Chapter 5

A home for institutional capital?

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The government has placed the provision of new housing firmly at the centre of its policy objectives, but without significant institutional investment this goal may be unattainable. Looking at the historical performance of the residential sector produces two clear-cut arguments for institutions to hold a significant proportion of their assets in housing. Firstly, UK residential investments have yielded a stronger and more stable performance than both equities and gilts; and secondly, within a multi-asset portfolio residential investments have provided significant diversification benefits, because of their low correlation with UK equities and gilts.

This chapter takes a closer look at the reasons behind low levels of institutional investment in the UK and suggests some practical ways forward for government, including changes to planning, taxation and lease structures. The sector itself, however, also has a role to play in encouraging investors and must deliver a more sensible mix of housing types for rent and encourage more professional management operations.

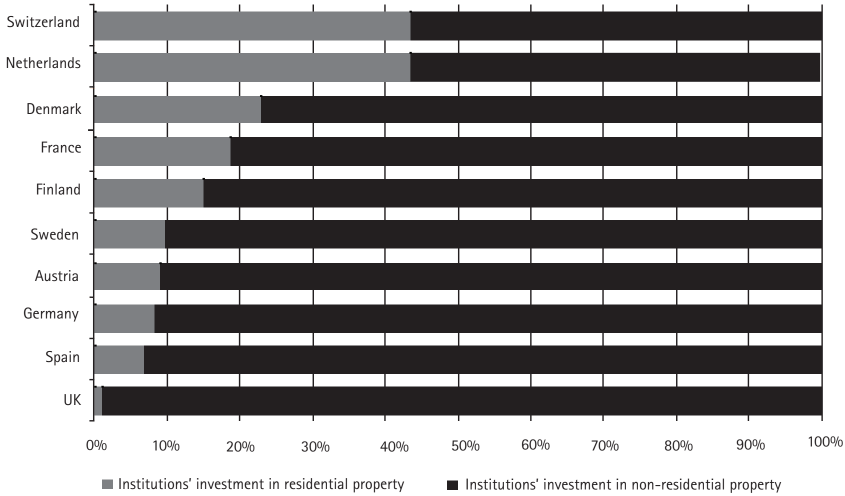
Barriers to investment

British institutions invest a significantly smaller proportion of their property portfolios in housing than their European counterparts. There are a number of reasons for the apparent ambivalence of UK institutions towards residential investment. Historical experience of over-regulation, reputational risk and, until fairly recently, a general trend in asset allocation away from property are all key factors in determining where institutional portfolios are today.

This trend is now beginning to change, with institutional investment in residential property having gradually risen over the last decade. Institutions, however, appear to have focused the majority of their attention on those residential investments with many of the characteristics of commercial property investments – those with long leases, strong covenants and fixed uplifts, such as student accommodation and retirement homes.

Conversely, private investors have embraced residential investment like never before, through the buy-to-let market. Rather than investing through an independent financial adviser in managed funds, which are often heavily weighted to equities, a large number of private investors have opted to put their money directly into the residential sector. This growth of the buy-to-let market has been matched by the subsequent returns that private investors have received on these highly geared investments, with prices having doubled on average over the last seven years. The average buy-to-let investor will have seen their equity more than quadruple. While this has been a strong growth area for private investors, institutions have not followed suit, owing to a number of barriers to large-scale investment – some of which are real and some of which are perceived.

Figure 1: European property holdings by institutions, 2006



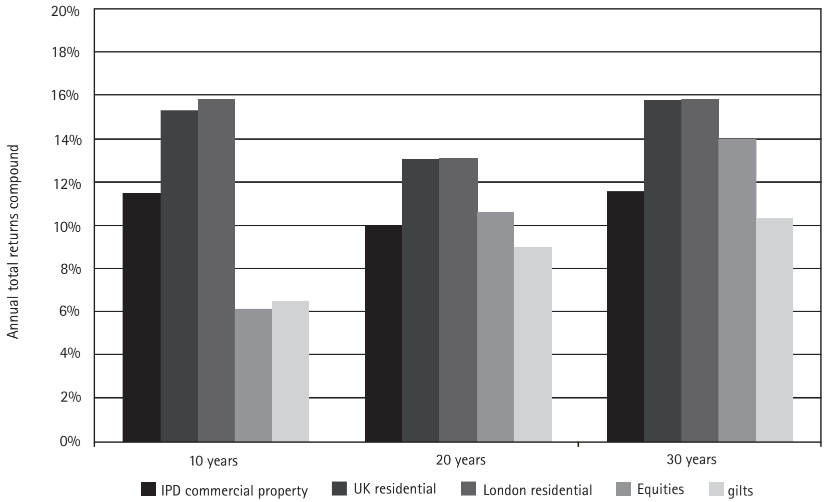
Source: Savills, IPD

One very real deterrent to greater levels of institutional investment in the residential sector has been the sharp increase in the taxation burden that the property industry has borne over the past decade. In this respect, institutional investors are penalised in terms of both higher levels of stamp duty than individuals (due to the larger lot sizes) and their inability to reclaim VAT on repairs. One method of encouraging institutions to invest in the residential sector is to grant exemption or reduce the rate of stamp duty paid on privately rented properties, and enable investors to reclaim any VAT incurred on the management of their rented properties. A potential solution is to charge stamp duty at an individual property level, rather than a portfolio level. This would level the playing field between private buy-to-let purchasers, who typically acquire one property.

Another important barrier to residential investment often cited by institutions is the fragmented nature of the market and the relatively small lot size of individual investments.

For larger institutional investors, the average lot size of their property acquisitions has increased steadily over the last two decades to more than £10 million. With the vast majority of developments built for owner-occupation, there are relatively few potential investment opportunities that meet these lot size criteria.

Figure 2: Investment performance by different asset class to end-2007



Source: Savills, IPD, Thomson Datastream

While this may seem a relatively banal reason for not investing, the rationale of gaining economies of scale is a strong one. The amount of management time expended on a single, £10 million office block, let on a long, full repairing and insuring lease to a substantial corporation, is far lower than the management costs incurred from running 50 flats let to individuals on short leases where the landlord is responsible for repairs and insurance. Any solution to encourage institutional investment in the private rented sector must address the problem of the lack of investable stock through changes in the planning system or economics of development.

Barriers to building

The planning system in the UK is a significant drawback to the provision of a sufficient number of new dwellings to meet demand. It is encouraging to see that the government is trying to address a number of deficiencies in the planning process by seeking to speed up approvals and loosen supply. To date, however, this has largely been focused on the social and owner-occupation markets, with little or no thought given to the role that the private rented sector can play.

This may change over the next few years, as the government finally recognises that the private rented sector – and especially the buy-to-let market – has a positive role to play in increasing the provision of housing, rather than crowding out owner-occupiers. Recent reports by London Residential Research and the South East England Regional Assembly have concluded that the number of new homes developed has increased as a result of buy-to-let investors underpinning the economic viability of development projects.

Over the next few years, higher interest rates and weaker house price growth are likely to reduce the supply of new homes through lower buy-to-let and owner-occupier demand. This may provide the ideal opportunity for institutions to enter the investment market, should the apparent barriers to investment be overcome.

In investment terms, the residential property market is very different from the commercial. In the residential market, values are determined separately from current and future cash flows, whereas in the commercial market the cash flow determines the value of the investment. This is the result of the dominance of owner-occupiers, rather than investors, determining the value of homes. Many institutional investors regard this as an additional risk to residential investment.

Probably the biggest barrier to increasing the supply of new homes, however, is the onerous burden of social housing and section 106 costs. With developers in London forced to provide up to 50% of new homes at low- or zero-profit social housing, the risk premium or profitability on the private housing must commensurately increase. A key issue here is that the private rented sector is not differentiated from the owner-occupied sector when considering planning gain or the provision of social housing.

Practical ways forward

There are two possible routes to increasing the provision of privately rented accommodation: either a planning use class for privately rented accommodation (with a greatly reduced social housing component, or none at all) or a licensing scheme whereby a development would be licensed to be privately rented for a number of years, after which time the developer or owner could realise a significant reversion to full open market value.

The latter was a key recommendation of a recent study undertaken by Savills for the British Property Federation and the Greater London Authority. The report identified that a designated planning use class would have negative long-term effects on the housing market and would in effect create another tenure with similar characteristics to social housing, in that the reversionary value of the investment would be removed. Therefore a licensing system, negotiated through the section 106 regime, was the recommended way forward. This approach would meet both the government's objectives of increasing supply and institutional investors' objectives of providing an asset class that is priced more closely to the cash flow derived from the investment with a reversion to full market value.

In addition to potential changes to the planning system, more thought should be given to the type of property being built. UK house builders currently have a less than enviable reputation for the quality of their buildings. That said, they are acting entirely rationally, building a product for very short-term gain – sale to owner-occupiers. The product delivery is entirely focused on the desirability of individual units to individual owner-occupiers, rather than the efficient functionality of the entire development – something which an investor may favour.

There are a number of possible solutions to this: increase the National House-Building Council guarantee period to 25 years rather than the present 10 years; tighten building regulations; and raise enforcement levels closer to those in Continental Europe. This may encourage the development of more robust and efficient developments, designed and built to be run as a single entity. Before any significant change in the functional design can occur, however, demand must exist from large-scale investors for the product, which again raises the concept of licensing or a planning use class.

On its own, a new use class or licensing system is unlikely to kick-start the market, as institutions are unlikely to direct a significant proportion of their investments towards a new and untried asset class. What will be needed is an injection of significant capital. Outside of public subsidy, the only place that this can come from is existing investors in the buy-to-let market. In order to tempt these investors away from direct ownership, some form of tax-efficient transfer of their existing assets into a pooled institutional investment structure is likely to be necessary.

The government may indirectly be encouraging private investors into pooled professional investment structures through increased regulation, such as licensing for houses in multiple occupation, the tenancy deposit scheme and requirements for annual gas safety certificates (the absence of which is a criminal, not civil, offence). Many private investors, however, are oblivious or unaware of both the regulatory and financial risks they are running within their often highly geared portfolios. In practice, these burdens fall on large professional residential landlords, who fail to avoid the onerous legislation aimed at the smaller landlord.

One area in which institutional investment has flourished in the residential sector is where the investment has been transformed into something that looks like a commercial investment. The provision of longer leases to stronger financial covenants has been a key factor underpinning the development of institutional investment in the student accommodation market. This model can easily be transferred to other parts of the residential market through social and intermediate PFI housing, where the rental cash flow is either wholly or partially underwritten by government or quasi-governmental institutions.

Alternatively, the development of a wider range of intermediate landlords, who stand between the property owner and individual occupiers, could be encouraged. These already exist in the serviced apartment sector, so why should there not be similar intermediate landlords specialising in the delivery of mainstream private rented properties, or even providing intermediate or social housing? These types of investment would be immediately attractive to institutional investors and valued on the same basis as the commercial investments with which they are already familiar.

In addition, the separation of ownership and management would overcome a number of the most commonly highlighted issues for institutional investors – the high burden and cost of management, the relatively low level of net income yield, and the lack of specialist professional managers.

That said, there may not be enough profit on the table to make this type of structure attractive outside the serviced apartment and student accommodation market.

This is, nevertheless, unlikely to go the whole way towards encouraging institutional investment in the private rented sector. Institutional investors have become increasingly focused on income-generating assets. On a risk-adjusted basis, an asset class that has weaker tenants and shorter leases than the commercial market might be expected to produce premium levels of income return. The income return, however, is only half of the total return equation, a factor that buy-to-let investors have fully embraced.

Conclusion

The greatest danger to continued institutional investment in the residential sector may be too much change, too rapidly. Too great an increase in the provision of new accommodation could result in oversupply and falls in values and rents, which could set back residential investment another 20 years. The ideal scenario would be one of reasonable growth of the sector on the back of significant improvements in the attraction of the private rented sector to institutions through changes to planning, taxation and lease structures. The sector itself must deliver a sensible mix of housing types for rent and encourage the development of more professional management operations. In addition to this, the broad population will need to be encouraged to adopt a more favourable view of living in flats, closer to that held across most other EU countries.