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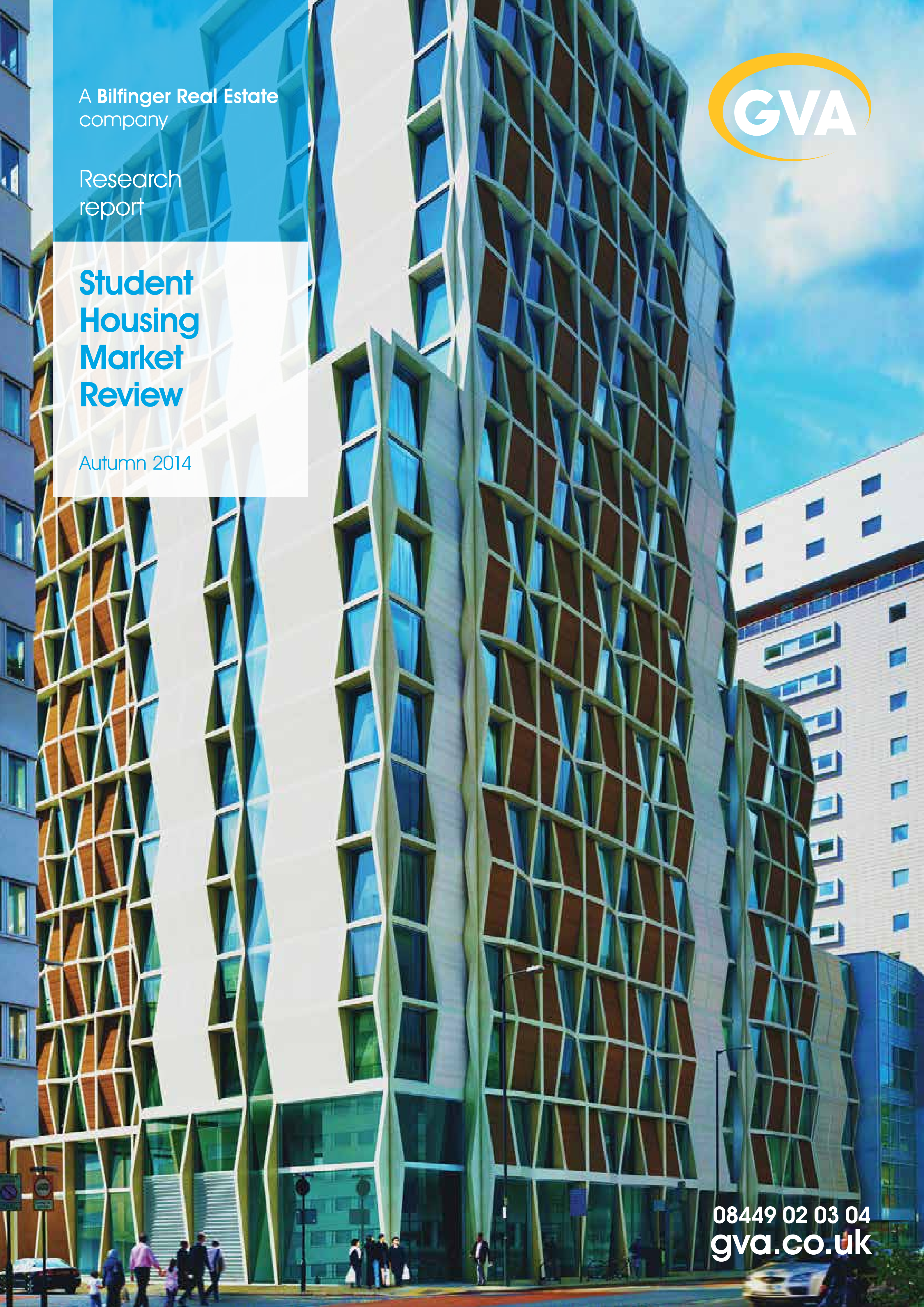
Research report

Student Housing Market Review

Autumn 2014



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Student Housing Market Review

Introduction

This is the fifth annual report from GVA on the UK student housing market. This year we take a close look at the dynamics affecting the sector, focusing on demand, supply and the investment market.

Student housing continues to evolve. In the last 12 months, there have been some significant changes to the structure of the sector, with some large established names disappearing and a raft of new entrants from the UK and overseas active in the portfolio market in particular.

Having prospered during the downtown as a safe counter cyclical hedge against mainstream commercial property, student accommodation is facing greater challenges from competing land uses and policy changes. Strong residential values in the central London market and the added cost of the Community Infrastructure Levy (CIL) are putting an additional burden on viability for some schemes. At the same time, the regional markets are proving to be increasingly appealing, offering greater scope for yield compression thanks to lower costs and high demand rates.

One new trend is the shift by investors away from nomination agreements with universities or third party operators and instead towards direct lets. As the sector continues to mature, investors are recognising that the perceived extra risk can result in more flexible management and higher returns.

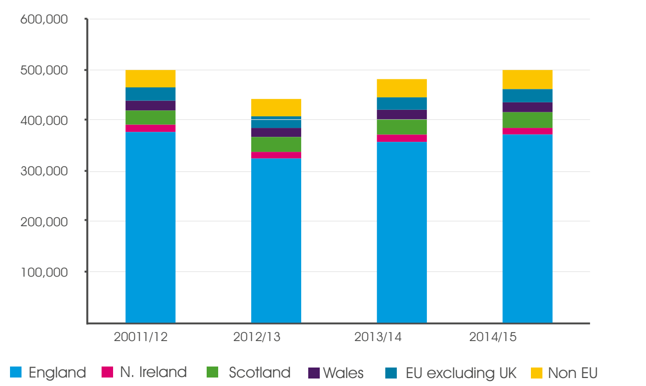
At the same time, GVA believes that customer satisfaction is going to become an increasingly important issue, especially when value for money is taken into account. Like many 'alternative' assets, rental income from student accommodation is largely governed by long leases on fixed or index linked uplifts. Consequently, it is essential that future asking rents that provide this income are reflective of the quality of the product on offer.

Demand

The number of applications for university places for the start of the 2014/15 academic year was the highest since 2011/12, the last year under the old tuition fee regime. Across the UK, there were a total of 499,370 applications for university places at the end of September 2014.

This is a rise of 3.9% year on year and a 12.8% increase on the 2012/13 academic year, which saw applications fall by almost 56,000 when tuition fees changed from £3,000 to a maximum £9,000 per annum **(Figure 1)**.

Figure 1 – Applications



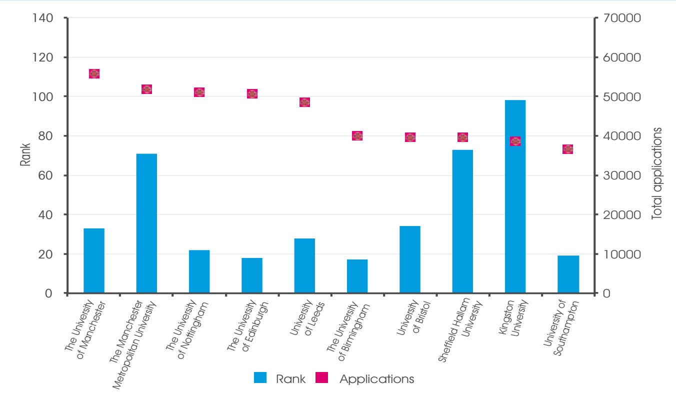
Source: UCAS

The largest increases over the course of the past 12 months were a 5.2% increase by Welsh students and a 7.7% increase from EU students (excluding the UK). Total overseas applications from outside the EU saw an increase of 4.7% and now account for 7.7% of all applications, up from 6.8% in 2011/12. Despite the changes to tuition fees, the Scottish fees anomaly (for students for the rest of the UK) and the increase in foreign students, the annual share of applicants per country has remained broadly stable over the last four years.

One of the concerns raised by the introduction of increased tuition fees was that it would make higher education more of a business and push universities into competition with each other to attract students. Back in 2012 when the system changed, there was a noticeable difference in terms of an increase in applications year on year between the top 10 ranked universities (up 1.9%) and those at the lower end of rankings (down 14.9%).

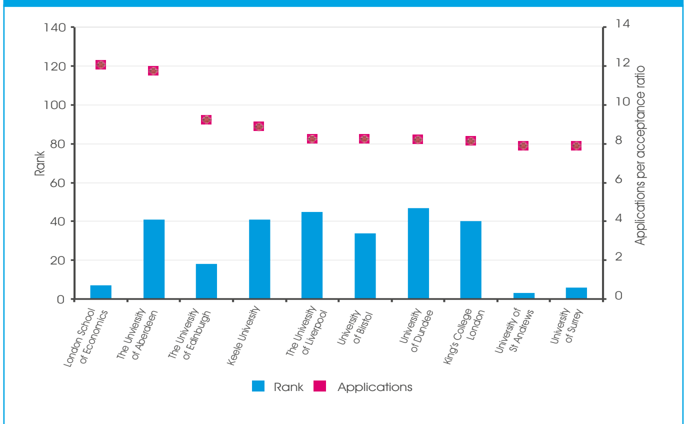
Using data for the last academic year, **Figure 2** shows the 10 most popular universities in terms of applications. Based on the rankings provided by the Guardian, only three of these are in the top 20, namely Edinburgh, Birmingham and Southampton. However, the most popular university (Manchester), ranks 33rd, while there are three institutions ranked 70 or higher, Manchester Metropolitan, Sheffield Hallam and Kingston. Overall, the average rank for these universities is 41.3.

Figure 2 – Top 10 universities by applications



Source: UCAS

Figure 3 – Top 10 universities by applications per acceptance



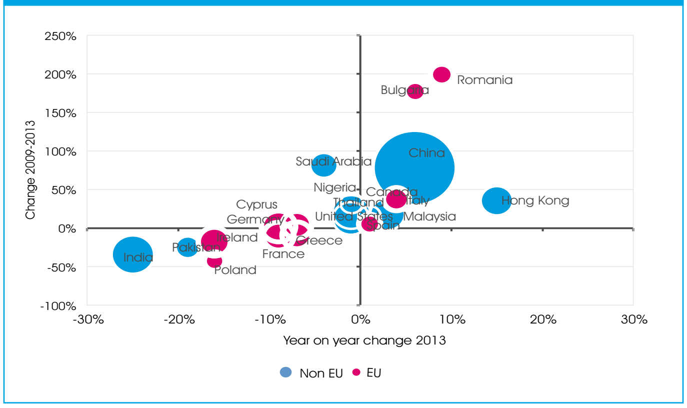
Source: UCAS

However, by looking at the ratio between the numbers of acceptances per application, we can establish a clearer picture of those universities which are over-subscribed and carry a premium **(Figure 3)**. In this instance, the average ranking decreases significantly to 28.2, with all of the top 10 on this measure within the 50 best ranked universities in the UK, three of which are ranked the 7th best or lower. Edinburgh is the only university to feature on both measures. The most overly subscribed university is LSE with 12.1 applications per acceptance, closely followed by Aberdeen with a ratio of 11.7. The average application to acceptance rate for the UK is 5.5.

The relaxation of the cap on student numbers by an additional 30,000 people for the 2014/15 academic year, announced by George Osborne in the autumn statement last December will have contributed to the annual increase in applications, and for 2015/16 the cap will be removed completely, allowing universities to take on as many students as they wish. By shifting towards a more demand led model, more universities are likely to move into competition with each other, particularly for coveted AAB+ students. GVA has already reported that there appear to be a shortage of beds in some local markets such as Birmingham, Bristol, Canterbury and Aberdeen.

International students are a key component of demand for purpose built student accommodation, with almost 425,300 in the UK at the end of the 2013 academic year. Between 2009 and 2013, the number of EU students in the UK increased by 6%, with the largest increases coming from Bulgaria (177%) and Romania (199%), taking the total number of students to over 6,000 for each country, while the number of French, Irish and Greek students fell by as much as 18%. The number of Polish students fell by 42%, to just over 5,000. **(Figure 4).**

Figure 4 – International students



Source: HESA

As a result of free tuition in Scotland for EU students (excluding the rest of the UK), there was a 37% rise in EU students in the four years to 2013. The impact of this benefit is that Scottish institutions account for 15% of all EU students studying in the UK but just 9% of total students. There are over 18,640 EU students north of the border, with Germany and Ireland contributing the largest number with over 2,300 each.

The latest figure for overseas students in the UK from outside of the EU shows that in 2013, there was a 1% decline with the total number dropping below 300,000 from a year earlier. This was driven largely by a steady fall of nearly 20,000 students from India and Pakistan from 2011-2013 as a result of tighter visa controls from the Home Office.

Students from China and Hong Kong account for a third of all non EU overseas students, with a combined total of approximately 97,000 in 2013. The total number of Chinese students rose 6% year on year in 2013 and has risen by 78% since 2009. Despite recent falls in numbers, Indian students still number over 22,000, while the fastest growing nationalities over the last four years are Saudi Arabia (81% - 9,440), Thailand (32% - 6,180) and Nigeria (21% - 17,395).

Overseas students have an important role to play for higher education. British universities are competing in a global market for the best talent and these numbers reflect the quality of UK institutions with 29 universities in the top 200 worldwide and Oxford, Cambridge and Imperial in the top 10. From a student accommodation perspective, overseas students are more likely to use purpose built accommodation, particularly in London.

London is a focal point for international students, who account for one in five students in the capital. The total number for 2013 was 50,520, with non EU students outnumbering EU by a ratio of two to one. While the number of students in London is equal to 14.2% of the total student population of the UK, 23.2% of all EU and 21.8% of all non EU students are based there. This is reflected in the fact that the London School of Economics consists of 45% overseas students, while the University of the Arts, Imperial and University College London are all 38% or higher.

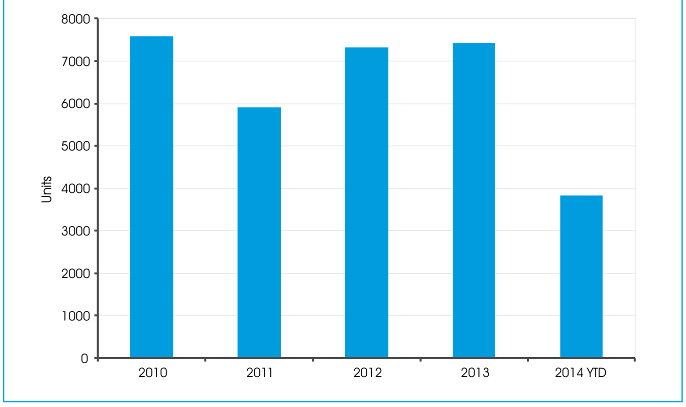
Supply

Since the downturn in the residential and commercial property markets in late 2008, student housing has enjoyed a period of prosperity, with development, investment and occupier demand all increasing and it is now recognised as a good asset to generate steady long term income streams.

In many regional city markets, large scale, high density residential developments that had lost viability when the housing market stalled were able to benefit from a change of use to institutional accommodation.

Meanwhile, the sector enjoyed a period of steady growth in the capital between 2010 and 2014, driven by a combination of the high concentration of overseas students and weak market conditions for alternative land uses. In 2010, planning permission was granted for over 7,500 beds in London, with similar numbers consented again in 2012 and 2013. In the year to date for 2014 (1st November), planning permission has only been granted for 3,828 beds, a fall of 38% year on year on a pro rata basis **(Figure 5).**

Figure 5 – Planning permissions for student accommodation in London

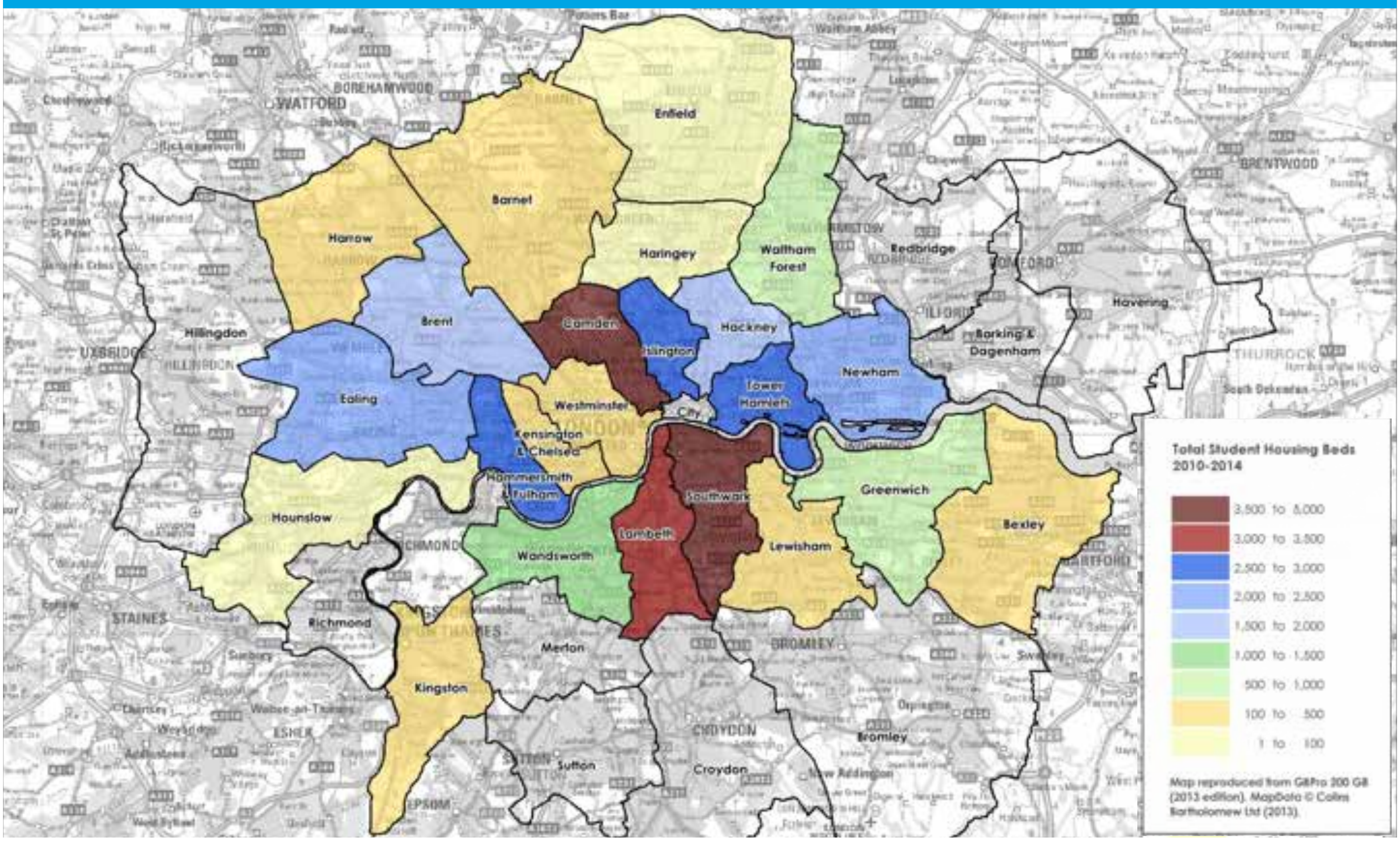


Source: EGI

Since 2010, almost three quarters of all planning permissions for student accommodation in terms of total beds have been concentrated in just eight boroughs, as highlighted by the map in **Figure 6.** Due to their central locations, close proximity to the main universities and good transport links, both Camden and Southwark have seen the lion's share of this activity and have agreed to nearly 4,000 beds each, with a further 3,000 in Lambeth So far in 2014, only 400 new beds have been approved in these three boroughs, equivalent to just 10.7% of the year's total for London.

So what is behind this sudden decline in the pipeline of London's core markets for student housing?

Figure 6 – Planning permissions by borough 2010-2014 (Total beds)



Source: EGI

Viability and alternate land uses

One argument is that the improving conditions in the economy, the commercial property market and more importantly, the continued capital value increases in the housing market in London (prices for London in Q3 2014 are now 32% above the Q3 2007 peak, according to the Nationwide), means that viability is now coming under closer scrutiny.

As land values increase, at some stage a tipping point will be reached for student housing values, compared to the possible returns that residential development could offer. If a developer or investor were to pay a significant premium per square foot for a site, then some of this would need to be recouped via the rental income stream later on.

But as was shown to devastating effect by the Southern Cross crisis in the healthcare market, there is a limit to how long that approach can last when taking into account a 25 year lease with fixed or index linked uplifts at regular intervals before it starts to become unsustainable.

With lenders still significantly wary of potential risk, the preferred option may be to seek an alternative land use such as residential, with a greater guarantee of higher values that can be sold on the open market at a suitable profit over a much shorter timeframe. This is one reason why large parts of Westminster and Kensington & Chelsea are so devoid of any student accommodation and will also become a major consideration in the existing, established markets as prime residential values spread further eastwards.

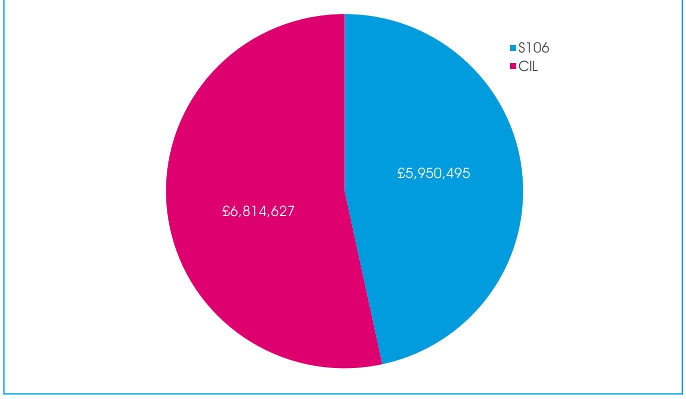
Controlling supply

Another potential reason behind the noticeable decline in bed numbers gaining planning permission is that local authorities are becoming wary of over-supply within the sector; and with land use at a premium in central London, the detrimental impact that large amounts of student housing is having on other possible uses, in particular social housing.

While there have been over 2,150 beds refused since 2010, the only major planning refusal in 2014 has been for the 450 bed Arsenal Student Tower in Islington, although this was refused at appeal over concerns about height, rather than the use type.

One way to help control the number of new student accommodation beds coming on to the market and to address any shortfalls in affordable housing, is via the use of payments as a condition of the planning consent, in addition to the existing Section 106 arrangements.

Figure 7 – Student accommodation commuted payments 2013-14 (London)



Source: GVA/EGI

Since 2013, the use of the Community Infrastructure Levy (CIL) as an additional consideration for securing permission has become increasingly widespread. In London, the amount charged through CIL for student accommodation developments in the last two years has been £6.8 million, compared to £5.9 million from Section 106 **(Figure 7)**. In some cases, not only have the developers had to contend with the Mayoral CIL, ranging from £20 to £50 per additional net sq m of new space, there have also been cases of the local borough CIL being applied as well.

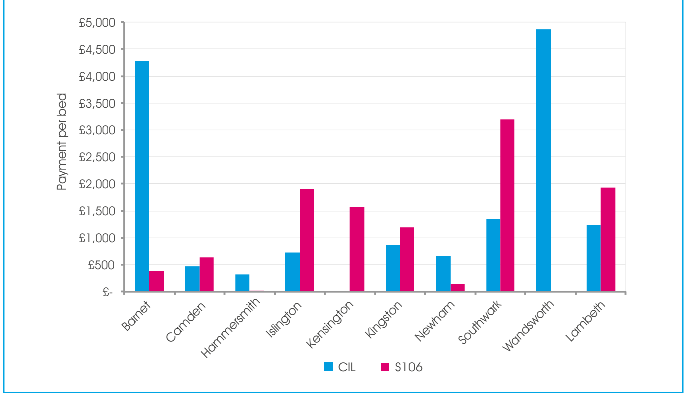
The two boroughs with the highest average CIL payments per bed were Barnet and Wandsworth. In both these boroughs, planning approval was granted for a scheme which was predominantly student accommodation but with an element of hotel space as well. The Barrowfen Properties development on Upper Tooting Road, SW17 of 99 student beds and a 78 bed hotel had to pay £376,604 for the Mayoral CIL at £50 per sq m, as well as £768,752 for the local authority levy.

In Barnet, the Pulse development at the former Colindale hospital, comprising 319 student beds and a 99 bed apart-hotel, had to contribute £720,650 for the Mayor, £644,490 for the council and a further £123,000 on S106 payments towards parking zones, public transport, travel monitoring and expansion of parking permit schemes.

In terms of future London supply however, these two boroughs only account for a small proportion of total bed numbers.

The boroughs which have concerns over the volume of student housing coming forward such as Lambeth, Southwark and Islington charge less for CIL payments per bed than they do on the same basis for S106 payments **(Figure 8).**

Figure 8 – Costs per bed for CIL and S106



Source: GVA

Even so, the cost per bed is in excess of £1,200 for both Lambeth and Southwark, which when combined with the cost per bed for the S106 as well as the payments on debt to finance the scheme and the high cost of the land in these central zone 1 and 2 boroughs means that viability for developers is squeezed even further with the introduction of CIL payments.

The consequences of this are either increased costs for student occupiers but greater risk of default if rents become unsustainably high; or the site is used for an alternative use which has the potential to generate higher margins or resale value, which in the current market would point towards residential use.

The latter is the option that has been taken by Bilford for its site on Weston Street in Southwark. Instead of providing 470 flats in the

375ft tall tower, potentially the tallest student accommodation scheme in London and referred to as the Quill, the developer has announced plans to provide 119 luxury flats, reflecting the changing market conditions in the capital.

Investment Market

The investment market for student accommodation has seen a hive of activity over the course of the past 12 months. A recurring theme over this period has been the purchases of portfolios, with Greystar's purchase of over 7,000 beds from Opal late in 2013 the starting point.

Greystar bought a further 1,129 beds from the Oasis Capital Bank/Unite joint venture portfolio in the first half of 2014, comprising of three properties in central London for £174 million, while Campus Living Villages snapped up 4,500 former Opal beds from PWC for £245 million. Portfolio sales in the last 12 months amount to £820 million, or 57% of the total value of the investment market over the same period.

Another long running issue during 2014 has been that of Brandeaux's Liberty Living vehicle. Having suspended trading in all of its eight funds in July 2013 due to concerns about liquidity from investors, Morgan Stanley was appointed to test the waters for a possible £1 billion flotation.

With increased equity in the markets and appetite for real estate, the venture was well placed. Brandeaux has an adjusted NAV of £809 million, with over 40 schemes in 17 cities, making it one of the largest operators in the country.

However, the IPO was cancelled in the summer due to "adverse public market conditions" although in reality it would appear there were some major hurdles to overcome to make the switch to a publicly listed body. At roughly the same time, the newly established REIT Empiric raised £85 million through its IPO, following on from the £70 million raised by newly active Gravis Capital Partners (GCP) in May 2013.

Instead, the 17,000 bed Brandeaux portfolio has been put on the market with the Canada Pension Plan Investment Board (CPPIB) and Greystar in direct competition, following the withdrawal of Europa Capital from the bidding process. At the same time, several smaller portfolios are also on the market, such as the £500m Westbourne portfolio from Knightsbridge Group and the Carlyle Group's Pure Student Living portfolio, also at £500 million.

As Figure 9 shows, there is significant appetite across the UK within the sector, with regional investment deals and direct lets featuring prominently over the last two years. Schemes which are guaranteed by a university still offer the lowest yields, starting from 5.35% in London and ranging between 5.85% to 6.35% for regional locations (Unite, 2013).

There has been little movement in yields for direct let schemes in London over the last two years, although in the regions, Unite estimate a tightening of around 25 to 35 basis points. As land and development costs in the capital increase, the regions are likely to become even more popular with investors and developers alike given the high levels of demand and lower land costs.

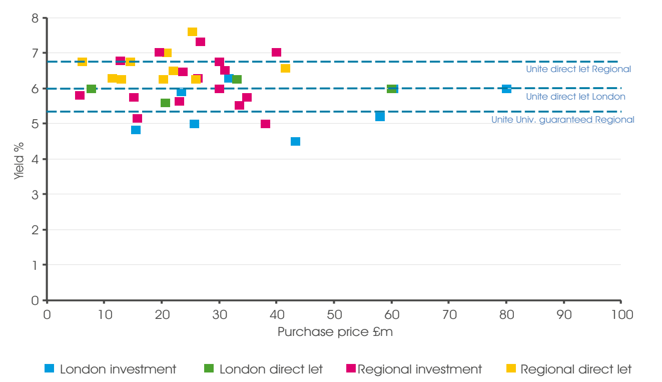
An emerging feature of the market is an increasing willingness by investors to buy direct let schemes. This enables them to bypass third party operators and nomination agreements. Over £112 million worth of regional deals in 2014 alone have been direct lets, with Curlew and Empiric Student Property some of the main purchasers.

The main benefit of direct let schemes is the higher return as a result of full market value being achieved year on year rather than the capped increase present in most nomination agreements. This of course is counter balanced by the lettings risk of attracting a new set of students every year.

The argument is that the turnover of students and the need to retain the current occupiers for the next academic year leads to higher quality building management and better customer service. Customer service has become a key area in the battle for the student population.

Direct lets also give the owner the ability to react to market trends, with a recent example being the availability of internet access or Wi-Fi throughout the building as a basic amenity. This ability gives direct let schemes a competitive advantage through increased quality and specification, leaving nominations and longer term agreements behind.

Figure 9 – Investment deals up to £100m 2012-2014



Source: GVA, Unite

Direct let accommodation is also a good way of avoiding building obsolescence. By having the ability to react to the ever increasing demands and needs of the student occupiers, owners can maintain best price in terms of rents charged. This is one issue that GVA believes could become increasingly important in the next few years. Students from the University of London have recently complained about the quality of their accommodation and value for money at two halls in Camden.

The sustainability of rents over the next five to 10 years could have a major impact on the viability within the sector, particularly in London where charges are already high. If a particular scheme were to get a bad reputation for being poor quality, there is a significant risk that occupancy rates and rental income may be adversely affected.

A large proportion of investment deals include fixed uplifts, income guarantees from the university, or are linked to an index such as inflation. This means that rents will continue to increase over the term of the lease, and in some cases for the next 25 years. It is vital that at the same time, the rent being charged reflects the service being offered. Some schemes already charge a significant premium due to their location and proximity to universities, transport links and other main attractions, such as nightlife and retail. The quality of the accommodation is also integral to this premium being sustained.

Conclusion

Despite on-going concerns over the impact of tuition fees and the inclusion of international students within possible immigration targets, demand in terms of student numbers is looking positive. Applications for the 2014/15 academic year were higher than the mad rush for places in the last year of the old fees regime (2011/12), while applications from within the EU and overseas continue to increase.

Thanks to the relaxation of the limits on the number of students each university can recruit, student numbers are likely to swell even further from 2015/16 onwards. By removing the cap, the institutions which offer the best courses will be able to recruit from a wider field of talent, while there will be no restrictions on overseas student. This market remains a valuable source of income in terms of higher fees (excluding the EU) and also forms a significant element of demand for the purpose built student accommodation sector.

The potential increase in the next few years in student numbers has obvious implications for supply. While the London market has been the main focus for both investors and developers in recent years, viability for future development is being limited by a mixture of high land costs, restrictive planning policy and higher returns available from competing land uses. It is no great surprise that there is little future supply proposed in the prime W and SW postcode sectors.

Core markets such as Southwark, Lambeth and Camden, which offer a central location and have accounted for the majority of recently consented supply in the capital, are becoming less viable as high residential values shift eastwards and councils apply greater costs for permissions via the Community Infrastructure Levy. Over the next five to 10 years, it is likely that fringe, central boroughs such as Newham, Hackney, and Lewisham will become new locations for development, centred on existing and planned transport hubs.

In some regional university towns, there are already shortages of purpose built beds, an issue that will only be exacerbated further by the removal of the cap on student numbers for each university. As it already stands, nine of the 10 most applied for universities are outside of the capital, while LSE and King's College are the only London based universities in the Top 10 in terms of the highest applications per acceptance ratio.

Investment transaction volumes remain high as a large number of portfolios are sold and new entrants enter the market. This means that the regional markets are offering a significant number of opportunities. The move towards the more management intensive route of direct lets also offers scope for high income returns and lower yields. The sector continues to offer a broad appeal and a likely increase in student demand over the next few years, maintaining a favourable outlook.

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