Building momentum in Scottish Build to Rent

An APLEONA company

Introduction

The last 12 months have seen a step change in Build-to-Rent (BTR) activity and the story has moved away from being London centric, as investors recognise the opportunity for attractive risk adjusted returns outside the capital. Having said this London still accounts for 57% of all activity in the UK (British Property Federation) and investor interest is also still weighted toward the capital.

According to British Property Federation (BPF) figures, there are now just over 95,000 BTR units either completed, under construction or with planning permission in the UK. This represents more or less a tripling in activity since the end of Q1 2017 and the increase in pace shows why the sector is one of the hottest topics in UK real estate. Its potential to contribute to the solution of the UK's housing shortage and deliver accommodation products that reflect millennial lifestyles have brought it to the attention of the mainstream press. Combined with this, a convergence of factors are driving investor interest, creating the step-change in the market.

Scotland is seeing an encouraging amount of activity and now has 10 major schemes either coming out of the ground or letting up. We look at these later in more detail later. This report will assess the factors that are driving the BTR market, with a focus on the appeal to the investment community, explore the Scottish market characteristics to understand the investment case, look at what's been happening on the ground and what the future holds.

Key macro drivers behind the investment case for BTR

Residential returns in the extended low interest rate environment

As Figure 1 shows, following the global financial crisis there was enormous compression of risk-free rates, driven by central bank expansionary monetary policy which pushed the yield gap with residential income return to historical highs. This has created very attractive compensation of the liquidity risk associated with BTR investments, especially if investors hold the assets long term to benefit from low volatility and high predictability. Along with this, the additional upside of potential capital growth and the value in inflation protection has made the sector much more appealing.

Prior to the global financial crisis the net income return on residential real estate was either lower or the same as the risk-free rate (see Figure 1) and for the brief period in the late '90s when it was higher, the spread was not enough to compensate for the additional risks associated with illiquidity and potential loss of income. Therefore the traditional investment case for residential was primarily driven by the prospect of capital value growth delivering returns and thus compensating for the lower income and increased risks.

This approach makes for back-end loaded returns and the requirement for assets to be frequently traded, creating additional cost and risk. This profile, along with other challenges such as amassing suitable scale, does not suit the investment criteria of many institutional investors and hence participation in the market was very limited.

The residential and commercial relationship

The narrowing spread between commercial and residential net yields in recent years has added to the investment case for BTR. Figure 4 uses compares both IPD and Capital Economics figures to show how the difference between residential income and commercial income returns has fallen. The Capital Economics figures give a more accurate reflection of the national picture as the IPD residential figures are heavily weighted toward London.

It puts current levels in a historic context and shows that the difference in income return is no longer a compelling reason for investors to choose commercial over residential. Recent divergence in sentiment between the outlook for income returns in the commercial sector compared to BTR adds to this. There's little quality stock in the office sector and with few sellers and falling development, there is little possibility of supply increasing. In addition, the long term decline in the amount of space needed in the retail sector and its poor outlook for rental growth are making it look less attractive. The rising stock of residential compared to these sectors and the huge amount of global money chasing income make a compelling case for BTR.

It is probable that as the BTR sector continues to emerge, developing scale and management efficiencies, it will deliver higher income returns than the residential sector has historically. This would likely go some way to offsetting any improvement in commercial income returns.

Income returns for residential vs 10-year gilts

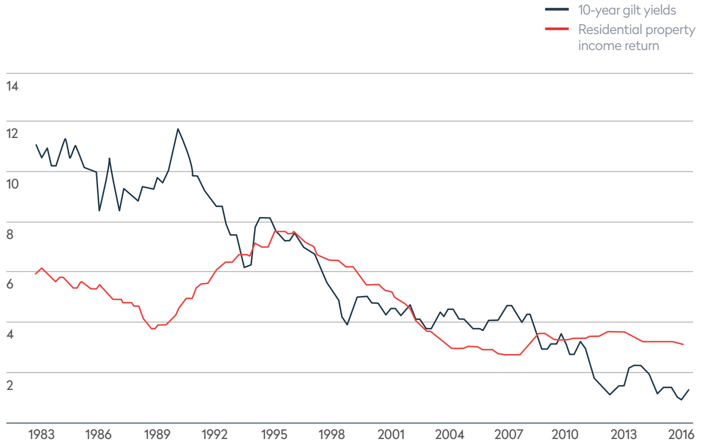


Figure 1 — **Source:** IPD, Bank of England

Income returns on commercial less income returns on residential

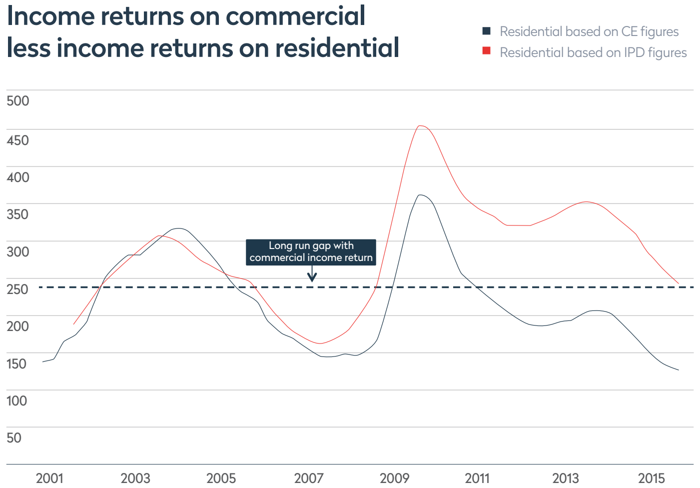


Figure 2 — **Source:** IPD, Capital Economics

Demographics, affordability of housing and the growth of private rental

The growth in private rental demand across the UK in recent years has been well documented. Scotland has seen the proportion of 16-34 year olds in the private rental sector increase from 16% in 1999 to 40% in 2016 (see Figure 3). This is being driven primarily by the difficulty in accessing home ownership and to a lesser extent lifestyle choices.

Housing affordability has declined in Scotland over the last 4 years and the average house price to earnings ratio is now around 6 (based on Acadata & ONS figures) and considerably higher in some urban centres. The affordability crisis has arisen as a result of an extended under-supply of housing driving up prices combined with a lack of real wage growth during the economic recovery.

Housing supply has failed to keep up with new household formation, population growth and stock replacement requirements and although a recent high of 16,498 new homes were delivered in 2016, this is conservatively around 40% short of where it needs to be.

The other main issue is the difficulty in accessing mortgage finance for first time buyers. Following the financial crisis and the Mortgage Market Review, lending criteria became much more stringent and deposit requirements higher. Help to Buy has gone some way to alleviating the deposit issue but in Scotland the average First Time Buyer (FTB) deposit is roughly £19,000, equivalent to 49% of average FTB income. The Help to Buy scheme has not curtailed the trend of an increasing proportion of people living in the private rental sector' to any significant extent.

The aspiration to become home-owners still endures among people in the private rental sector but the structural shortfall in housing delivery, squeezed incomes and difficulty accessing credit mean they are seeing rental as more than a stop-gap solution and looking for products which reflect this longer term need.

Further demand drivers in Scotland

In addition to the macro themes driving interest from professional investors, Scotland possesses the fundamental factors required for BTR to work, if the right product is delivered. Figure 4 illustrates at a high level, the supply and demand imbalance that exists in Scotland.

- Shelter estimate that the existing shortfall in housing supply is around 10,000 homes a year, just to keep up with demand, let alone address the existing backlog. Scotland has also a significant amount of poor quality stock, with around 40,000 homes that are considered below the tolerable standard.
- The proportion of 20-34 year olds living in urban areas is expected to increase, as is the marked trend toward more one person households with a 31% increase expected by 2039.
- Would be buyers are facing difficulty getting on the housing ladder. Difficulty accessing mortgage finance is clear with the CML reporting that the number of loans is still under half of its pre-crisis peak. The lending environment, combined with rising house prices and lack of real wage growth have pushed the average First Time Buyer age to 32.

The wide imbalance between supply and demand and no obvious dramatic shift in sight from either private or social housing delivery, strongly the suggest the trend in increased demand for rental property will continue.

Scottish tenure trends 16-34

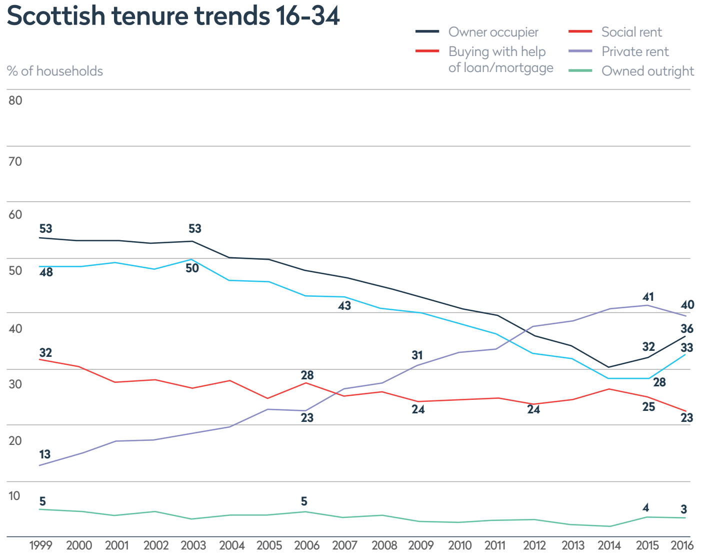


Figure 3 Source: Scottish Housing Survey

Scotland's supply and demand imbalance

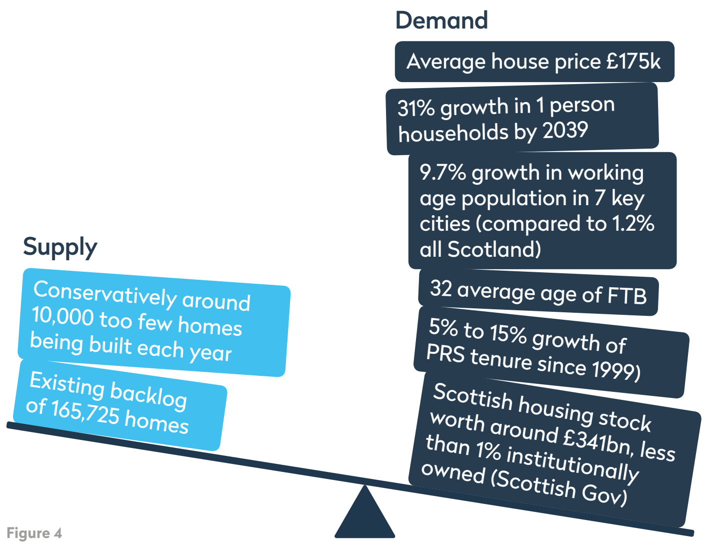


Figure 4

Generation rent in Scotland

The key BTR target market age group of 20-34, commonly termed 'generation rent' have come of age during a time of technological change, globalization and economic disruption. These factors and the set of behaviours and expectations they have created are in themselves drivers of BTR demand. Understanding the consumer is critical to guiding BTR product design, specification and the ensuing tenant experience and trends can be seen in the products emerging in Scotland that show this.

Much has been made of millennial requirement for experiences, convenience, flexibility and affordability rather than ownership. This is partly as a result of lower incomes but also the impact of technology and lifestyle changes. This means that rental is now seen as a genuine medium-term tenure choice and more than a necessary evil driven by lack of affordability, although as mentioned the majority of millennials still ultimately aspire to home ownership.

The latest LSL tenant survey shows that 82% of Scottish participants responded that renting suits their lifestyle and only 10% fewer said that flexibility was their main reason for renting rather than saving for a deposit/not having a deposit to buy. This survey isn't restricted to generation rent but they account for roughly 50% of Scottish participants.

A further indication that renting is more than a short term stop-gap is seen in the survey response that 1/3 of Scottish tenants would like a tenancy of 3 years or more. This also reflects the desire for increased security in renting, which is an important gap for BTR to fill. Indeed insecurity is the perceived biggest problem with renting in Scotland according to the survey. This is largely a function of the fragmented nature of the existing private rental sector which is dominated by small landlords and is an obvious easy-win for BTR with great value to the target market.

71%
Scottish respondents happy with renting

82%
Suited to the renting lifestyle

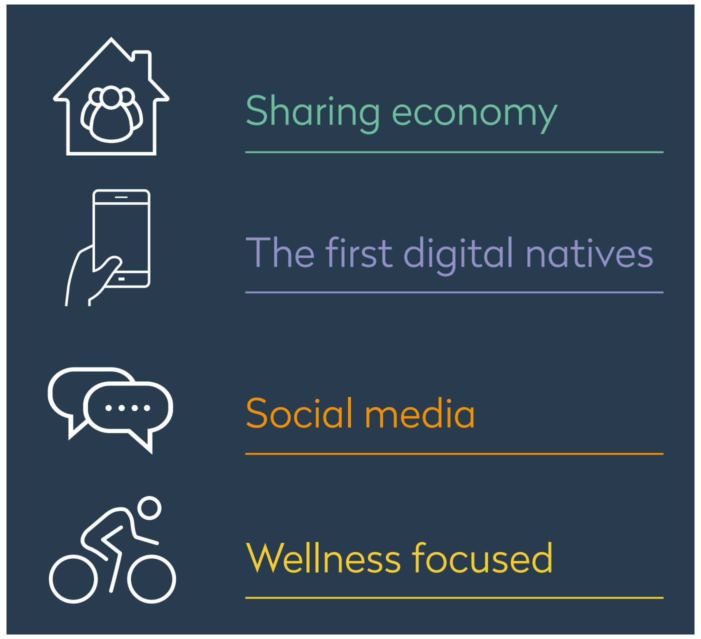
3 years
Preferred length of tenancy for a third of respondents

90%
Will look online for next rental property

3.5 million
People in the UK working more than 48 hr week

60%
Respondents who would participate in social activities

Figure 5 **Source:** LSL Tenant Survey



Other millennial trends further strengthen the case for BTR compared to traditional PRS. One of the commonly cited appeals of the multi-housing sector in the US is the community element. The rise of co-living products in London also reflects this, as young people increasingly want opportunities for social interaction. Mind, the mental health charity reported that loneliness and isolation affects more 18-34 year olds in the UK than over 55's. The LSL tenant survey found that 60% of Scottish respondents would participate in social activities in their rental accommodation.

Delivering a tenant experience that fulfils these needs must be considered from the beginning of any BTR scheme. They provide the opportunity to deliver product differentiation, additional revenue streams, create customer loyalty and achieve premium rents.

Reflection of these trends can be seen in the products being delivered in Scotland. The Vox scheme in Dundee, will provide a café, cinema/lecture space and gym. The Moda scheme at Fountainbridge in Edinburgh will have significant amenity space.

The investment market

There is a huge demand for income from real estate globally and large investment in residential rental property is becoming a global allocation phenomenon. Deals in the seven largest European markets reached E26.5bn last year, only constrained by lack of investable stock and indications are that this will be broken this year.

Figure 6 below shows investment transaction volumes in the UK across all property and Figure 7 shows the increasing allocation toward the alternative sectors since 2010. PRS was the biggest of the specialist sectors in 2016.

Annual value of investment transactions

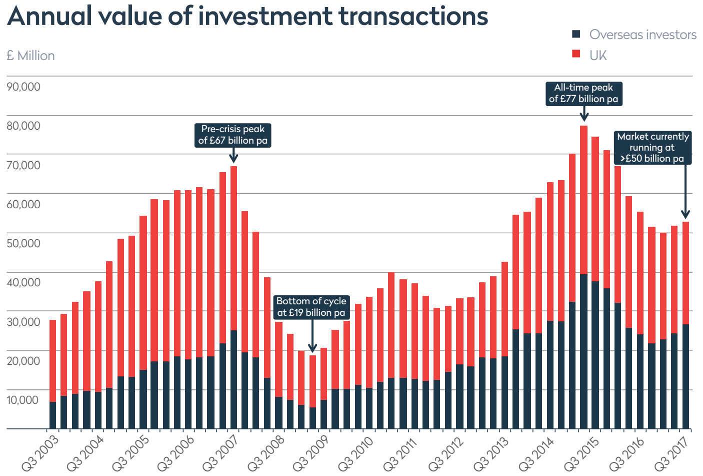


Figure 6 Source: Property Data

Investment by sector

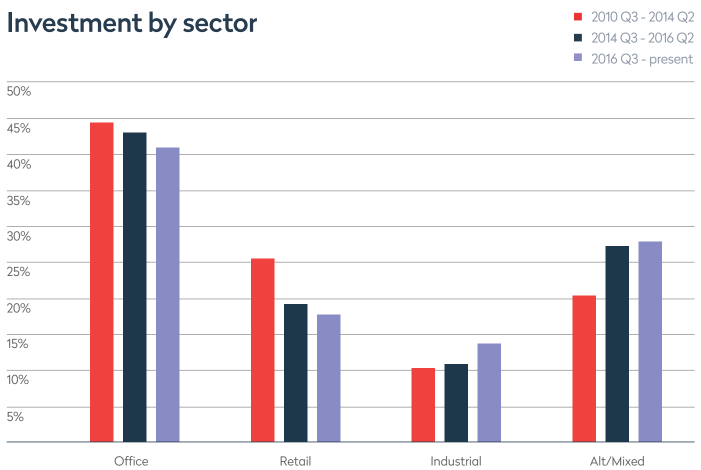


Figure 7 Source: Property Data/GVA

The British Property Federation estimates that the industry has £50bn available to invest in purpose-built residential housing in the UK alone. But the sector is hard to enter - the waiting time to enter UK residential funds, for instance, is up to 18 months and possibly longer. Furthermore, as a nascent asset class in the UK, the challenge remains to deploy capital effectively and deliver the right product.

Investment in the private rented sector is funded primarily by a mix of debt and equity. The relatively low net yield from investment in private rented housing limits the amount of debt that BTR investments can support, hence the requirement for equity investment.

Equity may be in the form of land or buildings which are used to seed the investment and lever further tranches of debt and equity. This is the model that FizzyLiving have used, where they have developed two buildings as demonstrators of their branded rented model, and have used this platform to lever institutional investment into their market rent fund.

Clearly, the type of funding used in BTR and the level of debt and equity employed will depend on the type of organisation, the investment strategy and the target rates of return. Listed companies for example, are able to draw on shareholder capital as well as employing debt and other sources of investment.

There are certain trends across the UK that are acting as investment barriers to more activity in the sector and some are more specific to Scotland. Encouragingly, the appetite to make schemes work in Scotland looks very positive. The range of interested participants with differing mandates is wide (see Figure 8), providing scope for partnerships and joint ventures.

Understanding the motivations and objectives of different types of stakeholders (used in its broadest sense) is key to forming an investment strategy and negotiating investment deals in the market. In addition, recognising the strength of joint venture partners or investment buyers is important.

For example, in some circumstances there may be a planning advantage for a private sector party to have a joint venture with a Registered Provider (RP) or Local Authority (LA). It is likely that it will become more commonplace where a planning application from a joint venture involves a RP, especially where the application is looking to optimise the S75 contribution in lieu of the delivery of market rent managed by the registered provider. Some LA's are also considering land swaps in order to unlock development.

An increasingly common trend in the residential sector is co-investment funding models, where risks and rewards are shared between stakeholders. Joint ventures and co-investment vehicles are popular due to the cost of finance and also because they permit investors to match equity with skills and assets in the sector. Overseas pension funds in particular have favoured this model because it allows them to invest in markets where they do not have the local knowledge or expertise to invest on a more direct basis.

Target returns by type of investment

Sector	Investors types	Net operating income (NOI) target	IRR target (ungeared, can be geared beyond Core)	Strategy	Timescale
Core	Institutions, REIT's, pension funds, RP's	4.5-5.0%	7-10%	Buy and hold at scale to gain a large NOI and build market cap. Aim to aggregate.	Long term, market driven
Core +	Institutions, REIT's, pension funds	4.5–5.5%	8-11%	Increase NOI. Might sell when asset becomes core + and market moves 100-150 bps.	Mid-long term, market driven
Value Add	Institutions,private companies, pension funds	5.0–6.5%	12-16%	Drive increase in NOI through forward funding and outperformance in management. Might sell when yield moves 100–150 bps.	3–5 years
Opportunistic	Property companies, private equity	5.5% + (or lower if purely cap growth driven)	17-20%+	Appetite for development risk and work on stalled schemes. Can develop and hold or sell. Focus on total returns and capital growth.	2–5 years, market driven

Figure 8 Source: GVA

Maximising viability

Critical to a flourishing BTR sector is overcoming financial viability issues and enabling bids to compete with market sale developers. We believe the structural environment in the UK should evolve to help support the sector, which will build further momentum but developers and investors also need to pursue best practice to drive viability.

Key initiatives that will benefit the sector:

The Scottish Government has published planning delivery advice focussed on encouraging BTR in Scotland. In summary the advice:

- Confirms support for the BTR sector as an opportunity to complement existing housing;
- Delivery and to increase the overall rate of delivery of housing; suggests that the planning system should be responsive to reflect varying approaches;
- Is not definitive on affordable housing provision; it defers to Local Planning Authorities to consider how best to deliver this. It does suggest that ownership and management of affordable rental units by the BTR developer may be appropriate;
- It reinforces the opportunities of BTR including delivery of housing at 'pace and scale', supporting economic growth;
- It is sensitive to a tailored / phased approach to developer contributions; and
- It acknowledges that there may be justification for a flexible approach to certain design elements, including minimum unit sizes, and single aspect dwellings.
- Mid-Market Rental (MMR) support and grants - Subject to the needs of a supportable proposal, completion of due diligence, and the requirements of State Aid, the Scottish Government can make the following financial support available to suitable MMR providers:
  - Grant funding;
  - A long term loan at a preferential rate of interest (a sample loan agreement will be provided shortly); or
  - A guarantee in order to help mitigate default risk and/or reduce the cost of private finance; or
  - Equity Investment.
- Rental Income Guarantee Scheme (RIGS) – This is likely to be implemented late this year. Essentially if a preliminary set of criteria are met, the government will guarantee to some degree to compensate for a shortfall in actual revenue vs projected revenue (independently verified). This removes risk and uncertainty but it is not clear how it would actually make a project viable if it doesn't work because of rental levels in the market.
- Government support of Modern Methods of Construction – the £1.2bn Accelerated Construction Fund and other central government measures are aimed at promoting innovative construction methods in the UK. These have huge potential application for BTR through significantly reduced construction time enabling income stream to be realised faster.
  - Particularly relevant as with multi-occupancy dwellings first rental can only be realised once the last dwelling has been finished. This becomes more accentuated for multi-occupancy, multi-storey buildings with high capital cost.
  - Allows for standardisation and economies as part of a wider programme. This is particularly relevant to Scotland as scale maybe harder to achieve than in other cities
- Central government consulting on changing the National Policy Planning Framework to encourage more BTR. This includes looking at allowing developers to offer affordable rental homes rather than other types of affordable housing and identifying government owned land that is suitable for development. In London this is now the case with London Living Rent – an affordable rented tenure that can be held by the BTR developer – rather than an RP.

There is some concern on the Scottish regulatory horizon. The recent Private Housing (Tenancies) (Scotland) Act 2016 will enable councils that think rents are rising too much in a certain area, to apply to Scottish Ministers to have that area designated as a 'rent pressure zone'. This means a cap is set on how much rents are allowed to increase for existing tenants each year in that area. At the moment this does not seem to be acting as a disincentive to investors but the trend to rent control maybe seen as concerning.

What is happening on the ground

The past year has been busy for BTR in Scotland. There are now 10 principle schemes either consented, under construction or letting up. The map opposite shows the location of the schemes and the key provides a brief overview.

1. Moda Living are developing the former police station in Strathclyde, Glasgow. This comprises 450 BTR units and 20,000sq.ft. of commercial space. Delivery is due 2021.

2. Moda are also developing the Fountainbridge site in Edinburgh which comprises 525 Apartments, 25,000 sq ft of commercial space, 15,000 sq ft of amenity space with delivery due from 2019 -2022.

3. Lochaber Housing Association are developing 200 units at Fort William. Delivery is due in 2020.

4. Vox Dundee. This is a mixed use scheme which has planning permission for 110 flats, cinema, café and offices being delivered by Whiteburn Projects Ltf. Delivery is due early 2020.

5. EDI Group,the arms length development entity of Edinburgh City Council, currently own the India Quay site which is a mixed use scheme with 438 homes planned. EDI currently being wound up by ECC so this is likely to be slow progressing although all current projects are expected to be completed.

6. Dandara have 342 residential and 2 commercial units at South Street Glasgow. Currently, the scheme has no start date

7. Dandara & La Salle also have 292 flats and houses and 3 commercial units at Stoneywood Aberdeen. These are due for completion by the end of 2017 and are now letting up

8. Get Living (London) purchased the site in Strathcyde Glasgow from Merchant City and are shortly to submit plans for 600 units. They are guiding a completion date of late 2020.

9. Inhabit have the site at Candleriggs in Glasgow. Currently consented for 513 units (inc student, hotel & commercial) it's held in an anonymous Guernsey vehicle (Candleriggs Limited).

10. Forth Ports also developed 96 mid-market rental (MMR)units in Leith (part of the huge 266 acre Leith Docks masterplan) the units were substantially over subscribed with over 3,400 applications for the 96 available units.

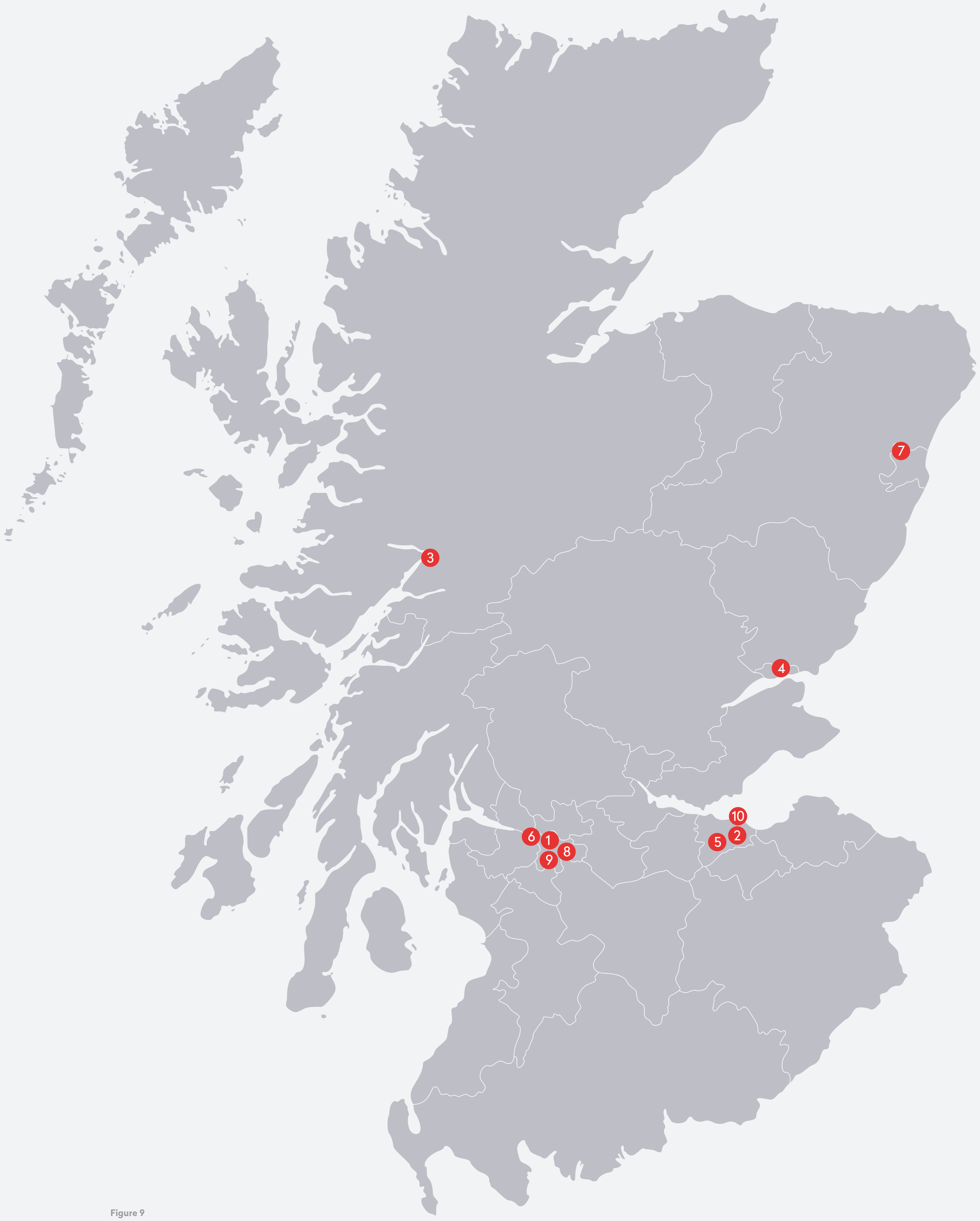


Figure 9

What cities offer the best potential

We believe that Scotland is an exciting opportunity for investors and BTR can work in all seven cities in the Scottish Alliance. Our assessment is that higher yields are more achievable in Scottish cities than the rest of the UK. The lower capital values means there is less pressure on discount to vacant possession value to make schemes work than in the more established UK BTR markets. For example in London, to achieve a 3.75% + net initial yield (NIY) at the point of exchange and a 4.25%+ NIY at the point of income stabilisation, the investor will need a discount in the region of around 15% to 20% to open market sales values.

The table below provides a high level assessment of the fundamental market drivers that underpin BTR in each of these cities and provides current indicative yields based on opportunities we have looked at and our market intelligence. The colouring of the yield figures indicates the confidence in that yield. Unsurprisingly there is less confidence in the indicative yields for the locations that haven't yet seen any BTR activity. The scoring system rates the presence of the drivers in each city compared to the Scottish average.

When considering specific opportunities, it's important to emphasise a rigorous research led approach at the micro level. Scottish cities look to offer attractive yields and low entry points compared to UK alternatives but the product needs to suit the local market.

The four hotspots of current activity – Edinburgh, Glasgow, Aberdeen and Dundee expectedly show the strongest presence of BTR market drivers and accordingly relatively better yields.

Edinburgh in particular scores 'very strong' across all indicators and has seen lots of interest and activity to date. Notably the BTR schemes in the city have all established premium rents over market levels with the strength of the product they are offering. This is key to driving viability and enabling BTR developers to compete with the private sales market in the city which remains very strong.

Glasgow has far greater divergence in house prices which brings down the HPE ratio but all other indicators are strong. The demand for city centre living and competition for land in prime locations is steep. There is a shortage of quality rental accommodation and lack of new developments in the pipeline which suggests plenty of opportunity for BTR.

Aberdeen's rental market now seems to have stabilised and all future indicators suggest a positive outlook for BTR demand. There is currently good demand for city centre rental accommodation in the city and undersupply of quality new build units.

Successful BTR in the remaining cities is more likely to be focussed around offering a better product to existing renters than carving out a new product to achieve a rental premium, although the VOX scheme will offer premium amenities. None of the cities have a below average proportion of the population in the private rental sector and with the exception of Inverness all the future indicators point to increased rental demand.

Although the analysis suggests each city is attractive for BTR, to-date it has been challenging for BTR schemes to compete with open market sales schemes. This next section considers the relative pros/cons of a BTR option for a developer.

	HPE Ratio	Current proportion in PRS (%)	Proportion of 20-34 year olds	Population growth 2025	Total workforce growth 2025	Economic growth 2025	Indicative NIY
Aberdeen City	Average	Strong	Very strong	Very strong	Very strong	Strong	5.25
Dundee City	Weak	Very strong	Very strong	Strong	Strong	Average	5.5
City of Edinburgh	Very strong	Very strong	Very strong	Very strong	Very strong	Very strong	5
Glasgow	Weak	Strong	Very strong	Strong	Strong	Strong	5.25
Inverness	Average	Average	Weak	Weak	Weak	Weak	Weak
Perth and Kinross	Average	Average	Weak	Very strong	Strong	Average	Weak
Stirling	Weak	Average	Average	Strong	Average	Average	Weak

Figure 10

Very strong · Strong · Average · Weak

The example below illustrates a hypothetical scheme in Scotland, with yields at the lower end of the spread and rents/sales at the higher, indicating there is significant upside for long term income yield in many of the cities, as long as the demographic drivers stack up.

It uses a forward funding model to show how the challenges of balancing viability for investors and developers along with competing with market sales can be overcome.

This demonstrates that forward funded BTR can provide a genuine and credible exit strategy for developers if they consider the Internal Rate of Return (IRR) alongside profit on cost (PoC). In this example, the debt facility for private rented sector housing increases from 50% to 65% because the end buyer has effectively de-risked the development from the lenders perspective.

As a result, the developer is required to use less equity and can speed up delivery because reliance on phased sales to owner occupiers has been removed. Because the developer is employing less equity and for a shorter time period, the internal rate of return rises from 18.50% to 26.0%. This type of financial structuring can have a significant impact on capital requirements. Although the developer takes a lower profit margin in cash terms, less equity is tied up and for a shorter duration which ultimately improves the IRR.

With the presence of good market demand and a number of phases of development, this de-risking, reduced equity requirement and project acceleration makes BTR a strong option. Furthermore, there are cost savings around sales and marketing along with finance costs and these are some of the factors that will drive the level of discount. Consideration of the likely sales rate a local level (scheme level) should also be factored in.

On regeneration schemes in particular, sales rates maybe slower especially in early phases of development and this factor will also impact on the appetite of a developer to consider a BTR exit and the level of discount applied to the aggregate sale.

Although this analysis is focussed on the seven Scottish cities, BTR and PRS market more widely has a part to pay in the housing mix for every Scottish town. In saying this, it is important to recognise that the BTR and PRS market will be segmented for different tenant and location demographics, thus each scheme must focus on the micro location under scrutiny.

BTR Scotland example

200 unit scheme

Sales value	£450 psf
Build costs	£150 psf
PRS market value	£405 psf
Gross rents	£27 psf
25% leakage (gross to net)	
5% NOI before purchase costs	

	Open market sales	BTR sales
Gross sales	£67.50m	£60.75m
Project length	32	25
Debt facility	50% cost	65% cost
Debt costs	6.5%, 1.5% in, 1% out	6.5%, 1.5% in
Equity	£27.10m	£18.30m
Sales costs	3.75%	1.75%
Profit	£11.7m	£7.5m
Profit on cost	21%	14%
Ungeared IRR	18.50%	26%

Conclusion

Momentum has clearly been building in Scotland's BTR sector along with the rest of the country. This year has seen a particularly dramatic shift in the pace of activity but it's important to remember that, despite all the headlines, BTR still only accounts for a small fraction of the rental sector.

Scotland is well positioned to attract investment into the sector. It has the right mix of fundamentals that underpin the investment case for BTR and an attractive risk/return outlook relative to other destinations. Other than London it it is the only location with specific BTR planning guidance and we expect this to develop further to help the sector. It is an exciting story in UK real estate and really can deliver great value for all stakeholders.

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