Investing in Build-to-Rent

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Why location, rental growth and affordability should be front of mind when investing in build to rent.

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Introduction

In 2020, the Covid crisis created a major systemic shock that has had a lasting effect on the UK economy and initially led to a recession that lasted for two quarters. The recession saw unusually high and rapid increases in unemployment and GDP contracted by almost a fifth in the second quarter of 2020.

One surprising benefactor of the Covid recession was the UK housing sector, partly due to pent-up demand post lockdown, but also changing patterns of working, with suburban locations and single-family housing the main recipient of this demand as home seekers chased space. For renters in particular, the evolution to hybrid working increased appetite for suburban homes as opposed to the multifamily market and opened up new regional rental markets for single family housing. As a result, house prices increased dramatically, and rents increased by approximately 10% per annum from 2020 onwards.

> "There are two competing forces currently influencing the UK rental market: demand for rental homes; and the Bank of England's battle with inflation and its impact on interest – and thus mortgage – rates."

The UK Rental Market

Looking ahead, the UK housing market faces economic headwinds from a cost-of-living crisis fuelled by high inflation and rising interest rates. This is impacting the ability and confidence of buyers to commit to new house purchases and therefore likely fuelling increased demand for rental homes.

There are two competing forces currently influencing the UK rental market. The first is the rise in demand for rental homes set against a simultaneous reduction in the supply of privately rented housing. Private landlords face either needing to increase rents to offset higher interest rates when refinancing – impacting tenants – or they may need to sell up. The second is the Bank of England's battle with inflation and its impact on interest – and thus mortgage – rates. Our view is that with rising mortgage rates impacting affordability and post GFC regulation sensibly limiting riskier lending, the proportion of people continuing to rent will rise and home ownership decline. This presents an opportunity to both professionalise and improve the quality of the rental market through an institutional single family housing rental model.

Factors Affecting Build-to-Rent

We believe there are three significant factors that investors should consider when investing in build-to-rent ('BTR'): location, rental growth and affordability.

In terms of location, we believe investors should focus on areas which have indicators of sustained pricing power to generate returns which are at least in line with inflation. This is generally going to favour locations where there is, for example, expected growth in the economy or population which will influence demand for housing. The areas of the UK we are currently focusing on are from Nottingham to Brighton on the North-South axis, and from Ashford to Bristol on the East-West axis. Within that diamond, there are a number of suburban sites close to large employment centres, which currently do not have a strong rental offering but which we believe are attractive to, and have the amenities to, meet the needs of family households. With respect to **affordability**, this is a consideration we overlay across all our sites: the ability of local median earners to afford to rent a property, especially considering the increasing costs such as energy.

In the short term, the shortfall in supply of rental homes relative to growing demand is outweighing any potential drag on values caused by an increase in the cost-of-living. However, looking to the future, investors must consider the combined rental and energy costs to futureproof assets against an affordability squeeze which could otherwise limit headroom for rental growth.

The BTR sector has a major opportunity to make a huge difference when it comes to climate change: zero carbon. The green agenda is something the BTR sector needs to approach head-on: it doesn't need to wait for the introduction of regulation and policy. Instead, players in the sector can – and should – push ahead of the traditional housebuilding sector to support the zero-carbon agenda. This responsible approach to investment in housing aligns environmental, social and financial interests and underpins the long-term asset value for investors.

At Man Group, we believe BTR should start with a focus on operational carbon – that is, carbon released from the ongoing operation of a building through heating, ventilation and lighting, for example. Once there is a clearer view of the implications from a cost and returns perspective, the focus can then move to embedded carbon, which is carbon emitted during the actual construction process. This will affect how buildings are designed and procured and introduces considerations around modern methods of construction – all of which has the potential to be accretive to returns, particularly for a rental model.

Conclusion

Overall, investors are looking for an opportunity to invest in an asset class that demonstrates the ability to deliver inflation linked returns whilst delivering social and environmental returns. We believe build-to-rent is one of the few remaining assets that can deliver on all these fronts.

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