Market Insight

BTR AND CO-LIVING

EXPLORING REAL ESTATE OPPORTUNITIES

In June 2023 ASK hosted a roundtable discussion forum for key players in BTR and co-living real estate, including developers, operators, funders and valuers. The group debated current appetite and opportunities in the sector and also its future shape and growth potential. The following is a summary of what was discussed.

RESILIENCE & GROWTH

What recent effects have we seen on the real estate fundamentals of this sector?

The current market has proven challenging. The effects of rising inflation and interest rates have filtered into real estate returns. We have seen yield adjustments and a slowdown in investment activity.

The build-to-sell market has been impacted by rising mortgage costs, the end of HTB and general loss of confidence, but the BTR and student sectors have proven to be remarkably resilient over the last 6-9 months. Yields on BTR have softened, but only by around 25bps. Whilst there is likely to be further movement following the recent base rate increase, this remains modest compared to other sectors and strong rental growth has so far offset the softening of yields. This has largely been due to an acute supply / demand imbalance. A number of drivers for this were given:

- Significant numbers of buy-to-let landlords have left the market, resulting in around 350,000 net redemptions in the private buy-to-let sector since 2016. BTR delivery has not met this shortfall.
- 100,000 proposed new homes have been stalled in London alone due to planning, construction and legislative issues.
- House prices have gone up 70% in the last ten years but rental prices have only gone up 22% compared to wage growth of 24%, therefore renting has become much more affordable.
- A societal change has occurred and people are happier to rent long term now, or have no other option.
- Recent statistics published by JLL state that 500,000 new homes for rent are needed based on projected population increase.
- In the UK currently 19% of people are in private rental accommodation, compared to 30%+ in Europe and the US.
- Rental growth of 8.2% in the UK in 2023 (10.2% in London). It is forecast that 2023-27 will see compounded rental growth of 18.3%.
- Weight of capital targeting the sector - £183bn has been invested into MFH across Europe since 2020.

"BTR has been one of the best performing sectors in the last 6-9 months"

"It is predicted that between 2023-27 we will see 18.3% rental growth"

AFFORDABILITY

How do you measure rental growth?

All agreed that the main measure is affordability which is already starting to bite. However, many felt we were just starting to see an adjustment in people's choices. Some are now having to look at cheaper areas or otherwise downsize and choose a one bed instead of a two bed for example, in order to be able to stay in the same area.

Rental reforms are coming in the next 18 months or so, meaning it will become very difficult to charge the rents needed to cover costs. Raising rents too much will make the industry targets for rent control measures.

"Regulations are hindering our ability to deliver new homes and break the supply demand imbalance."

Amory Tower, Canary Wharf where 133 units were acquired by a US fund for BTR, co-financed by ASK and OakNorth Bank.

LOCATIONS

Which locations hold the greatest potential for the sector?

Developers are having to charge higher rents and target the premium market in order to cover increased costs and make a scheme viable. London has almost become too expensive for this reason. Some felt that with build costs at £225-£235 per sqft, anywhere outside the big six cities is just not really viable. Sheffield was cited as an example where developers are restricted because the local market can't keep up with the higher rents required to create a sufficiently profitable scheme.

A lot of new regulations are hindering developers' abilities to deliver new homes; second stair cores were cited as a key example. This is only exacerbating the supply issue, as what does get built will attract a major premium from investors. The supply issue will only be resolved .by reintroducing government supply targets, accelerating planning reforms and abolishing the proposed rent controls.

FINANCE

What are the key aspects for underwriting in today's market?

All agreed that leverage points are dropping. With interest costs rising, this is putting more pressure on ICR covenants and hence making leverage lower. Increased finance costs are making forward purchasing stock more attractive. There is no shortage of money, viability is the problem. A yield below base is hard to justify. There are fewer LPs in the market as it is hard for them to get traction without a real offering; they need scale to deliver the homes to attract investment. Underwriting is tougher when the exit yield is softer, therefore rental growth remains a key assumption to make appraisals stack up. Some are finding it harder to finance nearer term projects, for example buildings at practical completion but with no units sold, or sites at the planning stage that require development finance.

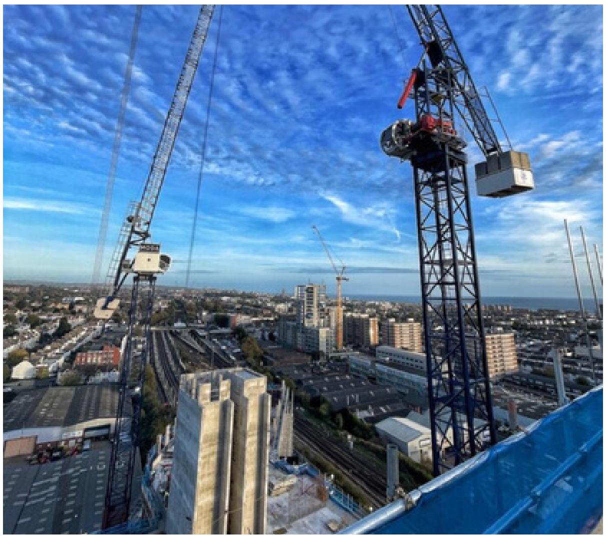
ESG CREDENTIALS

How important are ESG credentials?
All agreed that legislation is pushing the environmental factors and there is a desire to future proof builds. It is also attractive for grants. Customers don't usually ask for environmental benefits but do expect it. However, if it reduces or covers their energy costs dramatically then that becomes attractive.

One developer/operator was aiming to create zero cost homes in the SFH model. They said it would not improve the yield, or have any underwriting benefit, but they hoped it would increase the longer-term value of the properties.

In one scenario a company got overseas funding very much off the back of their ESG credentials. Another company has won a sustainability award for a number of years in a row and said that it does help their brand identity.

"Amenities are key to developing a social community which in turn improves retention rates."



Moda Living's Hove Central scheme, under construction. The acquisition of the site was funded by a co-loan between ASK and partner OakNorth Bank.

AMENITIES

What value do amenities add to the project?
All agreed it is hard to quantify the value to a project. Gyms for example are always used and considered a baseline amenity, yet cinema rooms require effort to attract use, such as organised pizza and movie nights. This can help fulfil the social aspect of ESG if it involves the local community. One company shared how they have started charitable initiatives whereby tenants donate a small amount to charity.

At the top end of the market, amenities are very 'instagrammable' which does drive lettings. One company has seen overseas customers sign up for apartments based on TikTok videos by influencers living in their buildings.

All felt amenities can be key to creating a community which is in turn critical to retention. One company said it uses a digital app to link up residents. This has been very effective for creating groups for runners and dog walkers. A few organised events then solidify the social interaction and once people have developed a social network they are much less likely to leave.

Co-working spaces have also been very successful for some and have provided another way for tenants to collaborate with each other.

One delegate pointed out that tenants do like to feel that they are getting value out of every sqft of space in a building so it's key to make spaces flexible so they can be well-used. For example a yoga studio in the day can be an event space in the evening.

Everyone agreed that buildings need to work well in the local community, and it is worth investing in the public realm. This is even more critical in peripheral areas where schemes might be only around 100 homes.

SINGLE-FAMILY HOUSING

The group discussed that single-family housing has advantages over multi-family. It is an uncomplicated model, with no staff, no cladding, no lifts, stair cores, gyms or other amenities. This creates much lower operating costs per sqm. Tenancies are longer and the churn is lower, as families are less likely to move away from schools and their local community. Rents are lower too, which therefore creates a wider market.

However, buying land is hard. House builders are the gatekeepers to land in the UK. It is key to develop relationships with the right people but ultimately no one can compete on build costs. There was a hope that house builders would start to see that bulk selling units to BTR operators would de-risk their exit but at the moment they are too concerned with the impact on their profit margins and share prices which really drive board behaviour. One delegate thought that once their landbank started to dry up they would be even less likely to sell off properties in bulk as they would be building less.

It was asked how much of a premium can we expect the SFH market to achieve on top of BTL. Multi-family schemes were said to achieve a 10-20% premium on BTL, and single-family products see a 10-12% premium on BTL. Yet it was considered hard to achieve these premium rents in single-family products on day one, as you are not selling a shiny new product. But all agreed loyalty would develop and tenants would start to recognise benefits such as maintenance and customer service.

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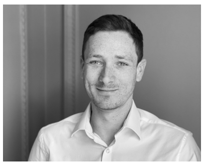

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"There is a lack of education in the UK around co-living."

CO-LIVING

Co-living was considered a very specific offering for certain locations despite being essentially studio-led BTR. Some thought it was always going to be a niche market.

However, as flat shares don't really exist in the way that they did some thought co-living could replace that. The all-in costs are a very attractive package for young people not used to budgeting but it is difficult to balance the dynamic between the very transient and the longer term renters.

All agreed that there is a lack of education around co-living. Investors position it in the gap between BTR and student accommodation. Local authorities tend to think it is an excuse to cram as many people as possible into a small space and as a way to get PBSA schemes through the back door. The term co-living is in fact not helpful, and because there are no ASTs, it gets compared to student accommodation. The fact that PBSA schemes are achieving planning approval while co-living schemes, which cannot accept students, are being rejected is challenging.

Germany was cited as an example where the co-living model works well and creates a strong community that is not transient or considered a stop gap.

Due to the higher density within co-living developments it was mooted that it could be a better financial proposition at the moment. But, all agreed it is much harder to get planning and buy-in for co-living schemes. Liverpool for example has put a blanket no on any further units because it had previously consented to 9000 units in one small area of the city which were sold for very over-inflated prices to overseas investors.

All agreed there are many operational hurdles but it will continue to evolve and be fine tuned.