

RESIDENTIAL
RESEARCH



STUDENT PROPERTY 2011

The case for investment in light of the changes
to higher education funding

Knight Frank

University funding: radical reform

34%

The increase in student applications between 2005 and 2010 (UCAS)

The UK's student accommodation market has emerged as a key asset class in the past decade, attracting growing interest from investors, developers and private operators alike, with the latter now providing nearly 150,000 student bed spaces in the UK.

The sector has proved relatively resilient in the face of the 2008-09 financial crisis, however, following the long-awaited review of England's higher education (HE) system, conducted by Lord Browne in 2010, the government is implementing sweeping changes to the university funding system. The scale and depth of these changes suggests the landscape of higher education in the UK is set to change irrevocably.

Radical reforms to university funding and student finance will have significant consequences for the student housing sector when they come into force in autumn 2012.

This report focuses on the opportunities and challenges facing developers and investors in the restructured student accommodation market. We assess whether student demand will weaken post-2012 and question whether Higher Education Institutions (HEIs) will still have the budgets to invest heavily in the provision, refurbishment and maintenance of their own student accommodation. We also explore whether students' requirements, in terms of accommodation type, length of tenure and target price, will alter considerably, before providing the Knight Frank view on where to invest.

In 2010, despite the uncertainty and nervousness surrounding funding reforms,

the publication of Lord Browne's report and the continuing turbulent economic climate, the student accommodation market saw a high level of activity. **The sector has become a critical component of a balanced investment portfolio**, this has been underlined by the significant flow of foreign and domestic investment into the sector.

Last year Knightsbridge Student Housing was established with backing from Oaktree Capital Management Ltd with the aim of acquiring £1 billion worth of assets in the UK student housing market. Likewise, the US-based Carlyle Group entered into a joint venture with Generation Estates Ltd with the aim of providing 4,000 bed spaces in London. Such investment is testament to the health of the market and the long-term attractiveness of student property as an institutional asset class.

At the heart of the student market's appeal is the current imbalance between the supply of accommodation and the demand for bed spaces. According to UCAS, demand for academic courses is at an all-time high with nearly 700,000 university applications received in 2010. But with UK undergraduate places totaling 490,000 demand clearly dwarfs supply. Student applications rose by 34% in the five years to 2010 whilst the number of available places increased by 20%, see figure 1.

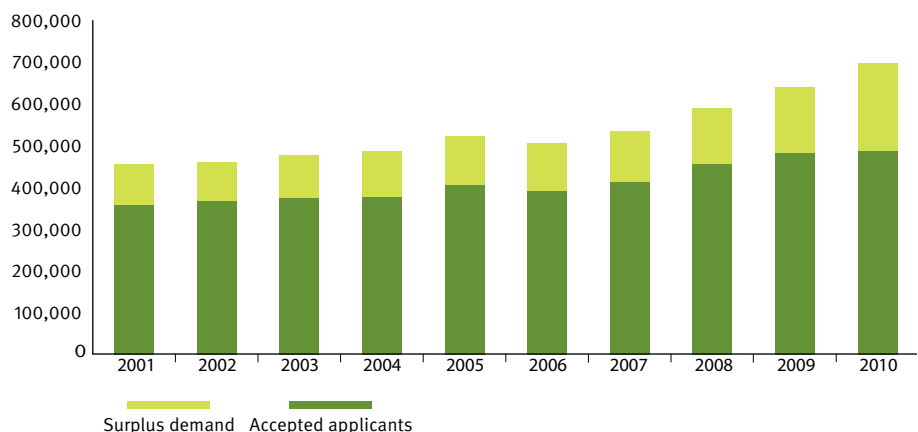
The application race

Applications in February 2011 were 2.9% higher than the same time a year earlier. Inevitably, many students will be motivated to apply in 2011 to beat the impending rise in tuition fees from September 2012 (see further details on page 4). Others, however, may be keen to shelter within higher education whilst the recession recedes and the employment market recovers.

Figure 1

Student demand for university places exceeds supply

All applicants vs accepted applicants, 2001-2010



Source: UCAS

The Knight Frank Student Accommodation Index

The student market has matured and emerged as a key investment sub-sector but until now there has been no means of monitoring its performance in a detailed and transparent way. However, Knight Frank is pleased to announce that it has launched the industry's first benchmark for prime student property – The Knight Frank Student Accommodation Index.

The Index provides investors and developers with a means of monitoring the performance of prime student property, both in London and the regional markets. Compiled annually, the index tracks a number of key variables – rents, investment yields and capital values – and is based on the achievable return of both en-suite bedrooms and studio apartments. Data has been collated from over 20,000 purpose-built student bedrooms located across key university towns and cities in the UK.

The first set of results show total returns across England and Wales stood at 13.53% in the year to December 2010. Student accommodation in the regional markets outperformed all other property asset classes, recording a total return of 14.65%, as figure 2 shows.

In London investment yields firmed up from 6.38% to 6.00% in the year to December 2010 and from 6.75% to 6.50% in the prime regional markets.

Historically, rental growth in the prime London student market has outperformed the regions but 2010 saw this trend reverse, largely due to pressure on London's high-end studio rents. In the regional cities rents rose by 4.1% in 2010, see table 1, whilst rents in London fell back by an average of 3.6% but this was on the back of substantial year-on-year growth. We expect London studio rents to stabilise in September 2011 and London en-suite rents to demonstrate growth.

Burgeoning demand from students combined with limited purpose-built supply has fuelled rental growth and better-insulated capital values in this sector. At the same time the drop in activity and the greater exposure of the alternative and more traditional asset classes such as offices and retail property has fuelled investor interest in the student sector further. The buy-to-let market – driven by parents buying property that doubles up as both university accommodation for their children and a long-term investment – has shrunk considerably since 2008, partly due to expectations of negative, or at best, static house price growth.

Table 1

The Knight Frank Student Accommodation Index

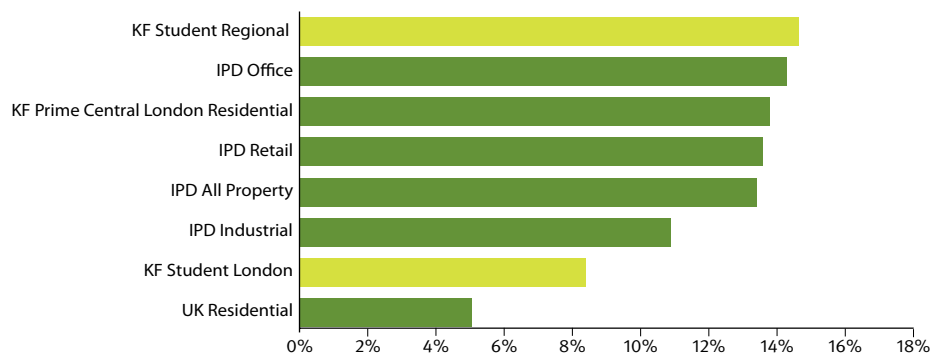
	London	Regional	England & Wales
Average studio rent	£257	£136	£178
Average en-suite rent for 2010/11	£192	£98	£112
Average rental change (year to December 2010)	-3.6%	4.1%	2.2%
Average capital value change (year to December 2010)	2.4%	8.1%	7.3%
Investment yield (December 2010)	6.00%	6.50%	6.25%
Total returns (December 2010)	8.41%	14.65%	13.53%

Source: Knight Frank Residential Research

Figure 2

Total returns, 2010

Student property vs other residential and commercial property types



Source: Knight Frank Residential Research

Market outlook

By March 2011, all that had been decided in relation to HE funding was the framework for tuition fees, which was set in December 2010 by parliament. This enables HEIs to charge an annual fee of between £6,000 and £9,000 per student. The White Paper, which was due to be published in March 2011 and would have fleshed out the government's plans in detail, was delayed in order to take universities' projected fees into account.

As a result, there may be some uncertainty in the market before firm plans are published but, as we discuss on page 6, there is, and will continue to be, a number of key cities across the UK where there is a significant

demand and supply imbalance and where investment opportunities continue to present themselves.

Whilst some HEIs may merge, sentiment suggests that the collapse of any institution as a result of the changes to HE funding is unlikely.

In terms of future market requirements, there is a structural undersupply of 'value' accommodation in London, good-value en-suites aimed at the £150-£200 per week price bracket. The inverse is true in the regional markets where the student accommodation sector is less mature and high-end studios, often targeted by postgraduates and mature students, are required.

Restructuring higher education: what does it mean for student housing?

In 2010 the government decided to implement a number of the reforms recommended by Lord Browne in his review of higher education funding. October's Comprehensive Spending Review had already announced that the HEI's non-research budget was to be cut by 40% or £2.9bn by 2014-15. Against this backdrop parliament voted in favour of allowing universities to charge between £6,000-£9,000 per annum in tuition fees.

“We estimate that in the next five years universities will generate £500m through the disposal of their existing halls of residence to the private sector.”

According to the government, the key attraction of the proposed changes will be that up-front costs will be borne by the government, not the student's family, and the subsequent payment of the debt is contingent with the graduate's income, with repayments beginning when the graduate's salary hits £21,000, rather than the current threshold of £15,000 (see table 2).

Table 2
Proposed thresholds for repayment of tuition fees by graduate earnings

Annual earnings	Monthly gross income	Monthly payment
£0	£0	£0
£21,000	£1,750	£0
£25,000	£2,083	£30
£30,000	£2,500	£68
£40,000	£3,333	£143
£50,000	£4,167	£218
£60,000	£5,000	£293

Source: Securing a Sustainable Future for Higher Education in England, 2010

In short, the government's reforms represent a step-change towards a more market-driven higher education system; one which promotes higher standards via a more competitive environment.

In our view the government's changes to higher education funding are unlikely to deter student applications and intake significantly. Undoubtedly, the exponential growth we have experienced in the past decade will taper off, but the Higher Education Policy Institute forecasts that after a one-off dip in applications in 2012 student demand will recover and show steady growth. Young people will continue to see the value of a graduate degree, particularly in a recession, when faced with an increasingly competitive employment market.

The revised funding system is forecast to allow for a 10% increase in university places over three years but, unlike before, individual institutions will face no restrictions from the government on how many students they can admit. Those institutions that are regularly oversubscribed will be free to increase the number of places more quickly, enabling them to increase their fees faster than their less popular counterparts.

The changes to funding will mean students will become consumers which we believe is a radical but progressive step. Private operators in the student accommodation market have treated students as consumers for many years, but now universities will have to follow suit.

The removal of public subsidy for courses other than priority courses (clinical medicine, nursing, science, technology and modern languages) will mean HEI income will principally be dependent on student numbers. This radical shift, combined with wider cuts in public expenditure, rising pension costs, and ageing facilities suggests there will be a greater reliance on the private accommodation sector in the coming years. HEIs will find themselves having to focus more on their core services – the provision of teaching and research – and less on accommodation provision, in order to attract students and boost revenues.

There are significant opportunities for the private sector. We estimate that in the next five years universities will generate £500m through the disposal of their existing halls of residence to the private sector. Previously, private sector involvement was mostly welcomed by the more disparately-located universities, those with multiple sites spread across towns and cities. However, changes to higher education funding will mean most HEIs will need to review the ownership, management and maintenance of their student halls, including the numerous campus-based universities.

Rental push from universities

We anticipate that rents for university halls of residences will rise significantly in September 2011 driven by the expectation that there will be a record-breaking number of applications from students wanting to avoid the tuition fee rise in September 2012.

With so much funding uncertainty we predict universities will want to 'work' their existing assets with a view to maximising revenues. By increasing rents now universities are preparing the ground for the disposal of their accommodation stock at improved values.

The withdrawal of government funding and the greater distance between the state and HEIs will be an interesting trend to monitor. **It will mean HEIs, like housing associations, will become highly regulated and will start to conduct themselves as independent financial entities**, enabling greater transparency of accounts and a firmer structure for covenant-related negotiations.

Knight Frank anticipates that the majority of the upper quartile universities will charge the maximum fee of £9,000. To do so they will need to gain the approval of the Office of Fair Access (OFFA) in relation to their fee waiver and bursary package in order to boost access to students from lower income families. We believe there will be a strong correlation between the elite universities and those opting to charge higher fees as they seek to re-affirm the quality of their teaching and the exclusivity of their institution. The maximum fee is expected to spread beyond the Russell Group of Universities to all those HEIs genuinely able to demonstrate academic excellence.

By emphasising the quality of their teaching, HEIs will be able to attract a greater number of students from overseas – an income stream that will become increasingly important in the new funding era. The latest figures from UCAS, see figure 3, show a significant rise in demand from the EU, the Far East and Hong Kong between 2010 and 2011.

Universities are likely to focus more on their offer of research and postgraduate study due

to the greater funding available. In 2009/10 around 56% of the 298,000 full-time postgraduates studying in the UK were from overseas, a figure which is expected to continue to grow.

A key characteristic of the student housing market over the next five years will be a shift towards flexible study. We expect HEIs to offer a wider range of two-year degrees instead of the traditional three-year courses, in many cases providing vocational or work-based learning with an increasing number part-sponsored by employers.

Applications from mature students, particularly for vocational courses, are forecast to rise. HEI applications from over-21s (UCAS definition of a mature student) rose by 15.3% in January 2011 compared to the previous year. This growth in mature students and postgraduate demand may cause developers to re-think the accommodation style they deliver.

This cohort of students usually have different requirements to undergraduates such as longer tenancy periods, higher budgets and a desire to share with fewer people. This changing pattern in demand is likely to lead to a growing tendency for year-round tenancy periods, more cluster flats and fewer students sharing accommodation. There will also be a drive towards higher specification units which will bear a closer resemblance to private apartments rather than institutionalised accommodation as has been evident in the past.

“A UK university education continues to be held in high esteem around the world and this demand is set to expand exponentially in line with global wealth generation.”

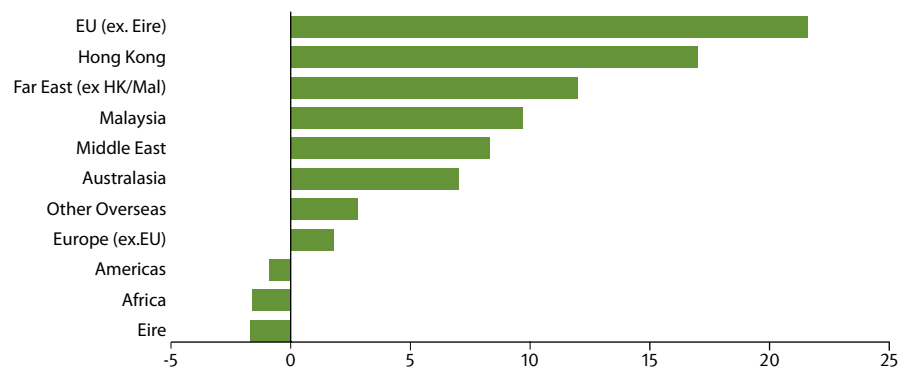
The value of a UK education

According to HESA the UK (in particular London), is a key focal point for international demand with the number of international students in the capital rising by 9% year-on-year in 2009/10.

Clearly, a UK university education continues to be held in high esteem around the world and this demand is set to expand exponentially in line with global wealth generation. The number of UK universities, by comparison, is a finite resource and looks set to remain so as government budgets are constrained.

In our recent Global Wealth Survey which examined the views of 350 wealth professionals, London was ranked the highest amongst all global cities for its educational offer and this factor was deemed a key purchaser motive amongst the world’s super-rich.

Figure 3
International applicants to UK Higher Education Institutions
% change 2010 to 2011



Source: UCAS

Student accommodation: identifying investment potential

A number of university towns – due to their location, the state of the local economy, the volume of student demand and the comparable level of supply – will emerge as investment targets worth monitoring in the coming years. Below we have selected 20 of the UK's 66 university towns and cities that we believe represent those top 20 locations with the strongest investment potential in relation to student accommodation.

Based on the Student Property Team's knowledge, acquired via its UK-wide valuation and consultancy work, we have assessed the 20 selected towns and cities on a number of key criteria. From a demand perspective we have taken into consideration the latest student intake figures and five-year growth patterns. Our assessment also looks at the composition of growth in terms of postgraduate and international students; a key revenue generator for universities in the coming years. On the supply side, Table 3 shows the volume of university-owned accommodation available but we have also had regard to purpose-built private accommodation as well as the underlying value of development sites in each town and city.

On this basis, the towns and cities listed below represent those we consider to hold the

strongest investment potential based on demand, supply and local economics. It is by no means an exhaustive list; there are 46 locations outside of this list that host universities many of which still have compelling investment dynamics. Due to data availability the ranking of student towns will never be an exact science but we hope you agree the results provide a wealth of information for a developer or investor looking to enter these markets and highlights some interesting trends.

In the case of the top five locations all the towns share a single characteristic; they each have a restricted supply of development land despite the recent recession and lending constraints. Furthermore, in each of the top five cities there is evidence of an underlying level of commercial investment across all asset

classes be it retail, office or leisure, suggesting investor confidence in the wider local economy remains high.

In locations such as Birmingham and Nottingham which we have positioned at the bottom of our top 20, here, land values have had a direct impact on investment prospects.

With 291,000 full-time students enrolled across 40 HEIs, London clearly remains a hub of student activity and continues to occupy the top position. It boasts a large proportion of both postgraduates and international students, yet only 15.4% of its students are housed in university-owned accommodation. Knight Frank consider London needs a further 100,000 student bedrooms providing transport-accessible, value accommodation in the £150-£200 per week price range.

Table 3
Where to invest in the UK?

Overall ranking	Town/City	No. of HEIs per town	All full-time Students 2009/10	Growth in student nos 2004/05-2009/10 (%)	Students enrolled vs university-owned bed spaces (demand/supply)	Full-time postgraduates as a % of all full-time students 2009-10	International students as a % of all full-time students 2009-10	Ranking average house price (Dec 2010)
1	London	40	291,815	20.7%	15.4%	25.5%	35.0%	1
2	Kingston	1	21,675	39.9%	10.9%	15.7%	22.3%	2
3	Brighton	2	25,345	18.1%	21.5%	13.9%	19.8%	5
4	Edinburgh	5	46,270	12.4%	20.8%	19.9%	32.3%	6
5	Oxford	2	31,620	6.7%	54.3%	27.7%	30.2%	3
6	Durham	1	14,290	2.6%	40.3%	21.5%	21.2%	19
7	Manchester	4	79,405	14.7%	18.7%	16.9%	21.2%	18
8	St Andrews	1	7,760	4.1%	50.2%	21.2%	47.3%	15
9	Bristol	2	38,560	18.0%	20.5%	15.1%	18.5%	12
10	Exeter	1	16,175	50.0%	26.6%	23.7%	25.4%	7
11	York	2	17,350	27.3%	33.9%	21.9%	19.8%	9
12	Newcastle	2	39,195	15.1%	20.3%	18.1%	23.8%	17
13	Glasgow	5	50,155	7.7%	13.2%	18.2%	18.1%	14
14	Bath	2	16,845	20.1%	25.7%	14.3%	25.5%	4
15	Canterbury	3	30,185	27.0%	22.5%	11.8%	17.5%	8
16	Bournemouth	2	16,170	41.0%	18.6%	9.1%	14.5%	11
17	Cambridge	2	30,790	10.4%	48.5%	24.0%	30.5%	10
18	Cardiff	2	29,760	10.0%	20.5%	18.1%	31.6%	13
19	Birmingham	5	55,300	18.0%	18.4%	18.4%	24.0%	16
20	Nottingham	2	50,630	20.0%	22.9%	17.8%	21.4%	20

Source: HESA, Good University Guide, Land Registry, Registers of Scotland
Note: House price rankings based on Local Authority level data

Expert insight

The higher education sector faces considerable upheaval in the coming years. While that presents some uncertainty for the student housing sector, James Pullan, head of student property at Knight Frank, believes it presents opportunities in equal measure, Vicki Shiel reports.

When you consider the tense political climate prevailing in higher education last year, from the protests and riots to the uncertainty surrounding Lord Browne's review, the student accommodation sector has demonstrated very stable performance.

According to James Pullan, head of student property at Knight Frank, student property has emerged from the global economic crisis to see new sources of investment being utilised, demand for university places growing further, and interesting new opportunities presented to developers and investors by the changing make-up of the student population in the UK.

"Before the credit crunch new projects were funded by banks lending to developers and property companies. Now the core funding comes from overseas equity houses, pension funds and high-net-worth individuals," Pullan explains. "During mid-late 2009, new interest was spurred in the sector, with joint ventures being formed between investors such as the Bahrain-based Oasis Capital Bank and student property developer Unite Group."

This evolution in project funding, combined with the surge in demand for university places as young people place even greater significance in higher education, makes for a positive outlook for 2011 and beyond. Pullan admits that the sharp increase in university applications is partly due to the impending fee rises recommended in Lord Browne's report. But it is also due to the perceived importance of having a degree in the increasingly competitive job market, he says.

Changes in the way that higher education is provided in the UK will change the face of the student population. With universities under increasing pressure to provide more two-year degrees and work-based learning (particularly in professions such as surveying, accountancy, business and

media), the number of mature, part-time and post-graduate students is likely to increase significantly, as is the average age of students.

In Pullan's view, there are big opportunities for new developments in the larger undersupplied cities such as London, Edinburgh, Cardiff, Newcastle and Manchester, as well as popular residential locations such as Exeter, Bath, Kingston, Oxford and Brighton.

Those looking to capitalise on the significant demand in London should consider plugging the gap in what is considered to be 'value' accommodation, in the £150-£250 per week range. This would work particularly well in strategically significant transport locations such as Wembley, Stratford and Acton, he adds.

But applications for London schemes are facing increasing resistance from planners, Pullan warns. "In the regions, planners have only been too supportive of student accommodation schemes, often fast-tracking private sector projects or assisting them in other ways. But the opposite is true in London, where boroughs appear to be resisting schemes at every turn, despite encouragement for them from Boris Johnson and the London Plan."

This battle has intensified, with many London boroughs demanding that private schemes provide affordable housing as part of their applications. The London Borough of Southwark's new core strategy, for example, dictates that schemes must provide 35% affordable housing.

For Pullan, this is a hostile move from the planning authorities. "London faces an acute undersupply of 'value' student accommodation and insisting that students pay for the burden of affordable housing will have a critical impact on the viability of future student accommodation schemes" he explains.



James Pullan
Head of Student Property

Valuation forecast



Neil Armstrong is a Valuation Partner within the Student Property Team and offers his views on where the market is headed.

This year national providers of student accommodation have generally reported a picture of full occupancy across their portfolios. Rents in the regions have seen steady growth in the private sector and we predict this trend to continue. London has typically seen full occupancy combined with rental growth for stock priced up to £250 per week. Top-end London studio rents saw price falls in 2010 but we anticipate rents will stabilise in this section of the market in 2011.

We have seen evidence that several HEIs are looking to make above-trend rent increases at their halls of residence against a backdrop of an application race in September 2011. The growth in accommodation rents at university halls could well be a prelude to a new phase where we see HEIs adopting a "disposal strategy" of their owned and operated stock.

Yields in the sector held up well in 2010. In the first quarter of 2011 direct let yields for prime student accommodation assets were 6.5% (regional) and 6.0% (London). Investments let to HEI covenants have become particularly attractive to investors seeking annual uplifts. We have seen significant yield compression in the HEI lease section of the market in the run up to the first quarter of 2011 with yields typically falling in the 5.00% to 5.75% range for the best prime investments.



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