Build to rent

Foundations for progress

BARCLAYS

Introduction

In the fifth article in our Home Truths series, we ask our Real Estate team: has Build to Rent finally arrived in the UK?

Availability and affordability remain stubborn barriers for those seeking to enter the UK housing market, but one factor at least is shifting: the range of tenure options. The market has recently widened to offer broader choice than ever before.

Build to Rent is rapidly establishing itself as one of those options. Recent figures from the British Property Federation[1] show a 31% rise in available units over a year, albeit from a very low base.

There are now almost 35,000 completed Build to Rent homes, with a similar number under construction and a further 77,500 with planning permission. Even once all these are completed, Build to Rent will represent only around 0.5% of UK housing stock[2].

Since the sector's potential has been estimated at 1.7m homes,[3] it is clearly still in its infancy. But the model continues to gain traction and support from the Government, which set out Build to Rent guidance in its latest National Planning Policy Framework[4].

Dennis Watson, Head of UK Real Estate

A diverse market

"You might start in student accommodation, switch to co-living or HMO, then move into Build to Rent and later into retirement living. 20s to retirement is a large and varied market to cater for". - Andrew Wainwright

This asset class has huge potential to evolve to meet the needs of a wide range of tenants, says Real Estate Debt Structuring Specialist, Andrew Wainwright: "You might start in student accommodation, switch to co-living or HMO, then move into Build to Rent and later into retirement living. 20s to retirement is a large and varied market to cater for."

A recent analysis by JLL studied seven completed Build to Rent schemes revealed an occupier age range from 18 to 55, challenging perceptions that this asset class is only serving affluent or transient young professionals.

While the idea of a 'rental generation' may be at odds with the UK's historic attitude to home ownership, it offers a variety of options for occupiers at different stages of their lives, as their earnings and lifestyles change.

However, the relative infancy of Build to Rent means there remain scant data available to support consumer demand, says Daran Sahota, Relationship Director. "That poses challenges for investors and valuers when trying to appraise viability of a scheme, and to lenders when reviewing client strategies," he says.

Unlocking the potential of build to rent, Website resource

Service counts

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The schemes, as referenced in the recent JLL study, achieved an average rental premium of 9.3% compared with rental markets in their neighbourhoods. However, while acknowledging this report as a useful starting point, Sahota points out that this figure masks a very wide variation in premia, ranging from 22.9% to minus 6.8%.

Predicting the premium for a new development requires analysis of the types of amenity that will be desirable to the target audience. In some locations this might take the form of private dining space or a swimming pool, but delivering the right customer service is important even in less luxurious developments.

As our recent Home Truths report noted, the US multi-family model is characterised by excellent service. The UK industry is now starting to recognise the importance of customer experience in this asset class, says Andy McDonald, Head of Debt Structuring.

"It's not always about a high-amenity offering that is heavily featured in the marketing of schemes," he adds. Cording Real Estate Group, for example, focuses on the affordable mass market. The business, which recently secured debt facilities from Barclays totalling £40m, has identified regional cities and locations outside Central London where demand for rented accommodation is strong and set to grow.

"While luxury features can be useful to differentiate schemes, the basics of good, reliable customer service, security and sense of community within the buildings will always be critical in determining long-term success," believes McDonald.

In response, the Build to Rent industry is increasingly recruiting from the service industries.

Valuation methodology

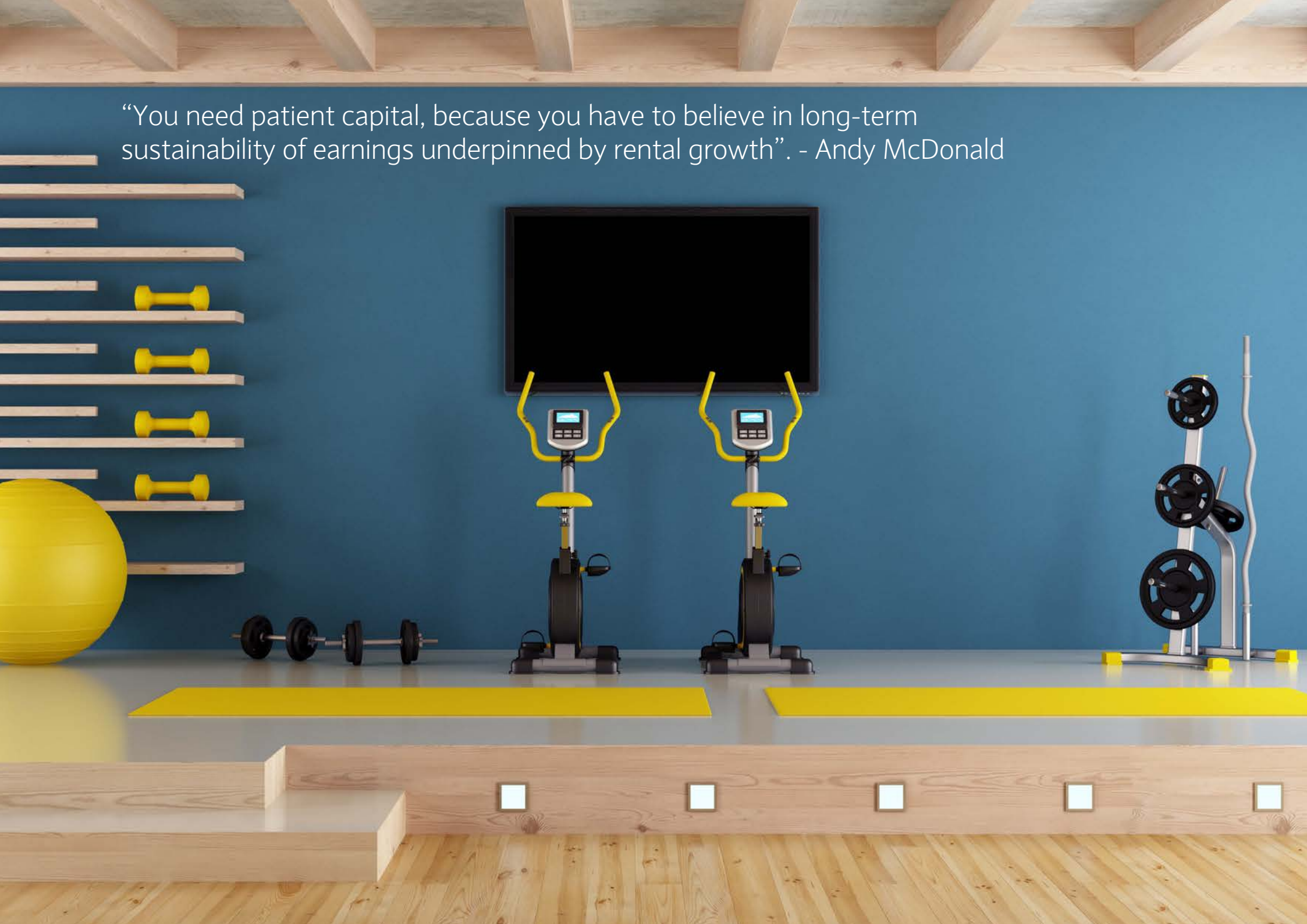
"We want to know that these assets are going to remain competitive in their areas, that they're going to continue to operate successfully and that there are suitable controls around the costs of operating those assets".
- Andy McDonald

Operators who forge a reputation for offering the right levels of service will establish demand for their brands in different locations. In the same way that hotels range from functional two-star accommodation for business travellers to five-star service for luxury tourists, Build to Rent schemes might pitch to their own demographics – and live or die by customer reviews.

This brand value will become increasingly important for lenders and occupiers alike. As with any operational real estate asset class, lenders will be looking for evidence of operational due diligence and asset management capability.

"We want to know that these assets are going to remain competitive in their areas, that they're going to continue to operate successfully and that there are suitable controls around the costs of operating those assets," says McDonald.

Uncertainty surrounding the valuation of Build to Rent assets has been addressed by new RICS guidance. It sets out key valuation considerations, including the security of existing income, potential for rental growth and the likely tenant change and void rates.


“You need patient capital, because you have to believe in long-term sustainability of earnings underpinned by rental growth”. - Andy McDonald

Clawback

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Another factor in valuation is the potential clawback of any affordable housing value, if a development is ultimately sold off for private ownership. In any case, the configuration of purpose-build rental accommodation is not always conducive to sale as individual units.

Government guidance suggests that 20% of Build to Rent properties should be provided as affordable homes – that is, let at a 20% discount on market rent. It suggests that Section 106 agreements include a mechanism to recoup the value if affordable private rent homes are converted to another tenure.

This is likely to make a sell-off impractical from a lender's perspective, says Wainwright. "Lenders should be mindful of this. They need to approach their assessment first and foremost on the basis of an operational business plan developed specifically for the asset – not against an alternative recovery strategy that would entail releasing the units on the open market," he warns.

Patience required

If valuation of Build to Rent schemes is becoming more straightforward, the same is not yet true of stabilisation – the point where a development has reached its core level of occupancy and rental demand is sustainable.

This point is less obvious than for other sectors such as student accommodation, says McDonald, and will vary from scheme to scheme. "It's probably going to take three years to see some of these assets stabilise," he says.

"You can't just assume that when you reach a certain occupancy milestone, you've established your core earnings potential. Much of the earnings potential will only really 'prove through' a few years after core occupancy has been achieved."

Achieving stabilisation requires patience from lenders and borrowers alike, he stresses.

"The word 'patience' really resonates across this asset class – you need patient capital, because you have to believe in long-term sustainability of earnings underpinned by rental growth that will match or exceed inflation and outpace interest rate increases."

Despite the challenges, the barriers to Build to Rent are being lifted. As more occupants and investors see evidence that they can benefit, a tipping-point for the sector may be within reach.

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To find out more, go to www.https://www.barclayscorporate.com/insights/industry-expertise/build-to-rent/

Sources

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