

# Residential Build to Rent Q&A

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<sup>1</sup> MSCI Quarterly Index Reference Table to Q3 2020

Peter Lowe (Manager of the BMO UK Housing Fund) addresses a number of questions we hear being asked by UK Pension Funds who may be considering an investment into the UK Residential Property Market. With the uncertainty associated with COVID-19, does the asset class still have a strong investment and social case for potential investors?

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### How has the residential Build to Rent (BTR) market been impacted, from an investment perspective?

- The sustainability of income has heightened interest from investors. The BTR market in the UK has high levels of occupancy (+90%), and rent collection (c. 95%), and delivered more stable and positive rental growth over recent history than the real estate market as a whole.<sup>1</sup> Latest Quarterly MSCI data shows residential assets out-performing 'All-Property' over 1, 3, 5 and 10 years in terms of total returns.<sup>1</sup>
- Evidence suggests that this is down to a combination of the occupier characteristics (demand is inelastic due to housing being a necessity, therefore rent is prioritised) but also professionalised management behaviours in the institutional BTR sector.
- Net initial yields for operational BTR stock have compressed slightly in 2020, both across London and in the higher-yielding regional markets. Prime regional yields are at c4.5% but are reported to be trending stronger.

### Key Risks

Past performance is not a guide to future performance. The value of investments and any income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

The value of directly held property reflects the opinion of valuers and is reviewed periodically. These assets can also be illiquid and significant or persistent redemptions may require the manager to sell properties at a lower market value adversely affecting the value of your investment.

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The pandemic has affected rental growth this year, but independent forecaster PMA is predicting a return to positive rental growth in 2021, with total returns to be consistently positive on annual basis to average more than 7% pa over the next 5 years (CBRE).<sup>2</sup>

## 2 What is the shape of the Residential Build to Rent Market, and where are the various entry points for Pension Funds?

- We continue to see home ownership out of reach for many, with persistent pressures on affordability. There is a growing recognition of the depth of demand and an unserved need from low to middle income households. In addition to younger professionals, the typical rental occupier is now older, often has a family, and remains in rental accommodation for longer.
- As such, the residential sector is evolving and there are now multiple strategies available to UK Investors, ranging from premium to mid-market BTR but there are also social and supported housing strategies. All tenures are recognised as important and BTR is increasingly a staple of large-scale regeneration masterplans where mixed tenure is favoured as a key part of the delivery mechanism.
- There is space for all of these strategies, many of which are entirely complementary, although differences in risk and return and hold periods do exist. The majority of products within the market offer reduced liquidity, being closed or semi open ended, primarily on account of the relative illiquidity of the asset class, in part due to the development lead in required for construction.

## 3 Can you explain the definitions of both “Affordable” Housing and “affordable” Housing?

- All forms of affordable housing are there to ‘meet the needs of those who needs are not met by the market’. This need is

met by the provision of rental or for sale housing at sub-market pricing levels and eligibility criteria is used to award a tenancy. There is a marked difference in the approach to leasing structures, Affordable Housing is let on a long lease to a Registered Provider (RP) with all operational considerations the responsibility of the RP. affordable housing will be directly let (where the landlord grants multiple short leases to the individual occupiers directly).

- ‘Affordable Housing’ with a capital ‘A’ is also known as Traditional Affordable Housing or Social Housing. It encompasses all forms of sub-market rent or sub-market sales housing, but must be operated by a Regulated Provider. With fixed delivery costs and reduced end value (a result of the discounted price or rent), subsidies are provided by government for Affordable Housing to be built. Further subsidy is provided to the household to support rent payment. Due to the subsidy, Affordable Housing must be operated by a RP to enable the government to retain visibility on the use of its subsidy. Rents are typically at a 40% to market.
- ‘affordable Housing’ with a little ‘a’ is also known as Discounted Market Rent or Affordable Private Rent. It is a tenure designed to support the delivery of affordable housing without the burden to government. Rents must be sub-market (at least 20% discount to market) and delivered as part of a Build to Rent scheme. With the operation of sub-market rent without the delivery subsidy, an appreciation of burden rates on the occupier and long-term sustainability of the income should be taken into

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Market yields for prime institutional stock have remained stable at c.4.5%, though trending slightly stronger for prime regional assets.

<sup>2</sup> CBRE United Kingdom Multifamily Investment, Q4 2020



consideration. The merits of affordable housing are the low volatility income streams and the ability for an owner to retaining control over the management of that income.

#### 4 From an investment thesis perspective, what return profiles may be expected against other real assets and maybe more interesting, within residential funds specifically?

- There is a desire for diversification into real estate markets with increased structural and policy support. Residential has a lower correlation with other property sectors. As opposed to being viewed as an alternative to traditional real estate exposure we see it as complimentary.
- Total returns have traditionally lent on both yield and rental growth, which has tracked incomes, therefore offering attraction to those with matching adjustment portfolios. For those with greater risk appetite the sector has also been able to offer capital led returns via the development market (although most institutions favour a funding arrangement based upon a fixed price construction contract with a financially robust development partner, therein delivering a J curve, infrastructure style return). Once stabilised, operational schemes present access to a 'proxy' for long dated income.

- Such approaches raise observations around counterparty and funding risk, management control, reputational and depreciation risk. However, the 7%pa expected total returns from the sector<sup>2</sup>, led by c.2-3% pa of income, look relatively attractive in an era of low yields, and continued uncertainty in the stock market<sup>3</sup>. Exposure to long term BTR incorporating affordable rents offers further positive social impact through direct Environment, Social and Governance touchpoints.

#### 5 In your experience, how have landlords reacted to tenants who have missed rental payments, due to financial difficulties?

- Working with reliable, experienced and accountable operational partners clearly aligned to the product is important as is prioritising communication, transparency and strong governance.
- Process is important, but interactions with occupiers in financial difficulty do not have to be prescribed. The key is flexibility. The use of repayment plans for example is relatively commonplace, on-site debt advisory & counsel is something that can be employed, rent holidays are also relatively common. Education, for example in recommending intermediate housing products if they are better suited to an occupier's needs is also part of the toolkit for better assisting the customer base. Eviction is always a last resort.

<sup>2</sup> CBRE United Kingdom Multifamily Investment, Q4 2020

<sup>3</sup> Property Market Analysis LLP, UK Service – National Forecasts, Winter 2020

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