

LGPS Intelligence: Build to Rent – inflation hedging with local flavour?

The build to rent (BtR) sector has the potential to fulfil place-based investing targets and help ease the UK's chronic housing shortage, while providing a welcome inflation hedge.

For Local Government Pension Scheme (LGPS) investors, the ability to invest in a sector that can positively impact communities around the country may be particularly of interest, as the scheme and its constituent local authorities continue to evolve.

A relatively new asset class, BtR has characteristics that may make it an attractive addition to local authority pension fund portfolios. These characteristics include:

- Regional solutions to increasing the UK's nationwide housing supply
- The ability for the LGPS to support investment locally
- The potential for resilience in the face of slowing economic growth in the UK
- Contributing to the UK's stock of energy-efficient homes
- The current energy supply shock may boost occupier demand for more energy efficient BtR homes

It is important to note that there are macroeconomic risks to this sector, some of which are outlined within this paper.

Inflation and the residential rental real estate sector

Supply-side disruptions, rising energy costs and the war in Ukraine have underlined inflation concerns for 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



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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.

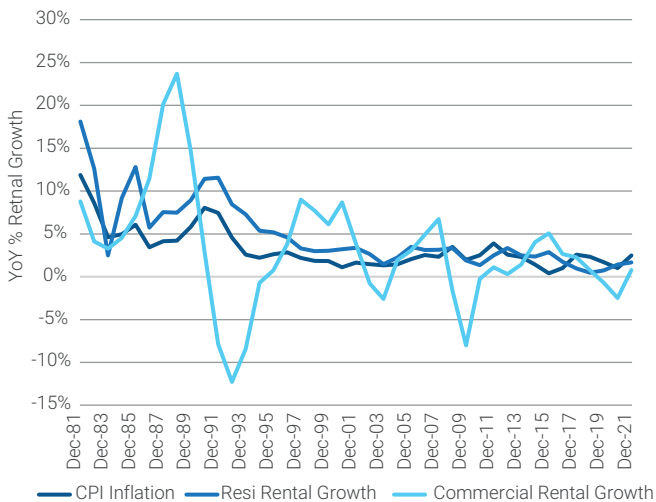
For real estate to offer suitable inflation protection, sectors need to be supported by favourable market fundamentals such as growing occupier demand, the asset owner's ability to pass on higher running costs to occupiers and an environment where the asset is integral to either business activity or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



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

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.

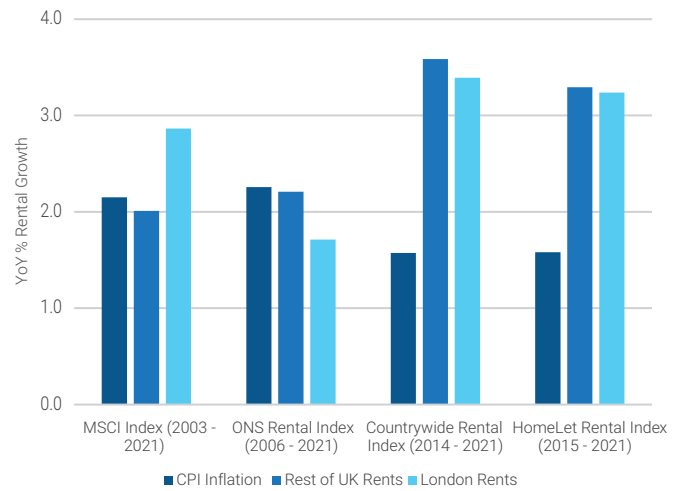
Data from the OECD shows that between 1981 and 2021, residential rents grew by 4.8% per annum (p.a.) ahead of CPI inflation which averaged 3.3% p.a¹; with commercial rents growing by 3.2% p.a. While it's worth noting that OECD data imperfectly reflect ongoing market prices, due to inclusion of other 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.

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

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

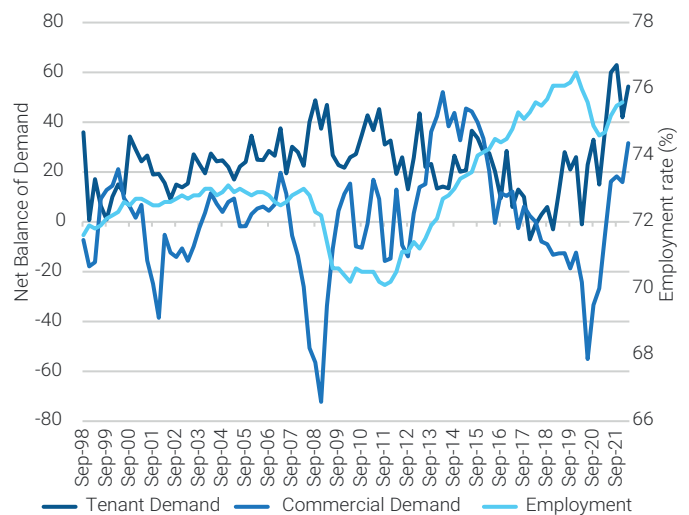
Rental resilience in the face of rising prices



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

The rental demand chart below 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.

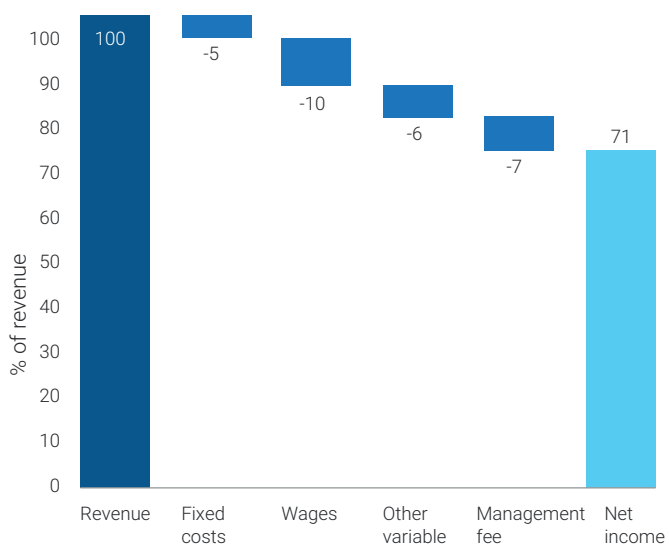
Watch the wages

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 as shown in Figure 4.

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.

Residential gross to net income



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

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

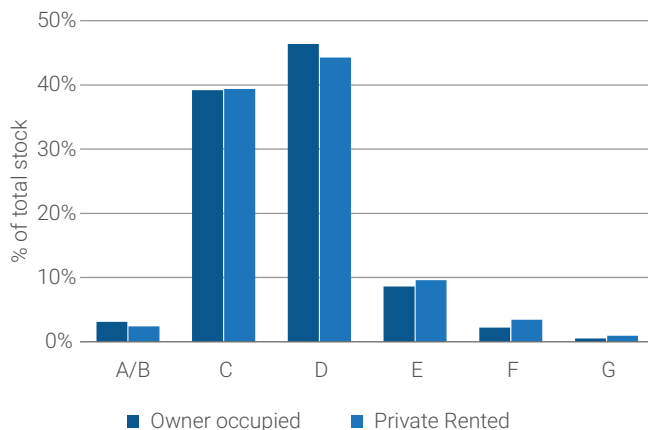


BtR tenants – weathering rising energy costs?

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 shows that 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.

The Legal & General BtR Fund, for example, has an average EPC rating of B.

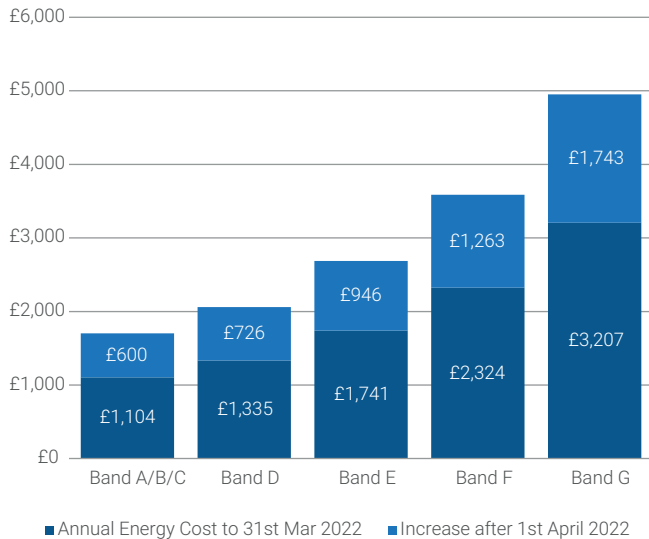
England housing stock EPC rating



Source: UK Government DLUHC English Housing Survey, 2020.

It is estimated that there is a cost saving on annual household energy bills ranging from £360 to £3,250, depending on the EPC rating of the home.⁴ 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.

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, in our view.

4. Source: JLL & ONS as at March 2022.

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

Conclusion

We believe the BtR sector could help local authority pension fund investors provide much needed energy efficient rental properties across the country, and benefit from the UK's housing and supply and demand imbalance.

While the macro environment poses some risks to the sector, the inflation-hedging features of BtR and its positive societal benefit combine to make it worthy of consideration by local authority pension funds, in our view.



Contact us

For further information about LGIM Real Assets, please visit lgim.com/realassets or email contactrealassets@lgim.com



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