

Build to Rent: Hedge appeal?

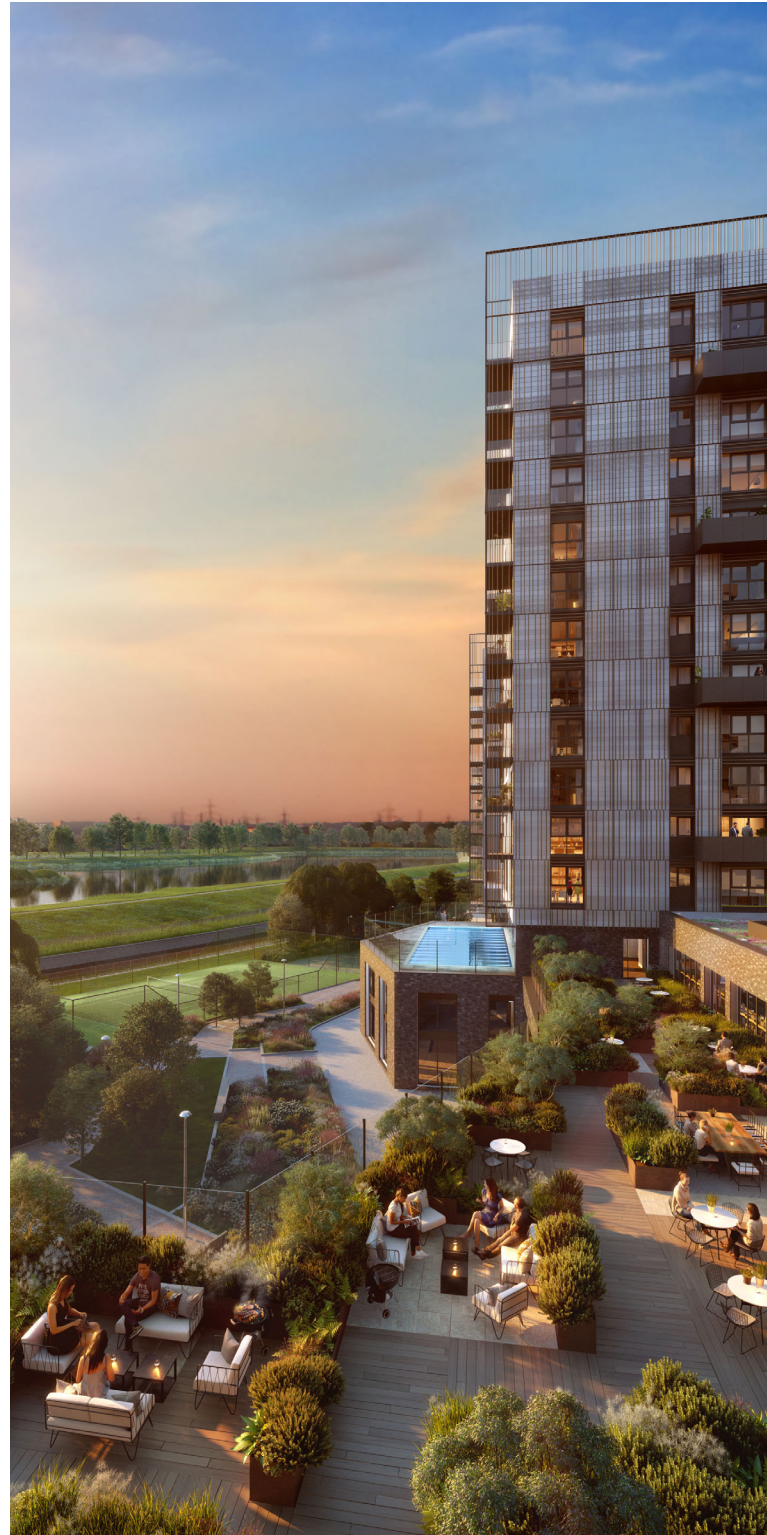


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Key takeaways

- To offer inflation protection, real estate sectors must be supported by robust occupier demand that allow for rents and income to grow further
- In this regard, we believe Build to Rent (BtR) is one of the better placed sectors to provide an inflation hedge
- The basic need for housing means that occupier demand is relatively stable and resilient to an economic downturn
- Historically, residential rents have outpaced inflation over the long term, contrasting with commercial rents which, broadly, have not
- While higher wage costs may impact residential asset performance, rental growth is implicitly linked to wage growth, thus potentially offsetting some of this effect
- The current energy supply shock may boost occupier demand for more energy efficient BtR homes



Inflation protection stems from strong fundamentals

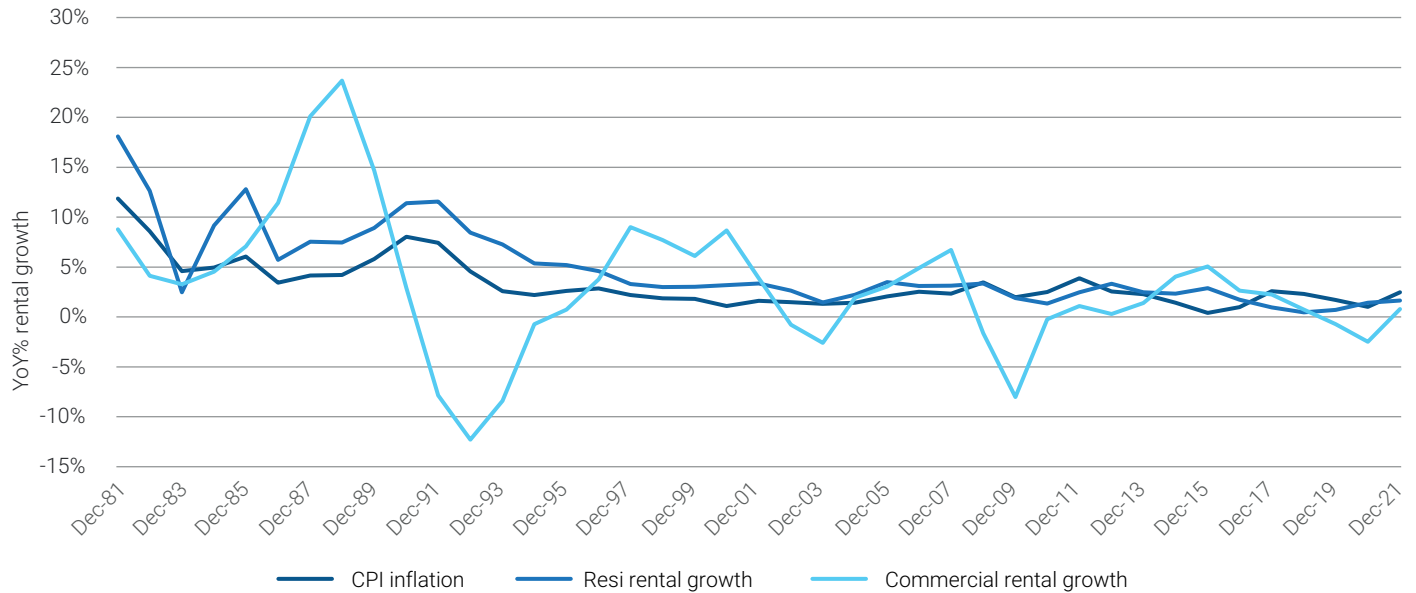
Supply side disruptions, rising energy costs and the war in Ukraine have underlined inflation concerns for institutional investors. Real estate's inflation hedging characteristics are mixed, with inflation protection dependent on the type of inflation and specific real estate sector.

Rising inflation due to strong economic growth (demand-pull), should encourage stronger occupational demand for real estate, resulting in better rental growth, income and asset performance. However, where inflation is being driven by rising costs (cost-push), as is currently being experienced in the UK and Europe, this does not necessarily translate into stronger occupier demand, as rising costs for occupiers potentially limit their ability to absorb higher rents.

For real estate to offer suitable inflation protection, sectors need to be supported by favourable market fundamentals such as growing occupier demand, the asset owner's ability to pass on higher running costs to occupiers and an environment where the asset is integral to either business activity or human need.

We believe residential assets in the BtR sector display these characteristics and are well-placed to provide a meaningful inflation hedge.

Residential rents: the calm in an inflation storm?



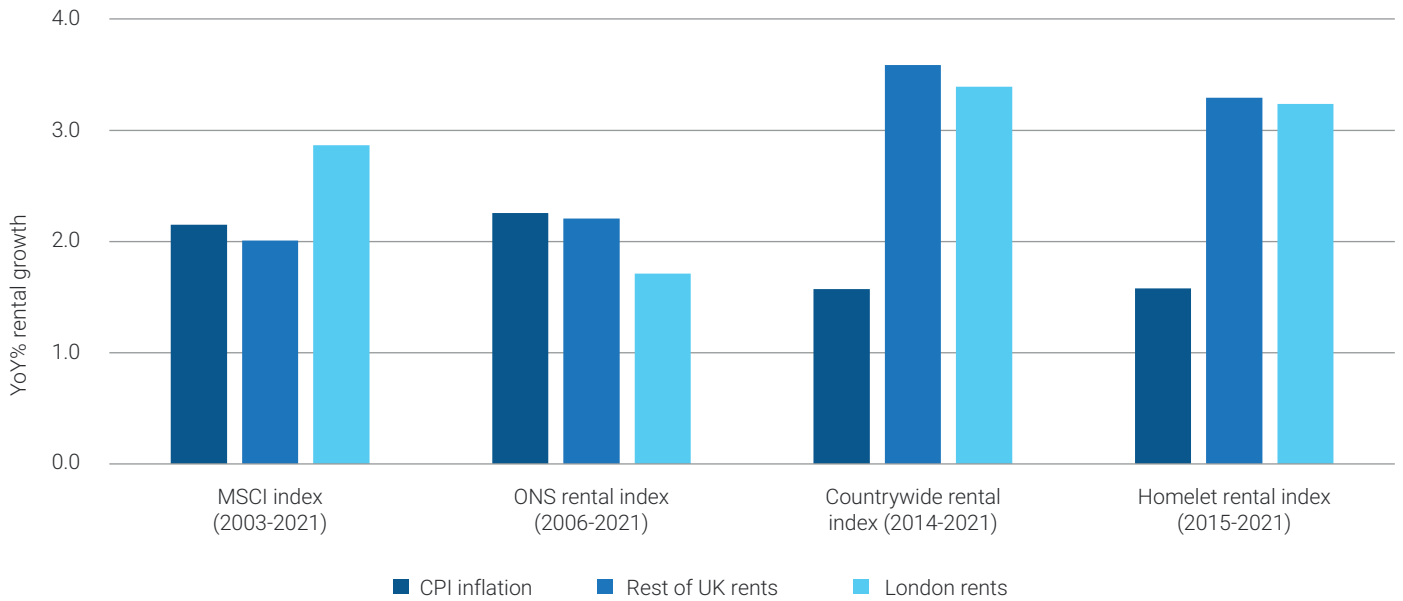
Source: OECD & MSCI UK Property Annual Index as at May 2022.



Residential rents: outperforming inflation over the long term

Historically, residential rents have tracked inflation trends closely and, over the long term, outpaced inflation. This contrasts with commercial real estate sectors where rental performance is more closely linked to the swings vagaries of the economic cycle. Additionally, rental leases in the residential sector are typically short in duration, providing asset owners with more flexibility for near-term adjustment of rents, to reflect potential price rises in the wider economy.

Residential resilience in the face of rising prices



Source: ONS, MSCI UK Property Annual Index, Countrywide/Hamptons, Homelet as at May 2022.

Data from the OECD show that between 1981 and 2021, residential rents grew by 4.8% per annum (p.a.) ahead of CPI inflation which averaged 3.3% p.a.¹; with commercial rents growing by 3.2% p.a. While it’s worth noting that OECD data imperfectly reflect ongoing market prices, due to inclusion of other rental tenures, more appropriate shorter-term data highlight a similar relationship of rents growing in line with or ahead of CPI inflation.



¹ Source: MSCI, period covered 1981 – 2021.

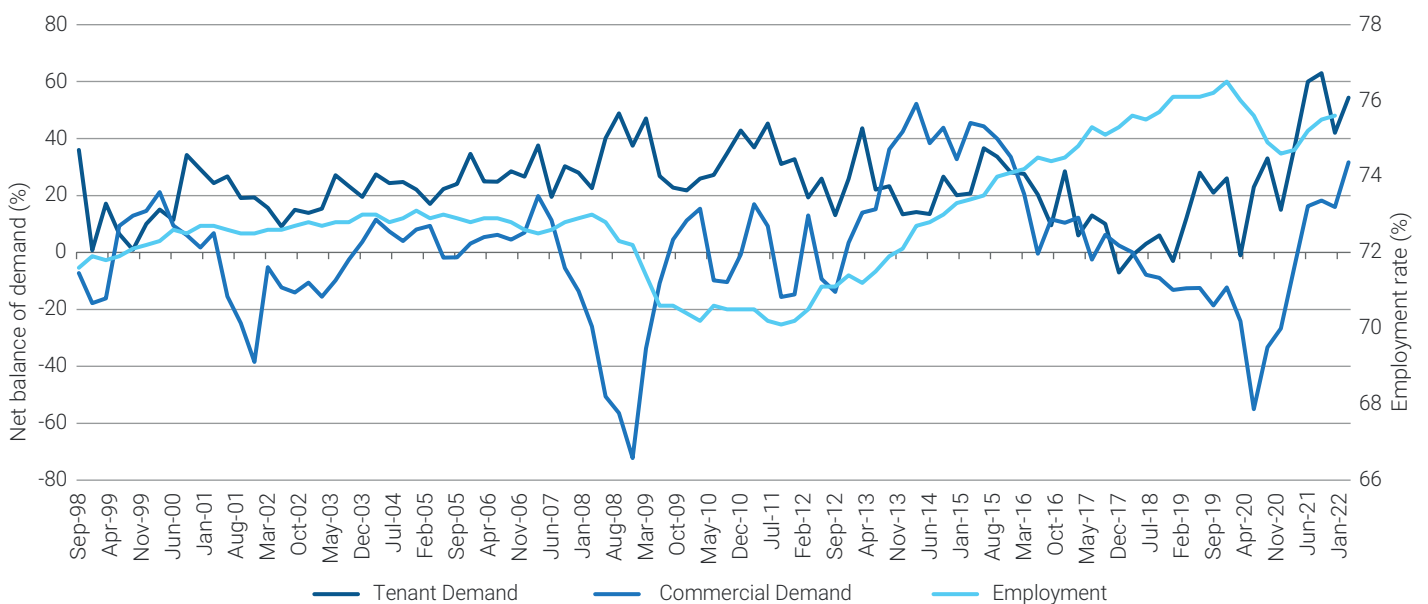


Occupier demand: remaining stable

Occupier demand in the sector is typically stable and non-cyclical relative to the wider economic cycle, driven by needs-based housing. The demand for rental housing in particular is reinforced during economic downturns where home ownership can become more constrained, as we saw during the Global Financial Crisis (GFC). This can lead to forced renting, or households spending longer than intended in rental housing, as they wait for more certainty over their finances or the wider economy.

The below chart, showing rental demand, illustrates this point. While residential rental demand diminished somewhat at the outset of the 2008 downturn, it remained positive² before recovering relatively quickly to pre-GFC levels. By contrast, commercial assets, where occupier demand is more closely linked to the economic cycle, saw greater levels of volatility.

Occupier demand and employment levels



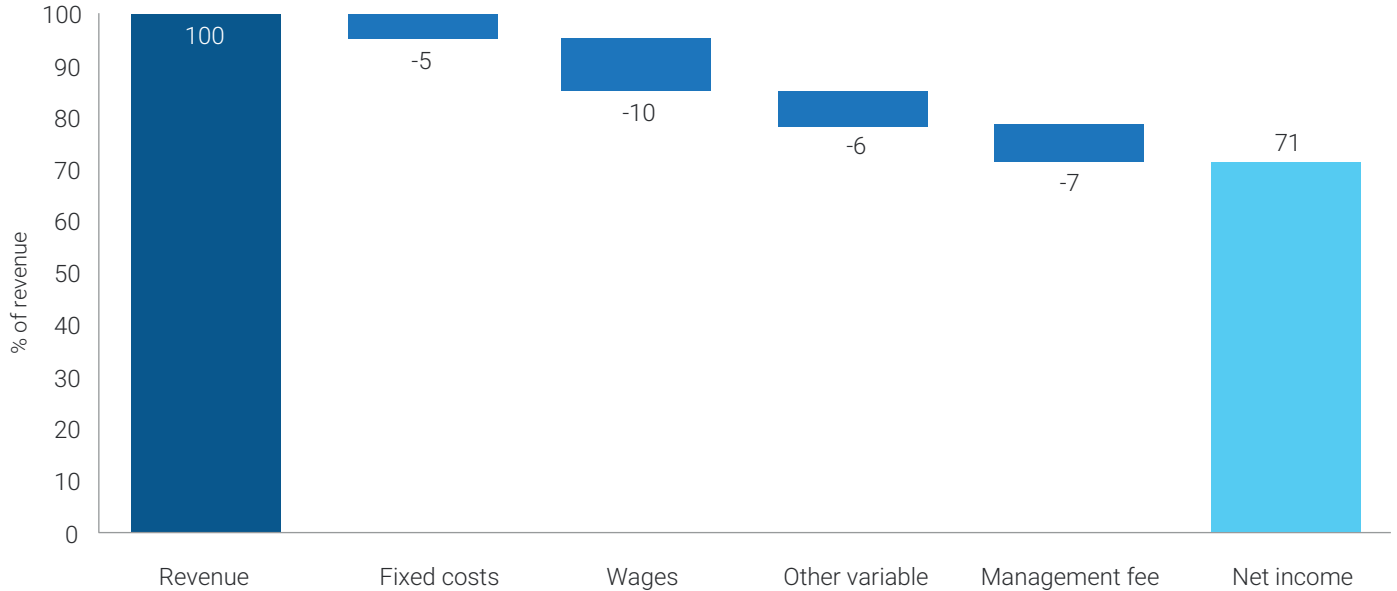
Source: RICS, ONS as at May 2022.

² Source: Any reading above 0 in the survey indicates positive demand.

Watch the wages

A key consideration for investors is the effect that increases in wages, from rising inflation, may have on operating costs and net income. This is significant, as staffing costs make up around 35% - 40% of total residential operating costs.

Residential gross to net income



Source: LGIMRA Research, market best estimates as at May 2022.



However, rental growth is intrinsically linked to wage growth. Intuitively, while the imbalance between residential demand and supply fundamentally drives rental growth, the magnitude of the growth is regulated, to some degree, by the available household incomes. We believe that potentially higher wage growth is likely to be positive for rental growth, offsetting some of the costs.

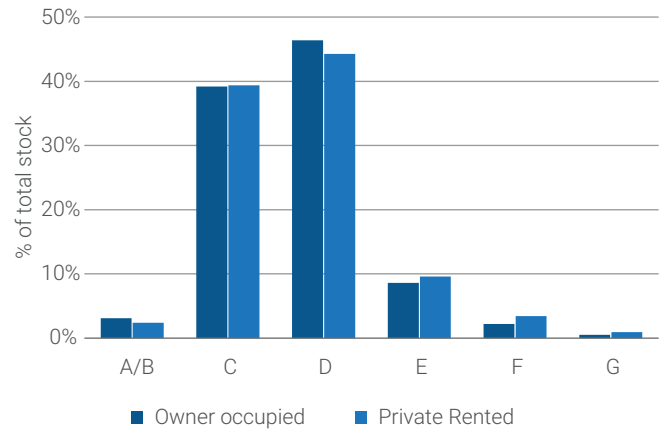
The relationship between rents and income is also evident with regards to rental affordability. Rental affordability nationally has stayed within a tight range of 32% - 34% of household income over the last decade³. The stability of the rent/income ratio suggests a degree of self-regulation, with household income playing an important role in checking the pace of achievable rents.

³ Source: ONS & Oxford Economics as at May 2022.

BtR tenants – weathering rising energy costs?

We also see BtR residents as relatively more protected from rising energy costs. In general, the stock of rental housing in England is old and not energy efficient. Government data show 58% of homes in the sector are below an EPC rating of C. The BtR sector however, being newer and developed to higher building standards, is more energy efficient.

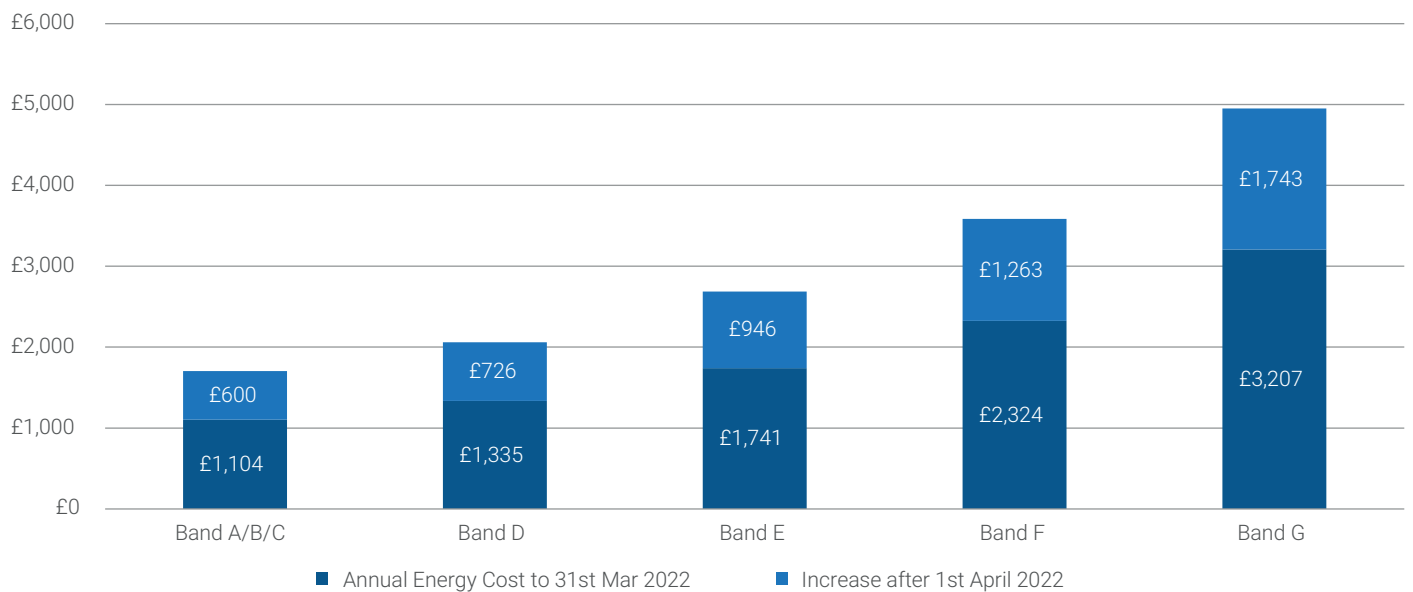
England housing stock EPC rating



Source: UK Government DLUHC English Housing Survey, 2020.

It is estimated that there is a cost saving on household energy bills ranging from £360 to £3,250, depending on the EPC rating of the home⁴. We believe that the significance of the potential savings may incentivise some occupiers to choose BtR homes over less efficient housing stock.

Estimated annual energy cost increases by EPC ratings



Source: JLL & ONS as at March 2022.

⁴ Source: JLL & ONS as at Mar 2022.



Growing pains – the challenge of sourcing materials

Rising inflation is also impacting the construction sector and the development cycle. Pandemic-related supply chain disruptions and the war in Ukraine have contributed to material prices growing by 12.4% p.a. since 2020⁵. This, coupled with structural wage price inflation in the construction sector, has led to a more challenging development environment.

With the BtR sector being heavily development led, this is likely to have some impact on performance. Some of these challenges will be reflected in direct development costs, as well as in adjustments for risk, with investors being asked to share a greater proportion of construction risks. We would expect this to result in higher development costs and longer construction periods in delivering new schemes.

However, this environment may also result in a reduction in the potential level of future residential supply and further entrench the demand and supply imbalance in UK housing. As a result, investors in the sector could see that the short- to medium-term impact on performance through the development cycle may be mitigated by upward pressure on rental growth.

Conclusion

In summary, we believe that the inflation hedging characteristics of real estate lie in the ability of the asset to benefit from strong occupier demand and grow income as a result. We see the residential sector as one of the best placed sectors within real estate to do this.

The needs-based occupier demand for housing, particularly in the UK, with its fundamental imbalance of demand and supply, allows for resilient and potentially growing occupier demand despite slowing UK growth.

⁵ Source: BEIS,ONS, London Metal Exchange as at May 2022.

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