Resolution Foundation

Making Institutional Investment in the Private Rented Sector Work

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Background

As an increasing proportion of people on low to middle incomes find themselves shut out of home ownership, there is a pressing need for growth in the private rented sector (PRS)[1] to meet the needs of these long term tenants and improve the affordability of the sector. This does not replace the importance of investment in affordable housing to meet the need for more vulnerable households but neglecting the PRS will push more working families onto housing waiting lists and eventually hamper growth and employment in many cities where rents continue to rise

Since the early 1990s, the PRS has grown from 8 percent of the housing market to 16 percent today, as social renting fell from 25 percent to 18 percent.[2] Projections commissioned by the Resolution Foundation and Shelter indicate that demand for private rented housing will continue to grow, reaching 22 percent by 2025 under a weak economic recovery and as much as 37 percent in London.[3] Those living in the private rented sector will increasingly include families with children who are poorly suited to the variable quality and lack of security provided by today's buy to let sector (see Figure 1).[4] As one private tenant in the low to middle income group commented, "the insecurity and its effect on your quality of life is not good – because you're worried that if you get kicked out you've got to find £1,500 for a new deposit".[5]

Given significant cuts to public investment in housing, the need for new sources of private investment to increase the supply of private rented housing has never been greater. Successive governments have sought to bring institutional capital from pension and life funds into the residential market in line with other developed economies. There have been a small number of success stories, most recently the purchase of the Olympic Village by a sovereign wealth fund, but institutional investment has not taken off as hoped. Institutions continue to invest principally in commercial rather than residential property with the exception of social housing.

The Department for Communities and Local Government is shortly expected to publish the findings of an independent review into institutional investment in build-to-let development conducted by Sir Adrian

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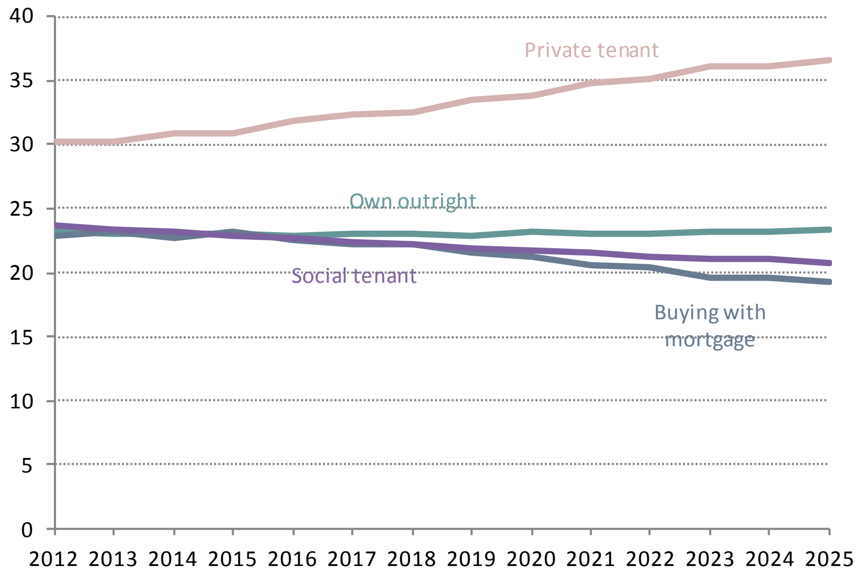
[1] The private rented sector comprises all non-owner-occupied property other than that rented from local authorities and housing associations plus that rented from private or public bodies by virtue of employment.
[2] Whitehead, C., Williams, P., Tang, C and Udagawa, C. (2012) Housing in Transition: Understanding the dynamics of tenure change, The Resolution Foundation and Shelter.
3 Whitehead, C., Williams, P., Tang, C and Udagawa, C. (2012) Housing in Transition: Understanding the dynamics of tenure change, The Resolution Foundation and Shelter.
[4] Darian, L. (2011) Meeting the Housing Needs of Low to Middle Earners, The Resolution Foundation.
[5] Resolution Foundation focus group with PRS tenants, London, 27th October 2011

Montague.[6] This briefing sets out an approach to build-to-let development that could kick start institutional investment and identifies the policy changes that would be required to support it.

This briefing is based on a financial model for debt and equity investment in the PRS that the Resolution Foundation has been developing in collaboration with the Royal Bank of Canada (RBC) over the last 12 months. The model targets households on low to middle incomes, building on the conceptual approach set out in the Resolution Foundation's 2011 report, *Making A Rented House a Home: Housing solutions for 'generation rent'*.[7]

Figure 1: Household projections by tenure, London (%)



Scenario: Scenario: weak; social rented stock: constant; excess social rented demand: all to PRS

Source: Whitehead, C., Williams, P., Tang, C and Udagawa, C. (2012) Housing in Transition: Understanding the dynamics of tenure change, The Resolution Foundation and Shelter.

The barriers to institutional investment

Government reviews have generally identified a common set of barriers to institutional investment in the private rented sector: lower yields in the residential than the commercial sector; the lack of opportunities

[6] http://www.communities.gov.uk/publications/housing/prsreviewcall
[7] Alakeson, V. (2011) Making a Rented House a Home: Housing solutions for 'generation rent', The Resolution Foundation

for investment at scale; concerns about possible risks to reputation; and the lack of efficient, high quality management.[8]

Perhaps the most significant barrier to unlocking the potential of institutional investment is to get the proposition right for investors. In general, investors are reluctant to invest in the development phase to get rental schemes up and running. This is a relatively risky proposition for investors and one for which it is particularly hard to make a case when investors do not have any track record in the sector. Their preference is to buy rental units at scale once they have been built and let and are generating an income stream. At this point, investors can be sure what level of return the units are generating and can invest with greater confidence that their expectations can be met. Once they are fully let, private rented schemes can provide investors with a long term, inflation-linked income stream that can match their long term liabilities.

But development finance to get schemes off the ground is difficult to raise in the current banking environment and raising development finance without a guaranteed buyer increases the costs of borrowing. At the same time, investors do not want to commit their money several years in advance of the rentals units being ready to buy, creating a vicious circle around the development of build-to-let schemes. House builders currently face a similar problem. With restricted access to mortgage finance, builders cannot be certain that new homes will be bought and, therefore, supply has been choked off.

In contrast to other kinds of property assets such as office buildings, retail complexes and student accommodation, there is not a ready stock of build-to-let assets for investment funds to buy. Creating a vibrant build-to-let sector supported by institutional investment will depend on overcoming the barrier identified above to create a proposition that can draw in private capital. The model set out below provides one potential route to kick starting institutional investment in the PRS.

A model for institutional investment in build-to-let

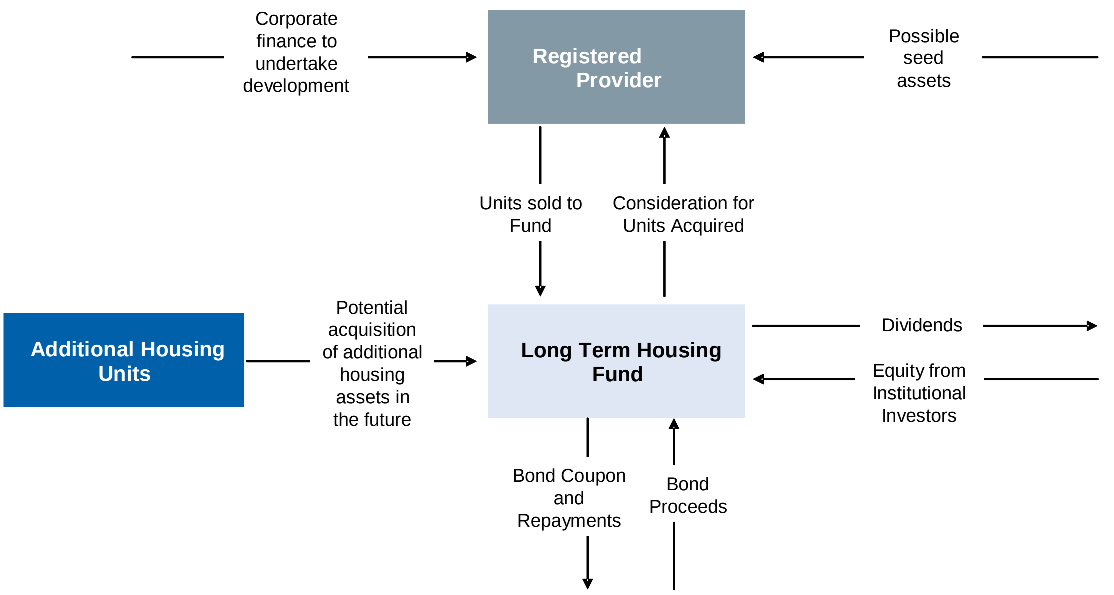
As developers and managers of housing assets with a long term interest in housing, some Registered Providers (RPs)[9] have the capacity to kick start institutional investment in build-to-let in the private sector. Diversifying their portfolio of property away from affordable housing can help sustain their core activity in the absence of significant investment from government, as well as providing a progression route for their tenants as part of mixed tenure housing developments. Furthermore, RPs require lower returns that private sector developers and have the ability to use newly built stock in other ways if an investment fund does not

8 HM Treasury (2010) Investment in the UK Private Rented Sector, HM Government.

9 Registered Providers are housing providers registered with the Homes and Communities Agency for the provision of social housing. Under changes brought in under the Housing and Regeneration Act 2008, Registered Providers can be both for profit and not-for-profit.

materialise to buy the stock once completed. This overcomes the barrier of investors having to commit money several years in advance. The model would work as follows (see Figure 2):

Figure 2: The development and long-term operating phases of build-to-let



- A consortium of Registered Providers builds private rented units on balance sheet, benefiting from their ability to raise construction finance competitively given their status as government backed organisations.
- Units could be built by the consortium on sites across the country to generate the scale of investment required by investors without that having to be delivered on a single site. For example, 10 sites that could accommodate 100 units each could create a fund of £100 million to attract large scale investors.
- Once the units were built and let and the income stream from the units stabilised, the units would be sold onto an investment fund which would buy and hold the units for the long term. This would allow RPs to recycle the capital from the development phase to invest in affordable housing or further PRS units.
- If necessary, RPs could hold the units and draw on the income stream for the length of time required to generate adequate scale to exit into the institutional market for example by listing the fund as a real estate investment trust (REIT). This would allow investors to trade shares and move in and out of the REIT rather than being committed to invest over a specific length of time. This may increase the attractiveness of the investment for equity investors.

- RPs could maintain an equity stake in the fund or REIT and use the returns from that stake alongside the proceeds from the initial sale of units into the fund to recoup their costs of development and the upfront costs of the land.
- RPs would manage the units over the long term and insulate investors from day to day issues with tenants and mitigate any reputational issues for investors.

Once a fund had been raised and investors had developed greater confidence in the sector as an investment proposition, it is likely that investment could be drawn into the sector at the development stage or guaranteed at the point at which the units were built and let.

The Resolution Foundation and Royal Bank of Canada are currently working with a group of five RPs to model the returns that would be generated by this approach to build-to-let development. The details of this work will be published this autumn.

How policy can help support institutional investment

There are four critical ways in which policy could support greater institutional investment in the private rented sector. Without action on these fronts, institutional investment will struggle to get off the ground, limiting much needed growth in the private rented sector.

1. Political leaders at the national, regional and local levels need to give a clear signal that they see the private rented sector as a strategic priority and are committed to supporting build-to-let. While investors see political interference in the housing sector and sudden changes in policy as highly undesirable, investors and other stakeholders in the sector need to know that government is serious about supporting the private rented sector. While the government has understandably been strong on its support for first time buyers, it has been less vocal about its support for a high quality, private rented sector. Leadership in this area will be critical.
2. Local Authorities need to include the private rented sector as part of their overall housing strategies and recognise those in work who cannot access either home ownership or affordable housing as a legitimate form of housing need. This marks a move away from a bifurcated approach to housing policy which previously recognised home ownership and social housing and left much of the rest to the market.
3. It will be critical that Local Authorities support PRS development through the planning system. Central to this will be their ability to strategically designate land for PRS development rather than for residential development in general. This will lower the price of land and make returns more viable for institutional investors. To satisfy these planning requirements, Local Authorities should insist that

properties are maintained in rent for the long term, meet the needs of groups who are shut out of ownership and offer tenants a quality product with greater security of tenure than the current buy-to-let sector. The current flexibilities in the planning system allow Local Authorities to promote PRS development in this way without needing to introduce a separate planning class for private rented property.

4. The Homes and Communities Agency (HCA), the national housing and regeneration agency for England, should designate a proportion of public land specifically for build-to-let development which can be invested or purchased on a build now, pay later basis. As part of the strategic use of public land, the HCA needs to incorporate land held by other government departments, the NHS and transport agencies, as well as supporting Local Authorities to invest their land on a similar basis.

Early indications are that the Montague Review will make recommendations in a similar vein to the ones above.[10] The onus will then be on government to respond positively with concrete policy actions to stimulate the build-to-let sector.

As rents continue to rise, the urgency felt by families for access to a better quality product in the private rented sector grows. Institutional investment in build-to-let provides an opportunity to create a new, professionally-managed product better suited to long term tenants as well as increasing the overall supply of housing and stimulating economic growth through construction.

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[10] http://www.insidehousing.co.uk/finance/private-rented-funding-formula-revealed/6522524.article

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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