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Residential

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How one asset class is proving its resilience

KEYNOTE INTERVIEW

The relative resilience of rented housing

The development of family-friendly rental housing in the UK and Ireland offers the potential for both opportunistic returns and resilient income, argues ESO Real Estate's David Christie

Build-to-rent residential in the UK is a fast-evolving market and the pandemic is perhaps the first test of its efficiency in product design, asset management and service performance, argues David Christie, partner and head of real estate at ESO Capital Management. The private equity investor's ESO Real Assets Fund I is backing two rented housing development platforms: Placefirst in the UK and Genesis in Ireland. Christie tells *PERE* why he believes the sector will show relative resilience of performance while still providing opportunistic returns as the property market absorbs the impact of covid-19.

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Q What's driving investment in residential property markets in the UK and Ireland?

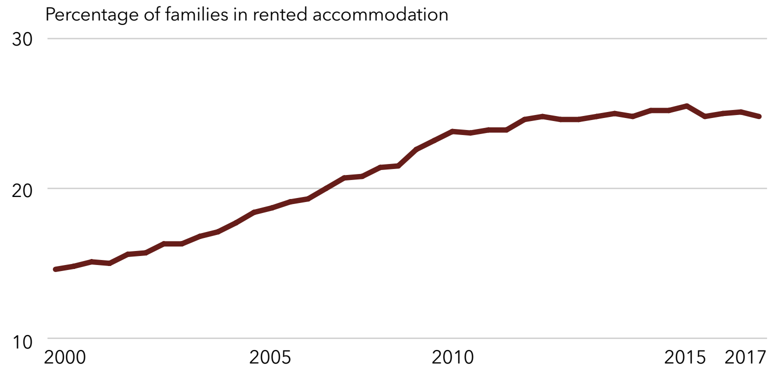
Opportunistic investors are increasingly moving the weighting of their portfolios towards sectors which were historically less represented, such as rental residential and healthcare. That may seem like nothing new to US investors, but for UK and European cities these are very much nascent sectors.

While investors might hitherto have resisted taking on the operational risk involved in those asset classes, they have already become more comfortable with that because traditional sectors have also become more operational – in retail we see more turnover rents and offices are increasingly dominated by space-as-a-service concepts. Meanwhile, there is a growing acceptance that alternative property asset classes provide a more robust income profile together with a hedge against inflation.

Although residential leases are short there's a high propensity for tenants to renew and rental levels track inflation well. That income will also be relatively resilient in the face of the pandemic. We have seen a lot of disruptive factors in retail and offices and this crisis will accentuate some of those disruptors.

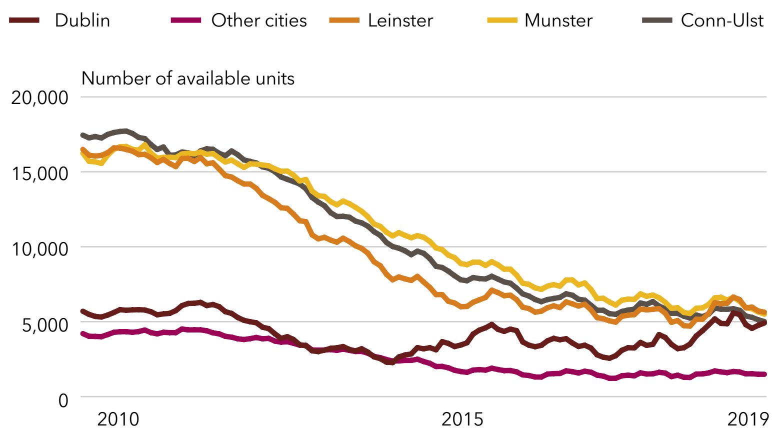
The negative impact on retail is already evident, and the long-term effect of the enforced changes in working behavior on the way people occupy office space is difficult to predict. In residential our focus has been on supplying attainable housing in the UK regions and in Ireland, and a high proportion of the residents in those schemes are key workers whose household incomes are less likely to be impacted.

The percentage of families in rented accommodation in the UK has almost doubled over recent years



Source: UK Office for National Statistics/Resolution Foundation

The supply of housing to rent in Ireland has dwindled



Source: Daft.ie

Q What are the obstacles to deployment?

The major challenge for investors in the residential sector is to deploy their capital at scale. In the private equity real estate world, we have seen a lot of very large multi-billion-dollar funds raised, and the ticket size for those funds needs to be at a minimum level for transactions to make sense. That prevents them from accessing certain markets, or only allows them to access one segment of those markets.

For example, as the UK build-to-rent market has developed we have seen the delivery of large-scale apartment schemes in cities targeted at young professional renters. These developments frequently take more than two years to deliver, and if you look at the level of unlevered returns that you can achieve it is very difficult to identify the opening for opportunistic capital, because pension funds and other institutions with a much cheaper cost of capital are accessing that market through forward funding structures with big developers. The only way you can really get comfortable is on the assumption of rental growth, which in the current climate is far from certain.

We take investment decisions mainly on the basis of unlevered returns and seek to understand the risk profile of the strategy rather than just looking at the levered income flow. We do not necessarily introduce debt as a way of boosting returns. Leverage at a conservative level allows us to recycle capital more efficiently and helps us to protect against the potential downside.

Q What segments do offer the potential for opportunistic returns?

If you look at housing as if it is a consumer product and try to identify where demand is coming from, the majority of people who rent housing in the UK are not single professionals, but young families, and they're not located just in London or Greater Manchester, but across the regions, and they want houses with gardens and family amenities, not apartments. Because of constrained supply, UK house prices have risen by 259 percent since 1997, compared with a 68 percent rise in annual earnings. That has driven increased demand for rental housing. However, the development market for smaller-scale regional housing schemes with a development value that might total only £15 million-£20 million ($19 million-$25 million; €17 million-€22 million) is very much undercapitalized.

Historically, regional developers would have spoken to private equity funds. But with the race to scale over the past decade, PE funds have outgrown the lower end of the market. At

Placefirst

Developing family rental housing in the UK

Placefirst develops and renovates multifamily housing for low to middle income renters in suburban and transport-oriented locations in the north of England, including Liverpool, Greater Manchester, Sheffield and Leeds.

Typical project:
50-150 houses, value £10 million-£40 million

Secured pipeline:
2,000 units, with 3,500 targeted by 2023

the same time there are few traditional lenders focused on this segment, so these smaller developers are pushed towards the alternative lending market, which is not cheap. They have to create deal-by-deal funding structures, so the management team is spending half its time trying to build the capital structure, which might not be their skill set.

The market in Ireland has many parallels with the UK. Real estate capital markets do not function well outside Dublin. CBRE figures show the capital city accounts for 97 percent of the investment in rented residential real estate. The regional market is dominated by small housebuilders which construct a few units, sell them, and recycle the capital. That has led to an acute shortage of rental housing in major employment areas outside Dublin.

Q Why invest in proprietary operating platforms?

Accumulating a portfolio by acquiring individual assets is too time-consuming. Taking controlling interests in development platforms allows us to aggregate small projects into much larger portfolios while ensuring that the underlying real estate is of institutional caliber. For the delivery platforms working with us as strategic partner and capital provider frees up management time to focus on their core business that would otherwise be spent on finding capital solutions.

Our controlling interest ensures that we have strong alignment of interest, so our partners move away from thinking of themselves as third-party asset managers to start thinking like an owner. They're incentivized on the equity aggregation and net asset value accretion of our portfolios, and we're able to allow them to invest in their own business infrastructure in a way that is difficult to do in other types of single-asset or transactional relationships.

The exclusivity of the relationship encourages collaborative working as it enables a two-way exchange of intellectual property that would not be possible working with different developers on a solely project basis. That allows us to create a self-sufficient envelope of services that wraps around the portfolio to deliver high-quality projects.

The rented residential markets in the UK and Ireland are dominated by small, non-professional landlords, and we didn't want that to be tenants' experience of interactions with our brands. This is why we created our own residents' services provision, which enables us to build up data on what residents need, which informs our understanding of future scheme design. Placefirst also has its own construction capability so that it's not reliant on the performance of small, regional contractors and can exert better control over its supply chain to keep building costs down.

Q What is your exit strategy?

We plan for flexibility. It is a closed-ended fund but the nature of our investment pool is such that many of our investors would see the attraction in a longer term involvement in the portfolio, so there is not the same pressure to facilitate an exit as you see with some other opportunistic funds that invest in single assets. However, in a downside scenario we may potentially want to repatriate money through refinancing assets, or by selling individual rental homes to owner-occupiers. On the upside, you only have to look at the US market to see the potential for the creation of residential REITs, and some of those vehicles have already been established in the UK.

Q How do you expect covid-19 to impact residential property markets?

We have to accept that we are in a consumer-led recession and the rate at which consumer confidence returns will determine the speed of recovery in the different property sectors. Even when people are still in employment, they may be less inclined to buy a home, and even if they are, it may be harder for them to get a mortgage.

It'll also be interesting to see whether a period spent largely at home leads people to examine whether their accommodation really suits their needs. ■