

Investing in residential property

A British Property Federation guide for asset allocators

Acknowledgements

We are grateful to the following for all their contributions and assistance in compiling this guide:

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Andy Leahy, Bespoke Property Group
Andrew Moffat, Pramerica Real Estate Investors
Duncan Salvesen, Dorrington
David Toplas, Mill Group
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Mark Weedon, Investment Property Databank
Paul Winstanley, Allsop
Mike Wisgard, Mill Group
Andrew Yates, Berwin Leighton Paisner

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Disclaimer

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Foreword

Her Majesty's Revenue and Customs (HMRC) figures show that financial institutions' and property companies' spending on UK residential assets is on an upward trend.¹

Increasing interest from institutions in residential property should come as no surprise, because whether looking over the short, medium or long-term, residential has delivered far better returns than the more traditional investment assets of stocks, gilts and commercial property. Over the past ten years the performance of UK residential property has far surpassed commercial property, with a total annualised return of 9.6%, versus 6.9%.²

Past performance can of course be no predictor of future performance, but against a backdrop of high occupier demand and a housing supply shortage that shows no immediate signs of abating, the economic fundamentals suggest UK residential property will continue to perform well for many years to come, and in a very uncertain world, expose the investor to less risk than many other asset classes.

The purpose of this guide is not to twist arms, but to inform by illustrating that the UK residential sector provides a greater range of opportunities than perhaps is often perceived, and that there is a growing infrastructure and body of expertise for organisations contemplating residential investment.

The residential sector already encompasses well-established recipients of pension and insurance funds – for example the ground rent and student accommodation sub-sectors, the latter also generating interest from private equity investors. Other parts of the sector, such as assisting home owners, and social housing investment, are only just starting to establish themselves, and sitting in the middle is the market rented sector.

What we have sought to do in this guide is to illustrate the key characteristics of different residential assets, using a market rented portfolio as a comparator to highlight their different facets, performance and risks.

We hope you find this publication informative and helpful.

Nick Ritblat

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President, British Property Federation (2007-08)

1 Based on HMRC figures as reported in the Financial Times, 23rd December 2011.

2 Investment Property Databank (IPD) results for the year to 31 December 2011 (see www.ipd.com).

Executive summary

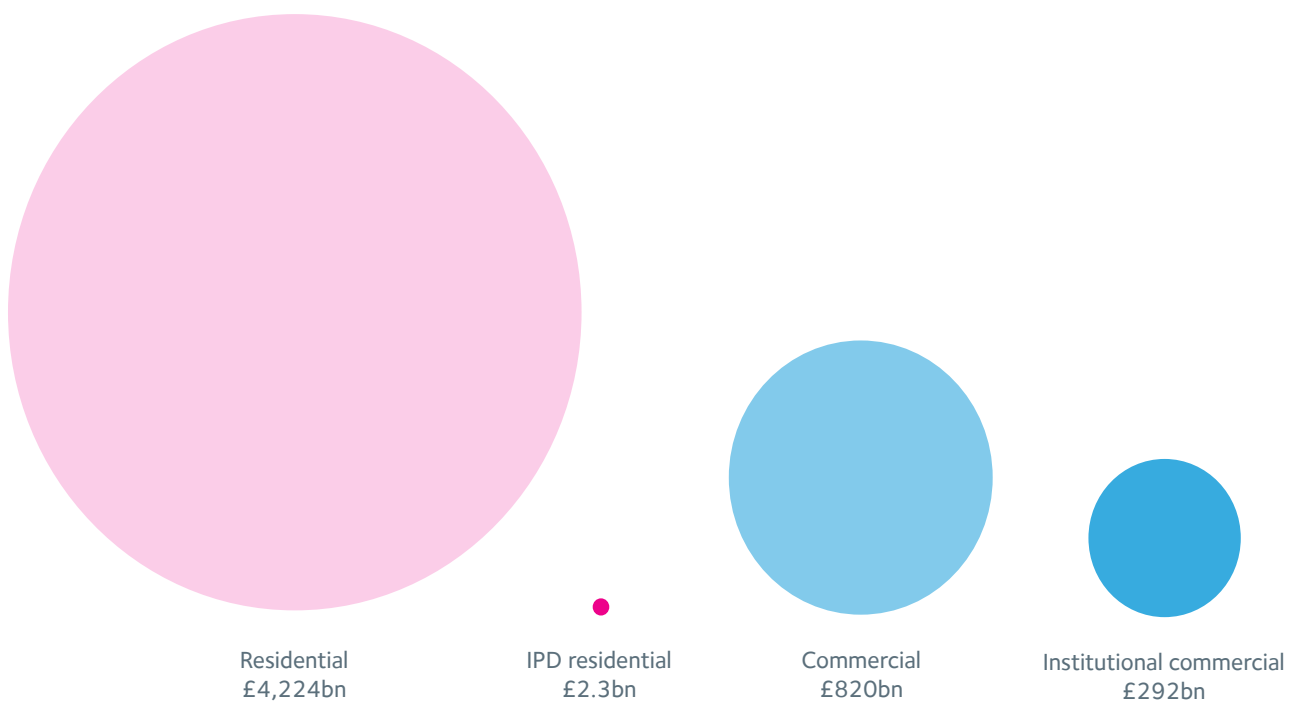
- 1 Residential property is the UK's largest investment asset class and on a total returns basis has been the best performing investment asset over most timeframes over the past thirty years.
- 2 There are very good reasons why institutional interest in the sector has been slight, but also why it is increasing. The economic fundamentals of housing supply and demand look out of kilter, and should help create demand for quality rented housing in many localities for the foreseeable future.
- 3 There is now also strong political support for institutions investing in residential, which has been in evidence recently, via the Montague Review of Housing Investment, on-going reform and proposed reform to Stamp Duty Land Tax (SDLT), institutional support from the likes of the Homes and Communities Agency (HCA), and more general direct aid to the development industry. In London, the Mayor is seeking to grow an institutional investment sector. There is unprecedented interest from local authorities, and developers, construction firms and housing associations, all looking to build-to-let.
- 4 Residential also regularly features in polls of institutional investors, with regard to where they believe more institutional money will be invested in the future.
- 5 Residential can aid portfolio diversification and the sector itself is far larger and more diverse than is perhaps often perceived. Traditional assets such as ground rents are only a small part of the investment market these days, with sectors such as purpose-built student accommodation and market renting well-established, and new sectors, such as social housing emerging, as well as various products to assist people into home ownership.
- 6 These different sub-sectors themselves have different characteristics. Part of this guide is devoted to these, and help to explain how they might be compared. Regional variations in performance can also produce very different returns in some sub-sectors.
- 7 As the sector grows, so does the infrastructure and expertise to support it. Residential is now part of the all-property IPD index, meaning institutional investors' overall performance is measured to take account of some institutional holding of the sector.
- 8 There is a plethora of organisations that can assist investors with their expertise in assessing investment opportunities, or on-going asset or property management.
- 9 Residential though, is not a passive investment. Returns can be enhanced through stock choice and location, good design, efficient management, and decisions taken over structures. There is a range of structures to use – Real Estate Investment Trusts (REITs), Property Authorised Investment Funds (PAIFS), unit trusts, property companies, joint ventures (JVs). This guide summarises briefly some of the major features of the attractiveness and appropriateness of each.
- 10 Residential also has its differences, which investors more used to commercial property investment need to understand. This guide provides a section on valuation issues, and understanding the differences with commercial. Understanding how voids and rent-free periods are treated is also essential when making comparisons with commercial property returns.

We hope this guide fills a void in helping to explain the residential investment sector.

Why residential: potential

The residential sector is far larger than any other asset class in the UK (c£4,224bn, according to chart 1). The commercial sector is worth about £820bn, of which about £292bn is held by institutional investors, REITs and companies. Institutions only have a very small exposure to residential property - for example, the IPD market let residential index only covers £2.3bn of residential assets.

Chart 1: Value of UK residential sector



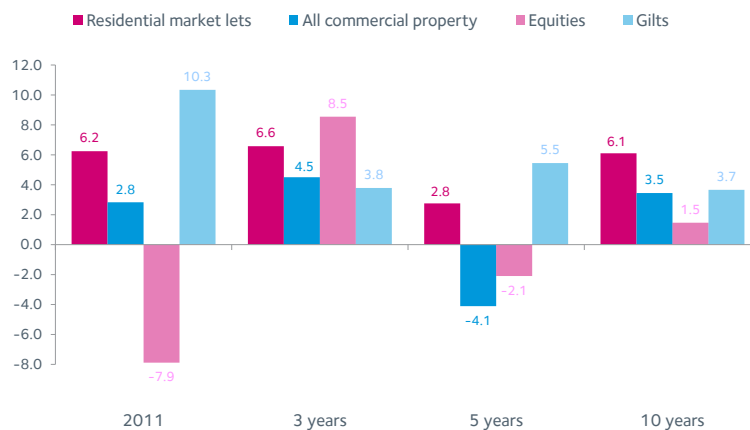
Source: Property Industry Alliance (PIA) Property Data Report 2012, and IPD (to scale).

Why residential: performance

Residential property delivers better long-term value growth than any other investment asset. On a total return basis, it has been the best performing investment asset over most time-frames in the past thirty years (chart 2), and residential also offers better returns for less risk (chart 3).

Chart 2: Inflation adjusted investment performance by asset class (10 years to end 2011)

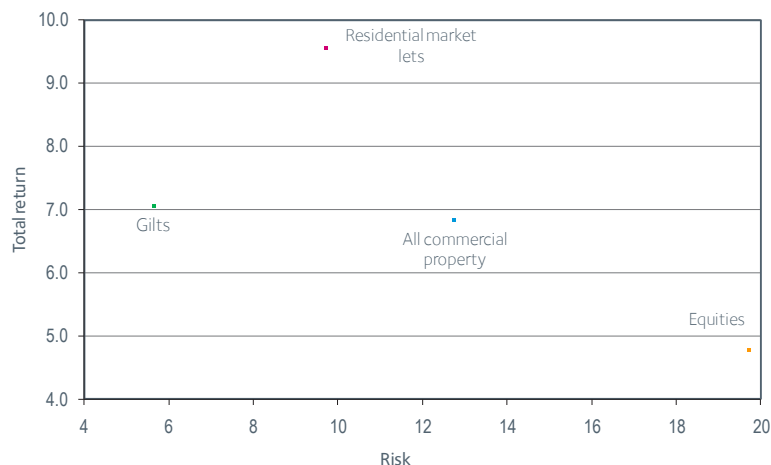
Retail Price Index (RPI) adjusted annualised total return – current, medium and long-term



Source: Office of National Statistics RPI Inflation, IPD residential index, IPD UK quarterly property index, FTSE all-share index, UK gilts index 5-15.

Chart 3: Risk reward spectrum: UK residential delivers higher total return at lower risk

Ten year total return vs standard deviation 2001-2011 (top right corner represents optimum profile)



Source: IPD residential index, IPD UK quarterly property index, FTSE all-share Index, UK gilts index 5-15.

Why residential: portfolio diversification

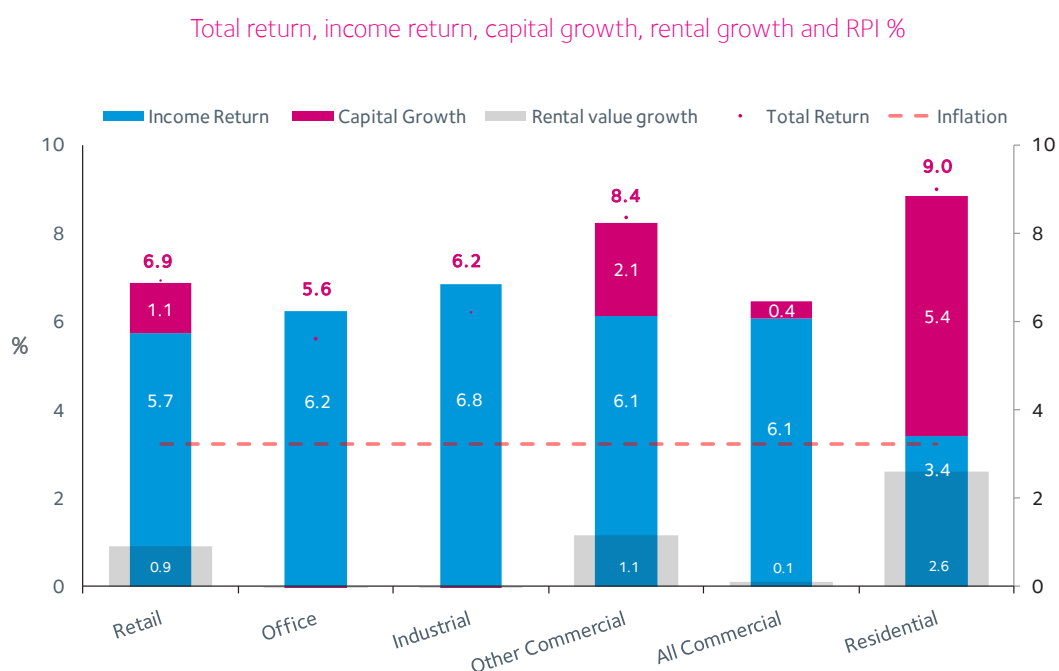
Institutional investors will be very familiar with commercial property investment. Residential investment has many similarities. There are also differences, but some that are exaggerated.

For example, residential is thought to be low yielding, but like most property investment it depends on the asset and how occupation is structured. As the rest of this guide will show, the diversity within the residential sector provides opportunities to have lower or higher yields, index linked returns, and high or low (but rarely negative) capital growth.

As an example, the student accommodation sector provides different levels of risk and return depending on how the deal is structured, with some providers letting direct to students, some having nomination agreements with universities and education providers, and some letting direct to universities and therefore drawing on a slightly lower return, but very little risk of voids.

One perception is that residential is necessarily low yielding because of high house price inflation, but yields vary significantly across the country, and rental value growth has been better in residential against commercial property over the past decade (see chart 4).

Chart 4: UK residential against commercial investment performance (10 years to June 2012)

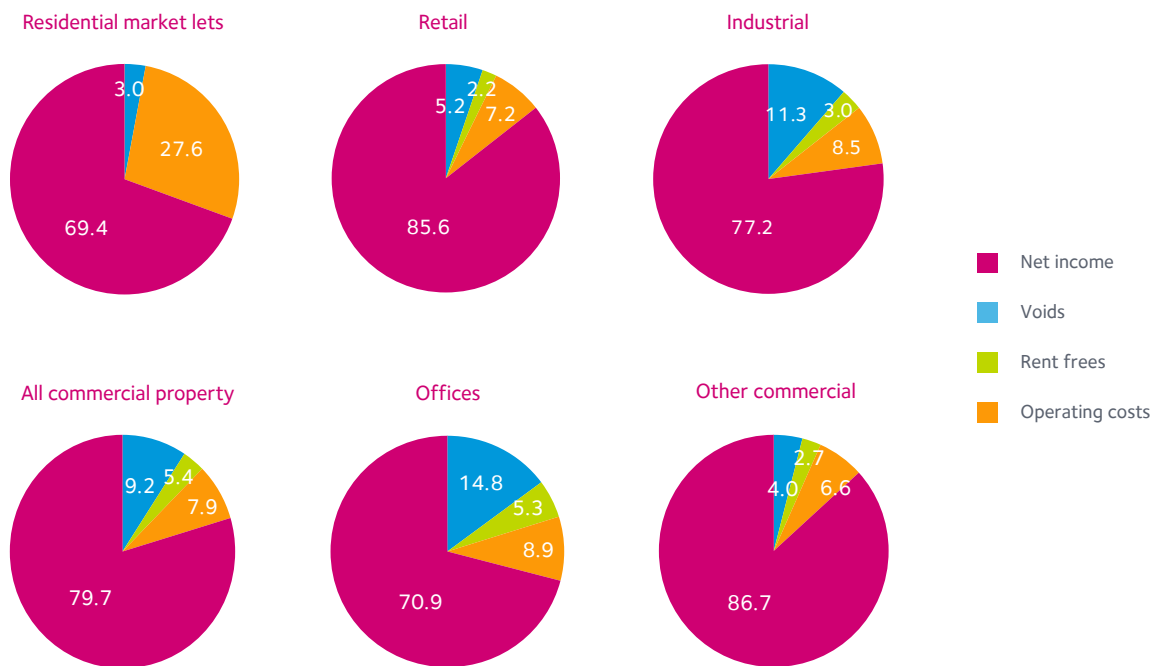


Source: IPD.

Another common belief is that there is a significant loss of income between gross and net in residential compared with commercial property (see chart 5). Comparisons, however, tend to fail to take account of long rent free periods in commercial and higher rates of voids. When both are accounted for the gross to net comparison shows less of a gap.

Chart 5: Property management efficiency by UK property sector in 2012

Percentage of gross income* lost to operating costs, voids and rent free periods in six months to June 2012



Source: IPD.

*Gross income= Maximum total income if all units fully let by paying tenants.

Why residential: future housing demand

Significant household growth and a lack of access to mortgages should ensure strong long-term demand for homes. Longevity, migration and higher birth-rates are projected to increase the UK population from 63m to 70m by 2021. London's population alone has grown by 600,000 over the past five years, and is predicted to expand by a further 1m people by 2021.³

Official projections suggest that the number of households in England will rise to at least 26m by 2026 – an increase of between 220,000 and 225,000 new households each year. Around 70% of these new households will be one person households.

When other requirements are added – for example, for second homes – an additional 242,000 dwellings will be required each year, comprising 145,000 market homes (60% of total); 30,000 intermediate homes (12%); and 67,000 social rented homes (28%). More than half of the required homes will be concentrated in four areas: London, south east, south west and east of England. Table 1 demonstrates the mix of tenures, sizes and price ranges that the demand needs to satisfy.

Table 1: 2008-based household projections for England, by household type (in thousands)

	2011	2016	2021	2026
Couple, no children	7,358	7,628	7,819	7,979
One child	1,607	1,617	1,627	1,589
Two children	1,727	1,677	1,673	1,645
Three or more children	812	805	830	847
All couple households	11,504	11,727	11,949	12,060
All lone parent households	1,811	2,035	2,292	2,495
One-person households	7,773	8,558	9,340	10,194
All other households	1,301	1,287	1,264	1,268
All households	22,389	23,608	24,843	26,016

Source: Department for Communities and Local Government (DCLG)

National House-Building Council (NHBC) statistics show, however, that there were just 113,340 housing completions in 2011, nearly 130,000 units shy of requirements. Also, the average age of a first time buyer is 33 years old and the average deposit required to buy a home, £26,000.⁴ Many of those new households with housing requirements are therefore not going to be able to access the property market using the traditional mortgage market route to first time home ownership. This will create demand for new investment in housing, whether in social or private renting, or investors assisting peoples' efforts to buy their own home.

Most growth in housing has come over the past decade from households seeking private rented sector accommodation. There were 1.8m more households private renting in 2010 than there were in 2000. Overall this has meant the private rented sector has grown from 10% to 17% of the housing market in a decade and one-in-five households are predicted to be private renters by 2020.⁵

3 Office of National Statistics, as reported in The Daily Mail, 29 September 2012.

4 Council of Mortgage Lenders (CML) statistics (see: <http://www.cml.org.uk/cml/publications/newsandviews/104/390>).

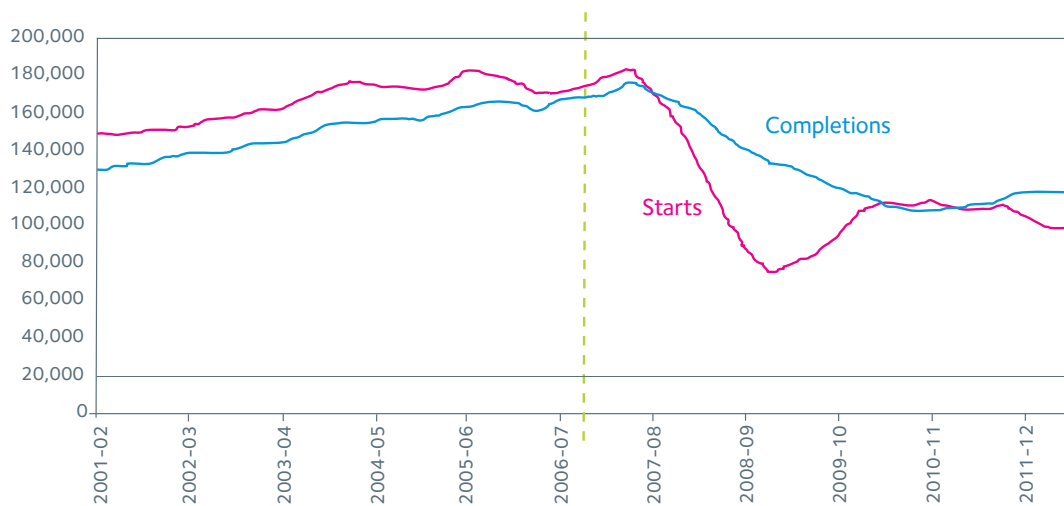
5 BSHF 2010, Tenure Trends in the UK: Will the Private Rented Sector Continue to Grow?

Why residential: future housing supply

Besides demand there is a congregation of different factors which make investing in residential property particularly relevant now.

As well as strong demand, housing supply is very low. House building starts and completions have been at historically low levels for several quarters, as highlighted by chart 6 below.

Chart 6: Trends in house building, England (12 month rolling average)

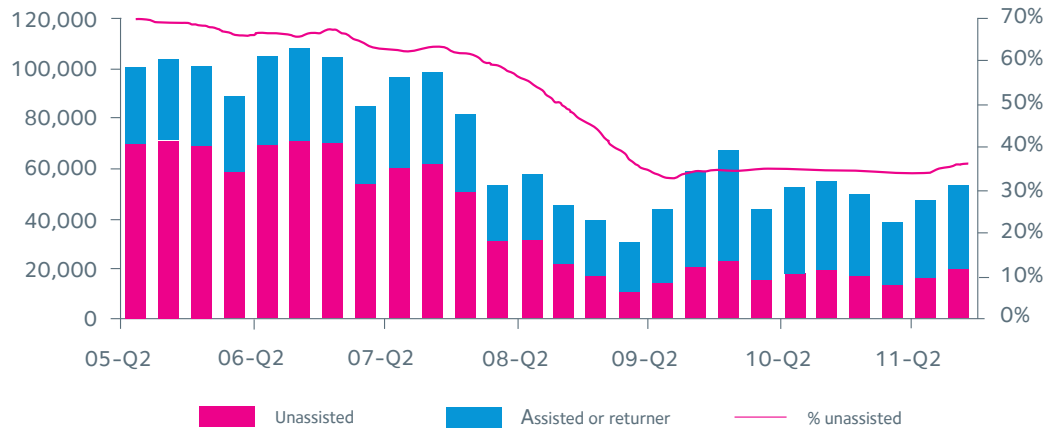


Source: DCLG.

Access to finance for first-time buyers remains hard to obtain. According to the CML the number of first-time buyers has declined from a long-term average of around 500,000 a year to just 200,000. Much of this reflects difficulties raising a sufficient deposit to access mortgage finance.

Currently, the average deposit for a first-time buyer is over £26,000. That represents 79% of the average annual income from which the mortgage is paid. The size of deposit has doubled since 2007, when it averaged around £13,000, or 37% of annual income (see chart 7, overleaf).

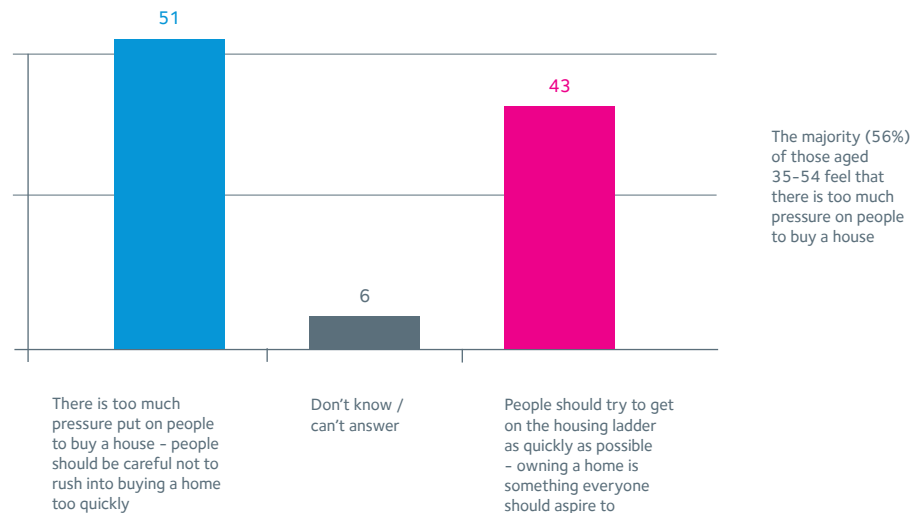
Chart 7: First-time buyers (numbers and proportion unassisted)



Source: CML Regulated Mortgage Survey.

People's attitudes are changing to renting. There is a large part of the population who want to own their home, but a growing part of the population that either want to rent, feel uncomfortable with buying in an uncertain climate, or simply cannot access owner occupation (see chart 8).

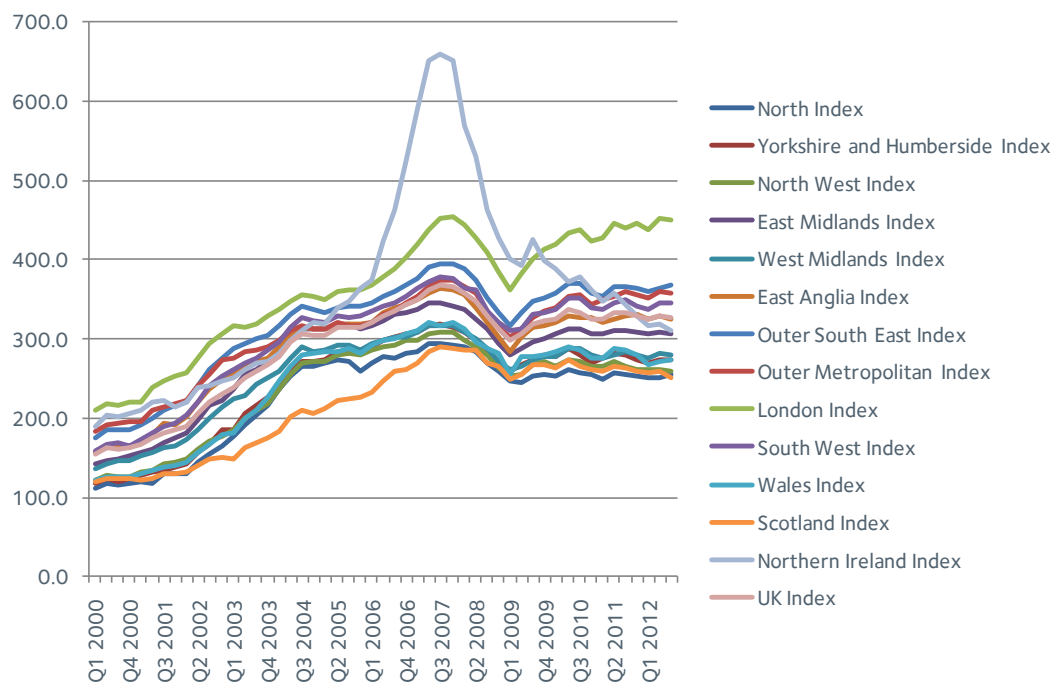
Chart 8: Buy or rent?



Source: Brunswick PR, survey of 2,220 people.⁶

House prices have softened in many local markets, meaning stock should be cheaper to obtain. House prices are generally off peak by 10-15% in most regions (see chart 9). The exceptions are Northern Ireland, which has seen prices drop by over 40%, and London, where prices have recovered back to peak.

Chart 9: House prices by region, Q1 1993 = 100



Source: Nationwide.

Why residential: political support

Residential investment has enjoyed a relatively benign political climate over the past 24 years. Since the 1988 Housing Act, successive Governments have supported a relatively light-touch regulatory regime and market-based system.

The current Government has made various policy reforms which seek to support investment in residential property, and is proactive in keeping the door open for further support if it will deliver more housing supply.

The Montague Review recommendations are currently being implemented by Government.⁷ As part of a package of support, £200m is being made available on an equity share or loan basis to construct units with the aim that these be held by institutions for market rent. A further £10bn of debt guarantees is being made available to provide cheap debt finance for the long-term holding of rental homes, both social and market rent.⁸

Many of the other recommendations of the review are work-in-progress, but seek to provide local authorities with the confidence to support a build-to-let market in their localities, and investors with a yield that will prove attractive.

The Montague Review group's other recommendations are:

- 1 Providing local authorities with specific guidance on the planning treatment of build-to-let developments, which clarifies that local authorities are able to take account of the different viability considerations of a long-term investor, with a reduced or zero affordable housing requirement, and to apply a planning condition to keep a development as 'market rental' for a period of 10 years plus.
- 2 Encouraging local authorities to make their land available for build-to-let developments, and that 'best value' considerations do not act as a barrier to this.
- 3 A task force of private sector expertise, which local authorities can call on where they are considering build-to-let, and want assistance with negotiations.
- 4 A kite mark, which gives local councils confidence that build-to-let developments will be managed well.

News on how these recommendations will be taken forward is expected to follow shortly.

7 Review of the barriers to institutional investment in private rented homes, August 2012 (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/15547/montague_review.pdf).
8 <https://www.gov.uk/government/news/next-steps-for-10-bn-housing-guarantees>.

Stamp duty land tax on bulk purchases of much residential property is now charged on the mean, rather than aggregate value of the purchase. This can lead to significant savings for investors where the conditions for the relief are met:

- A block of 30 flats bought for £6m, SDLT on the aggregate value would be 5% of £6m = £300,000
- A block of 30 flats bought for £6m, SDLT on the mean value would be 1% of £200,000 x 30 = £60,000
- SDLT on a commercial property valued at £6m would be 4% of £6m = £240,000

Reforms have also been made to the rules on REITs. These took effect from Finance Act 2012, and will make the REIT structure more attractive to large scale investors in residential property.

- 1 **Relaxing the listing requirement**, so that a new REIT can be listed on trading platforms such as AIM, Plus and their foreign equivalents.
- 2 **Giving a grace period**, so that a new REIT has a 3-year period to meet the condition that its shares be widely held (known as the 'non-close company' condition).
- 3 **Relaxing the non-close company condition**, so that the interests of certain institutional investors should not make a company close for REIT purposes.
- 4 **Abolishing the entry charge**, so new REITs will not have to pay 2% of the market value of assets at conversion.

For investors seeking to build-to-let, public land is being made available for development. This is being co-ordinated by the Government's agent for public land, the HCA, which has an enhanced role to act as the co-ordinator of land sales across central Government.

"We will support the development of new investment and management models through HCA-led pilots. The HCA has been investigating the potential for marketing sites specifically to include homes to rent. Schemes will be piloted in partnership with local authorities, investing HCA land in the development of new rental homes.

*The first scheme will be at Spencers Park in Hemel Hempstead. The land for rental homes will be put in as an equity investment on a deferred receipt basis. The inclusion of rental homes will also speed up on-site delivery. Following the marketing of the Spencers Park site, further sites will be announced."*⁹

For housing developers there is also broader support.

- 1 **Build Now Pay Later** gives builders access to public sector land, which they only pay for once the homes are built.¹⁰
- 2 **Get Britain Building** is a £570m fund that is aimed at building firms who are finding it difficult to raise funding for stalled sites. The Government will inject its funds as investment capital rather than grant funding. A second round of the funding is at due diligence stage for submitted bids.¹¹

9 Laying the Foundations, A Housing Strategy for England, DCLG, November 2011 (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/7532/2033676.pdf).

10 See <http://www.communities.gov.uk/publications/housing/buildnowpaylater>.

11 See <http://www.homesandcommunities.co.uk/get-britain-building>.

And a new planning regime which places more emphasis on local authorities meeting housing demand in their areas. The new National Planning Policy Framework (NPPF) places an emphasis on local authorities making sufficient provision for housing demand in their areas and the presumption in favour of sustainable development acts as a significant incentive for local authorities to have up-to-date local plans.

At a London level, the Mayor is also very supportive of investment in rented housing. The current draft Revised Housing Strategy, published in December 2011, stresses:

“The Mayor will encourage the supply of a range of tenures delivered through new forms of funding, such as long-term institutional investment, by working with boroughs and delivery partners to develop an enabling policy framework, encouraging institutional investment on land in GLA Group and other public ownership, and fostering and brokering arrangements, where required. The potential of reforms to REITs to attract investment should be optimised.”¹²

The Mayor now has control of significant land sites in London, having taken control of the HCA’s activities in London, as well as inheriting land from the London Development Agency (LDA) and Thames Gateway Local Development Corporation, in addition to existing Greater London Authority and Transport for London holdings.

The latest support from the Mayor for institutional investment is in the Mayor’s Housing Covenant. In it, the Mayor notes the London Plan already provides broad policy support for the private rented sector (PRS), and the November 2012 Housing Supplementary Planning Guidance (SPG) provides further detail on implementation of this policy. The SPG makes clear that positive support should be given for private renting through the use of the land use planning system at local as well as strategic level and through development management, especially by recognising the distinct economics of the sector relative to mainstream market housing when undertaking viability assessments. In order to promote a new kind of PRS, the Mayor also pledges to bring forward a new competition for the best design for purpose-built private rented accommodation.

Local authorities are both interested in working with private investors and encouraging their own local authority pension funds to invest in residential property. The British Property Federation and London Councils have published a guide ‘Invest to rent’ for council officials and members,¹³ which seeks to explain to them the benefits of institutional investment and the support institutions might need when contemplating investing in housing.

Some councils, such as Ealing, Islington, Manchester, Birmingham and Bristol, have been seeking to work with private sector partners, and in some cases their own pension funds, to invest in residential property.

“A plan to boost home building in Manchester – the first initiative of its kind in the country – has been agreed this week that will make new homes more affordable for Manchester residents.

¹² Draft Revised Housing Strategy, Mayor of London, December 2011 (<http://www.london.gov.uk/publication/revised-london-housing-strategy-public-consultation>).

¹³ See http://www.bpf.org.uk/en/files/other_documents/Invest_to_rent_guide.pdf.

Manchester City Council, in partnership with the Greater Manchester Pension Fund (GMPF) and the Homes and Communities Agency, has signed a memorandum of understanding that will bring together a completely new way of funding home building in the city.

Initially the scheme will be applied to five sites across the city, which will see more than 240 new homes built for sale or rent that are designed to a high standard and specification – providing a real choice of decent homes for people across the city.

Development land will be provided by the city council, including one site offered by the HCA, while the Greater Manchester Pension Fund will finance the building of the homes.

Together the partnership will choose a contractor to build the homes and a property manager to manage the rented properties – with the city council supporting the buyer by taking an equity share in the property, making the new homes more affordable and mortgage costs lower.

It is hoped that buyers could get a home for 20 % less than the normal market level, providing a genuine route on to the property ladder for people struggling to afford to buy at the full rate.

The scheme relies on the fact that the city council can invest land, while a partner – in this case the Greater Manchester Pension Fund – invests the finance required to build the homes. The partnership chosen contractor will design and build the homes but without the risk associated with a normal development, as their overheads are minimised and they have no sales risk.

The partnership will generate a revenue return from their investment through rents and a capital return through house sales.

If successful the housing investment fund scheme could set a precedent for much bigger projects with other major investors – securing a bright and sustainable future for the Manchester housing market.”¹⁴

Overall, there is a political consensus in the UK that we need more homes and that institutional investment offers the opportunity to support supply. Politicians from all political parties are therefore supportive of growing institutional investment, and Government is prepared to put in capital and land from its own resources to help schemes that add to housing supply.

Why residential: expertise

For those institutions seeking to invest in the sector there is an abundance of expertise to draw on.

Performance benchmarking data provided by IPD: the IPD residential index (www.ipd.com) has a track record of 11 years' of analysis, and can be used to compare long-term performance and asset management cost differentials of different investment funds. More generally, it can be used to provide comparisons across sectors and explore the relationship between residential investment performance and other asset classes. There are also house price indices provided by Halifax,¹⁵ Nationwide¹⁶ and DCLG.¹⁷

Local market and site specific data from Hometrack: Hometrack (www.hometrack.co.uk) provide research and information about the UK housing market, and can drill down to data on localities. In the UK, their data is used to value over two-thirds of all remortgages and they provide automated valuations and risk services to over 90% of mortgage lenders. Top house builders use their analytics reports at critical stages of site development. They also provide housing intelligence to over a third of the UK's local authorities and Government agencies, and are used by the largest housing associations to inform their business strategies.

Bespoke advice from some of the world's leading agents, planning consultants and lawyers: a number of the big UK property agents have research expertise in housing and its sub-sectors: private rented accommodation, student housing, retirement homes, affordable housing, etc. For specific strategies and transactions there is a wealth of specialist consultants, agents, lawyers and planners, who are well versed in the needs of residential investors.

Quality property managers and letting agents: the day-to-day management of most large scale investment in private rented sector housing is done via private sector property managers and letting agents. Many of these firms will be members of organisations such as the Association of Residential Letting Agents (ARLA), Association of Residential Managing Agents (ARMA), National Approved Lettings Scheme (NALS) and Royal Institution of Chartered Surveyors (RICS).

Existing participants in the sector looking to JV: entry into a new market can be intimidating, however, in most sub-sectors of the residential market there are investors with experience, developers and construction firms keen to build residential investment stock, and public and private sector land owners with land for housing.

Increasingly there are also registered providers, housing associations, with social and market rented sector stock that they own and manage, who are looking to work with private sector investors.

15 http://www.lloydsbankinggroup.com/media1/economic_insight/halifax_house_price_index_page.asp

16 <http://www.nationwide.co.uk/hpi/default.asp>

17 <https://www.gov.uk/government/organisations/department-for-communities-and-local-government/about/statistics>

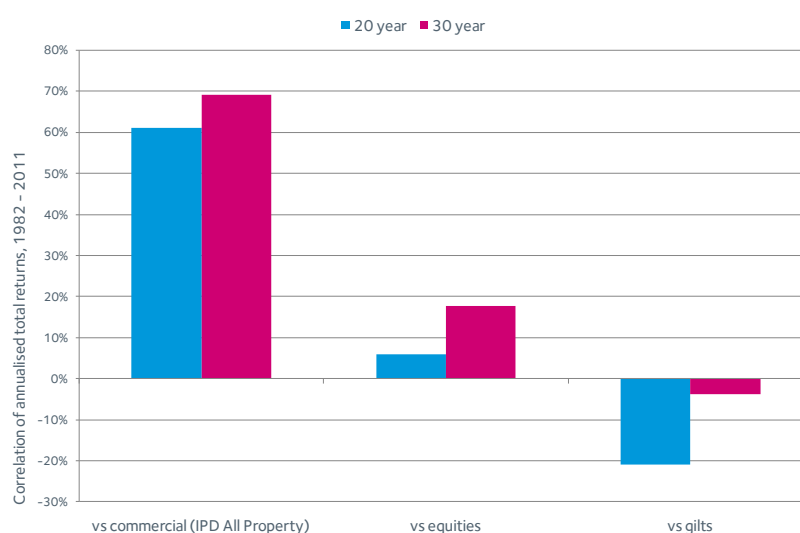
Characteristics and performance of residential against other investment assets

Residential investment can offer different performance and risk characteristics, making it an excellent asset for those seeking diversification. Some of this can be explained by economic fundamentals. At points of low growth or recession in the economic cycle when equities are performing poorly, there will tend to be strong demand for rented homes, as people exit or struggle to get into home ownership. A tougher job market will also drive more young people into higher education, further creating demand for renting. Investors may also be in a better position to buy stock at points when house prices are relatively depressed and when owner-occupiers find it difficult to raise funds.

Diversification

UK equities and gilts show a strong correlation each year. Similarly, commercial and residential property returns are closely correlated. These figures take market renting as the comparator. Other forms of residential investment, for example investment in social renting, will display different performance characteristics and a stronger correlation with other assets. Care must therefore be taken in deciding which part of the residential sector will provide the diversification or substitution characteristics that investors are seeking. Most of the rest of this section assumes a comparison with market renting, before going on to explore how other residential assets might replicate the characteristics of other investment assets.

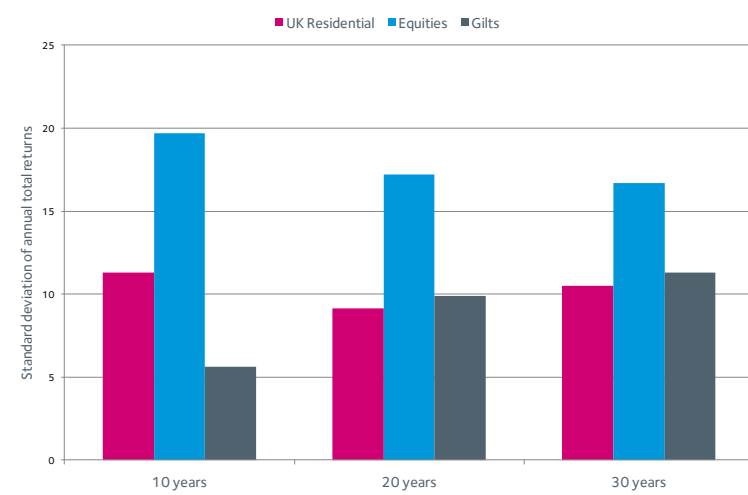
Chart 10: Diversification benefits of residential



Volatility

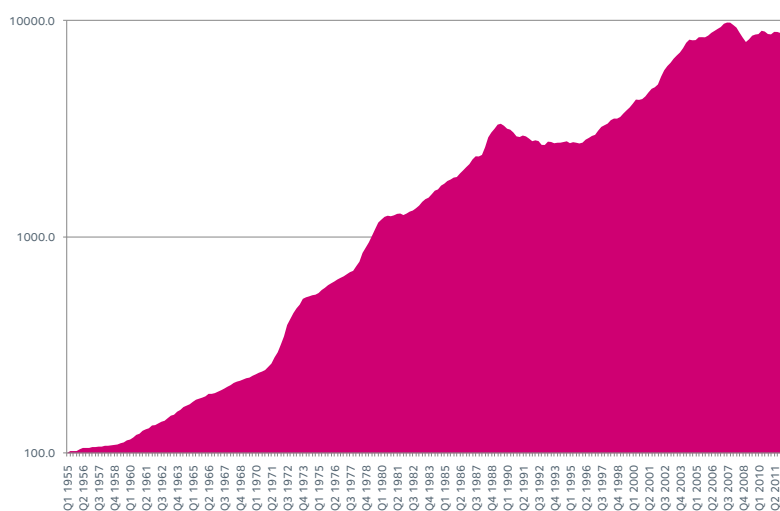
Residential property returns are less volatile than equities and stand good comparison with 'safer' gilts (see chart 11). There have also been very few long-term periods of sustained house price falls over the past 60 years (see chart 12).

Chart 11: Risk adjusted residential against equities/gilts



Source : Savills, IPD, Nationwide.

Chart 12: House price index (Q4 1952 = 100)



Source : Nationwide.

Utility

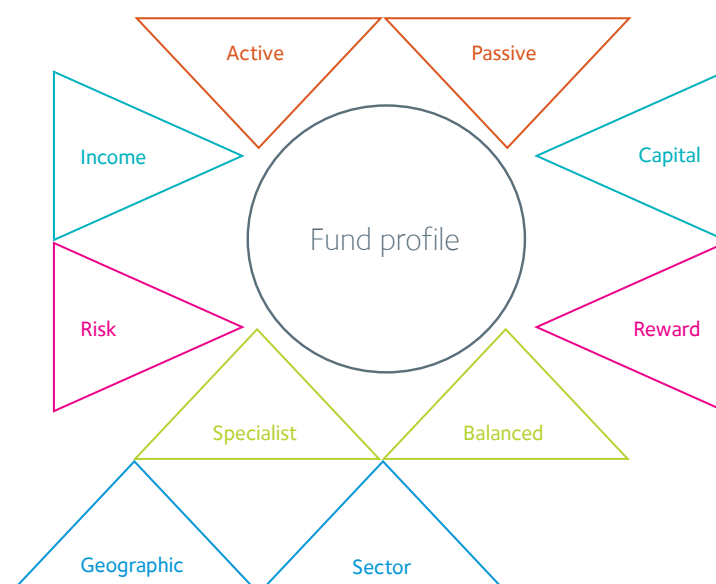
In contrast to bonds or equities, residential and commercial property is more tangible. An investment can be seen, touched, photographed, walked around or driven past. This can be seen as a strength, but as a tangible asset, residential property also needs to be managed, and there are associated costs. How the property is managed and the efficiency of management can provide a differentiator in performance. Unlike commercial property, residential property rarely depreciates. With a commercial property the structure of the building ages and occupiers' preferences change, leading to a need for refurbishment and eventual redevelopment.

Residential property on the other hand, often appreciates as the area in which it is located becomes more established. A proactive landlord and manager, providing good service and investing in upkeep and improvement can help maintain or boost value, particularly on a new development.

Management

A proactive landlord can also add value through good asset management. Researching and spotting trends, buying and selling property at the right points, spotting new and emerging markets where rental or capital growth will be strong. For example, in areas of regeneration there will be the opportunity to 'add-value' as a development is built out, facilities come on line, and 'place' is created.

Residential also offer significant diversification within a portfolio. With relatively small lot sizes in comparison with commercial property there is greater opportunity to create a mix within a portfolio and therefore help to manage risks. A specialist residential investor should be able to create a portfolio that caters for an end-investor's requirements with various variables that can be tailored to a fund manager's needs (see below).



The variety in the residential sector

The residential sector is varied: different sub-sectors can replicate the characteristics of other investment assets. Market renting, for example, provides a mix of income and capital returns, with historical rental growth having a good correlation with average earnings. Other residential assets, such as shared-ownership or co-ownership may offer a different income and capital profile.

Social housing on the other hand offers little capital appreciation, but has bond-like qualities in offering investors rents linked to the retail price index and a good covenant from a highly financially regulated landlord.

Student housing can be structured in various different ways to provide a range of risks and returns: the safest option being to contract for occupancy with a higher education provider, but with a slightly lower return, or have a slightly riskier nomination agreement with slightly better return, or simply market the accommodation direct to students, which generally offers the best performance, but with increased risk.

For those seeking strong capital appreciation sub-sectors like executive homes, or even a more geographical based fund, for example based on central London property, could offer investors what they want. The capital's place as a 'world city', and incessant demand for quality housing from mobile and well-off 'world people', could help investors who want to invest in strong house price inflation, but also with a coupon, and therefore prove an attractive alternative to equities.

Which asset: the range

Some sub-sectors of residential are very well established asset classes, while others are emerging. Within the sector as a whole there is a growing range of established investment assets with different characteristics and risk profiles, which will suit specific investors' needs (see below).



Which asset: comparing performance and risk

To illustrate the range of different residential investment assets and their performance characteristics we carried out an indicative benchmarking exercise below (see chart 13). In doing so the goal has been to provide a transparent framework to encourage investment into the UK residential sector by treating it as a whole market rather than a series of individual 'silos'. The context is that at present institutional and retail investment in UK residential property is patchy and tends to focus upon specific routes (e.g. investment in house builders' shares).

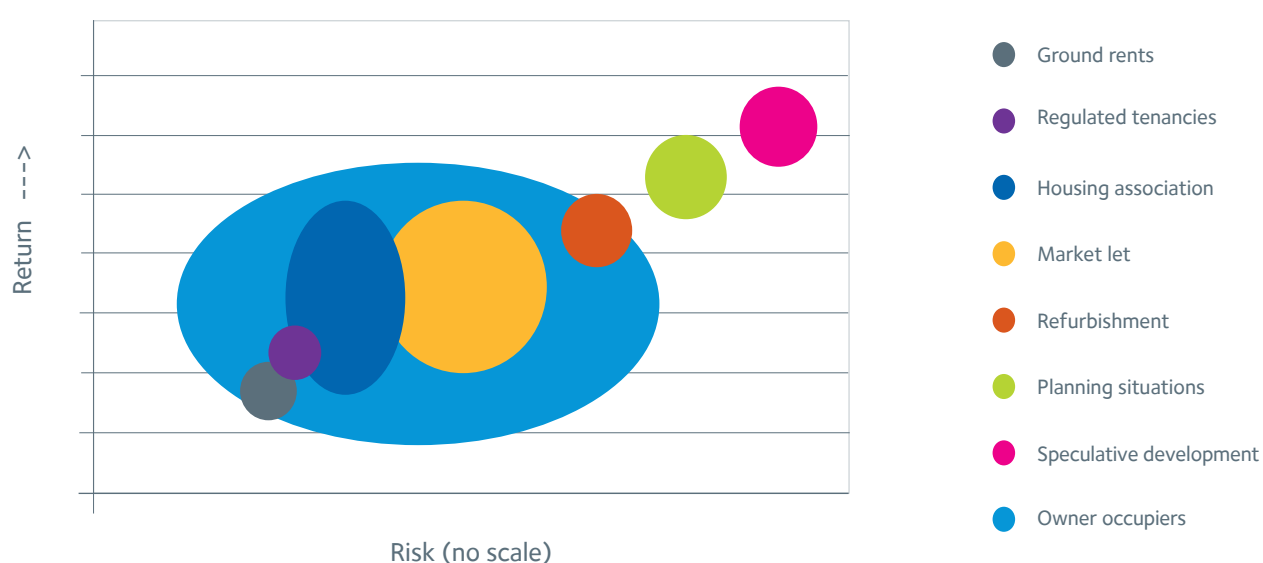
By using a benchmark model and relating all other investment methods to it, allows all forms of investment to be seen as a single sector with the attraction of multiple entry methods. The results are presented in a format, which allows easy comparison to a benchmark or other forms of investment.

Setting a benchmark

Chart 13 below shows that the residential property market offers a wide spectrum of risk and reward.

Chart 13: Theoretical risk/reward profile in residential property

The relative risk/reward profile of different categories of residential property investment



The development market offers a wide spectrum of risk in itself but is relatively small compared to the investment market. The investment market is larger but generally offers lower returns. The market is fragmented with few large blocks or portfolios available other than by the purchase of new build stock.

Policy measures are increasingly in favour of the investment sector and in particular the Montague Review has created an official framework. Note this excludes gearing but this can be used to increase risk and reward – but mainly for shorter term projects as investment yields are too low to permit long-term high leverage.

Choosing a comparator

The chosen comparator for this exercise is a theoretical portfolio based upon IPD data and comprises medium scale market let fund, as it offers an easily understood style of investment and also sits towards the middle of the risk return spectrum.

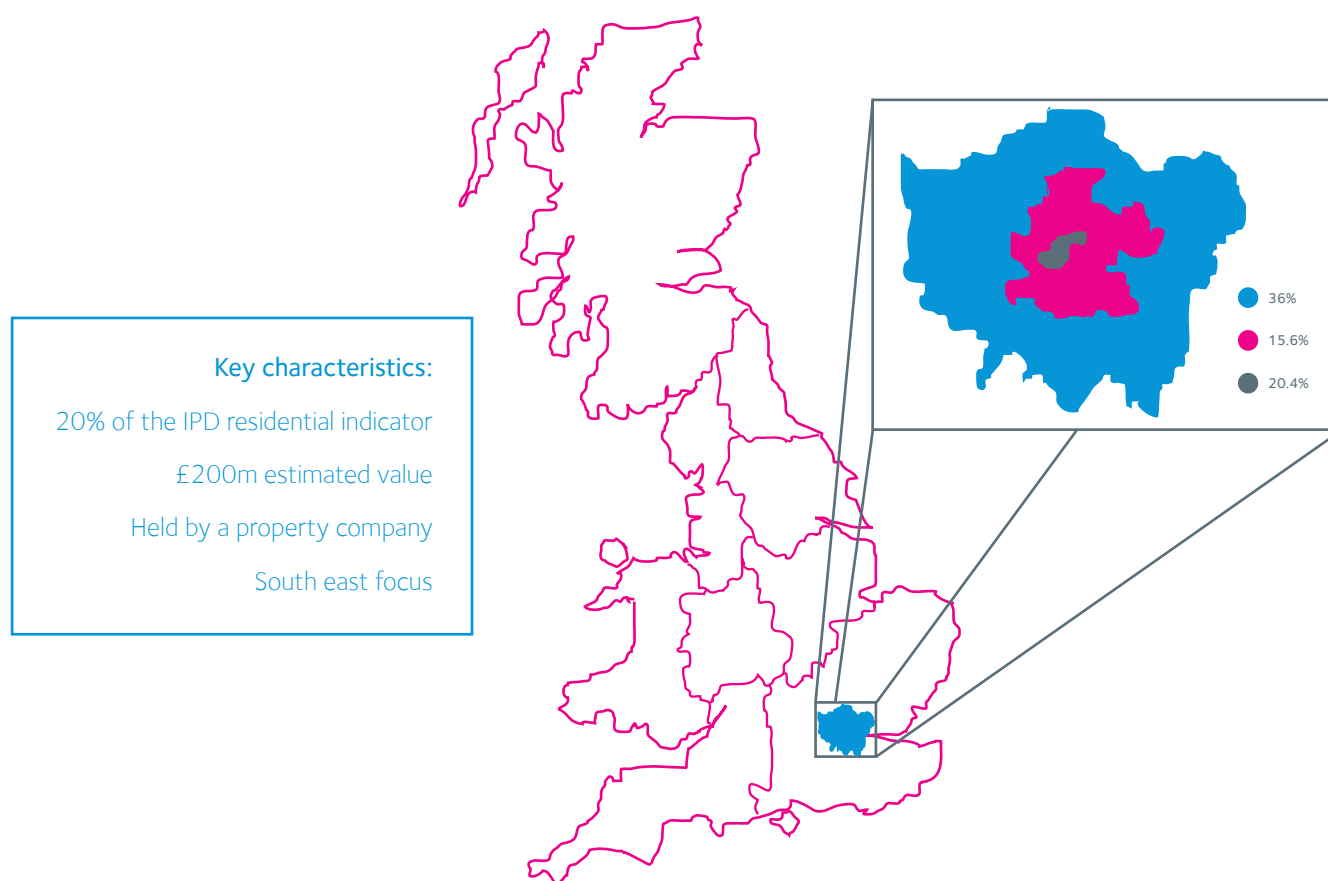


Table 2: Indicative returns on the comparator

Annualised total return (including transactions but before asset management fees)	8.8%*
Annualised capital growth (including transactions)	4.6%*
Current gross yield (standing investments)	5.7%*
Current net yield (standing investments)	4.0%*

* Note – the figures quoted are indicative and highly dependent on portfolio mix and individual property factors and should not be relied upon for investment purposes.

Indicative comparisons

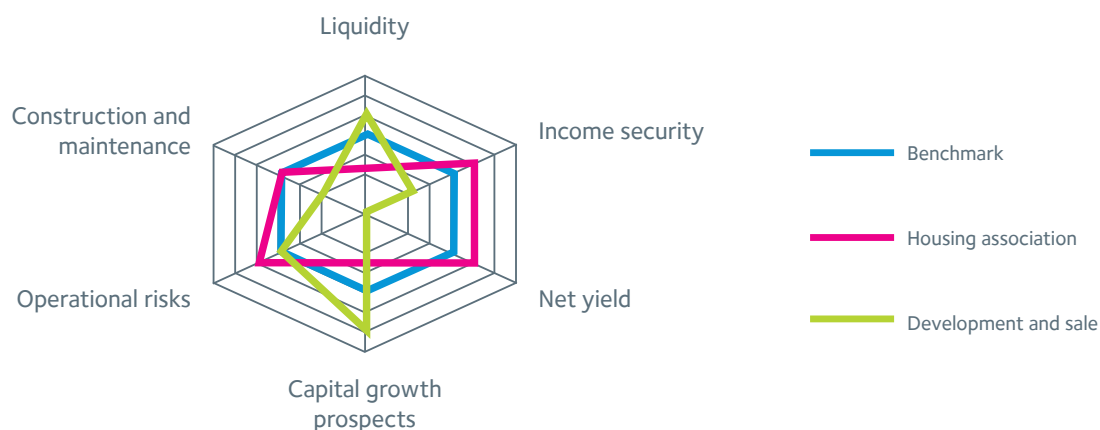
This table assesses the relative attractiveness of the different routes to investment in the sector and does not include gearing.

Table 3: Different routes to investment in the residential sector

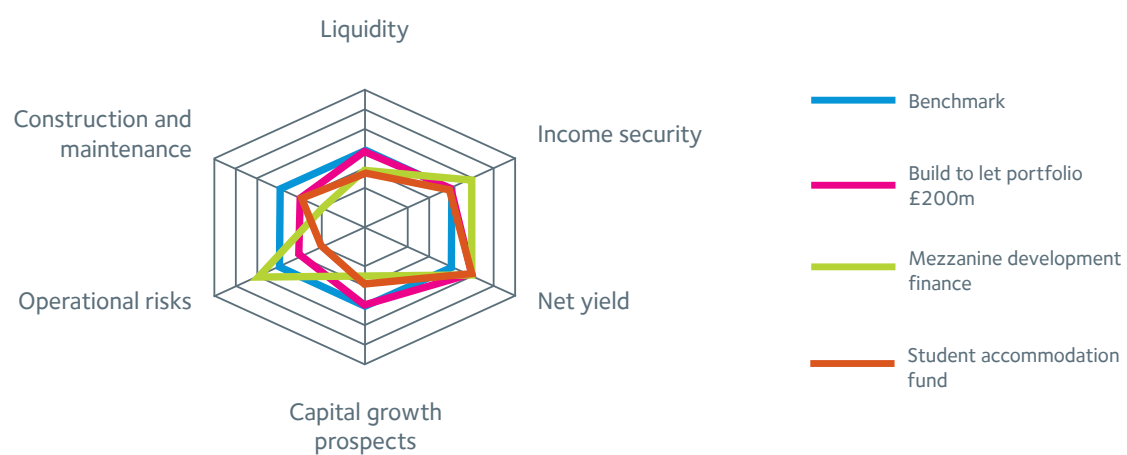
Sub-sector characteristics		Liquidity	Income security	Net yield	Capital growth prospects	Operational risks	Construction and maintenance risks
Benchmark							
	IPD based existing portfolio	◄►	◄►	◄►	◄►	◄►	◄►
Alternatives							
	Build-to-let portfolio £200m	◄►	◄►	▲	◄►	▼	▼
	Housing association Let portfolio	▼	▲	▲	▼	▲	◄►
	Development and sale	▲	▼▼	▼▼	▲	◄►	▼
	Mezzanine development finance	▼	▲	▲	▼	▲	▼▼
	Student accommodation fund	▼	◄►	▲	▼	▼▼	▼

Legend	Benchmark	Better	Weaker	Much Weaker
	◄►	▲	▼	▼▼

The following radar charts show the same information and graphically highlight the variable strengths and weaknesses of each investment type. (In the example below, the inherent lack of stability in the development model is illustrated by its dependence on one particular characteristic: capital growth prospects.)



Here is another example of some comparators.



Which asset: structuring and tax considerations

Private rental housing – a time for investment opportunity

It is a time of opportunity for new housing investment. New structures and approaches are developing, particularly in areas of public sector land and affordable housing. At the same time the tax and regulatory situation is in a state of flux. As well as traditional factors, these are significant issues for those structuring potential residential investments.

Sir Adrian Montague was invited by Government to undertake his Review of the barriers to institutional investment in private rented homes. He published his report in August 2012, recommending various courses of action. In September, the Government responded with a range of proposals to encourage the provision of new homes and the rental market, including establishing the Build-to-Rent Fund to invest £200m (see page 14 of this guide).

Housing is certainly an area where the Government and the public sector have started to lead the way. Much interest was generated by the sale of the Olympic Village to Delancey and Qatari Diar. Prior to that there was the highly publicised private JV between the Homes and Communities Agency and Berkeley. The Olympic Village and Berkeley Homes JV were both structurally unique and hence do not provide easily replicable legal models. However, they certainly fuelled interest in this area and lessons can be taken from them.

The London Borough of Barking and Dagenham has also been innovative in this area announcing completion of a development deal to secure brand new affordable residential units with Laing O'Rourke. The council has reported how it secured private sector funding for hundreds of new homes.

This transaction may mark out Barking as one of the first local authorities to be progressing this type of deal, but it comes at a time when a number of local authorities are looking at similar structures, facilitating new house building through arrangements driven and financed by the private sector. Generally these are likely to be based around forty to sixty year leases to a public body with index linked rental arrangements that leave management headaches with the public sector, registered provider or an Arms-Length Management Organisation (ALMO).

The Barking deal may be indicative of further interest from the investment sector in housing as an asset class in its own right, particularly where the public sector is willing to retain a financial interest. This comes at an interesting time given the launch in February 2012 of the IPD's new index, which integrates residential investments into the IPD's all-property UK index.

In any event, there is already growing interest from foreign investors looking at the sector. Swedish and Canadian investors are said to be at the forefront of those buying homes to rent on a large scale.

Public sector initiatives

During the later part of 2012 we saw the advancement of specific Government initiatives such as HCA's Get Britain Building (GBB) fund. The HCA's GBB investment models are structured as loans to house builders. Principally either term loans or 'equity-sharing' loans where returns are proportionate to contributions.

In December, the HCA, along with the DCLG and the Mayor of London, published the Build-to-Rent Fund prospectus. The focus of this is on encouraging the early supply of new homes for rent. It contemplates making a fully recoverable investment by way of loan or equity finance on commercial terms so as to meet state aid rules. It will not take the form of gap funding or subsidy and will target projects of scale that will facilitate sale or refinancing to an institution or similar investor.

Tony Pidgely, Group Chairman of Berkeley Homes, led another Government initiative to investigate how public sector land can be better used to tackle the UK housing crisis. Berkeley and bodies such as the HCA continue to push the 'Build Now Pay Later' scheme in which Government departments offer their land for sale but defer payment until homes are being sold.

The HCA has already developed various contractual structures and precedents that could facilitate this approach. Following on from their 'public land initiative' they developed an interesting new model which takes traditional overage clauses to a new level. It facilitates deferral of land consideration payments, something that can be key to viability where development finance is so constrained and 'build-to-rent' viability marginal. It would be easy for local authorities to follow this approach.

The HCA's published Land Development and Disposal Plan for 2012-13 provides the specific example of their private rental structuring work in Manchester. There, they are working with Manchester City Council to identify public sector land that has the potential for development as private rented housing. They are developing and testing a model which will bring together two investment partners: the Council with land and an investor with cash. Together the two investors will procure a house builder and managing agent to whom they propose to grant a medium term lease. The new Build-to-rent Fund is expected to take this type of arrangement to the next level.

There is considerable potential for public sector entities to retain a longer term equity interest in private rental sites. This could be achieved through a headlease arrangement based on a form of side by side or geared rental arrangement. This type of structure, which was so common place for town centre retail schemes, could readily be adapted to private rental residential blocks where a local authority retains a freehold reversion.

Procurement regime

Hence various developers and investors are looking at the potential for new residential schemes which involve public sector bodies. Public sector covenant strength and the role that it can play in delivering index linked rental streams is proving attractive.

However, comment on structuring deals in this area would not be complete without reference to market concerns about the cumbersome and costly implications of the Official Journal of the European Union (OJEU) and public procurement rules. These are frequently cited as a reason for many developers' unwillingness to look at innovative schemes with the public sector.

Nevertheless, careful analysis of Government guidelines on the procurement rules means that complex competitive dialogue procedures are not always necessary. Recent case law has vindicated the view that, in particular, land sales and leases need not necessitate the procurement process where they do not contain a development obligation and hence do not give rise to the problematic 'public works contract'. Where the commercial deal allows the development partner a genuine choice on whether or not it will press ahead with the development, the fact that a public authority protects its interest by policing what can be built or by having the right to take back an undeveloped site, does not have to turn an exempt land agreement into a works contract with the procurement law issues that flow from this. This is an important issue to bear in mind where private sector investors are looking at new ways of participating in the housing market with public sector partners.

State aid and best consideration rules have to be taken into account when structuring housing investments deals with the public sector. However, with pragmatic advice this need not be difficult.

Affordable housing

The last two years have seen growing interest in the affordable housing sector as an opportunity for new forms of residential investment. This is driven by the attraction of regulated counter parties and index linked income. This is coupled with increasing awareness of the size of registered provider portfolios and their management expertise.

During 2012, the HCA published revised guidance making it easier for social landlords to dispose of surplus land and vacant homes. Social housing providers will now need to seek approval from the HCA for policies relating to disposals, scrapping the current system where each individual disposal has to be approved. This further reinforces the increasing significance of registered providers and social landlords in the investment sector. The HCA commented that its change was intended to recognise that a programme of sales is increasingly likely to be an important part of providers' strategies. Good news for investors.

With the intermediate affordable rent product, social landlords are able to charge rents up to 80% of local market levels. This applies to new properties and some re-lets where linked to an agreement to build new homes. Despite some uncertainties around affordable rent it has created a new area of

investment interest. DCLG is continuing to assess the ability of the affordable rent approach to lever in more private investment.

The Government is also keen to stimulate further innovation by facilitating the entry of new providers into affordable housing. The registration of for-profit providers is now possible and more private companies have been applying for registration.

There has also been interest in the Scottish Government's approach with its support from the Scottish Futures Trust. It developed the National Housing Trust initiative to facilitate private sector funding supported by council borrowing. However, as the model uses a Scottish Government Guarantee to support council borrowing there is no immediate sign of this being replicated in England.

The social housing sector has traditionally secured debt finance through bank lending or the capital markets, principally the former. However, long-term facilities at extremely competitive rates are no longer available. Banks are also seeking opportunities to renegotiate existing loans where any form of variation is required by their social landlord borrowers. This is contributing to their need to look elsewhere for finance. Some associations continue to secure their debt through the bond markets at attractive rates.

Nevertheless, the registered providers are having to diversify their sources of finance and are increasingly looking to other mechanisms. These include the potential REIT but also sale and leaseback structures, particularly with institutional investors.

The Government's REIT consultation of April 2012 emphasised: *"housing associations can offer an attractive form of investment because they provide a stable, inflation linked income stream from social rents; a large and conservatively valued asset base; and are effectively regulated"*. As many pension funds and insurance companies have already invested in the social housing sector through the purchase of public bond issues their interest in new approaches is expected to grow further and there appears to be growing evidence of this. This is likely to revolve around leaseback structures and these will in turn be assisted by more regulatory flexibility in this area.

What legal structure?

Historically, there has been no 'one-size-fits-all' when it comes to the structuring and holding of residential property transactions. Different models exist, from UK and offshore tax resident companies – both listed and unlisted, internally and externally managed – to offshore unit trusts and partnerships, each designed for specific business models and target investor bases, taking into account practical issues and, necessarily, based on the tax and regulatory regime at the relevant time. Times move on, as we will see below. What was a perfectly good structure when it was set up, may or may not now be the ideal structure for attracting intended investors going forward. A clean approach may need to be taken. However, certain fundamentals remain the same.

Structuring considerations

From a pure tax position, the primary aim in structuring an investment is to avoid unnecessary tax leakage at vehicle level and unusable tax credits for investors. These would only reduce investor returns and impair the performance of the structure compared to other investment options. In some cases, appropriate structuring can actually put investors into a better situation than had they invested directly, or give them some other benefit, such as liquidity, making the investment more attractive. With this in mind, tax free re-investment of gains, minimisation of tax leakage on income, use of the lower rates of SDLT where possible, and minimisation of irrecoverable VAT, are all goals of the investment manager, where possible. No (or reduced rates of) stamp duty or SDLT on transfer of assets or interests can also be important.

In choosing the ideal structure in the context of residential investment, various other issues can be important: the distinction between trading and investment being one. Determination of this would always be a question of fact, with different circumstances being taken into account. Most commonly, however, trading will generally arise in a straight development for sale situation, but it is also potentially relevant elsewhere, such as on shared ownership, a planned disposal programme or equity release. Importantly, the outcome of the investment versus trading review can affect the structuring decision.

The identity of the investors too will be important. For example, in an investment context, tax exempt investors, such as UK registered pension schemes, will favour a structure which is either exempt from tax on income (such as a REIT or PAIF), tax transparent for tax on income (such as most offshore unit trusts) or a Luxembourg fonds commun de placement (FCP), or one which gives a refundable credit for tax suffered in or by the vehicle (such as the UK exempt unauthorised unit trust). In a trading context the same investors may require a ring-fence to ensure that they are not actually treated as trading themselves and, indeed, will seek a tax regime that avoids tax leakage on that transaction, if possible.

Another thing to bear in mind is that the different tenures and asset types within the sector can each have their own particular quirks and treatment - in particular for SDLT and VAT. This should always be checked on the facts. Registered providers may be able to take advantage of SDLT exemptions and, structured appropriately or with the right portfolio mix, on large-scale residential acquisitions, the purchaser may pay SDLT at a rate based on the average price in the portfolio, subject to a 1% floor, rather than on a linked asset basis, at 4-7%. The holy grail on new builds or conversions, is to optimise the use of zero-rating and minimise irrecoverable VAT on fees and other ongoing costs and cash-flow to the extent possible.

Of course, tax is not the only issue that drives the optimal structure: familiarity, certainty, liquidity and practicalities, such as cost efficiencies, financing, effective management of the property, protection of landlords' rights (such as preventing tenants' rights of pre-emption and enfranchisement) and, increasingly, regulatory change may do so also. While the latter may include optimal structuring within the proposed new regulatory requirements of Solvency II for insurers (is, for example, the investment of a global equity, real estate or corporate debt?), a key regulatory concern, more generally, is ensuring

access to the target market not just in the UK, but also across Europe. The industry is becoming increasingly aware of the implications of the Alternative Investment Funds Management Directive (AIFMD), which comes into force in July 2012 in this regard, but review of appropriate structures to target retail clients in the light of Financial Services Authority (FSA) proposals is also now becoming relevant.

What legal structures?

The list of potential structures for the residential sector is long. Often, there is potentially a choice. New vehicles and improvements to many existing vehicles are being put in place all the time, but regulatory changes, market practice and investor or manager appetite may dictate a particular outcome. Though not limited to the following, current structures include:

- 1 REITs
- 2 PAIFS
- 3 Unit trusts (onshore and offshore)
- 4 Property companies (onshore and offshore, listed and unlisted)
- 5 Land or debt-based JVs
- 6 Co-ownership structures.

The most common are considered further briefly below.

REITs

REITs are closed-ended, UK tax resident companies which are broadly tax exempt on property rental and capital gains provided they satisfy various conditions. These include having 75% of their income and assets in property rental business and distribution of 90% of their property rental income. The latter is taxable in the hands of investors as if it was property income (after 20% withholding tax, if applicable), effectively taxing investors as if they owned the property directly. REITs have to be admitted to trading or listed on a recognised stock exchange, but can be internally or externally managed.

The Government is keen to encourage more investment in residential REITs, in particular, and so recently has made substantial improvements to the regime to encourage more start-ups and large-scale institutional investment. These changes include an ability to list on less expensive and less onerous exchanges, such as AIM, abolition of the previous 2% entry charge, a three year grace period before the REIT is required to be 'non close', and (if AIM listed) before it has to meet a requirement that shares are 'actually traded', and more flexible rules for 'institutional shareholders'.

Though there is a rule effectively prohibiting payments or dividend to 10% corporate shareholders, this is usually able to be dealt with successfully in practice. Where the REIT is externally managed, one

potential issue, in a residential situation, is that VAT levied on management fees will not be recoverable. However, the REIT is an internationally recognised brand and can be sold to any type of investor – with potential attractions for capital raising and liquidity.

PAIF

The PAIF is essentially the open-ended version of the REIT. It comes in two forms: a non-UCITs retail scheme (NURS) open to every type of investor, and a qualified investor scheme (QIS), which is only open to sophisticated investors. Each is regulated by the FSA. Other distinctions between the QIS and NURS include redemption periods, gearing restrictions and appropriate diversification. In each case, provided conditions are met (including the 60% of the income and assets is in property rental business – which in a PAIF, includes shares in certain REITs), income and gains in the PAIF are tax free. Income is paid (or treated as paid – as accumulation units are permitted in the PAIF) after 20% withholding (other than where investors are entitled to gross payments). While there is a 10% corporate shareholder restriction, most PAIFs are established with feeder vehicles to ensure that they can indirectly freely admit corporate investors regardless of size and reach their target markets effectively. Being a UK authorised fund, fund management fees are exempt from VAT.

Unit trusts

These come in many varieties, exempt unauthorised onshore, authorised onshore and unauthorised offshore, to mention just a few. In the residential investment context, the offshore (income transparent) unit trust has, historically, been popular. The reasons include lack of VAT on fund management fees, no stamp duty or SDLT on unit transfers, no tax leakage on income and tax-free roll-up of gains in the vehicle, as well as general operational flexibility. EU and FSA regulatory changes should, however, be reviewed going forward, depending on the target market, to ensure a particular product remains suitable.

Property companies

These can take a variety of forms, but simple UK property companies are popular still, particularly if there is much trading involved. Helpfully, here, the rates of UK corporation tax are coming down to 21% over the next few years. With the improvements to the REIT regime, many residential investment companies are considering converting to REIT status, to achieve the REIT tax exemptions and access a potentially wider market.

Alternatively, offshore companies can be popular, through the ability to have tax-free capital gains roll-over in the vehicle, effectively lower rates of tax on income and also, potentially dividend returns and lack of stamp taxes for investors. It remains to be seen, however, how well these vehicles will continue to fare in the future, with the more general investor aversion to high levels of debt and, particularly if the vehicles are incorporated in tax haven jurisdictions, as the the regulatory changes of Alternative Investment Fund Managers Directive (AIFMD), come through and operate in practice.

Potential changes

We are, however, living in a world of tax change. Some of these changes, such as the change in some of the REIT terms and multi-dwellings rate of SDLT, have been specifically intended to help stimulate investment in the residential sector. Others, however, such as the 15% rate of SDLT for certain property over £2m and the proposed capital gains tax (CGT) and annual residential property charge on certain dwellings over £2m from April 2013 have been aimed at targeting identified tax avoidance structures in the higher value end of the sector.

These changes do not, of course, affect the whole sector, but should be identified and consideration given to them, where appropriate. Happily, for the industry as a whole, it is intended that from Royal Assent to Finance Act 2013, none of these changes should apply to genuine property investment businesses, such as those contemplated in this guide.

Which asset: valuation

Residential and commercial property investments are valued differently in the UK, and for some commercial and overseas investors these differences are difficult to understand.

The most confusing aspect for a commercial investor is often said to be that tenanted income producing residential investments, trade, and are valued, at a lower price than vacant non-income producing assets. In reality, however, for more than a single residential property (where a tenant could justifiably be viewed as an encumbrance), this is seldom the case. For example, a block of one hundred flats will usually be worth more tenanted than vacant. The differences that are sometimes thought to reflect tenancies are often a reflection of scale or bulk. Understanding the difference in the market for single dwellings and collections of residential assets is crucial.

This paper outlines the predominant basis of valuation for residential investments in the UK today, sets it in its historical context, highlights the differences between commercial and residential property and discusses how the residential market may evolve if the sector grew in scale and maturity.

Comparative method of valuation

The definition of market value as stated in the RICS Valuation – Professional Standards is:

“The estimated amount for which an asset or liability should exchange on the date of valuation between a willing buyer and a willing seller in an arm’s length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.”

Most residential properties are valued with reference to the price which would be paid by a prospective owner occupier or buy-to-let investor for a single property (or the aggregate in the case of a block or portfolio). This is because the vast majority of transactions conducted of individual properties are of vacant houses and flats between private owners and this market provides valuers with a significant body of evidence. These transactions are not only investment led but also reflect individuals’ need for shelter and emotional attachment to their prospective home.

In practice, the valuer assesses the value for each individual residential property with reference to the actual prices obtained for similar properties. The prices paid for any comparable properties are analysed and adjusted for differences (as applicable) in such factors as location, physical condition, size, age, tenure and time of sale.

Since house price transaction data has become readily available through the Land Registry, obtaining information on the price paid for residential property has become easier and more reliable. The information available from the Land Registry reflects individual property transactions and allows valuers to select recent sales in locations comparable to the subject property.

Valuing residential investment assets

In the case of a block or portfolio of residential property, a valuer has to consider the assets in terms of the residential investment market rather than purely as if it was sold in the owner occupier market. Here, a number of additional factors have to be considered, not limited to the number of properties, the lot size, the scale and demand of the local rental market (the security of income), availability of finance and the prospects for selling individual units into the owner occupier market and the timeframe involved.

Put simply, the valuer has to assume that owner occupier and small scale buy-to-let investors are unlikely to be 'willing buyers' of collections or blocks of residential property. Therefore, rather than the Land Registry, the valuer will look to the investment market for comparable evidence upon which to form an opinion of value. This part of the residential market has no official source for transactional data. The only source for information on large investment deals is from vendors, purchasers and their agents.

The resultant valuation will typically be expressed as a 'discount to vacant possession value', which in reality is a form of analysis only. In most cases, the aggregate of individual unit vacant possession values needs to be treated with caution – certainly in blocks of numerous similar dwellings where the market would be flooded were all dwellings made available to homebuyers simultaneously – but of course no vendor would choose to do that, opting instead to release units into the market in a phased and orderly way.

The use of a 'discount' in the valuation of investment property stems from a historic situation, relating to tenancy contracts that were used before 1988. Prior to this, tenants in the private rented sector had much greater security of tenure and it was much harder for landlords to evict and gain possession of their rental investments. Many landlords found this situation problematic, particularly if they wished to sell their property as a vacant dwelling; having a 'sitting tenant' reduced the value of the property as the tenant had rights of occupation at artificially low rents that were enshrined in legislation. This situation led to the use of an effective 'discount' in the valuation process and ultimately, the security of tenure offered to tenants at the time led to major landlords in the residential sector divesting from the residential investment market.

With less than 15% of the market in investors' hands, house prices are based from the likely price paid by a potential owner occupier, who would generally not be concerned about the income generating potential of the assets they acquire. Historically, an investor holding a portfolio of residential properties subject to pre 1988 Housing Act tenancies would seek to create a return by capitalising on this characteristic, by selling individual units to owner occupiers over time. The advent of assured shorthold tenancies (ASTs) with their very limited security of tenure and market rent levels meant the 'discounts' narrowed and therefore the potential to enjoy windfall capital gains when tenancies ended diminished. Owner-occupier sales, however, do offer an additional exit route for bulk investors.

Following the Housing Act 1988 assured shorthold tenancies became the standard tenancy for those renting privately. The only security this type of agreement gives the tenant is that the landlord cannot

evict them for the first six months of a tenancy. After that, unless a new tenancy agreement is signed, the tenant can be evicted at any time with a minimum of two months notice.

Even though security of tenure is not as substantial an issue in modern residential leases, the 'discount' to vacant possession value is still a prominent feature of residential investment valuations in the UK. This reflects that the investment market for blocks and portfolio is smaller (by number of participants) than the owner occupier market, and is driven by a wide range of investment criteria (including break-up potential, net income, asset management performance and capital growth) but without emotion.

Residential investment values

As stated, owner occupiers provide the base figure for individual residential properties, whilst price movements largely reflect current and expected household incomes, mortgage interest rates and the availability of mortgage finance. Low income growth and high mortgage interest rates result in weak or falling house prices while high income growth and low interest rates result in rising house prices.

Since the credit crunch, the imposition of lower loan-to-value requirements and more stringent qualification of mortgage applicants have reduced the availability of mortgage finance, especially for first time buyers. The cost of deposits has overtaken the cost of debt repayments as the single biggest issue determining affordability. Prices have therefore been under pressure in many areas of the UK, particularly outside London and the south east.

A reduction in the number of first time buyers has also directly increased demand for rental and shared ownership properties. Rental levels have increased in many parts of the country as a result of this increased demand, and with capital values simultaneously under pressure, investors are seeing rental yields rise. This effect is being amplified by the industry as a whole not building new dwellings at a pace to keep up with demand.

As a result of this, after a quiet period immediately following the credit crunch, the residential investment market is currently very active again. New entrants have already made purchasers and experienced investors are taking advantage of income opportunities where they can. In areas of stagnant capital growth and for blocks where there is no (or an extremely limited) identifiable owner-occupier market, investment buyers become the dominant (or only) buyer. Income is of paramount importance to investors and in these circumstances valuers are looking at rental yield evidence as well as their assessment of the aggregated vacant possession value if such exists. This is particularly important in areas where a break-up sales programme would potentially take years because of the disinterest from owner occupiers in absorbing the stock in any sort of sensible time scale.

Previous growth of rental properties in the UK had been fuelled by buy-to-let mortgage finance. However, in the last five years, since the credit crunch, the growth in the number of market-rented properties suggests that the current residential property investment market is more dominated by cash than borrowing.

Investment drivers

In times of strong house price growth, investment in residential property was driven by the ability to capture capital growth. This was the driver of the buy-to-let mortgage market. However, with a weakened owner occupier market, and strengthened rental prospects, the drivers for investment have shifted away from phased trading of properties with vacant possession, and towards holding for long-term income.

Historically, residential property has struggled to attract income-seeking institutional investors because of the low net yields available. However, in a low interest rate environment, where alternative investments such as Government bonds yield only 1%-1.5%, residential has become increasingly more attractive. The dynamics of residential investments, especially its ability to meet pension and insurance company's asset and liability matching criteria, should make it a highly attractive institutional investment.

Investment yields will likely be reset in the next few years, and the fundamentals suggest that residential property will be increasingly favoured by these corporate investors. If income driven corporate investors were to enter the market en masse, capital values for residential investment portfolios or blocks could increase, especially as rental growth offers good income streams. Residential is already an income producing investment but it also offers an added opportunity to benefit from capital growth via the housing market at a granular level.

Improvement in yields

As indicated above, the combination of rising rents and house prices being under pressure is leading to some improvement in yield levels nationally. According to Savills the average gross income yield based on market value for blocks and portfolios with lot sizes of £1m plus now stands at 7.25% nationally, but there are significant variations within the market, for a number of reasons. One factor is capital value: gross yields are much higher on less valuable properties, where owner-occupier demand has been hardest hit by the squeeze on mortgage lending and rental demand is naturally concentrated.

Table 4: Investment transactions blocks and portfolios in 2012 (lot sizes £1m plus)

Region	Indicative gross initial yields based on investment market value (not aggregate vacant possession value)
Greater London	5.50%
East Anglia	8.50%
South east	6.50%
South west	7.25%
North west	9.25%
North east	11%
Yorkshire and Humber	10%
UK average	7.25%

Source: Savills.

According to Savills, income yields on one-bedroom properties average 8.2% based on market value. Regional differences are noticeable, with yields tending to be higher in the north than in the south. Within regions there are also significant variations relating to the characteristics of the local market. There are therefore opportunities for investors to achieve more than headline gross yields, whether by buying smaller units or in lower-value local markets. Large scale investors buying units in bulk are also able to boost yields by taking advantage of their purchasing power and sellers needing a comparatively quick sale. The headline average gross yield is 7.25% for those investors in a position to negotiate lower aggregate prices for bulk purchases.

The future? – the potential of using cashflow appraisals

In most active owner-occupier areas, the residential investment market is predominantly driven by relativity to vacant possession values with a secondary relevance to yield. If large scale, long-term, investors with an emphasis on long-term net income become major players in the market, and they base their transaction pricing purely on net yield then it will be appropriate that valuers reflect that shift in market behaviour, pricing and analysis in their approach to valuations.

The investment method of valuation is based on the premise that market value is a function of current and future rental income. The potential income from a property or portfolio is relatively easy to establish, this being the rent which the property(ies) can actually achieve, or could be let at. However, as well as the quantity of the income (rent) which the property interest is capable of producing, the investor will also be concerned with the quality and growth prospects for this income (i.e. is it likely to go up or down in the future?).

Typically in investment markets buyers are looking for future income growth, market value stability or future capital growth or a combination of these factors. The investment method is used as appropriate in the bond market, the equity share market and the real estate market. It is adopted where it is possible to assess the relationship between the price paid by buyers and the expected income to be derived from ownership. In its simplest form the relationship is expressed as a multiplier or capitalisation rate. The relationship is more complex where there is a variable income expected and where that income may be time constrained.

As example of residential assets where the investment method is used is in the US multi-family market. As the owner-occupier market is irrelevant to valuation calculation (due to no prospect of individual unit sales), these residential investments are priced using a Net Operating Income (NOI) approach and a capitalisation rate. Normally, calculating the NOI involves assessing the annualised income less actual prior year costs adjusted for inflation or other abnormalities. The NOI is capitalised and on average yields range from between 7% and 9%. These rates reflect that the asset can only remain as a rental investment and therefore capital growth is only possible through yield compression not growth in house prices. The valuation approach is very similar to hotels.

Were the residential investment market in the UK to see similar large scale assets which had to remain tenanted in the long-term, it is likely that these investments would be valued via NOI or DCF methodology.

Other examples of residential assets where there is no potential to access the owner-occupier market are the related property sectors of social housing and student accommodation, where net income is the key driver of value. These assets are priced by the explicit modelling of cashflow over either an effective perpetuity or a defined hold period with assumed exit, and this is the established valuation technique.

This approach could be appropriate to portfolios of market rented property, where the investment fundamentals are geared towards income rather than capital growth, with a known holding period and where buyers typically adopt this approach when formulating bids. We envisage this would require some form of medium to long-term planning restriction that all units be rented and not released for sale to individual purchasers and that developments would be purpose-built and designed for long-term rental provision.

These hypothetical investments would require specific assumptions to be made on the following variables when approaching an investment purchase decision or a valuation:

- 1 Multiple tenancy types, rents, growth rates and turnover rates
- 2 Void and bad debt rates
- 3 Individual cost elements, including catch-up repair, cyclical and response maintenance, major works, programmed repairs, management, together with specific growth rates for each cost line.

Net income would therefore be explicitly forecast in nominal terms, allowing the incorporation of, for example, identified programmes of stock condition works.

Pricing of the net income for such assets could then be made by reference to the appropriate risk-free rate, with the difference from this informed by, amongst others, the nature of the properties and their relationship with local rental and capital market characteristics, historic performance versus accepted benchmarks, the cost of funds to a potential purchaser, tenant profile, and the marketability in the secondary market for the portfolio in question.

This approach would be more sophisticated than a more simplistic percentage of aggregated vacant possession appraisal (or 'discount') and would reflect the requirement for the asset to be held as a rental investment for the medium to long-term without an exit route to the individual purchaser markets.

For more mainstream assets – and particularly those in London and the south east where there continues to be active owner occupier markets in most areas for flats and houses alike, pricing and valuations based on an analysis against vacant possession value will remain the benchmark for value given that this is how the investment market currently appraises investments and it is the valuer's job to reflect the market. In parts of the UK where there is less demand for owner-occupier stock, yield is more relevant – but more to ensure strong income cover for debt in the short term rather than for a longer term cashflow.

Glossary

Affordable housing – A term used to encompass any form of housing that is part-sold or rented at below market levels. The exact definition is currently contained in planning guidance and usually excludes market renting or any form of full market sale.

AIFMD – Alternative Investment Fund Managers Directive.

ALMO – Arms-Length Management Organisations manage former council housing independently from their local authority.

ARMA – Association of Residential Managing Agents.

ARLA – Association of Residential Letting Agents.

Build-to-rent and build-to-let – Purpose-built accommodation, which is designed for market renting, rather than owner-occupation.

CML – Council of Mortgage Lenders.

Co-investment – The purchase of a single property by a home buyer with a small deposit of 5-10% and an investor who provides the balance of the purchase price. The home buyer has full rights and responsibilities of home ownership and a share of any capital gain, enabling investors to benefit from higher net yields.

DCF – Discounted cashflow. An alternative method for valuing residential assets held for their income.

DCLG – Department for Communities and Local Government, is the Government department which has responsibility for housing and planning policy.

HCA – Homes and Communities Agency is the Government's national housing and regeneration delivery agency for England.

NALS – National Approved Lettings Scheme.

NHBC – National House-Building Council is the leading warranty and insurance provider and standards setter for UK house-building for new and newly converted homes.

NOI – Net Operating Income. An alternative method for valuing residential assets held for their income.

OJEU – Official Journal of the European Union

REITs – Real Estate Investment Trusts are a corporate structure, which allows investors to invest indirectly in property, but achieve, broadly, the same tax outcome as a direct investment.

RICS – Royal Institution of Chartered Surveyors.

Student housing – In the context of this report refers to purpose-built student accommodation.

Appendix – descriptions of different residential assets

Market rent – portfolio

Commonly investors have accessed market let portfolios by purchasing existing stock from other owners. There is, however, a growing interest and activity in build-to-let. This can help deliver improved performance, for example by designing more efficient purpose-built rental accommodation, which is easier to maintain and manage. The investor can also share in any development profit, however may also shoulder development risk. Many of the large construction contractors have been showing interest in working with investors to deliver build-to-let projects. The other option is to work with house builders in pre-purchasing a range of their stock, but this may prove expensive as house builders will often seek prices comparable with what they could achieve from home buyers and smaller investors.

A further issue to consider with any build-to-let project is the extent to which the developer will have to make a contribution towards affordable housing and the impact that might have on project viability. The Growth and Infrastructure Bill currently passing through Parliament applies a stiffer viability test, and allows the developer to appeal to the Planning Inspectorate, but ideally how build-to-let is treated for planning purposes should be set out in guidance. At present, that is not the case.

Market rent – single project

Many of the same issues apply, whether investing in a market let portfolio or single project. The scale of opportunity is increasing for investors in single projects. These are no longer limited to small scale sites, but at the other extreme the Olympic Village. Clearly whilst it is unique, the willingness of the HCA and other public bodies to contribute land to build-to-let projects is opening up scale opportunities to support sizeable single projects. Investors may have concerns about diversification, but as is illustrated elsewhere in this publication there is a wealth of expertise and information to assist due diligence. One particular issue that can dissuade some investors from residential is the covenant offered by individual occupiers, which will not match a retail occupier say, in the commercial sector. However, the diversity of occupiers and assistance offered by the state via housing benefit, plus the significant supply/demand mismatch for housing, helps to ensure that voids on institutional investment residential stock are very low.

There are also ways of mitigating voids in parts of the market let sector, for example, some local authorities operate private sector leasing schemes. The Localism Act 2011 may also create more demand for private sector tenancies, as it changes the law, allowing local authorities to discharge their duty to find homes into the private rented sector, providing the tenancy offered is for at least 12 months.

Market let – housing associations

Some of the UK's largest housing associations are significant housing developers in their own right. Increasingly such organisations are providing a range of housing to meet their communities' needs, including market rent accommodation. In a world where there are limited opportunities to purchase portfolios of market rented stock, developer housing associations may offer a route to acquire stock. This might be either via outright sale, freeing up capital for the housing association, or some sort of JV or packaged solution for investors, which might also offer a steady flow of tenants and management services.

Shared-ownership/shared equity

Shared-ownership has become a popular way for individuals to access home-ownership in an era where deposits are often unaffordable and access to mortgage finance constrained. Some housing associations provide their own products. There is also a suite of products provided by Government under the banner of Homebuy, which covers shared ownership housing schemes including part rent part buy, rent to buy and shared equity or equity loan schemes such as FirstBuy and HomeBuy Direct.

In a simple shared ownership scheme the occupier buys a proportion of the property (usually 25%-75%) and pays a rent (usually below market) on the proportion of the property they do not own, providing some income for the housing association or investor. Although the maximum share can sometimes be capped, with most schemes the occupier can 'staircase' to full ownership in future (i.e. buy more shares in the property up to 100% ownership). These shares normally involve the property being revalued and shares bought at revised market value. Repairs and maintenance is usually the responsibility of the occupier. The investor therefore derives a below market rent and with lower costs than with market renting.

There is the opportunity to also achieve capital appreciation, but the timetable for that appreciation will be dictated by the occupier buying more shares or wanting to sell, and therefore is outside the investor's control. There are some private organisations that have bought shared ownership stock off housing associations. This helps the housing association, which can then deploy the freed up capital for building more homes.

Co-investment

The challenge for many would-be homeowners at present is to access a mortgage and provide what can sometimes be deposits running to tens of thousands of pounds. The co-investment model works by creating a 'co-investment' between an investor and a home buyer ('co-owner'), whereby the latter initially purchases up to 15% of the property with the investor providing the balance, together being cash buyers without any need for a mortgage lender.

In return for full and secure occupation rights through a 'tenancy in common', the co-owner pays an occupation charge on the share of the property held by the investor, which can be indexed to RPI, and agrees to maintain the property, paying insurance and other service costs. Capital value changes are shared between the investor and the co-owner as agreed between them.

The investor therefore benefits from an index-linked cashflow and a share of the growth in the value of the home, without the maintenance, insurance and other costs that would be the case with renting. Stock is bought on the open market.

Development and sale

There are opportunities for institutions to invest in various stages of housing development, from speculative land purchase through to funding construction. Probably one of the best known examples of investment in development and sale in the UK is the St Edwards Homes JV between Prudential Property Investment Managers (PruPIM) and Berkeley Homes. This was set up with contributions of land and buildings by both partners to develop major residential and mixed-use development schemes across the UK. From PruPIM's perspective it allowed it to capture the uplift in value that it had to some extent already created via its commercial developments, and by adding residential create further value through the creation of 'place'.

Ground rents

A ground rent is a regular payment required under a lease from the owner of leasehold property, payable to the freeholder. A ground rent is created when a freehold piece of land or a building is sold on a long lease. The creation of a ground rent on land provides an income to the landowner, while the builder will lease the land to build the house and then sell it on completion. Leasehold property can be single house, although it is more common to be divided into flats.

There are a number of companies which specialise in buying ground rents for long-term investment from landlords who want to sell their ground rents. Normally they focus on purchasing reversionary ground rents, either for initial income or for the opportunity of a reversion of the underlying property at some point in the future. The value of ground rents is affected by the rent review pattern on future income increases, the value of the underlying property, the unexpired lease length and whether marriage value is applicable.¹⁸

Equity release

Equity release allows homeowners to borrow money against the value of their homes, either to provide a lump sum, income, or some combination of the two. There are two common equity release products – lifetime mortgages and home reversion plans.

A lifetime mortgage allows the homeowner to take out a loan on their property in return for a tax-free lump sum, an income or a combination of the two. Much like a standard mortgage, the loan is secured against the property and the homeowner continues to own their home. The loan is repaid when either the home is sold, on death, or if the homeowner moves into long-term care. The homeowner can generally choose to pay interest as it accrues, or to roll it up into one end-of term repayment.

A home reversion involves the homeowner selling all or part of their home to a company in return for a lump sum or regular income and the right to remain living there. When the homeowner dies or moves into long-term care, the provider will be entitled to its share of the property's value at the prevailing market rate. The balance of the property that the homeowner owns remains theirs to go to their estate.

The equity release market has been in existence in the UK since 1965 and in 2004 lifetime mortgages became a regulated product under the FSA. Home reversions became regulated in 2007.

More than £1bn in equity release loans was taken out in 2008 and this figure is expected to grow significantly over the next few years. For more information on the equity release market, see the website of its trade association Safe Home Income Plans (SHIP), www.ship-ltd.org.

Student housing

The UK's student accommodation market has emerged as a key asset class in the past decade, attracting growing interest from investors, developers and private operators alike, with the latter now providing nearly 150,000 student bed spaces in the UK. This represents about a third of the 450,000 purpose-built bed spaces, with Universities and other education providers owning the balance of 300,000.

The market is valued at about £20bn, with private operators owning £7.5bn and education providers £12.5bn. Expectations are that the proportion of the sector owned by private sector investors will continue to grow as universities and other education sector providers face spending squeezes and funds necessary to renew an aging stock. The market for student accommodation also continues to grow with strong demand from overseas students and postgraduates.

Investors have the option of a number of different lease structures, either letting direct to the students, or leasing the whole building to a university, or having a nomination agreement with a university or more than one university in some of the larger student cities. Yields will typically reflect these different routes to market. Direct letting typically offer a slightly higher yield, but with it slightly higher risk. A university leasing arrangement will typically offer a lower yield, but security of income. A nomination agreement sits somewhere in between. As befitting a maturing asset class, there is a growing wealth of information on the sector and its performance, with most of the large property agents publishing regular and detailed research.

Social housing

There are approximately 4m social housing units in the UK, which equates to about 18% of total housing stock. This is split 2.4m with registered providers (10% total housing stock) and 1.7m still retained by local authorities (8% of stock). Almost half, 46% of registered providers' units, were once in local authority ownership. Much of the rent in the social rented sector, 62%, is paid by the state in the form of housing benefit.

Most registered providers are housing associations, which vary significantly in scale and breadth of operations. In total there are 1700, but only 393 with more than 1,000 units. These 393 represent 95% of the stock, and 59 hold more than 10,000 units (44% of stock). There are four registered provider groups that hold more than 50,000 units.

The registered providers have gross assets at book value of £95bn, but this has an estimated open market value of c£250bn. This is funded by grant (£37bn), debt (£45bn), and reserves (£16bn). Debt per unit is below £20,000. The grant is non interest bearing, repayable only on sale of asset, if not recycled. The rent the sector turns over is c£9.2bn per annum (c£75 per unit per week).

The sector has low voids (2%). Arrears run at 4.3% and there is some concern this might grow as Government reforms how housing benefit is paid. Most tenants have secure tenancies, although there is turnover of tenants of about 4-6% per annum.

The sector has not traditionally been one that seeks or attracts equity investment, although for investors looking for index-linked returns it should have attractions as its rental regime provides index linked cashflows of RPI plus ½% per annum. There is also an opportunity, albeit limited, of significant capital appreciation through possible reversion to open market.

Historically there has been limited interest from registered providers in alternative funding sources because of easy access to long-term cheap debt and high levels of grant. However, the bank debt market is now tighter and new debt can often come with the condition of repricing historical debt, which makes little financial sense for the registered providers. Grant levels are also at far lower levels for 2011-15 and expected to continue at low levels.

There is likely to therefore be increased interest from registered providers in new structures and one 'sale and leaseback' deal by institutional investors Aviva, with housing association Derwent Valley, has already been undertaken.

For investors not necessarily looking for property returns, but general needs cashflows uncorrelated to other investment markets, the social rented sector provides a deep pool of stock and potential property managers, with a relatively secure indexed link return.

Intermediate/affordable rent

An intermediate rental product has long been available as part of the affordable housing mix, but has been rarely used by social housing providers. Current Government policy, however, is seeking to encourage the greater use of so-called 'affordable rent', which allows for rents of up to 80% of market rent (rather than social rent) on new build affordable housing, and social housing re-lets. Note the provider need not specify the cap of 80%, and can set a rent below that figure. The market rent on which the percentage is based is calculated following RICS valuation methodology.



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February 2013