Build it and they will come

Legal & General Investment Management head of BTR Dan Batterton talks to *Pensions Age* about the growth of the build to rent (BTR) sector and the investment opportunities it provides for pension funds

What is the difference between the private rented sector and the build to rent sector – PRS and BTR?
The private rented sector is every house, flat, apartment that's rented out by individuals. Build to rent is a subsector within this, where the buildings were originally designed and constructed for rent by one owner, such as Legal & General Investment Management through pension fund investors, and is not broken up and sold to 200 different individuals.

When we started looking at the sector four or five years ago, we couldn't go out and buy a whole block that already existed, because they'd already been sold off to 200 separate owners. So the only option if we wanted to own a whole building was to build it.

So has build to rent as an investment opportunity only really occurred within the past five years?
The birth of build to rent in the UK was the athletes' village, after the 2012 Olympics, being turned into rental accommodation. That whole athletes' village is owned by one institution and is rented out. But if you go into the dim and distant past of 100 years ago, 90 per cent of the population in the UK rented; and they rented from pension funds and institutions like Legal & General who built homes and rented them to match their liabilities. We had just forgotten how to do that for 100 years.

How about the pension funds themselves, are they aware of build to rent as an investment opportunity?
We've raised over £400 million in the past two years from UK pension funds investing into this sector. There is more demand from investors than there are assets. We've had multiple generations' worth of failure to build enough homes in the UK so it is a needs-based asset class.

Over the long term, rents go up by more than inflation so that, as an asset, is attractive. There is also reduced downside risk, as the UK rental sector operates at 97 per cent occupancy, irrespective of boom and bust in the economy. The 3 per cent that isn't occupied is just normal turnover of people moving from one apartment to another.

Whilst the sector runs at 97 per cent occupancy, this is not contractually guaranteed income, it's only ever guaranteed for one month. Diversity and scale are therefore particularly important for pension funds. This means it is attractive to be in a fund that offers thousands and thousands of apartments and separate leases.

Local authorities have also been recommended to invest a minimum of 3 per cent of their pension pot into the residential sector. That's quite a big amount of cash and there aren't that many options for pension funds to invest into the residential sector.

Could you explain the ESG benefits BTR could provide?
We have a huge shortage of housing in the UK. Simply increasing the supply of homes is, therefore, seen as having a positive social impact. Also, the 'E' part of ESG is very much in the front of what we're doing on a daily basis.

When you're taking a 20, 30, 40-year investment horizon, it makes cold, hard, economic sense to put energy saving technologies into our buildings in to improve the energy efficiency of a building. Our buildings are highly energy efficient.

Within our buildings we are offering security and flexibility to our residents, with leases of up to five years but where they can leave whenever they want on one month's notice.

From a pure investment point of view, if people like living in our buildings, they'll stay there for longer and we'll have less turnover and less vacancies and our investment return will be improved.

From a 'social' aspect, out of our c. 4,000 apartments, around 20 per cent of our portfolio will be affordable housing. Our property in Walthamstow is a good example. It will have 479 apartments, with 105 apartments for key workers. Those apartments are exactly the same as every other apartment; they are intermingled across the buildings.

Is there a reputational risk for investors with BTR, in that residential property is a high-interest area within the public, politics and press?
We are nearly two years into having residents in our buildings and so far the vast majority of feedback we've had has been positive.

As Legal & General is seen as the landlord, we act as that reputational barrier for pension funds investing in BTR through us. The good and the bad news stops with us rather than going on to any underlying pension funds.

We let our residents know they're paying rent to pension funds and I think a quite interesting outcome from that is that our residents realise we're not a greedy landlord; we are the custodians of pension fund money and their rent is paying a pensioner. Whether it's linked or not, we've had zero bad debt since we've launched.

What other practical examples do you have of investing in BTR?
In terms of the investment return, our first operational scheme is called The Slate Yard in Salford and we're generating an income return to our investors of just over 4.5 per cent, which is above our target of a 4 per cent return.

Since then, we've now got a portfolio of 12 assets of around 4,000 apartments, which will be worth about £1.9 billion.

Our investors at the moment are getting the benefit of income from assets that are up and built, with people living in them, and also getting the development profit from us building the properties.

There are a lot of 'experts' who tell us that the people that rent are aged between 20 and 35; young professional sharers saving up to buy a house. That is not true. We've got 18 year olds and we've got 70 year olds living in our buildings.

We have retirees who have sold up and have decided they're going to rent for the rest of their life, because they see it as safer than owning a house with its maintenance costs, due to being asset rich and cash poor.

We recently did a survey of our residents and found 30 per cent were saving to buy a property, meaning 70 per cent were renting because they wanted to rent, not because they couldn't buy a house.

How do you decide in what regions to create BTR schemes?
We are equally exposed to London versus the rest of the UK. That is because there is a slight difference in timing in terms of rental growth over the long term between London and the rest of the UK. We're trying to establish a consistent, stable income stream, so by equally weighting between those regions, then we cancel out any of that lag.

We've then done huge amounts of research looking at every urban area in the UK with a population of over 100,000. We ranked all of those areas in terms of which we think will see the strongest rental growth over the next 10 years. That is generally the areas with the most acute supply/demand imbalance. But it's also areas where we see population growth, more businesses being set up, and high student retention rates.

Within those cities we are aiming for live/work locations, so areas where you will walk to work and to the nightlife. These are brownfield city centre redevelopments, underutilised land or derelict land and it's bringing it back to life, bringing people back into the town centres, being part of the regeneration of these cities.

What trends are you seeing within the BTR sector?
We're seeing lots of overseas investors who are completely comfortable with the BTR sector, because people choosing to rent is normal in their countries. So there's a lot of investment coming from the US and mainland Europe to the UK.

This is creating competition, which is driving standards. We need competition so that potential residents know about this sector, know that they can rent properties owned by pension funds rather than individual investors, and begin to understand that these properties should be higher quality and better managed.

Our investors are assuming a 40-year hold; they are not investing for short-term capital gain. They are not looking at house price inflation but are looking at very long-term, stable cashflows. We've generally got DB pension schemes and local authorities invested.

Research has suggested that up to 50 per cent of the real estate allocation should be in the residential sector. So that would be around 3-5 per cent of a portfolio into the residential sector. Bearing in mind that a lot of pension funds currently have zero allocated, the quantity of equity trying to invest into the sector is huge.

In association with Legal & General Investment Management