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If You Build It Will They Come?

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The summer has seen a drive for consensus on how to tackle viability in planning, with the publication of RICS and Local Housing Delivery Group guidance. The Government is also consulting on the relaxation of planning requirements to stimulate economic activity. In the midst of all this, the Montague Review has reported on how best to promote institutional investment in the Private Rented Sector (PRS) through direct funding of new development for long-term rent – 'Build to Let'. Roy Pinnock considers the backdrop to the Review and whether its recommendations can achieve the ultimate goal of mobilising institutional investment in volume homebuilding.

Look on the supply side

The Coalition Government took office with ambitious plans for housing – removing the targets and budgets for delivering it but ultimately requiring similar targets to be set locally through the National Planning Policy Framework (NPPF). It launched the abolition of the Regional Spatial Strategies as the most significant governmental intervention in support of house-building since the Second World War[1]. The 'gold-standard' against which the Coalition has said its reforms should be judged is whether they return house-building quantum to pre-recession levels.

Unfortunately, the gap between new households and supply is widening again. Fewer new homes are being constructed than at any time since 1924 (with average annual declines of 26,000 completions between 1997 and 2009). In each of the last two financial years, new output has only just exceeded 100,000 homes (against a need for 230,000 per year[2]). The concern is that reduced household formation will lead to overcrowding and social division.

How fiscal tightening and Localism will buck that trend remains unclear - planning approvals for housebuilding fell to a new low in 2011[3].

The Government's Housing Strategy (Laying the Foundations, November 2011) highlighted the role of the New Homes Bonus (NHB). The Localism Act 2011 introduces NHB as a 'local finance consideration' in planning, provided that it is material to applications. Doubts linger about ensuring that materiality and about the effectiveness of relatively modest payments in creating popular and political support for housing growth. Aside from whether a centralised payment system costing the taxpayer £200m each year is appropriate, NHB also appears to have been most frequently attracted by student housing and conversion of multi-occupied dwellings rather than net new build[4].

In tandem with a 50 per cent reduction in the affordable housing budget in the Comprehensive Spending Review, the Housing Strategy introduced 'Affordable Rent' as an effective replacement for 'social rent' tenures. In areas where there is most divergence between market and social rents Affordable Rent

BOX 1: DRIVERS FOR PRIVATE RENTED SECTOR

- **Demographic change**: declining ownership affordability, delayed family formation, student debt, smaller households.
- **Lifestyle choice**: young professionals where reduced costs and responsibilities of renting form part of a lifestyle choice, along with later family commitments.
- **Low entry/ exit costs**: suits transient populations – young professionals, contractors, migrant workers, home-leavers and students.
- **Choice and quality**: better locations and flexibility than ownership
- **Intermediate**: providing the only option now available to households earning low to medium incomes

(up to 80% of market rent) will rarely achieve development plan policy objectives. Local authorities are therefore considering whether to accept, modify or reject it. Delivery by housing associations and local authorities is now at a seven year low[5].

The role of the Private Rented Sector (PRS)

The previous Government's house-building targets aimed to increase owner-occupation and provide more affordable housing. In an economic environment struggling to deliver either, there is a risk of creating a two-tenure housing market unable to meet the housing needs of those who cannot access either but are not eligible for affordable housing[6]. There are around 3 million households living in the PRS, with 900,000 of those having becoming renters since 2005[7]. This includes a million households on low-to-middle incomes[8].

In 1918 almost 80 percent of households in Britain lived in rented accommodation. In Switzerland and Germany approximately two-thirds and half (respectively) of all households now rent. In the late 1930s, the PRS accounted for more than half of all UK households. By the late 1980s, this had declined to less than 10 per cent[9]. Renting hit an all time low of 10 percent in 1998[10], but declining ownership affordability, demographic change and mortgage lending liberalisation - 'buy to let' – have fuelled its recovery.

BOX 2: Barriers to Institutional Investment in Residential Property

1 A lack of available 'institutional grade' investment stock.

2 Historically low yields compared to other assets and unclear long-term demand

3 Small lot sizes increase portfolio transaction/ holding costs.

4 A lack of quality data and metrics compared with commercial property.

5 Ability to price assets based on an income multiple for valuation rather than the traditional UK residential approach of a discount to vacant possession value.

6 Residential seen as management intensive

Source: Hamptons International Research, May 2012

People on low-to-middle incomes who are locked out of ownership have become increasingly dependent on the private rented sector. The surge in demand for PRS accommodation is being driven by many of the same factors that are fuelling the housing crisis (Box 1). By 2008, 12 per cent of households were in the PRS and there was 25% more unmet demand for private rented accommodation than for buying homes[11]. A fifth of new housing supply needed to be privately rented to meet that demand[12]. Today, the PRS accounts for 17% of households[13], expected to rise to 27% by 2020[14].

In an era of fiscal tightening and housing shortage, there is a policy imperative to help the PRS provide more accommodation. Whilst 'buy to let' has recovered, it tends not to generate net gains in stock. Without a new source of private investment, the PRS is unlikely to be able expand enough to meet the needs of 'generation rent'.

Institutional interest

Institutions such as pension funds, insurance companies and sovereign wealth funds currently own only 1 percent of residential rental stock in the UK (compared to 10 to 15 percent in most European countries[15]). Harnessing some of the £2.4 trillion of annual institutional equity investment has therefore been the goal of successive administrations. Around £120bn of that investment is in commercial property[16].

Aside from providing a different source of development finance at a time when debt and public funds are retreating, institutional investment into the PRS would support a shift in the type of rental product that the sector offers for those who become long-term tenants. Longer term contracts, higher quality, more consistent management and the ability to make home improvements would replicate some of the desirable features of home ownership.

Barriers to entry

Institutional players are now interested in the PRS. Stable, and rising, rents and lower capital values have pushed yields out, whilst recent average residential property returns have been higher than for commercial property. Residential investment still does not fit with most institutional investment profiles though (Box 2). Overall residential rental yields are often underpinned by selling property - 'churn'. Institutions therefore remain concerned by the extent to which PRS performance is driven by capital appreciation rather than income generation.

Corporate investment in the PRS is evolving, but to date has not resulted in institutional Build to Let. Recent innovation has focussed on innovative social housing financing and acquisitions of 'oven ready' PRS portfolios by corporations and joint ventures (Box 3). This is linked to a wider switch to 'liability matching' assets – essentially investments that ensure that that cash is available for meeting payout events as they occur, rather than simply maximising returns from traditional fixed income assets. One further mechanism for institutional investment in PRS is through REITs, where individual 'retail' investment can be portable as a share. PRS portfolios have generally been acquired with planning permission in place, or already constructed. Built to Let - using institutional equity to design, promote and deliver PRS accommodation - has so far proved elusive.

PRS stock is more dominant in Germany and Switzerland because barriers to home ownership, culturally acceptable rent models (including long-term leases with transparent security and rent structures) have been accompanied by effective Government support through tax reform and planning/ zoning incentives[17]. The Rugg Review, commissioned by the previous Government in 2008, pointed to the need for regulatory reform to establish a long-term funding model for new private rented housing[18]. As a result, some recent changes have removed barriers to entry for institutions (see Box 4). The Treasury and CLG are also exploring options for adapting the REIT regime to support the creation of a social housing REIT business model.

What's new in Montague

The Montague Review invited representations in February on whether SDLT and REIT reform had gone far enough to generate significant new flows of investment (and what more can be done). The Review report is commendably brief. Its main message is that the government should explicitly recognise the value of Build to Let, encourage local authorities to use it to meet housing needs and acknowledge that private rented development has a different economic model to building homes for sale. It makes five recommendations.

Firstly, that the planning system should be used to support Build to Let, reflecting the needs of private rental markets in housing market assessments and restricting new PRS developments to private rent for 10 to 21 years. This control is critical to create a distinct land value for homes built for private renting rather than sale. The Review also suggests that relinquishing affordable housing will be appropriate in some circumstances. This is nothing new. Local authorities already have the discretion, and are under ever increasing pressures, to do so. They must balance their commitments to housing the most vulnerable, and low-middle earners outside the affordable sector, with a broader economic agenda for local growth and employment that depends on allowing delivery of homes, provided that they create a positive sense of place. The Review reflects the current search for viable models for delivering volume and affordability over the rest of this economic cycle - in some places 20% of something will trump 40% of nothing in affordable housing terms. Elsewhere, there is an ongoing challenge of identifying, explaining and evidencing where the planning balance lies.

BOX 3: PRS INVESTMENT INTEREST

Places for People (social landlord)

- £1bn raised through private finance in UK and overseas (compared to £340m received in government funding)
- £140m retail bond issued on the London Stock Exchange in Summer 2011 (fixed gross rate of interest of 5% per year until December 2016)
- £40m 10 year RPI linked bond issued in January 2012

Grainger-Bouygues Fund

- £150m joint venture fund between the French construction group and UK's largest listed landlord. 8 year life-span (with an option to extend it by three years)
- Upfront co-investment by the JV partners, with additional funding sought from institutional investors. Bouygues will build and Grainger will operate.
- 1,000 units across Four sites, all publicly owned and already consented

Aviva Investors

- Aviva Ground Rent, Student Assets, Social Housing and Commercial Assets Funds launched last summer
- Aimed at addressing under-funding and hedge against inflation risks

Portfolio acquisitions

- **Delancey/ Qatari Diar**: private sector Olympic Village housing acquired as rented portfolio
- **Akelius/ Terrace Hill**: £75.35m acquisition of 574 tenanted apartments from Terrace spread across 26 sites in London and the South East

The Review also stresses the need to release public sector land as an equity investment, which may often result in better returns than a straight land sale, on current values. Thirdly, the Review recommends targeted incentives to support investment in Build to Let, broadly providing the equity or debt support for demonstrator schemes (including construction finance where the public capital is recycled once the development is completed). The Review also recommends the creation of a Build to Let Taskforce to promote pilots, provide technical support and work with the HCA to maximise the use of public land. Given that the Housing Strategy aimed to release public sector land to deliver 100,000 homes by 2015, Government should start by earmarking some of the 4,300 hectares available for expedited Build to Let pilots. Around 4.5% of central Government's £280bn office estate is also vacant, expected to rise to 11% by 2020[19]. Some of this can be turned to residential. Careful consideration will need to be given to state aid issues when investing this land in funds. Finally, the Review sensibly proposes the creation of a clear brand for Build to Let, including voluntary standards to be used across the sector.

Further REIT reform is needed to permit a lower distribution rate than the current 90%, given the smaller yields in the PRS. Tax reliefs on capital improvements to residential portfolio and renewals are also likely to be needed to create a similar system of capital allowances to the commercial sector.

Other elements

There is a huge challenge for the public, private and third sectors in moving from interest in acquisition of existing stock to the creation of a new asset class with attractive yields for institutional investors that can support the injection of equity into funding the promotion and delivery of strategic housing. The costs of land and the costs of planning are critical factors. The assumption that values will not support institutional interest in Build to Let unless planning requirements (including affordable housing) are pared back or lost altogether is misplaced and several other approaches need to be explored by any Taskforce.

Firstly, if ensuring attractive yields is critical to bending institutional investment to PRS, land and management costs must be reduced so that continuous sales of the stock are not necessary. Likewise, portfolios must be sufficiently large and integrated to attract investment. Both require innovation by the development industry, because Build to Let will need to be designed, planning, restricted, rented and managed in new ways. If fully self-contained affordable housing is too expensive to deliver or manage within a Build to Let model, design innovation must reduce management costs. Switching to pooled facilities and designing buildings so that they can be redecorated quickly and cheaply between tenants have made a difference elsewhere. Build to Let will also need to draw on the management expertise of operators like Places for People to co-manage both the affordable and market units at sensible economic levels.

BOX 4: RECENT REFORMS

HCA Private Rental Sector Initiative (PRSI)

- Reinvestment deal with Berkeley, using £29m Kickstart funding, to take a 20 per cent equity stake in a new fund that will buy and manage 555 new homes for private rent across ten sites
- £16m National Affordable Housing Programme funds to allow Berkeley to build 299 affordable homes across the ten sites, to facilitate a further 922 homes for private sale

SDLT reform

- Purchasers completing acquisitions of more than one residential dwelling in one transaction after 18 July 2012 are entitled to relief, with the rate of SDLT determined by mean, not aggregate, consideration (subject to a 1% minimum rate).
- only applies to tenanted properties let on less then 21 year terms.

REIT reforms (Finance Act 2012)

- Offshore property companies can convert to UK-REIT status without the previous 2% entry charge
- Institutional investors may be able to establish wholly-owned UK-REITs
- AIM and PLUS listing to be allowed.
- specified institutional investors will no longer breach the non-'closed company' restrictions

Secondly, using planning obligations to limit Build to Let stock to rental (or create staggered releases after an initial lock in) must depress land values to aid viability and underpin yields. The objective should be to reduce both the need for 'churning' stock back out to owner-occupation and arguments that affordable provision and other mitigation is unviable. The Review does not explore the role that compulsory purchase powers can and should play in achieving this goal in areas where viability assessments currently show low land (and therefore compensation) values if policy compliant development is approved.

Thirdly, the planning process is often unnecessarily complex, protracted and expensive. One of the easiest ways for the public sector to speed delivery is to adopt realistic development plan policies and allocations for strategic housing delivery – that will provide the certainty the market needs to enter into the partnership dialogue ultimately necessary to develop and deliver on Build to Let. The NPPF moves this closer, but there is a risk that the Local Plan process will become bogged down in viability navel gazing and legal challenges. Similarly, reducing the amount of paperwork that developers need to produce and officers must review would be a start. If there is a real political commitment to volume Build to Let, it should begin with a process for expediting site allocations and applications where policy compliant levels of affordable housing would be delivered (or there is a sufficiently pressing need for market housing delivery). Equally, some authorities should be able to meet the Review halfway, by looking at the contribution 'short-life' affordable provision can make - allowing rented units to fall out of affordable status after a few years, and then stay as rented for a set period before eventual sale would still create an investment asset. Something is better than nothing. Finally, authorities must be sensible about Community Infrastructure Levy (CIL). Sacrificing affordable housing delivery to generate CIL revenue is short-sighted and may, in some cases, be unlawful following the Localism Act because it arguably puts at risk the development of the area in accordance with the development plan at structural risk.

Conclusion

Target portfolio sizes are likely to be at least 2,000 properties and even if the eventual yield is high enough, taking on the risk of an unlet project at this scale is unappealing. As well as looking at how CPO and planning powers can be used alongside investment of public land, the key focus for any Taskforce should be to bring registered providers, developers, planners and investors together to create long-term rental products that will create an attractive product for both renters and institutional investors.

Endnotes

1 Grant Shapps, Minister for Housing appearing at the House of Commons Select Committee (Communities and Local Government) Inquiry into the Abolition of Regional Spatial Strategies on 13 September 2010

2 CLG Household Projections Live Table 401

3 New Housing Pipeline Q4 2011 Report (Home Builders Federation, 2012)

4 Bonus that doesn't fit the bill Raynsford N. (Public Finance, 1 May 2012)

5 UK Housing Review 2012 (Chartered Institute of Housing)

6 'Making a Rented House a Home: Housing solutions for 'generation rent' ' (V Alakeson/ Resolution Foundation 2011, August 2011)

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8 Whittaker, M 'Squeezed Britain: the 2010 audit of low-to-middle earners' 2010

9 The private rented sector: professionalism and quality – the Government response to the Rugg Review Consultation (CLG, May 2009)

10 Darian, L 'Meeting the housing needs of low-to-middle earners', 2011

11 'Large-scale Investor Opportunities in Residential Property: An Overview' (Investment Property Forum, 2007)

12 'The future of the private rented sector' (Centre For Cities, 2008)

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14 National Landlords' Association survey (August 2012)

15 Williams, P. Salisbury, N. and Caven, R. 'Opportunities for Institutional Investment in Affordable Housing', 2011

16 BPF submission to the Communities and Local Government Committee (October 2011)

17 'Making a Rented House a Home: Housing solutions for 'generation rent' ' (V Alakeson/ Resolution Foundation 2011, August 2011)

18 The Private Rented Sector: Its Contribution and Potential (Rugg, J and Rhodes, D) 2008

19 Commons Public Accounts Committee 11th Report of Session 2012-13 'Improving the efficiency of central government office property' (31 August 2012)

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