19 September 2024

Why Build-to-Rent Can't Fix the UK's Housing Crisis

Despite being one of the nation's most pressing issues for years now, the UK's housing market has trudged along in a miserable state. We've written about the system's woes before, which include unaffordability, a lack of new construction, and inadequate quality. The persistent supply and demand problem in the UK rental market has attracted attention from real estate developers around the world. One of the most commonly cited solutions is build-to-rent (BTR) housing, especially from developers in the United States. BTR has successfully brought cost effective housing to the American market, and there is interest in whether the same strategy could work across the Atlantic.

However, what's good for the goose isn't always good for the gander. While BTR may work in select instances in the UK, our analysis suggests that the model may not be sustainable outside of gateway cities such as London for anything beyond core income and "build to core" strategies.

Let us illustrate the issues with implementing BTR at scale by first considering the key costs associated with a BTR project in the UK. We can conservatively assume that hard costs are approximately £250 psf NIA, soft costs £40 psf, and interest expenses £40 psf. All told, BTR project development costs are around £330 psf NIA, and we haven't even factored in the cost of land! However, we'll continue to work with the £330 psf figure for the sake of simplicity.

We would expect that to be attractive to value-add investors in today's market, a new-build development should target an 8.75% gross yield, or about 6.5% net. Against a £330 psf basis, this hypothetical UK BTR project should charge at least £29 psf annually in rent.

This leads us to our first issue: UK building regulations impose minimum space requirements on new builds that may or may not be what the market needs. According to the latest housing regulations, all newly constructed one-bedroom accommodations must be at least 398 sq ft (37 sqm) in area for single-occupant flats. For two occupants, the minimum space value grows to at least 538 sq ft (50 sqm).[1] Using 490 sq ft as a middle value nets a monthly rent of £1,185 for a one-bedroom flat based on the rent calculations above, and we haven't even accounted for land or rolled-up interest. A brief search on Rightmove shows us what one might find at this range in central Leeds: a 479 sq ft one-bedroom new build for about £1,200 a month.

Total Addressable Markets

While the aforementioned new build apartment complex would provide much-needed housing to the Leeds market, it also highlights key uncertainties of the BTR business model. Chiefly, the pricing for one-bed accommodations caters to a small total addressable market and limits the ability of developers to scale the product over time.

To illustrate this point, if we assume that a resident should spend no more than 40% of their net income on rent, then a tenant of a £1,200 pcm flat should take home at least £36,000 per year, which equates to a gross salary of £45,500. As the data below show, this gross salary level roughly aligns with the 80th percentile of earners in Leeds, as well as other regional cities.

[1] DLUHC

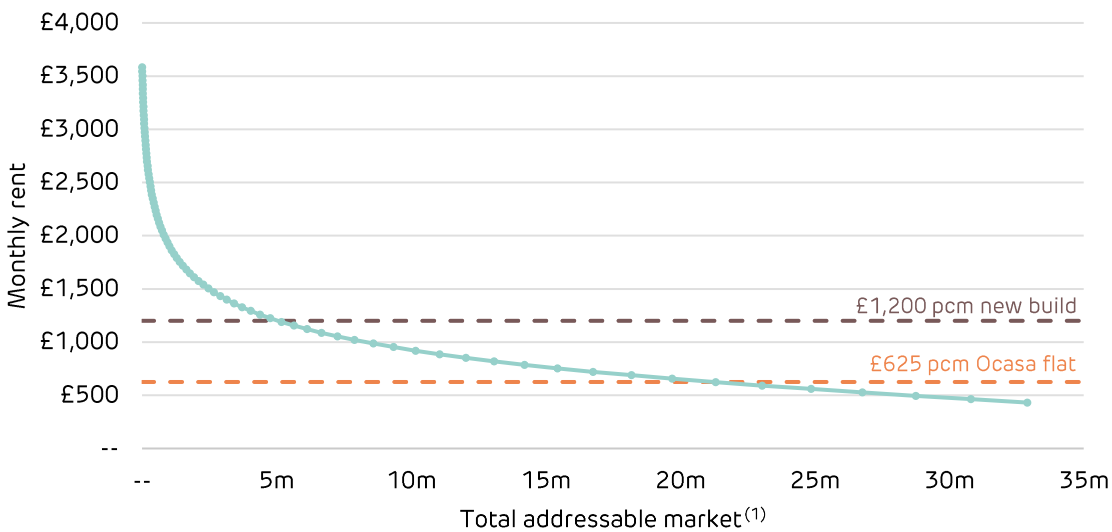
Figure 1: Pre-tax income distribution by UK metro area (£)

	Leeds City Region	Greater Birmingham and Solihull	Greater Manchester	Liverpool City Region	York and North Yorkshire	London
50 percentile	31,200	32,391	31,075	31,600	31,013	39,806
60 percentile	34,882	36,873	35,116	35,121	35,126	45,328
70 percentile	39,879	41,387	39,863	40,045	40,440	51,480
80 percentile	46,587	48,251	46,800	46,140	47,939	60,117
90 percentile	56,456	59,795	59,353	56,867	61,335	79,726

Estimating Leeds' total addressable market, we find that of the 400,000 workers in the city, 80,000 aged 16-64 can afford a city centre 1-bed. However, this is likely an overestimation, as older workers are less likely to live in small flats in city centres. Using city-level data to estimate the share of younger adults (16-35 years), the potential market reduces to 36,000 renters, but this number can be whittled down further. Not all would choose city centre living, a one-bedroom new build, or to allocate up to 40% of income to housing. Also, the top earners are likely older, skewing the age distribution. Therefore, the estimated market of 36,000 seeking a £1,200 new-build flat is likely to be an overstatement.

For some investors, this proposition may represent a sufficiently large addressable market. However, it's improbable that such an offering can sustainably grow rents into the future. Using income survey data, we can plot out how much of the working population falls below a certain monthly rental spending level. As the graph below shows, the total addressable population plummets at rental values over £1,200 per month, suggesting that very few UK workers can afford to spend more than that on rent. Additionally, lowering rents by 10-15% when starting from such an expensive starting point will have limited impact on growing the addressable market. As such, there is very little room to manoeuvre asking rents at this level, leading to a situation where BTR developments in regional UK markets face poor prospects for long-term nominal income growth.

Figure 2: UK addressable market by monthly rent [2]



(1) Total addressable market represents population of UK workers who earn at least 2.5x the monthly rental value in post-tax income

[2] ONS

Of course, wages will rise over time, which should expand the size of the addressable market. However, we expect some of the fastest wage growth to occur at the bottom of the scale. This outcome will be the result of multiple factors. European reindustrialisation, for example, will raise demand for service sector and manufacturing employees. Additionally, artificial intelligence is more likely to disrupt mid-/high-earning knowledge sector jobs that can be digitised over blue collar, hands-on work. We might then expect faster relative income growth to occur not in the middle or upper-middle quintile of earners, but rather the bottom segments.

We believe this exercise helps explain why BTR has only contributed about 100,000 new houses in the UK over the past decade despite widespread demand for more accommodation.[3] Even with the generous assumptions used throughout the calculations we've presented (recall that we assumed no cost for land or capitalised interest), it's hard to justify BTR as a strategy in most places outside of London due to its high costs, small addressable market, and limited ability to grow rents.

How Ocasa Provides a More Scalable Alternative

In our time developing our residential platform, Ocasa, we've come to recognise that there are better options to address the large population of underserved renters in the UK. Specifically, we've found that refurbishing existing assets allows us to provide housing options at accessible rental points without sacrificing management, amenities, or sustainability. As the numbers will show, Ocasa's model offers a better solution to provide quality housing to a broad array of tenants across the UK.

Ocasa accommodations have an average rent of approximately £650 per month. As these flats are fully furnished, we can deduct £25 per month to account for the fact that renters don't have to buy furniture during their tenancy. Using the same calculations from earlier, we can estimate that a potential tenant would have to earn £21,000 annually before taxes to afford an Ocasa letting.

When we apply this salary bracket to the demographic makeup of Leeds, we observe a significant expansion in the addressable market. Instead of being limited to the top 20% of earners, an Ocasa letting is accessible to 85% of the market. After restricting the age bracket to 16-35, we achieve an addressable market of 152,000 earners. Unlike before, this value is less likely to be an overestimation, as more of this population will be younger people who haven't reached their peak earning years and occupy smaller flats. This shows us that the market for a newly-refurbished, professionally-managed, fully-furnished product like Ocasa is likely 4-6 times larger than a new-build offering, and there is much more room to grow rents, too.

To put this into more easily understood terms, we can consider the types of workers that an Ocasa offering can appeal to.

- A first-year NHS nurse earns about £27,000
- A grocery store employee earns about £22,000
- An Amazon fulfilment centre worker earns about £24,000

Overall, this array of workers provides a broader addressable market upon which we can build our platform. With a larger base of potential renters, we are confident that a model like Ocasa is better able to scale across the UK, outperform during macroeconomic headwinds, and provide more rental growth for investors.

[3] Savills

What About the United States?

While BTR has its challenges in the UK, taking a look at an instance where it works can show us what might need to change for the strategy to fare better in the UK. To do so, we can shift our market analysis to the US, where BTR projects have succeeded in providing accessible housing in the nation's quickly growing Sun Belt.

Firstly, it's important to consider the differences in zoning regulations. Most jurisdictions in the US abide by an "as-of-right" zoning system. This system lowers construction barriers by restricting the discretionary dismissal of projects that satisfy all basic criteria. Additionally, the US has a less stringent building code than the UK, which allows developers to build more economically, instead of forcing them to negotiate with local authorities. Finally, many places in the US lack a minimum area requirement, allowing the market to determine adequate residence sizes. Overall, simpler processes in the US contribute to cheaper housing outcomes.

American workers also tend to earn more relative to the cost of construction than their British counterparts. Consider a flat (or in this case, an *apartment*) renting for $1,500 per month near downtown Houston. For that price, a tenant can get a similarly-sized one-bedroom accommodation to what was seen in Leeds.

Unlike in Leeds, however, a $1,500 per month rental is affordable to a much larger segment of the population. To keep rental expenses at or below 40%, a potential tenant in Houston should earn about $54,000 per year before taxes.

Figure 3: Pre-tax income by US broad metro area ($)

	Houston	New York	San Francisco	Philadelphia	Atlanta	Miami
50 percentile	44,341	52,006	70,000	51,026	50,250	42,004
60 percentile	55,000	65,565	90,100	65,070	60,905	50,030
70 percentile	70,100	85,436	111,120	81,283	75,000	60,001
80 percentile	93,004	110,548	141,050	107,502	100,001	80,000
90 percentile	140,320	165,001	191,700	150,515	143,100	117,004

While in the UK the threshold for new-build affordability was at the 80th percentile, in Houston that figure is below the 60th percentile. Furthermore, the aforementioned apartment complex in Houston offers smaller spaces for $1,375 per month – with an area roughly equal to the UK minimum. At rates like that, a tenant would only have to earn $42,000 before taxes. This means that a compact new-build in a major US urban location is affordable to a majority of that city's residents – a concept that is almost unfathomable in the UK. This also bodes well for future rent growth, for the same reasons outlined earlier.

Solutions from All Sides

This comparative analysis of outcomes in Leeds and Houston shows that factors such as building codes, construction costs, and local wages all come together to make BTR a viable mass-market strategy in the US, but not the UK. In the UK, new-build accommodations are only feasible options to the top quintile of earners, while the barrier to entry is significantly lower in the US.

BTR may not be a panacea to the UK's housing crisis, but that doesn't mean it doesn't have its place in the market. In areas with higher average incomes, there may be a large enough total addressable market of renters who can support the higher costs of new-build schemes as well as enable rental adjustment over time.

Given the severity of the UK's housing crisis, however, it's critical for the market to prioritise scalable solutions. This process will be multi-faceted and require immense investment from actors of all types, with a key role for the central government. While current efforts to reform the planning system are a critical step, filling a shortfall of 4.5 million homes will require the government to not only find ways to bridge the gap between rising construction costs and stagnant wages, but also reconsider its own role in promoting and even creating new housing stock. There is a growing undercurrent in the new Labour government that views housebuilding as no different than other forms of government-provided infrastructure when it appears there is a market failure occurring, and we may start to see this stance work its way into policy.

The path to normalising the market will therefore be a decades-long effort. Developers seeking exposure to the long-neglected UK housing market should thus direct their attention toward refurbishment led strategies such as Ocasa, which both address a larger segment of the total population and provide ample room to adjust rents throughout long market cycles.