UK RESIDENTIAL UPDATE

January 2023

EXECUTIVE SUMMARY

Shortfall in housing supply and barriers to home ownership expected to fuel rental demand

Persistently high inflation, and the way in which central banks are responding to it, is dominating the macro-economic outlook. Since December 2021 the Bank of England (BoE) has increased interest rates from its record low of 0.1% in response to soaring prices. Expectations of sharply higher interest rates and rapidly rising debt costs have caused significant movements within the household mortgage market. **It means households are paying the greatest portion of their income on mortgage payments since 1989 at a time when the rate of inflation is running at a 40-year high.**[1]

This article looks at the current state of the UK housing market and indicates how we think it will impact the emerging institutional build to rent (BtR) market, akin to the multifamily market in the United States. Increased difficulty in the mortgage market is expected to fuel demand for rental properties in the UK. As the BtR market matures and the quality of rental accommodation improves, we expect consumers to realize the benefits of purpose-built apartments, with more people choosing to rent their housing based on preference rather than financial restrictions. Key findings include:

1. The knock on effect of rising mortgage rates and slowing house sales has been a surge in demand in the build to rent market.
2. High inflation and the rising cost-of-living are likely to put downward pressure on home sales and transaction prices, as higher interest rates add further pressure to already squeezed household budgets.
3. Overall, we expect less distress in the UK housing market as compared with previous market downturns; however, things could change in the event of a severe recession which has a significant impact on job security.
4. New housing supply is expected to fall even further behind target as a result of tightening market conditions.
5. Investors continue to favor living assets for their favorable demographic drivers and income stability.

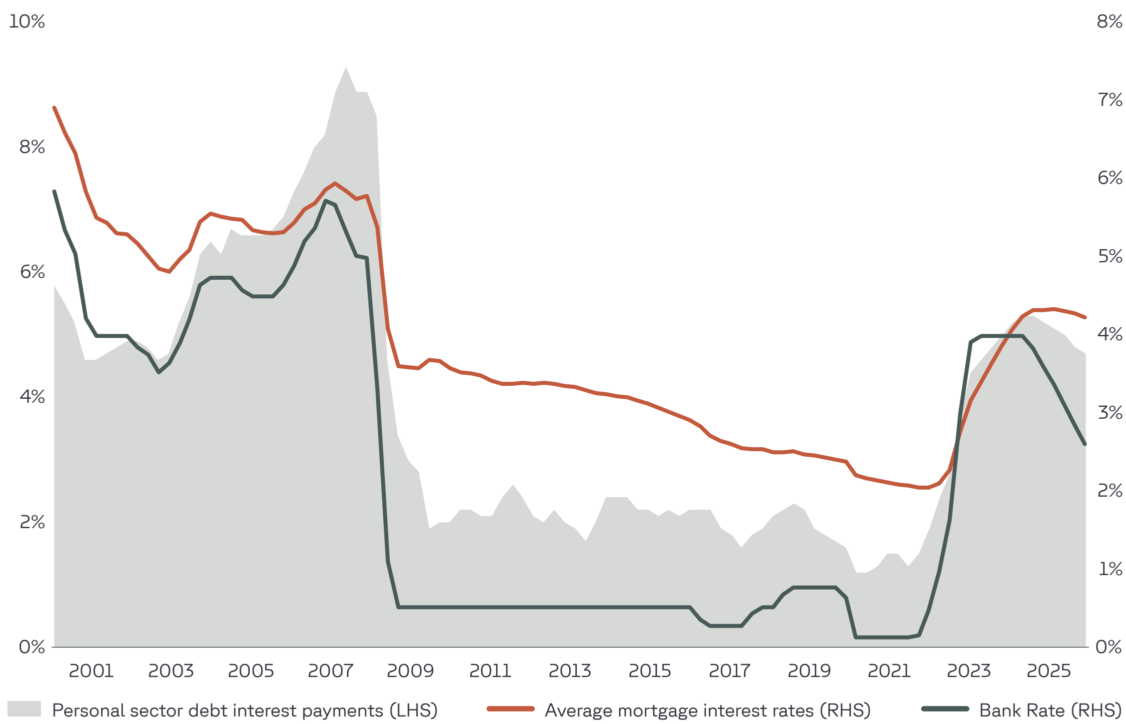
1. Oxford Economics. Fallout from mini-Budget set to ignite recession. October 13, 2022

Household Finances Under Pressure

For UK borrowers in particular, the challenges presented in the current market may become evident sooner, where the majority of mortgages are based on fixed rates of 2 to 5 years.[2] The high share of short-term fixed-rate mortgages (approximately 74%) will mean most homeowners have not yet seen their rate impacted.[3] However, data from the Bank of England and UK Finance suggests that around 45-50% of mortgages are either on variable rates or are on fixed-term contracts that are due to expire by the end of 2023.[4] **To the extent that rates stay elevated, this means that as many as half of mortgage holders will be adversely impacted in the next 12 months.**

Oxford Economics expects gross debt interest payments to increase to an average of 5.2% of household income in 2024, up from just 1.5% in 2021 and the highest share of income since 2008 (**Exhibit 1**).[5] **Debt servicing costs are expected to more than triple as a share of household income.** The government's support for energy bills will help to offset some of the financial pressure homeowners are facing. However, household finances are likely to be under increased strain in an environment where most people are faced with falling real wages and the economy is contracting.

EXHIBIT 1: UK PERSONAL SECTOR DEBT INTEREST PAYMENTS & INTEREST RATES



Source: Oxford Economics

2. Note: UK mortgages are generally amortized over 25 years. At the end of a 2 or 5 year fixed rate, mortgages default to the lenders standard variable rate.
3. UK Finance. How the Bank Rate Affects Mortgage Rates. December 16, 2021
4. Macro Strategy Partnership. Endgame: what will cause the Fed to turn? October 5, 2022
5. Oxford Economics. How the surge in interest rates is crushing affordability. October 12, 2022. Note: The calculation of gross debt interest payments as a proportion of household income, excludes interest received on savings.

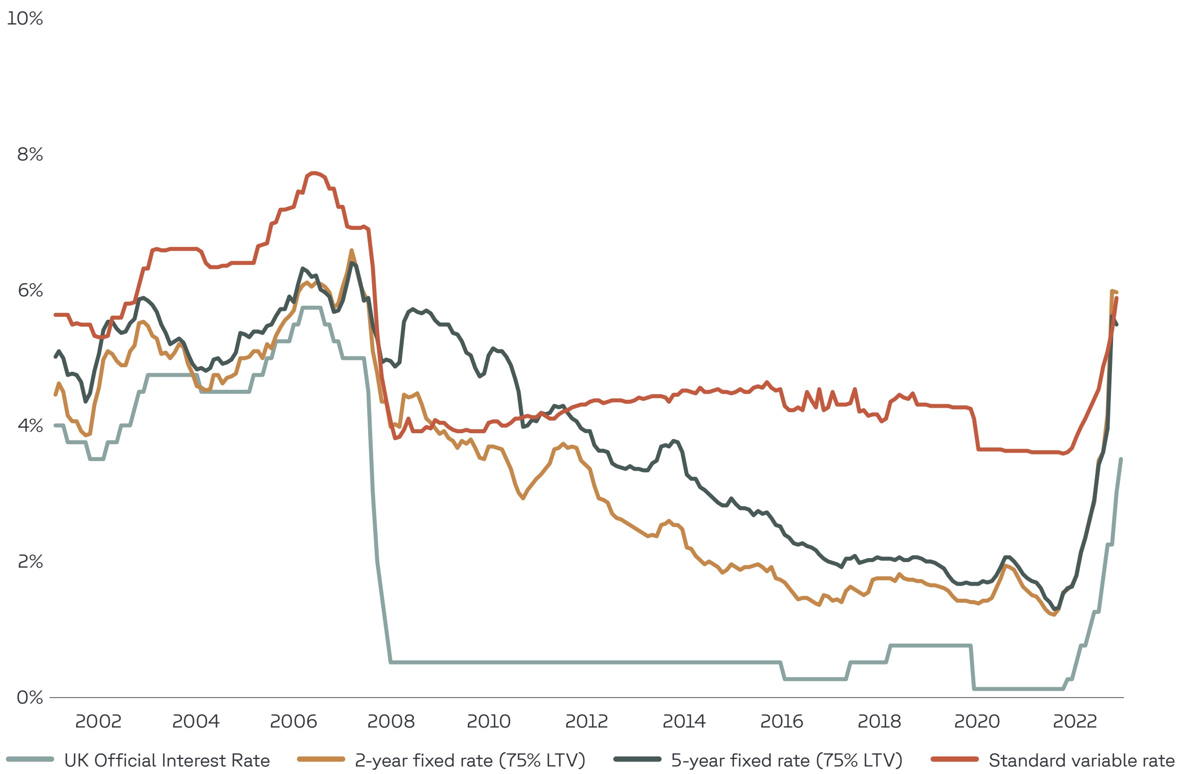
Political Turmoil Adds to Economic Woes

The combination of elevated inflation, war in Ukraine, ongoing energy price shock and tighter monetary policy have led to a downgrade to the growth outlook. **Recent political turmoil in the UK has compounded the economic uncertainty resulting from higher energy bills and the wider cost of living crisis.** The government's mini budget in September, contained a number of supportive economic policies and tax cuts. However, it caused turbulence in financial markets due to concerns over how spending promises would be funded.

Bond yields, swap rates, and other debt costs soared in the aftermath. By early October, two- and five-year swap rates were 130bps and 150bps, respectively, higher than their mid-September levels.[6] Several lenders withdrew all or some of their mortgage offers amidst the market turmoil. The residential mortgage market lost 935 types of household mortgage products in a single day. This is the highest daily fall in mortgage products registered on record.[7] These offers have gradually returned to the market, but are more expensive, sending household mortgage rates upwards. The average 2-year fixed mortgage rate hit 6.0% in November 2022, while the average 5-year rate was 5.5%, compared to rates of 1.57% and 1.59% respectively in December 2021 (See **Exhibit 2**).[8] This means that for the average UK house buyer, monthly mortgage payments have increased by over 50% since December 2021 on a loan of the same amount.[9] A spike in borrowing costs, continued high inflation and the rising cost-of-living have prompted fears of steep falls in UK house prices.

We expect the tightening in financial conditions to continue as central banks remain focused on tackling inflation. Oxford Economics is forecasting the Bank of England bank rate will peak at 4.00% in 2023, with subsequent rate cuts postponed until 2024.[10] The rise in living costs and interest rates is expected to put increased pressure on the finances of UK households in the coming months.

EXHIBIT 2: HISTORIC INTEREST RATES AND MORTGAGE RATES



Source: Bank of England

6. Ibid
7. Moneyfacts. Which lenders have removed their mortgages thus far? September 29, 2022
8. Bank of England Data. Accessed on December 7, 2022
9. Note: This calculation is based on the average price of a home in the UK - £273,135 as of Q3 2022. It assumes a 15% deposit is available, and a mortgage term of 25 years on a repayment mortgage.
10. Oxford Economics. UK Economic Forecast. December 2022

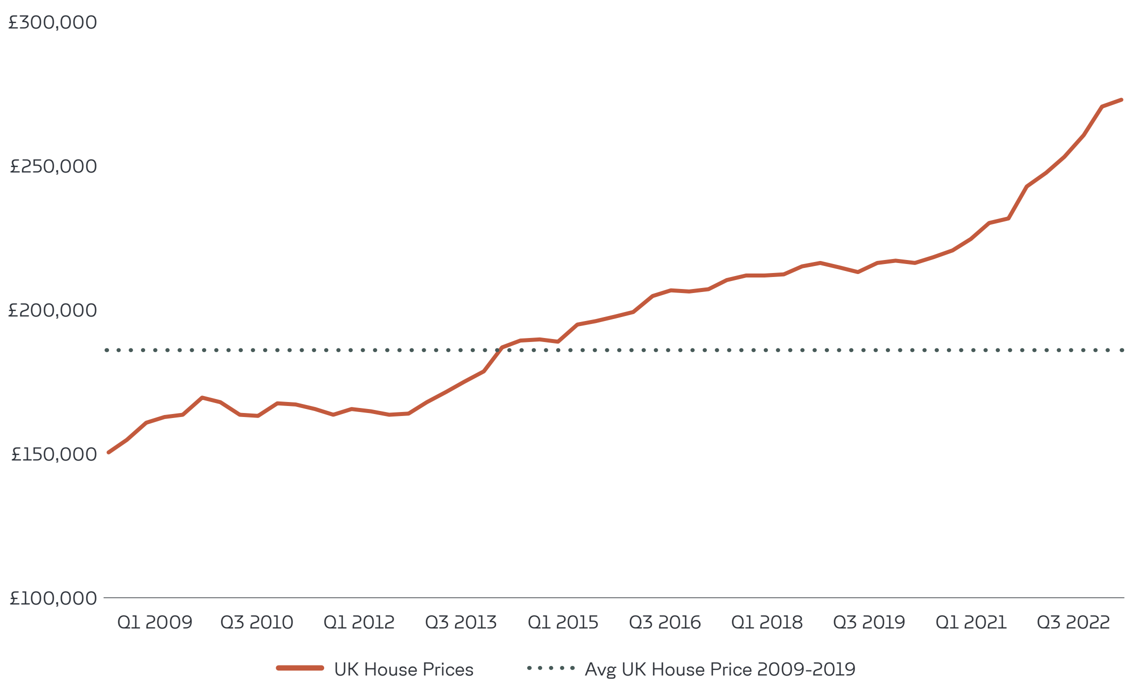
We expect there to be a steep fall in UK housing transactions as potential buyers sit out the market.

Sales Market Loses Momentum

It is still too early to assess the full impact of changes to the economy on the UK housing market. However, it looks likely that home sales and prices will fall as higher interest payments add further pressure to already squeezed household budgets. Indicators on buyer demand, agreed sales and new instructions remain negative in November 2022.[11] **At a minimum, we expect there to be a steep fall in UK housing transactions as potential buyers— particularly those reliant on high loan-to-value borrowing— sit out the market.**

Strong demand for housing, coupled with a shortage of supply and an unprecedented period of low borrowing costs has driven strong house price growth over the last 15 years. In the period following the Global Financial Crisis (GFC) interest rates averaged 0.5% and hit a low 0.1% in 2020.[12] This has fueled the near doubling of the average price of a British home to £273,135 from just £149,709 in 2009 (**Exhibit 3**).[13]

EXHIBIT 3: UK HOUSE PRICES 2009 – 2022



Source: Nationwide, Q3 2022

11. Royal Institute of Chartered Surveyors. UK Residential Market Survey. November 2022
12. Bank of England Data. Accessed on December 7, 2022
13. Nationwide. UK House Price Index. Compares Q1 2009 with Q3 2022

For the time being, house prices are still edging higher, underpinned by the lack of available stock. UK house prices have continued to defy the odds, with annual growth reaching 2.8% in December 2022. Nevertheless, the pace of growth has moderated noticeably from 4.4% in November 2022. December also marked the fourth consecutive monthly price fall, which left house prices 2.5% lower than their August peak.[14] This has prompted questions about how far house prices may fall. Against this backdrop, Oxford Economics is forecasting that UK house prices will fall by 13% over the next two years and that based on the affordability of mortgage repayments, house prices are now 37% overvalued.[15] Stretched housing affordability is also a reflection of underlying supply constraints, which may provide some support for prices.

Fewer Signs of Distress

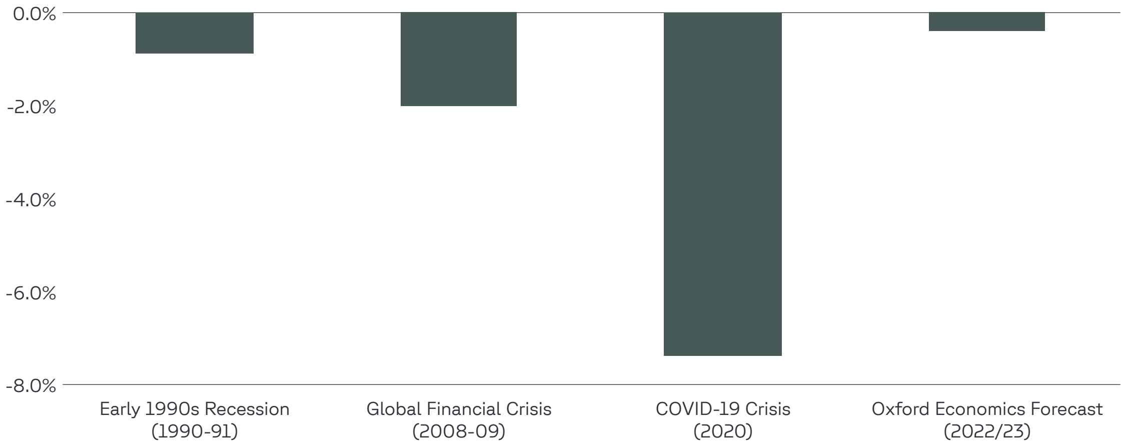
Overall, we expect that there will be less distress in the UK housing market during the present downturn as compared with previous market downturns. During the early 1990s, inflation climbed to 8.4% and GDP was also low, similar to today's environment. House prices fell 20% between 1989 and 1993; however, this period was also marked by high unemployment which peaked at 10.4%.[16] This is in contrast to the current jobs market where unemployment was 3.7% for August to October 2022, the third-lowest rate since 1974.[17] **Analysis of previous downturns shows that labor markets have often been the decisive factor in determining the severity of a housing market downturn.**[18]

While unemployment is expected to rise in the coming months, it is expected to reach only 4.4%, well below the average of 6.8% since 1971.[19] During the GFC, house prices fell by around 19% cumulative; however, we do not think the current environment is comparable to market conditions at the time of the GFC.[20] The UK has almost full employment and more conservative lending rules mean far fewer households have mortgages of 90% or more. Further, households have built up a significant equity buffer with 60% of outstanding mortgages at less than 75% loan-to-value (LTV).[21]

14. Nationwide. UK House Price Index. December 2022
15. Oxford Economics. How the surge in interest rates is crushing affordability. October 12, 2022
16. Ibid. Note - Cumulative change from Q3 1989 to Q1 1993; Office for National Statistics. Accessed on November 3, 2022
17. Office for National Statistics. Accessed on January 3, 2023
18. Oxford Economics. Past house price crashes show jobs and rates are key. December 19, 2022
19. Oxford Economics. UK Economic Forecasts. December 19, 2022
20. Nationwide. UK House Price Index. December 2022
21. JLL. Residential Market Update. October 2022

While there might be an increase in people falling behind on mortgage payments, it is still quite unlikely for repossessions to become a recurring event as lenders will only do so as a last resort. At the moment, **employment is resilient; however, things could change in the event of a severe recession which we expect would have a significant impact on job security.** The UK economy is expected to enter a recession, with GDP forecast to fall by -1.3% peak to trough during 2022/2023. While we think growth will fall, this is not of the same magnitude as during the GFC when GDP fell 6.3% peak to trough (**Exhibit 4**).[22]

EXHIBIT 4: CHANGES IN REAL UK GDP DURING RECESSIONS



Source: Oxford Economics

Transmission to Rental Market

As a result of tightening market conditions, new housing supply is expected to fall even further behind target. The UK government has set a target to deliver 300,000 new homes annually; however, the country is expected to fall far short of its own goal and these targets are unlikely to solve the need for housing.[23] The knock-on effect of a slowing of house sales has been a surge in demand in the BtR market. Robust demand for quality rental housing is reflected by the ongoing institutional investor appetite for purpose-built rental homes. Annual investment in the UK living real estate sectors has exceeded £10 billion in the third quarter of 2022, which puts the sector on track for a record year.[24]

Long-term investors are looking beyond the current market turbulence to provide homes for the growing tenant base.

Investors continue to favor living assets for their favorable demand drivers and rental stability. Uncertainty in the economy and squeeze on household incomes is likely to temper rental growth over the rest of this year and into 2023. However, the imbalance between supply and demand is likely to continue to be the overriding factor that determines the direction of rental movements. Ongoing strong investment means the UK's BtR stock now stands at 76,800 completed homes with a further 49,800 homes under construction. This is equivalent to just 1.4% of the total private rental sector.[25] The current lack of supply of quality, purpose-built rental housing is so acute that we expect to see further, albeit more modest, rental growth in the short term.

22. Oxford Economics, UK Economic Forecast, December 2022
23. JLL. Residential Market Update. October 2022
24. Ibid
25. Savills. UK BtR Market Update Q3 2022 & Office for National Statistics. Working and workless households in the UK: April to June 2022

We see an opportunity to capitalize on unmet consumer and investor demand for institutionally-owned multifamily housing in the UK through developing rental housing in locations with compelling market dynamics. We are focused on investing in this sector and see a maturing opportunity to leverage our multifamily expertise across the UK.

Challenges in the household mortgage market means we expect increased demand for rental properties in the UK. Rising interest rates mean that home ownership is likely to remain out of reach for even more people. The government's "Help to Buy" program, aimed at helping first-time buyers get a property with just a 5% deposit, has now ended, which means the number of first-time buyers is likely to fall. Rising energy bills may also increase the attractiveness of new BtR product which are more energy efficient. The Royal Institute of Chartered Surveyors reported demand for rental properties was still outstripping supply in October 2022. Near-term expectations point to growth in rental prices over the coming months.[26] This is backed up by forecasts from JLL which indicate cumulative rental growth in the UK BtR sector of 22.8% over the next five years.[27] Rental growth is expected to be particularly strong at the front end of the five-year period before falling back in line with historic norms of around 3%.

We expect demand for newer BtR product to increase, as consumers realize the benefits of purpose-built apartments that are more flexible, suited to current needs and meet the latest energy efficiency and safety standards. BtR developments are also professionally owned and managed, which makes it more likely residents will receive a swift response to any maintenance requests. BtR projects often offer a range of amenities, including: onsite gyms, communal workspaces, games rooms and roof terraces. The offering of events and communal amenities in BtR developments can facilitate a strong sense of community and provide more opportunities for socializing than standard rental accommodation. **With interest rates rising, prospective homebuyers will be met with the prospect of higher mortgage payments which may exacerbate affordability constraints and cause many households to remain or become renters. Further, as the stock of quality renting options available with the BtR sector expands, we expect many households will become renters "by choice."**

26. Royal Institute of Chartered Surveyors. UK Residential Market Survey. November 2022
27. JLL. Residential Market Update. October 2022

CONCLUDING THOUGHTS

It is clear that recent shifts in the UK economy will have detrimental ramifications across the housing for sale market. However, we do not believe the distress will be comparable to market conditions at the time of the GFC. We expect some of the price gains made in market values over the recent past to erode over the period of the next 12 months in softer market conditions. The extent to which that occurs will depend on the level at which interest rates peak and the period during which they remain at elevated levels before lower inflation allows the Bank of England to bring them back towards around 2%. History shows that if labor markets can remain strong, then the chances of a milder correction are higher.

In the rental market, investor appetite for the BtR sector shows no sign of slowing, partly because these assets offer defensive characteristics well suited to the current market conditions. Shorter leases and a frequent turnover of tenants enable rents to keep pace more closely with inflation. Short-term inflationary pressures will, inevitably, act as a moderating force on rental growth as household finances are squeezed. However, the spike in mortgage rates means the financial benefits of buying versus renting are declining. We therefore expect tenant demand for the UK BtR sector to remain strong.

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