Investment Property Forum

Large Scale PRS: Overcoming the current industry hurdles

A discussion paper

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First edition of **'Large Scale PRS: Overcoming the current industry hurdles' A discussion paper'** published in the United Kingdom by Investment Property Forum.

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Introduction

Investment Property Forum (IPF) briefing paper, **Mind the viability gap: Achieving more large-scale, build-to-rent housing (2015)**[1] focused on the viability and building of large-scale, build-to-rent housing. The purpose of this discussion paper is to consider:

- The current level of institutional, mainstream investment in the private, market-rented sector (PRS); and
- The perceived barriers, or hurdles, to establishing an institutional residential investment market that complements the existing market for commercial property.

These hurdles have been identified, but not addressed, by the market over the past decade. They include the difficulties of achieving sufficient scale of investment, political risk, market liquidity/transparency and pricing, together with management expertise. The relative weighting given to each appears to vary over time, as evidenced by the findings of the IPF's annual UK Residential Institutional Investment Survey[2], which captures institutional attitudes and investment intentions for UK residential property.

This paper considers the hurdles relating to liquidity/transparency, pricing and management expertise that impede residential holdings from being integrated into mainstream (i.e. largely commercial property) investors' property portfolios. These hurdles, and what is being done (and proposals as to what should be done) to overcome them, are reviewed under the following section headers:

- **Hurdle 1: Valuation methodologies applied to large-scale, private-rented residential (PRS);**
- **Hurdle 2: Requirement for a widely adopted Index; and**
- **Hurdle 3: Developing professional management capabilities.**

The IPF organised a panel discussion in London on 12 October 2016 to discuss current initiatives to overcome these hurdles. The event informed the final version of this paper, which we hope will generate further discussion within the industry, resulting in these and other hurdles being removed.

1 In September 2015, the IPF published the briefing paper, 'Mind the viability gap: Achieving more large-scale, build-to-rent housing'. This was written by a sub-group of the IPF Residential Investment Special Interest Group (Residential SIG) and sought to highlight the role that the large-scale build-to-rent sector could play in addressing the chronic shortfall in the delivery of new homes in the UK: Some 240,000 new homes need to be delivered annually but current output averages less than 150,000. The paper then went on to explain, using a detailed worked example, the financial viability gap that exists when seeking to deliver build-to-rent housing, compared with build-to-sell models. Finally, it was suggested that local authorities seeking to attract such development could adopt a number of approaches to planning obligation flexibility to help bridge the viability gap.

2 The UK Residential Institutional Investment Survey is published annually by the IPF Research Programme. Copies of the surveys are available to download from the IPF website: www.ipf.org.uk.

1: Context

INSTITUTIONAL INVESTMENT IN THE PRIVATE, MARKET-RENTED SECTOR (PRS), IS VERY SMALL COMPARED TO THE LEVEL OF INVESTMENT IN THE UK COMMERCIAL MARKET AND ALSO LOW BY INTERNATIONAL STANDARDS, AS OUTLINED BELOW.

A. Institutional mainstream investors in the UK property market

The value of the UK property market is estimated to be £6,245bn[3] as at end-2015, constituting £5,375bn (86%) residential and £870bn (14%) commercial. Figure 1 shows the comparative growth in value in these two sectors since 2003.

Despite the stronger growth by residential during that time, investors in PRS[4] hold only 19% (£1,015bn) by value of the total, compared with 55% (£483bn) of the commercial universe. However, PRS is dominated by private landlords and the mainstream commercial property investors account for only a small proportion of the market, as shown in Figure 2. That said, mainstream investor exposure to residential has been growing rapidly in recent years – the 21% increase in 2015 was far greater than both the rise in institutional exposure to commercial property and the increase in the size of the total private rented sector stock.

Figure 1: **Growth in value of the UK residential and commercial property markets since 2003**

Source: The Size and Structure of the UK Property Market: End-2015 Update, IPF Research Programme July 2016

Figure 2: **Residential investment by mainstream investors**

	2014 £bn	2015 £bn	Change %
Total residential stock: capital value	5,062	5,375	6
Private rented residential stock: capital value	922	1,015	10
Private rented: mainstream investors only	14	17	21
Student accommodation: mainstream investors	9	12	33

Source: The Size and Structure of the UK Property Market: End-2015 Update, IPF Research Programme July 2016

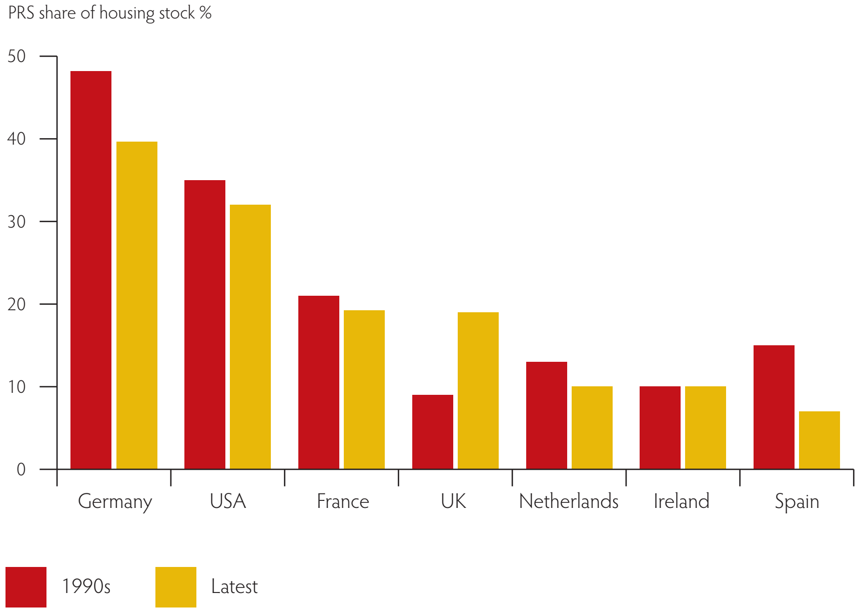
3 The Size and Structure of the UK Property Market: End-2015 Update, IPF Research Programme July 2016

4 Private rented residential market, defined in 'The Size and Structure of the UK Property Market: End-2015 Update' as income-producing residential assets let at market rents, which includes student housing but excludes care homes etc. and development land.

B. International housing markets – PRS share and institutional investment[5]

Although the PRS share of the UK housing stock has grown from circa 9% to 19% since the 1990s, the current level is still below that in several other mature investment markets, as shown in Figure 3.

Figure 3: **The changing share of PRS in the housing market by country**



Sources: Private renting in other countries; English Housing Survey 2014-2015, DCLG; The Private Rented Sector in the New Century – A Comparative Approach, University of Cambridge and London School of Economics 2012; Eurostat

Note: 1990s figure shown for Germany is for West Germany only.

The size of the PRS sector in each country is largely a result of differing historical, cultural, legislative and taxation regimes. For example, in post-War (West) Germany house building was encouraged through direct subsidies and tax exemptions available to public, private and non-profit making entities but there was little demand from potential owner-occupiers due to lack of finance, so the majority of new housing provision was for rent. Conversely, the private sector in the UK was excluded from housing subsidies during the same period of history and therefore it concentrated on building for sale.

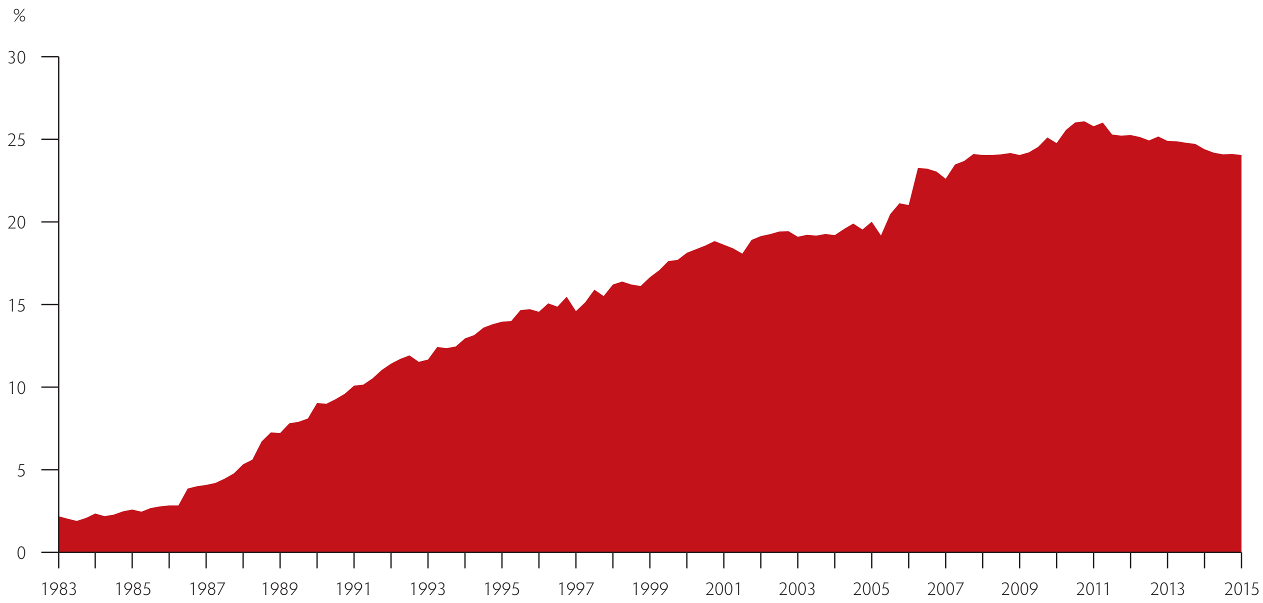
The level of homeownership versus market-rented and social housing is not a fixed ratio but changes over time, as shown in Figure 3.

Regardless of the relative size of the PRS market in these countries, they tend to be dominated by private investors to a greater (as in the UK) or lesser degree. Most of the rented accommodation in the Netherlands is provided by housing associations but institutions account for over a quarter of the PRS. This is a similar proportion to that in Germany and the multifamily sector in the US. The latter was very much an individual/private equity industry until the REITs and institutions started to invest in the 1990s (see Figure 4), not least as a result of advantageous tax changes in the late 1980s[6]. An overview of the development of this sector is included in Appendix 2.

5 For a more detailed comparison of international PRS markets, please refer to 'Residential Investment in International Markets', Short Paper 21, published by the IPF Research Programme November 2014.

6 Under the Tax Reform Act (TRA) 1986.

Figure 4: **US private-sector apartments – proportion owned by institutional investors**

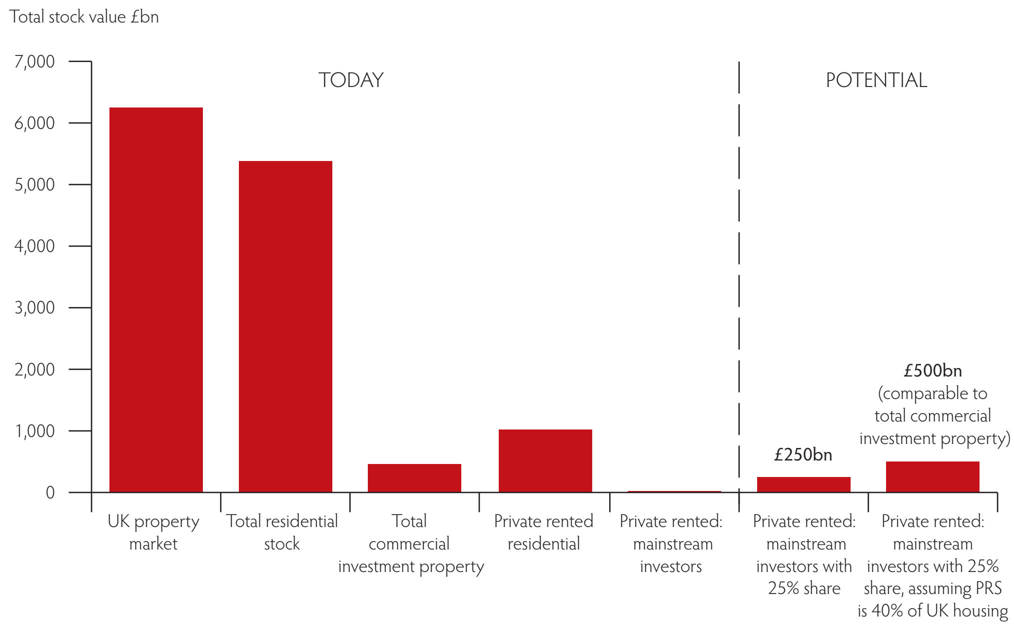


Source: CBRE Econometric Advisors and NCREIF

C. Potential for the UK institutional market-rented sector

At current day values, an increase in institutional holdings, such that they constituted 25% of the PRS market, would create an investment market worth £250bn. This could double if PRS was to constitute 40% of UK housing by tenure. At that point, institutional holdings in market-rented residential property would be comparable to that in the commercial sector – see Figure 5.

Figure 5: **Potential for the UK institutional market-rented sector**



Source: The Size and Structure of the UK Property Market: End-2015 Update, IPF Research Programme July 2016

2: Hurdle 1 – Valuation methodologies applied to PRS

THE DEVELOPMENT OF A LARGE-SCALE, INSTITUTIONAL PRS MARKET IS IMPEDED WHILE PRS IS VALUED AT A DISCOUNT TO VACANT POSSESSION VALUE.

Different residential valuation methodologies are used across the sub-sectors of the residential market, as shown in Figure 6. The valuation of large-scale PRS holdings has started to evolve from the application of a discount to the vacant possession capital value in the owner-occupier market – see Figure 7.

Figure 6: **Different residential valuation methodologies**

Type	Main valuation methodology
Build to sell	Sales comparables
Senior living for sale	Sales comparables, taking into account any restrictive covenants
Build to rent/let portfolios	Discount to sales comparables and/or net operating income (NOI) x yield
Senior living to rent	NOI x yield
Student housing	NOI x yield

Figure 7: **The valuation of large-scale PRS**

Date	Main valuation methodology
2000	Discount to comparables
Today	Discount to comparables & NOI x yield
Future	NOI x yield

Current valuation guidance

The RICS published an information paper[7] in September 2014 that provides in Section 7.2.1 of the paper for the NOI x yield based valuation in the context of a 'defined minimum period'[8], i.e. where a Section 106 agreement requires the residential property to be rented for a minimum number of years:

"Where a residential property is restricted to market renting for a defined period, the value of the property is likely to reflect the potential income generated during the restricted period and the increasing proximity of the reversionary value at the point of release from the restriction. During the period of the restriction, a valuer may consider adopting an explicit discounted cash flow approach based on either the gross rents or NOI. If institutional investors play an increased role in the residential investment market, it is anticipated that an analysis of NOI will become more common. This approach is widely adopted for other assets, such as affordable housing and student accommodation..."

However, valuers may adopt whichever approach their clients require including valuation on a discounted vacant possession basis. This approach is appropriate for mortgage purposes, which constitutes the majority of residential valuations, but not for large-scale, long-term market-rented holdings.

7 'Valuing residential property purpose built for renting', RICS information paper, England and Wales, 1st edition, September 2014

8 Section 7.2: Application of discounted cash flow methodology from 'Valuing residential property purpose built for renting', RICS information paper, as in footnote 5.

Proposal for discussion

More detailed RICS guidance on valuation methodologies is required.

Discussions within the IPF Residential SIG and during the IPF event held on 12 October 2016 suggested scale (number of units and/or scale of income) and the provision of amenity/services as possible determinants as to when the NOI x yield valuation approach should be used. For example, the time to sell all individual units within a large block with vacant possession when they are currently let (even if on assured shorthold tenancies) may well take in excess of what might be deemed 'a reasonable marketing period' within the definition of open market value, based on the use of comparable transaction evidence. The provision of significant amenity space and services for existing tenants would also suggest that the approach should be based on NOI x yield, as per purpose-built student accommodation, care homes, etc.

Next steps

The RICS has established a taskforce to update the first edition of 'Valuation of residential property purpose built for renting' and publish it as a Guidance Note rather than an Information Paper. RICS will be inviting an industry review of this through public consultation in due course.

The IPF will alert members and others as to the review commencement date as soon as this is made public.

3: Hurdle 2 – Requirement for a widely-adopted index

INVESTORS NEED TO BE ABLE TO BENCHMARK THE PERFORMANCE OF THEIR HOLDINGS AGAINST THE PRS SECTOR AS A WHOLE, THE COMMERCIAL PROPERTY SECTOR, ALTERNATIVE REAL ASSET SECTORS AND OTHER ASSET CLASSES.

Figure 8 outlines the prerequisites of an index to enable the development of residential portfolio analysis and benchmarking (against the sector and cross sector) in order to meet the needs of mainstream PRS investors.

Figure 8: **An index for large-scale PRS – Investor requirements**

Overview

The relevant index needs to be easy to be supported by all professionals, in order to support scale and relevancy:

- Representative of the overall market (e.g. not just London-centric)
- Ideally integrated with other sectors to support asset allocation

KPIs

Measure NOI in a consistent manner:

- Measure capital return
- Measure total return

Frequency

Quarterly Index with quarterly valuation:

- Based on desktop valuations

Proposal for discussion

Over the last 18 months, members of the IPF Residential Special Interest Group (SIG) have been working with other industry participants to review the process of how residential performance measurement is undertaken at the present time and what changes are required to encourage more investors to contribute data on their portfolios in order to improve the transparency and availability of information on the sector.

Their findings suggest that to develop a PRS index that will be utilised to a similar extent as the existing MSCI/IPD indices for commercial property, there needs to be industry agreement on the following issues:

- TOP PRIORITY: The definition and calculation of NOI;
- Valuation methodology (see Hurdle 1) and the frequency of valuation, probably quarterly;
- Data provision, including the need to automate data provision from property and asset management systems to the index, together with the level of detail and consistency of the data provided;
- Definition of the unit of analysis to which performance data is attributed – more appropriate at the asset level (e.g. the block) rather than as individual units/flats; and
- Classification of residential stock, e.g. by new-build/existing stock, age, quality, location, level and type of amenities provided, etc.

Next steps

Establish consensus in the industry regarding the issues identified above, such that a sufficient number of investors in the market-rented sector feel confident enough to contribute their data. Only then will there be sufficient critical mass to underpin the production of comparable benchmarks.

4: Hurdle 3 – Developing professional management capabilities

THE REQUIRED ASSET AND PROPERTY MANAGEMENT SKILLS IN THE RESIDENTIAL SECTOR DIFFER SUBSTANTIALLY FROM THOSE IN THE COMMERCIAL SECTOR, WHERE CURRENTLY MOST INSTITUTIONAL INVESTORS HAVE THE MAJORITY OF THEIR PROPERTY HOLDINGS.

Research into residential markets in six countries carried out for the IPF in 2014[9] found that the maturity of the investor market and a well-developed asset and property management industry are very important. A strong relationship was clearly observed between institutional investor involvement in the residential sector and the availability of investment management organisations in the different markets. For example, investors in the Netherlands can choose from a wide range of asset management organisations, varying in investment approach, size and specialisation and they appeared to achieve a lower gross-to-net leakage than the other markets in the sample.

Figure 9: **The three core functions of large-scale residential portfolio management**

	Owner / Investment manager	Asset manager	Property manager
RESPONSIBILITIES	• Overall portfolio strategy • Acquisitions • Disposals • Key portfolio actions • Reporting • Annual budgets	• Supervise property manager • Identify/manage refurbishment • Control expenditure • Set lettings policy • Set health & safety (H&S) policy	• Let & interact with tenants • Manage income & expenditure • Manage regular contracts • Maintenance • Hold tenant deposits • Manage arrears • Implement H&S policy • Financial reconciliations

Figure 9 shows the three core functions of large-scale residential portfolio management. Figure 10 shows the two principal ways that the residential investment sector has apportioned these functions between investor in-house teams and external service providers.

9 Residential Investment in International Markets, Short Paper 21, IPF Research Programme November 2014.

Figure 10: **Principal residential investment management models**

Model 1: Fully-integrated E.g. Get Living London, Greystar

Owner / Investment manager / Asset manager / Property manager

Model 2: Semi-integrated E.g. M&G, PLATFORM_

Owner / Investment manager / Asset manager → **Property manager**

Pros and cons

Neither model is the preferred option – it depends very much on the investors' priorities and resources. There are pros and cons associated with both, as outlined in Figure 11.

Figure 11: **Pros and cons of the management models**

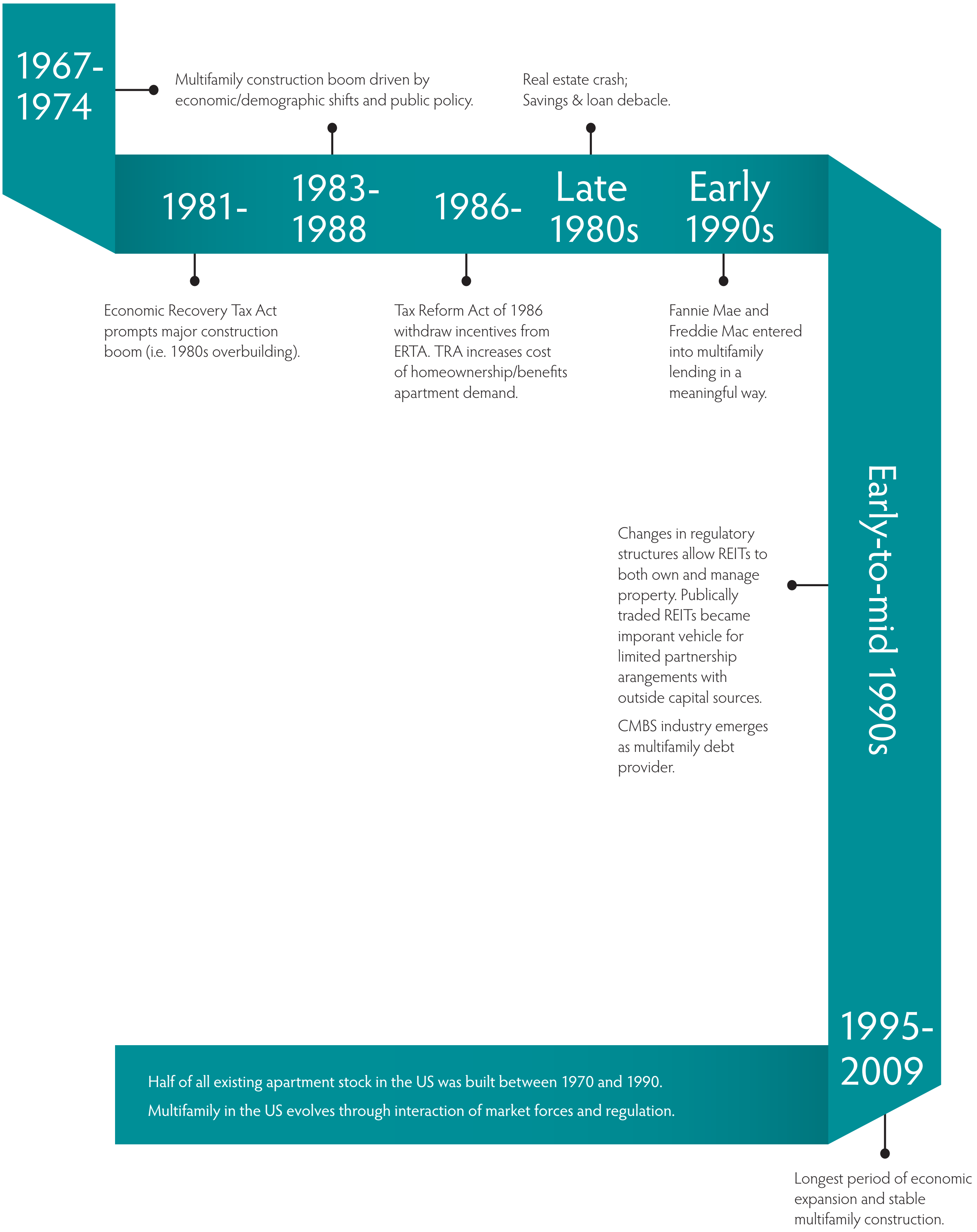
Model	Pros	Cons
1. Fully-integrated	• Integration of all resources and costs • Easier to ensure services delivered in accordance with investor's standards • Easier to monitor whole management provision • No VAT issues between different companies	• Requires full-time team – may not be cost effective for smaller holdings • Requires expertise in all areas of management
2. Semi-integrated	• Investor does not have to fund a large teams of property managers, extensive IT costs of property management databases etc. • Each party can focus on area of expertise	• More difficult to align interests with split of functions • Communication is more difficult when between two parties • Investor does not have same level of control over management provision

Appendix 1: Comparison of Institutional investment holding in residential and housing tenure profile by country

	Institutional holdings €m 2014			Proportion of housing tenure 2013		
	All Property	Residential	Residential %	Owner %	Market rent %	Social rent %
Austria	27,677	6,682	24	57	27	16
Belgium	45,305	–	0	72	19	9
Czech Republic	12,991	–	0	80	16	4
Denmark	42,850	4,444	10	63	37	0
Finland (KTI)	50,000	13,176	26	74	11	16
France	299,839	40,553	14	64	19	16
Germany	322,172	34,634	11	53	39	9
Hungary	7,840	–	0	90	3	7
Republic of Ireland	22,636	–	0	70	16	14
Italy	91,942	–	0	73	14	13
Netherlands	110,935	54,756	49	67	33	0
Poland	27,996	–	0	84	4	12
Portugal	20,169	–	0	74	11	15
Spain	54,854	983	2	78	13	9
Sweden	126,790	22,987	18	70	30	0
UK	563,976	28,199	5	65	17	18
Eurozone	**1,045,530**	**158,395**	**15**	**67**	**22**	**11**
EU	**2,028,351**	**289,248**	**14**	**70**	**19**	**11**

Sources: MSCI/IPD, EuroStat

Appendix 2: Development of the US multifamily industry



Source: CBRE Capital Markets, US

This publication was written by a working group of the IPF's Residential Investment Special Interest Group. The main Group was established in 2009 to look at the potential for greater involvement in the private rented sector by institutional investors and the barriers to their participation in that market.

In 2012, the Group undertook a survey of 42 institutional inventors with total property assets of £180bn in order to provide a basis for responding to the Montague Review commissioned by the Department for Communities and Local Government (DCLG), which looked at the potential for institutional investment in the private rented sector. The results of the survey were published as 'Institutional Attitudes to Investment in UK Residential Property' by the IPF Research Programme. This survey is now conducted annually and the 2016 results can be downloaded from the IPF website: **www.ipf.org.uk**

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Lastly, thanks go to Colleen Pentland Lally and her colleagues in the US Capital Markets team of CBRE for providing the data for Figure 4, together with the diagram outlining the development of the US multifamily industry included in Appendix 2.

About the IPF

The IPF is one of the leading specialist property industry bodies in the UK. It comprises an influential network of senior professionals, all active in the UK property investment market.

The IPF's mission is to enhance the understanding and efficiency of property as an investment, including public, private, debt, equity and synthetic exposure, for its members and other interested parties, including government, by:

- undertaking research and special projects and ensuring effective communication of this work;
- providing education; and
- providing a forum for fellowship, discussion and debate amongst our members and the wider investment community.

For further information about the IPF and its research/publications, contact Sue Forster, Chief Executive, email: sforster@ipf.org.uk, tel: 020 7194 7922.

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