4th May 2017

Sigma Market Commentary - Final 040517

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Dear Sirs,

UK HOUSING MARKET COMMENTARY

RESEARCH AS AT 4th MAY 2017

The Directors of The PRS REIT plc, N+1 Singer and Stifel have instructed Savills Advisory Services Limited to provide market commentary in relation to the UK Housing Market for inclusion in the Prospectus to be issued in connection with the admission of the Company's Ordinary Shares to trading on the Specialist Fund Segment of the Main Market of the London Stock Exchange (the "Savills Report") In accordance with this instruction, we have provided independent market commentary on the supply and demand dynamics impacting on the UK housing market, focusing on the private rented sector.

We confirm that we are not aware of any conflict of interest that may prevent us from providing you with this information.

Introduction

This commentary concerns the UK housing market and the private rented sector (PRS). The PRS comprises dwellings owned by landlords and let to tenants on the open market, typically using Assured Shorthold Tenancy contracts. This is distinct from the social rented sector, where registered providers or local government let dwellings at subsidised rents; we have excluded the social rented sector from our analysis for this report.

According to the Department for Communities and Local Government (DCLG), there were 23.5 million dwellings in England as at 1 April 2015 of which 4.3 million, or 19%, were privately rented. We estimate that the total value of residential property in England is £6.8 trillion of which £1.4 trillion or 21% is tied up in the PRS (Savills, January 2017).

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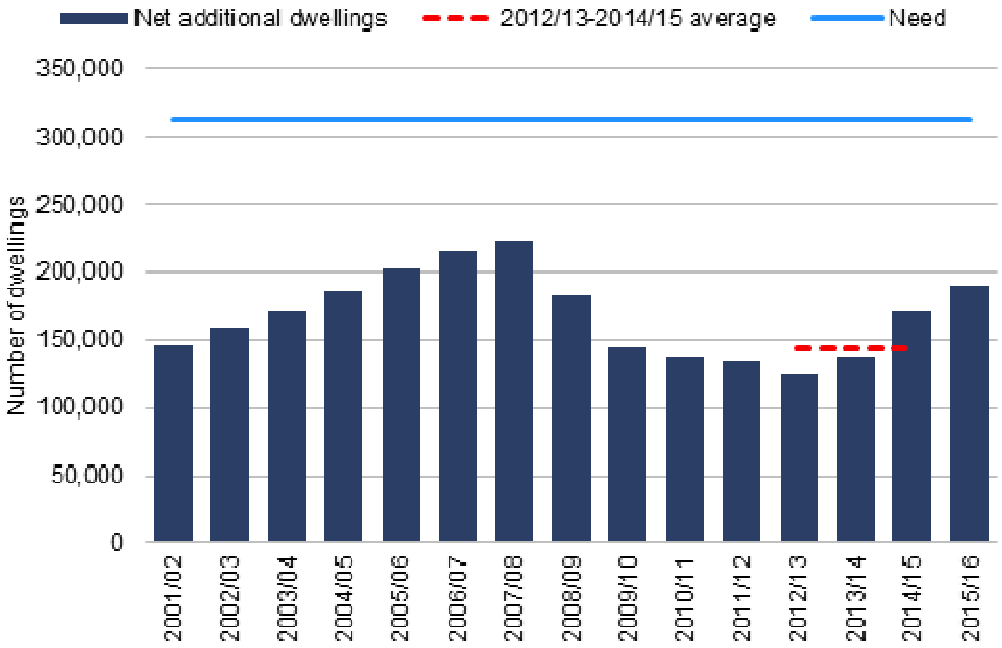
National Housing Market

England faces a long-term structural undersupply of housing. The Town and Country Planning Association (TCPA) estimates that England needs an additional 312,000 dwellings per year to meet need and address historic undersupply. Actual housing delivery is much lower: there were 144,000 net additional dwellings each year on average between 2012/13 and 2014/15, indicating a shortfall of 156,000 homes.

This shortfall and rising pressures on the housing market means that housing has risen up the political agenda. The Government has announced a housing delivery target of one million homes by the end of the current parliament. When this target was announced it corresponded to annual target delivery of 200,000 homes per year. However, delivery since then has been below this level so housing development will have to accelerate to meet the Government's manifesto commitment. PRS is increasingly recognised as a mechanism to accelerate housing delivery.

The recent publication of the Housing White Paper, *Fixing Our Broken Housing Market*, is part of the Government's efforts to accelerate housing supply. It includes the encouragement of institutional money into the PRS to assist in accelerated delivery and further professionalise the rented sector.

Housing Supply and Need, England



Source: TCPA, DCLG, Savills

The Private Rented Sector

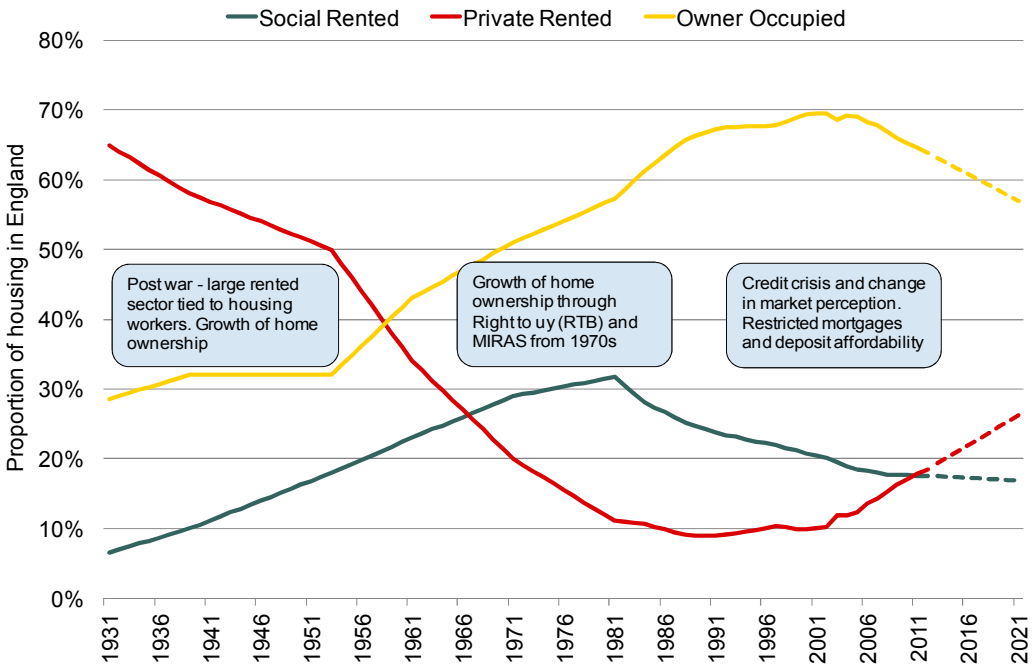
Private renting was the majority tenure in the UK until after the Second World War with institutions and corporates owning most of the stock. The sector declined through most of the 1900s due to tightening rent regulation and legislation (rent control and security of tenure) which made it difficult for landlords to repair and maintain their investments. As stock became old and in need of repair, there was a mass exodus from the market.

At the same time, Government support of home ownership through mortgage interest tax relief (MIRAS) in the private sector and Right to Buy in the social sector led to very strong and rapid growth in owner occupation.

During the 1990s, the Government eased the regulation of rents and reduced tenants' rights of occupation. Both of these measures improved the attractiveness of the sector to investors and landlords. The subsequent introduction of buy-to-let mortgage lending broadened the market to a wider range of investors who typically invested in small scale, sub 10 unit portfolios, allowing the sector to grow.

Since then the PRS market has grown substantially. In 1991 just 9% of households were renting privately; this has more than doubled to 19%. We expect the proportion of households renting privately to continue growing, as shown by the following chart which predicts the market will expand to 25% of households by 2020.

Long Term Tenure Trends, England



Source: DCLG, Savills

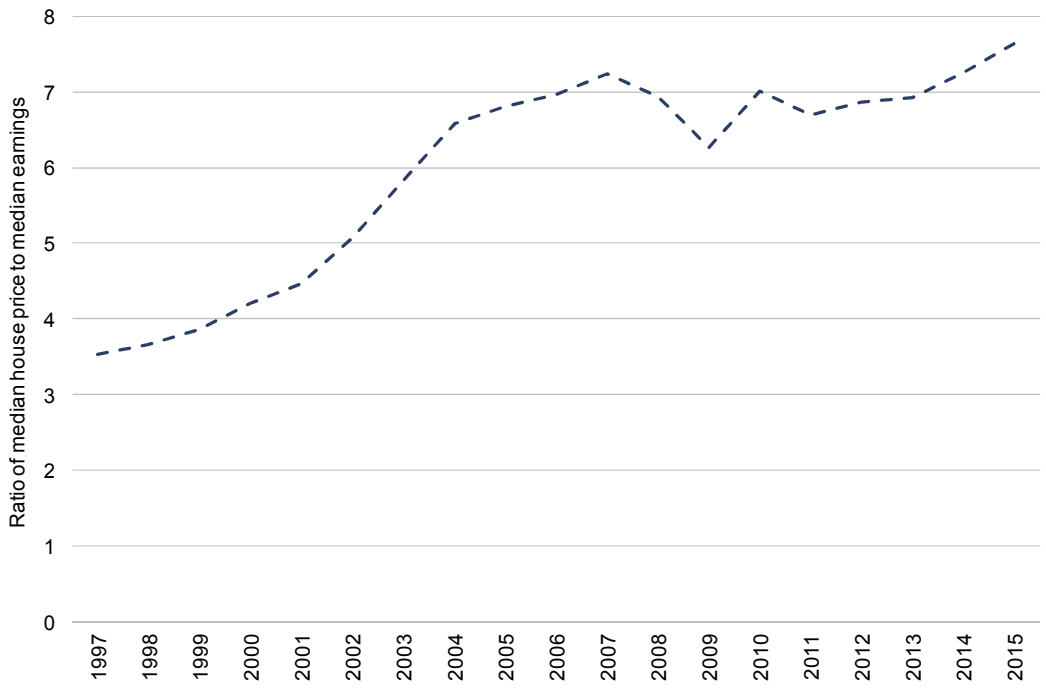
A key reason why the PRS market is growing is restricted access to other tenures. Access to owner occupation is particularly limited due to high house prices and low mortgage availability. Since 1998 the ratio of house prices to earnings has more than doubled. As shown below the ratio of median house prices to median earnings reached 7.6 in 2016, the highest it has ever been. Affordability is increasingly constrained making it more difficult for households to buy a home which is directly increasing the demand for privately rented housing.

Before the Global Financial Crisis in 2007/08, households could buy homes despite rapid house price growth because mortgage finance was widely available. Interest only mortgages were common place as was self-certification.

Since then, mortgage lenders have had to restrict their lending and interest only mortgages have all but disappeared. In 2014 the Financial Conduct Authority (FCA) introduced the Mortgage Market Review (MMR).

The review obligates lenders to make sure their borrowers can afford to service and repay the loans and are required to use a series of stress tests. This means that lenders face a cap on lending to households at loan to household income ratios over 4.5. With the ratio of median house prices to median earnings in England at 7.6, this restricts the number of households able to secure mortgage finance.

Ratio of Median House Prices to Median Earnings, England



Source: DCLG

The largest barrier to home ownership is the size of the deposit required to purchase a property. This is one of the key reasons why more and more people are turning to the rented sector. During the 1990s, first time buyers needed approximately 5% of the total value of their property as a deposit, representing around 12% of their annual household income. In 2016 the average first time buyer had to pay 16% of the property value as a deposit, or 62% of their annual income. This large, up-front payment acts as a significant barrier to home ownership, creating even greater demand for PRS housing.

In addition to affordability constraints, Savills survey of What Tenants Want in 2014 highlighted the key reasons for households renting. While many tenants cited affordability and mortgage availability as primary reasons for renting, lifestyle choice also emerged as a big driver of demand – 24% of tenants stated that they rent because they liked the flexibility of being able to move home quickly when circumstances change.

The survey also highlighted that the physical nature of the property and its neighbourhood are important to tenants. Tenants value proximity to main transport links, ease of access to their place of work or study, access to a private garden, a larger property and a new property. New PRS landlords that run a professionally managed business offering better quality stock suited to the broad range of tenants that rent will help to push up the proportion of renters over time and tap into the growing tenure base.

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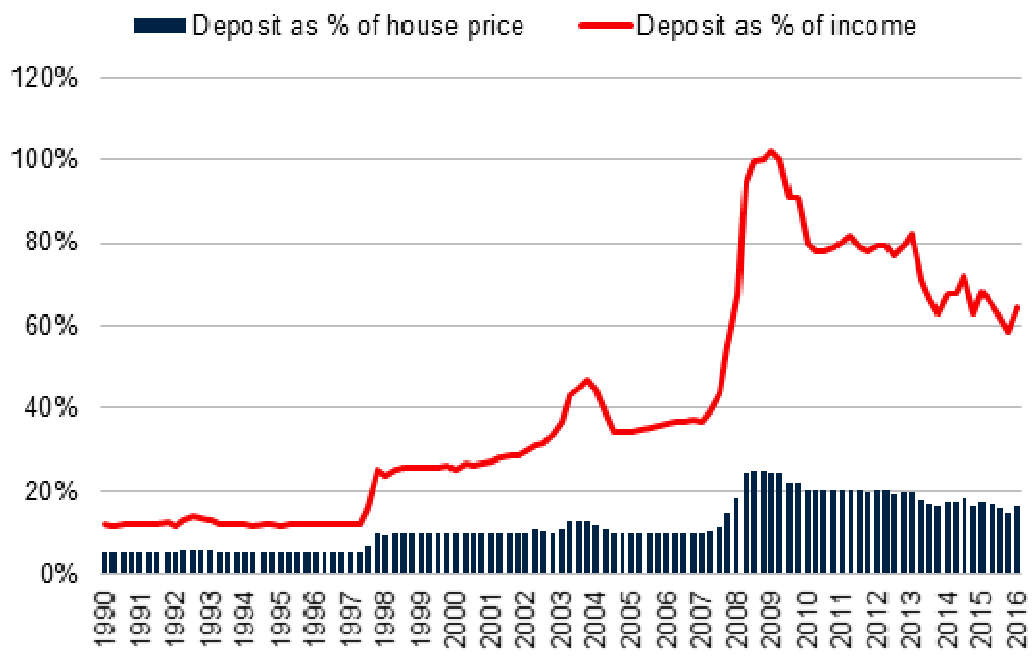
First Time Buyer Deposit Trends, UK



Source: CML

Future Demand

The population of the UK was 65.7 million in 2016 and is forecast to grow by 5.4% over the next ten years. In terms of households, there were 27.8 million households which is projected to grow by 8.1% over the same period. This equates to an additional 3.5 million people and an extra 2.0 million households (OE, DCLG). The rate of household growth is higher than population because the average household size has been decreasing, a function of both increased rates of divorce and couples delaying starting a family.

In terms of the new forming households, we expect the vast majority to enter the PRS. The latest data from the English Housing Survey shows that 196,000 new households formed within the sector in 2015-16. This clearly demonstrates that both population and household growth is directly impacting on the demand for rental property.

The most likely demographic group to live in the PRS are those under the age of 35. According to the ONS in 2015, there were 15.6 million people aged 18-35, or 23.9% of the population. Given the constraints and barriers of entry into the private for-sale market we would expect a large proportion of this young population to live in the PRS.

Constraints on the Buy to Let Market

The 1988 Housing Act and the introduction of Buy to Let mortgages paved the way for small investors to acquire vast amounts of residential stock. The Government has since withdrawn support for the sector in favour of supporting first time buyers. Investor buyers now face a 3% stamp duty surcharge if they are buying a property not for use as a primary residence. Buy to Let mortgages, previously available on an interest only basis, can now only be issued with a repayment plan and enough rental income to cover 140% of the mortgage payments. Mortgaged Buy to Let investors also receive less tax relief on their mortgage interest payments, making many investments marginal or even loss-making.

As a result, we have observed falling numbers of mortgaged Buy to Let transactions. The number of Buy to Let mortgages for new purchases issued in 2016 was down 13% on 2015, reflecting these tax changes. We expect new rental supply from Buy to Let investors to continue falling. The slack will be picked up by large scale Build to Rent (BTR) investors that the Government is now actively encouraging and can structure their investment in such a way as to avoid punitive taxation. We expect that as the institutional BTR sector matures, more tenants will prefer the quality, security and professional nature of the stock offered by the Build to Rent sector.

Government Support for Build to Rent

The Housing White Paper set out the Government's support for new housing development across a range of tenures, and particularly Build to Rent (BTR): "[we will] encourage more institutional investors into housing, including for building more homes for private rent".

Government has already shown support for BTR through its £3.5 billion PRS Housing Guarantee Scheme and the £1 billion Build to Rent Fund. The Housing White Paper includes proposals to change national planning policy so that local authorities must proactively plan for BTR. Certainty and speed of housing delivery makes BTR attractive to local authorities searching for ways to meet their housing need locally.

Unlike the new build 'for-sale' market that is constrained by monthly sales rates, developers of BTR can deliver faster, as they are motivated to create their income stream as soon as possible rather than maximising potential unit values.

As well as schemes directly targeted at BTR, the Government is also supporting residential development through the £3 billion Home Building Fund, which provides development and infrastructure finance, and the £2 billion Accelerated Construction Fund, which guarantees to buy unsold new build homes. This accelerated development could provide additional supply for BTR investors.

Regional Market Dynamics

House prices are lower in the North and Midlands than the national average. For example, average values in Greater Manchester were £154,000 and £180,000 in Manchester city centre in the year to December 2016, 32% lower than the England & Wales average at £231,000.

Although house prices are lower and appear more affordable than those in the South, average incomes are also lower. The median full-time worker in Manchester earned £24,000 in 2016, 12% lower than the median for England & Wales at £28,353. Both house prices and incomes are lower, which means that the North and Midlands regions suffer the same affordability barriers to home ownership as the rest of the country.

This means that the relatively high house prices and housing deposits act as a barrier to home ownership in the Midlands and the North. The chart below demonstrates how the ratio of first time buyer deposits to incomes has evolved in the North West and the West Midlands – households currently need to raise a deposit of 55%-60% of their income to secure a mortgage. These affordability issues increase demand for rented housing in many parts of the country and especially in the high demand regional employment centres.

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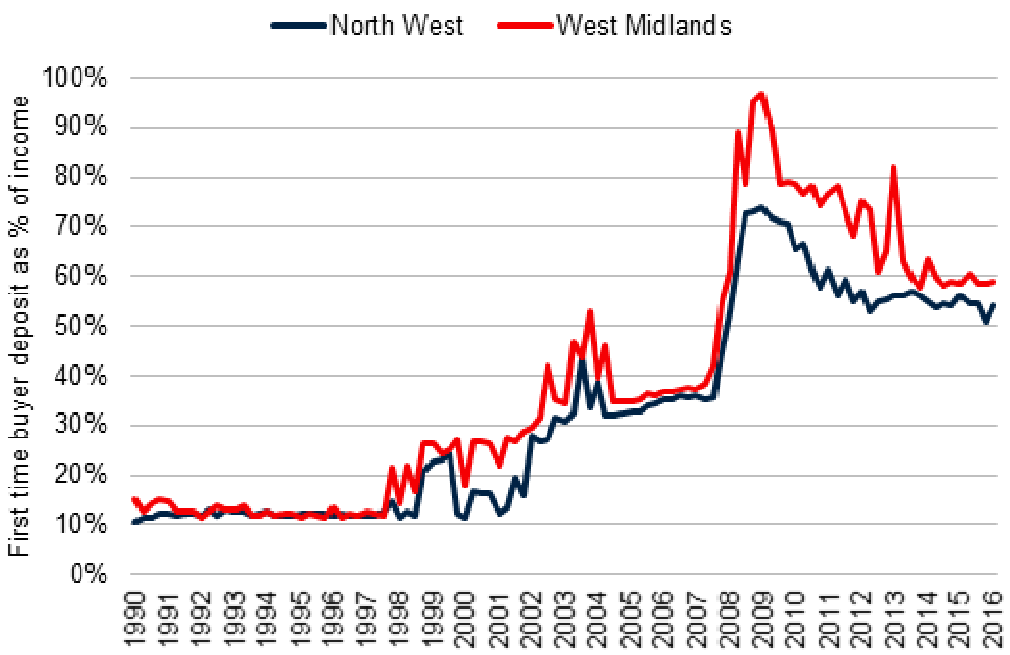
First Time Buyer Deposit Trends, Regional



Source: CML

The cities of the North and Midlands are home to some of the best universities in the country, including the University of Liverpool, University of Manchester, University of Leeds, and the University of Birmingham. These academic institutions provide these cities with a pipeline of highly skilled workforce. Manchester, for example, reportedly retains 60% of its graduates in the local economy.

Attracted by this demographic and lower commercial property costs than in London, many businesses have relocated jobs from expensive markets in London and the South. Significant examples include the BBC moving 24 departments to Salford and HSBC moving over 1,000 jobs to Birmingham.

With the continued strength of the North and Midlands' universities, and the imbalance in office costs between London and the rest of the country, we expect this trend to continue. This means employment prospects for the North and Midlands are strong.

The North and Midlands also benefit from a high proportion of public sector jobs. A broad base of employers offers some level of resilience during periods of economic downturn that tend to have a more immediate effect on the private sector. In 2016, the public sector employed 20% of workers in the North East and 18% of workers in the North West, compared to the UK average of 17%. This reflects the Government's attempts to cut public spending by moving employees to cheaper office markets. Continued efforts from the Government's Property Unit to create regional office hubs means this trend is likely to continue, supporting further employment growth.

The Northern Powerhouse

The current and previous Governments have committed support to developing "The Northern Powerhouse", an agglomeration of urban areas across the North of England. The proposal includes infrastructure improvements, devolution of power to urban areas in 'City Deals', and investment in businesses and innovation.

Cities of the North and Midlands will therefore have more power to control their own development as a result of these City Deals. Directly elected Mayors will have power over policy including planning, housing and transport. The City of Liverpool has had a directly elected Mayor since 2012. The first elections for the Mayor of Greater Manchester and the Mayor of West Midlands (Birmingham and Coventry) are due on the 4th May 2017. There are also proposals for elected Mayors for Sheffield and other markets in the North East, with elections planned for later in 2017. These Mayors will have control of spatial planning and housing in their regions, which should speed up the planning and development process and make it easier to develop homes across these areas.

HS2 is a £50 billion national rail infrastructure project likely to have significant positive effects on regional economies. Work on the first phase is scheduled to commence this year, with services to Birmingham running by 2026, and full completion to Manchester and Leeds expected by 2033. These infrastructure improvements are aimed at rebalancing the national economy. They will attract investment to cities in the North and Midlands, improve the competiveness of regional economies and help to create more jobs. HS2 Ltd predicts that additional commercial development brought forward surrounding HS2 stations could support up to 100,000 jobs. This employment growth will clearly drive up demand for housing in these areas.

Government has also committed £60 million development funding to plan for the Northern Powerhouse Rail. This is a proposed rail line between Manchester and Leeds, with the aim of reducing journey times from 50 minutes to under 30. This will also help drive economic growth in the regions, pushing up wages and demand for housing.

Family Housing Demand and Scarcity of Product since 2008

Families make up a large proportion of the 10.6 million households living in the Midlands and North of England (Census 2011). 6.6 million (63%) are households with children, couples, or pensioners.

Families face competition on a number of fronts when trying to find suitable housing. Young families looking to buy compete directly with Buy to Let investors for the best value housing stock. Despite measures from Government to limit Buy to Let landlords, it is still difficult for equity-poor families to outbid equity-rich investors, who can often purchase properties more quickly without mortgage finance. Families also face a decreasing pool of housing stock: in 2015/16, 4,760 houses were converted into flats across England.

There is also a mismatch of supply and demand in new housing completions. An increasing proportion of residential stock available to buy is made up of flats, particularly in urban areas. In 2016 in Birmingham, over 50% of new home sales were flats; in Manchester around 45% of new home sales were flats. This suggests that the supply of housing suitable for families in these locations is limited. As a lot of this for-sale product ends up in the rental market though buy to let, there is a limited supply of family housing in both the owner occupied and rental markets.

Looking just at PRS households in the North and Midlands, 873,000 (51%) of renters comprise families. The number of families in PRS increased by 86% between the 2001 and 2011 Censuses: from 470,000 in 2001 to 873,000 in 2011. Despite this, there is relatively scarce supply of family-sized rental properties. In 2016 just a third of rental listings across these regions had three or more bedrooms. Going forward, our analysis of the new build for rent stock shows that in the North and Midlands flats comprise 93% of the pipeline.

Our What Tenants Want survey highlighted that families in the private rented sector have very specific needs and requirements that are not necessarily serviced by existing rental stock. 42% of respondents with children identified that they would pay a higher rent to be located near to a good school. Access to childcare is also important: 36% of families rated access to a nursery or childcare as important and 23% would pay more rent just to be near those facilities. Families also rated private gardens and larger properties as important, with 45% and 39% of respondents willing to pay a higher rent for these attributes, respectively.

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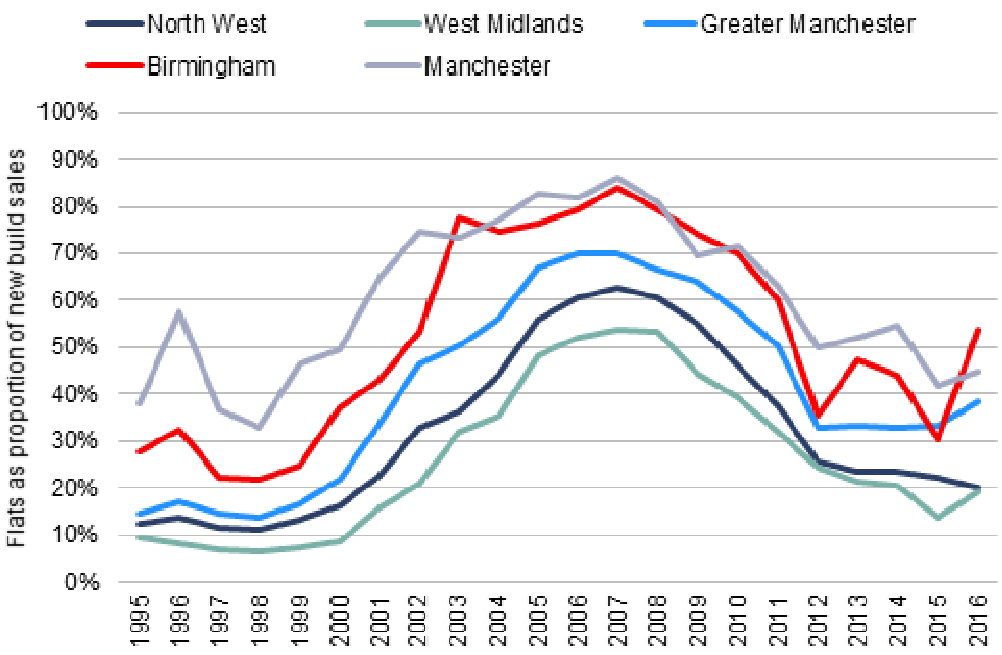
New Build Residential Sales by Dwelling Type



Source: Land Registry

Build to Rent Supply

In total across the UK there are currently c.70,000 new PRS units completed, under construction, or with planning permission as at Q1 2017. 22,000 of these are in the North and Midlands. Most of this pipeline has yet to complete: in the North and Midlands there are just 2,600 completed PRS units, mostly located in the urban conurbations of the North West. The vast majority of the BTR pipeline in these regions comprises flats: 93% of the pipeline is on schemes composed entirely of flats. This leaves a large gap in the market for BTR investors and developers offering rental product targeting the needs of families.

Planning portals such as Glenigan include descriptions of the type of residential stock delivered. In terms of PRS, there are four commonly used typologies including:

- Stock retained by the deliverer for the private rented sector (PRS);
- Stock purchased for the PRS;
- Stock built using the Homes and Communities Agency (HCA) Build to Rent Funding; and
- Stock designed and purpose built for the rented sector, often using a forward funding approach.

Many commentators on the market refer to all this new PRS stock as BTR. This is mainly attributed to the fact that the stock is owned by a single entity, operated as a single investment and professionally managed. Therefore, BTR is not just related to the physical form or the type of stock, it also refers to an operational model.

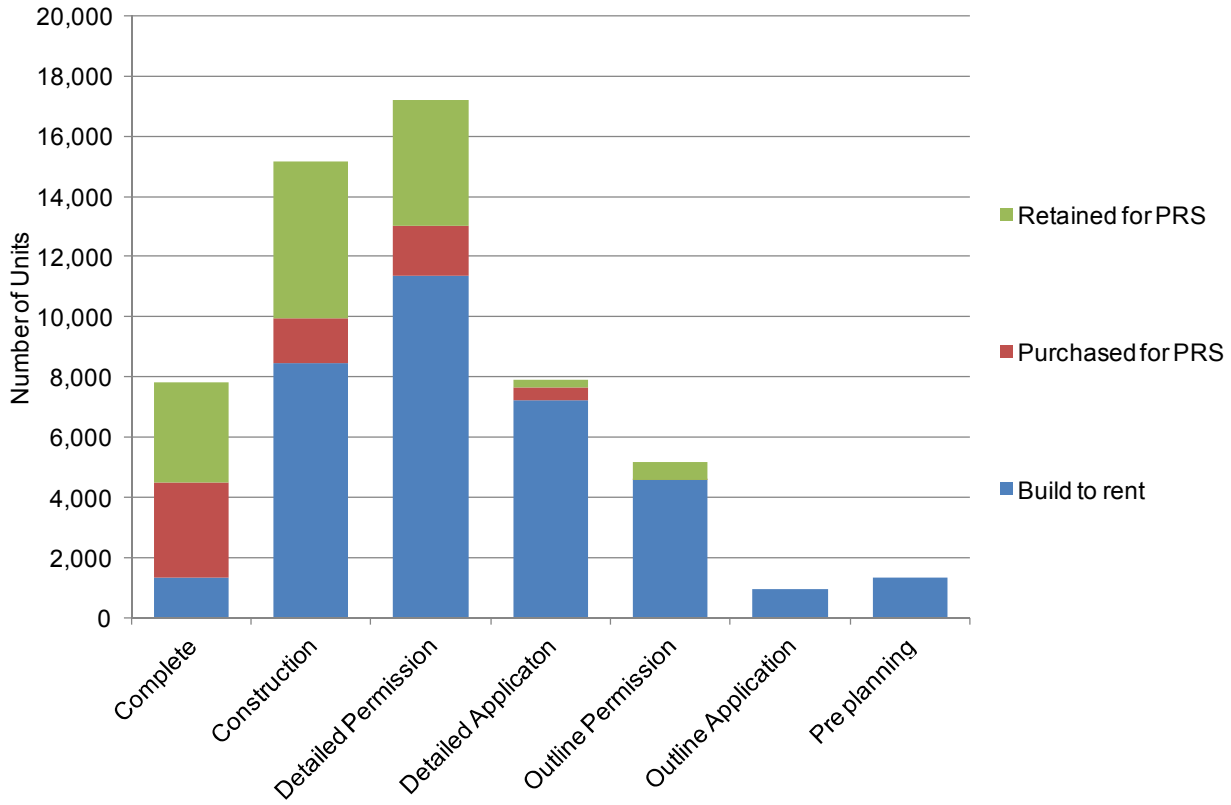
At this point in the market, more traditional approaches to PRS are still the most prevalent forms of PRS delivery. In terms of completed PRS units, of the c.7,800 units completed across the country approximately 40% have been retained for PRS by the deliverer (not BTR) and 40% have been purchased for PRS or forward purchased by the investor. Schemes purchased for PRS are considered BTR because of the funding

structure or source of funding used. Many of these schemes have not been designed specifically for the rental market and in most cases they are schemes that were originally intended for the build for sale market.

There have been just c.1,300 units (20%) delivered using a BTR approach (i.e. purpose built and intended for PRS use) including those funded by the HCA Build to Rent Funds. This demonstrates that rental stock aggregated into a build to rent portfolio or business model is still a relatively new concept in the UK. As a result there are limited opportunities to invest in build to rent portfolios that are income producing and designed to maximise income by being purpose built and designed for the rental market.

Going forward, there are many more schemes that have been identified as pursuing a BTR approach. In terms of stock under construction, BTR units make up c.9,900 of the c.15,100 units coming forward. Longer term, BTR makes up c.27,500 of c.32,500 units being delivered. This is clear evidence that BTR, as an operational model, is becoming a more accepted form of delivery in the UK housing market.

PRS Units by Development Status and PRS Type, England and Wales



Source: Molior, Glenigan, BPF, Savills

Market Prospects

The private rented sector (PRS) in the UK is worth over £1.4 trillion. The vast majority of this (98%) is reportedly tied up in the hands of small individual and small corporate landlords (IPF, 2015). As a result, there is a lack of aggregated investment stock available for institutional investors. Many new investors therefore have a strong focus on the development of new BTR assets. This gives them the opportunity to influence the design, mix and specification to enhance investment returns from completed stock.

BTR is a new product for the UK and takes many of its principles from the US multi-family rental market. In essence, the UK market is creating institutional grade assets in the residential space driven by the strong underlying supply/demand fundamentals in the housing market and the desire by institutions to access income returns linked to earnings.

Coupled with these drivers is the rising demand for professionally managed, purpose-built rental housing. This is due to the higher quality of service provided by purpose-built and managed schemes, the opportunity to live in a newly constructed property, and access to amenities and concierge services. It is also because there is a perception that small-scale landlords manage their properties less professionally, maintaining them reactively or to a lower standard.

According to recent research by the Investment Property Forum (IPF), institutional investors hold c.£17bn of market rented assets (excluding student halls). Given the rising number of investors seeking exposure to the market we expect this to grow substantially over the next 10 to 15 years as the market starts to gather momentum.

In terms of the future potential of the market, the supply data shows that there is potentially £13bn of assets in the pipeline in London and £4bn across the rest of the UK. Compare this value to the potential requirement to accommodate future growth in the rented sector (1.1m households across the UK over next 5 years), this produces a potential for the delivery of c. £300bn of residential assets based on the average values across the UK. The very large gap between supply and demand is a key reason why investors are seeking to invest in residential property.

The BTR market in the UK is still immature: the US equivalent took over 20 years to become established, whereas the UK sector is only in its seventh year. There is limited stock available for investors to acquire, which makes it difficult to achieve sufficient scale in the market at the speed at which investment capital is available.

Lack of scale means the BTR sector has become more innovative. Investors use alternative routes to market, including forward purchase, forward funding, and direct development. However, there are still substantial barriers to entry with access to stock, funding and finance key issues. Most investors do not have the supply chain and expertise required to develop BTR units successfully on their own. These barriers to entry present an opportunity to the few companies able to overcome them.

Conclusions

This market commentary demonstrates the strong supply and demand fundamentals underpinning PRS investment. Lack of new housing supply, strong population growth and rising household formation have all contributed to pushing up the price of housing beyond the reach of many working people.

As well as high house prices, mortgage rationing restricts the number of people that can take their first step onto the housing ladder. Limits on loan to value ratios and high housing deposit requirements mean that many more people cannot afford the costs of home ownership. These affordability constraints directly contribute to the rising demand for PRS housing, a sector that has doubled in size over the past 20 years.

The growth of the rental market has been enabled by the buy to let lending market. Buy to let mortgage products paved the way for a whole new class of investor – individuals and small property companies investing in residential property. This market has been instrumental in housing the additional 2.4 million households that have been added to the PRS in the past 20 years. However, like the mainstream mortgage market, this market is also being regulated and restricted by Government policy and tax regime in a bid to level the playing field with first time buyers.

Recent changes to stamp duty land tax (SDLT) introduced an additional 3% surcharge for investor buyers over and above what a first time buyer would pay. Tax relief on the income received by buy to let investors

was also changed which has reduced the overall attractiveness for these investors. This is evident from the lower numbers of buy to let mortgage transactions since the changes.

At the same time as discouraging buy to let investors, the Government is showing support for large scale investment in recognition of their ability to accelerate housing delivery and introduce alternative sources of capital to fund housing delivery. Many of these large investors have a strong focus on the development of new build to rent assets. By funding new build development, the onerous taxation that applies to buy to let investors can be mitigated. Developing new assets also presents investors with the opportunity to influence design, mix and specification to maximise investment returns.

In the current market, there are limited opportunities to invest in income producing portfolios in the UK rented sector. Aggregators of stock that can offer investors an entry route into the market are attractive given the weight of capital targeting the sector. The vast majority of the pipeline of stock coming forward is comprised of flats, while there are clearly high demand from young families. This creates a major opportunity for investors offering rental product targeting the needs of families in appropriate locations.

Important Note

In accordance with our normal practice, we would state that this commentary is for general informative purposes only and does not constitute a formal valuation, appraisal or recommendation. It is only for the use of the persons to whom it is addressed and no responsibility can be accepted to any third party for the whole or any part of its contents.

Our findings are based on the assumptions given. As is customary with market studies, our findings should be regarded as valid for a limited period of time and should be subject to examination at regular intervals.

Whilst every effort has been made to ensure that the data contained in it is correct, no responsibility can be taken for omissions or erroneous data provided by a third party or due to information being unavailable or inaccessible during the research period. The estimates and conclusions contained in this report have been conscientiously prepared in the light of our experience in the property market and information that we were able to collect, but their accuracy is in no way guaranteed.

Yours faithfully,

For and on behalf of Savills Advisory Services Limited
Jacqui Daly
Director
Residential Investment Research and Strategy