

Demand patterns in the private rented sector in Scotland

Time to commit to residential investment?

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Summary

The report examines historic and possible future demand trends in the private rented sector in Scotland with a view to providing a base for future investment in the sector in Scotland.

There is clear evidence of a building momentum in tenant demand and the report suggests that this trend is not simply a result of short-term effects caused by push factors such as mortgage affordability.

We believe that there is a great deal of potential for investors in the Scottish market. The underlying fundamentals are strong and the market is growing, underpinned by pronounced imbalances between supply and demand. Developments are starting to emerge and there is significant pent up demand for rented housing in the years up to 2020.

We suggest that these trends are unlikely to be affected by Scotland's new tenancy arrangements, which, it can be argued, at least remove uncertainties for both tenant and landlord. The only limitation is likely to be supply.

Author notes

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1. Introduction

There have been clear structural changes in home ownership and renting patterns through the 20th century and into the 21st. In the early years of the 20th Century social housing was virtually non-existent, the two dominant housing tenures were owner occupation and private rental. There was a structural shift through the twentieth century, however, which saw home ownership progressively increase together with the social housing component of the rented sector. In Scotland, housing tenure has changed dramatically over the last 50 years with the proportion of households in owner occupation increasing from 25% in 1961 to 60% in 2014 (although it peaked in 2005 at 66% and has subsequently declined - see later). Over the same period there was a commensurate fall in households in the Private Rented Sector (PRS, from 41% to 14%) and those in social housing (from 34% to 24%)^{1,2}. These longer term changes are rooted in the more tenure neutral housing policies adopted across the UK since the 1960s, the significant reduction in social/affordable housing supply as a consequences of right to buy and the lack of investment in replacement and additional stock amplified by the affordability challenges faced by potential homebuyers since the Global Financial Crisis (GFC) of 2007/2008³.

However, the dynamics of the private rented sector are changing and what was often seen as the tenure of last resort is no longer the case. Many are renting over the long term as a lifestyle choice. This, together with the continued and expected rise in the numbers of households and population in general in coming years, is putting pressure on all sectors of the market, not just the PRS^{4,5} and in this context institutional investment in the sector offers an opportunity for both for the investor and for the Scottish Government.

To a large extent the case for including private rented residential property in investment portfolios has largely been made. This report does not seek to do that per se but looks at the

¹ Scottish Government (April 2012): *Evidence review of the private rented sector in Scotland*.

² Scottish Government (August 2015). *Scottish Household Survey, 2014*

³ See also Paragon (2015). *Today's Private Rented Sector: A home for one in five households*

⁴ Scottish Government (August 2015) *Scottish Household Survey 2014*

⁵ National Records for Scotland (July 2014) *Housing Projections for Scotland*. The numbers of households in Scotland is expected to increase from 2.42m in 2014 to 2.78m by 2037 partly driven by an increase in population over the period but also as a result of a projected fall in the size of households with more people either living alone or in smaller households.

historic occupation trends in this sector in Scotland and examines future demand trends with a view to providing a base for future investment in the sector in Scotland.

2. Current demand pressures

Renting trends in recent years have been influenced not only by the structural shift detected in lifestyle choices noted above but also by the rapid rise in house prices, tighter lending requirements since the 2008 recession following the GFC and the requirement for households to put up larger deposits to secure a mortgage.

The impact of poor affordability and tighter mortgage constraints has led to an increase in those unable to buy and to a group now dubbed **Generation Rent**. The term is loosely and varyingly defined, but refers typically to households in the age range 16 to 34 that have sufficient income to service a mortgage but are likely to remain in the private rented sector for at least five years, as they are unable to meet deposit requirements⁶. Increasingly though it also refers to that group in society who are looking for flexibility in their housing choices both in terms of location and type of property. This includes households from a wide range of life stages, household compositions, income groups etc. who will have a variety of housing needs in the PRS. The only thing that these households have particularly in common is that they aspire to homeownership and in previous years had the opportunity to fulfil this aspiration earlier. Other significant areas of recent growth⁶ are:

- **Young professionals** who live in the PRS as a lifestyle choice. Private renting affords this group mobility, which aids employment opportunities, an access to locations that might not be affordable in other tenures, or desirable as a long term home.
- **Families with dependent children** who would have previously lived in either social or owner occupied housing
- **The housing benefit market**, (which comprises around 25% of private renters) in one form or another, including the provision of temporary accommodation for homeless households.
- **'Top end' renters**, a small but significant sub-market for those on high incomes. Located in prime areas (particularly London), properties tend to be of premium quality.

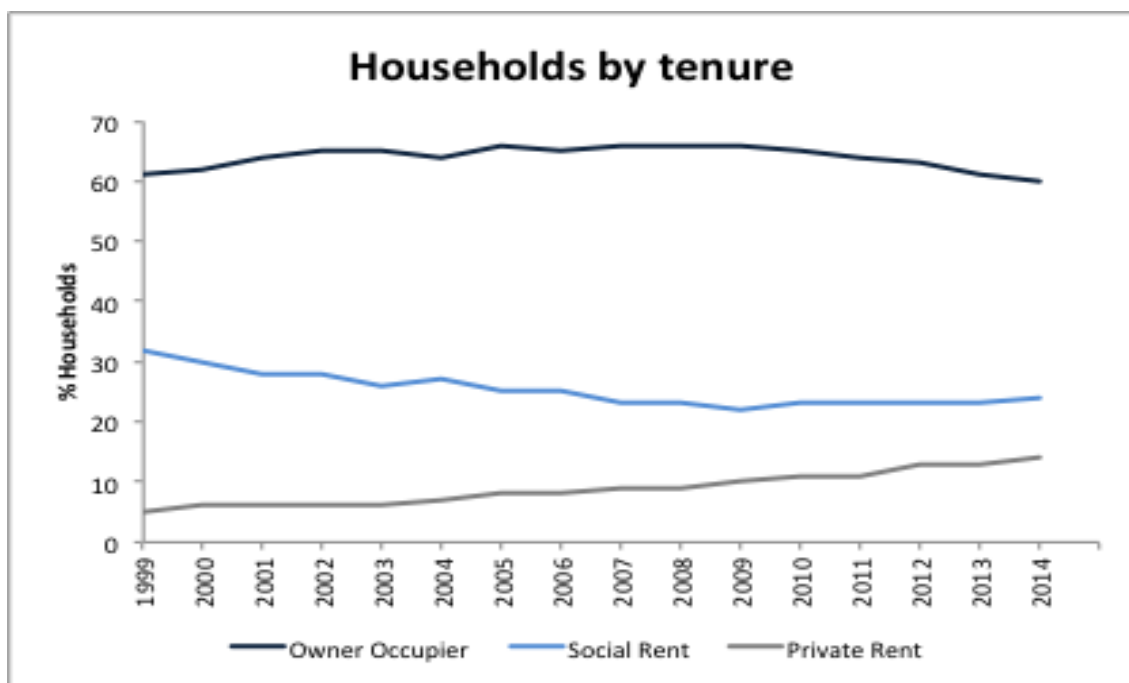
⁶ British Social Housing Federation (BSHF) January 2013: *Who lives in the private rented sector*.

3.Recent trends in renting and drivers of demand

3.1 The private rented sector this century

The PRS is now home to over 330,000 households in Scotland⁷. Although it remains the third tenure of choice overall in Scotland (Chart1), in some urban locations it is now the first tenure of choice (see later) and is clearly playing a crucial role in housing provision in Scotland. Although the percentage of households in the PRS sector has fallen over the last 50 or so years (see earlier), the proportion has increased significantly over the last 15 years both in terms of the proportion of households in the sector and numbers of households (Charts 1 and 2). Despite still being the third tenure of choice the gap between it and social housing is closing rapidly. This mirrors the general trend across the UK while in England there are now more private renters than social renters by a significant margin⁸.

Chart 1. Tenure of household by year (%)



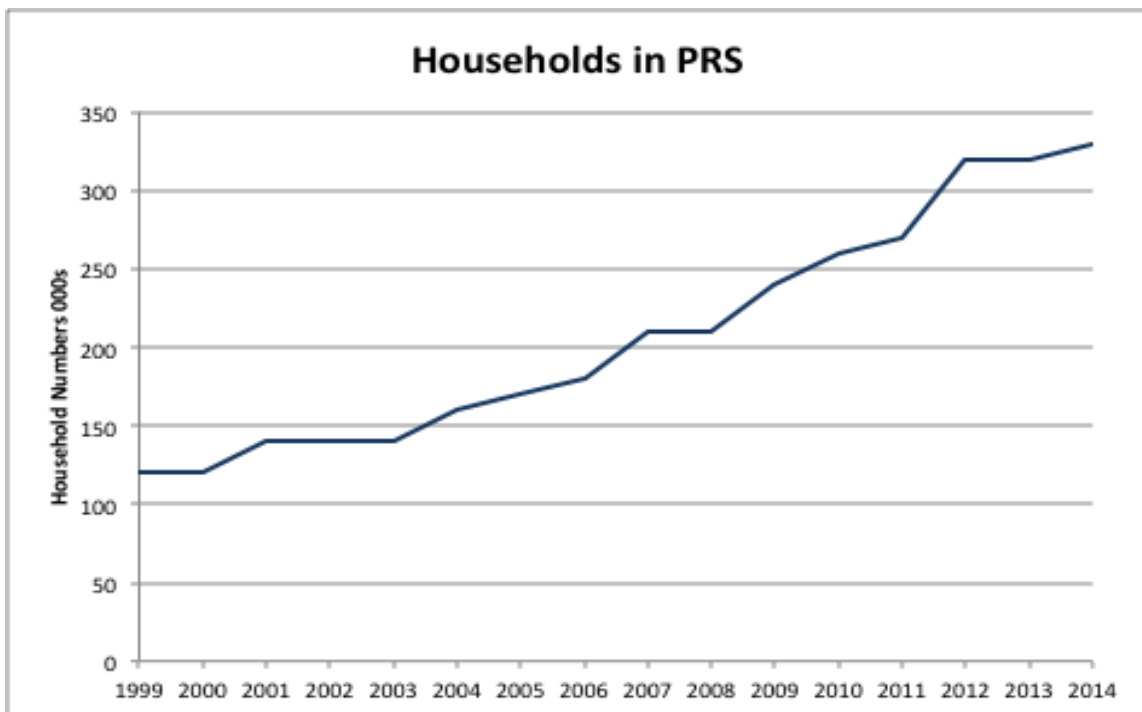
Source: Scottish Government (August 2015) Scottish Household Survey 2014.

In contrast, owner occupation in Scotland has declined since 2005 from 66% of households to 60% in 2014. The total number of households in owner occupation has also fallen, from 1.5 million 1.46 million over the same period.

⁷ Scottish Government (August 2015) *Scottish Household Survey 2014*

⁸DCLG (July 2016). *English Housing Survey 2014/15*

Chart 2. Total numbers of households in PRS



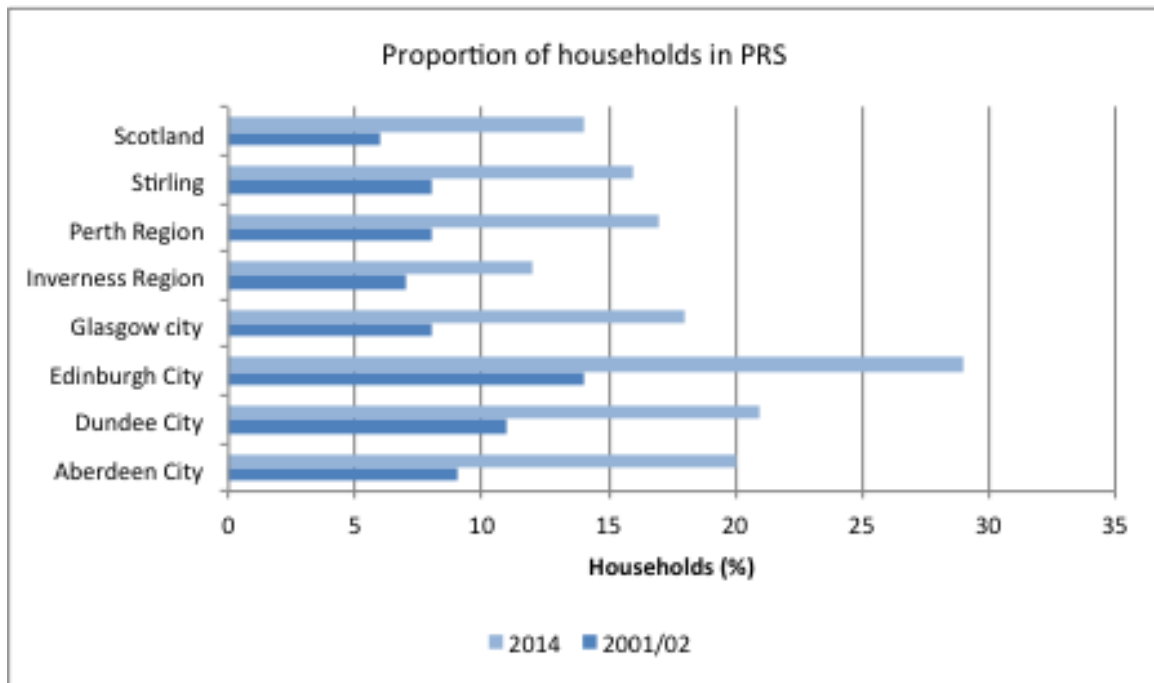
Source: Scottish Government (August 2015) Scottish Household Survey 2014.

The proportion of households in PRS, however, varies widely within Scotland with urban areas showing a much higher proportion of households in the sector (Chart 3). In this context, all of the main urban areas shown in Chart 3 have a significantly higher proportion of households in PRS than the Scottish average and have had over the thirteen year period covered by the chart from 2001/02 to 2014⁹. Also of note is that the average growth across the main city comparator centres has been nearly 110% with the likes of Aberdeen and Glasgow showing over 125% growth during the period, and Edinburgh around the average, at 110%. Chart 3 also shows data for the Perth region (Perth and Kinross Local Authority region) and the Inverness Region (Highland LA) for completeness.

As a measure of its growing importance, PRS in Edinburgh is now the second tenure of choice and close to being the second tenure of choice in both Aberdeen and Stirling. However, even this does not tell the whole story with the centres of some of these urban areas showing much higher proportions of households in PRS accommodation (see Appendix 1 which maps households in PRS accommodation in central Edinburgh, Glasgow, Dundee, Perth, Inverness and Aberdeen using 2011 census data).

⁹ The Scottish Government Household Survey data until 2011 uses financial year data not calendar year

Chart 3. Households in PRS by Local Authority areas



Source: Scottish Government: Scottish Household Survey (2014) LA data. Published October 2015.

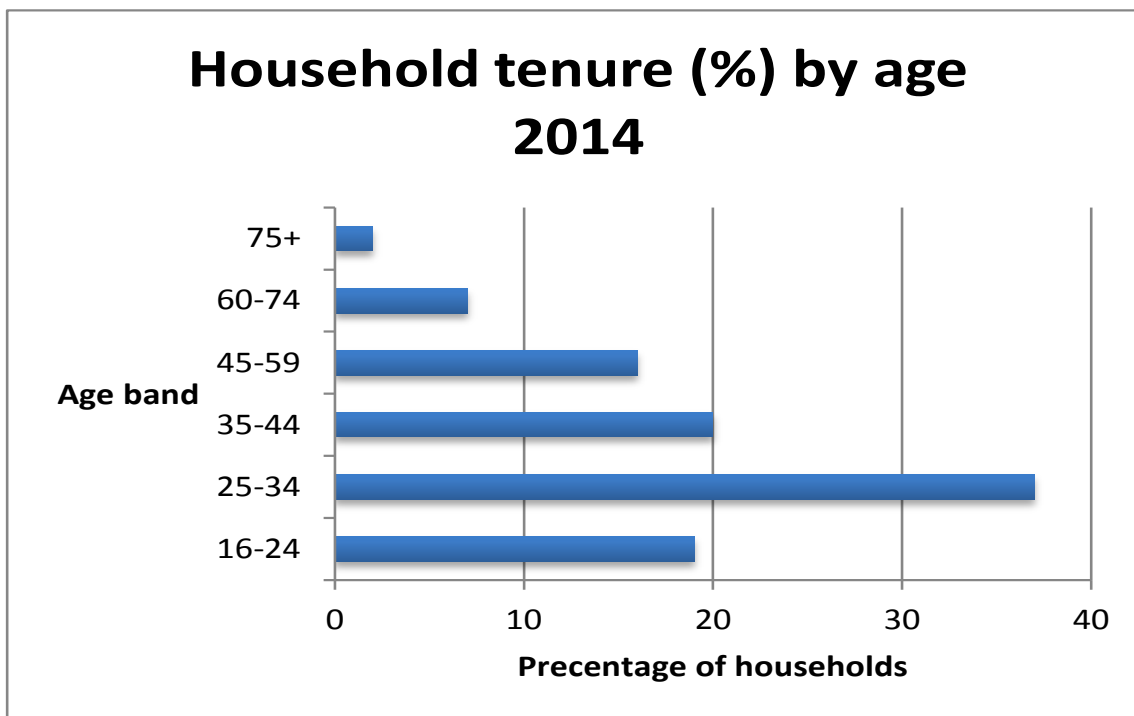
3.2 Who are the PRS tenants in Scotland?

Traditionally associated with young people and students, the private rented sector is now home to a wide range of tenants both in terms of age and household status. While the 25-34 age group still dominates the sector, increasingly tenants in the age band 35 to 59 are turning to PRS (see Chart 4).

The proportion of those over 59 is still relatively small in comparison (Chart 4), although downsizing to good quality institutional PRS could affect this in the future. Although not significant at the moment, there are indications that this sector of the market could grow¹⁰. It is a trend detected in *for sale* developments of a similar nature to many multi-unit PRS developments. A good recent example of this is the Parkview development of a good quality, well managed, 45 unit conversion by Whiteburn Projects in Dundee’s West End, which has attracted downsizer purchases and which is being used as a model for possible future PRS schemes in that city.

¹⁰ Mobility in the owner occupier market will be impacted by recent increases in LBTT in Scotland (an affordability issue) and as far downsizing in the 59 plus age group is concerned it could be impacted by their tax position as much as anything else.

Chart 4. Household tenure by age band



Source: Scottish Government (August 2015) Scottish Household Survey 2014.

There are indications that downsizing to good quality institutional PRS by those in the 59 plus age group could grow. The Parkview development in Dundee, albeit for sale, has attracted downsizers and could be used as a future PRS model. Also, initial enquiries at India Quay in Edinburgh have, in the main, been from young professionals and downsizers.

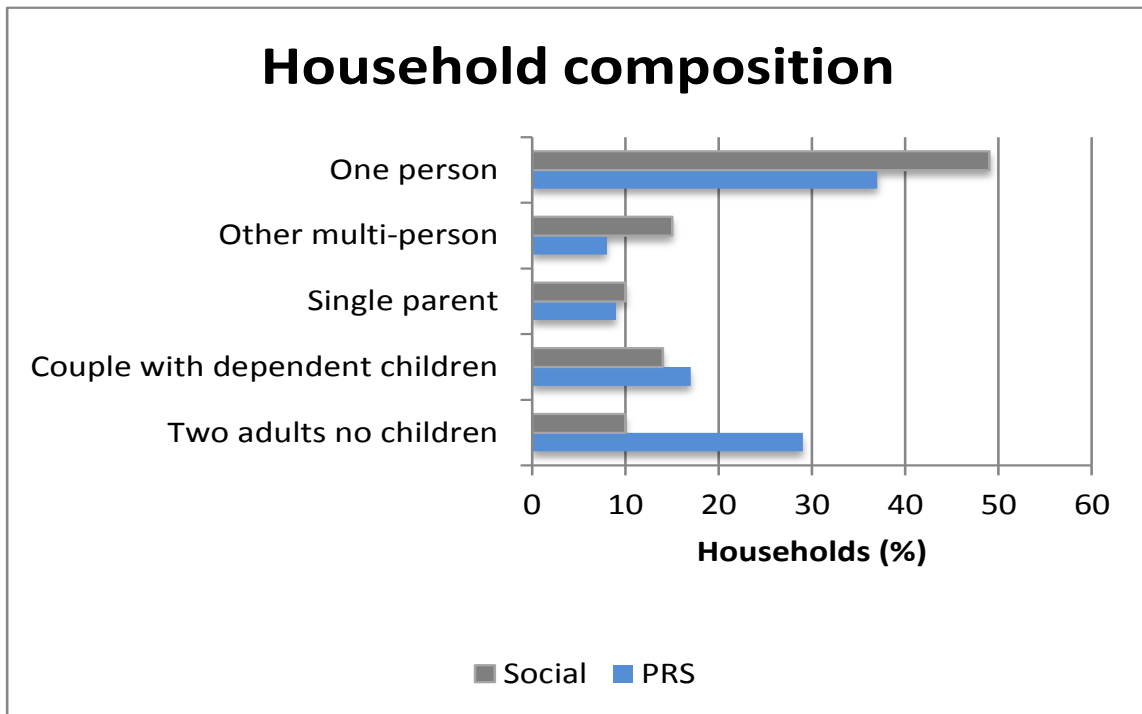
Source Whiteburn Projects and EDI 2016

The average net household income of PRS tenants is around £20k (51% in the £20k(-) group and 49% in the £20k(+) group)¹¹. However, while income plays a role in the likelihood of households deciding to live in the sector, there is also evidence that some people with higher incomes choose to live in the sector even when they could afford to buy a house. This suggests that lifestyle considerations are driving their decisions of where to live¹². Recent surveys also suggest¹¹ that an increasing percentage of families (couples with dependent children and single parents) are living in the sector. Not only that, but the percentage of families living in the PRS has now overtaken the number of families living in social rented homes. (Chart 5).

¹¹ Scottish Government (August 2015) *Scottish Household Survey 2014*

¹² Grosvenor (prepared by Volterra; June 2015): *Economic Benefits of Build to Rent Development in Edinburgh*.

Chart 5. Household status in the private rented sector



Source: Scottish Government (August 2015) Scottish Household Survey 2014.

'There is evidence that some people with higher incomes choose to live in the sector even when they could afford to buy a house. This suggests that lifestyle considerations are driving their decisions'.

Source: Grosvenor 2016

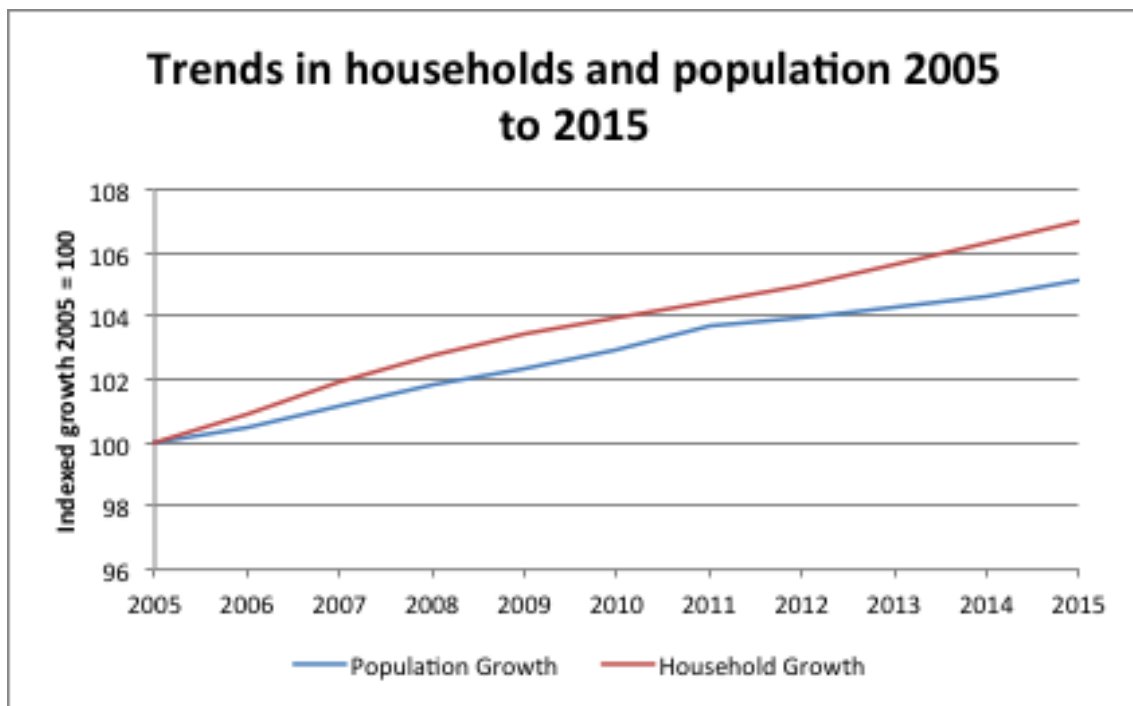
3.3 What is driving demand?

In keeping with our earlier observations, Pattison et al¹³ notes that the most likely causes for the change in tenure patterns seen in recent years are a combination of political, economic and social drivers. They suggest (as above) that lifestyle changes, increasing the desire for mobility, and affordability issues relative to owner occupation are the two most important drivers for change in the PRS sector. Clearly though, important push factors¹⁴ like increasing population and decreasing household size in Scotland in recent years have helped drive demand. Average household size has fallen from 2.21 people per household in 2005 to 2.17 in 2015 and the growth in households has been faster than the population because of this (Chart 6).

¹³ Pattison P, Diacon D and Vine J (2010). Building and Social Housing Foundation. *Tenure trends in the UK housing system: will the private rented sector continue to grow?*. quoted in Scottish Government (April 2012): *Evidence Review of the Private Rented Sector in Scotland*

¹⁴ Push and pull factors are the reasons and conditions that drive people from one socio-geographic landscape and pull them to another.

Chart 6. Trends in households, dwellings and population, June 2005 to 2015



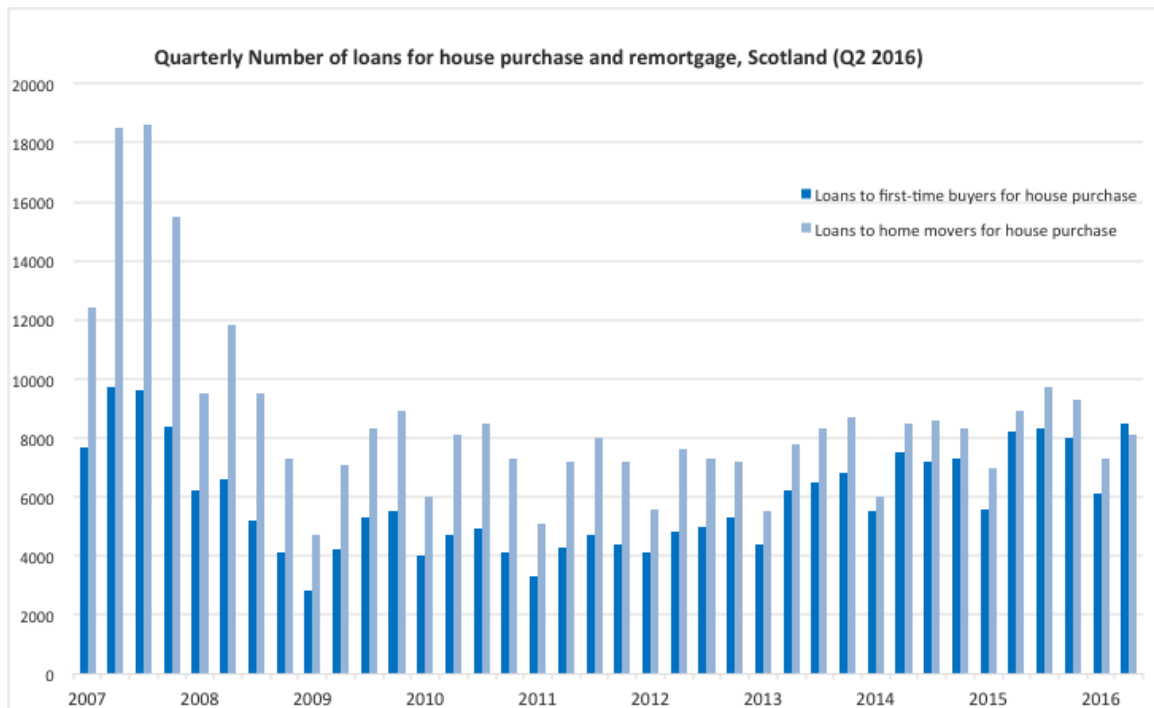
Source: National Records of Scotland: Estimates of Households and Dwellings in Scotland 2015 (Published 2016).

We have already noted the slowdown in owner occupation as a factor and a measure of this is recent data from the Council of Mortgage Lenders which suggests that the number of home-owner house purchase loans advanced in Scotland in recent years is still well below those levels seen pre-GFC in 2007, despite recent increases in the numbers of loans advanced (Chart 7). However, there is no evidence yet that the recent improvement in the numbers of loans advanced has impacted on the proportion of households in PRS (which have actually increased over the same period, see earlier, Chart 1).

No specific details have been published on the proportion of these mortgages relating to the Buy to Let market in Scotland, although UK data¹⁵ suggests that these have been around 10% to 14% of all loans advanced month on month over the period 2013 to March 2016, when a flurry of loans were taken to forestall the new 3% Additional Dwelling Supplement (for purchases of less than six properties) introduced in April 2016 (they fell subsequently to around 8% of loans). It should be noted that the Additional Dwelling Supplement does not apply in Scotland and that this effectively gives a 3% enhancement in value to Scottish properties compared to the rest of the UK (crystallised on ultimate sale).

¹⁵ Council of Mortgage Lenders (2016)

Chart 7. Number of loans for house purchase and remortgage in Scotland



Source: Council of Mortgage Lenders (2016)

In terms of drivers of PRS though, it has been argued¹⁶ that *‘whilst buy-to-let has been fundamental in enabling the PRS to grow, it has not been the reason for its growth. The sector has grown to accommodate more households because of a sustained demand from tenants’*. In this context, Bank of England UK data¹⁷ suggests that while buy to let mortgages funded more than 70% of the expansion of the PRS sector pre-GFC they only funded around a third of the expansion post-crisis.

‘Whilst buy-to-let has been fundamental in enabling the PRS to grow, it has not been the reason for its growth. The sector has grown to accommodate more households because of a sustained demand from tenants’.

Source: Paragon 2015

Mortgage affordability studies¹⁸ suggest that buying remains 21% more expensive than renting on a month-to-month basis when mortgage costs, and additional costs for maintenance, repair

¹⁶ Paragon 2015: Today’s Private Rented Sector

¹⁷ BoE Bank Underground (July 2016): The Ballard of the Landlord and the Loan

¹⁸ Savills: Spotlight on Rental Britain as an Asset Class Autumn 2012

household goods and services are taken into account. A recent study in Edinburgh¹⁹ suggests that in this city at least the figure could be even higher (around 30% or more for two and three bedroom properties). So even if the accessibility to mortgage finance improves, first time buyers will still be hampered by deposit and capital repayment affordability.

In the context of the new Additional Dwelling Supplement, demand in the PRS market could be affected if these and other recent fiscal changes impact on buy-to-let supply. However, it is too early to say which is the most likely and this needs further analysis since the impact could be either negative, if house prices fall, and owner occupation increases, or positive, if the supply of rented property decreases.

A recent online survey of nearly 1,200 tenants²⁰ indicated that *'My choice/preferred/suited needs'* scored highly in the responses to *'why renting?'* (48% ticked this box) but 58% of the tenants also chose *'Unable to buy the property they wanted/needed'*. A common response in the survey was that renting meant no property maintenance costs and the ability to move easily. Drawbacks noted included possible rent increases, lack of long term security and general market increases in rents.

A demand driver, which has not been explored in any depth in the UK, but is beginning to be addressed in the US, is that relating to student debt. There has been little mention in UK studies of student debt in the context of housing affordability/ downturn in owner occupation here. However, the US work suggests that renters with student loans are 28% less likely to say they will buy, rather than rent, their next home than those without student loans²¹.

US studies suggest that student debt will play a part in dampening owner occupation

The decline in the numbers of households in social housing (or perhaps more correctly the ability of those concerned to access social housing given the longer term changes rooted in the

¹⁹ Grosvenor (prepared by Volterra; June 2015): *Economic Benefits of Build to Rent Development in Edinburgh*.

²⁰ Why Research Scotland (2015): *Tenants' Opinions and Needs. Report of research findings of an online survey*.

²¹ Quiang C and Shahdad S (July 2016) Fannie May Commentary. *Student Debt: Whose Homeownership Rate Does It Hurt Most*. <http://www.fanniemae.com/portal/about-us/media/commentary/072816-cai-shahdad.html>

more tenure neutral housing policies adopted across the UK since the 1960s)²² is an additional driver of demand in the PRS. Ultimately though, PRS offers flexible, low barriers to entry housing options that allow residents to upsize or downsize their housing to meet their needs¹⁹.

3.4 Tenant demand – typical lengths of stay

Data on typical lease lengths in the private rented sector is patchy and to some extent confusing²³. The Scottish Housing Survey gives the average length of stay at the **current address** as 2.7 years. This is not the same as the average length of lease (in theory the lease could have been taken for longer), but is still a useful indicator of lease length and of course tenant's demand. The figure of 2.7 years though is slightly misleading in as much as it is a weighted average heavily influenced by tenants who have occupied an address longer than 10 years (mainly older occupiers in rural communities). In absolute terms the percentage of households in this category is small (6%) but they have a disproportionate affect on the weighted average. What is perhaps more interesting is that 71% of occupiers had only been in a PRS property for less than two years (44% less than a year, see Chart 8).

This part of the Housing Survey data is much more consistent with data from the Association of Residential Letting Agents (ARLA) which gives the average length of a tenancy (different from the time at a present address and *post hoc* giving weight to the evidence) for Scotland of around 15 months, close to the UK average of 17 months²⁴. Also the recent survey in Scotland by Why Research²⁵ (see also earlier), using a sample frame of letting agents and urban agents, estimated average tenancy lengths of 18 months, consistent with the ARLA data.

There is not much granularity in this data in terms of the type of property occupied and it begs the question whether lease length/ lengths of stay are higher in good quality institutional property, extremely relevant to the investment decision. Again the data is patchy and hampered by the maturity of Institutional schemes on which to base estimates. Our own limited survey is positive in this regard. Sigma Capital (an Edinburgh based firm who currently operate in selected regions of England) for example note that while there is no hard evidence to support the theory that good quality institutional type stock will secure longer term tenancies they believe it will, especially for family housing. At present a good (unspecified)

²² The impact of which has been amplified by the general undersupply of homes and the affordability challenges faced by potential homebuyers.

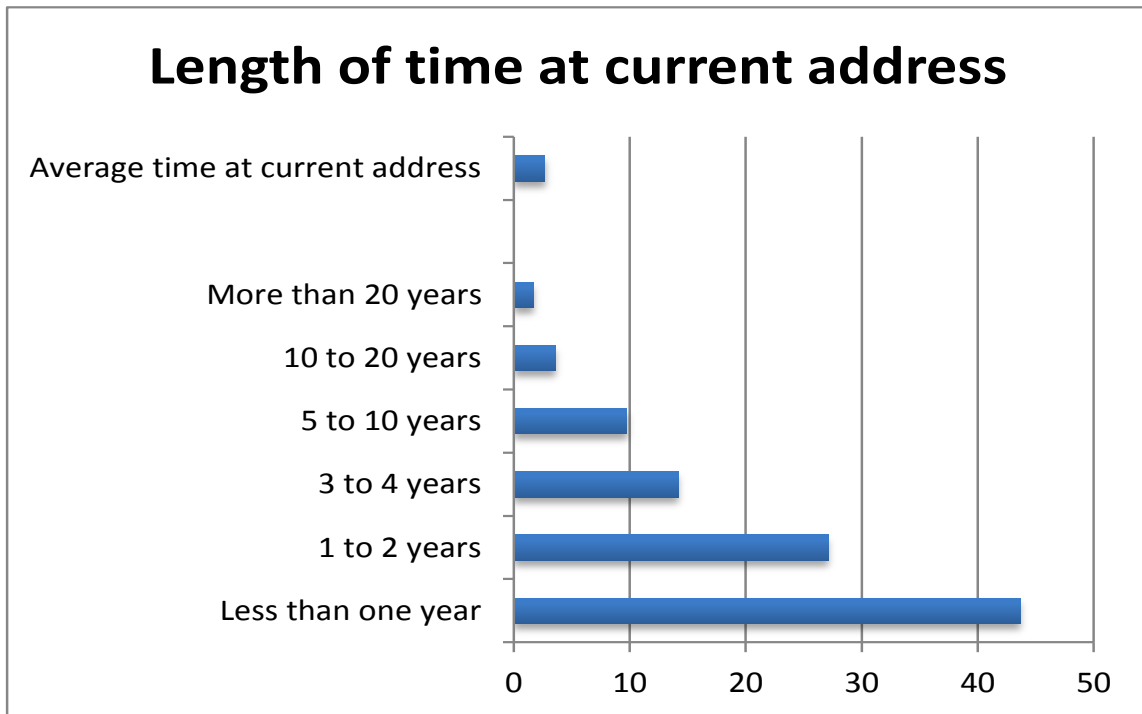
²³ The same is true of good rental data

²⁴ Source: ARLA Private Rented Sector Report June 2016

²⁵ Why Research Scotland (2015): *Tenants' Opinions and Needs. Report of research findings of an on line survey.*

percentage of their tenants who signed for an initial six month lease have renewed for a further 12 months.

Chart 8. Trends in occupation length in the PRS in Scotland



Scottish Government (August 2015) Scottish Housing Survey 2014

‘While there is no hard evidence to support the theory that good quality institutional type stock will secure longer term tenancies we believe it will, especially for family housing..... at present a good percentage of our tenants who signed for an initial six month lease have renewed for a further 12 months...’

Source: Sigma Capital 2016

There is also evidence²⁶ from existing tenants in a variety of institutional schemes that were built more than five years ago that the average length of stay to date is 3.8 years. This is limited but powerful evidence that institutional schemes will attract and keep tenants.

There is limited evidence of higher (than UK) average lease lengths in a variety of institutional grade schemes built more than five years ago.

Source: Aberdeen Asset Management 2016

²⁶ Aberdeen Asset Management (2016). This data was from a variety of schemes south of the border. All of the data was from whole blocks, some quite small (sub-10 units). Only one block had more than 50 units.

4.Future demand trends

To commit to further investment in the PRS investors need to be sure that future demand is not just about **Generation Rent**, and therefore that demand for the PRS will not fall off if mortgage availability improves (that there is a longer term trend which they can tap into). In addition, they need some comfort that recent changes to tenancy arrangements in Scotland are not likely to affect demand.

While there are no detailed longer-term forecasts in this regard, there are some indicators that longer-term growth prospects are reasonable and not just determined by the push factors described above. These are mainly UK wide based studies not specific to Scotland. A study in 2010²⁷ suggested that should tenure trends over the period 2005-2009 persist then the PRS could account for 20% of households in the UK as a whole by 2020. This was a relatively cautious study which took account of increases in PRS pre-2007.

In a separate study²⁸ it has been estimated that the sector in the UK overall could grow by 1.1 million by 2021. Using household projections and tenure estimates for the whole of the UK for 2014²⁹ this would suggest that the proportion of households across the UK in PRS could rise to just over 22% by 2021.

We have undertaken a trend analysis of historic demand in Scotland using a best-fit line of historic data on the proportion of households in PRS. This trend has been projected forward to 2020³⁰ (Chart 9). The data suggests that, assuming no major structural changes in the sector between now and 2020, the proportion of households in the PRS could be as high as 19% in 2020, an increase from the current 14%. This is consistent with the overall UK estimate.

If the forecast figure of 19% in PRS by 2020 is combined with the Scottish Government forecast of numbers of households in Scotland in 2020 (2.531m)³¹ the data suggests that there could be many as 480,000 households in the PRS in 2020 in Scotland, an increase of 150,000³² from 2014, assuming current trends persist. This figure results from both an increase in the estimate

²⁷ BSHF (2010): *Tenure trends in the UK Housing System: Will the private sector continue to grow?*

²⁸ Savills (Feb 2016). *Spotlight Rental Britain*

²⁹ ONS (May 2016). *UK Perspectives 2016, Housing and Home Ownership in the UK.*

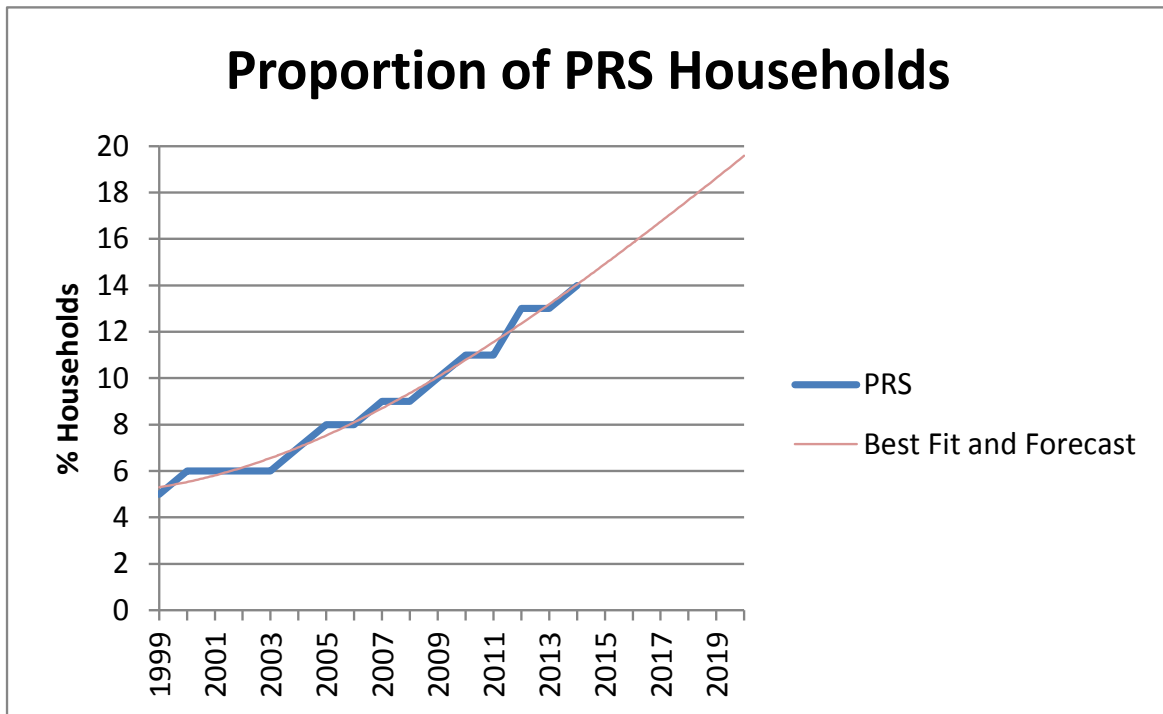
³⁰ There are dangers in trying to extrapolate data much beyond this but the trend analysis has been carried out to indicate demand trends in the short to medium term.

³¹ Household Projections for Scotland 2012 based. July 2014

³² A figure more or less consistent with the figure suggested by the Savills work of an additional 1.1 million in the PRS in the UK overall.

of the numbers of households over this period (6%) and the increase demand for PRS estimated in Chart 9.

Chart 9. Forecast of the proportion of Scottish households in PRS



Source: E Trevillion using Scottish Government (August 2015) Scottish Housing Survey 2014.

However, the forecast increase in PRS households above is significantly bigger than the Scottish Government forecast for the increase in households across all tenures in Scotland over the period 2014 to 2020 of 110,000³¹. This suggests that even if all new build to 2020 met the 110,000 increase in households overall and all of this were PRS (unlikely) there would still be a significant shortfall in PRS supply and that in order to meet demand there needs to be a significant structural re-arrangement of household tenures from owner occupation and social housing to PRS over that period.

In any event, in order to satisfy demand across all tenures in Scotland in **excess of 18,500 homes each year need to be built just to accommodate household growth**. The reality of demand could be much higher than this though. For example, Shelter estimate that Scotland needs 12,000 new affordable homes a year alone to meet demand in that tenure³³ and Homes for Scotland³⁴ are asking for a 10% year on year growth to return to pre-recession levels of 25,000 new homes pa. Symptoms of the shortfall can be seen in the large numbers of

³³ Scotland Shelter News October 2015

³⁴ Homes for Scotland (2015): *Building Enough Homes for Scotland*

households on the waiting lists for social housing (150,500 in 2014³⁵). The Commission for Housing and Wellbeing estimates that 23,000 new homes are required each year to cope with household growth and demolitions³⁵. This supports the view that current need/demand is outstripping supply across all tenures and PRS can help to meet this demand. It really is questionable, however, whether supply could match this kind of increase when current new housing completions are sitting at around 15,000 per annum³⁶. However, for investors there is clear evidence of a building momentum in demand for the PRS sector in Scotland with early indications of increasing lease lengths, particularly in good quality schemes.

We suggest that these occupier demand trends are unlikely to be affected by Scotland's new tenancy arrangements, which, it can be argued, at last remove uncertainties for both tenant and landlord, despite concerns over the removal of the initial term. Even with a minimum term of six months, the evidence is that tenants stay longer than they commit to at the start of the tenancy (see earlier) and there is no reason to assume that this pattern of behaviour will change with the removal of the initial term. Tenant demand might actually be improved as a result of the new arrangements and from the investors point of view the new arrangements at least now offer the opportunity to manage risks without further uncertainties. Certainly the evidence overall now suggests that recent trends in the PRS are not a result of short term effects caused by push factors and it can be argued that there is no reason why current trends should not continue given the currently high proportion of households in the PRS and that the UK's PRS is small compared to the European market³⁷. The only limitation is likely to be supply of the product. In this context, a recent survey does suggest that investors looking at Scotland as an investment opportunity in the sector are split 50:50 in their response to the new tenancy arrangements with half saying that they would no longer consider investing in Scotland as a result of these new arrangement and an equal number saying they would despite the changing legislation³⁸.

³⁵ Commission on Housing and Wellbeing: *A blueprint for Scotland's future* June 2015. And update 2016.

³⁶ Housing Statistics for Scotland June 2016

³⁷ But catching up. Recent work suggests that the proportion of households in the private rented sector is around 45% in Germany and 23% in France but the proportion is smaller in The Netherlands (10%), Denmark and Finland (17.5%), Ireland (10%) and Spain and Italy (14 to 15%). (source: OECD 2014: Revival of the private rented sector of the housing market. Lessons from Germany, Finland, the Czech Republic and the Netherlands. Rik de Boer and Rosemaria Bitett).

³⁸ Knight Frank (2016) Tenant Survey 2015/16

We suggest that recent trends in occupier demand in the PRS are unlikely to be affected by Scotland's new tenancy arrangements which, it can be argued, at last remove uncertainties for both tenant and landlord,

It is too early really to judge what effect BREXIT will have on the market. There are too many uncertainties at the moment. Recent commentaries (for example see *The Post-BREXIT Roadmap*. JLL Residential July 2016) rightly judge that whatever happens in the UK as a result of BREXIT we still have a housing crisis, a challenge which needs to be faced. This is not helped by post-BREXIT referendum challenges in the house building industry which may limit supply in the short to medium term as house builders remain cautious in the face of market uncertainty following the BREXIT vote. However, there appears to be an underlying market strength with buyers keen to identify good value properties.

If the commercial market is anything to go by, a recent survey by *PREQUIN* suggests that while a majority of institutional investors with exposure to real estate will reduce investment in the UK in the coming 12 months, over the longer term the outlook looks more positive and the majority of investors interviewed do not expect BREXIT to affect their approach to the UK market. Notwithstanding that, funds have re-adjusted their view of fair value and real estate values have been adjusted down in July and August by 5% on the advice of valuers³⁹ (it has to be said with little market evidence, as yet, to support that downward adjustment).

5. The potential for investors

We believe that there is a great deal of potential for investors in this sector in Scotland. The underlying fundamentals are strong. The market for privately rented housing is generally strong and growing, and is underpinned by pronounced imbalances between supply and demand. New purpose built proposals are starting to emerge and there is significant pent up demand for rented housing in the years up to 2020, at least. In addition, there are strong synergies with liabilities. Advertised rents for new lettings in the private rented sector have tended to rise roughly in line with real average earnings⁴⁰ and in recent years at or above inflation rates (Chart 10). This is widely seen as an excellent match for liabilities arising in

³⁹ In early July, Henderson's, M&G Investments, Standard Life Investments, Aberdeen Asset Management and L&G all reduced the values of their property portfolios between 4.5 and 5% using fair value adjustments (FVA) on the advice of valuers. Scottish Widows funds managed by Aberdeen increased the FVA to 10% later in July before reducing back to 5% mid-August (source: EGI August 2016).

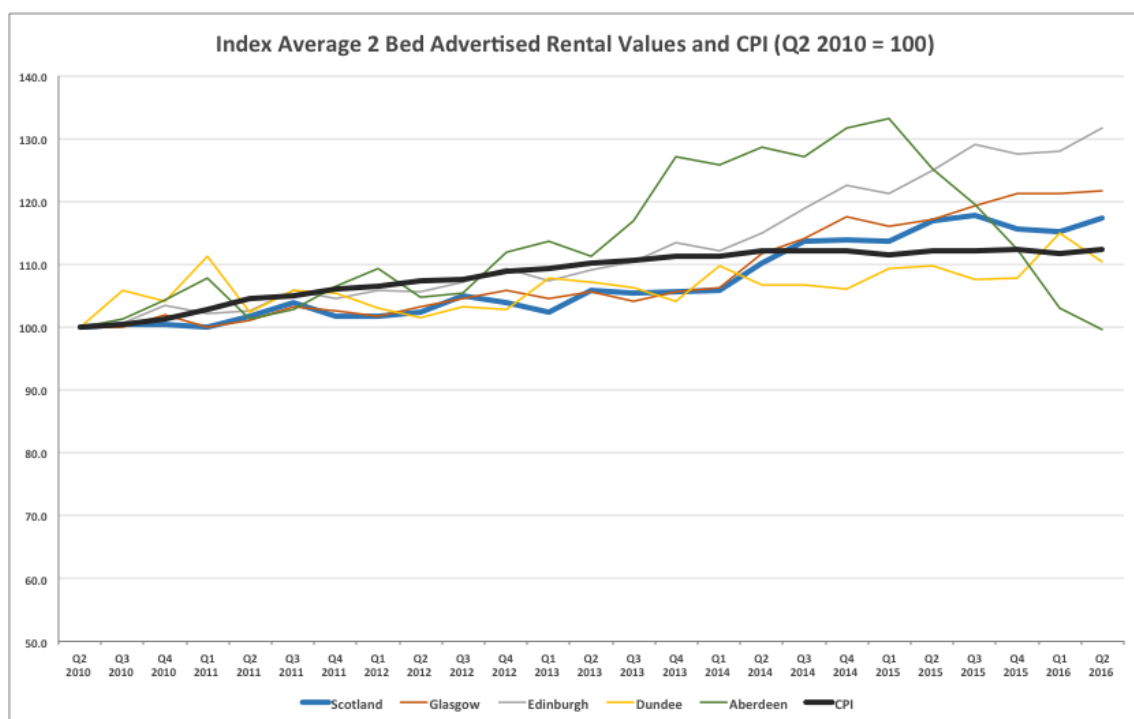
⁴⁰ See Knight Frank (2014). *The rental revolution: Examining the private rented sector 2014*.

pension funds. The private rented sector also continues to offer the advantage of multiple exit strategies, including flotation, aggregation, refurbishment, REIT status or sale to other investors as PRS schemes.

We believe that there is a great deal of potential for investors in this sector in Scotland. The underlying fundamentals are strong. The market for privately rented housing is generally strong and growing, and is underpinned by pronounced imbalances between supply and demand.

It remains the case, however, (and recognized for some time), that in the UK as a whole a significant part of investors' returns from the residential sector have come in the form of

Chart 10. Rental growth and inflation



Source: Dan Cookson based on City Lets data 2016

capital growth (on the eventual sale of rented assets to the owner-occupier market), especially in London and the South East of England. Historically Scotland and the North of England (no specific Scottish data is available) have delivered lower total returns than London and the Southeast but have delivered higher than average (all-residential) net income returns (4.1% compared to all residential of 2.7%)⁴¹. So investors interested in long-term income have the

⁴¹ See MSCI/IPD Annual Digest Dec 2014. Annualised total returns for residential markets lets in the UK for example over the period 2011-2014 were 12.1% (mostly as a result to capital growth of 9.7% and mostly down to capital growth in London markets) compared with just 0.2% in the North of England and

opportunity for good income returns on the back of good rental value growth. But there is now no reason why the good quality schemes coming forward cannot also offer the opportunity of good capital growth.

Scotland. However, net income returns in for the North of England and Scotland were 4.1% compared with 2.7% for the UK as a whole.

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Appendix 1 Households in PRS

Source: D Cookson based on 2011 Census data from National Records of Scotland

Chart 1a Aberdeen

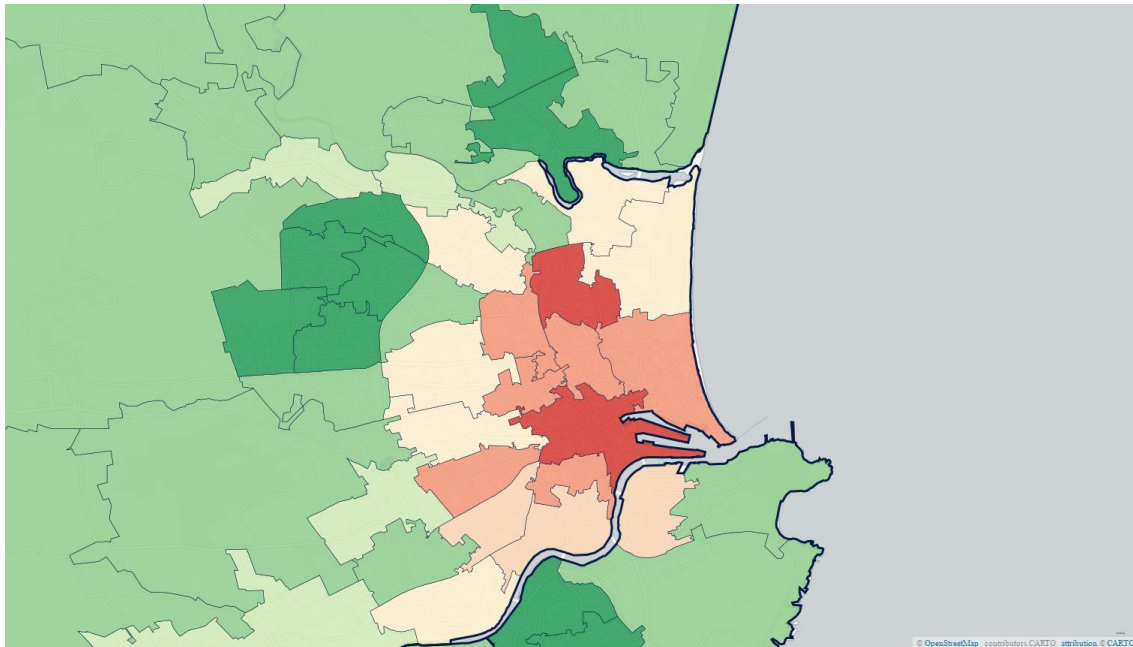
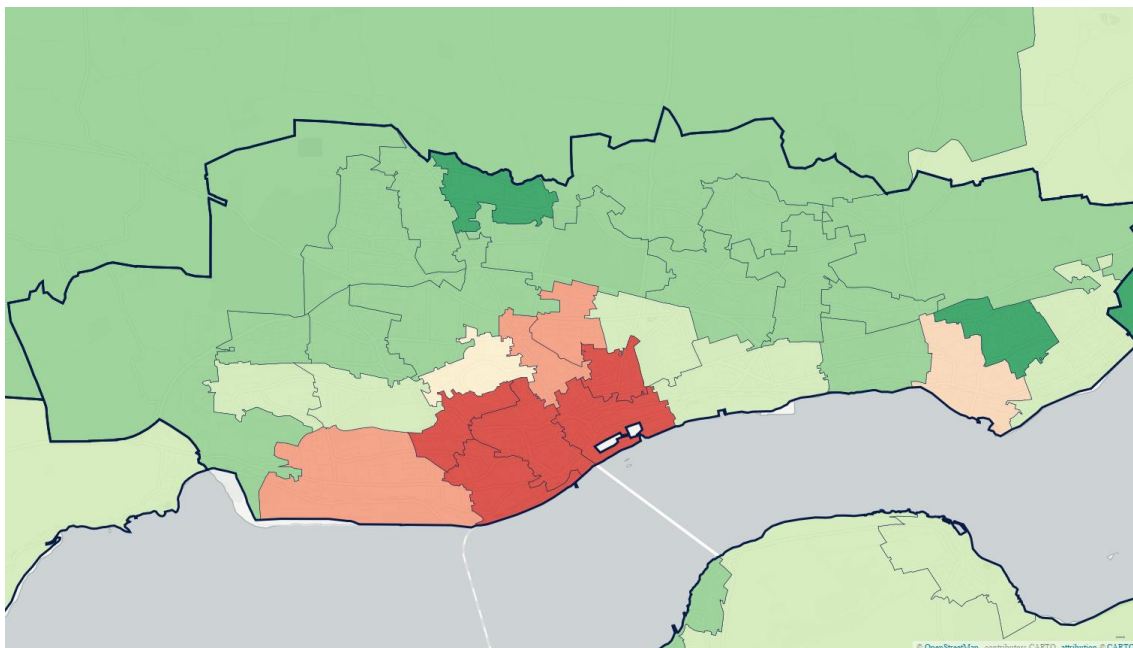
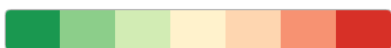


Chart 1b Dundee



< 5% < 10% < 15% < 20% < 25% < 40% > 40%



Appendix 1 Households in PRS (cont.)

Source: D Cookson based on 2011 Census data from National Records of Scotland

Chart 1c Glasgow

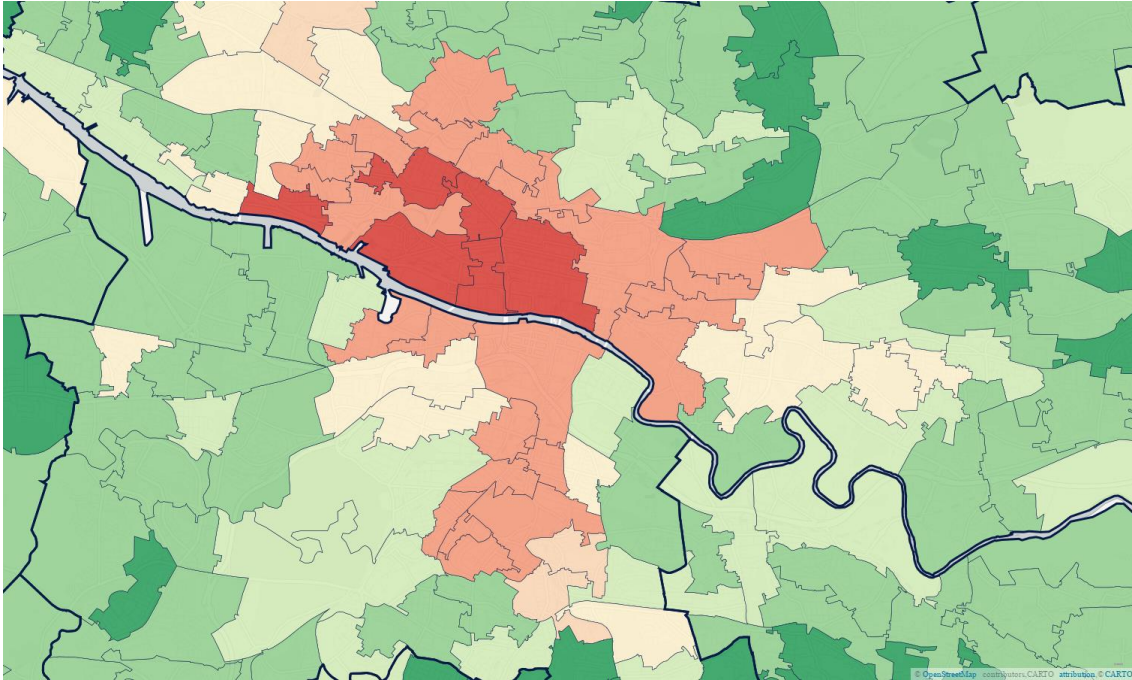
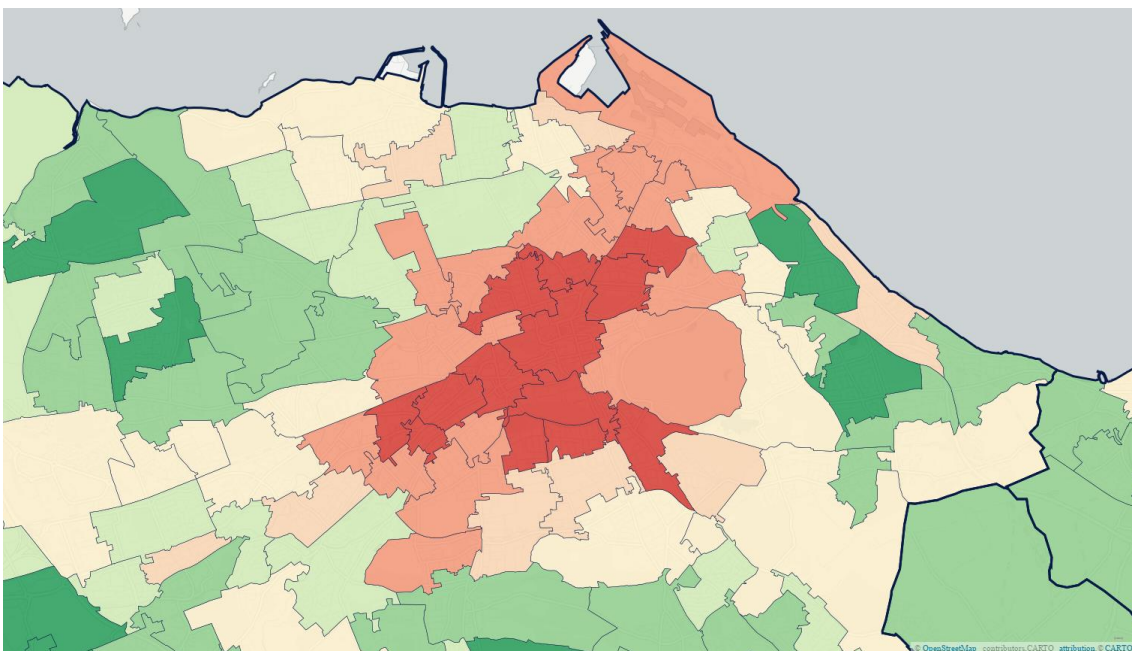
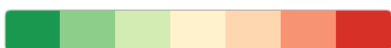


Chart 1d Edinburgh



< 5% < 10% < 15% < 20% < 25% < 40% > 40%



Appendix 1 Households in PRS (cont.)

Source: D Cookson based on 2011 Census data from National Records of Scotland

Chart 1e Inverness

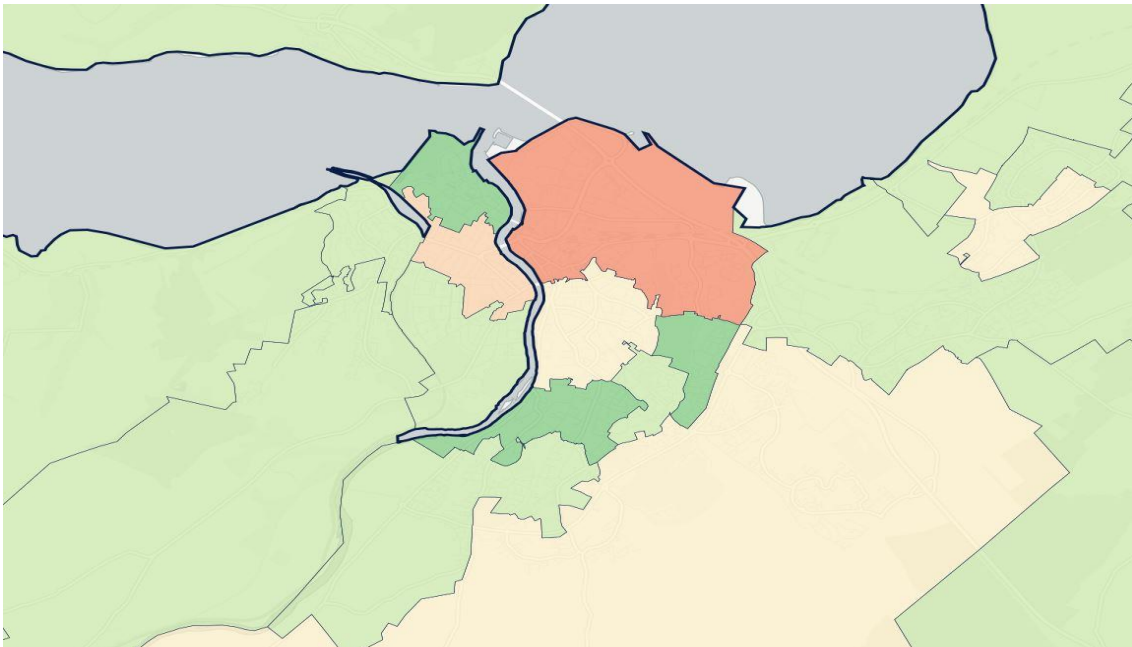
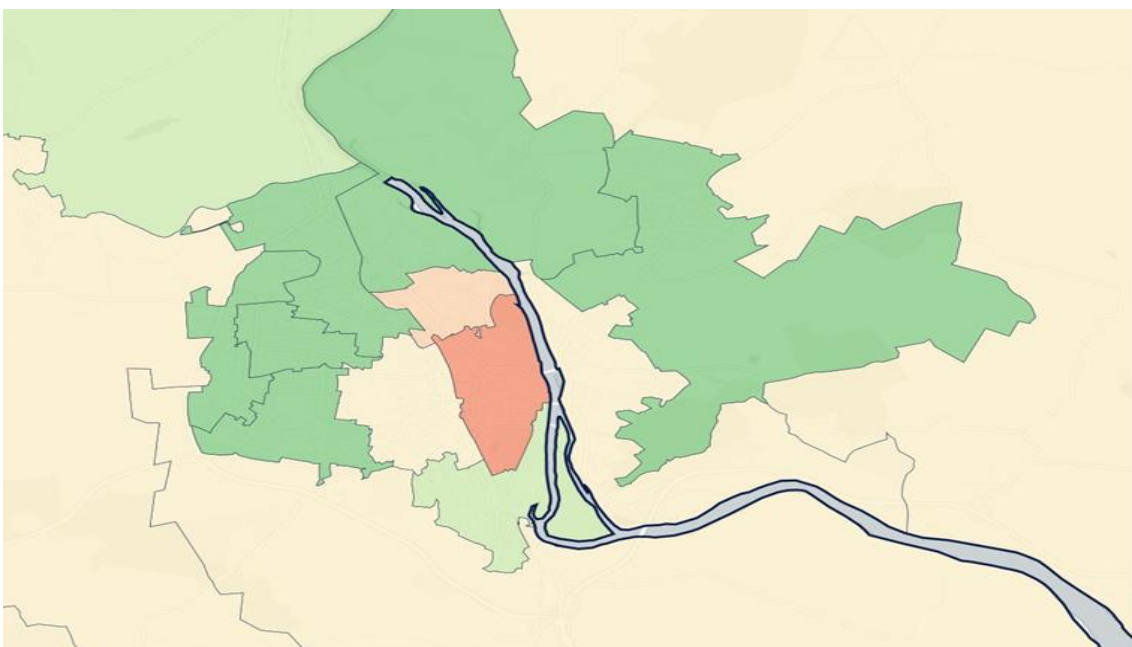


Chart 1f Perth



< 5% <10% <15% <20% <25% <40% >40%

