



# Individual investment in the UK Private Rental Sector

A roundtable policy discussion on institutional investment in the UK Private Rental Sector (PRS) was held at HM Treasury on 31<sup>st</sup> March 2010. The key messages raised by participants are summarised below.

## Topic 1: The role of institutional investment in the UK PRS

Factors prompting recent institutional interest in investing in the PRS - do these reflect a long-term change in investment opinion?

- Look at the wider investment landscape, in particular the influx of foreign money in response to the weaker exchange rate.
- Disinvestment from other asset classes; residential property has seen less volatility, and income remains correlated to rise in average earnings.
- Interest is apparent but actual investment has not emerged; have seen recent disinvestment by institutions from the sector.
- Unclear whether interest is long or short-term; currently interest from equity investors, typically with a 7 to 10 year horizon and focussed on London.

Benefits of institutional investment to the sector, and the housing market more generally:

- Long-term investment; strategic approach to where to invest is more likely to be in line with long-term housing supply agenda.
- High standards of management and quality stock because of the importance of reputation.
- Flow of capital into the market.
- Promoting the PRS as a viable alternative tenure choice – increasingly important.

Barriers to institutional investment in residential property compared to commercial property:

- Perception that it is too difficult, for example, to assemble a portfolio.
- Perception of risk associated with shorter lease length; reflects a lack of understanding or experience of the sector.
- Overseas investors want to see evidence of home investment before entering the market themselves (REITs regime served this purpose for commercial property).
- Scale; residential REITs regime in the US has been able to develop due to availability of large scale investment opportunities e.g. gated developments helped by wider availability of land.
- Stock not sufficiently attractive/available, in particular new build (where institutional investment is most likely to focus), but the Private Rented Sector Initiative has been able to bring sites on-stream.

- Capital growth is more important than income but the systemic restrictions and barriers for trading make this difficult to achieve for institutions – buy-to-let market favoured in this respect.
- Tax system, including VAT, adding to costs of maintenance and management, and repair. Capital allowances could allow for tax depreciation and enhance return.
- The order of importance to barriers: (i) stock, (ii) tax, (iii) structures.

## Topic 2: Rates of return and attractiveness to institutional investors

How do the rates of return on investment in the PRS compare to those expected/required by institutional investors?

- Residential income returns approx. 3.5% (net), compared to 7.3% for commercial (although closer to 5% now).
- Total returns (including capital growth) are higher for both, and mean that residential returns are comparable to commercial, but investors would need to sell their portfolio to realise this gain.
- Looking forward, capital growth in the residential sector will be low (approx. 2.5% over inflation) however; this is still better than the prospects for commercial.

To what extent are the reputational and financial risks of residential property more of a problem than yield?

- Residential property is harder to manage (no existing model).
- PRS is still largely a 'cottage industry' although the nature of BTL investors is changing towards a smaller number of lower-g geared semi-professional landlords holding 20 to 40 properties.
- Reputation risk depends on relationship between the institution and the tenant (but unlikely to be a direct relationship).

Given these benefits, and the fact that total returns are actually quite high, why is there no impetus to invest?

- Residential stock is less volatile than commercial (for example, if you have two or three tenants, as in commercial, and one moves out you suddenly lose a third of your income, whereas with residential the loss of a single tenant in a block of 200 flats is insignificant).
- Stamp duty, Capital Gains Tax and VAT are all barriers to residential investment (particularly capital allowances).
- Total returns are only high if property is sold into the owner-occupied market.

### Other points

- There is large underutilisation of owner-occupied stock (this wouldn't happen with PRS).
- The Business Expansion Scheme had a significant impact on investment in the PRS.

### **Topic 3: Barriers to portfolio acquisition and SDLT bulk purchasing rules**

Importance of scale economies and minimum lot size to ensure viability:

- The number of units is more important than the value but the minimum will depend on the nature of the asset. Viable investment could be anything from 25 to 2000 units.
- Different scale economies for new-entrants to the market and established investors. The latter may be able to buy single properties.
- Geographic spread of investment – achieve economies of scale in one location but risk of over-investing and competing with yourself.
- Stock needs to generate the right yield for investors.

Barriers to portfolio assembly and impact on rate of return.

SDLT:

- SDLT rules on bulk purchasing; particular concern over new 5% rate; barrier for new investors in particular, and institutions where transactions are larger.
- The changes to SDLT rates in the Budget have created uncertainty about property tax in the longer term – political risk.
- 1 or 2% higher tax rate on a bulk purchase could have impact of approx. 25bps on a yield of 3/3.5%
- Creates a perverse incentive to break up portfolio which is off-putting to institutional investors.

Other tax issues raised:

- VAT, capital allowances, treatment of income (whether trading or investment with the former incurring a tax penalty).

Impact of changing bulk purchasing rules of level of investment:

- Necessary change but not sufficient in itself to significantly alter the level of investment as the barriers are a blend of factors.
- Possibility of repatriating some investment currently made offshore.
- New investors/additional investment in the market would bring additional revenue for the Exchequer as well as stimulate house-building and the economic benefits associated with that.

### **Topic 4: Real Estate Investment Trusts and other investment vehicles**

What are the most suitable or tax efficient vehicles for institutional investment in residential property?

- Very few new vehicles (G-Res, 2007 is the most recent).
- Investors want:
  - Tax transparency
  - Certainty (the right long-term structure)
- Problems of offshore are:
  - Certainty of tax treatment
  - Liquidity (as an exit strategy)
- Need a vehicle which can trade / is liquid and represented residential.

What are the disadvantages of institutional investments through these vehicles?

- Open-ended vehicles (e.g. PAIFs) might work for institutions, but not for retail market.
- If you don't need liquidity then limited partnerships work.
- Investment vehicles are different models with different vehicles suiting different investors.
- Space for a 'one-size-fits-all' vehicle in the form of a Resi-REIT.

What in your view on the key barriers to investment in residential property through UK-REITs, and what changes would be needed to address them?

- General barriers to residential investment:
  - Low net rental yields.
  - Need to 'churn' property (although arguably not as churn is expensive).
  - Large inefficiencies in management costs.
- Legislative barriers to residential REITs:
  - 2% entry charge.
  - Interest-cover ratio of 1:1.25
  - Distribution requirement (90%).
  - Closed company rules.
- Possible changes to REITs:
  - Allow all residential transactions to be treated as investment, not trade (with caveat for length of ownership).
  - Modified closed company rules to allow ownership by diversely owned owners.
  - Change entry charge to an exit charge on the individual properties.
  - Adjust other tax barriers (e.g. SDLT, VAT).