Student housing review

Spring 2018

Front cover image: Three Mills West ,Stratford E15 – Developer Alumno Developments, Forward Funded by Legal & General.

Introduction

UK student accommodation remains an attractive asset class with specialist funds, REITs and particularly overseas investors who are able to benefit from Sterling's current weakness. The investment community continues to chase long-term stable income in a low interest world where more traditional property sectors look less attractive than they have historically. Thus appetite for student property remained strong in 2017 with prime operational assets being in particularly high demand and evidence of yield compression in the UK's best university locations.

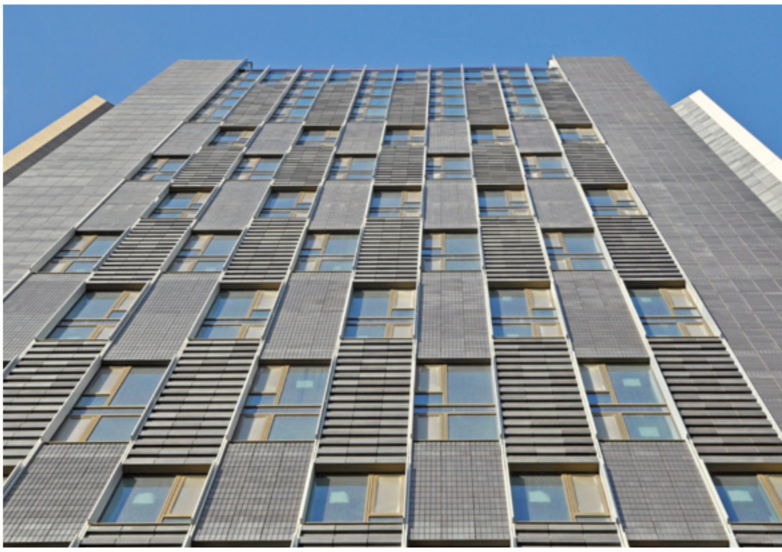
Beyond this, student accommodation has further positive underlying dynamics driving the investment case:

- The enduring strength of the UK higher education system, with excellent international appeal.
- Strong defensive characteristics – excellent performance during previous recessions.
- Rental growth outperforming inflation in recent years
- An enticing demographic case, with more students continuing to enter higher education and the global middle class projected to grow significantly.

The appetite for student assets arising from these factors has led to the UK's development pipeline reaching historically high levels (although this varies significantly between cities). High levels of development are likely to continue, particularly as many of the major operational portfolios have been traded recently, so investors need to look to development opportunities. As a result, we have some concerns around over supply in some locations, particularly with studio units which account for a large proportion of the private sector purpose built student accommodation (PBSA) pipeline. In addition to this we believe investors face some further risks in the current market:

- Severe lack of long lease/nomination product
- Increasing build costs impacting on development viability
- Brexit/prospect of other immigration reform damaging sentiment and threatening future overseas student numbers
- Indications that some markets have reached saturation
- Higher education review – just announced, this could either end up boosting or dampening demand as the government reviews university tuition fees as part of a broader review

Although the 2017 cycle saw a small reduction in the total number of placed applicants, overall it was a strong year for the sector. Over £4 billion was transacted with a number of deals achieving record yields and despite the small drop in applicants, the demand picture remains very strong.



Student numbers

The 2017 cycle saw the first reduction in total placed undergraduate applicants for five years and only the third reduction since 2006. Applications from England and Wales fell 2% compared to the previous cycle's figures while Northern Irish applications fell by 3%. Universities UK has pointed out that there has been a fall in the number of 18-year-olds across the UK population which will account for some of the decline.

EU applications also fell by 2% which in the context of previous rates of growth is a dramatic change, as in each of the last four cycles EU applications grew between 5% and 10%. However this should be seen in the context of record overall numbers currently studying in the UK.

Scotland continued its trend of increased applicant numbers for the last five years, with a 2% year-on-year increase. Non-EU placed applicants have also increased, rising by 4% from last year and at 36,850, now represents the highest number of non–EU applicants on record.

Of the non-EU countries, by far the largest proportion is accounted for by China. In terms of our total student population, Chinese students now account for 95,090, a 13.5% increase since 2013. Of the major overseas contributors to our student population, only Hong Kong has surpassed this rate of growth with a 27.6% increase for a 2017 total of 16,680 students. Nigeria and India were the biggest fallers in this category, dropping 27% and 26% respectively.

A recent study by London Economics has highlighted the benefits of international students to the UK economy. The research suggests that the total benefit of the 2015/16 cohort of international students (both non-EU and EU) over the duration of their studies will be £22.6bn. This means a net economic impact of approximately £68,000 for each typical EU domiciled student and £95,000 for non-EU students (almost 15 times the total cost).

Theresa May has to date refused to remove students from figures on net migration which is seen as a key obstacle to the UK's attempts to boost overseas recruitment. There have recently been suggestions that she is increasingly isolated on this issue and given the lack of a majority in the Commons, it could mean a change is pushed through by MP's when proposals for post-Brexit immigration rules come before parliament. This could provide a notable demand side boost for the market.

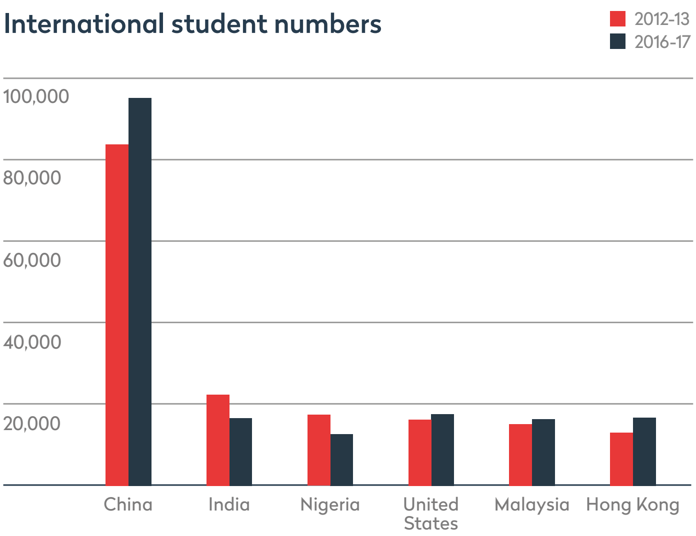
Less positively the study highlights the negative impact on the UK economy and indirectly on the student housing market if, as evidence suggests, Brexit is putting off some overseas students from applying.

There has been a notable increase in the number of masters students, up 6.25% from last year. Other postgraduate numbers have stayed pretty flat so this increase is likely due to the government introduction of a new loan scheme for master's funding. From summer 2018 there will also be a new loan scheme of up to £25,000 for postgraduate doctoral courses, which will probably lead to an increase in doctoral numbers.

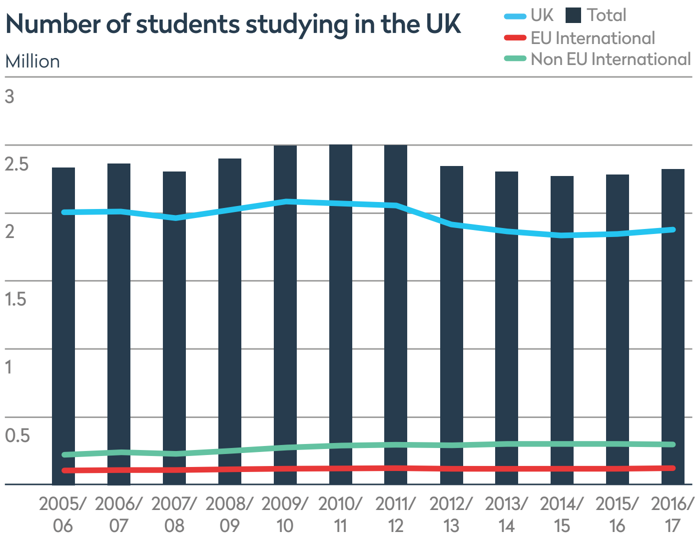
Another message from the most recent data is the continuation of the 'flight to quality' by students. Medium and higher tariff institutions (UCAS measure reflecting levels of academic attainment) have again seen an increase in acceptances while lower tariff providers have seen a decline. There was a 0.4% increase proportionally for higher tariff providers, 2.3% growth at medium tariff and a decrease of 5.4% at lower tariff. This is partly attributable to students placing increased emphasis on getting value for their money, as the cost of attending university has increased greatly since the changes in tuition fees. This is a significant trend for accommodation providers particularly for cities that have more exposure to lower tariff institutions.

Overall the demand picture remains strong, total student numbers are now at their highest level since their peak in 2012/13, following the rush to get in before the fee hike was introduced. The impact of Brexit remains a lingering uncertainty and its potential impact on EU students is something to watch. Having said this, Sterling's weakness continues to make the UK more attractive to overseas students and should continue to provide relief if Brexit is perceived to be going badly, unless immigration policy negatively affects non-EU students.

International student numbers



Number of students studying in the UK



Source: HESA, Universities UK

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>
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Image courtesy of Almuno Developments

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Investor activity

Investor activity in the UK commercial market has been resilient over 2017, with investors remaining pragmatic as the UK continues to be viewed as a stable global property market and Sterling's weakness adding appeal. The fundamentals of the UK's PBSA sector have meant that the sector has once again formed a prominent part of the wider UK commercial investment market, with continued investment from both international and domestic investors over the course of the year.

There was just over £4 billion transacted in the UK PBSA market during 2017, with portfolios accounting for almost three quarters of these transactions. The most noteworthy of these was the Enigma portfolio, comprising of 15 assets and purchased by Brookfield. The price paid was £520m, reflecting 5.50% and representing a premium on single asset pricing. Other noteworthy regional portfolios transacted include the Downing Portfolio, with Tristan Capital/AIG purchasing a 90% stake in the 8-scheme portfolio for £439m, reflecting 5.70%. As with previous years, investors in the sector are driven by the desire to scale platforms, explaining the strong demand and premiums visible in portfolio transactions.

Prime yields for university leased, long-term income have followed the wider investment market trend and hardened, with investors especially driven by the strength of university covenants and the underlying residual value of the PBSA sector. A notable example of this was the forward funding of Lincoln's new town centre PBSA scheme, which had the benefit of a 20-year lease to the University of Lincoln and achieved a yield of <4.00%.

The direct-let market has also continued to perform well over 2017. Prime yields for modern, income producing assets in the best university cities are now in the range of 5.50% - 6.00%. Noteworthy transactions include Ninety North's £17.2m purchase of The Union in Leamington Spa, the first PBSA scheme to open in the town and Unite's forward funding acquisition of DH1 in Durham, a 222-bed scheme located adjacent to the University of Durham's sports facilities.

The London PBSA market has also performed well in 2017 with a number of individual direct let transactions at record yields. Transactions of note in the capital include GCP Student Living's purchase of Woburn Place in Bloomsbury for £135m, reflecting 4.50%, as well as Unite's disposal of Kirby Street in Farringdon, where the 128-bed scheme was sold for £42m, reflecting 4.25% and a price per bed in excess of £325,000. The most noteworthy transaction, however, was the Regent Portfolio, which was purchased by iQ in December. The portfolio comprised of 11 schemes, with the vast majority of beds situated in the capital and achieved a price of £869m, reflecting a significant portfolio premium on individual values and the best schemes individually priced at sub 4.00%.

While demand for proven, income producing assets has grown over the past 12 months, the market for forward funding has remained challenging. Investors are taking a more cautious approach to these transactions, particularly in studio schemes in cities with only one university, where potentially the demand/supply balance is marginal. As such, there are a number of forward funding opportunities across the UK from 2017 which have failed to attract the necessary levels of pricing to be viable.

2018 is likely to continue in a similar manner to 2017, with demand in the sector being underpinned by PBSA's strong cash generating characteristics and its reputation as a 'safe asset'. Demand for bulk is likely to continue, therefore portfolios will likely still be in high demand, as will income-producing proven assets in strong university cities and schemes where asset management initiatives can be undertaken to drive rents and values.

Portfolio	Purchaser	No. of beds	Price	Price per bed	Date
Regent Portfolio	iQ	3,644	£869m	£238,474	Dec-17
Study Inn Portfolio	Arlington Investors	1,494	£135m	£90,361	Dec-17
Enigma Portfolio	Brookfield	5,507	£520m	£94,425	Dec-17
Downing Portfolio	Tristan Capital/AIG	3,644	£439m	£120,472	Sep-17
Unite Portfolio	Brookfield	4,175	£295m	£70,659	Feb-17

Supply of student accommodation

We monitor the key indicators from student accommodation markets in the main student towns and cities across the UK, covering over 70 universities. This data includes pipeline information, structure of ownership, rent monitoring and deal tracking.

At the headline level, this year has seen an increase in the total number of purpose built beds of 22,247, or 5%. University owned accommodation is still the most prevalent accounting for 51.6% of the total. This is down on last year's proportion, reflecting the fact that the private sector added more beds over the course of the year. There are now just under 219,000 private purpose built beds, representing a 9.2% increase on last year, compared to 1.7% for university owned stock. En-suites and studios are by far the most prevalent in new developments, with the private sector delivering a disproportionately high number of studios. We believe this is an over-supply risk in some locations and something that needs to be closely monitored when assessing locations.

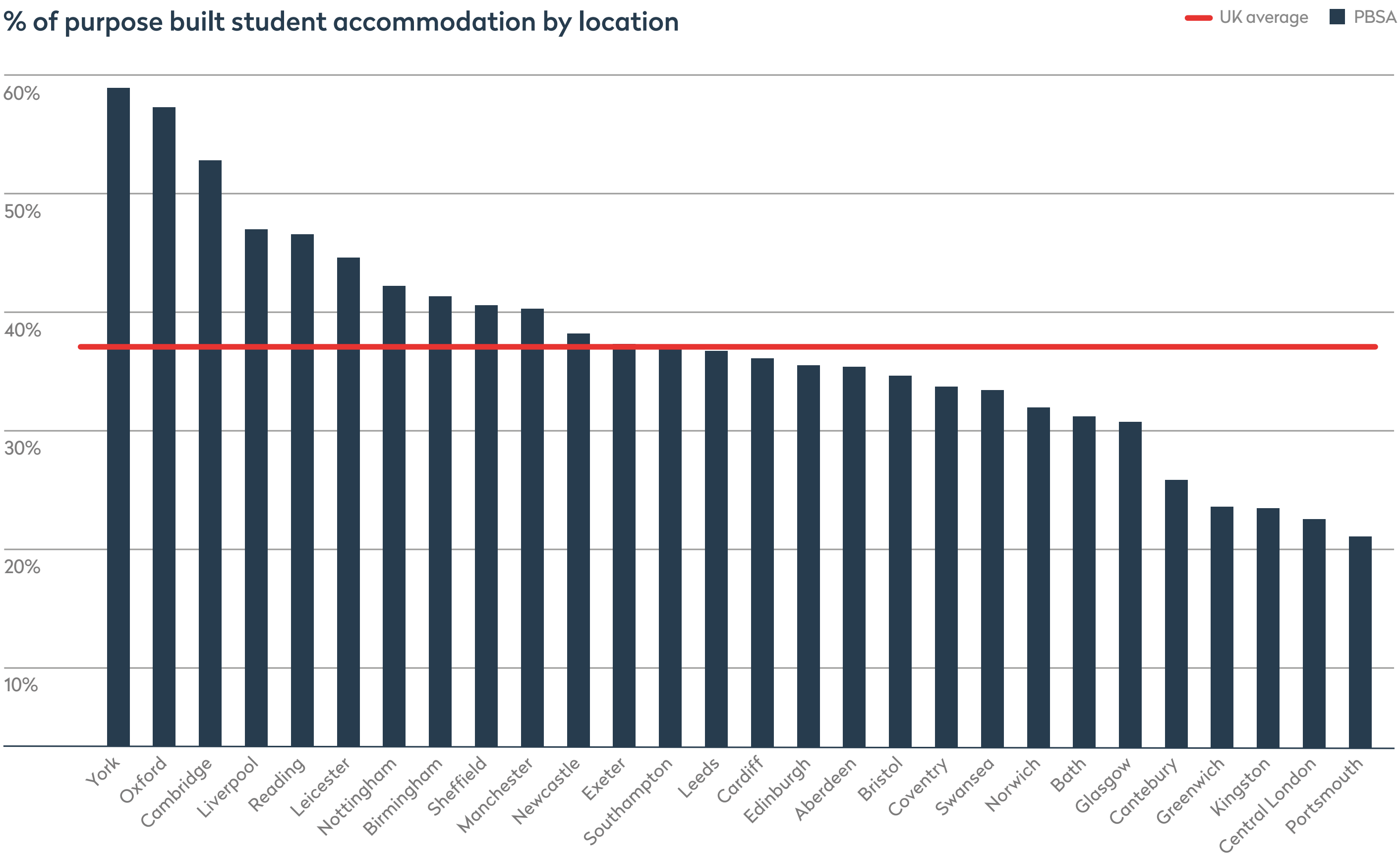
Kingston saw the biggest increase in purpose built beds, with almost 21% more than last year. This was followed by Glasgow with a 16% increase and Cardiff and Coventry both showing roughly 11% increases in supply. Only Birmingham saw an overall reduction in purpose built supply, losing just over 1.5%. Cambridge, Canterbury and Reading were all flat, with no new purpose built beds being added over the year.

At a high level, rental growth in London has been almost flat and just under 2% across the other locations. It's important to emphasise that despite this, there is a lot of variance between locations with some returning healthy rental growth and others showing oversupply and falling rents, despite healthy demand at the national level.

This year we have included the number of beds under construction so that, along with the PBSA share relative to the number of full time students in each location, we get an outlook for the supply demand dynamic. This shows that there are still several locations that look to be able to support a healthy amount of new PBSA development.

It is also worth mentioning that many local authorities now have Article 4 Directions in place to limit the amount of new HMO's, largely as a result of concern over loss of family homes. Historically these have been an important source of supply for students but in many locations these will not deliver significant new supply in the future.

% of purpose built student accommodation by location



Student housing in key markets

Source: GVA

Development outlook

The current climate for UK construction is fairly challenging with the industry still reeling from Carillion's liquidation and the full implications for the contractor's vast supply chain of 25,000-30,000 firms is yet to be seen. Recent data trends have provided little good news, with both the IHS Markit/CIPS UK Construction Purchasing Managers' Index (PMI) and ONS construction output trending downward over the latter part of 2017.

In our last report, the consensus expectation was that tender prices would fall in 2017 but the latest set of BCIS data has shown the opposite actually occurred with tender prices rising significantly over the course of the year. The industry experienced inflationary pressures in the supply chain with rising costs and prices being cited in various surveys over the course of the year.

The current central forecast from BCIS predicts that the rate of tender prices will fall over the rest of 2018 before rising in 2019 and 2020. This central forecast reflects a moderate Brexit scenario and an otherwise stable political climate. Obviously there is a high degree of uncertainty around the result of Brexit negotiations and the construction sector has particular exposure – its reliance on migrant labour, overseas imports and exposure to Sterling's performance being the most obvious.

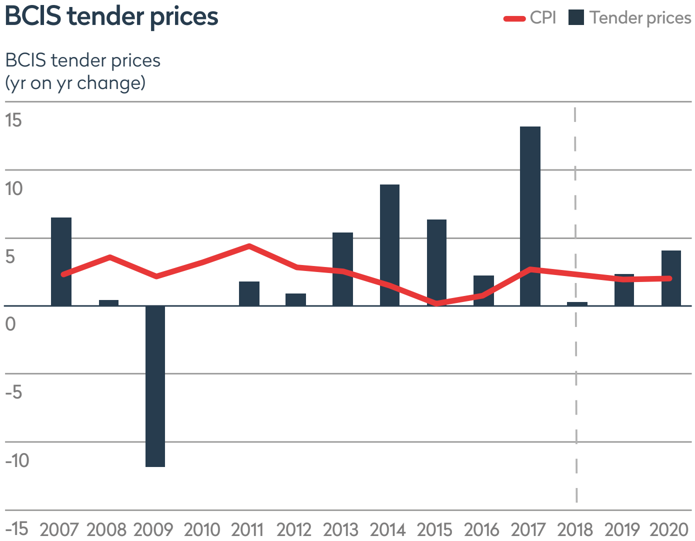
On a more positive note, optimism among UK construction companies appears to be improving and many companies expect a pickup in new business wins later in the year. Despite the challenges in the UK construction market which will put pressure on margins for student developers, the overall picture remains positive.

There is still a structural under supply in PBSA at a national level and given the level of investor appetite for the sector, we expect strong development activity to continue for the foreseeable future. As mentioned, individual markets now look more divergent with some representing much better opportunities than others.

Student demographics, university quality, land values, site characteristics and pipeline are all key determinates and as the market matures and our macro environment looks more uncertain, market intelligence is more important than ever.

There are also considerable opportunities for investors to work with universities to improve or rebuild their existing accommodation. Surveys suggest that applicants are placing increasing emphasis on the student experience and accommodation quality when choosing a university and it is now also a consideration in some university league tables. A lot of existing stock is in need of regeneration and partnerships can help deliver excellent results for both parties and address many of the development challenges.

BCIS tender prices



Source: BCIS

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Image courtesy of Almuno Developments

Should you wish to discuss any details within this report please get in touch.

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