

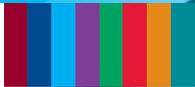


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SHORT PAPER 16

Institutional Attitudes to Investment in UK Residential Property

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JUNE 2012

Institutional Attitudes to Investment in UK Residential Property

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This Programme supports the IPF's wider goals of enhancing the understanding and efficiency of property as an investment. The initiative provides the UK property investment market with the ability to deliver substantial, objective and high-quality analysis on a structured basis. It encourages the whole industry to engage with other financial markets, the wider business community and government on a range of complementary issues.

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Institutional Attitudes to Investment in UK Residential Property

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Institutional Attitudes to Investment in UK Residential Property

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Institutional Attitudes to Investment in UK Residential Property

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Institutional Attitudes to Investment in UK Residential Property

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Institutional Attitudes to Investment in UK Residential Property

1. INTRODUCTION

A number of people, including me, believe that UK institutional investors should have a much greater exposure to residential property than is generally the case. Ever since the 1997 Labour Government chose to retain the Assured Shorthold Tenancy rules, the main political risk with investing in the public rented sector (PRS) was removed. But institutions have been slow to take up the opportunity despite the excellent returns on offer; yet private individuals have taken full advantage, investing over £200 billion to create the modern 'buy-to-let' market.

Greater involvement by institutions could generate a number of benefits, notably driving up management standards and ensuring they are maintained in the future. It is important to understand, therefore, why there has been so little investment by institutions in the sector. This research seeks to identify why this is so, particularly in the context of the Montague Review commissioned by the Department for Communities and Local Government (DCLG).

The IPF is most grateful to all who participated in the survey and I commend the results as a good snapshot of current thinking in respect of institutional interest in residential property.

Robin Goodchild
Chairman, IPF Residential Special Interest Group

June 2012

2. BACKGROUND

At the request of the Minister for Housing and Local Government, in February 2012 Sir Adrian Montague issued a call for evidence of how to encourage greater investment in privately rented properties, being part of the Government's Housing Strategy. It investigated how to boost investment in rental properties in order to support more rapid growth of the private rented sector through an increase in the supply of affordable homes. (The terms of reference for this review are attached as Appendix 1).

The Montague review sought to address two key questions: Would the changes that the Government had introduced go far enough to generate significant new flows of investment? If not, what could be done to accelerate things?

The review aimed to identify what further initiatives Government needs to pursue in addition to recent changes to the stamp duty on bulk purchases and reforms to residential real estate investment trusts (REITs). Submissions were sought by 31 March and Sir Adrian's findings and possible recommendations were scheduled to be presented to Ministers in June 2012.

3. IPF SURVEY

In order to inform its response to this review, the IPF undertook a survey of institutional investors in real estate, based upon a questionnaire (see Appendix 2).

In total, 54 organisations were approached to participate in this research. Participants were primarily UK pension funds, life assurance companies, property companies, including real estate investment trusts (REITs), fund managers, other financial institutions and a number of consulting actuaries who advise many public and corporate pension funds. These organisations include both investors in the sector and those without any exposure to residential real estate within their investment portfolios currently. Forty-two entities contributed data or shared their views on those issues that they consider impact on institutional investors' appetite for residential investment. Interviews (the majority conducted by telephone) were carried out over a four-week period between 1 and 29 March. The results were referred to in the AREF/BPF/IPF joint response to the Montague Review, dated 30 March 2012 (see Appendix 3).

4. SURVEY RESULTS

The survey focused on three principal areas: the current degree of investment in the sector; reasons for not investing in residential property; and what Government could do to increase investment/attract investment for the first time. An additional, supplementary set of questions were asked of those who invest in student accommodation, as the terms of reference of the consultation included a question as to what lessons could be learned from large-scale investment in student housing.

4.1 Current investment in residential property

4.1.1 Overall investment

The 42 respondents to the survey currently invest in excess of £180 billion in global real estate assets. Of these, the exposure of 28 investors amounts to a headline total of almost £7.6 billion of residential real estate within their portfolios (averaging a little under 6% of their total real estate investment), ranging from in excess of £1.5 billion to as little as £1 million. However, the category of residential property captured by this overall figure includes market rented (MR) including assured shorthold tenancies (ASTs), student housing, ground rents, social housing, regulated tenancies, development land and 'Other' (see below for type of holdings covered by this classification).

The average exposure of those investing directly is £271 million, whilst the median value holding for this sample is £86 million. Expressed in percentage terms of their total real estate holdings, 16 of the 28 respondents' investment represents less than 5% of their holdings (a little over £900 million by value). A further five organisations hold between 5% and 10% of their property in assets classified as residential (£2.335 billion). The remaining seven contributors to the survey hold in excess of £4.3 billion of assets in residential property, representing some 16% of their real estate investment on average.

4.1.2 Type of investment and asset

Twenty-five of the 28 investors in residential property hold their assets directly or in a combination of direct and indirect ownership via private funds. No respondent identified listed vehicles as a means of exposure to residential, which may be as a result of listed stocks being classified or managed as equity investments. More detailed description of investment method, by reference to value or proportion per investment type, were not recorded.

Six categories of residential holding were listed to identify which, if any, form of residential investment is favoured currently. In order of preference, it appears that the majority of investors (three-quarters) have some exposure to MR/ASTs; the next most popular asset being development land (over half), followed by student housing and ground rents (each being held by more than one-third of respondents). With a number of investors not providing details of asset types by value, an accurate quantification has not been possible but more than £3 billion (42% of total asset values) is currently invested in the MR/ASTs segment of the market by respondents, with about a further £1.2 billion invested in student accommodation.

4. SURVEY RESULTS

Table 4.1 summarises the position.

Table 4.1: Current investment in the residential sector

	MR/ ASTs	Dev't. Land	Student Hsg	Ground Rents	Reg. Tenancies	Other ¹	Social Hsg	Total
No. respondents	21	15	11	10	7	6	5	-
Proportion	75%	54%	39%	36%	25%	21%	18%	-
Value (£m)	3,176	822	1,178	139	179	885	1,214	7,593
% of total	42%	11%	16%	2%	2%	12%	16%	100%

4.1.3 Rationale for investing in residential property

Respondents were invited to select from four criteria for investment and rank these, as well as to provide additional reasons for holding UK residential property.

The majority (23) identified the **returns profile** as being a major consideration and, of those who provided rankings, 13 considered it to be the prime driver.

Stability of income was identified by 19 respondents as an important factor, although only three ranked it above all others.

Low correlation with other asset classes was cited by 18 investors, of whom two gave this as their number one ranking.

More than half (17) viewed **capital value stability** (relative to commercial real estate) to be of importance, although none ranked it as the principal consideration.

Other reasons for investing made reference to the defensive qualities provided due to the very different characteristics of each sub-sector of residential property. Several respondents identified their exposure as a default position, resulting either from acquisition of residential property ancillary to commercial investments or as a condition of planning in development situations or to maximise value from mixed-use development; this was especially the case in central London. Table 4.2 summarises these responses.

Table 4.2: Reasons given to invest by existing investors in the residential sector

Reason to Invest	Rank							Not ranked
	Total	1	2	3	4	5	6	
Returns profile	23	13	7	1	1	0	0	1
Stability of income	19	3	5	6	2	1	0	2
Low correlation with other asset classes	18	2	5	6	4	1	0	0
Stability of capital values	17	0	3	5	8	0	0	1

¹ Examples of 'Other' types of residential asset included: grace and favour/retired worker, sheltered housing, shared ownership and residential care homes. Residential development to be sold on rather than held as investment stock was also classed in this category by respondents.

4. SURVEY RESULTS

4.1.4 Investment over the next 12 months/three years

Existing investors were asked to provide an indication of their expected investment activity in the short-term as well as over the next three years. 19 respondents (68% of existing investors), of whom 11 were fund managers, anticipate investing further over the next 12 months and 23 over the next three years. The extent of their investment could be between £2.6 billion and £2.7 billion, the majority being from the fund management sector (£2.125 billion to £2.25 billion in the case of the 11 fund management organisations responding to this question).

Four REITs, all of which already invest in the sector, anticipate committing further monies (of around £300 million) over the next 12 months to three years, although one would not specify a figure as it has no definite target and will act opportunistically. All four will consider development projects (including for ground rent holdings or buying one-off sites) and three will contemplate ASTs.

The type of residential property that may attract this level of investment was not specified in many instances. However, those investors that did indicate a preference favoured the private rented sector (eight), development (six) and student housing (five). A number of respondents in addition to REITs commented that their approach would be opportunistic and responsive to market conditions at the time.

One fund manager indicated that it would be unlikely to invest in the future as the current allocation was historic, being in the client's portfolio when the mandate was won. They will retain the assets because they produce good returns but have no mandate to increase the allocation.

4.2 Non-Investor responses

4.2.1 Reasons for not currently investing

Fourteen of the 42 survey participants (33%) do not currently have any investment in residential property. Six factors were suggested as being deterrents to investing in the sector. Responses were varied, although the majority acknowledged that it is "just too difficult" in terms of management, etc. Income yield was also cited as being a significant barrier to investment. Table 4.3 summarises these responses.

Table 4.3: Reasons given for not investing in the residential sector

Factor	No. Responses
Just too difficult/management issues	12
Income yield too low	9
Lack of liquidity/insufficient market scale	9
Pricing not right	6
Reputational risk	5
Political risk	4
Other	3

4. SURVEY RESULTS

Other reasons mentioned were the current economic background and speciality of the asset class, the latter of which perhaps captures several of the factors specifically listed. One REIT mentioned that it would not invest as the income yield is too low and would have a too dilutive affect on distributable income if a meaningful position were to be built up.

One other respondent specifically mentioned the issue of scalability as being the main barrier to their entry to the market currently.

4.2.2 Alternative investment

Contributors were asked if their lack of investment in residential property was because their organisation invests in other assets as proxies or substitutes for the sector (such as house builders, nursing homes, residential mortgages but not student housing). With the exception of one respondent, the answer was “no”. The only qualification made was that the organisation invested in a listed house builder with a strategy to sell rather than to retain for rental.

4.2.3 Future investing intentions

Asked if they would commence investing in the residential sector within the next 12 months/three years, three contributors may invest in the next year, with a further five potentially investing within three years. Thus 57% of the ‘non-investors’ may enter the residential market in the medium term and the likely volume of funds that could be invested is between £350 and £840 million.

Most favoured types of residential investment are MR/ASTs and student housing (both attracting interest from six prospective investors) and ground rents (four).

4.3 What more can Government do?

All respondents were invited to give their views on what more Government could do to make residential more attractive or to increase existing investors’ commitment to the sector.

The four suggested changes proposed to respondents (listed in Table 4.4) attracted a range of support, see Table 4.4.

Table 4.4: Possible changes by Government that would encourage residential investment

Change	No. Responses
Remove/materially reduce VAT on repairs & management fees	25
Remove S.106 planning requirements/charges for market rent housing	23
Encourage/permit SIPPs to hold in (un-listed) residential property	11
Permit ISA accounts to hold AIM-listed REITs	10

Other unprompted suggestions included reducing the administrative burden created by the level of regulation applicable in management of residential property and the level of legal protection that tenants enjoy.

More clarity in the planning system and calls for a change to the Use Classes Order were well-supported, particularly reiterating a need to abolish the requirement to provide a social housing element within new developments.

4. SURVEY RESULTS

More favourable tax treatment was cited in several instances, including introducing taper relief on capital gains tax to encourage longer term investors into the asset and encourage more development and standing investment.

Several respondents considered that no further Government intervention is required, particularly in the case of those already investing in the sector. Alternatively, whilst a number of initiatives might prove helpful, these would not be critical in any decision to invest.

One or two contributors rejected certain suggestions, such as encouraging or permitting SIPPs to be invested in residential – this was viewed as entirely unnecessary as there are other options already available. It was also considered inappropriate to lobby Government to allow SIPPs to invest in unregulated collective investment schemes simply because no-one had created an eligible scheme under existing rules. This approach was viewed as: "... the wrong way round and the wrong logic."

4.4 Investment in student housing

With one exception, this sector of the market was not considered a proxy for investment in residential per se. For those surveyed who have invested in student housing, additional questions were asked about how they hold these investments and why.

A total of 20 contributors (48%) have an exposure to student accommodation, some using more than one investment method. Eleven have invested directly in the sector and investment via private funds proved almost equally popular (nine respondents). Only two investors hold listed company shares for student exposure.

The most acknowledged reasons for investment in student accommodation were the returns profile and income stability, followed by lease structure and indexation. A more detailed breakdown of responses is contained in Table 4.5.

Table 4.5: Reasons given for investing in student accommodation

Reason to Invest	Rank							Not ranked
	Total	1	2	3	4	5	6	
Returns profile	17	9	4	1	2	0	0	1
Stability of income	18	5	6	5	1	1	0	0
FRI leases with RP indexation	16	4	5	3	3	1	0	0
Stability of capital values	15	1	4	1	5	2	1	1
Low correlation with other asset classes	12	0	1	4	3	2	2	0
Similarity to commercial property management-wise	11	0	1	1	3	2	4	0

In addition to the above, respondents cited such features as 'scalability' and occupier demand as supportive of their investment, as well as the high income return when compared to other types of residential property.

5. CONCLUSIONS

This survey is based on responses from 42 institutions with total property assets of £180 billion – a 78% response rate from organisations approached. It identified a surprisingly large volume of residential investment (totalling £7.6 billion) but, on closer analysis, less than half of this sum was invested in MR/AST stock with the balance in student accommodation, ground rents, development land and dwellings for sale. Notwithstanding, the 28 survey respondents (67%) with residential investments hold a total equivalent to 80% of the IPD annual residential index, emphasising that investors in the sector are disproportionately represented in the survey.

The results of the survey show that, among existing investors in residential, the key attraction is the returns profile but stability of income and the low correlation with other assets are recognised as helpful attributes too. A number of institutions with small residential holdings regard their investments in the sector as accidental rather than deliberate, because the exposure emanates, for example, from a mixed use project including attractive commercial assets. Overall, fewer than 30% of respondents have a portfolio exposure of more than 5% to residential and it is these investors that should be regarded as committed to the sector.

There is no question that institutions have not taken advantage of the opportunities presented by the PRS, in marked contrast to private 'buy-to-let' investors, who have committed over £200 billion to the sector since 2000.

68% of existing investors in the survey are expecting to increase their exposure to the sector, which could increase their total residential investment by over a third.

33% of respondents have no exposure to residential currently. The main barrier to investment among these institutions is primarily management ('just too difficult') plus the level of yield and issues around achieving investment scale. Political and reputational risk are seen as much less significant. However, over half of the 'non-investors' expect to enter the sector over the next three years and could commit over £500 million. If this investment is added to the expected commitments from existing residential owners, it would still not increase the IPD residential exposure to the 5% threshold for overall property holdings.

The favoured ideas for helpful Government interventions focus principally on tax incentives and changes to the planning system, notably in connection with affordable housing requirements. These changes should improve the net yield, which is seen as an important barrier to investment.

Just under half of respondents own some student accommodation, reflecting the rapid growth of this sub-sector over the last decade, and totalling £1.2 billion. Just as with market rented residential, the returns profile is the main attraction but stability of income and leases formally indexed to the Retail Price Index are important benefits too.

Overall, the survey shows that there is some interest among institutional investors in increasing their exposure to residential but it is limited. The main barrier is the management challenge, reflecting the very different nature of residential tenancies relative to commercial, which is an industry issue. Government, however, can assist; anything that improves the net yield, e.g. reducing VAT on repairs and management costs, would help to attract investors.

NOTES

APPENDIX 1

Montague Review – Terms of Reference

Independent Review of the Potential for Institutional Investment in the Private Rented Sector

A1.1 Background

The Private Rented Sector has grown rapidly in recent years, and now houses 3.4 million households. During that period of rapid growth, rents remained stable in relation to earnings, and the quality of housing in the sector has improved. However in the last two years, rents have started to rise faster than earnings in some areas. At the same time, the dominance of small landlords has increased to the point where just 1 per cent of private landlords own more than 10 properties.

In this context, this government has been exploring the scope for the private rented sector to attract investment and, in particular, investment in new housing:

- In September 2010, we published the “Government response to the consultation on investment in the private rented sector”, which included a full consideration of potential tax measures;
- This led to measures in the 2011 Budget Statement to encourage increased investment;
- In November 2010 we published “Promoting investment in Private Rented Housing Supply: International Policy Comparisons”; and
- Most recently, there has been progress in developing models to increase the potential for institutional investment in the private rented sector and a handful of schemes are now underway.

A1.2 Purpose and aims

This review will build on this work and will avoid re-visiting issues which have already been considered in detail – in particular through HMT’s 2009 consultation. Instead it will focus on the potential for investment in the private rented sector in current market conditions. In particular:

- What evidence is there about the ability of the private rented sector to respond to future demand, and the impact of this on labour markets and growth? Is there a market failure?
- How does this compare to other countries?
- What interest is there among institutional investors for long term investment in housing?
- What are the characteristics of housing investment which might attract (or deter) institutional investors?
- What has been the experience of those who are developing new models for investment in the sector?
- What can we learn from large-scale investment in student housing?
- What drives current landlords’ business plans – costs, income, risks, long term strategies?
- How has the sector responded to the changing profile, expectations and aspirations of those who rent?

NOTES

APPENDIX 2

A2.1 Survey

Questionnaire for Institutional Investors re. UK Residential Property

Institution _____ Date _____ / _____ / 2012

Respondent _____ Position _____

Q1. Do you have any residential property holdings in your UK investment portfolio(s)?

YES

NO

If NO: go to Q7 on page 14 below

Q2. What is the approximate value of your residential holdings and what proportion do they make up of your property investment portfolio(s)?

Value £ _____ millions

Proportion _____ %

Q3. Is your investment in residential through direct property holdings or indirectly (public or private)?

Direct holding

Private fund

Listed company shares

Q4. What type of residential property are you invested in?

Type	Yes/No	% of Residential Holdings
Market rent/ ASTs		%
Student housing ²		%
Ground rents		%
Social housing		%
Regulated tenancies		%
Development land		%
Other (please specify):		%

Q5a. Why is your institution invested in UK residential property?

Q5b. Is it because of :

The returns profile?	Yes/No
Stability of capital values (relative to commercial)?	Yes/No
Stability of income?	Yes/No
Low correlation with other asset classes?	Yes/No
Other (please specify):	Yes/No

² If the investor has exposure to student housing, there is a specific question (Q 11) at the end of the questionnaire. Also if student housing is the institution's only residential holding it may be best to treat them as having no exposure, i.e. go to Q7.

APPENDIX 2

Q5c. Which of these is the most important?

	Rank
The returns profile	
Stability of capital values (relative to commercial)	
Stability of income	
Low correlation with other asset classes	
Other (please specify):	

Q6. Will you be increasing your residential exposure over the next 12 months/ 3 years?

12 months YES NO
 3 years YES NO

If YES: By how much and of what type?

£ _____ millions

If NO: Why?

NOW GO TO QUESTION 10 ON PAGE 15

Q7. (for those answering NO to Q1)

Why doesn't your institution have any exposure to UK residential property?

Are any of the following factors discouraging you investing in the sector?

Political risks e.g. legislation too uncertain	Yes/No
Reputational risks	Yes/No
Pricing is not right	Yes/No
Just too difficult / management issues	Yes/No
Income yield is too low	Yes/No
Lack of liquidity / insufficient market scale	Yes/No
Other (please specify):	

APPENDIX 2

Q8. Is your lack of investment in residential property because your institution invests in other assets that are proxies or substitutes for the sector (e.g. housebuilders, nursing homes, residential mortgages)?

YES NO

If YES: What type of investments are they and what is your institution’s scale of exposure?

Type of Investment:

Value £ _____ millions Proportion _____ %

Q9. Will your institution start investing in the residential sector (proper) in the next 12 months / 3 years?

12 months YES NO

3 years YES NO

If YES: By how much and of what type? £ _____ millions

Type	Yes/No	% of Residential Holdings
Market rent/ ASTs		%
Student housing		%
Ground rents		%
Social housing		%
Regulated tenancies		%
Development land		%
Other (please specify):		%

Q10a. (for all) The Government has reduced SDLT for bulk residential purchases and is changing the REIT rules to make residential more attractive. What else could Government do to increase your investment / cause you to invest for the first time in residential property?

Q10b. Would any of the following changes cause you to increase your investment / invest for the first time?

Remove S.106 planning requirements/charges for market rent housing	Yes/No
Remove or materially reduce VAT on repairs & management fees (so increasing net yields)	Yes/No
Encourage/permit SIPPs to invest in (un-listed) residential property	Yes/No
Permit ISA accounts to hold AIM-listed REITs (from Q3 2012 when REITs will be able to list on AIM)	Yes/No
Other (please specify):	

APPENDIX 2

Q11. What is the approximate value of your institution's total UK property holdings and what proportion do they make up of your total investment portfolio(s)?

Value £ _____ millions Proportion _____ %

Q12a (for those invested in student accommodation) Is your investment in student accommodation through direct property holdings or indirectly (public or private)?

Direct holding _____ Private fund _____ Listed company shares _____

Q12b. Why is your institution invested in Student accommodation?

Q12c. Is it because of:

The returns profile? Yes/No

Stability of capital values (relative to commercial)? Yes/No

Stability of income? Yes/No

Low correlation with other asset classes? Yes/No

FRI leases with RPI Indexation? Yes/No

Similarity to commercial property management-wise? Yes/No

Other (please specify): Yes/No

Q12d. Which of these is the most important?

Rank

The returns profile

Stability of capital values (relative to commercial)

Stability of income

Low correlation with other asset classes

FRI leases with RPI Indexation

Similarity to commercial property management-wise

Other (please specify):

Q12e. (for those invested in student accommodation only) Why is your institution invested in Student accommodation rather than other types of residential?

Many thanks on behalf of the IPF. This survey is being carried out to inform the IPF's response to the latest government review (chaired by Sir Adrian Montague) on the barriers to investing in residential property that are perceived by institutions.

APPENDIX 3

A3.1 AREF/BPF/IPF letter on joint response to the Montague Review of the Barriers to Institutional Investment in Private Rented Homes



The Association of
Real Estate Funds



The PRS Investment Review
Department for Communities and Local Government
Eland House – Floor 1/D1
Bressenden Place
London
SW1E 5DU

30 March 2012

Dear Sir,

Review of the barriers to institutional investment in private rented homes

We are pleased to enclose a copy of our response to the current call for evidence from Sir Adrian Montague as part of his review to examine how best to encourage greater investment in homes to rent.

The response is submitted by The Association of Real Estate Funds (AREF), the British Property Federation (BPF) and the Investment Property Forum (IPF), in consultation with the Royal Institution of Chartered Surveyors (RICS). This collaboration reflects the importance the industry attaches to the need for larger-scale investment targeted at increasing the overall supply of housing in the UK through building housing for market rent.

We would like to make the following key points:

- Greater institutional investment would make a significant contribution to increasing housing supply and growth in the UK.
- We consider 'Build to Let' is the only way to significantly increase the supply of private rented housing, given that the current development market is dominated by the requirements of the owner occupier sector. This would be best achieved using S.106 agreements to treat 'market rent' dwellings as affordable housing through a covenant that all units on a development will be rented for a minimum period of 10 years from first occupation.
- Were this approach adopted, the DCLG should add further impetus to ensuring its success by advising local authorities as to the benefits that 'market rented' housing can provide in their local market and how it can be used to fulfil their requirements in the NPPF to identify a supply of housing sites.
- We welcome the introduction of new REIT rules later in 2012. The development of residential REITs will encourage new investment in the sector. However, there are still some issues requiring clarification by Government, not least the tax distinction between trading and investment activity and the uncertainty around how it applies in the context of residential investment models.

APPENDIX 3

We would be delighted to discuss any of the issues raised in this response in more detail – please contact Sue Forster (sforster@ipf.org.uk, tel: 020 7194 7922) in the first instance.



John Cartwright

Chief Executive,
The Association of Real Estate Funds



Andrew Stanford

Residential Committee member,
British Property Federation



Sue Forster

Executive Director,
Investment Property Forum

APPENDIX 3

A3.2 Response to Montague Review



The Association of
Real Estate Funds



Department for Communities and Local Government

The combined response of:

The Association of Real Estate Funds (AREF)

British Property Federation (BPF)

Investment Property Forum (IPF)

March 2012

This response has been prepared by three of the leading UK property industry bodies; The Association of Real Estate Funds (AREF), the British Property Federation (BPF) and the Investment Property Forum (IPF). Whilst the Royal Institution of Chartered Surveyors (RICS), another leading UK property industry body, is not a signatory to this response because of its corporate communications policy not to make joint submissions, it has contributed to this letter and confirmed to us that it is broadly supportive of its contents.

We welcome the opportunity to comment on the call for evidence by Sir Adrian Montague.

Sir Adrian's terms of reference of the review are:

".... [To] build on this work and avoid re-visiting issues which have already been considered in detail – in particular through HM Treasury's 2009 consultation. [To] focus on the potential for investment in the private rented sector in current market conditions."

1. FUNDAMENTAL QUESTIONS

- Will the changes that Government has introduced go far enough to generate significant new flows of investment?

The two major changes are:

- The reduction in SDLT costs for the bulk purchase of properties.
- The introduction of new REIT rules later in 2012 that should encourage greater institutional investment in the residential and commercial property sectors.

The SDLT reduction is very welcome and will substantially reduce the costs of institutional investment in properties with an average price of £500,000 and below; in addition:

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- This helps provide a 'level playing field' with Buy to Let (BtL) investors who often purchase investment properties on an individual basis rather than on a bulk purchase basis; and
- Substantially reduces the costs of entering the residential sector for those investors more used to investing in the commercial property sector.

However, it is worth stressing that stability in the policy environment and confidence in it are two key considerations for institutional investors. We are still working through the full impact of the Budget changes to SDLT, and whilst the public profile of these is to rightly stop tax evasion, it is becoming increasingly apparent that the substance will impact on wholly legitimate corporate and other institutional vehicles who are not just investing in top-end property. It is not clear, for example, whether the SDLT rules on six or more units being treated as a 'commercial' transaction have survived the current legislative drafting. More generally, measures meant to focus in on well-off individuals could have the effect of discouraging overseas institutions, such as pension funds, from investing in UK housing.

The new REIT rules are also welcome as they offer investors greater opportunity to invest in a tax transparent vehicle; but the success of these new rules for residential investors depend on a range of factors, most significantly, the need to create potential residential REITs from scratch. There are some signs that such vehicles will be promoted but there are significant challenges because it is extremely difficult to attract capital for a 'blind pool' REIT without a compelling track record.

It would be helpful if HMT would clarify the rules on 'trading' as managers and investors require more clarity as to whether this activity would jeopardise REIT status (see also previous Property Industry Alliance (PIA) submissions on REITs).

The announcement on the chance to facilitate social housing REITs in the Budget is also very welcome. There is considerable scope for institutional investors to invest in social housing attracted by well secured, index-linked, income streams. However, to date, most housing associations have not engaged with institutions effectively to attract private equity capital.

- **And, if not, what can be done to accelerate things?**

Although expansion of the private rented sector (PRS) has been strong over the past decade this expansion has not contributed significantly to housing supply. With no expenditure on Government's part, institutional investment in market rented homes could be making a significant contribution to housing supply and growth. The key measure, which DCLG should introduce to support the development of a large-scale PRS, boost housing supply and economic growth, is to encourage explicitly 'Build for Rent'. We believe this is the only way to realise large-scale projects designed for renting, with the associated economies of scale, in a market where the development industry is entrenched in the provision of dwellings for sale.

This is best achieved using S.106 agreements to treat 'market rent'¹ dwellings as affordable housing through a covenant that all units on a development will be rented for a minimum period of 10 years from first occupation.² Contemporaneously, Local Planning Authorities need to be advised by DCLG of the benefits that

¹ We believe that 'market rent' is a useful term of art for properties let on ASTs to distinguish them from older forms of tenure that fall within the PRS.

² This approach has been adopted successfully for a project in Birmingham.

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market rented housing can provide in their local market and how it can be used to fulfil their requirements in the NPPF to identify a supply of housing sites.³ Research by Hometrack demonstrates that 80% of tenants in the PRS could not afford to buy the unit they rent, emphasising the intermediate status of market rented stock and the contribution it can make to overall residential provision.

The minimum 10-year period is required to attract institutional investment into Build to Rent. It is quite possible that such stock will be rented for much longer but institutions will need the assurance of potential sales value into the owner-occupied market to provide an exit value to justify the investment.

Analysis of NHBC data shows a pipeline of 300,000 units yet to be built, which reflects the stock of house builders' land banks. The planning pipeline for all residential consents and applications will be larger still. A Build for Rent model would provide another option for owners of these sites and so speed up new construction.

There are also ways to accelerate investment via Registered Providers. This would be greatly assisted by changing the designation of the existing historic Social Housing grant that sits on the balance sheets of Registered Providers in order to create the headroom to release equity into the institutional markets. It is estimated that this would attract around £25 billion of equity funding across at least three tranches and deliver around 160,000 new affordable houses over a 10-15 year period without the need for Government to issue any further grant.

2. SPECIFIC QUESTIONS RAISED

- **What evidence is there about the ability of the private rented sector to respond to future demand, and the impact of this on labour markets and growth? Is there a market failure?**

- **The ability of the private rented sector (PRS) to respond**

The PRS accommodated 2 million households in 1999; this increased to 3.35 million by 2009/10. This is unusual for a developed economy where the PRS is usually static or in decline (see LSE report referred to below on page 7). The biggest response to the demand for rented properties has come from the BtL sector of private direct investors. In 2001, the Council of Mortgage Lenders reports that there were 73,000 BtL mortgages; its latest figure is 1.3 million, a 27% compound annual growth rate, that suggests modern BtL landlords own a third to one half of the current PRS. In 2011, 84,000 properties were purchased using a BtL mortgage, compared to 93,000 bought at the height of the market in 3Q2007, so this market continues to be active.

³ There are a number of examples where LPAs have adopted proactive strategies towards 'market renting', e.g. 'Invest to Rent - A guide to developing partnership investment in new private rented homes for Londoners' BPF & London Councils 2010

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Private investors are more confident about investing in PRS properties than in most other investment sectors. This attraction may be based on four factors:

- **Lack of trust in other financial products** – The Equitable Life and Northern Rock’s problems have made investors more cautious and many see ‘bricks & mortar’ as the best form of saving for their future.
- **The tax advantages** – The costs of maintaining the property, the interest costs of a BtL mortgage and the costs of letting and management (plus associated VAT) are all deducted, before the remaining income is subject to Schedule A tax.
- **The leverage advantage** – BtL property is one of very few personal investments that individuals can leverage on an interest-only basis, as can be seen by the extraordinary growth in BtL lending.
- **Lack of regulated investment vehicles that invest in the PRS** – The fund management sector has never been provided with a tax transparent investment vehicle that could compete with the tax and leverage advantages of the BtL sector.
 - **Impact on labour markets and growth**
The benefits to labour mobility of flexible housing provision are well recognised in academic research – see, for example, Lux & Sunega (2012).⁴ UK specific research on this topic is generally dated being analysis of the effects of the ‘Right to Buy’ in 1981, e.g. Bover et al. (1988)⁵ and the work of Professor Forrest, University of Bristol in the 1990s. More recent analysis was published by ONS in Labour Market Trends.⁶

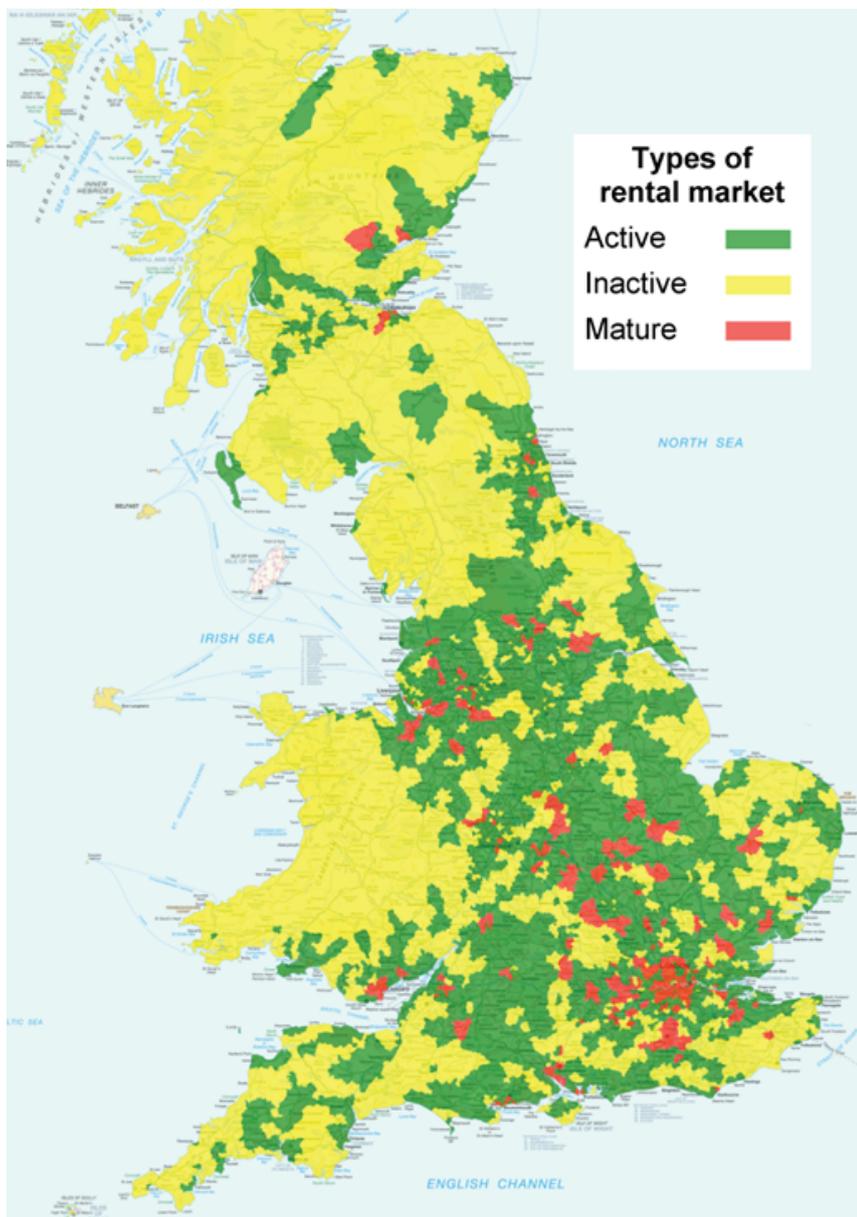
⁴ Lux, M & Sunega, P (2012) ‘Labour Mobility and Housing – The impact of housing tenure and housing affordability in the Czech Republic’ Urban Studies Vol 49 No 3 pp 489–504

⁵ Bover, O Muellbauer, J & Murphy, A (1988) ‘Housing, Wages and UK Labour Mobility’ Discussion paper 268, Centre for Economic Policy Research

⁶ ‘Housing Tenure and the Labour Market’ October 2002 pp523–534

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Figure A3.1: UK Rental Market Segmentation



Source: Hometrack

A vibrant privately rented stock promotes labour mobility. 62% of moves in the latest English Housing Survey were to rented accommodation yet the PRS comprises only 16% of the stock.⁷ Moreover, it is noticeable that the strongest PRS markets are associated with the UK's main employment centres, i.e. London, Manchester, Bristol etc. (see Figure A3.1). Hometrack identify 29% of the PRS stock as being located in 'mature' markets where the risk of voids is low and rental levels are well established, while 38% is located in mainly rural areas they classify as 'inactive' where void risks are much greater.

⁷ English Housing Survey: Household Report 2009/10, DCLG, July 2011

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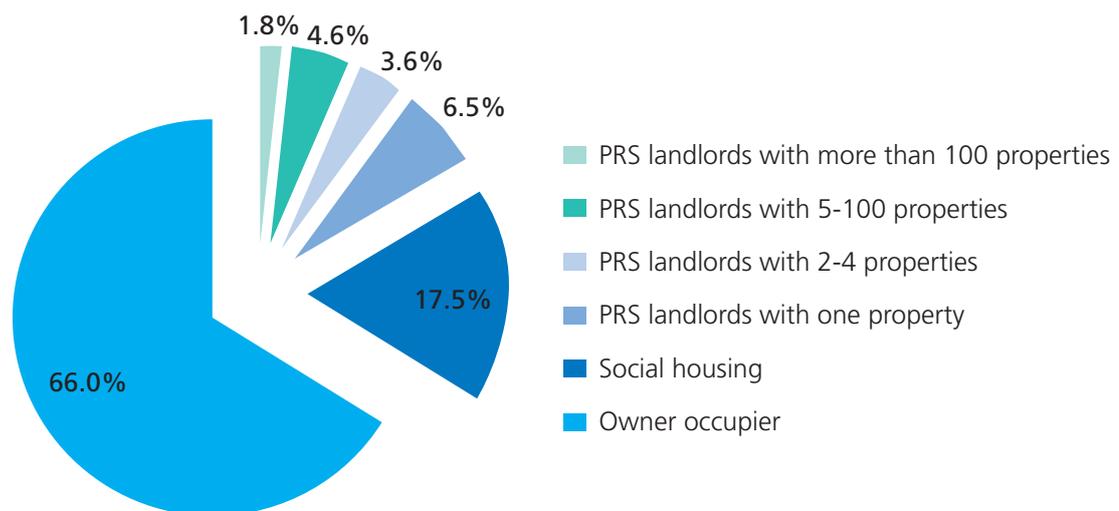
The provision of quality rented accommodation is especially important for attracting international businesses and housing availability is a significant component of global Cost of Living indices designed to help multi-nationals with location decisions, e.g. Mercers Worldwide Cost of Living 2011 survey.⁸

- **Is there a market failure?**

In one sense there is no market failure, as individual BtL investors have clearly responded to the demand for rental properties, particularly since 1997 when the new Government made it clear it wanted a vibrant market rented sector and did not change the assured shorthold tenancy (AST) rules.

However, there is a market failure in respect of the provision of accommodation specifically designed for market renting so that economies of scale can be captured. Moreover, large landlords (whether institutional or private) own remarkably little of the PRS (see Figure A3.2).

Figure A3.2: Distribution of Ownership for UK Housing Stock



Source: DCLG, Private Landlords Survey 2010

Stock designed for market renting has a number of specific features, inter alia:

- Communal heating services to avoid the need for individual, annual boiler checks and for more efficient maintenance; and
- Built-in durability as the 'market rent' sector largely now lets un-furnished; as tenants move more often than owners, this requires better protection to doors and corners in particular, as well as goods lifts in the larger blocks to facilitate regular moves.

Properties like this are not currently built because all dwellings constructed are expected to be sold to owner-occupiers.

⁸ <http://www.imercer.com/content/costoflivingpr.aspx>

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This market failure is exacerbated by VAT. VAT is a material cost especially to large residential landlords because it is not recoverable as input tax as is the case with most commercial property investments. This reduces the net income by around 7.5%. Many private BtL owners self manage their assets so they do not incur VAT on those costs. Net income is a key metric for institutions (see below) and a reduction in VAT to 5% on repairs, maintenance, letting and management would have a material affect on the return profile.

Management standards in the 'market rented' sector are generally much better than popular myth suggests. Reforms like the Tenancy Deposit Scheme have helped this. However, these changes increase law-abiding landlords' costs. We would like to see a scheme whereby landlords who adhere to high standards are rewarded by, for example, a tax break like VAT relief. This could also encourage institutional investment because it should reduce reputational risk issues in the sector.

- **How does this compare to other countries?**

We refer the Review Panel to a 2011 study by the LSE entitled *'Towards a sustainable private rented sector: The lessons from other countries'*.⁹ While we do not agree with all the report's conclusions, it does provide a comprehensive review of the situation in other countries.

The report analyses experiences in Germany, the Netherlands, USA, Denmark and Ireland in detail, while also reviewing other markets like Australia and Switzerland. One of its key findings is that institutions are not the main owners of privately rented stock outside of Switzerland and that private landlords play an important role everywhere.

The authors' conclusions are slightly negative to the UK PRS in that they view it as driven by "'push' factors... [which]... do not suggest that private renting is a tenure of choice."¹⁰ We believe this to be an out-dated view as there is now a material part of the population who appreciate the tenure's flexibility and not having a large debt secured against an asset whose price can be volatile. Moreover the authors are not especially supportive of institutional investment in the sector.

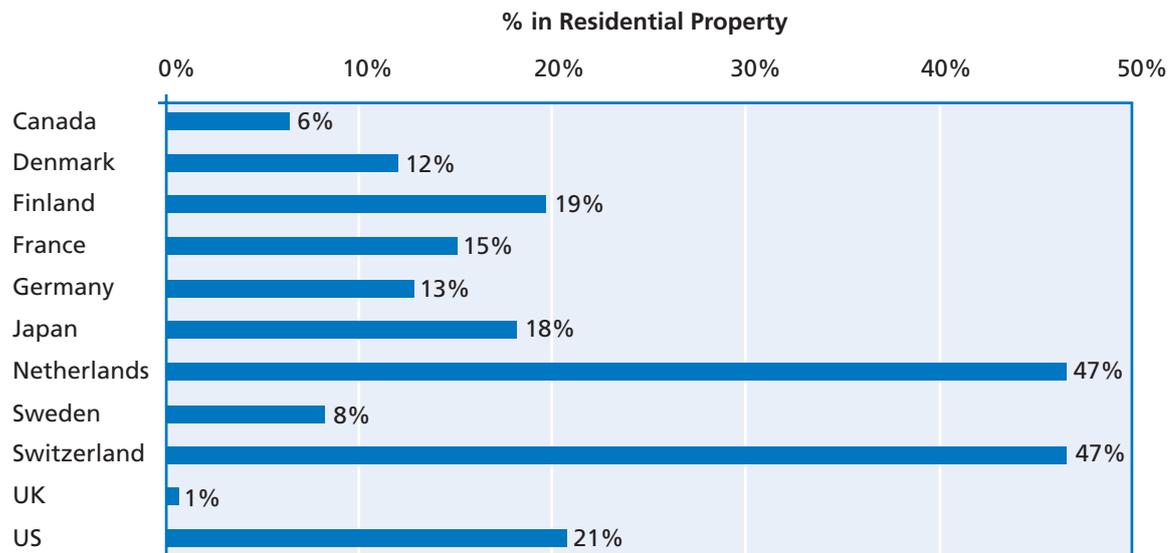
Notwithstanding, the scale of UK institutional ownership of residential property is still very low by international standards (see Figure A3.3). While each national market has its own particularities which affect the level of local institutional investment, it is reasonable to believe that UK institutions should hold much more residential property than at present.

⁹ www2.lse.ac.uk/geographyAndEnvironment/research/.../Book.pdf

¹⁰ Ibid p 139

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Figure A3.3: Exposure to Residential in Institutional Property Portfolios



Sources: IPD, KTI 2010

- **What interest is there among institutional investors for long-term investment in housing?**

There *is* interest among institutional investors to invest in the sector long term. The IPF has recently carried out a telephone survey of pension funds, insurance companies, institutional managers and REITs (during February and March 2012). While the full results will not be available until after 30 March, the preliminary indications are that over 60% of the respondents anticipate investing in the PRS, either directly or indirectly, within the next three years. The main barriers to investment identified in this survey are the difficulty of investing in sufficient scale and the low net income yield. Management challenges are also perceived to be a significant issue.

The Build to Rent idea (which was suggested by some respondents) should enhance the net yield because land prices would adjust to provide deal economics that are acceptable to the final owner. Build to Rent could have a number of extra useful benefits that support other DCLG policy, for example, in the re-use of redundant office buildings and in promoting the revitalisation of High Streets consistent with the Portas Review.

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- **What are the characteristics of housing investment which might attract (or deter) institutional investors?**

- An attraction is the sector's relatively low volatility and correlation compared to other UK asset classes.
- For pension funds, in particular, holding an asset whose capital value rises more in line with real average earnings is an excellent match for liabilities. Investors in large-scale portfolios can benefit from reduced operating overheads and investing in a larger number of locations.
- Institutions are deterred by the lack of a Build to Rent option in the planning regime. This option could lead to reduced build costs and improved use of space and so enhance that crucial net income yield.
- Institutions are deterred by the inability to buy sizeable portfolios, by many of the management tasks that can rarely be carried out in-house and, in some cases, by reputation risk.
- Many commercial property investors expect most of their total return to come from income, not capital appreciation. With UK residential, net income only provides about one third of the total return with capital appreciation delivering the balance.

- **What has been the experience of those who are developing new models for investment in the sector?**

New models have failed to attract investor interest, largely because it has proved very difficult to create teams with all the relevant skills, especially proven PRS management expertise, in combination with existing assets, so that investors are not required to commit to a 'blind pool'.

It is also apparent that foreign institutional investors, with good experience of the residential sector in their domestic market, are interested in investing in the UK. However, they have been put off from investing in vehicles by the absence of local institutional partners. This suggests to us that it should not take much to start a band-wagon effect, given the reluctance of most institutions to be pioneers. If the proportion of residential in the IPD All Property Index increases to 5%, some investors without exposure will enter the market to match the benchmark weightings.

- **What can we learn from large-scale investment in student housing?**

The student housing market has seen considerable institutional investment over recent years and the market has emerged to being a niche commercial asset class with an attractive return profile. In general, institutional investors do not view this sector as a proxy for residential investment although there are some similarities with market rented residential property as the student housing market has an imbalance between supply and demand as well as a mixture of good and poorer quality, aged supply.

One key difference between student housing and the market rented sector is the net yield, which for the former averages 5-6% and is more in line with commercial property. Other attractions of investing in student lets are the opportunities for rent guarantees or nominations agreements from universities to enhance secure, long-term cash flows.

Asset management and stock transfer opportunities create the potential to expand the supply of institutional ownership through means other than new build.

Finally in most cases, student housing does not have a C3 residential use class and this means that for planning purposes it does not have to deliver affordable housing requirements. Thus many schemes have come forward in recent years that have delivered better land value economics than private housing for sale or rent.

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We estimate that UK institutions have invested circa £1.75 billion, in student housing in the last 10 years through both direct ownership and private funds managed by the likes of Unite, Cordea Savills, Quintain and Aviva. We expect this investment to continue to increase.

- **What drives current landlords' business plans – costs, income, risks, long-term strategies?**
 - Investing in the residential sector requires a long-term business plan and a close understanding of local demand/supply characteristics in each market.
 - Rental income and rental growth is driven by a number of factors, including the type of properties local renters require, local employment growth, nearby local and national transport infrastructure and the easy accessibility of local shops and services.
 - Property repairs and maintenance are the responsibility of the landlord in the residential sector; having large portfolios in local markets can help control costs.
- **How has the sector responded to the changing profile, expectations and aspirations of those who rent?**
 - Thirty years ago people generally rented furnished accommodation for a relatively short period before trying to buy their own property; they made few demands on their landlords and this led to low standards in the sector.
 - Twenty years ago, initially in London and later in many other UK towns and cities, market tenants started to rent for longer periods and this led to increasing demand for un-furnished properties. Tenants gradually became much more demanding about the quality of rented property, the locations and the willingness of their landlord to deal quickly with repairs and maintenance issues.
 - From 2001 to 2007, BtL investors purchased new properties off-plan from house builders to rent in the PRS. This led to a further improvement in the quality and availability of rental homes, but the eventual over-supply of flats in 2007 in some provincial centres, has since left a number of investors with very poor returns in many parts of the UK.
 - The Tenant Deposit Scheme has been a considerable success, improving the repayment of deposits but at an increasing cost to landlords; this has helped to improve the standing of the sector amongst the increasing number of tenants.
 - Tenants have strong tenancy rights and landlords have had to balance their voids concerns against the risks of a tenant failing to pay their rent; landlords prefer long-term tenants, with good payment records and who treat the property as their home. Consequently good landlords have focused on providing high levels of customer service to encourage their tenants to behave likewise. Tenants with poor reputations or poor payment records are finding it increasingly hard to rent in a market where demand outstrips supply; as a result they are reliant on the social housing sector for accommodation.

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Conclusions

We believe that Government is close to creating an environment that will promote significantly more institutional investment in 'market rented' residential. The changes to SDLT and the REIT rules are very helpful.

The enabling of Build to Rent through use of S.106 agreements, in substitution for affordable housing requirements, has the potential both to increase the stock of the PRS, which should promote labour mobility, and increase the overall housing stock which remains chronically under-supplied. Moreover this change can be effected at negligible cost to Government.

Institutional Attitudes to Investment in UK Residential Property

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