

Build-to-rent

An opportunity for institutional investors to bridge the housing deficit

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Introduction

Low interest on savings and inflated house prices have meant that many in the UK have been unable to climb onto the property ladder. A fifth¹ of the UK population are now living in private rental accommodation, leading to the nickname 'generation rent'.

The build-to-rent (BTR) market aims to increase choice and standards for those in rented accommodation. BTR offers customer-friendly contracts, for professionally managed sites with attractive communal facilities.

BTR presents an interesting opportunity for institutional investors who will be vital to fund the 110,000² BTR units that are currently in planning or under construction in the UK. BTR has the potential to provide an asset with a favorable yield, a long-term income stream, significant collateral backing and well diversified credit risk.

While notable progress has been made in BTR finance in the last few years, the market is still in a relatively early stage in its development. A number of banks and institutional investors have made their debut in the sector, however, it is likely that some of the key longer-term investors have yet to make their first move. Investors have found BTR debt challenging to price due to a lack of track record operational data and as a result, the institutional debt market has yet to gain momentum. Investors that are able to get comfortable with the lack of data may be rewarded by higher risk-adjusted returns.

This paper explores the BTR investment opportunity. It covers:

1. Introduction to BTR – an introduction to BTR as an investment. It considers the risk, rewards and how investors might participate.
2. The BTR market – this section explores the sources of finance to date and draws insight from the student accommodation and U.S. Multi-family housing market, in order to understand how the institutional debt market might develop.
3. Investor considerations – the last section looks at BTR from the point of view of an institutional investor. It considers appetite for both BTR debt and equity, as well as the operational and regulatory challenges.

¹ English Housing Survey Headline Report, 2016-17

² British Property Federation as at Q4 2018

1.1 What is BTR?

For the purpose of this paper, in line with the British Property Federation definition³, we consider BTR to include:

- ▶ **Rental accommodation** – residential units that are built specifically to rent, as opposed to for sale. The rental nature is evident in the design of the property. For example, rental units are made from hard-wearing materials instead of materials that look attractive on sale but wear over time.
- ▶ **Multiple units** – BTR is used to describe sites where multiple residential units are clustered together (usually 50 or more).
- ▶ **New developments** – BTR sites are typically new developments or have been converted from other uses.
- ▶ **Single owner** – usually a single owner owns all of the units on the site.
- ▶ **Professional management** – BTR developments are operated as a business, usually by a professional management company.

BTR developments are designed to be operationally and cost efficient. For example, units often have features such as rubbish shoots and are clustered in a single location, making them easier to clean and maintain.

Investors should assess the ability of the operating business to provide a stable income in excess of costs.

Example BTR income statement

No. of properties	1
No. of units	100
£ Per Unit	
Revenues	
Gross potential rent	10,390
Rent Revenue collected	9,582
Losses to vacancy	629
Collection losses	64
Tenant incentives	116
Other revenue	601
Total revenue	10,183
Operating expenses	
Salaries and personnel	959
Insurance	163
Tax	1,283
Utilities	228
Management costs	281
Administrative	190
Marketing	137
Contract services	273
Maintenance	320
Total operating expenses	3,835
Net operating income	6,348

Note this is an example Income Statement only and has been based on data from the National Apartment Association in relation to BTR-type developments in the United States.

1.2 BTR as an asset

Investment capital will be vital to fund the development and operation of BTR projects. When considering an investment in BTR, investors should base their assessment on the merits of the business as well as the value of the physical development.

The business makes profits from rental income in excess of operating and financing costs. High tenant turnover and long vacancy periods reduce income, therefore BTR developments are designed to attract and retain tenants. In particular:

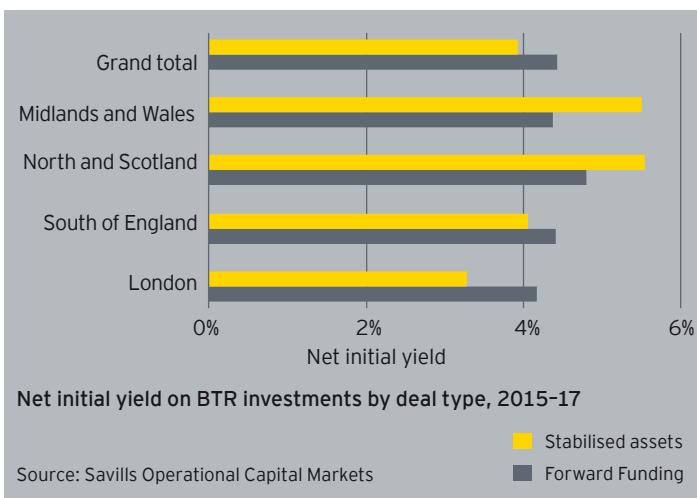
- ▶ **Facilities** – While there is no formal definition, similar to the hotel industry, offerings are often marketed as 3, 4 or 5 star. While 3 star is more basic, a 5 star development may include a concierge, a gym or a cinema.
- ▶ **Customer-focused** – Operators aim to provide a customer-focused service often with an in-house maintenance team, reduced agency fees and longer tenancies on offer.
- ▶ **Community** – Developments often include a communal element (such as a shared dining space or communal roof terrace), which encourage tenants to build networks and establish roots, reducing turnover.

³ BPF paper entitled *Unlocking the Benefits and Potential of Build to Rent* dated 7 February 2017

1.3 Investment rewards

Net initial yields on BTR deals averaged 4.3% from 2015 to 2017.⁴ Over this period, 18,500 units with an aggregate value of £4.1 billion changed hands. Two thirds were forward funding deals (where the yield is based on forecast income), and the remaining were standing stock.

The graph below illustrates the variation in yield across the UK. In general, you would expect the yield on forward funding deals to exceed that on standing stock as investors require compensation for taking the construction risk. The graph illustrates a wide variation in yields on standing stock, with the yield exceeding that available on forward funding deals in some of the more northern areas (although this could be due to issues with quality of some of the standing stock and attaching rental covenants).



While the initial yield may give investors a sense of the income return available, that is only part of the picture. Over the last 15 years capital growth has contributed a further 5.2%⁵ p.a. to total returns on UK BTR assets (however this is based on relatively small portfolio of existing assets).

1.4 Investment risks

Risk exposures can be separated into four main buckets:

- ▶ **Construction risk** – The construction phase considers the design and the physical build. It is capital intensive, subject to regulatory risk and can suffer from time and cost overruns.

While planning permission is also a major factor, the majority of funding agreements are implemented once planning permission has been granted.

- ▶ **Tenant demand** – Macroeconomic and demographic risks impacting the rental market as a whole. For example, the impact of changes in house prices, population growth, wages, government initiatives for first time buyers etc.,
- ▶ **Property and location risks** – Risks specific to the property, both in terms of its value and desirability for tenants. For example, what if the location of the property becomes less desirable or the facilities outdated?
- ▶ **Operational management** – Risks relating to the ability of the operator, including reputational risk and the ability to maintain a high utilization rate while minimizing costs.

1.5 Investment models

BTR caters for a wide variety of investment models. Investors can opt for an equity or debt holding and can take an exposure to the construction and/or operational phase.

Equity – Investors can gain an equity exposure directly, via funds or by purchasing shares of a listed Real Estate Investment Trust (REIT) such as the PRS REIT.⁶

Development phase finance – Investors can choose to invest through the development and operational cycle. Under this model investors provide upfront funding to cover the costs of the site, the construction and initial operational costs. In return investors receive a fixed (if debt finance) income stream that typically starts once the development is operational and return of capital (at eventual sale).

Forward funding – Investors can take a capped exposure to the construction phase through a forward funding arrangement. Typically, the investor pays for the build up to a set amount and commits to buying the development at an agreed price, once it has reached a critical stage.

Take-out funding – Those investors less familiar with construction phase risks can opt to provide take-out funding whereby, the investor only provides funding once the build is passed a critical phase (allowing the developer to 'take out' its initial capital).

In general, the earlier in the development cycle that an investor invests, the higher the potential for returns but the larger the risk.

⁴ Savills Operational Capital Markets

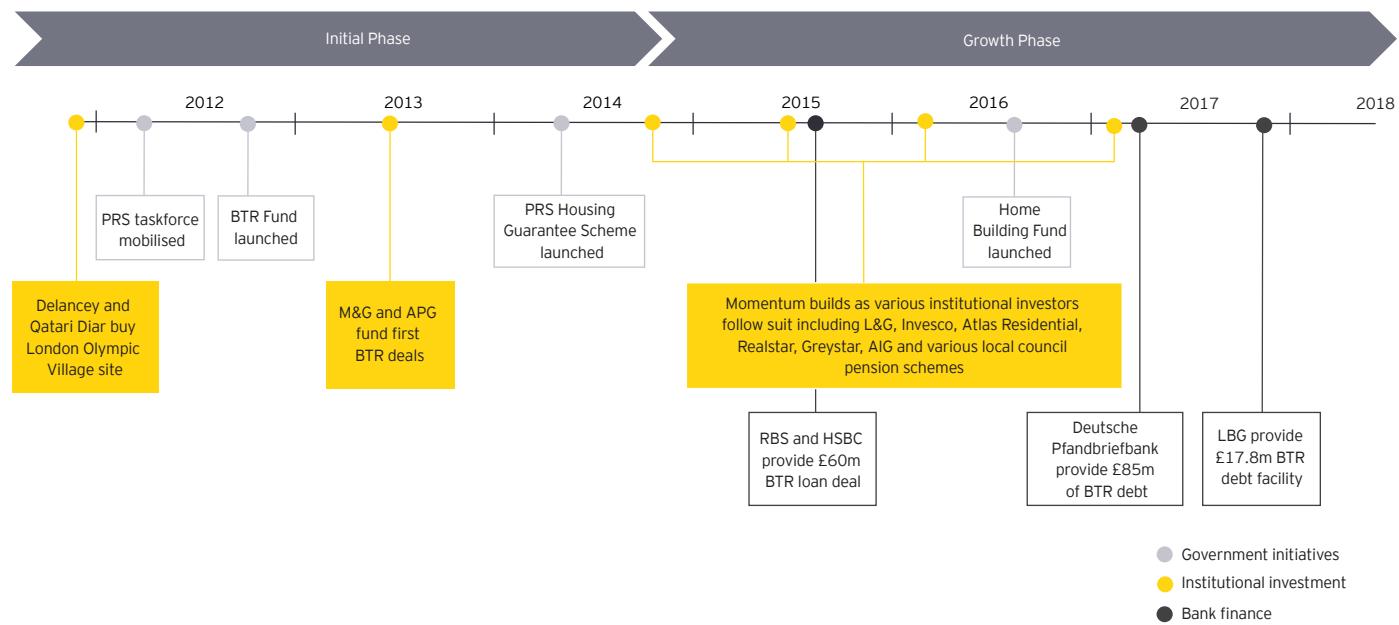
⁵ Savills Research using MSCI

⁶ www.theprsreit.com

While notable strides have been made in the BTR in the last few years, the market is still in a relatively early stage in its development. A number of banks and institutional investors

have made their debut in the sector however, and it is likely that a number of key longer-term investors have yet to make their first move.

2.1 How has the UK BTR market evolved?



Initial phase

The purchase and conversion of the London Olympic site, East Village, in 2011 was widely considered to be the birth of BTR in the UK.

In 2012 the Government demonstrated its support for the sector by mobilizing the Private Rental Sector (PRS) taskforce, tasked with encouraging institutional investment in the sector and launched the BTR Fund which made available £200,000 of short-term construction debt finance. This was the first of several Government initiatives that provided funding for BTR projects.

In 2013, a number of institutional pioneers entered the market, including:

- ▶ **M&G** – Prudential's Property Investment Management division PruPim (later renamed M&G Real Estate) became one of the first UK institutional investors in the BTR space when it acquired Berkeley Group Holdings plc's £105.4 million residential portfolio. The portfolio consisted of 534 private rental units in 13 locations across Greater London, the south east and southern England which would be managed on a day-to-day basis by Savills.⁷
- ▶ **APG** – The Dutch pension fund manager, APG, partnered with residential landlord Grainger to create GRIP, a joint venture formed by the pair in order to acquire the residential property portfolio G:res1 (which was in liquidation). GRIP, was structured as a long-term fund with five year renewable terms, with asset and property management services provided by Grainger.⁸

⁷ <https://www.mandg.co.uk/-/media/Literature/UK/Prupim%20press%20releases/PRUPIM-acquires-residential-portfolio.pdf>

⁸ <https://corporate.graingerplc.co.uk/media/press-releases/2013/22-01-13.aspx>

Growth phase

Over the next few years investor appetite for BTR grew with finance provided by a number of institutions and banks, including:

- ▶ **Legal and General (L&G)** – L&G made its first investment in the private rental sector in 2015 when it acquired a £25 million BTR site in Walthamstow, London with the intention of building and renting 300 1,2 or 3 bedroom flats. A spokesman stated that once operational the investment would allow the Group to 'enhance returns' and 'achieve a better match to long-term annuity liabilities than existing fixed income assets'.⁹
- ▶ **RBS and HSBC** – In 2015 Royal Bank of Scotland (RBS) and HSBC announced a £60 million, 4-year loan deal to Essential Living to finance the build of 249 new homes in Greenwich.¹⁰ A number of other banks later followed suit including Deutsche Pfandbriefbank AG¹¹ and Lloyds Banking Group.¹²

2.2 How might the UK BTR market develop going forwards?

In order to gain insights into how the BTR market might develop we can look at similar asset classes, for example UK Purpose-built Student Accommodation (PBSA) or we can consider BTR markets abroad, for example the multi-family market in the United States.

UK PBSA market

2.2.1 Similarities between BTR and PBSA

BTR is similar in many ways to student accommodation, in particular:

- ▶ They both consider large residential developments, that aggregate a number of individual units.
- ▶ The buildings are designed to specifically rent.
- ▶ Involve a construction and an operational phase.
- ▶ The developments are operated as a business where the primary objective is to maximize occupation and retain tenants (albeit student accommodation is occupied during term time only).
- ▶ Consider similar risks e.g., will there be demand for rental accommodation? Will this specific development appeal to renters? How capable is the property management operator?



⁹ https://www.legalandgeneralcapital.com/media-center/_press-releases/Walthamstow.pdf

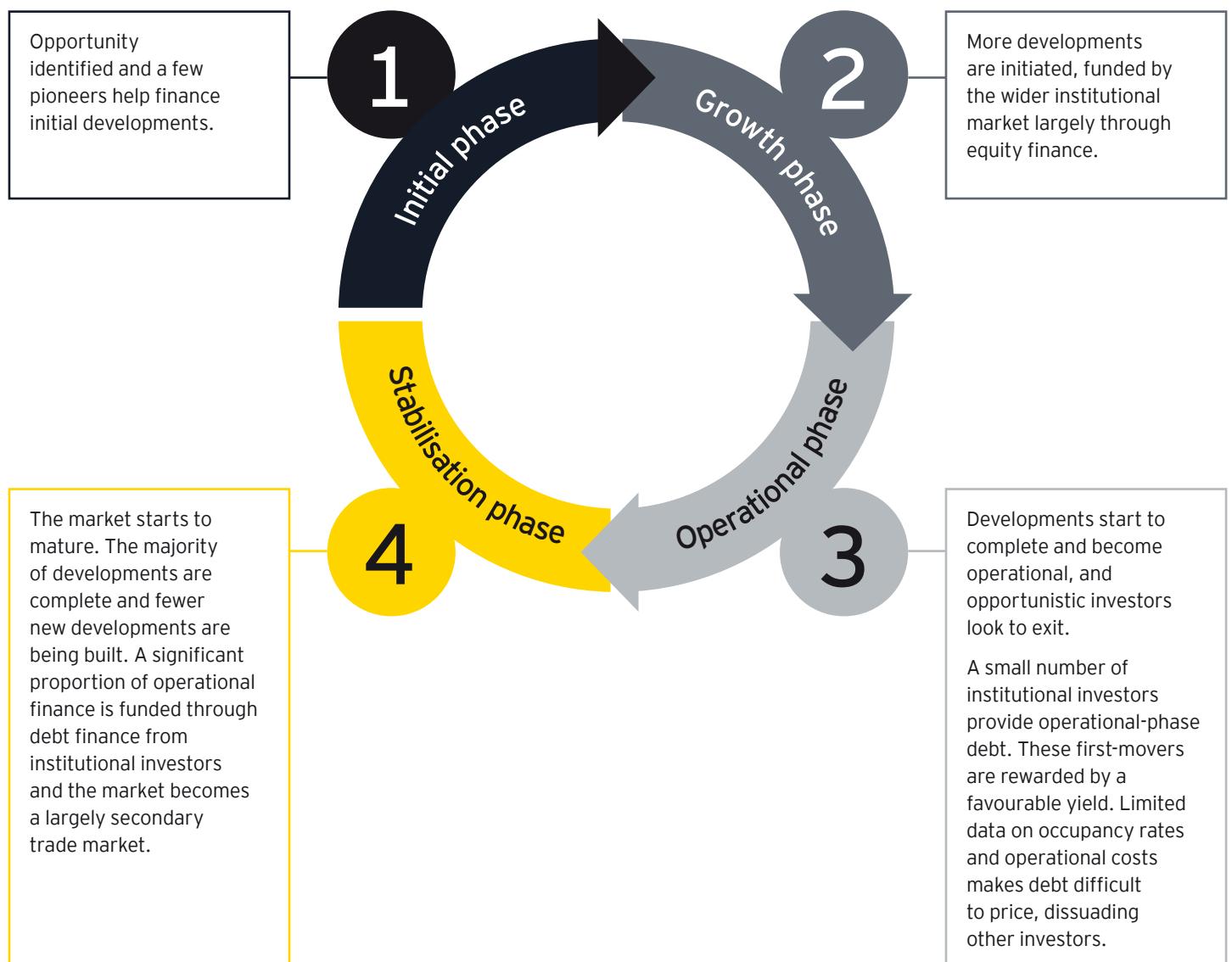
¹⁰ <https://www.construction.co.uk/construction-news/223225/essential-living-secures-60m-loan-from-rbs-and-hsbc>

¹¹ <https://www.pfandbriefbank.com/medien/pressemittelungen/detail/news/apache-capital-partners-mod-a-living-joint-venture-agrees-pound85-mn-senior-debt-financing-with-pbb-deu.html>

¹² <https://www.propertyweek.com/news/lloyds-bank-enters-btr-lending-market-/5089236.article>

2.2.2 Evolution of the UK PBSA market

The UK PBSA is comparatively more mature, with a proven track record and a total market value of c. £48 billion.¹³ Development of the PBSA market can be broken down into the following four phases:



For more information on PBSA see:

ey.com/Publication/vwLUAssets/ey-uk-purpose-built-student-accommodation/%24FILE/ey-uk-purpose-built-student-accommodation.pdf

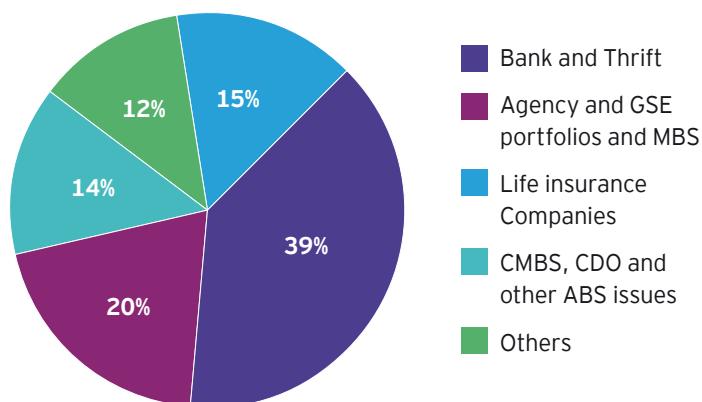
¹³ Knight Frank

US Multi-family housing market

With over a third of the U.S. population living in private rental accommodation and 36%¹⁴ of renters living in multi-unit rental communities, BTR or Multi-family Housing as it is known, is a familiar concept in the United States.

According to the National Multi-family Housing Council the multi-family market is worth a total of \$3.3 trillion¹⁴ with the majority of capital provided by banks, life insurance companies, CMBS or Government backed lending programs such as Fannie Mae and Freddie Mac. Life insurance companies such as MetLife, Northwestern Mutual Life and New York Life are vital to the funding landscape. According to the Mortgage Bankers Association life insurers hold 15% of outstanding Multi-family debt, totalling \$497 billion.

Commercial Multifamily Mortgage Debt Outstanding by investor Group – Q4 2018



Source: MBA Quarterly book – Q4 2018

2.2.4 Future of the BTR market in the UK

Compared to the PBSA market and the U.S. Multi-family market, the UK BTR market is in its infancy. The majority of developments are still being constructed and availability of institutional debt is limited.

According to the British Property Federation, as at Q4 2018, there are c.29,000 completed BTR units in the UK and a further c.110,000 either in planning or under construction.

Status	Total (as at Q4 2018)
Complete	29,416
Under construction	43,374
In planning	66,718
Total	139,508

Source: British Property Federation

As the BTR market matures, as we have seen in PBSA and Multi-family markets, long-term institutional investors likely to be enticed by the opportunity to receive a long-term stable income stream collateralised on a significant tangible asset.

We expect long-term institutional investors to continue to monitor the risk-reward trade off. First-movers that are able to get comfortable with the lack of operational data may be rewarded by higher risk-adjusted returns.

¹⁴ National Multi-family Housing Council

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Investor considerations

3.1 Investor appetite

Operational-phase BTR debt or equity could be an enticing opportunity for institutional investors looking to match long-term liabilities.

Insurers may wish to hold BTR debt as part of their annuity portfolio. Annuities offer policy-holders a guaranteed, long-term income stream which is often inflation-linked. To back annuities, insurers typically look for assets with a long-term, stable income stream, that are likely to receive a favourable capital treatment. Operational-phase debt has the potential to meet these requirements, however insurers will need to overcome challenges around liquidity, valuation and capital treatment. In addition, insurers may opt to hold BTR debt or equity in their shareholder funds but this will depend on the insurer's risk/return appetite.

The majority of UK defined benefit (DB) schemes are now closed.¹⁵ As a result, many schemes are looking to de-risk into matching assets with a stable fixed income stream appropriate to the nature, timing and duration of the scheme's liabilities. DB schemes may consider operational-phase equity or debt, accessed through a fund. For example, a number of local government pension schemes have taken an exposure to BTR equity, though dedicated funds.

3.2 Valuation

Institutional investors in the UK are required to report an ongoing 'fair value' of their assets under various regulatory regimes. This is a challenge for investors of private asset classes where there is no market observable price. It is even more of a challenge for assets in relatively new markets like BTR, where there is limited data.

3.3 Liquidity

A key consideration for investors is liquidity. For institutional investors, liquidity refers to how easily an asset can be converted into cash at the prevailing fair value. The liquidity of a BTR asset will depend on a number of factors including the stage of development, condition of the property, location, buoyancy of

the market, whether the investor's holding is listed or unlisted etc. Those with long-term liabilities are more likely to be able to accommodate an illiquid asset but will expect to receive an illiquidity premium for doing so.

3.4 Capital treatment

Both pension schemes and insurance companies are required to hold assets to back their liabilities.

The amount of assets that an insurer is required to hold is dictated by the Solvency II Directive. While the Directive does not directly apply to pension schemes, trustees may find it indicative of the risks involved.

The Solvency Capital Requirement ('SCR') sets out the minimum required ratio of money on the balance sheet to liabilities. It is calculated by applying a 1-in-200 shock to the insurer's asset and liability values, where the shock scenario is defined differently depending on whether they are a Standard Formula or Internal Model firm. Under the former the stress factors and methods are prescribed by the Solvency II legislation, while the latter is based on management's view of the risks associated with the asset.

Standard Formula

Under the Standard Formula the capital requirement is determined by considering individual risk exposures (known as risk modules) which are then aggregated together.

The SCR for a BTR asset will depend on the exposure held. Where an investor has an indirect exposure e.g., through a collective investment scheme, they will be required to apply a 'look-through' approach where they look-through to the underlying asset.

The table overleaf sets out the prescribed stresses under each of the applicable risk modules. The table sets out the applicable stress when considered in isolation. In reality, the stressed asset value may be partially offset by an increase in the liabilities.

¹⁵ According to the Pensions Regulator's paper entitled Defined Benefit (DB) Landscape 2018, only 14% of UK DB schemes remain open to both new members and future accrual.

Solvency II capital stress

Exposure	Risk module	Stress ¹⁶	
Equity			
Equity in the operator	Equity risk module	39-49% + symmetric adjustment	<p>Investors are required to apply a 39%-49% stress to the value of the equity holding, depending on whether it is an OECD listed equity or not.</p> <p>The symmetric adjustment is prescribed and varies depending on the level of the market vs. the 3-year rolling average.</p> <p>If the insurer is deemed to have a strategic participation in the operator as per Article 171, the base stress applied may be reduced to 22%.</p>
Equity exposure to the underlying property/land.	Property risk module	25%	Investors are required to apply a 25% stress to the value of the property holding.
Debt			
Private placement debt	Interest rate risk module	Prescribed term structure stress	<p>The larger of a prescribed upward and downward shift across the interest rate term structure.</p>
	Spread risk module	12.95%	<p>Depends on the modified duration and credit rating of the debt.</p> <p>For example, an unrated debt exposure to BTR with a 12 year duration would have a capital charge of:</p> $(5 \text{ years} * 3\%) + (5 \text{ years} * 1.7\%) + (2 \text{ years} * 1.2\%) = \mathbf{25.9\%} \text{ of market value of the debt.}$
<p>Debt collateral that meets the requirements set out in Article 214 of the Solvency II Delegated Act, could receive a reduction in the required capital of up to 50%.</p> <p>25.9\% x 50\% = 12.95\%</p> <p>For the purposes of our example we have assumed that the debt collateral qualifies for the reduction. Whether or not an asset would qualify often requires close consideration of the specifics of that underlying asset. Where debt BTR has been restructured it may be more of a challenge to meet the qualifying criteria in which case the spread risk charge would remain at 25.9%.</p>			
<p>Debt exposures to BTR could be made to be Matching Adjustment (MA) eligible such that the resulting asset provides fixed cash flows and 'sufficient prepayment protection'. MA eligible assets benefit from a reduced capital requirement.</p> <p>As the BTR debt market is still developing, it may be possible to negotiate MA features into bilaterally negotiated debt.</p>			

¹⁶ For simplification we have assumed that the asset cash flows and the insurer's liabilities are in the same currency and that the insurer's asset portfolio is sufficiently diversified such that no concentration risk capital is required.

Internal model

Insurers may opt to apply an internal model approach if they believe that the capital charge under the Standard Formula does not fairly reflect the level of risk. For example:

- ▶ Bilaterally negotiated debt is unlikely to be externally rated. Insurers may choose to establish an internal ratings framework to rate the debt themselves and achieve a more favourable capital treatment.
- ▶ An insurer may argue that the expected loss for operational-phase BTR debt is lower than implied by the Standard Formula as the debt is collateralised on the physical property (particularly where the debt has a low loan-to-value and has not met the qualifying criteria of Articles 176(5) and 214).

Conclusion

BTR provides an interesting opportunity for institutional investors, both in terms of meeting investment objectives and its social contribution. While a number of institutional investors have contributed to BTR to date, the investor profile is likely to significantly evolve over the next few years as the sector builds up a tangible track record and the BTR debt market matures.

Long-term institutional investors will continue to monitor the risk-reward trade off. First-movers that are able to get comfortable with the lack of operational data may be rewarded by higher risk-adjusted returns.

How can EY teams help?

EY teams have extensive experience advising clients on the implementation of illiquid asset strategies and has a dedicated team of experienced real estate professionals. We can help with:

- ▶ **Capital risk and analysis** – advising on structuring and hedging strategies to improving capital efficiency.
- ▶ **Internal rating systems** – developing or validating an internal system used to assign a credit rating to BTR-backed debt instruments.

- ▶ **Valuation framework** – guiding the development of a market-consistent valuation methodology to meet reporting requirements.
- ▶ **Tax** – advice on BTR structures in order to improve post-tax returns.

In some cases, we may be able to assist in identifying opportunities and facilitating investment opportunities between finance providers and BTR developers.

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