TO RENT OR OWN?

AFFORDABILITY IN THE UK RESIDENTIAL MARKET

September 2023

EXECUTIVE SUMMARY

The current state of the economy is having an impact on the UK housing market.

The cost of servicing a mortgage has increased as a result of rising interest rates, in part driven by elevated inflation. The effect on the residential market in the UK is more pronounced due to its unique shorter-term and largely floating rate mortgage market, which requires more rapid refinancing as compared to most of Europe and the US. This has meant the financial benefits of renting could outweigh those of buying. Simply put, on average, renting is now cheaper than buying in the UK. This paper explores the affordability of renting versus owning and examines the implications for the UK rental market. Specifically, we expect renter demand to remain robust, with a structural shift towards renting by choice. Investment in the sector is supported by these demand drivers and tight supply.

ECONOMIC BACKDROP

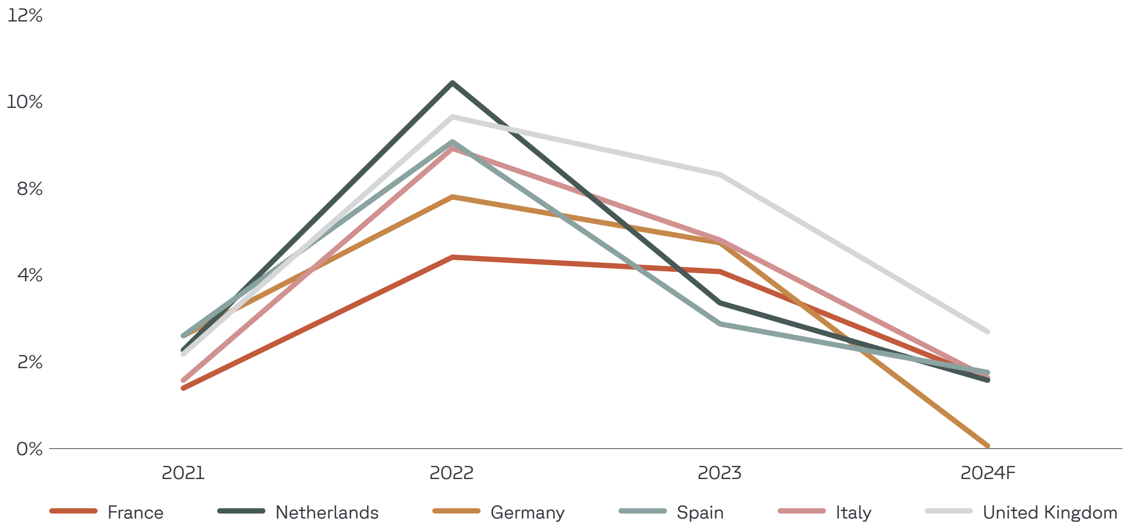
RISING INTEREST RATES

Inflation in the UK is proving higher and stickier compared to most European advanced economies (**Exhibit 1**). To hold back inflation, the Bank of England has increased interest rates since the end of 2021. The Bank Rate has increased from 0.1% at the end of 2021 to 5.25% in August 2023, which is the highest this rate has been since 2008.[1] The knock-on effect has been a notable rise in household mortgage rates (**Exhibit 2**). **The result of this is that monthly mortgage costs increased by 61% in 2022.**[2] **Additionally, 27% of outstanding fixed-rate mortgages are set to mature in 2H 2023 and 2024.**[3] The shorter-term nature of residential mortgage products in the UK is causing a more rapid unwinding of mortgage affordability for the consumer, as compared to Europe and the US.

1. Bank of England Data, August 2023
2. For detached homes; https://www.finder.com/uk/mortgage-statistics
3. https://www.reuters.com/markets/rates-bonds/is-britain-edge-mortgage-market-meltdown-2023-06-22/

This is having a notable impact on the UK residential market, and affecting the relative attractiveness of owning versus renting a home. **Higher mortgage rates mean that renting has become cheaper than buying a home for the first time since 2010.** For a first-time buyer, monthly rental payments are estimated to be £122 cheaper than the mortgage repayment on the same property.[4]

EXHIBIT 1: INFLATION RATE IN THE UK AND IN OTHER MAJOR EUROPEAN ECONOMIES

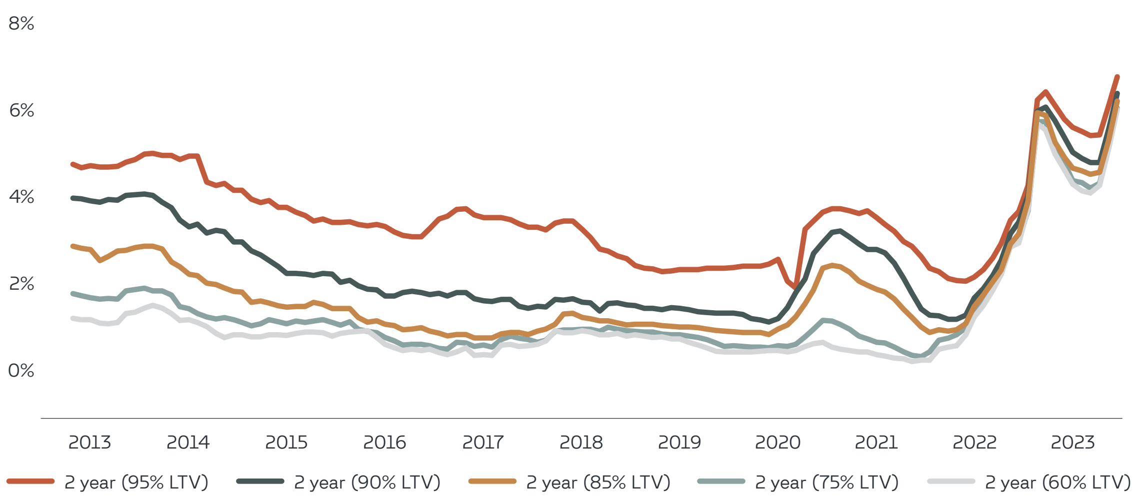


Source: Oxford Economics

Mortgage Costs Have Increased Significantly

As interest rates have increased, this has often resulted in 'sticker shock' as fixed-rate mortgages expire and are re-set to current market levels. This can be seen in the effective interest rate on variable rate mortgages which have increased significantly to rates not seen in more than a decade. The effective interest rate on outstanding mortgages with a fixed rate was 2.44% in June 2023, according to the Bank of England. This contrasts with an average interest rate of 6.29% on variable-rate mortgages and quoted household interest rates on new fixed-rate mortgages in excess of 6%.[5] This is a concern for many first-time buyers and those on variable-rate mortgages, but also for the more than 1.2 million people on fixed-rate mortgages that are due to mature over the next 12 months.[6]

EXHIBIT 2: QUOTED HOUSEHOLD MORTGAGE RATES ON 2-YEAR FIXED RATE MORTGAGES

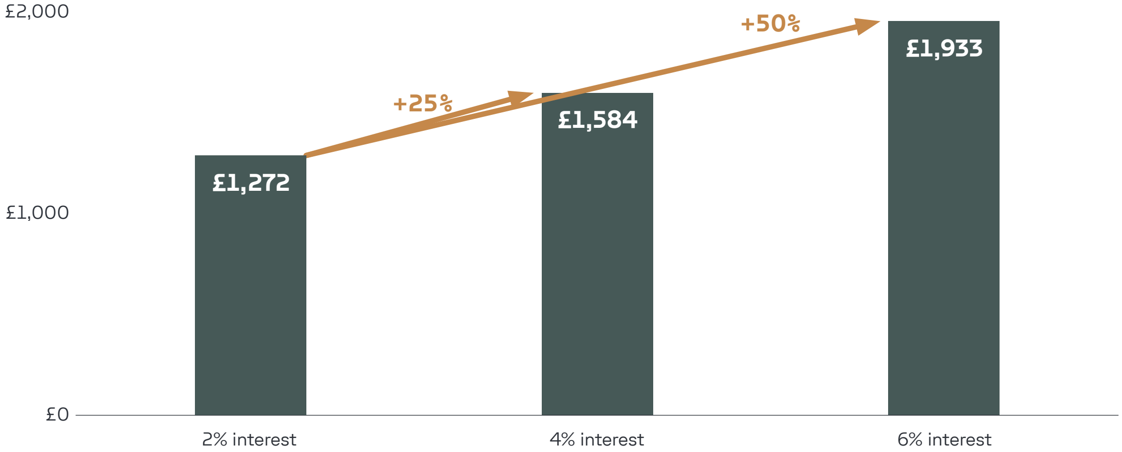


Source: Bank of England

4. https://www.zoopla.co.uk/discover/property-news/is-renting-cheaper-than-buying-a-home/
5. Bank of England Data. Effective Interest Rates. June 2023. Quoted Interest rates. July 2023
6. Bank of England Data. Lending secured on dwellings. Includes period from Q4 2023-Q3 2024

Exhibit 3 looks at different indicative amounts left to repay on mortgages with varying interest rates. Should the interest rate on a £100,000 mortgage increase from 2% to 6%, assuming a 25-year capital and repayment mortgage, then the monthly mortgage repayment on the same mortgage would increase by £220 (from £424 to £644). However, assuming the same increase on a £500,000 mortgage, monthly repayments would rise by £1,103 (from £2,119 to £3,222).[7] Each 2% increase in the interest rate translates approximately to a 25% increase in the monthly mortgage cost.

EXHIBIT 3: MONTHLY MORTGAGE COSTS AT DIFFERING AMOUNTS OF FIXED INTEREST RATES, £300,000 MORTGAGE



Source: Office for National Statistics. Assumes a 25-year repayment period for a capital and repayment mortgage.

7. Assumes a 25-year repayment period for a capital and repayment mortgage.

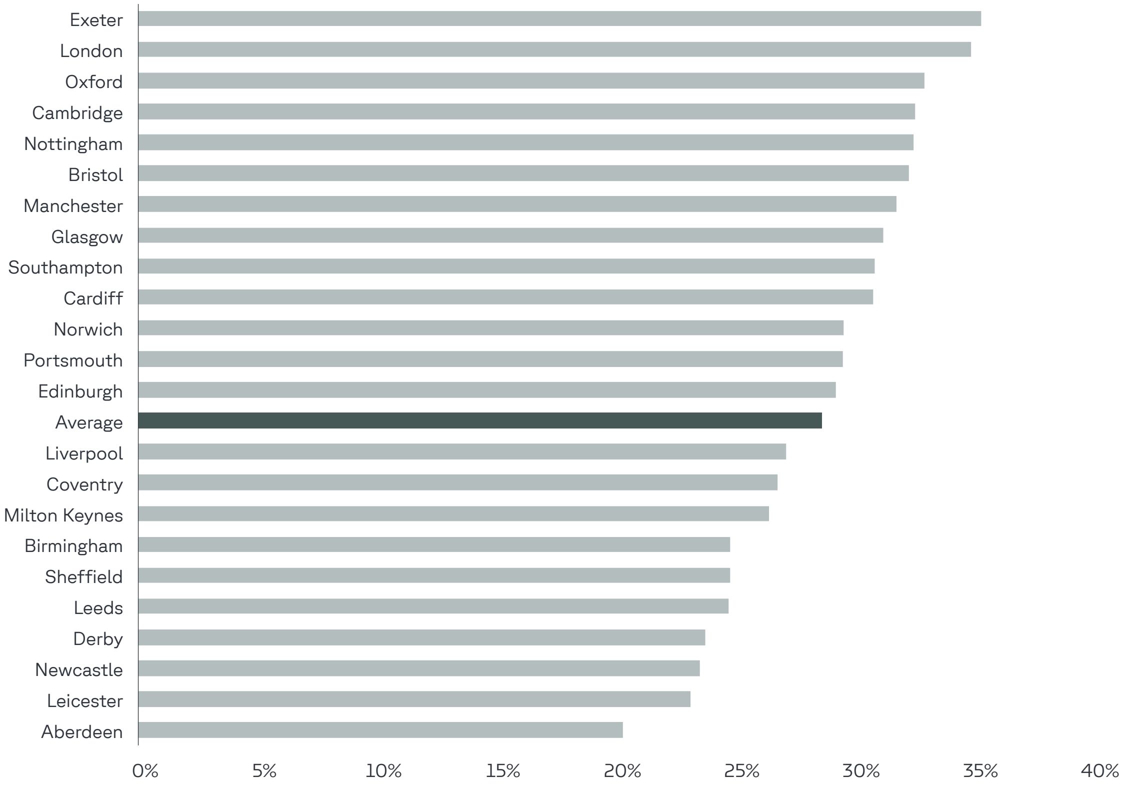
RENTS STILL LOOK AFFORDABLE

Rents have also increased, but to a lesser extent than mortgage repayments. **In the 12 months to Q2 2023, average rents in the UK rose by 10.4%, compared with an increase of over 60% for mortgage payments on re-set interest rates.**[8] Rents now account for 28.3% of average earnings, slightly above the 10-year average level (27%).[9] However, a rental affordability ratio of between 30-40% of earnings may be more widely considered acceptable for the build-to-rent sector (BTR) in the UK.[10] Purpose BTR communities are one of the ways that developers and institutional investors have attempted to address the housing shortage in the UK.

Our analysis of the top 23 markets across the UK indicates rental affordability is most stretched in markets including Exeter, London, Oxford and Cambridge (**Exhibit 4**). However, across all markets the rent-to-income ratio is below 40% suggesting there is scope for further rental growth, albeit perhaps at a more modest rate.

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

EXHIBIT 4: BTR RENTAL LEVELS VS AVERAGE HOUSEHOLD INCOME IN UK CITIES AS OF JUNE 2023

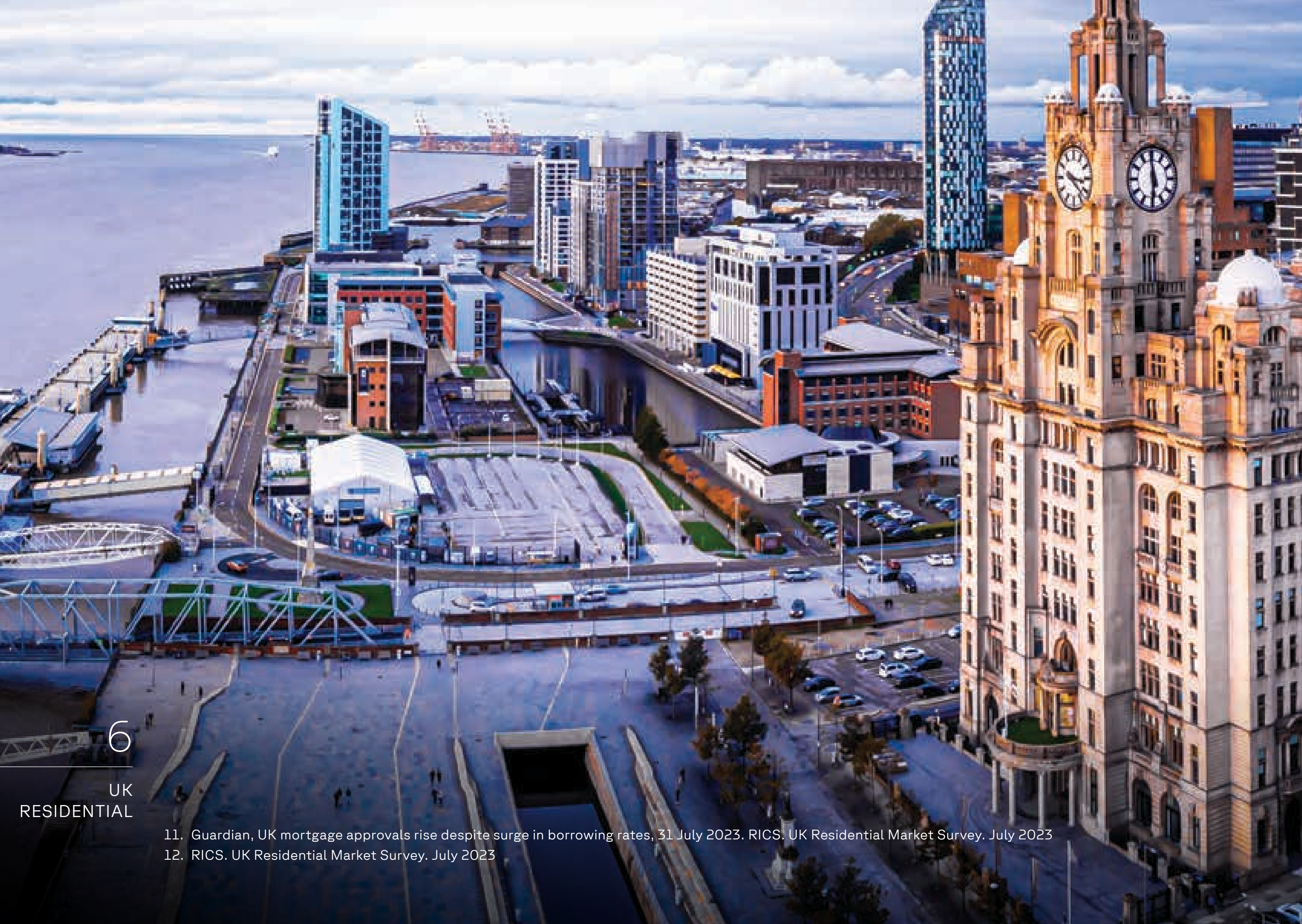


Source: Affinius Capital Research, Zoopla, Varbes, Oxford Economics. Note: Based on average household income (nominal). Rents are based on average rental market levels, but assume a 20% premium for the BTR sector.

8. For detached homes; https://www.finder.com/uk/mortgage-statistics
9. https://www.zoopla.co.uk/discover/property-news/is-renting-cheaper-than-buying-a-home/
10. Affinius Capital Research based on conversations with brokers including JLL and Knight Frank.

IMPLICATIONS FOR THE UK RENTAL MARKET

Elevated mortgage rates are pushing many people, particularly first-time buyers who may be struggling to save a deposit, to rent for longer. Mortgage approvals were down 15% year-on-year as of June 2023, and home sales have fallen to their weakest point since the start of the pandemic, according to a recent survey by the Royal Institution of Chartered Surveyors.[11] Despite price declines in the for-sale market, this has not yet brought buyers back to the market, primarily due to the continued need for a higher deposit and the elevated total monthly mortgage costs. Conversely, in the rental market, tenant demand has risen at the strongest pace since the start of 2022 because landlords put fewer properties on the lettings market. That left a net balance of 63% of those surveyed expecting rental values to rise in the coming months, a record for the report.[12]



11. Guardian, UK mortgage approvals rise despite surge in borrowing rates, 31 July 2023. RICS. UK Residential Market Survey. July 2023
12. RICS. UK Residential Market Survey. July 2023

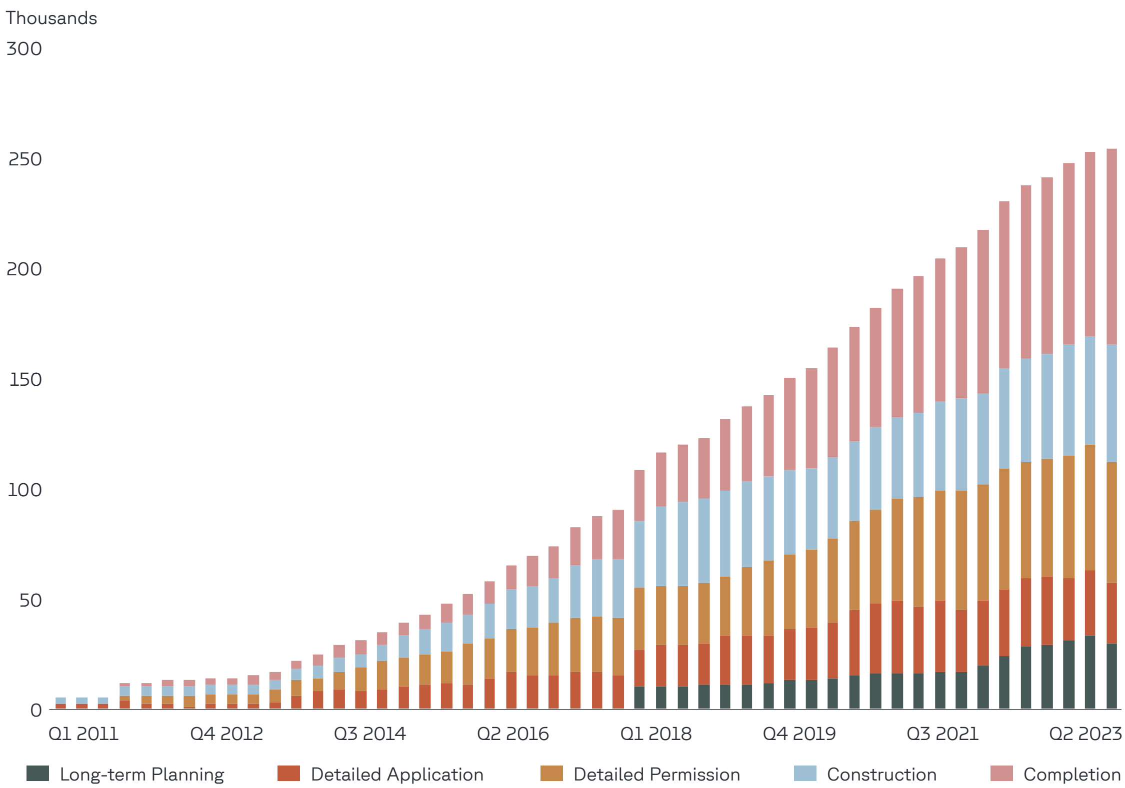
LIMITED RENTAL SUPPLY

Given the increase in mortgage rates, many individual private landlords are exiting the sector as it becomes less financially viable. As a result, the supply of rental accommodation is dwindling and future growth in supply is unlikely to occur via this route. With fewer homes to rent, we expect demand will continue to outstrip supply for rental accommodation in the UK.

> This trend should continue to support rental growth, particularly for newly built and professionally managed accommodation which provides additional amenities.

The UK residential sector is structurally undersupplied, and the current stock suffers from high levels of obsolescence. Institutional investors have responded to the increase in demand for rental housing by developing purpose build-to-rent (BTR) accommodation. As of Q2 2023, UK BTR stock stood at 253,400 homes, including those in the planning pipeline, an almost 80% increase in the last five years (**Exhibit 5**).[13] However, UK BTR is dramatically undersupplied, with existing UK BTR supply accounting for just 1.3% of the private rented sector market.[14] We therefore believe that there is a growing opportunity for investors to provide high-quality, professionally managed rental accommodation in a market that is undersupplied, creating expected accretive investment returns in an undersupplied market with anticipated strong rent growth potential.

EXHIBIT 5: UK BTR SUPPLY



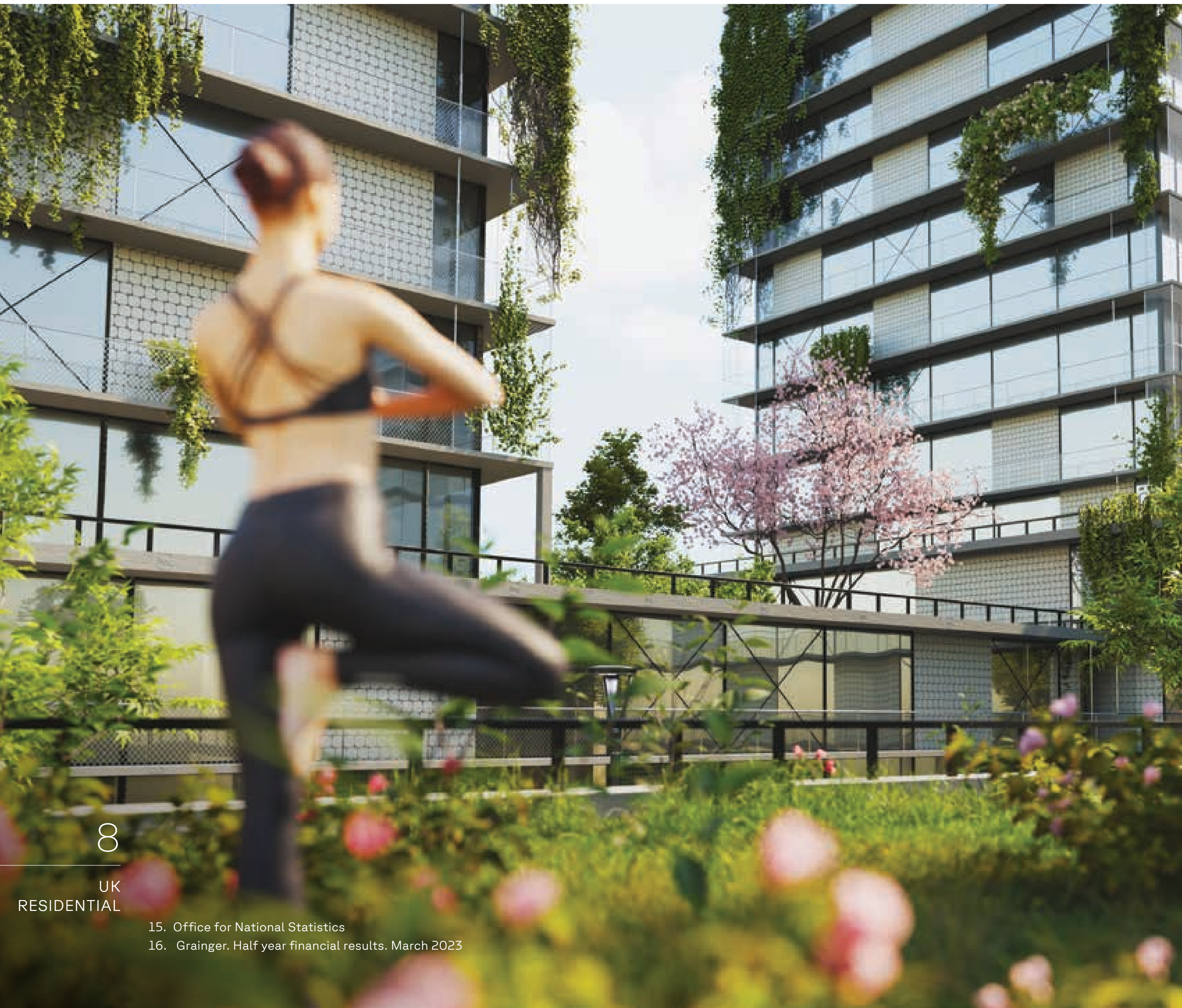
Source: Savills, Q2 2023

13. Savills, UK BTR Market Update. Q2 2023
14. Knight Frank Research. December 2022

RENTAL GROWTH OUTLOOK

In the short-term, the current economic backdrop is likely to boost demand for rental housing. Over the longer-term, rental demand is being further bolstered by the conscious lifestyle choice of certain groups to rent for longer than used to be the norm. Many BTR properties offer amenities like workspaces, gyms, and event spaces, not to mention long secure leases and a higher quality of service, all of which are attractive to renters. The population of owner-occupiers has already fallen from 71% in 2002, to 64% in 2022, and we expect this trend to continue.[15]

Overall, while we do expect short-term inflationary pressures will act as a moderating force on current larger rent rises and as household finances are stretched, longer-term the market will continue to be underpinned by strong fundamentals of tight supply and robust demand paired with many consumers being challenged to afford to buy and leave the renter pool. Grainger plc, the UK's largest listed residential REIT, reported occupancy of 98.5% and a 12% increase in net rental income for the six months to March 2023.[16] This supports our view that there is headroom for further rental growth.



15. Office for National Statistics
16. Grainger. Half year financial results. March 2023

CONCLUDING THOUGHTS

Overall, as a result of increasing mortgage rates, the UK residential market is undergoing noticeable changes and at this juncture, there are more benefits to rent from an affordability perspective. Longer-term, we expect rental demand to be driven by people consciously choosing to rent. Given the supply and demand dynamics, we anticipate further rental growth albeit at a more modest rate. As a result, we believe a growing opportunity exists for investors to provide high-quality, professionally managed rental accommodation in a market where rental growth and occupancy have remained strong.

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