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What does 2023 have in store for UK residential?

Key trends

Compounding shortage of houses, which reduces affordability:

- The number of households will continue to grow, while construction of new homes slows
- House prices and rent continues to be unaffordable for many

Inefficient allocation of resources:

- What we are building is often the wrong size, location or price to satisfy demand
- Our existing housing stock will continue to be used inefficiently without government intervention

Inadequate quality and energy efficiency:

- Much existing stock is unsafe and energy inefficient
- Refurbishment of existing housing stock provides route to bring unoccupied stock to market

Capital is flowing into residential, despite development slowing.

- **Higher inflation** means that new houses cost more to build, curtailing new supply and limiting price falls. Inflation is also pushing rents up, making rental property relatively inflation-proof.
- **Higher interest rates** will create some buying opportunities. However, as mortgage rates rise, more people have to rent, so rents can be expected to go up.
- **Regulatory changes** including Minimum Energy Efficiency Standards and the abolition of Section 21 evictions will make residential better suited to professional investors.

Introduction

> What 2023 has in store for UK residential is the eight trillion pound question, of interest to investors and homebuyers alike...

From an investment perspective, residential is the single largest asset class in the UK. In fact, residential in the UK is worth eight times the value of commercial property, which includes offices and warehouses that provide the infrastructure for our economy. This market offers one of the best risk/reward ratios available at scale, and, unlike many other investment sectors, demand is non-cyclical and growing.

Residential property also makes up a significant portion of our national and personal wealth and it is responsible for people's shelter, making it both economically and socially vital. As a result, investing in UK residential in 2023 is not just about getting exposure to a compelling return.

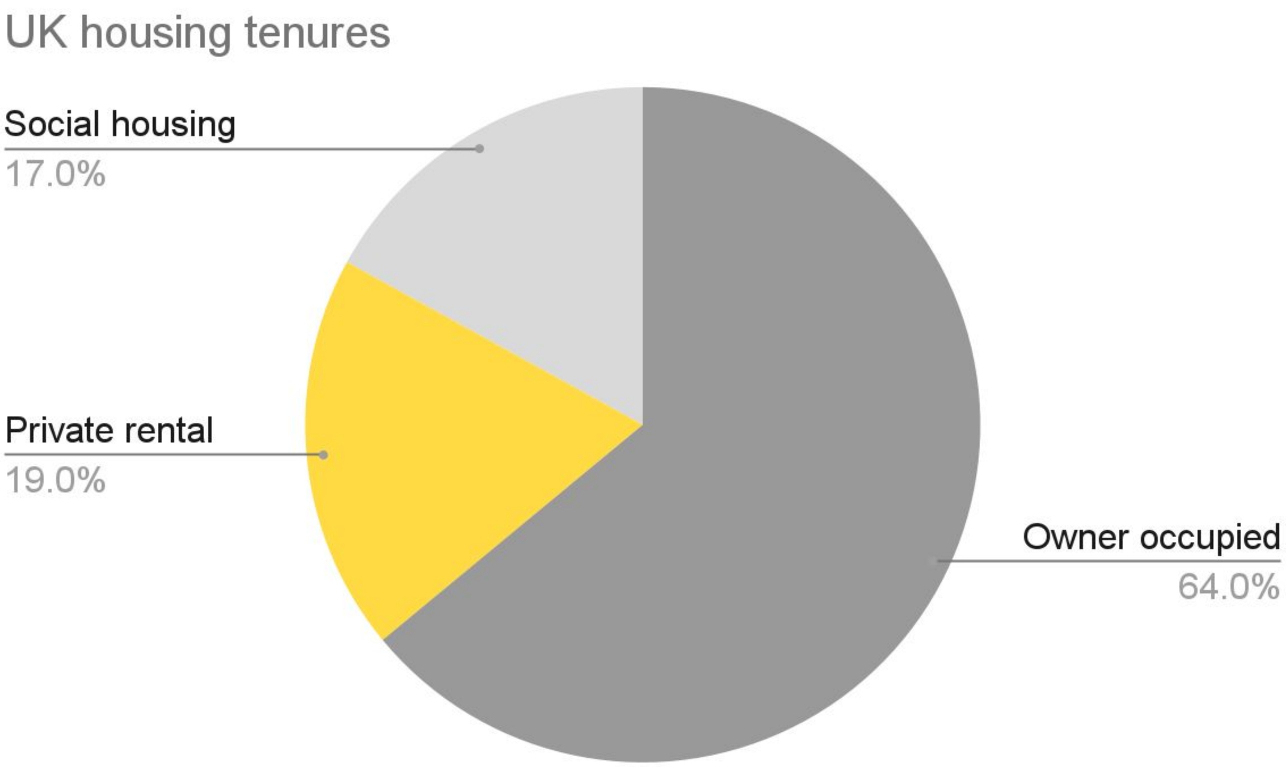
Investors must increasingly consider the consequences of their investments, including facilitating economic activity, serving a social need, and helping to improve the impact that living and investing have on the environment. Environmental, Social and Governance (ESG) factors in turn raise the importance of residential as an investment class, because of the rising significance of ESG to investment attractiveness and importance.

To answer the question of what 2023 has in store for UK residential as an investment, we first look at the recent past and what's changing across all tenures, with a focus on three key structural problems. Understanding these is vital. In the words of Albert Einstein, "the formulation of a problem is often more essential than its solution")Then we will look at the outlook for residential as a result of key macroeconomic factors.

Three structural problems affect UK housing across tenures

The UK housing market is not one market. The problems affecting it are not as simple as demand exceeding supply.

There is much variety within the main tenures:



Each tenure suffers a similar problem, often condensed to: 'housing demand exceeds supply'.

In fact, there are three key structural problems, of which the supply shortage - a lack of volume - is just one. These are:

- A compounding shortage of houses as a result of shrinking household sizes and an ageing population, which reduces affordability;
- Inefficient allocation of resources; and
- Inadequate quality and energy efficiency.

A compounding shortage of houses, which reduces affordability

There are not enough houses available for the number of households we have. This has been the case for many years, pushing up prices and rents beyond what is affordable. Economic and social problems including vast inequalities of opportunity result.

The shortage of homes is getting worse. 2021 ONS Census data shows the population of England and Wales is the largest it has ever been at 59,597,300[1]. The ONS forecasts that the number of households in England will increase by 1.6 million (7.1%) over the 10 years from 2018, from 23.2 million to 24.8 million in 2028[2]. 95% of this projected increase is attributable to shrinking household sizes, in particular the growth of one-person and multiple adult households without dependent children[3].

If we were to build c. 160,000 homes a year, we should keep pace with the growth in housing demand that results from shrinking household sizes. However, shrinking household sizes, population growth and 'high net migration' put together vastly exceed the delivery of new homes.

In 2021-22, we built 232,820 net additional dwellings, a 10% increase on 2020-214. This compares with our annual housing target of 300,000[5] which has not been achieved since it was set. The annual target has proved to be challenging in the context of planning controls and the commercial realities of building and selling homes. Meanwhile, in 2022 alone, the UK had 504,000 net migrants[6], suggesting that our housing targets, even if achieved, are inadequate.

The shortage of housing means rising costs for buying, renting or running a home, to the point where home ownership and renting are unaffordable for many. In the UK, the average home is worth £296,000 at the time of writing[7]. Average household disposable income was £31,400[8]. This means that buying a home costs the average household almost 9.4 x their annual income, up from 3.5 x in 1997[9]. Rent for a single person is currently 35% of average incomes[10]

For those fortunate enough to be able to afford to rent or own their own home, affordability constraints still have a significant impact through reduced disposable income, in particular at a time of high inflation. The 'silent suffering' are increasingly recognised through non-traditional data sets such as food bank use, which was up 52% in the 6 months to September 2022 compared with the previous year[11].

Affordability is not just a money problem. Affordability constrains labour market flexibility and economic growth at a micro and macro level, and it limits access to jobs, education and healthcare for individuals. Its social consequences include homelessness and inequality of opportunity, both of which directly influence the well-being of individuals, families and communities.

The impact of the affordability and volume problem is disproportionately felt by younger and poorer people. It's no surprise that in 2021, 3.6m of 20-34 year olds (42%) lived with their parents, compared with 35% in 1997[12]. In 2020, over 1 million people were waiting for social homes[13]. Crisis estimates that more than 282,000 people are homeless (sleeping rough or in temporary accommodation) in England[14].

Despite growing demand, we are building less: 2.2 million net additions were built between 1961-71 (net additions means new homes completed net of those lost; in the 1960s this was largely a result of widespread slum clearance), compared with 1.7m net additions between 2006-2016[15]. What's more, in 2022, the supply of new rental listings was down 38% on the 5 year average, in part a reflection of the number of private landlords exiting the market[16].

The flip side of the affordability crisis is significant wealth gains for those who own property. 8.8 million homes (36%) are owned outright, giving these households security of tenure, a sense of ownership and access to the beneficial capital growth that is the cause of reduced affordability of housing. These are typically older, wealthier and more politically influential people[17]. Many want to protect the countryside (e.g. the green belt), and prefer not to have new housing projects built close to their homes (NIMBYism). For this reason, the supply shortage is not just an economic problem, but also a political one.

For investors, the closely related problems of undersupply and low affordability highlight the strength of demand for greater volumes of new homes at locally affordable price points.

Inefficient allocation of resources

If there were enough homes to accommodate our population, we would still have a problem. The trouble is that homes are in the wrong places, of the wrong sizes or price, or are not being used efficiently.

There are not enough homes that people can afford to live in, in the places people want and need to live when they are economically active. Demand for homes in economically successful urban areas vastly exceeds supply, pushing prices up and resulting in overcrowding, while there is an over-supply of homes in some parts of the UK. The percentage of overcrowded renters increased from 4.5% in 1995 to over 7.5% in 2019. Meanwhile there are areas of the country where homes that have fallen into disrepair have been auctioned off at starting price of £1[18]. There are large areas of rural Britain where poor access to key services and employment centres, especially by public transport or walking, makes them unattractive for those of working age[19]. This is one of the causes of the 257,000 long-term empty homes, part of a wider vacant total of over 479,000[20].

Then there is the question of fit between what is being built and what is needed. 95% of the forecast population growth in the decade to 2028 is from one or two person households, including the over-50s cohort. Meanwhile, the mix of what is built is trending in favour of larger homes. In 2021-22, just 6% of new homes across all tenures in England had one bedroom and 28% had two bedrooms. This compares with 19% having one bedroom and 32% having two bedrooms in 1991-1992[21].

As for pricing, the vast majority of new homes are at a premium level. In August 2022, for example, average new build homes were priced at £347,604[22], 18% higher than the average UK house price of £294,559[23], and 11.1x average disposable incomes. The perceived need for policies such as Help to Buy illustrates the extent to which what is being built is not affordable to first time buyers[24].

There are sufficient bedrooms to house our current population, but too many are underutilised. The 2021 ONS data reveals that 69.2% (17.2 million) of households in England and Wales in 2021 had more bedrooms than required, of which over half had at least two spare bedrooms[25]. More than 3.6 million homes across the country owned by over 65s have at least two spare rooms, worth an estimated average of £129,000 each[26].

The final point around distribution is that of intergenerational inequality. 'Housing privilege' is overwhelmingly the realm of older people. Almost three-quarters of people aged 65 years and over in England own their home outright. Meanwhile, younger people are less likely to own their own home, and they are significantly less likely to own their own home outright than in the past. Two thirds of people in their mid-30s to mid-40s had a mortgage in 1997, compared with just half by 2017. They are more likely to be renting or living with their parents.

The inefficient distribution of housing resources indicates the strength of demand from certain groups, in particular poorer and younger people. For investors, there is an opportunity to focus on serving these people, in particular the economically active 'squeezed middle'.

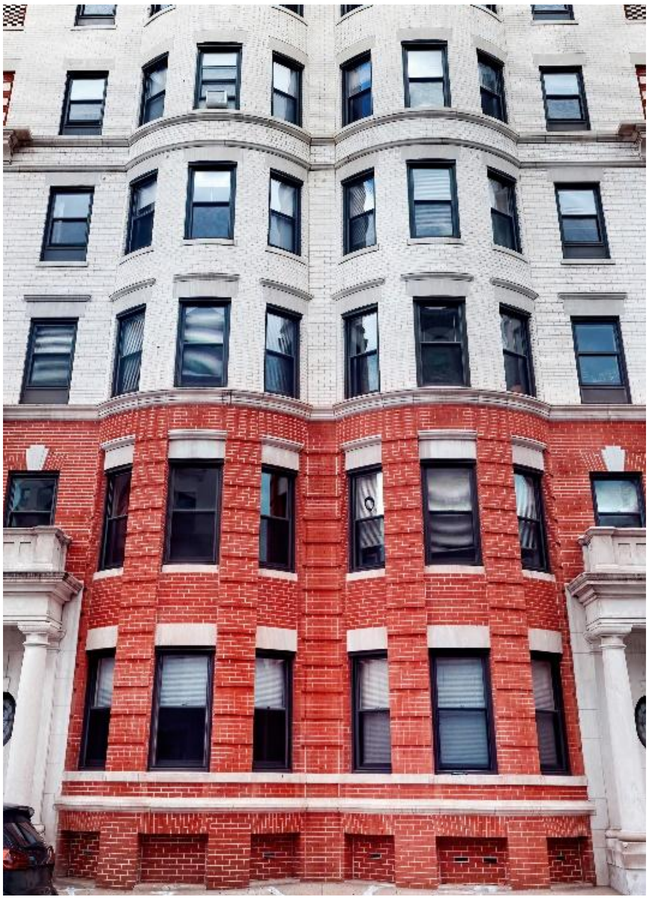
Inadequate quality and energy efficiency

It may come as a surprise that in a developed country such as England so many properties are classed as 'non-decent'. The private rental sector, lived in by typically younger and poorer people than those who own their own home, is the tenure with the highest proportion of non-decent homes (23%). The social rented sector has the lowest proportion of non-decent homes (12%). Among owner occupied homes, 16% failed to meet the Decent Homes Standard27. Shockingly, 12% of private rental sector properties have category 1 hazards, presenting risk of death28. Clearly, this presents a huge problem in terms of health, well-being and intergenerational inequality.

The second aspect of the quality conundrum is energy efficiency.

The UK has the oldest and leakiest housing in Europe. This is a problem for the environment and for achieving Net Zero by 2050, since 14% of UK greenhouse gases come from homes and up to 40% of carbon emissions come from real estate more broadly29. This is also a problem from a lifestyle perspective: 60% of homes fall below the planned Minimum

Energy Efficiency Standard of EPC C+30. The result is that increasing numbers of people are falling into fuel poverty. In 2019-2020, 19.2% of the population were in fuel poverty (spending >10% of their income on fuel), increasing to 55.8% in 202331 despite government intervention on Energy Price Guarantees to the tune of £18 billion at the time of writing. The social consequences of energy inefficient housing are clear, from higher NHS costs to children's' education suffering.



The housing quality problem in terms of standards, safety and energy performance, is pressing. The consequences of what we do, or fail to do, now are long term, since 98% of homes that will exist in 5 years time are already built and 80% of the housing stock in 2050 is already built[32].

The quality problem highlights the need for professional delivery of quality, energy efficient homes across all tenures. This point is echoed in other regulatory shifts, such as the proposed abolition of Section 21 evictions, making this investment more suitable for professional, long-term investors.

Structural problems and economic realities guide residential investors in 2023

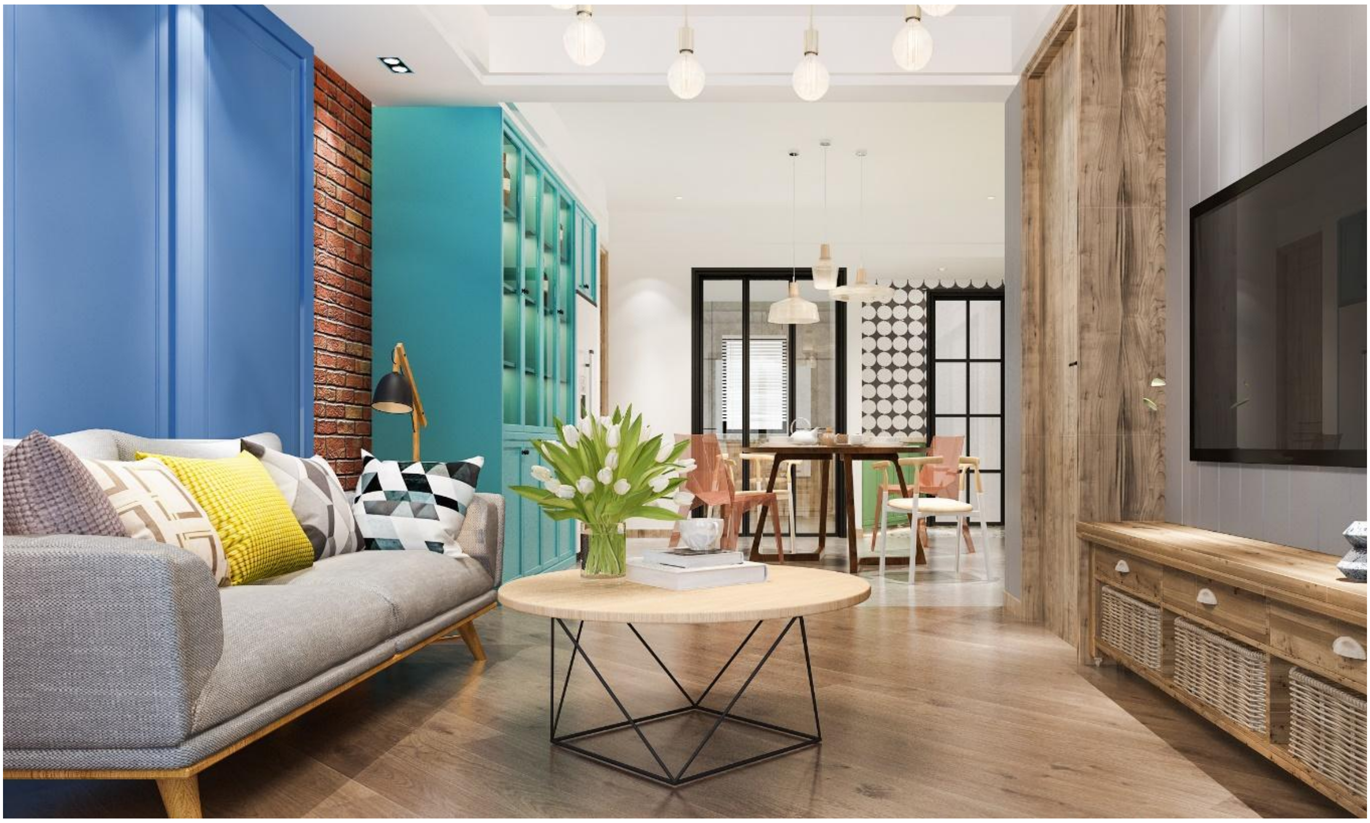
The problems of volume (and therefore price), distribution and quality are pressing. They set the context for the outlook for residential investment in 2023 and beyond. Smart long-term investors seeking non-cyclical returns are already focusing on how they can use their capital to help solve these problems, whether through building new or improving existing homes.

These structural challenges are helpful signposts for successful investors in 2023.

However, investors cannot make sustained returns from solving structural problems without understanding the current economic outlook.

They must consider key macroeconomic factors, such as:

- What is happening to capital flows?
- What will the consequences of inflation be?
- What will the consequences of higher interest rates be?
- How will investor risk appetites change to, from and within UK residential in 2023?



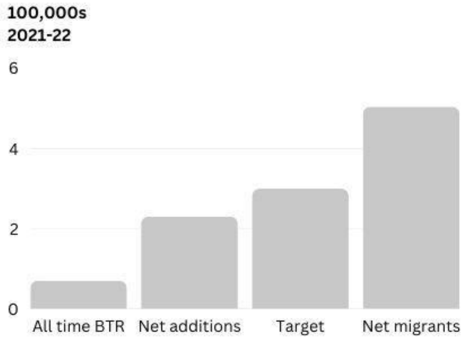
MARKET DRIVERS
UK RESIDENTIAL IN 2023

SUBSTANTIAL MARKET VALUE

UK residential is worth 8 x commercial property

WE ARE NOT BUILDING ENOUGH TO MEET GROWING DEMAND

We consistently fail to meet housing targets, themselves outstripped by high net immigration



OUR HOMES ARE UNAFFORDABLE

Existing homes are unaffordable for average earners; new build is worse

60%

of homes <EPC C

OUR HOMES ARE ENERGY INEFFICIENT

We have the oldest, leakiest homes in Europe, which cool 3 x faster

WITH SERIOUS ENVIRONMENTAL CONSEQUENCES

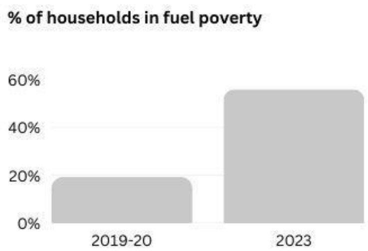
Low energy performance is holding us back from Net Zero

14%

of Greenhouse Gas emissions attributed to UK homes

40%

of carbon emissions attributed to real estate



WITH NEGATIVE SOCIAL CONSEQUENCES

More households are now in fuel poverty, despite £18bn government spending on Energy Price Guarantees

Find out more: hello@immo.capital

What is happening to capital flows in 2023?

Capital flows are driven by policy and macroeconomic factors. Across asset classes, investors are increasingly focused on investments that provide income yield and an inflation hedge. Residential yields are relatively stable and consistent, and rents can adjust quickly to inflation. As a result of this, significant capital is being attracted to this asset class.

In the words of Real Estate Professor Andrew Baum:

> *Residential investment is on the increase as part of a huge re-balancing of institutional real estate portfolios away from retail and office and towards residential, logistics and social infrastructure. This trend towards the broad rented residential sector looks likely to be boosted in 2023, especially given the 2022 drop in logistics prices. Development might be curtailed by supply side inflation, so this looks like a time to buy secondhand assets.*

Within residential, the impact of long term house price inflation is that poorer and younger people have just one option: private rental homes. This means that the investment case for investing in affordably-priced residential rentals remains strong, attracting capital into residential for rent focused on middle-income renters.

Build to Rent has emerged as an increasingly popular method of investing within residential, alongside the traditional model of building to sell. However, the combination of planning constraints, affordable housing requirements,

Section 106 contributions, post-Grenfell building safety requirements and the rising costs of raw materials mean that both building to sell or to rent are getting harder. Development is significantly harder at entry-level house prices or rents, due to the commercial realities of an inflationary, higher interest rate environment in which quality, safety and energy efficiency are a priority both in terms of policy compliance and morality.

What will inflation mean for UK residential in 2023?

Inflation of labour and material prices mean that the cost to build housing (and therefore the price it can be sold at) and the costs to provide and maintain homes for rent are rising.

Residential rental income is a reliable hedge against inflation. It's reliable because housing is essential. It's an inflation hedge because rental income tends to grow in line with or above wage inflation. This is vital for investors, in an environment in which the prices of other assets are volatile, and where inflation means money loses value when not invested.

In the words of Professor Andrew Baum:

> *"Higher inflation means that new houses cost more to build, curtailing new supply and limiting price falls. Inflation can push rents up, and in the residential market this can happen very quickly, and every year. In the office market the inflation/rent link is much less clear as rents are often fixed for 3 or 5 year periods.*

In addition, residential values are growing due to the outlined long term supply shortage. House price growth beyond what is affordable means rental demand is increasing further, pushing growth in rental prices. Growth in rental prices ensures that the yield-based valuation of properties continues growing.

What will higher interest rates mean for UK residential in 2023?

In the words of Professor Andrew Baum:

> *Rises in interest rates usually precede a fall in real estate prices. Given that UK government bond yields rose from 1% to 3.5% between December 2021 and December 2022, interest rate rises are certain to lead to weakness. However, more owners are now protected by fixed rate mortgages, limiting the impact of higher rates on existing owners, especially those with reasonable equity positions.*

Higher interest rates have two key consequences. Firstly, an increase in the cost of mortgages means some borrowers on variable or standard variable rate mortgages (in the UK, for example, this is c. 2m borrowers, representing c. 8% of homes) will face financial pressure as their mortgage interest rates could double, or more. Some of these property owners will choose to sell and live in rented homes. This creates a buying opportunity for well-capitalised investors focused on longer-term returns.

Both building and buying investment properties using finance becomes more expensive. This will have the knock-on effect of reducing the supply of existing and new rented homes. Both factors have the same result: more demand and less supply.

As a result, the shortage of quality, energy efficient, affordably-priced homes is getting worse. The result is that the investment case for residential investment is even stronger, whether for owner occupiers, private renters or social housing customers.

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How will investor risk appetites for UK residential change?

Perhaps the most important element of risk for residential investors is pricing risk. In the words of Professor Andrew Baum:

> *“The measurement of prices is very difficult when there is a good reason for markets to be falling, like now, because people do all they can not to sell into a weak market. As a result of this I do not think it is likely that we will see Halifax and Nationwide indexes falling by 10% in 2023 as many are predicting, but the spread of transaction prices will widen and there will be some distressed or reluctant sales at lower prices. When mortgage rates rise more people have to rent, so rents can be expected to go up. While the chatter has been, and will continue to be, about falling house prices it is the commercial real estate market that will see much more damage. This is because there is a perfect storm – weak demand plus over-supply, together with the impact of Covid, environmental unsustainability and technology (home shopping, home working). On top of this, residential is probably a better inflation hedge.*

In this environment, strategies that work are strategies focused on minimising risk rather than maximising returns. To do this, inventors must consider both how structural problems can be changed, and to do so in a way which acknowledges the economic environment we are in.

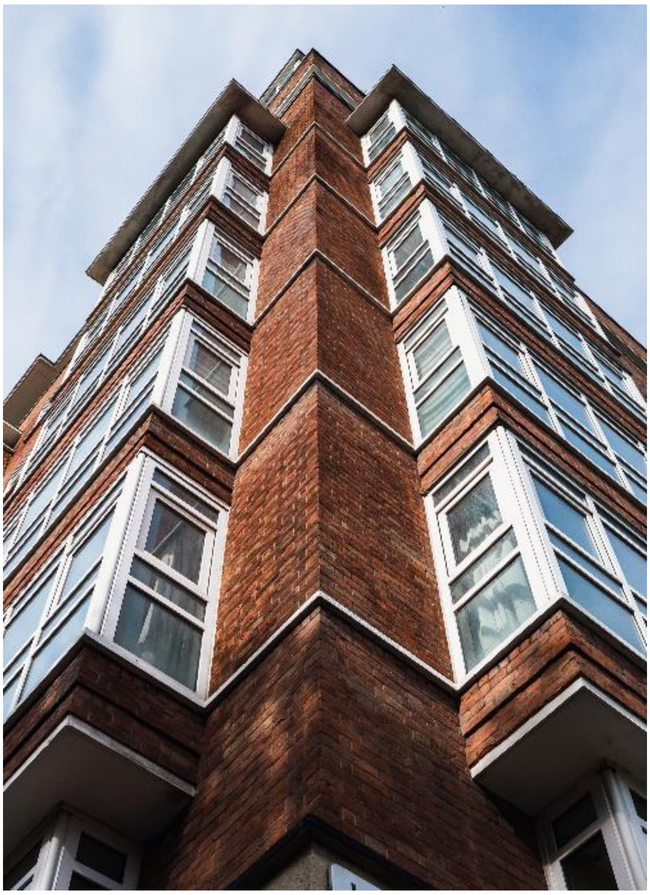
Summary

Residential is vital for our economy for individual households and, increasingly, for investors seeking to diversify into relatively stable asset classes. The outlook for 2023 and beyond for investors in this sector will be a product of:

- Their ability to resolve the three key structural challenges affecting residential property
- Their response to key macroeconomic trends such as inflation and interest rates

Given the relative variables and dynamics, in the view of Professor Andrew Baum:

> “*Residential investment will be a big relative winner in 2023.”*



IMMO’s Co-Founder and CEO, Hans-Christian Zappel concludes:

> “*The market timing is ideal for acquiring European residential. Rental demand is increasing, and supply of rental properties is falling. Pricing presents an opportunity for the institutions we work with. We process 320+ data points per asset to rapidly assess, filter and negotiate on available opportunities, to ensure we only acquire the best assets at the right prices.*

Who are IMMO?

IMMO is a leading European proptech platform creating single-family rental portfolios at speed and scale.

We use market-leading technology and data analytics to unlock 98% of the residential market made up of individual flats and houses, which has previously been ignored by investors. Then, we systematically retrofit properties to deliver quality housing in the places it's most needed.

We are currently allocating £2.5 billion of capital on behalf of institutional investors to income-generating residential portfolios across Germany and Spain.

Our vision is to use our technology at each stage of the value chain to transform the largest asset class on the planet, whilst solving the problems of all parties: investors, residents and sellers.

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