Institutional residential investment – opportunities and challenges

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Notwithstanding the industry's representations last year in response to HM Treasury's consultation on the private rented sector, the Budget 2011 announcements came as a bit of a coup for the sector. A lower SDLT charge, potentially, from 4% to 1%, will reduce the cost on certain residential portfolio investments, with effect from Royal Assent to the Finance Act this summer, and consultation is under way on a wide range of changes to the REIT regime which, if approved, will be brought forward in Finance Act 2012. The REIT proposals include the total abolition of the 2% conversion charge, AIM listing and a new diverse ownership rule aimed at facilitating investment by institutional investors.

Collectively, these proposals, if implemented, would reduce the headline costs of investment and would get rid of the main perceived deterrents to the UK REIT regime as a viable vehicle for institutional investment in the residential sector.

Perhaps most importantly, the proposals have produced a renewed optimism and energy in the residential sector, bringing different parties to the table and stimulating discussion of potential solutions to end the current impasse.

The opportunities

Timing is good. The different opportunities for investment in the residential sector appear to be coming together. Lack of mortgage finance is leading to anticipated steady growth in demand for rental accommodation for the foreseeable future. Shortage of supply is leading to higher returns in the private rented sector. Research by Hometrack indicates, moreover, that the increased demand is not limited to the private rented sector, but will extend also to other tenures, such as affordable and social housing.

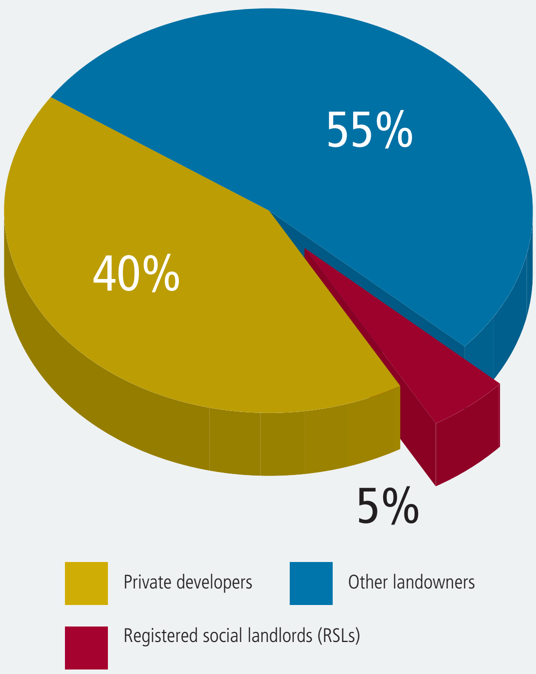
Availability of land for development to supply housing should increase as more developers, through falling sales figures and cash flow constraints, come to a suitable arrangement on pricing of land or products. They may also seek to take advantage of the potential REIT regime as an exit for their own properties.

The Government is strongly committed to planning new residential development as part of the growth solution. There are a number of ideas at large, including land auctions, which would transfer value for recycling into new infrastructure from land owners and developers to local authorities to support residential development. Supply should specifically be aided by the Government announcement on 9 June that, in addition to the current HCA activities, it would release previously developed land for 100,000 new homes by 2015 and encourage local councils to do the same. This could be particularly relevant given the large amount of suitable land currently in Government hands (see Figure 1).

Also helpful, potentially, on the supply side, is (1) the proposal to permit the change of use of empty office space into residential property for letting, without the need for planning permission and (2) the more general idea to move to localism in the planning system to reduce the existing bureaucracy, whose faults have become all the more clear in the recessional market.

As market and regulatory developments provide a catalyst for other changes, creative thinking is being applied to the sort of products that can help bring about the new supply. The need for registered providers (and others) to find alternative funding to make up for the reduction in the Government grant is, for example, giving rise to other opportunities. The affordable rent product (where registered providers will be allowed to charge tenants up to 80% of market rent, provided they commit to carry out new housing development) is just one of these. The returns from this could be packaged up in a way attractive to investors. The new regulatory climate under Solvency II for insurance companies is already changing investment behaviour and providing different opportunities for those entities and others to step into the funding breach, with various types of corporate lending and bond type structures, as well as land-based solutions and equity type investments. The new extended category of who can be a registered provider may well also provide new investors who can take advantage of the benefits that the new regime can offer.

Figure 1: Planning pipeline in London by proportion of private units, 2006

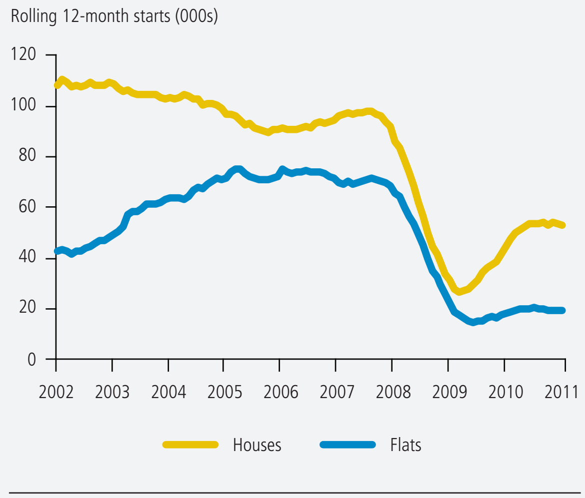


Source: London Development Research, 2006 for the GLA

The potential for a REIT (in its proposed form), being a UK-managed, tax efficient, liquid and regulated, income yielding entity, as the vehicle through which to bring more institutional money into the various parts of the sector should not be overlooked. While the REIT is not, of course, the only potential efficient vehicle for such investment, it is, as a result of the Budget 2011 proposals, the one that is currently stimulating the most positive interest. One reason is that a REIT would not only give access to UK institutional money, but, as an internationally recognised brand, it should attract capital from overseas investors, who are seeking an equity investment. This could, for example, include Dutch institutions, already familiar with the residential sector as an asset class. Unlike some of its offshore alternatives, a REIT could also be very attractive to UK 'retail' investors, in particular those investing through ISAs and SIPPs, who are not otherwise able to access the sector in a simple and tax efficient manner. This greater potential investor market of the REIT should help to provide to the institutional investor enhanced liquidity and scale in the residential sector.

Interestingly and potentially importantly, the REIT is also being actively explored by developers as an exit for land that cannot be sold into the private sector. Some are already effectively operating as landlords for these properties. A REIT exit could encourage developers to supply more appropriately configured properties for the rented sector (as opposed to larger housing), which have been in short supply over recent years (see Figure 2). For registered providers, the REIT is being explored as an alternative source of new capital to carry out development, in the face of reduced grant funding. If various tenures were brought together in the REIT, this could further improve diversity for investors.

Figure 2: Housing starts by type



Source: Hometrack using NHBC data

Not all REITs need, of course, to be new businesses with new management. There are already substantial portfolios in offshore structures, where the managers may take the opportunity to come onshore into a more operationally friendly environment. UK companies with large residential portfolios, particularly in these debt constrained times, may also find the potential to raise institutional capital and improve returns through the tax free environment of the REIT very attractive. Singly or as joint ventures, this could all help with bringing the necessary scale to the market and potentially increasing supply. Within constraints and particularly where it has an existing portfolio, the REIT could even undertake development itself.

There are clearly opportunities for the right management too. The concern here is to address the perception of management in the residential sector as being difficult, expensive and not always good enough or, where that is not the issue, to address the fact that there is not enough good management for the scale required. In respect of the former, we are seeing management increasingly put systems in place to do the job properly and to be seen to do so. As to the scale of management available going forward, opportunities exist for harnessing, in joint venture type arrangements, the skills of the registered providers and housing associations, who have been managing major portfolios for years. No doubt, we will see the good managers developing a brand. One of the issues that will remain to be played out, particularly given the low yield environment and irrecoverable VAT issue, is whether, if the REIT becomes the vehicle of choice, management should remain external or would need to become internal.

The challenges that remain

However, despite the opportunities, the industry still needs to dispel fully the adverse perceptions and myths of the residential sector that discourage institutional investment. Challenges remain.

One of these is planning, and in particular whether it will be fast enough to help bring through the necessary and appropriate supply. Though central Government is now acting to increase the supply of housing available for rental, it remains to be seen whether the NIMBY ('not in my back yard') aspects of localism will help or hinder the position. The jury is still out on this. One concern is whether, the locals will really favour a move to more rental accommodation, either through new build or the conversion of empty offices. Certainly, it is receiving some resistance. Even where planning permission exists, there will often still need to be planning changes to cater for the changing tenure pattern. Nonetheless, the overall direction should be to ease planning constraints on the release of land for development that is demonstrably sustainable. There also remains the hot topic of whether and how planning should be used as a tool to help bolster the returns from the sector and on the impact that this could have on the various models.

Another challenge for some, particularly if they wish to enter the REIT regime, is the issue of what constitutes trading? This is particularly so where the business model has some element of planned turnaround of assets. HMRC's position is that the law has not changed in this area and it does not intend to change it. However, for those that it concerns (and it should be emphasised that it does not concern all those in the sector, by any means), there remains doubt as to what this means in practice for their particular model. To help resolve this uncertainty, the industry has asked that HMRC publish some specific guidance.

The challenge that is, however, most often cited as being the main impediment to major institutional investment in the sector, is that of the low yields from residential rental investment. These average between 3.5% and 4.5%, compared with 5.5% to 6% in the commercial sector. It can be argued that this straight comparison does not reflect the full story as it does not take account of the differing risk-return profiles. However, pending proper clarification and marketing of the position (and work is being done on this at present by the sector), the issue nonetheless remains near the top of the agenda. The alternative, total return analysis, is not assisted either at the moment by the general agreement that substantial capital growth, which has been an important factor in returns from the sector over recent years, is not likely to be a feature of the market in the short term.

While the Budget proposals will have an immediate positive impact on yield, they will still not go as far to improve the disparity between the sectors as the residential industry would like. Reduction in irrecoverable VAT on management fees and refurbishment (which has partly driven people to use offshore structures in the past), would help, but it is not on the Government's agenda at the moment.

Going forward

Proponents of the sector argue that investment in the residential sector should not be measured only on a yield basis, but that it should be taken in the round, as an income-yielding, diversified, low-risk, counter-cyclical asset. It offers a hedge against house price and wage inflation and has the potential for gains over time – just the sort of asset that an institutional investor should have in a multi-asset portfolio. It will be interesting to see, as the requirements of Solvency II bed down, whether this view is more widely taken up across the sector.

The good news for now is that the Government is listening and, more importantly, it is trying to help. The key thing is to ensure that the current momentum is not lost.

What the industry needs is for at least one large institutional investment to launch and to be successful. This more than anything would break the impasse that we appear to be in.

The time for action must be now.