Briefing

Resolution Foundation

The challenges of build to rent for UK housing providers

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Introduction

Britain's housing crisis is well documented. Supply has failed to keep up with demand for many years, keeping prices historically high despite a prolonged downturn. This has become particularly pronounced in the private rented sector which in many parts of the country is now more expensive than owning a home with a mortgage given that interest rates remain low. However, difficulties accessing mortgage finance and raising a deposit coupled with a decline in the stock of social housing have left many low and middle income households with few options except the private rented sector. Over half of all younger low to middle income households now live in the private rented sector compared to just over a quarter in 2003-4.[1]

Kick starting the development of purpose built rental accommodation in the UK to increase the supply of private rented homes for those who are shut out of home ownership must now be a priority. As well as growing supply, build to rent could bring to market a new rental offer for tenants: purpose built accommodation, greater security of tenure, more transparent rental increases and more consistent management quality, with a new breed of lettings agents and asset managers. At present, the UK has one dominant private rental product provided by the buy to let market which is characterised by landlords who own one or two properties and, therefore, quality can be variable and longer term tenancies of more than six months are hard to find. This can be poorly suited to the growing number of families who are renting for the long term.[2]

In part, the creation of a build to rent sector depends on drawing in private investment from pension funds and other institutional investors to the residential sector to provide long term finance for rental developments. The Montague Review was commissioned by the Department for Communities and Local Government in 2012 to explore the barriers to institutional investment in the private rented sector. One of its conclusions was that investors would be more willing to invest in rented developments once they were built rather than taking risk on the development of properties. Without more purpose built rental developments being built, it would be a struggle to draw in significant amounts of institutional investment.[3]

The recent purchase of Berkeley Home's rented developments in London by M&G and the purchase of the Olympic Village by Qatari Diar have demonstrated that there is institutional and sovereign investor interest in established portfolios of rented properties. Housing providers from the social sector such as London and Quadrant and Thames Valley Housing have responded by starting to build up their own portfolios. The government has also responded with the creation of the Build to Rent fund: a £1 billion equity fund to get purpose built rental developments across the UK off the ground by 2015. The fund is administered by the Homes and Communities Agency and the first round of bids is currently being scrutinised by external experts, with an expectation that contracts will be signed over the summer. But is the UK housing industry well placed to make a success of build to rent? What are the challenges that build to rent poses for housing providers who largely have a track record in the development and management of social housing or homes for sale?

[1] Whittaker, M (2013) *Squeezed Britain 2013*, London: The Resolution Foundation
[2] De Santos, R. (2012) *Homes Fit for Families? The case for stable private renting*, London: Shelter.
[3] Montague, A. (2012) *Review of the Barriers to Institutional Investment in Private Rented Homes*, London: Department for Communities and Local Government.

The Resolution Foundation and Social Finance build to rent project

This briefing note looks at the challenges that build to rent poses for housing providers. It is based on a six month project conducted by the Resolution Foundation and Social Finance to develop a financing model for institutional investment in a build to rent portfolio of 778 rental units nationwide aimed at middle income households.

The portfolio is made up of 16 unique developments in London, the North West, South West, Midlands and Scotland put forward by the project's six housing partners: the Dolphin Square Foundation; Derwent Living; GreenSquare Group; Great Places: Home Group; and Plus Dane. The housing partners have been closely involved in the development of the modelling and have provided extensive information on development and management costs and expected rents for each development. A report outlining the project's full findings, including expected investor returns, will be published in September 2013.

Build to rent: a new asset class

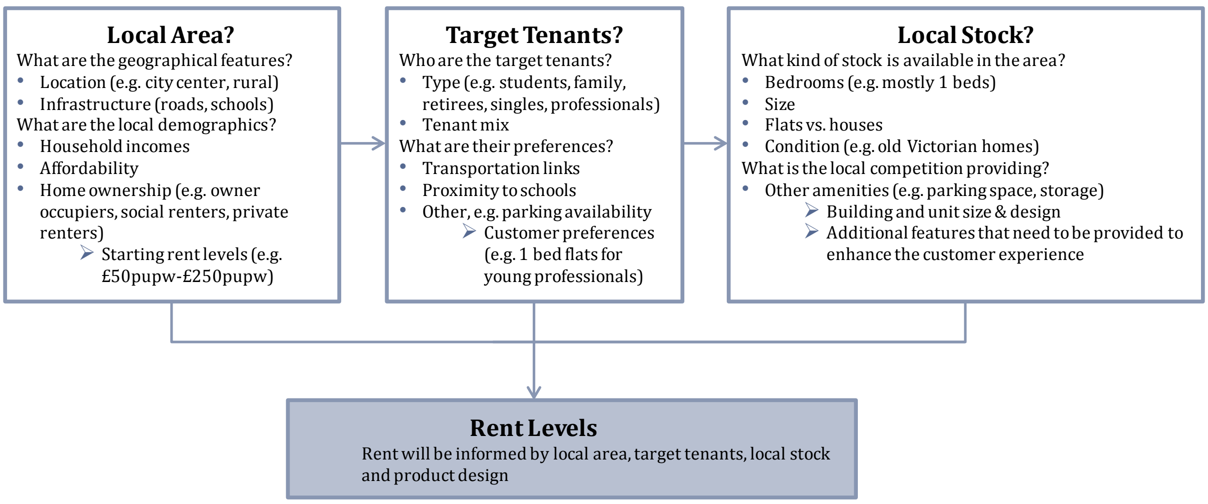
Historically, the UK has had purpose built, professionally managed rental developments owned by large financial institutions. Today, this remains true in the social housing sector but not in the private rented sector. New stock enters the private rented market when units in for sale developments cannot be sold or when existing owner occupied homes are converted into buy to let properties. First and foremost, this means that the development of most private rented stock does not start with the needs of a particular tenant group in mind. It is not built for long term renting; tends to be scattered rather than concentrated within purpose built developments; is predominantly old stock; and is not managed at scale with the economies and standards that this can bring.

In this context, build to rent represents a new asset class for housing providers in the UK and one in which few providers, whether housing associations or private developers and landlords, have a long track record. Optimising returns for investors in order to kick start and then grow the private rented sector will depend on a sound understanding of this new asset class and the ability to develop and manage it as efficiently as possible. This is all the more important in light of the reported lack of interest among banks and other financial institutions in administering the government's private rented sector debt guarantee due to tight margins.[4] Optimising returns will require a focus on the following five aspects of build to rent.

1. Identifying locations with long term rental demand

Build to rent is unlikely to work well in all parts of the country. This is not a simple story of London and the South East versus the rest of the country, as is often assumed. Across the 16 unique developments that we have analysed, schemes in London, the North West and the Midlands offered amongst the highest yields, but other schemes in the same regions offered among the lowest yields. The challenge is more one of picking the right places within regions based on who the target tenant is; the nature of the local area; and the existing local stock that acts as the competition (see Figure 1). These three factors combine to determine whether there is long term demand which in turn will determine rent levels. Given that little private rented stock is currently purpose-built and most new stock was originally built for sale, there is limited experience as to how to identify the places where investor returns could be optimised by addressing a market need for a particular type of tenant.

Figure 1: Factors that drive rent levels for build to rent



[4] '£10bn guarantees could be run by CLG', *Inside Housing*, http://www.insidehousing.co.uk/finance/%C2%A310bn-guarantees-could-be-run-by-clg/6527339.article

2. Designing a purpose-built private rental product

Related to the point above is the challenge of how to design a rented product for different types of tenants. With fragmented buy to let being the only product in the market at present, there is little industry wide understanding about what different tenants want from a bespoke private rented product and how that relates to the costs of development, costs of management and rent levels. What is the right mix of units for a particular development; what percentage should be flats and what percentage houses; what size of building would tenants prefer; what amenities do they look for and are some best provided for in common areas? What additional services will tenants pay a premium for and what would be expected as standard? Should units be unfurnished as in social housing or furnished as in the buy to let market? Does the nature (Registered Provider or private for profit) of the manager of the property and the letting agent matter to tenants? Optimising yields depends on a clearer understanding of these aspects of product design.

Development characteristics for the 16 developments if the Resolution Foundation and Social Finance created a build to rent portfolio

Unit Summary	Number	% of Total Units	
Total Units	**778**	**100%**	
By Unit Type:			
Studios	4	0.5%	
1 beds	62	8%	
2 beds	341	44%	
3 beds	295	38%	
4 beds	76	10%	
By Region:			
Central London	104	13%	1 housing partner, 2 developments
Outer London	152	20%	1 housing partner, 1 development
South West	164	21%	1 housing partner, 4 developments
Midlands	28	4%	1 housing partner, 2 developments
Northwest	270	35%	2 housing partners, 6 developments
Scotland	60	8%	1 housing partner, 1 development

Development Costs:	Aggregate	Average by Unit
Construction Costs	(£82,058,785)	(£105,474)
Land Costs	(£29,151,793)	(£37,470)
Other Development Costs	(£11,527,005)	(£14,816)
Administrative, Regulatory and Other	(£10,788,822)	(£13,867)
Developer Margin	(£6,676,320)	(£8,581)
Total Development Costs	**(£140,202,725)**	**(£180,209)**

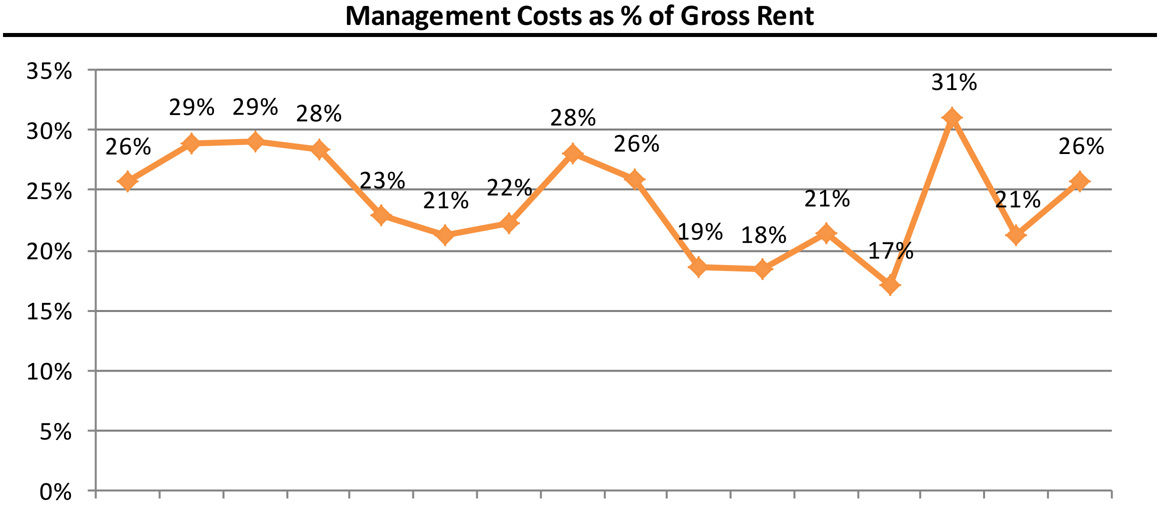
3. Identifying the costs of purpose-built private rented developments

The standard costs of housing developments for sale or for social housing are well understood. Our analysis based on the portfolio of developments shown above is in keeping with standard assumptions: construction costs account for around 60 per cent of overall development costs and land around 20 per cent (see box above). However, there is an assumption that purpose built rental developments should have a slightly different cost profile, although disagreement remains as to whether build to rent should cost more or less to build than homes for sale. Built assets consultants, EC Harris, for example, estimate that purpose built rental developments could have costs around 5 per cent lower than standard developments for sale.[5] However, given the emerging nature of the asset class, there is little hard evidence based on actual developments at this time to corroborate either lower construction costs or how construction costs relate to on-going management costs. Over time, there should be a growing body of intelligence from new build to rent developments to be able to make more fine-grained assessments of the costs of purpose built developments and further optimise returns.

4. Accurately estimating management costs

The viability for investors of any build to rent development is highly sensitive to assumptions about on-going management costs. These include the costs of managing, maintaining and re-letting property. Management costs is the one area where we found the largest differences between organisations, and the range of variation has the potential to make some high gross yielding schemes unviable and vice versa. According to our analysis, a 10 per cent fall in these costs would drive around a 10-20 basis point increase in the net yield. Interestingly we found across our sample of 16 developments no clear correlation between management costs and gross rents. This is illustrated in Figure 2 which shows management costs as a percentage of gross rent for each of the 16 schemes. Schemes are ranked by gross rent from low on the left of the chart to high on the right.

Figure 2: The range of management costs among the 16 unique developments

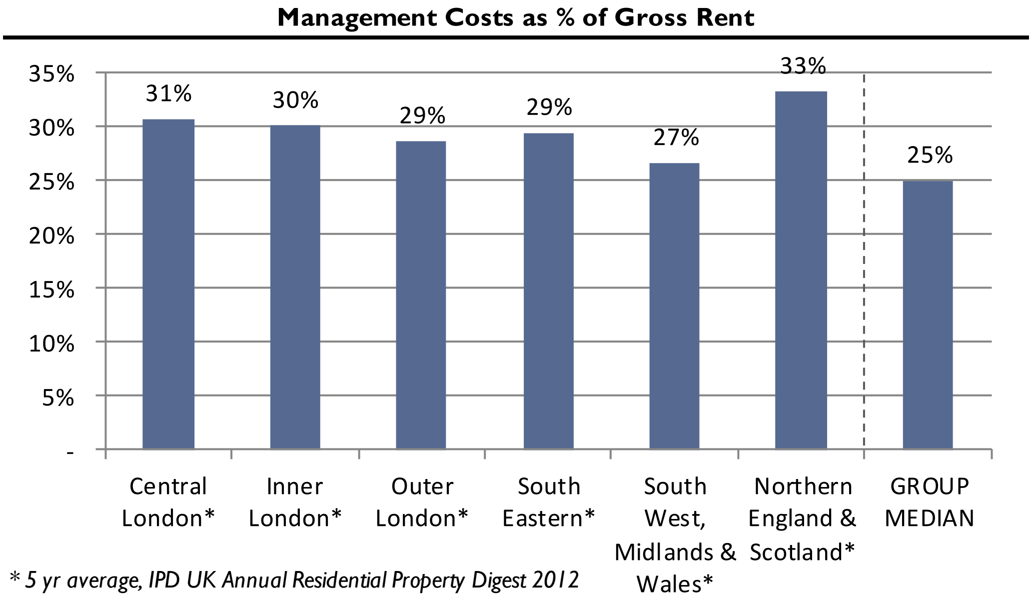


Knowing what percentage of gross rent should be accounted for by management costs in a build to rent development is tricky. First, the leading benchmark for the private rented sector, the Investment Property Databank (IPD), is based largely on old stock and is heavily weighted towards London. EC Harris assumes a 5 to 8 per cent discount to the IPD data on management costs for new build stock with improved efficiencies and scale (e.g. through the creation of larger buildings or a portfolio). Second, assumptions based on current practice in social housing where management costs can be in excess of 50 per cent of gross rent, are naturally skewed by the lower level of gross rent but also reflects a higher level of additional support services delivered by housing associations.

Third, it is important to be able to disaggregate the maintenance costs needed to maintain a property at its current lettable standard, and work that is undertaken to improve a property (to drive a rent increase). The second type of maintenance spending is highly relevant for older stock and is, therefore, a potentially significant part of currently reported maintenance costs for older portfolios such as those covered by the

IPD but would not be relevant for new build properties in the first 10 years. Overall, in-depth work with our housing partners to better understand management costs identified group median management costs of 25 per cent of gross rent which is in line with the discount EC Harris proposes to the IPD data. This is shown in Figure 3 below.

Figure 3: Group weighted average management costs compared to IPD management cost benchmarks by region



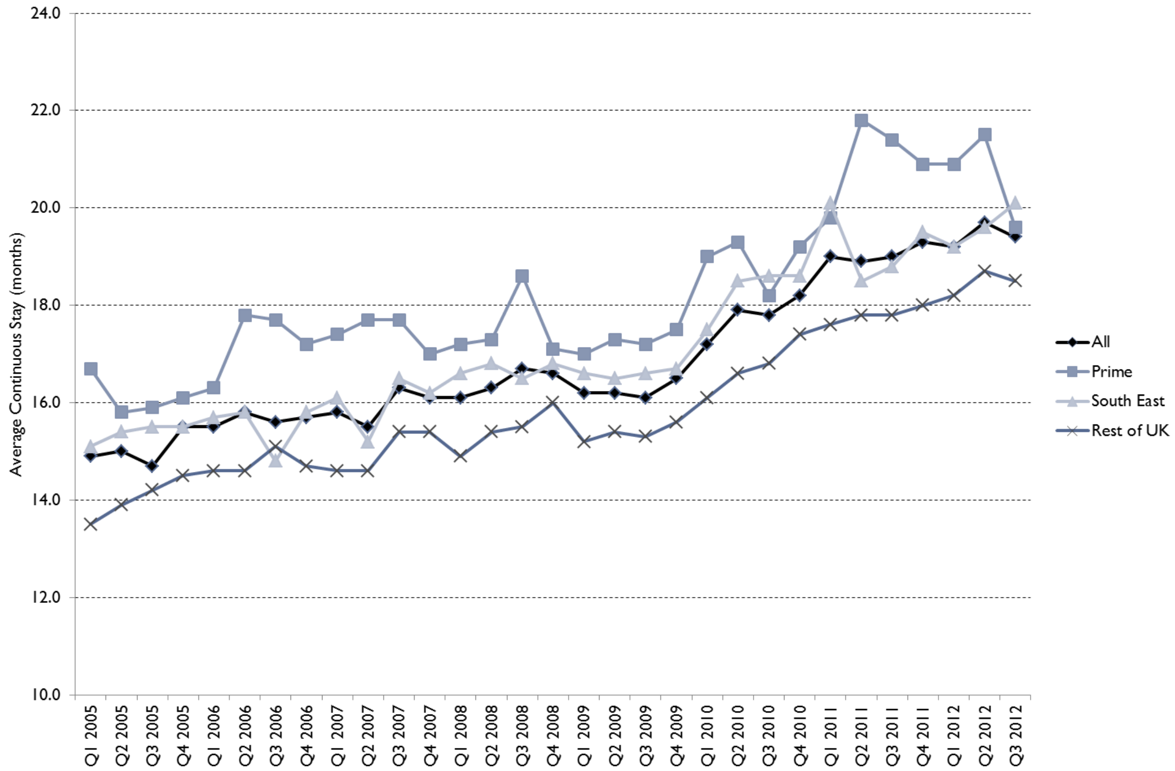
5. Estimating the impacts of longer tenancies

Occupancy has been steadily increasing in the private rented sector over the last decade as the number of people stuck in the sector grows. According to the English Private Landlords Survey, median tenancy length in 2011-12 was two years and mean tenancy length was close to four years. Figures from the Association of Residential Lettings Agents shows a similar increase over time (see Figure 4). Additionally as a consequence of the strong continued demand, void periods – the length of time a property is empty between tenants – have been falling across the country and are now typically between 15 and 25 days.

Although occupancy is on the rise, most private rented properties are offered on the basis of a six month short-hold assured tenancy which is simply renewed. This creates a sense of insecurity for certain tenants because it carries with it the threat that the landlord will ask them to leave at short notice. To address this perceived lack of security, there is appetite among housing providers to offer longer tenancies in build to rent, especially where they are targeting families rather than younger tenants. The Dolphin Square Foundation is offering three year tenancies on its London developments and Genesis Housing Association is offering private tenants in London the chance to sign up to a five year tenancy. After the first six months, tenants will only have to give two months' notice if they want to move.

Tenancy length is significant for two reasons: it affects void rates and the length of void periods both of which affect the net operating income from any build to rent development. The impact of introducing longer tenancies of between three and five years on void rates and void periods is hard to predict with such little experience of these products in the market place. Although void rates should fall if tenants sign up to stay longer, void periods may still need to be slightly longer if units are in need of a greater overhaul between tenants. As the sector gains experience of the demand for longer tenancies and their impact on void costs, it will be possible to adjust the cost base accordingly and optimise investor returns. Increasing tenancy length and reducing void periods are both potentially important parts of improving the net operating income of build to rent developments at the same time as creating greater security for tenants.

Figure 4: Change in tenancy length in the private rented sector over time



Source: ARLA Members Survey of the Private Rented Sector

The role of registered providers in build to rent

Build to rent provides an opportunity for Registered Providers (RPs) to attract new capital into their businesses as grant funding from government continues to decline. Developing private rented units and selling them onto investors to hold for the long term creates an opportunity for RPs to keep recycling their capital and to keep building. However, alongside the challenges that build to rent presents to all housing providers in the UK given that it is a new asset class, it presents four additional challenges to RPs whose core purpose has been the provision of social housing.

First, there is a challenge for each RP to identify how build to rent fits within its organisational purpose. Some see it purely as a market activity whose purpose is to cross-subsidise the core function of an RP which is to provide social housing. Others recognise that those who can no longer afford to buy represent a new form of housing need to which RPs are well placed to respond. Some RPs see build to rent as a threat to social housing because it may reduce affordable housing requirements; others recognise an opportunity to diversify their operations. It will be important for RPs to identify the role that build to rent can play within their organisational strategy in order to determine the terms under which they are willing to engage in build to rent and to work with investors.

Second, RPs will need to develop the capacity to deal with complex investment opportunities and structures. While some of the largest RPs are highly sophisticated businesses, the sector is diverse in size and capacity and some RPs are not currently well equipped to maximise investment opportunities. Issues such as the structure of performance-based contracts and equity stakes in long term financing vehicles are ones to which the sector has not traditionally had to respond but which will form a central part of negotiations with investors.

Third, for those RPs who are charities, the current lack of clarity as to whether build to rent fits within an RPs charitable purpose creates uncertainty in moving forward. It is currently ambiguous as to whether taking development risk on market rent properties, rather than simply investing in the private rented sector as part of a wider investment portfolio would be deemed to fit with an RP's charitable objects to house those in need. If RPs cannot develop through their charitable arm and have to use a non-charitable subsidiary, they will incur additional stamp duty land tax on land purchase, which will affect costs and, therefore, returns.

Finally, for the RP sector as a whole, the situation is complicated by the fact that the regulator is currently consulting on the regulatory framework for social housing in response to the growing diversification of the sector. The consultation specifically includes issues that will affect how RPs can structure deals with investors and are expected to manage risk. For example, the consultation raises questions about the need to ring fence social housing assets to ensure that they are sufficiently isolated from potentially riskier non-social housing activity. Ring fencing in this way would prevent RPs leveraging their social housing assets for build to rent developments. Whatever the conclusions of the consultation, a clear position from the regulator as to the permitted scope for RPs to engage in build to rent will be important to encourage the sector to move forward.

Despite these challenges, RPs also bring advantages to build to rent that make them well placed to play an important role in the development of this asset class in the UK. In giving evidence to the House of Commons Select Committee for Communities and Local Government Sir Adrian Montague himself described RPs as 'core contributors to the sector as it develops', although he was clear that new entrants would also be essential.

First, RPs have the capacity to finance the development of new build to rent units at a low cost of capital, creating new stock that can be sold onto investors. This overcomes one of the major barriers to getting this new asset class off the ground: the lack of stock for investors to buy. If RPs and similar housing providers in different parts of the country build rental units, let them to tenants and, once the rental income stream is stabilised, sell them onto long term investors, they could create build to rent portfolios of a scale that would attract institutional investors. This is the approach to build to rent that we have been modelling and will report on in September 2013.

Second, RPs represent the vast majority of large, professional housing managers in the UK. Although there are some large scale landlords in the private sector, the largest body of expertise and experience in housing management rests with RPs. Although they have to develop their management operations to better suit build to rent as discussed earlier, they start with a strong management track record and ought to be able to provide economies of scale in areas of the country where they are already actively managing social housing. Their wealth of experience will provide reassurance to investors who are new to build to rent.

Third, RPs are socially responsible landlords with a long term interest in housing and a track record of meeting tenants' needs and expectations. This makes them potentially well suited to developing a build to rent product aimed at those who will be long term private tenants, particularly families. Although most private rented housing in the UK to date has not started from the needs of the tenant, there is a need for innovation in the types of rental product that can be found in the UK and RPs have a clear role to play here.

Conclusion

There is a pressing need to create a new asset class of purpose built rental developments in the UK to increase supply in the private rented sector and to create a different product for tenants, particularly those who will rent long term. While build to rent is attracting a lot of attention from government, investors and the housing sector, it is not without its challenges for housing providers. Central to this is the fact that build to rent is a new asset class and, therefore, current assumptions about development and management costs are not necessarily fully informed. This makes it difficult to optimise returns from such developments which will be critical to accessing the long term finance from institutions that can sustain this new asset class. Optimising returns will be especially important if build to rent is to meet the needs of low to middle income households. To work for this group, build to rent needs to be viable without relying on above average inflation increases in rents and capital values which will erode affordability overtime. This, therefore, puts a premium on efficient design, construction, marketing and management.

While build to rent will undoubtedly draw in new innovative housing providers, there is a clear opportunity for RPs to play an important role in kick starting the sector. However, the scope for RPs to drive forward build to rent will heavily depend on the conclusions reached by the Regulator at the end of the current consultation period. If the Regulator insists on a firewall between an RP's core social housing activity and other commercial operations such as building homes for sale or for market rent, RPs will be significantly restricted in their ability to fund commercial activity, except through their non-RP subsidiaries. However, these would no longer benefit from the preferential terms that they currently enjoy because they would not be able to rely on the covenant of the RP parent organisation.

Many of the challenges raised in this briefing note will be overcome in time as the build to rent sector develops and matures and its cost base become clearer compared to social housing or homes for sale. In the meantime, there is a need to subject all assumptions to close scrutiny to ensure that they are optimised for this new asset class. Having done so, a question remains as to whether build to rent can generate a level of return that is attractive to different kinds of investors and where in the country attractive returns can be found. This will be discussed in detail in our final report to be published in September 2013.

The Resolution Foundation

The Resolution Foundation is an independent research and policy organisation. Our goal is to improve the lives of people with low to middle incomes by delivering change in areas where they are currently disadvantaged. We do this by:

- undertaking research and economic analysis to understand the challenges facing people on a low to middle income;
- developing practical and effective policy proposals; and
- engaging with policy makers and stakeholders to influence decision-making and bring about change.

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