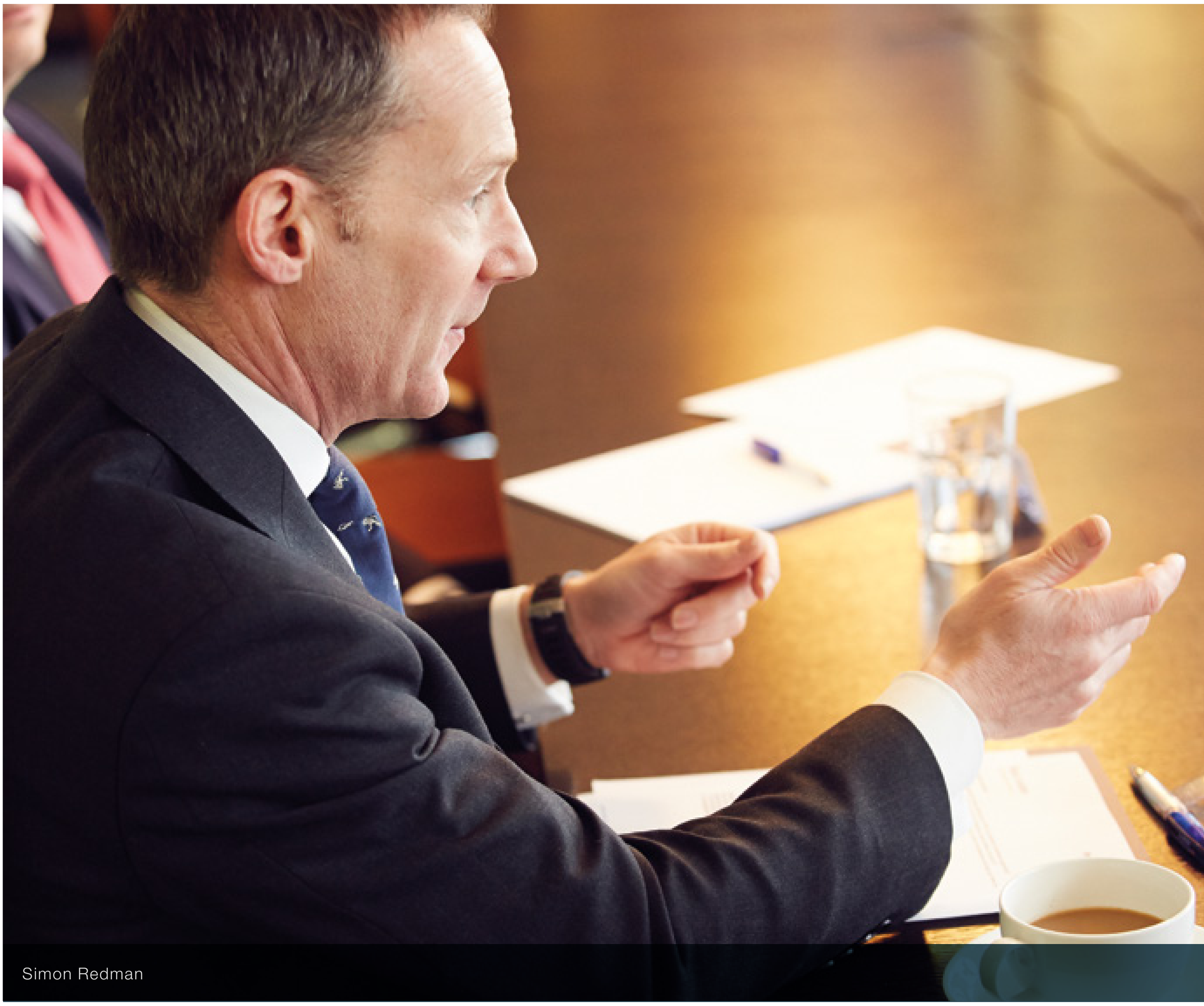
eral years as well. The purer play residential is something that we've not looked at explicitly – or at least not invested in explicitly – though we have a number of developments, such as our owning most of Woolwich High Street, and there's a lot of residential that comes with that. We also have a number of estate propositions around the country where residential is a consequence of the totality of the investment. Many of the pure, new PRS things have been very much about creating a professional community in the 'location of tomorrow' and have designed two-bedroom flats specifically for two who are not necessarily related or in a relationship, but professionals sharing with equal rights. And


Simon Redman

“Over the medium and long term, increased urbanisation will result in demand in many major cities. It comes down to the economics of a particular location as to whether it represents a good investment.” *Simon Redman*

they’re going to want gym facilities, a concierge and the like. They don’t necessarily need car parking spaces, but they might want a bike engineer on site, because of their new green lifestyle standards. The marketing brochure looks great, then you go to the site and ask why anybody would want to live there? This is the problem with regeneration – there seems to be pressure on the pension fund industry to put up the capital to fund it – and while Canary Wharf may look very impressive today, it went bust first. So I’m not convinced that early stage development is the first step for many. Getting into development capital, let alone residential development – that’s quite a large leap from a set of institutional investors that historically have done some fairly mainstream and dull office and retail investments.

Redman: Unless the fundamentals work in terms of providing accommodation in the right place to suit people’s needs. You need to have demonstrable demand and in locations where there are proper communications.

Jayasingha: The fundamentals matter and you need expert managers that know what they're doing on the development side. A lot of the development can be underpinned by contracts, but there are risks that you need skilled managers to oversee. Getting the location fundamentals right, such as job growth, population growth, transport nodes, etc. is critical. Another critical point, though, is that to do this well, you need to minimise the cost of collecting rent and ongoing operations in order to get the best end result for the client. To do that you need institutional-quality stock, and that doesn't really exist in size today, so you have to be creating that stock to be a first mover.

Where are the opportunities in the UK?

Barker: Asking the asset managers, that's a London-focused question. Or else it's Manchester versus the rest – which is usually my starting point.

Redman: You can look at it as short term and long term. Over the medium and long term, and this applies globally, increased urbanisation will result in demand in many major cities. It comes down to the economics of a particular location as to whether it represents a good investment.

Jayasingha: All of the big cities, long term, could be of interest as the key is population growth, job growth, and the demographic profile within that. The cost of land within central London might not support PRS, but there could be one or two nodes that really fit very well on the outskirts. We've been looking at assets and invested our clients' assets into structures that are on the outskirts of London, into Manchester and one in Birmingham at the moment.

James, do you have a view on the geography of the UK?

Walton: Certainly big cities, but it is very much asset-specific. There's been a big change in the construction costs. London has always had a premium associated with it, but you're getting much better construction costs, particularly for soft costs, in northern England, Scotland and Wales. We have clients who have gone into a large West London project, which they bought into directly. In a very short time, it has become a much more mature place for an institutional investor. But I wouldn't limit it to be a London or Manchester-only play.

Antony Barker

Are there opportunities in other European countries? Will UK pension funds look at PRS outside the UK?

Barker: Not really. It's still an emerging concept. Once UK pension funds get more comfortable with this proposition and it becomes accepted as the norm, then they will follow the same mechanics as they've done with every other asset class and diversify.

Jayasingha: It's rare for our UK pension clients to invest in a specific overseas PRS strategy. A very small minority of our clients have looked at specialist multi-family or residential strategies in the US and Japan. But it it is easier to invest in residential in the US as it is a big part of the US universe. A typical US core fund might have 25% or so in residential.

Redman: Investing in Germany and the Netherlands is a different proposition to the UK, but it is an institutional investment sector. The US and Canada are probably the best comparisons to where the UK could get to, because there is a similar rental environment.

Are pension funds using this as a fixed income alternative? Is it to generate cashflows and match liabilities?

Jayasingha: We don't encourage our clients to think of this as kind of a liability proxy. You can make an argument that the rental progression from residential has given you a reasonable match to inflation over the long haul but, in essence, they're short-term rental contracts so your contractual income can't give you the same comfort as fixed income. A long-let commercial property with a 25-year let to an investment grade tenant could give you more comfort over that contractual income stream. So while we haven't been placing PRS in that quasi-liability proxy bucket, we would consider long-let commercial property. PRS represents a different set of risks, and many strategies do offer quite attractive pricing for the risk that you're taking.

Redman: We're seeing both, but by far the majority fall into the property allocation. We haven't seen it actively yet, but we have seen it being considered as a liability-matching allocation.

How do investors address development and reputational risks? What's the secret to running good real estate?

Redman: There's no secret. You need the right teams and experience as you don't want to be learning at the investors' expense. If you are having to construct buildings, then first of all, there may be planning risk, though you can acquire sites with planning. That's a risk which for a lot of investors is a step too far, so removing planning as a risk is key for some investors. Then, from a construction cost perspective, we typically use fixed-price contracts, and have a lot of control to remove the potential for costs to exceed expectations.

Jayasingha: Stabilising the incomes is essentially leasing out the building, which is an important part of the de-risking. Good managers in this space are able to brand their building quite early on in the whole development to get a buzz going, to appeal to the 20 to 35 year olds, or whatever demographic the building's aimed at. That's often done using the internet, social media and other channels to rent your property. Branding is a skill set in itself.

Redman: Yes, and it's largely uncorrelated to commercial property. However, there are similar aspects to investing in hotels which apply to the residential space as well. It is about distribution and getting your message out there to your consumer, and there are a lot of property managers or real estate investors who have never had to do that. You need a different mind-set as your audience is different and you need to be able to interact with that audience – today's renters.

James Walton

Walton: There is also manager risk, especially while the sector is growing. Not so much from an execution risk point of view, but you don't want them learning at the expense of the investor. And there aren't many 'off-the-shelf' PRS managers floating about. As time goes on, you'll find more people with that skillset. You might import some of them from somewhere, but then they won't have the UK experience. Alternatively, they'll have some commercial fund management experience, but not residential. Otherwise, all those other risks are similar to commercial.

Barker: This is clearly not a sector for everybody. If the rest of your portfolio is all passive management

Paul Jayasingha and Antony Barker

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and treasury stocks, then this is not suitable, because it definitely needs active management. Likewise, if you feel you need a lot of liquidity in your portfolio, then you need to see it as a seven-years-or-more project, which may render it unsuitable.

Walton: Technology is already changing the way you can invest in this space. I was on a website only yesterday called Property Partner, which is a way of syndicating out ownership in individual properties. First, they start out with smaller properties, then they get blocks, and so forth. It's not big – around £25m – but what's interesting is that it has people in there who are ex-Granger, RBS, who are institutional people on this platform and it's backed by crowdfunding. The technology allows you to trade units and individual residential properties in the UK and it's quite a slick process.

We discussed technology but what else can we expect over the next five years?

Barker: The number of rented units – relative to owned units – will increase. Look at the number of £1m


Simon Redman and James Walton

"Technology is already changing the way you can invest in this space. I was on a website only yesterday which is a way of syndicating out ownership in individual properties and it's backed by crowdfunding." James Walton

properties that are supposedly being built in London and then start doing the maths – if you had to do a 5% interest rate stress test on the mortgage, what would be the cost of purely servicing the mortgage? There would have to be a whole population earning £300,000 a year just to pay the debt, let alone rates, furnishing it, etc. With the shift in compensation patterns in financial services, I don't see that this population exists and every developer cannot sell to the same universe of overseas buyers. This is not only a financial, but a cultural thing. People are coming into rented accommodation when a student or perhaps in their first jobs. The quality of that housing stock has improved and service expectations have risen. It becomes a much more natural transition into a rented space for your first home. Coupled with people wanting mobility, and not be tied to any one particular location or lifestyle, then it could mean it's your second and fifth home too.

So how do you maximise your returns?

Barker: There's no clear consensus as to whether it is new build, a retro-fit of existing houses or taking a portfolio from 100 separate landlords and then creating a business model around it. This is because you can only invest in the opportunities that are available today, which aren't necessarily the ones you would use if you went back to the drawing board and started afresh.

The insurance sector is increasingly switching away from fixed income into real estate and overseas investors appear to have a much lower cost of capital, or total return requirement, compared with pension funds in deficit, which means that there's always a risk that prime prices get bid up.

Jayasingha: We're positive on the outlook, as it's got attractive top-down tailwinds from urbanisation, population growth, the younger professionals finding it harder to get mortgages, or actually just not wanting to commit themselves to large mortgages.

The general demand for increased professionalisation in this space should lead to a positive outlook. Office rents are volatile. The average office rent probably still hasn't beaten its position in the 1990s, whereas the rental growth proposition for residential tends to be far more attractive. Implementation is going to be more difficult. We do think the build-to-rent, or retro-fitting and then hold-to-rent is a good place to be, in the sense that you need scale. You need to minimise that gross-to-net yield spread.

Barker: Plus, you've got to have housing stock in a place where people have established that's where they want to live for reasons other than cost – it's all about the experience.

Jayasingha: Yes, you've some element of proof there and in that context, we think it has a positive role to play in portfolios. So if you think about the opportunity set, actually, residential is not a bad place to be in terms of the tailwinds that it's got supporting it over the next 20 years.

Redman: It's such a large sector already, so having it more professionally-managed, and arguably better value, if nothing else, could mean it cannibalises the individual landlord market. You don't necessarily need the sector to grow for this to be a success. If you're providing what is better accommodation, at a similar price, people will vote with their feet.

Paul Jayasingha

UK residential investment

By John German, senior director – residential investments, Invesco Real Estate

The UK residential market is made up of a diverse universe of sub-sectors. However, we believe the UK Private Rented Sector (PRS), a sub-sector with an estimated value of £1.16tn[1], is one which currently offers potentially attractive opportunities for institutions.

Residential markets are typically impacted by two variables: population growth and the supply of new homes. Today, the UK is facing a demand and supply imbalance in its housing market. Demand for housing is under pressure with an increasing population, which is one of the highest in the EU, and with house prices rising, (the average house price being £198,000[2]), owner occupation has become less affordable, making many people turn to the rental market. Coupled with the fact that about 100,000 too few houses are being built annually across the UK, this suggests that the UK is potentially facing a 1.1m housing deficit by 2020, if supply isn't increased from current levels.

We believe the current opportunity lies in developing intelligently-designed rental accommodation, which will be professionally managed and seeks to meet the needs of this growing population who need to rent. From an investment perspective, the sector potentially offers the opportunity to match liabilities, through income streams, which provide a correlation to inflation; potential diversification within multi-asset portfolios; as well as the potential for total return, all attributes important to institutions.

Lessons from the US

An integral part of the opportunity is to provide modern rental accommodation for the next generation, which is in low supply. Research shows that 48% of the current PRS housing stock in the UK was built before 1945, with only 18% built in the last 25 years[3]. There is therefore an opportunity to kick-start a process that began in the US some 30 years ago and which has grown into that country's huge multifamily sector of today.

In considering the UK PRS as an asset class, an initial comparison with the multi-family rental market in the US, which is now a well established institutional investment class, provides a useful guide. We analysed the UK IPD Residential Index ("UK Index") and the US NCREIF Index ("US Index"), which measure the market value of institutionally owned residential investments in these respective countries. In 1982 the UK Index amounted to £15.6m and the US Index was £88.4m. However, by 2014, the UK market had grown to £5.8bn, whilst the US market had increased to £62.2bn.

The US Index has remained at or around ten times larger than the UK Index over this timeframe. Given that the US population is circa five times that of the UK, the UK Index is significantly under represented. This suggests that there is an opportunity for institutions to increase their exposure to the UK residential sector. A further factor to consider is the historic performance of the UK Index. Analysis of the UK and US indices shows that from 1982 to 2014, the UK Index had average returns of 13.9% per annum, whilst over the same period the US Index has delivered 9.5% per annum. Over this period, the UK outperformed the US in 22 of the 33 years[4].

And performance against other real estate sectors?

An investment in residential is an investment not only into a property market that is recognised globally, but also into a strategic market sector, which has been less volatile than other more 'traditional' real estate[5]. UK residential has been a long-term outperformer against traditional commercial real estate in the UK (office, retail) and has outperformed gilts and the IPD All UK Property Index over all periods measured and UK equities over longer periods (5/10/15 years) (see Figure 1).

Figure 1: UK residential – A long-term out performer

Sources: IPD, Macrobond and IRE as of December 2014. latest available data. Total return, annualised, in sterling. Core and Value Fund data from INREV. Past performance is not a guide to future returns

Size of the UK PRS market

Relative to the IPD All UK Property Index, the UK PRS market is materially larger. The estimated value of the PRS is about £1.16tn compared to £187bn in the IPD All Property Index[6]. The bulk of this market is held by private investors who have a small number of units, typically on a buy-to-let basis. Based on the 2015 Investment Property Forum (IPF) survey of 47 UK institutional investors, 38 of the investors owned a total of £15.4bn in the UK PRS with an average holding value of circa £428m at the time of the survey in May 2015.

Why consider the UK PRS market?

Our research shows that despite rented residential being the fastest growing tenure and has historically been the highest performing real estate asset class in the UK (see Figure 1), today under 5% of the UK PRS is owned by institutions[7]. We believe this provides potentially attractive opportunities for institutional investors as it has the potential to act as a diversifier in a balanced real estate or mixed-use portfolio due to: its track record as the best performing, largest UK real estate sector; its low correlation with other UK real estate sectors[8]; the current supply not meeting housing demand, creating an increasing under supply; UK population growth being one of the highest in the EU, creating demand; demand for rental product increasing; historic relative stability of income and capital values (see Figure 1); and its development potential.

We believe that the demand and supply imbalance present in today's UK housing market has the potential to lead to positive outperformance and, as such, provides an opportunity for investment. UK residential, however, does require in our view, specialist expertise to access and assess opportunities that have the potential to deliver attractive returns over the longer term.

Invesco Perpetual

Sources: 1 Department for Communities and Local Government (DCLG), June 2015. Latest available data. 2 Nationwide, January 2016. 3 English Housing Survey Headline Report 2013/14. 4 IPD/NCREIF, July 2015. Total returns in sterling. 5 IPD, 20 years to end of 2013. Latest data available. 6 DCLG, IPD, Savills, IRE as of June 2015. 7 2016 ARLA, DCLG, July 2015. 8 Total return: IPD and Datastream, 14 years to December 2014. Latest available data.

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